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THE ECONOMICS OF TREATY RATIFICATION

Vincy Fon[*] & *Francesco Parisi*[†]

I. INTRODUCTION

The study of reservations in multilateral treaties reveals a striking paradox: the number of reservations attached to international treaties is relatively low despite the rules governing reservations set forth in the Vienna Convention that create a natural advantage in favor of the reserving state (Gamble 1980; Grieg 1994; Parisi and Sevcenko 2003; Fon and Parisi 2008). In search of a possible explanation for this phenomenon, we study the possible role played by the legal regime governing treaty reservations set forth by Articles 19-21 of the Vienna Convention.[1]

Under the rules governing treaty reservations introduced by the Vienna Convention, after a treaty has been signed, states have an opportunity to attach reservations to it before ratification. For example, a U.S. treaty signed by the Secretary of State will not become effective unless ratified by the Senate. Reservations to the original treaty can be introduced at the time of ratification. In the absence of constraints dictated by political or diplomatic expediency, individual states may have incentives to utilize the ratification process to introduce reservations that create a unilateral advantage, which may lead to sub-optimal outcomes, creating a prisoner's dilemma for all states.

In this paper, we analyze the rules governing treaty ratification and reservations under the 1969 Vienna Convention[2] and formalize the intuition

[*] Associate Professor, George Washington University, Department of Economics.

[†] Oppenheimer Wolff and Donnelly Professor of Law, University of Minnesota and Professor of Economics, University of Bologna. We thank Anthony D'Amato and the participants in the Northwestern University School of Law Faculty Workshop for valuable insights that led to the drafting of this paper. We also thank Dan Milkove for valuable comments and suggestions and Katherine Sevcenko for research provided during the early phase of this project.

[1] Vienna Convention on the Law of Treaties, arts. 19-21, May 23, 1969, 1155 U.N.T.S. 331 (*entered into force* Jan. 27, 1980) [hereinafter Vienna Convention] (The United States is not a party to the Vienna Convention; however, the international community generally accepts the Convention as an authoritative codification of treaty law.).

[2] *Id.* at art. 21(1) (defining the matching-reservations mechanism as: "A reservation established with regard to another party in accordance with articles 19, 20 and 23: (a) modifies for the reserving

put forth in previous literature, according to which the matching-reservations mechanism introduced by Article 21 provides an effective solution to such a prisoner's dilemma. A state that wants to exempt itself from a treaty obligation must permit other nations to escape that same burden (Parisi and Sevcenko 2003). States know that the matching-reservations mechanism will make their sought-after advantage automatically available to others. When states enter into negotiations with symmetrical incentives, they have no reason to attach merely strategic reservations to the treaty. In such settings, the matching-reservations constraint set forth by Article 21 leads to socially optimal levels of treaty ratification. When states face asymmetric incentives, however, recent game theoretic models raise some doubt on the effectiveness of matching constraints, such as those set forth by Article 21 (Fon and Parisi 2003).

We develop an economic model of treaty ratification to study the role of Article 21 of the Vienna Convention in promoting optimal levels of treaty ratification when states with potentially asymmetric incentives are involved. Given that states likely anticipate the reservation strategies of other signatory states, the results of this paper shed light on the process of treaty formation, which reflects states' subsequent ratification strategies. This model may help explain why the number of reservations attached to international treaties is relatively low in spite of the natural advantage of reserving states pointed out by Fon and Parisi (2008).

II. THE VIENNA CONVENTION ON TREATY RESERVATIONS

The purpose of the 1969 Vienna Convention on the Law of Treaties was to articulate the framework for treaty-making, codifying a comprehensive set of principles and rules governing significant aspects of treaty law. The treaty came into force in 1980 as the result of international efforts that began in 1949. The Vienna Convention mostly codifies established international practice on how to conclude, apply, and interpret treaties. On some issues, however, the Vienna Convention brings about a change in the governing treaty formation rules. Although the line between the two sets of

State in its relations with that other party the provisions of the treaty to which the reservation relates to the extent of the reservation; and (b) modifies these provisions to the same extent for that other party in its relations with the reserving State.").

rules is often unclear, it is commonly accepted that the specific provisions governing treaty reservations (Articles 19-23 of the Vienna Convention) depart from preexisting customary law. The innovative nature of these provisions is revealed by the drafting history and the animated debate that surrounded the issue of reservations during the negotiations of the Vienna Convention. In this respect, the Vienna Convention breaks away from the previously followed rule of unanimous acceptance of reservations as articulated by the International Court of Justice in the Genocide Convention (Sinclair 1984, 12-13).[3]

The new regime in the Vienna Convention was chosen to foster multilateral treaties in the face of occasional impediments by signatory states to full ratification. To inject greater flexibility into multilateral treaty making, the Vienna Convention introduces a relatively liberal approach that draws on the concept of reciprocity, one of the basic meta-principles of international law.[4]

Article 21(1)(d) of the Vienna Convention defines a reservation as a unilateral statement, however phrased or named, made by a State when signing, ratifying, accepting, approving, or acceding to a treaty, whereby it purports to exclude or to modify the legal effect of certain provisions of the treaty in their application to that State.[5] In breaking away from the older unanimity rule, Article 19 of the Vienna Convention allows states to include reservations in their acceptance of treaty obligations, unless the treaty itself expressly forbids reservations or the reservation is incompatible with the object and purpose of the treaty.[6] Although it is possible to object to a state's reservation, an objection to a reservation does not preclude entry into

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[3] *See* Parisi and Sevcenko (2003) for a more extensive discussion of Article 21 of the Vienna Convention on treaty reservations, from which the following synopsis is drawn.

[4] *See* Keohane (1986), Grieg (1994), and Parisi and Ghei (2002) on the role played by reciprocity in international law and international relations.

[5] *See* Pellet (1998) for a brief history of the contested definition of reservation.

[6] Vienna Convention, at art. 19(c) (The compatibility of a reservation "with the object and purpose of the treaty" constitutes the benchmark test for its admissibility. Signatory states decide for themselves whether the reservation can be considered compatible with the object and purpose of the treaty. If a state believes that the reservation of another state is incompatible with the purpose and object of the treaty, it can oppose such reservation with an objection. As a result of a state's objection, the relevant treaty provisions will become inapplicable between the reserving state and the objecting state. Ultimately, disagreements concerning the admissibility of reservations may necessitate a dispute settlement mechanism, and many treaties indeed contemplate such dispute resolution procedures.)

force of the treaty between the two states.[7] Rather, Article 21 tailors the relations between reserving and non-reserving states through a mechanism of matching reservations. If a state does not object to a reservation, it modifies the treaty relations between the two states according to the scope of the reservation, and the limitation imposed by the reserving state applies equally to both parties. If a state objects to the reservation, then the entire provision does not apply between the two parties. The objecting state may also declare the entire treaty not in force between the two countries.

While the more liberal approach to reservations introduced by the Vienna Convention might make one anticipate many reservations appended to multilateral treaties, few states actually attach reservations to their accession to a treaty (Parisi and Sevcenko 2003).[8] One argument is that states care more about the integrity of the treaty than promoting their particular interests through the use of reservations. We propose an alternative and more plausible explanation for the fact that the more liberal approach to treaty reservations has caused no explosion in the number of reservations to treaties. In the following section, we develop a model of treaty ratification to verify the suggestion of previous literature according to which the matching-reservations mechanism of Article 21 deters strategic reservations, since other signatory states would also gain an exemption from treaty obligations to the extent of the reservation. The matching-reservations effect of Article 21 is likely accounted for by signatory states that anticipate the reservation strategies of other signatory states and adjust the treaty terms accordingly. We study the extent to which such a constraint is effective in the presence of asymmetric states.

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[7] Article 20 outlines the circumstances under which reservations must be accepted by other parties; otherwise, if a state does not object to a reservation from another state within a set amount of time, its silence is construed as tacit acceptance.

[8] Although the percentage of treaties with reservations rose after World War II, the high point remained at only six percent of treaties in force, as of 1980. This means that a state makes, on average, one reservation to a multilateral treaty every ten years. The impressive finding is that in eighty-five percent of all multilateral treaties that allowed reservations, no state introduced any reservations and only sixty-one treaties had more than three. *See* Gamble 1980, 378-9.

III. A MODEL OF RATIFICATION OF INTERNATIONAL TREATIES

Articles 19-21 of the Vienna Convention regulate the effect of a state's reservations in a multilateral treaty setting. The multiplicity of bilateral effects created by unilateral reservations to a treaty makes it necessary to study how reservations affect interactions between two states. We thus proceed to model the impact of unilateral reservations between two representative states who are parties to a multilateral treaty.

We consider two states whose payoffs are interdependent upon each other's treaty ratification levels and facing a prisoner's dilemma problem. The degree of treaty ratification indicates the states' willingness to invest in international cooperation. Such ratification levels for states 1 and 2 are denoted s_1 and s_2 respectively, where $s_1, s_2 \in [0,1]$. When both $s_i = 0$, there is no ratification of the treaty, and when both $s_i = 1$, there is full ratification. Intermediate levels $0 < s_i < 1$ indicate cases of partial ratification where state i introduces reservations limiting its obligations under the treaty. In the case of a two-state treaty, the payoff function for state 1 depends on the treaty ratification choices of state 1 and state 2, $P_1(s_1, s_2) = -as_1^2 + bs_2$, and the payoff function for state 2 can be similarly written as $P_2(s_1, s_2) = -cs_2^2 + ds_1$. Note that greater levels of treaty ratification undertaken by one state impose a cost upon the ratifying state while creating a benefit for the other state. Although treaty ratification problems need not necessarily reflect this property, it is safe to assume that states generally receive a benefit from other states' compliance with the treaty and do not receive any direct net benefit from their own compliance. If they could take advantage of other states' fulfillment of the treaty obligations, without fulfilling their own, they would happily do so.

This characteristic of the treaty ratification problem leads to a potential prisoner's dilemma. In the absence of other constraints, both states face dominant, non-ratification (defection) strategies. Whatever ratification strategy s_2 is chosen by state 2, state 1 prefers to avoid investing in international cooperation and chooses $s_1 = 0$. To examine such a prisoner's dilemma and ensure that the strategy of no ratification is dominant for both states, we consider the natural case in which each state's efforts towards international cooperation, s_i, both impose a positive cost on the state that

exerts them ($a>0$ and $c>0$) and generate a private benefit for the receiving state ($d>0$ and $b>0$). Further, the prisoner's dilemma prescribes that the payoff of a state from full mutual treaty ratification (that is, $P_1(1,1)=-a+b$ and $P_2(1,1)=-c+d$) is greater than the state's payoff when both states fail to ratify the treaty (that is, $P_1(0,0)=0$ and $P_2(0,0)=0$). Hence $-a+b>0$ and $-c+d>0$ are also assumed. Combining these requirements, in order to capture the essence of the prisoner's dilemma where the Nash equilibrium of joint defection ($s_1=0, s_2=0$) is inefficient, we assume that $0<a<b$ and $0<c<d$.

Under these assumptions, neither state is willing to invest in international cooperation. Yet states can enjoy positive payoffs only through cooperation. For example, in an ideal world in which the willingness of state 1 to undertake a certain ratification level s_1 induces state 2 to undertake an equal ratification level so that $s_2=s_1$, then the matching-reservations payoff function of state 1 becomes $P_1(s_1,s_2)=P_1(s_1,s_1)=-as_1^2+bs_1$. Consequently, the marginal benefit of ratification in a matching-reservations regime for state 1 is b, and the corresponding marginal cost of ratification is $2as_1$. This is the best scenario that state 1 can expect. Less desirable instances involve situations where state 2 undertakes lower levels of ratification.

Thus, both states can induce and internalize some benefit through mutual cooperation. Under the best scenario from the viewpoint of the individual states, b and d are the marginal benefits of ratification when ratification is matched by the other state, while $2a$ and $2c$ are the corresponding marginal costs at full treaty ratification level ($s_i = 1$). The marginal-benefit/marginal-cost ratios of state 1 and state 2 with matching ratification can thus be denoted as $b/2a$ and $d/2c$ respectively. Without loss of generality, we assume that state 1 has a lower benefit-cost ratio: $b/2a<d/2c$. For simplicity, we refer to state 1 as the high-cost cooperator, as it obtains a lower net benefit from cooperation. Since state 1 is the high-cost cooperator, its desired level of matching treaty ratification (which happens to be $b/2a$) is lower than that of state 2 ($d/2c$). Under the rules set forth by the Vienna Convention, this lower level of ratification of state 1 becomes the de facto level of treaty ratification for both states, as will be clarified below.

We now turn to the different matching-reservations equilibria and the possible social optima.

A. *Matching-Reservations Equilibrium*

Under the regime set forth by Article 21 of the Vienna Convention, each state knows that, within the limits of mutually agreeable levels of cooperation, the lesser level of treaty ratification chosen by any two given states becomes the de facto level of international cooperation under the ratified treaty. The impact of such a constraint on the ratification and reservation strategies of the two states and the subsequent equilibrium will be investigated. To start, we look at individual ratification payoffs incorporating the matching requirement for each state. As indicated above, the model focuses on the degree of ratification. The highest level of ratification, $s=1$, indicates that the state accepts the treaty obligations in full, without reservation. When states introduce a reservation, treaty obligations are only partially ratified with $0 < s < 1$.

The matching-ratification payoff function for state 1 is given by $\pi_1(s_1,s_2)=\begin{cases}-as_1^2+bs_1 & if \;\; s_1 \le s_2 \\ -as_2^2+bs_2 & if \;\; s_1 > s_2\end{cases}$. In the upper branch, state 1 is assumed to desire a degree of treaty ratification that state 2 is willing to undertake. In this case, state 1 does have a choice on the degree of treaty ratification, and it chooses $s_1 = b/2a$, as this ratio maximizes state 1's payoff $\pi_1(s_1,s_1)=-as_1^2+bs_1$. This choice of treaty ratification by state 1 then becomes binding for both states. In the lower branch, state 1 desires a higher level of treaty ratification than state 2, but this is not feasible as the degree of agreeable treaty ratification by state 2 is binding. All state 1 can do is to match state 2's degree of treaty ratification s_2. Along this branch, state 1's payoff is $\pi_1(s_2,s_2)=-as_2^2+bs_2$. Likewise, the matching-ratification payoff function for state 2 is given by $\pi_2(s_1,s_2)=\begin{cases}-cs_2^2+ds_2 & if \;\; s_2 \le s_1 \\ -cs_1^2+ds_1 & if \;\; s_2 > s_1\end{cases}$. In the upper branch where state 1 is more than willing to match any level of treaty ratification desired by state 2, state 2 chooses $s_2 = d/2c$ to maximize its payoff, and this choice becomes

the effective treaty obligation for both states. In the lower branch where state 1's ratification choice binds as an upper limit on the effective treaty obligation, state 2 can only take advantage of the matching effects of Article 21 and go along with the lower ratification level determined by state 1. State 2's payoff thus becomes $\pi_2(s_1, s_1) = -cs_1^2 + ds_1$.

It is clear that when the marginal benefit-marginal cost ratios from ratification for both states exceed one ($1 \le b/2a \le d/2c$) both states are willing to ratify the treaty in full under Article 21. In this case, it does not matter which state's desired degree of treaty ratification is binding, as the preferences converge at or beyond full treaty ratification.[9] Full treaty ratification becomes the equilibrium strategy for both states ($s_1^* = 1, s_2^* = 1$).

Such convergence of preferences is not likely to be found in the case of asymmetric states. In spite of the reciprocal effects of reservations under Article 21, asymmetric states may nevertheless prefer different levels of treaty ratification. The ratification choice favored by one state under Article 21 may not be matched by an equal willingness to ratify by the other state. Clearly, the most desirable partial cooperation levels $b/2a$ and $d/2c$ for states 1 and 2 are the maximum levels of treaty ratification they are willing to undertake. The value of each maximum agreeable treaty ratification level depends on how the marginal benefit under matching-reservations compares with the marginal cost at full ratification. Assuming that the states desire partial treaty ratification, we now need to analyze individual reactions of the two states.

Consider how state 1 reacts to state 2 when the most desirable level of treaty ratification of state 1 is less than full: $b/2a < 1$. If state 2's expected level of treaty ratification s_2 is less than $b/2a$, state 1 cannot choose $b/2a$ in spite of its preference. State 1 is forced to go along with state 2's level of treaty ratification: $s_1 = s_2$. On the other hand, if state 2's level of treaty ratification is expected to exceed or equal $b/2a$, state 1 is free to settle on

[9] Ratification levels greater than 1 can be interpreted as a state's hypothetical willingness to ratify a treaty that creates even higher obligations than the current treaty, if faced with an opportunity to do so.

its privately optimal partial treaty ratification level; it would react by choosing $s_1 = b/2a$.[10]

Next consider how state 2 reacts to state 1 when the most desirable level of treaty ratification of state 2 is less than full: $d/2c < 1$. When state 1's expected level of treaty ratification is less than $d/2c$, state 2 must match state 1's level of treaty ratification ($s_2 = s_1$), in spite of its preference. However, if state 1's expected level of treaty ratification is greater than or equal to $d/2c$, state 2 is free to react and to choose $s_2 = d/2c$, its privately optimal partial ratification level.[11]

Thus, assuming that the other state is willing to cooperate and that the individual state is able to select its desired level of ratification, state 1 chooses $b/2a$ while state 2 chooses $d/2c$. Given the asymmetry of the two states, the privately optimal values of ratification do not coincide for the two states except in very special cases.[12] Given the matching effects of reservations under Article 21, the two states are only bound to undertake treaty obligations to the lesser level of treaty ratification desired by the two states. Since state 1 is the high-cost state and $b/2a \leq d/2c$ is assumed, the maximum agreeable ratification level chosen by state 1, $b/2a$, becomes the binding strategy for both states. Hence the matching-reservations equilibrium strategies are $s_1^* = b/2a, s_2^* = b/2a$.

To recap the matching-reservations equilibrium, if $1 \leq b/2a \leq d/2c$, both states desire full ratification and both states afford the maximum ratification possible $(s_1^* = 1, s_2^* = 1)$. The payoffs for the two states are both positive ($\pi_1^*(1,1) = b - a > 0$ and $\pi_2^*(1,1) = d - c > 0$). If $b/2a < 1$, then the partial ratification level chosen by the high-cost state (state 1) becomes binding for the other state as well. In this equilibrium induced by the reciprocal effects of Article 21, the partial ratification level desired by state 1 becomes

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10 Thus, the reaction function of state 1 is given by: $s_1 = s_2$ if $s_2 < b/2a$ and $s_1 = b/2a$ if $s_2 \exists b/2a$.

11 The reaction function of state 2 is given by: $s_2 = s_1$ if $s_1 < d/2c$ and $s_2 = d/2c$ if $s_1 \exists d/2c$.

12 The desired level of cooperation for the two states is not equal except in the special case in which the states have identical marginal cost-benefit ratios in spite of their asymmetric payoff functions.

the mutually binding ratification level for both states $(s_1^* = b/2a, s_2^* = b/2a)$. In this case, the payoffs for the two states are also positive as well.[13]

These matching-reservations outcomes should be contrasted to the alternative Nash equilibrium. Absent a matching-reservations constraint, the Nash equilibrium strategies are $s_1 = s_2 = 0$ and the payoffs for the two states fall to $P_1(0,0) = P_2(0,0) = 0$. Thus, the existence of the matching constraint set forth by Article 21 of the Vienna Convention induces states to undertake higher levels of treaty ratification than they would without any constraint, and this leads to a substantial improvement over the payoff under Nash equilibrium. In this respect Article 21 constitutes a valuable instrument to promote international cooperation through treaty formation, while providing the desired flexibility for the necessary ex post reservations of signatory states.

B. *Social Optimum*

Next we turn our attention to the social problem in which the joint payoffs of the two states is maximized, assuming feasible ratification levels:

$$\max_{s_1,s_2} \overline{P}(s_1,s_2) = \overline{P}_1(s_1,s_2) + \overline{P}_2(s_1,s_2) = (-as_1^2 + bs_2) + (-cs_2^2 + ds_1) \quad s.t. \quad 0 \le s_1 \le 1,\ 0 \le s_2 \le 1$$

One can find the social optimum by comparing the marginal cost of strategy of one state s_1 $(MC_1 = 2as_1)$ with the social marginal benefit enjoyed by another state $(MB_1^S = d)$ rather than with the private marginal benefit under matching-reservations of the first state $(MB_1^R = b)$.[14] Thus, without considering feasibility, the socially desirable levels of treaty ratification are given by the social marginal benefit-marginal cost ratios $d/2a$

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[13] The payoffs are $B_1^*(b/2a, b/2a) = b^2/4a$ and $B_2^*(b/2a, b/2a) = [b(2ad-bc)]/4a^2$.

[14] Note that the subscript 1 for marginal cost (*MC*) and marginal benefit (*MB*) does not refer to state 1. Instead, it refers to the level of treaty ratification provided by state 1. Clearly, private marginal cost and social marginal cost coincide in as much as the cost of treaty ratification is borne by the ratifying state. On the other hand, the private marginal benefit enjoyed by state 1 is provided by the ratification choice of state 2, and vice versa.

(for state 1) and $b/2c$ (for state 2). Clearly, these two benefit-cost ratios may not coincide and they may not be feasible (either benefit-cost ratio can exceed one). If either or both marginal benefit-cost ratios are not feasible, then one or both states are required to undertake full treaty ratification.

Thus, depending on the relative magnitudes of the social marginal costs and benefits of the treaty, the social optimum may be characterized by one of the following. (1) There is full treaty ratification from both states: $\bar{s}_1 = 1$, $\bar{s}_2 = 1$. (2) There is partial treaty ratification from one state and there is full treaty ratification from the other state: $\bar{s}_1 = d/2a < 1$ and $\bar{s}_2 = 1$, or $\bar{s}_1 = 1$ and $\bar{s}_2 = b/2c < 1$. (3) There is partial treaty ratification from both states: $\bar{s}_1 = d/2a < 1$ and $\bar{s}_2 = b/2c < 1$. It is noteworthy that state 1 may be required to undertake full ratification while state 2 undertakes partial ratification (the second case in (2) above) in spite of the fact that state 1 is the high-cost cooperator. This can happen only when the social marginal benefit of s_1 is much higher than the private marginal benefit of s_1.

Given that alternative socially optimal strategies exist under different situations, the relationship between matching-reservations equilibrium and social optimum also varies, depending on the costs and benefits of treaty ratification for the states.

C. *Article 21 and Socially Optimal Treaty Ratification*

Thus far the economic model confirms the general intuition that the reciprocal effects of unilateral treaty reservations created by Article 21 provide a viable solution to prisoner's dilemma problems. The matching effects of treaty reservations always induce states to adopt levels of treaty ratification higher than those that they would otherwise adopt in Nash equilibrium. But, while improving on the Nash equilibrium, to what extent is Article 21 also capable of generating socially optimal levels of treaty ratification?

First and foremost, given asymmetry between the two states, the social optimum calls for equal levels of treaty ratification from both states only in the unlikely case where the social marginal benefit-marginal cost ratios $d/2a$ and $b/2c$ are the same, or in the more plausible case where both states need to undertake full treaty ratification in order to maximize their

joint surplus from the treaty. Thus, if the social optimum requires asymmetric levels of treaty ratification from the two states, the presence of a binding matching constraint, as required by Article 21 and leading to equal levels of treaty ratification, would obviously prevent the achievement of such an ideal optimum. For the matching-reservations equilibrium outcome to be socially optimal, it is then necessary that identical levels of treaty ratification for the two states be required under a social optimum. This means that the effectiveness of a matching-reservations constraint to induce socially optimal strategies may be impaired when heterogeneous states are involved. The equilibria induced by Article 21 may be second-best in a world of strategic players, but they are not necessarily first-best outcomes when asymmetric incentives are at work.

There are two ways in which the matching-reservations constraint set forth by Article 21 will lead to socially optimal outcomes. First, if all private and social marginal benefits are large enough so that the social marginal benefit-marginal cost ratios ($d/2a$ and $b/2c$) as well as the private marginal benefit-marginal cost ratios for individual states ($b/2a$ and $d/2c$) are greater than or equal to one, then both the social optimum and the matching-reservations equilibrium are characterized by a full treaty ratification level. In this case, the benefit is so great that, even though both states may desire different amounts greater than what is feasible, full treaty ratification is all that can happen in practice.

Second, as intimated earlier, convergence of preferences is not likely in the case of partial treaty ratification. Even with the assurance of matching treaty ratification, the high-cost state, state 1, will prefer a lower level of treaty ratification ($b/2a$). This lower level of treaty ratification will *de facto* characterize the mutual treaty obligations in the regime set forth by Article 21 of the Vienna Convention. In order for this matching-reservations equilibrium level of partial treaty ratification to be socially optimal, it must equal the two social marginal benefit-marginal cost ratios ($d/2a$ and $b/2c$) as well. This implies that $b=d$ and $a=c$ must hold. In other words, if the equilibrium partial treaty ratification induced by the matching-reservations constraints are socially efficient, the states must be homogeneous.

This is an important result: if the social optimum requires partial levels of treaty ratification for the two states, such equilibrium is obtainable under

a matching-reservations rule only if the players have symmetric payoff functions. In the case of asymmetric states when the privately optimal level of treaty ratification for at least one state falls short of full treaty ratification, the matching-reservations levels induced by Article 21 will not coincide with the social optimum. Thus, with asymmetric players, partial treaty ratification will always be dictated by high-cost states. The resulting equilibrium treaty obligations under Article 21 will be privately optimal only for these high-cost states and will never be privately optimal for the low-cost states or socially optimal for the international community as a whole.

IV. CONCLUSIONS

In this paper we study the effects of Article 21 of the Vienna Convention on states' ratification incentives. The economic model of treaty ratification identifies the strengths and weaknesses of the matching-reservations mechanism introduced by Article 21. The incentives for unilateral reservation are substantially reduced because the matching-reservations effect created by Article 21 basically transforms a situation of unilateral reservation into one of reciprocal reservation. When states have symmetric incentives, optimal treaty obligations are likely included in the original treaty agreement. Strategic unilateral reservation matched by others would occasion mutual losses for all states involved and would thus not be introduced. States refrain from introducing strategic unilateral reservations as a way to maximize their expected returns from the treaty relationship.

When states face asymmetric incentives, the rules introduced by the Vienna Convention may not discourage all reservations. In such cases, some states may introduce unilateral reservations in spite of the matching-reservations effect of Article 21. Erosion of the original treaty content may be inevitable, unless the signatory states opt out of the regime set forth by Article 21, by precluding reservations in the treaty itself.

We also examine the welfare properties of the matching-reservations outcomes generated by Article 21, starting with states that have different payoff functions. Specifically, we consider two asymmetric states with payoff functions that engender a prisoner's dilemma in their ratification choices. We identify the matching-reservations equilibrium — equilibrium in which states introduce reservations knowing that Article 21 allows other,

non-reserving states to invoke equal levels of reservations to their advantage — and show that Article 21 provides quite an effective solution to the prisoner's dilemma problem. However, the matching-reservations equilibrium does not always induce socially optimal levels of ratification. The model shows that a social optimum is achieved under Article 21 only in the limited subset of cases where signatory states have homogeneous payoff functions, or when all states prefer full ratification, despite facing different incentives.

The present article focuses on the effects of the matching-reservations mechanism introduced by Article 21 of the Vienna Convention on states' ratification strategies. At the stage of treaty ratification, Article 21 deters strategic reservations, since other signatory states also gain an exemption from treaty obligations to the extent of the reservation.

Real-life examples can be analyzed though the framework of this paper to assess the effectiveness of matching-reservations mechanisms vis-à-vis explicit exclusions of reservations in the original treaty agreement. Consider for example a reservation to a free trade treaty, restricting trade for a specific category of products (e.g., sugar). States that are likely to introduce such reservations are net importers, attempting to protect their domestic industries. The matching effects of such reservations give little benefit to the non-reserving states. States that are large producers of sugar would in fact gain little advantage from a restriction on imports of those products from reserving states, since such kinds of imports would be unlikely to begin with. Our analysis of asymmetric states brings to light the limits of the matching-reservations mechanism in these real-life scenarios.

Future extensions should consider the impact of such expected ratification strategies in the earlier stage of treaty negotiations. For example, when asymmetries between states render unilateral reservations likely under the regime set forth by Article 21, it is natural to expect that states will anticipate future reservation strategies and adjust and/or react accordingly. In this respect, the results of this paper may provide the basis for a more complete understanding of a treaty formation process, in both its formation and ratification stages.

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REEVALUATING LEASING RESTRICTIONS IN COMMUNITY ASSOCIATIONS: REJECTING REASONABLENESS IN FAVOR OF CONSENT

*Zachary M. Rawling**

INTRODUCTION

The popularity of Community Associations ("CAs") in residential markets across the country has magnified the legal importance of restrictive covenants, which play a significant role in defining the character of housing developments and in maintaining property values. CAs house more than 42 million Americans in 16.4 million residential units in planned communities, condominiums, and cooperatives,[1] where most new housing developments require membership in some form of Property Owners' Association ("POA").[2] CAs describe a variety of housing forms;[3] however, the defining characteristic of all CAs is the extensive use of servitudes, most commonly in the form of Contracts, Conditions & Restrictions ("CC&Rs"), to enforce reciprocal obligations among property owners.[4]

By purchasing property in a CA, owners automatically bind themselves to the terms of the CC&Rs, thereby forfeiting "certain rights and privileges which traditionally attend fee ownership of real property, and agree[ing] to subordinate them to the group's interests."[5] Property owners sacrifice those rights in order to enjoy the potential benefits of: (1) collective ownership and management of common property, including recreational facilities; (2) social community, using CC&R restrictions to discourage potential buyers with lifestyle preferences dissimilar to existing owners; and (3) superior ambience, employing reciprocal land use regulations to

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* Law Clerk, Hon. Jay S. Bybee, Circuit Judge, United States Court of Appeals for the Ninth Circuit. J.D., UCLA School of Law; B.A. in Economics, University of Virginia.

[1] CLIFFORD J. TREESE, COMMUNITY ASSOCIATIONS FACTBOOK 3 (Frank H. Spink ed., Community Associations Institute Research Foundation) (1999) [hereinafter CAI FACTBOOK].

[2] Laura Castro Trognitz, *Co-Opted Living: As Condos and Other Common Interest Communities Proliferate, So Do Rules and Conflicts That Lawyers Increasingly Are Being Asked to Sort Out*, 85 A.B.A. J. 54, 55 (Oct. 1999) (describing nationwide adoption of "automatic, mandatory membership associations for property owners" in new housing developments).

[3] Among 16.4 million CA units, approximately 64% are single-family homes, 31% are condominiums, and 5% are cooperatives. CAI FACTBOOK, *supra* note 1, at 3.

[4] ROBERT G. NATELSON, LAW OF PROPERTY OWNERS ASSOCIATIONS 58 (1989) [hereinafter NATELSON, LAW OF POAS].

[5] 15A AM. JUR. 2D *Condominiums and Cooperative Apartments* § 40 (2008).

reduce neighborhood effects below levels tolerated by zoning and nuisance law.[6]

The enjoyment of social community and superior ambience in a development depends heavily upon the stability of residency in a CA. Owner-occupants who intend to live in a CA for an extended period have a strong incentive to develop relationships with their neighbors, to avoid antagonizing them by causing nuisances, and to maximize the value of their home by maintaining and improving their property. In contrast, renters are generally highly mobile and have a finite legal and economic interest in their leased residence. As a result, renters may be less likely to build relationships within a development, to subordinate their interests to those of their neighbors by abstaining from nuisance-like behavior, and to maintain or improve their residences.[7] While POAs have the ability to issue and to enforce rules to mitigate nuisances caused by renters directly, enforcement may be costly and bitterly contentious, further undermining social community.[8]

As a prophylactic measure, a growing number of CAs are enacting restrictions or prohibitions on leasing to avoid the problems associated with renters.[9] As used in this paper, the term leasing restrictions refers to either a complete prohibition on leasing or significant restrictions on the terms of permitted leases, usually for a minimum of six months to one year. Such

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[6] Lee Anne Fennell, *Contracting Communities*, 2004 U. ILL. L. REV. 829, 841-43 (2004).

[7] "The . . . conclusion that as a rule [renters] are more neglectful and cause more property damage than owner-occupants is common knowledge among all people with even a lick of experience in real estate investment." NATELSON, LAW OF POAS, *supra* note 4, at 160. However, those problems should vary inversely with the (1) duration of the lease; and (2) length of a settled tenant's occupancy. Robert C. Ellickson, *Cities and Homeowners Associations*, 130 U. PA. L. REV. 1519, 1551-52 (1982). First, the market value of a tenant's leasehold is affected by community policy, and if rent is fixed, the tenant's stake in the community varies directly with the length of his remaining term. Second, "[a] settled tenant is likely to have sentimental ties with neighborhood people and places . . . . [that give] the tenant a stake in community affairs." *Id.*

[8] NATELSON, LAW OF POAS, *supra* note 4, at 158 (describing the leasing of units as "a fertile source of dispute . . . between resident owners, nonresident owners, and lessees").

[9] Katharine N. Rosenberry, *Home Businesses, Llamas and Aluminum Siding: Trends in Covenant Enforcement*, 31 J. MARSHALL L. REV. 443, 461-66 (1998). An alternative explanation for the adoption of leasing prohibitions is that developers and POAs are not motivated to prohibit leasing because of how renters behave but because of who they are. *See* David E. Grassmick, Note, *Minding the Neighbor's Business: Just How Far Can Condominium Owners' Associations Go in Deciding Who Can Move Into the Building?*, 2002 U. ILL. L. REV. 185, 211-13 (2002) (arguing that facially neutral leasing prohibitions may have a disparate impact on minorities and could be attacked under the Fair Housing Act); *see also* Villas West II of Willowridge v. McGlothin, 841 N.E.2d 584, 608 (Ill. App. Ct. 2006) (affirming judgment of the trial court that a CA's total prohibition on leasing had a significant disparate impact on racial minorities in violation of the Fair Housing Act). At the federal level, the Fourteenth Amendment, the Civil Rights Act of 1866, and the Fair Housing Act of 1968 with its 1988 Amendments prohibit intentional discrimination in CAs. *See* Rosemarie Maldonado & Robert D. Rose, *The Application of Civil Rights Laws to Housing Cooperatives: Are Co-ops Bastions of Discriminatory Exclusion or Self-Selecting Models of Community-Based Living?*, 23 FORDHAM URB. L.J. 1245, 1256-57 (1996).

restrictions likely improve the quality of life for owner-occupants within developments and may translate into higher property values. When those restrictions are specifically recorded in the development's declaration CC&Rs and purchasers buy property subject to them, the enforcement of leasing restrictions is relatively uncontroversial. Analyzed within a contract paradigm, CC&Rs are a set of reciprocal agreements adopted by unanimous consent and into which all property owners enter through the purchase of property. Applying a contractual framework, however, is more problematic to analysis of amendments to CC&Rs approved by a supermajority or even a simple majority of property owners.[10] Those amendments allow the majority to benefit at the expense of a minority of owners who value their property's income-generating potential and who did not expressly consent to the restrictions imposed on their property at the time of purchase. As a consequence, the enforceability of retrospective restrictions remains highly controversial, leading many to decry the "tyranny of the commonality."[11]

The legal standard applied to determine the enforceability of leasing restrictions has profound fairness and market efficiency implications. This comment argues that both considerations are ultimately a matter of consent: fairness demands that property owners agree to be bound by a restrictive covenant before it burdens their land,[12] and market efficiency requires that current and future property owners be allowed to enter voluntarily into the contractual arrangements that optimize their individual well-being.[13] Resolving the issue of consent in the context of CA governance is problematic because CC&Rs run with the land and must be responsive to the preferences of both current and future property owners. Part I discusses the processes by which CC&Rs are implemented and the governing structures they create. Part II analyzes the substantive arguments concerning the enforceability of leasing restrictions. Part III presents and critiques the majority rule of reasonableness developed in case law. Part IV surveys two statutory

[10] Todd Brower, *Communities Within the Community: Consent, Constitutionalism, and Other Failures of Legal Theory in Residential Associations*, 7 J. LAND USE & ENVTL. L. 203, 242-43 (1992).

[11] Nahrstedt v. Lakeside Vill. Condo. Ass'n, 878 P.2d 1275, 1297 (Cal. 1994) (Arabian, J., dissenting) (internal quotation marks omitted).

[12] "I am bound because I intend to be bound." JOSEPH M. PERILLO, CALAMARI AND PERILLO ON CONTRACTS 8 (5th ed. 2003) (summarizing the Enlightenment idea that intention is the foundation of contract law); JOHN LOCKE, THE SECOND TREATISE ON CIVIL GOVERNMENT § 99 (1690) ("[T]hat which begins and actually constitutes any political society is nothing but the consent of any number of freemen . . . to unite and incorporate into such a society.").

[13] "[P]eople allocate society's scarce resources through the exchange process. Voluntary exchange occurs in a free-market setting because the parties, seeking to maximize their economic welfare, give up resources in return for more valuable resources. Such exchange is socially desirable because it moves resources to 'higher valued uses,' thereby increasing 'allocative efficiency.' By pursuing self-interest, then, people promote the interests of society." PERILLO, *supra* note 12, at 9-10 (quoting ROBERT A. HILLMAN, THE RICHNESS OF CONTRACT LAW: AN ANALYSIS AND CRITIQUE OF CONTEMPORARY THEORIES OF CONTRACT LAW 214-15 (1997)).

alternatives and advocates adoption of the Restatement rule limiting the enforceability of leasing restrictions to those contained in or authorized by: (1) declaration CC&Rs; (2) amendments ratified or Board of Directors' rules issued pursuant to declaration CC&R provisions explicitly authorizing the future adoption of leasing restrictions; or (3) amendments adopted by a unanimous vote of property owners.

I. STRUCTURE & PROCESSES OF CA GOVERNANCE: A HIERARCHY OF AUTHORITY

CAs include a wide variety of residential and commercial forms of property ownership; however, this comment focuses on leasing restrictions in condominiums and cooperatives. The likelihood of negative neighborhood effects associated with renters varies directly with the density of housing in a development. Because of the high population densities in condominiums and cooperatives, owners in those types of developments have stronger incentives than owners of single family residences to restrict leasing to avoid the negative neighborhood effects associated with renters.

In a condominium, property owners hold title to their specific units in fee simple absolute and an undivided interest in the development's common property. Common property typically includes exteriors of the development's building or buildings, grounds, and recreational facilities.[14] In contrast, in a cooperative, a corporation or trust holds title to the entire development, including both the individually occupied units and the common property. Owners purchase shares in the corporation and receive proprietary leases for exclusive use of units for a specified period of time.[15] An elected Board of Directors manages the development pursuant to the corporation's bylaws.

The governing systems of both condominiums and cooperatives share two common goals: (1) the protection of owners' investment-backed expectations; and (2) the fulfillment of owners' social community or lifestyle preferences.[16] Those goals are necessarily in tension when a majority of owners in a development wish to adopt leasing restrictions to promote their social preferences over a minority of owners' objections. A court's resolution of that tension depends both upon the legal and economic structures of the development and the manner in which a leasing restriction is imposed. In general, a court may be more willing to look beyond contractual provisions to protect the alienability of property owned in fee simple, as in

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[14] *See* JESSE DUKEMINIER & JAMES E. KRIER, PROPERTY 926 (5th ed. 2002).

[15] DAVID CLURMAN, F. SCOTT JACKSON & EDNA L. HEBARD, CONDOMINIUMS AND COOPERATIVES 185 (2d ed. 1984).

[16] Brower, *supra* note 10, at 205-06; WAYNE S. HYATT, CONDOMINIUM AND HOMEOWNER ASSOCIATION PRACTICE: COMMUNITY ASSOCIATION LAW 42 (3d ed. 2000).

planned communities and condominiums, than when occupied under a proprietary leasehold, as in cooperatives. A court is likely to enforce a leasing restriction contained in declaration CC&Rs, but it may closely scrutinize subsequent restrictions adopted by amendment or promulgated by a Board of Directors.

A. *Condominiums*

Condominium governance operates within a clear hierarchy of legal authority, consisting of: (1) state enabling statutes; (2) declaration CC&Rs; (3) post-declaration amendments to CC&Rs; and (4) regulations promulgated by Boards of Directors. Leasing restrictions may be adopted at any level of that hierarchy and may not be overridden by lesser authority. Because of procedural differences employed in rulemaking at each level of authority, the hierarchy reflects the degree of property owners' consent to CA rules. The origin of a leasing restriction within the hierarchy of authority, therefore, strongly influences a court's willingness to enforce that restriction as a contractual obligation between property owners.

State statutes establish condominiums as a valid form of real estate ownership and set the procedural and substantive parameters for the private governing systems that manage them.[17] Within this statutory framework, the foundation of condominium governance is the declaration, or master deed, which contains the CC&Rs and may include the bylaws of the development's POA.[18] A developer drafts and records the CC&Rs prior to the sale of any units. Prospective purchasers have notice of the CC&Rs, and the voluntary act of purchase implies consent to their provisions.[19] CC&Rs impose reciprocal obligations among owners, which: (1) define the character of the community through use and occupancy restrictions, including leasing restrictions; and (2) empower a POA to manage the operations of

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[17] State enabling statutes facilitate condominium development by: (1) recognizing divided ownership in condominium units and undivided ownership of common property; (2) providing for enforcement of declaration CC&Rs, which run with the land as equitable servitudes; (3) prohibiting the partition of common property; (4) mandating individual assessments of units for property taxes; and (5) creating adequate legal safeguards to encourage institutional lenders to issue loans secured by mortgages on condominium units. CLURMAN ET AL., *supra* note 15, at 14.

[18] EVAN MCKENZIE, PRIVATOPIA: HOMEOWNER ASSOCIATIONS AND THE RISE OF RESIDENTIAL PRIVATE GOVERNMENT 127 (1994). The declaration typically consists of six legal documents: (1) CC&Rs; (2) POA bylaws; (3) articles of incorporation for the POA; (4) plats demarcating common areas and individual owned units; (5) unit floor plans; and (6) deeds granting title to individual units in fee simple and an undivided interest in common areas. HYATT, *supra* note 16, at 204-05.

[19] *See, e.g.*, Timberstone Homeowner's Ass'n v. Summerlin, 467 S.E.2d 330, 331 (Ga. 1996) ("Where a restrictive covenant is recorded, the purchaser is charged with legal notice of the covenant, even if it is not stated in his own deed.").

the condominium development.[20] Because declaration CC&Rs are approved by the unanimous consent of property owners through the act of purchase and delegate administrative and rulemaking powers to a POA, the CC&Rs are analogous to a constitution.[21] Accordingly, leasing restrictions contained in the declaration CC&Rs are presumptively valid.[22]

Since developments may exist in perpetuity and CC&Rs run with the land, condominium governance must be responsive to the evolving preferences of property owners in a development.[23] To accommodate the changing needs of a community, new or modified leasing restrictions may be adopted by an amendment to the CC&Rs or by a vote of the Board of Directors. The declaration CC&Rs typically define an amendment procedure, which must balance satisfaction of the preferences of the majority of owners with preservation of the property rights of the minority.[24] A simple majority vote standard is undesirable because it would provide a potentially large minority of owners with little protection from redistributive policies enacted by the majority. A unanimous consent requirement is equally unsatisfactory because it would encourage a minority of strategic hold-outs to frustrate the enactment of policies beneficial to the majority of owners.[25] As an imperfect compromise, most CC&Rs require a supermajority vote by property owners to ratify amendments, recognizing that some beneficial amendments will fail and some redistributive amendments will succeed. Leasing restrictions passed as CC&R amendments by a supermajority vote are generally afforded deference by courts; however, because amendments are not approved by unanimous consent, they are scrutinized more carefully than restrictions contained in the declaration CC&Rs.[26]

If CC&Rs are analogous to a constitution, regulations issued by a Board of Directors are comparable to statutes.[27] Property ownership in a

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20 HYATT, *supra* note 16, at 205.

21 Carl B. Kress, Comment, *Beyond Nahrstedt: Reviewing Restrictions Governing Life in a Property Owner Association*, 42 UCLA L. REV. 837, 840 (1995). *See also* Ellickson, *supra* note 7, at 1526-27 n.29 (citing JAMES M. BUCHANAN & GORDON TULLOCK, THE CALCULUS OF CONSENT (1962)).

22 Hidden Harbour Estates, Inc. v. Basso, 393 So. 2d 637, 639 (Fla. Dist. Ct. App. 1981).

23 HYATT, *supra* note 16, at 210.

24 *See generally* Wayne Hyatt, *Reinvention Redux: Continuing the Evolution of Master-Planned Communities*, 38 REAL PROP. PROB. & TR. J. 45, 55 (2003) ("As community associations seek to create and to maintain community, they will need to balance the interests of the individual and the group."); Ellickson, *supra* note 7, at 1531 (describing different types of costs associated with amendment processes).

25 Ellickson, *supra* note 7, at 1532; RESTATEMENT (THIRD) OF PROP.: SERVITUDES § 6.10 cmt. a (2000) ("The power to amend the governing documents in a common-interest community prevents a small number of holdouts from blocking changes regarded by the majority to be necessary to adapt to changing circumstances and thereby permit the community to retain its vitality over time.").

26 *See* Breene v. Plaza Tower Ass'n, 310 N.W.2d 730, 734-35 (N.D. 1981) (holding that leasing restrictions adopted by amendment were valid only when applied prospectively to owners who purchased after their adoption).

27 Kress, *supra* note 7, at 841.

condominium development includes membership in a POA and entitles owners to elect a Board of Directors by majority vote.[28] A Board of Directors serves both legislative and executive functions by issuing regulations to control the use of common areas and to prevent nuisances and by enforcing those regulations and CC&R restrictions.[29] CC&Rs typically limit the substantive rulemaking authority of a Board of Directors; however, they may grant it general rulemaking power to advance the interests of the community.[30] When leasing restrictions issued by a Board of Directors are disputed, courts must determine whether those restrictions are within the scope of a Board's delegated powers.[31] Those restrictions generally receive less judicial deference because of property owners' attenuated consent to them.

B. *Cooperatives*

State cooperative or corporate law provides the framework for residential cooperative governance. A certificate of incorporation creates the legal entity that holds title to the real estate and authorizes an elected Board of Directors to manage the operations of the cooperative development according to procedures established in corporate bylaws.[32] The legal structure of cooperatives produces greater financial interdependence among owners than in condominiums. A single corporation holds title to the entire development, including both common areas and individually occupied units, so the failure of any individual shareholder to pay his percentage of the corporation's liabilities threatens the interests of all of the cooperative's shareholders.[33] Because of this interdependence among owners, cooperative bylaws almost universally require approval by the Board of Directors before shareholders may sublet, or even sell, their units.[34] In part because the

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28 Brower, *supra* note 10, at 210-11.

29 More specifically, the duties of the Board of Directors include: (1) preparing an annual budget and overseeing finances; (2) assessing and collecting POA dues; (3) maintaining common property; (4) making personnel decisions and contracting for services and repairs; (5) issuing regulations; and (6) enforcing regulations and CC&R restrictions. HYATT, *supra* note 16, at 82-83.

30 *See, e.g.*, Beachwood Villas Condo. v. Poor, 448 So. 2d 1143, 1144 (Fla. Dist. Ct. App. 1984).

31 *See, e.g.*, Shorewood West Condo. Ass'n v. Sadri, 992 P.2d 1008, 1013 (Wash. 2000) ("[U]se restrictions appearing in unrecorded amendments to bylaws and not in the declaration are invalid. . . . The statute does not allow an association of apartment owners to restrict leasing in a bylaw where the declaration itself permits leasing.").

32 *See, e.g.*, NY COOP. CORP. LAW § 11 (McKinney 2008).

33 DUKEMINIER ET AL., *supra* note 14, at 942-43.

34 CLURMAN ET AL., *supra* note 15, at 212. For an example of cooperative bylaws, see Kelley v. Broadmoor Coop. Apartments, 676 A.2d 453, 457 n.2 (D.C. 1996) (quoting cooperative bylaws: "The primary object of this Corporation is to operate and maintain its property on a mutual and cooperative basis for the housing needs of resident members. . . . The right of occupancy under the use contract is, nevertheless, a matter of discretionary decision of the Board of Directors and every transfer to resident membership, with its right of occupancy . . . is subject to the approval of the Board of Directors."); *see*

restrictions are contained in the cooperative's founding documents, the enforceability of subletting restrictions is uncontroversial.[35] Courts remain deferential to those restrictions even when they are used by a Board of Directors to screen potential residents based on purely social criteria.[36] As the New York Court of Appeals held in 1959, "there is no reason why the owners of the co-operative apartment house [cannot] decide for themselves with whom they wish to share their elevators, their common halls and facilities, their stockholders' meetings, their management problems and responsibilities and their homes."[37]

C. *Private Governments Not State Actors*

A POA serves many of the functions of a municipal government within a CA. Like a traditional local government, the POA is responsible for maintaining common property, issuing rules to monitor land use and to minimize nuisances, providing public utilities, and funding its activities by taxing property owners through both periodic and special assessments.[38] A POA may enforce a development's rules by charging fines or late fees, by prohibiting the use of common facilities, by posting notices of violations to increase social sanctions, or by suing in court.[39] Like delinquent taxes, unpaid POA assessments and fines create liens against a property owner's unit, which enable the POA to foreclose on the property.[40] Because of the parallels between municipal governments and POAs, commentators have argued that POAs should be treated as state actors, subject to Constitutional limitations on their powers.[41]

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also id. at 455 (quoting a perpetual use contract: "[The member] will not lease or permit the sub-leasing of the purchased apartment, or transfer the use or possession thereof without the written consent of the Co-operative, and any approved leasing shall be on standard contract form prepared and furnished by the Co-operative."); Weisner v. 791 Park Ave. Corp., 160 N.E.2d 720, 722 (N.Y. 1959) (quoting lease provisions).

35 68 Beacon St., Inc. v. Sohier, 194 N.E. 303, 305 (Mass. 1935) ("The validity of a stipulation in a lease against assignment or subletting has been recognized and upheld for many years.").

36 *See* N. R. Kleinfield with Tracie Rozhon, *In Flat Market, Co-op Life Has Steep Ups and Downs*, N.Y. TIMES, Oct. 30, 1995, at A1 (citing brokers who say Co-op boards are increasingly refusing to approve sales to qualified buyers, and describing boards' behavior as "intrusive, autocratic and quixotic").

37 Weisner, 160 N.E.2d at 434.

38 RESTATEMENT (THIRD) OF PROP.: SERVITUDES § 6 introductory note (2000).

39 HYATT, *supra* note 16, at 157.

40 *Id.* at 157.

41 *See* Steven Siegel, *The Constitution and Private Government: Toward the Recognition of Constitutional Rights in Private Residential Communities Fifty Years After* Marsh v. Alabama, 6 WM. & MARY BILL RTS. J. 461, 467 (1998); David J. Kennedy, Note, *Residential Associations as State Actors: Regulating the Impact of Gated Communities on Nonmembers*, 105 YALE L.J. 761, 788-89 (1995).

Two theories of state action could potentially apply to POAs: (1) the judicial enforcement theory; and (2) the governmental function theory. The Supreme Court articulated the first theory in *Shelley v. Kraemer*,[42] finding state action where there was judicial enforcement of a racially restrictive covenant.[43] The Court articulated the second theory in *Marsh v. Alabama*,[44] finding state action where a company-owned town prosecuted a pamphleteer for refusing to leave after being told not to disseminate religious material on the town's streets. Despite the express finding of state action in judicial enforcement of CC&Rs in *Shelley* and the parallels between POAs and the company-owned town in *Marsh*, courts have been reluctant to hold that POAs are state actors absent discrimination against a constitutionally protected class.[45] Instead, by analyzing CA governance within a private contractual framework, courts have enabled POAs to appeal to idiosyncratic property owners' preferences by imposing stricter property use and occupancy restrictions than would be within a state actor's power. Whether allowing POAs to exercise that discretionary authority is socially desirable remains the subject of academic debate.

II. SUBSTANTIVE MERITS OF LEASING RESTRICTIONS

Freedom of contract and satisfaction of consumer preferences are the most frequently cited justifications for the enforcement of leasing restrictions.[46] In the CA housing market, individuals reveal their preferences by voting with their dollars. The aggregation of individuals' votes produces a market price. Developers in turn adjust their production of housing based upon the market price of new CAs in relation to the expense of their creation.[47] Because peoples' housing preferences vary, profit incentive motivates developers to create CAs with a variety of living arrangements from

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42 334 U.S. 1 (1948).

43 *Id.* at 19.

44 326 U.S. 501, 506 (1946).

45 *See* RESTATEMENT (THIRD) OF PROP.: SERVITUDES § 6 introductory note (2000). *See, e.g.*, Comm. for a Better Twin Rivers v. Twin Rivers Homeowners' Ass'n, 929 A.2d 1060, 1074 (N.J. 2007) (holding that a CA "is not acting as a municipality."); Brock v. Watergate Mobile Home Park Ass'n, 502 So. 2d 1380, 1382 (Fla. Dist. Ct. App. 1987) ("A homeowner's association lacks the municipal character of a company town. . . . [T]he services provided by a homeowners association, unlike those provided in a company town, are merely a supplement to, rather than a replacement for, those provided by local government. As such, it cannot be said that the homeowners' association in this case acts in a sufficiently public manner so as to subject its activities to a state action analysis.").

46 *See* Ellickson, *supra* note 7, at 1527; Grassmick, *supra* note 9, at 204-06.

47 *See generally* MILTON FRIEDMAN, PRICE THEORY (1976) (describing a comprehensive treatment of the role of prices in a market economy). The creation of new CAs may require new construction or the conversion of existing property, often either rental or commercial, into CA housing.

which individual purchasers may choose.[48] Purchasers in turn buy property in the CA that best satisfies their preferences.[49]

A. *Public Policy Against Restraints on Alienation*

In free markets, voluntary exchanges of goods and services take place until no further mutually beneficial trades are possible and an efficient allocation of resources is achieved.[50] It is surprising, therefore, that leasing restrictions, forms of restraint on alienation, are justified in free market terms. The common law has disfavored restraints on alienation since medieval times.[51] Four policy justifications underlie that negative predisposition by courts against enforcing restraints on alienation: (1) restraints can prevent creditors from reaching property; (2) restraints can perpetuate the concentration of wealth by preventing sale of property and the improvident consumption of the proceeds; (3) restraints can discourage improvement of property; and (4) restraints can make property unmarketable.[52] While restraints on alienation of property prohibiting transfer in fee simple violate all of those policy considerations, leasing restrictions in condominiums and cooperatives generally do not implicate any of them.

First, leasing restrictions are likely advantageous to lenders because they may protect the value of lenders' security by maintaining property values. Institutional lenders may actually condition loan approval on satisfaction of a minimum percentage of owner-occupants within a CA. For example, in order to sell mortgages on the secondary market to Fannie Mae, a lender must comply with Fannie Mae's underwriting standards for CA developments. Those standards disfavor condominium projects dominated

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[48] *But see* MCKENZIE, *supra* note 18, at 12 (1994) ("As [common interest developments] spread, and as old housing is replaced by new CID housing, consumer choice is increasingly restricted. In short, growing numbers of Americans who wish to purchase new houses are going to be living in CIDs, and under the rule of private governments, regardless of their preferences.").

[49] *See generally* ADAM SMITH, THE WEALTH OF NATIONS 484-85 (Edwin Cannan ed., Modern Library 1994) (1776) ("[E]very individual, therefore, endeavours as much as he can . . . to employ his capital in the support of . . . his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. . . . By pursuing his own interest he frequently promotes that of society more effectually than when he really intends to promote it."). Adam Smith generally receives credit for identifying the connection between profit incentives and allocative efficiency, describing the workings of the market as an "invisible hand" promoting the common good.

[50] *See generally* ROBERT H. FRANK, MICROECONOMICS AND BEHAVIOR 563-65 (4th ed. 2000) (providing a mathematical proof of Adam Smith's Theorem of the Invisible Hand in a simple exchange economy). *See also* Ronald Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 1 (Oct. 1960).

[51] JOHN CHIPMAN GRAY, RESTRAINTS ON THE ALIENATION OF PROPERTY 2 (2d ed., Boston Book Co. 1997) (1895).

[52] DUKEMINIER ET AL., *supra* note 14, at 227.

by absentee owners,[53] requiring additional review before purchasing a mortgage in a development that is less than 70% owner-occupied.[54] Fannie Mae standards also allow cooperatives to reserve an approval right over subleasing as long as that right is not "unreasonably restrictive."[55] Because restrictions are usually recorded in CC&Rs, lenders have constructive notice of them and can adjust their lending behavior accordingly.[56] Rather than preventing creditors from reaching property as security, the overall effect of leasing restrictions may be to increase the availability of mortgage financing, which facilitates the free alienation of CA units.

Second, leasing restrictions in CAs do not perpetuate the concentration of wealth. The goal of leasing restrictions is to promote owner-occupancy, which necessarily frustrates the interests of absentee landlords who own multiple units. Leasing restrictions may also encourage owners of inherited property to sell their units, further diluting the concentration of wealth in real property. The creation of new CAs or the conversion of rental property into CAs requires the subdivision of real property, which necessarily expands ownership.[57] To the extent that leasing restrictions increase the value of CAs, and therefore encourage new CA development, public policy against concentrated real property wealth should favor the enforcement of leasing restrictions.

Third, leasing restrictions likely encourage property improvements because of the different incentives of owner-occupants, absentee owners, and renters. Both the present enjoyment of improvements and the promise of increased property values motivate owner-occupants to improve their property.[58] Absentee landlords maximize rental income rather than their own enjoyment of the property, which leads them "rarely [to] do more than minimal rehabilitation when leases end."[59] Renters have a finite legal interest in property and maximize their enjoyment of a property for the duration of their lease. Renters are not significantly affected by changes in property value, and therefore, they do not internalize most of the benefit or harm caused by their behavior to their leased property. As a result, renters are more prone than owners to neglect, or even affirmatively to misuse, their property. Public policy encouraging the improvement of real property should favor leasing restrictions that promote owner-occupancy.

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53 DENNIS P. ANDERSON AND GURDON H. BUCK, ATTORNEYS' AND LENDERS' GUIDE TO COMMON INTEREST OWNERSHIP ACTS: CONDOMINIUMS, COOPERATIVES, AND PLANNED COMMUNITIES 30-39, A.B.A. SEC. REAL PROP. PROB. & TR. L. (1989).

54 *Id.* at 76; *see also id.* at 148, app. 2.

55 *Id.* at 125.

56 Vincent DiLorenzo, *Restraints on Alienation in a Condominium Context: An Evaluation and Theory for Decision Making*, 24 REAL PROP. PROB. & TR. J. 403, 415-16 (1989). *See, e.g.*, Flagler Fed. Sav. & Loan Ass'n v. Crestview Towers Condo. Ass'n, 595 So. 2d 198, 200 (Fla. Dist. Ct. App. 1992).

57 DiLorenzo, *supra* note 56, at 410-12.

58 *Id.* at 415.

59 CLURMAN ET AL., *supra* note 15, at 40.

Fourth, leasing restrictions have a theoretically ambiguous effect on the marketability of property; however, restrictions may increase the value of and expand the market for CA units. The market for condominiums consists of roughly three groups of prospective buyers: (1) owner-occupants who have no intention of ever leasing their property; (2) owner-occupants who value the right to lease their property; and (3) absentee owners who value their property's income generating potential. At one extreme, an absolute leasing restriction may appeal to the first group of owner-occupants but alienate the other two. Cooperatives have essentially adopted this option because Boards of Directors usually have an absolute approval right over subleasing. Empirical evidence suggests restraints on alienation, in the form of absolute approval rights by a Board of Directors before sale or leasing, reduce the value of cooperatives by 12% compared to similar condominiums.[60] At the other extreme, the absence of any leasing restrictions may appeal to the third group of absentee owners but alienate the first two. Apartment buildings provide some insight into the effect of large numbers of renters on property value; the conversion of an apartment building into condominiums may increase the aggregate value of the property by 200 to 300%.[61] Comparisons across forms of property ownership, however, provide only minimal insight into the more limited effects of leasing restrictions on condominium marketability.

Absent empirical data, predicting the impact of leasing restrictions on the value of CA units requires insight into local housing markets and understanding of prospective buyers' preferences. Developers predict which leasing restrictions will optimize the marketability of units during the drafting of declaration CC&Rs. CA owners may subsequently modify those restrictions by amending the CC&Rs, and courts may override both decision makers by refusing to enforce leasing restrictions. Developers likely have the best information about housing markets, and their incentive is to maximize their profits by increasing the sale price and marketability of units. CA owners have the best information about their own subjective preferences, and they have a strong incentive to maximize the value of their units; however, CA owners may be willing to diminish their units' market value in exchange for the ability to exclude renters from their neighborhoods. Courts likely have inferior information about housing markets and CA owners' preferences, making them the least competent decision makers. Perhaps, for that reason, states have moved away from analyzing leasing

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60 Allen C. Goodman & John L. Goodman, *The Co-op Discount*, 14 J. REAL EST. FIN. & ECON. (SPECIAL ISSUE) 223, 231 tbl.3 (1997), *in* THOMAS THIBODEAU, HOUSE PRICE INDICES 223 (1997).

61 DiLorenzo, *supra* note 56, at 411.

restrictions as restraints on alienation either by statute[62] or by judicial decision.[63]

B. *Tiebout Model and the Problem of Public Goods*

Rather than functioning as an impediment to the operation of a free housing market, leasing restrictions may promote market efficiency by solving the collective action problem associated with the provision of public goods. Public goods are "[g]oods or services which, if they are provided at all, are open to use by all members of society."[64] Standard examples include parks, roads, and law and order. Because people may use public goods without paying for them, the price system fails to embody their true social value, and public goods are systematically under produced. To cure this market failure communities typically rely on governments to provide public goods allocated by a political process and financed by taxation. In the context of CAs, common areas, social community, and superior ambience are public goods. To provide those benefits optimally, a CA needs a high percentage of owner-occupants who have a long term interest in maintaining the CA's property and in forming lasting social relationships with neighbors. CC&R leasing restrictions in a CA are analogous to taxes in a municipal setting because they enable a CA to provide public goods within a community and to allocate the costs of those public goods, in the form of the foregone property rights, to the community members who enjoy them.

In the free market, exchange only occurs if all parties to a transaction benefit; market participants receive the benefit of goods or services of at least equivalent value to what they pay for them. In contrast, a majoritarian political process enables the majority to benefit itself at the expense of a minority. Because the majority may subsidize its enjoyment of public services by taxing the minority, people do not necessarily receive governmental benefits comparable to what they pay in taxes. As a consequence, political processes generally do not result in an efficient allocation of resources. However, Charles Tiebout has theorized that efficient allocation of

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62 *See, e.g.*, CONN. GEN. STAT. ANN. § 47-70(c) (West 2008) ("[T]he rule against perpetuities and the rule restricting unreasonable restraints on alienation shall not be applied to defeat any rights given by the condominium instruments or by this chapter.").

63 *See, e.g.*, Breezy Point Holiday Harbor Lodge-Beachside Apartment Owners' Ass'n v. B.P. P'ship, 531 N.W.2d 917, 919 (Minn. Ct. App. 1995) (classifying prohibition on leasing as a use restriction, not a restraint on alienation); Le Febvre v. Osterndorf, 275 N.W.2d 154, 158-59 (Wis. Ct. App. 1979) (holding that leasing restrictions encourage the sale of property and do not constitute a restraint on alienation).

64 JOHN BLACK, DICTIONARY OF ECONOMICS 379 (2d ed. 2002).

public goods by municipal governments may be possible if individuals are highly mobile and there are a large number of competing jurisdictions.[65]

According to the Tiebout Model, when choosing where to live, a prospective homebuyer purchases a residence in the municipality that offers the combination of public goods and taxation that best satisfies his preferences subject to budget constraints.[66] Individuals' mobility forces municipalities to compete for residents by providing an appealing combination of public goods and taxes; in essence, this competition creates a market for public goods and converts taxes into user fees. By analogy to the Tiebout Model, competition among CAs for potential residents is likely to produce an efficient allocation of public goods within private developments. Developers' profit incentive encourages the creation of a variety of housing options with different combinations of common property, social community, and ambience. Prospective purchasers choose the combination of public goods that best satisfies their preferences and pay for them by foregoing a commensurate degree of freedom, which may require compliance with leasing restrictions.

Six assumptions underlie the Tiebout Model: (1) there are a large number of communities; (2) communities are optimally sized to provide member households with their desired bundle of public goods at the lowest average cost; (3) communities' provision of public goods produces no external effects; (4) households are fully mobile; (5) household employment does not restrict mobility; and (6) households have perfect knowledge of community characteristics.[67] The private housing market for CAs likely satisfies the first three assumptions of the Tiebout Model better than the market for municipal governments. First, there are more than 205,000 CAs in the United States,[68] providing households with more housing options than choices in municipal governments. Second, developers' profit incentive likely encourages the creation of CAs that appeal optimally to prospective purchasers more effectively than the political mechanisms employed by municipalities.[69] Third, the external effects produced by CAs on neighboring communities are likely less severe than externalities created by municipalities competing for residents.[70]

Critics argue that CAs produce negative externalities by draining surrounding communities of wealth and by denying the public access to tradi-

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[65] Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416, 419-20 (1956).

[66] *Id.* at 418.

[67] *Id.* at 419.

[68] CAI FACTBOOK, *supra* note 1, at 3.

[69] Fennell, *supra* note 6, at 857.

[70] An externality is "[a] cost or benefit arising from any activity which does not accrue to the person or organization carrying on the activity." JOHN BLACK, DICTIONARY OF ECONOMICS 167 (2d ed. 2002).

tional public goods like roads and parks built by CAs.[71] In particular, leasing restrictions may impose costs on society by depriving renters, who tend to be less wealthy than homeowners, of quality housing within CAs.[72] Because CAs are self-selecting communities, CAs generally target discrete economic groups and provide valuable public goods to households commensurate with their willingness and ability to pay for them. The exclusive character of CAs allows residents to enjoy the benefits of public goods while barring access to less wealthy non-resident households who do not contribute to the cost of them. That outcome indicates that the housing market is working properly; voluntary market transactions occur in order to satisfy individual preferences, not to redistribute wealth to parties outside the transaction. The prevention of wealth redistribution may be less desirable in the municipal context where "fiscal zoning" intended to exclude low-income renters from municipalities prevents members of those renting households from benefiting from public goods such as strong public schools and safe neighborhoods.[73]

The Tiebout Model's fourth and fifth assumptions about household mobility are satisfied better in the private housing market than in the choice of municipalities. Prospective homebuyers likely have greater mobility between CAs than they do between municipalities because movement between CAs may involve shorter distances and may not require changing municipalities. Whether moving between municipalities or moving between CAs within a municipality, relocating households incur realty fees, transportation expenses, potential tax liabilities, and loss of subjective value in a home and neighborhood relationships; however, households moving between municipalities may incur additional costs like switching school districts. To the extent that moves across municipalities involve greater distances than relocations within a municipality, households may tend to incur larger losses in subjective value caused by leaving familiar neighborhoods, and their mobility may be more constrained by employment market rigidity. In either case, the existence of moving expenses introduces some inefficiency into the market for public goods.

Violation of the sixth assumption of perfect information further threatens the optimal allocation of public goods in the Tiebout Model. The market system allocates housing resources efficiently when the price fully reflects the benefits and potential burdens for property owners. Accurate housing prices require that consumers have perfect information about

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[71] *See also* Kennedy, *supra* note 41, at 775 (arguing that CAs impose external costs by "assuming control over facilities created at public expense" and "siphon[ing] off additional public resources through tax deductions").

[72] *See* Grassmick, *supra* note 9, at 190-91 (arguing that condominiums "crowd new rental properties from the market" and leasing restrictions further limit housing opportunities for low-income families).

[73] Fennell, *supra* note 6, at 864-65.

community characteristics. In the context of CA leasing restrictions, property owners' access to information is fundamentally different regarding the content of: (1) restrictions recorded in the CC&Rs at the time of purchase; and (2) future restrictions adopted through a majoritarian political process. This disparity in the availability of information affects the accuracy of CA property prices, and therefore, the efficient allocation of housing resources.

1. Leasing Restrictions in Recorded CC&Rs at Time of Purchase

By the act of purchase, owners of property in a CA unanimously consent to the restrictive covenants recorded in the CC&Rs or articles of incorporation at the time of purchase.[74] The CC&Rs establish binding contractual obligations among owners, but they also circumscribe the permitted uses of the property, limiting the extent of the property interest acquired.[75] CC&R restrictions are therefore embedded into the purchase price of property within a CA.[76] To the extent that purchasers expect that leasing restrictions will succeed in promoting sound management and maintenance of common property, in fostering social community, and in maintaining superior ambience, those restrictions will elevate property values. To the extent that purchasers believe leasing restrictions will prove excessively burdensome, those restrictions will alienate prospective buyers and depress property values. Through that evaluation process, CC&R restrictions effectively screen buyers for compatibility so that buyers with similar preferences will purchase property in the same developments and will form the community atmosphere they desire. When restrictive covenants are recorded at the time of purchase, the information costs of learning them are low, and consumers adjust their willingness to pay based on the desirability of those restrictions. As a consequence, the benefits and burdens of recorded restrictions will likely be reflected in the price, and the market will allocate housing efficiently.

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74 Ellickson, *supra* note 7, at 1526-27.

75 Woodside Vill. Condo. Ass'n v. McClernan, 806 So. 2d 452, 456 (Fla. 2002) (quoting Pepe v. Whispering Sands Condo. Ass'n, 351 So. 2d 755, 757-58 (Fla. Dist. Ct. App. 1977)).

76 Courts have recognized the incorporation of contractual restrictions into the purchase price as early as 1848. Tulk v. Moxhay, 41 Eng. Rep. 1143 (Ch. 1848) ("[T]he question is . . . whether a party shall be permitted to use the land in a manner inconsistent with the contract entered into by his vendor, and with notice of which he purchased. Of course, the price would be affected by the covenant, and nothing could be more inequitable than the original purchaser should be able to sell the property the next day for a greater price, in consideration of the assignee being allowed to escape from the liability which he had himself undertaken."). William A. Fischel argues that not just restrictive covenants, but the quality of all local governmental services are capitalized into home prices within a political unit. For a summary of Fischel's theory, see Richard Schragger, *Consuming Government*, 101 MICH. L. REV. 1824 (2003) (reviewing WILLIAM A. FISCHEL, THE HOMEVOTER HYPOTHESIS: HOW HOME VALUES INFLUENCE LOCAL GOVERNMENT TAXATION, SCHOOL FINANCE, AND LAND-USE POLICIES (2001)).

2. Leasing Restrictions Adopted After Purchase by CA Political Process

The potential for adoption of future leasing restrictions by an amendment to CC&Rs or by a Board of Directors' regulation approved by less than unanimous consent of the property owners poses a greater challenge to efficient resource allocation based on market price. Unlike a voluntary market transaction, in which all parties must benefit for exchange to take place, the political amendment and rulemaking processes employed in most CAs allow the majority of owners to benefit themselves at the expense of the losing minority. Minority owners may avoid leasing restrictions by exiting the development; however, some redistribution may occur whenever minority owners: (1) face high moving costs; (2) subjectively value their property for more than its market price; or (3) cannot avoid the negative impact of a redistributive policy because the policy lowers the market value of their property.[77] At the time of purchase, prospective buyers must calculate the expected benefits and burdens of future amendments and adjust the price they are willing to pay for the property accordingly; however, calculating those risks may be impossible or costly.[78] Unlike obtaining copies of recorded CC&Rs, predicting future amendments requires prospective buyers to undertake the expensive and most likely prohibitively cumbersome task of surveying other owners in the CA to determine their probable voting behavior.[79] The uncertainty of future redistributive policies should lead risk-averse buyers to discount the price they are willing to pay;[80] however, poor information prevents buyers from discounting those expected harms accurately.

3. Homebuyer Ignorance

Critics of the Tiebout Model analogy to the market for CAs emphasize that prospective purchasers of CA units are often either: (1) ignorant of the content of CC&R restrictions or (2) aware of undesirable CC&R restrictions but involuntarily accept them because those restrictions are bundled with other housing characteristics like location and architectural style that make a unit more desirable than housing alternatives.[81] When asked in a

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77 Ellickson, *supra* note 7, at 1525.

78 *See* Breene v. Plaza Tower Ass'n, 310 N.W.2d 730, 734 (N.D. 1981) ("[K]nowledge of the provisions for amendment does not, without more, constitute the degree of knowledge necessary to establish a voluntary and intentional relinquishment of the statutory right to notice of a restriction prior to the purchase of a condominium unit.").

79 Ellickson, *supra* note 7, at 1525-26.

80 *Id.*

81 Fennell, *supra* note 6, at 873-82.

Gallup survey: "How well did you understand the community's covenants, rules, and restrictions before buying?", 23% of CA residents surveyed responded that they had an extremely good understanding, 40% had a very good understanding, 24% had a fair understanding, 7% had a poor understanding, and 6% had no understanding.[82] When asked to identify the "Factors Influencing Home Purchases," the CA residents surveyed listed in decreasing order of priority: (1) Safe Neighborhood; (2) Location; (3) Purchase Price; (4) Good Investment; (5) Architectural Style; (6) Strong Sense of Community; (6) Schools; (7) Social Reasons; and (8) Amenities.[83]

The limited understanding by CA homebuyers of CC&R restrictions and the bundling of CC&R restrictions with other housing characteristics does not necessarily prohibit the market from allocating housing efficiently. A housing market characterized by imperfect information may still produce an efficient price if developers compete for a subset of buyers willing to expend the resources necessary to obtain accurate information.[84] The significance of CA units as major household investments ensures that a substantial percentage of prospective buyers are willing to undertake the search costs necessary to maintain efficient prices.[85] In the housing market, the 63% of well-informed CA residents comprise enough of the market to require CAs to compete for their business or to suffer significant declines in property values. As a result, the majority of informed buyers set the market price, thereby protecting the minority of uninformed buyers from undesirable restrictions.[86] Given the presence of a significant percentage of informed buyers, the decision by a majority of prospective CA buyers to forego their own investigation of CC&R restrictions may be entirely rational.[87] That analysis substantially weakens claims that CC&R restrictions

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[82] CMTY ASS'NS INST., NATIONAL SURVEY OF COMMUNITY ASSOCIATION HOMEOWNER SATISFACTION 39 (Mar. 1999) (reporting on a survey conducted by The Gallup Organization and presented at the National Press Club, Washington D.C., June 23, 1999) [hereinafter CAI SURVEY].

[83] *Id.* at 20.

[84] *See* Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630, 635-39 (1979).

[85] Ellickson, *supra* note 7, at 1524 n.24.

[86] Protection by marginal consumers works most effectively in markets for homogeneous goods. Leasing restrictions exist along a continuum, which poses analytical challenges to reliance on the marginal consumer. The marginal consumer still may generate efficient prices in a market for heterogeneous goods if the housing market tends to divide into discrete classes of living arrangements. For example, exclusive owner-occupied developments, primarily owner-occupied developments, and investor friendly developments likely form three largely distinct CA submarkets. Assuming an uninformed investor undertakes the minimal search costs necessary to identify his preferred submarket, marginal investors within those submarkets will produce efficient prices. Schwartz & Wilde, *supra* note 84, at 658-62. *But see* James L. Winokur, *The Mixed Blessings of Promissory Servitudes: Toward Optimizing Economic Utility, Individual Liberty, and Personal Identity*, 1989 WIS. L. REV. 1, 31-33 (disputing the theory that marginal purchasers ensure allocative efficiency by protecting uninformed buyers from suboptimal servitude regimes).

[87] Winokur, *supra* note 86.

should be subject to substantive review by courts to protect ignorant home-buyers from overreaching by POAs.

The fact that CC&R restrictions are bundled with other characteristics is also not fatal to efficient market operation. As long as there are numerous CAs, prospective buyers will have significant choices about the degree of freedom they are willing to sacrifice in order to enjoy strong social community or superior ambience. According to survey data, good investment, strong sense of community, social reasons, and amenities are among the top eight motivations for CA purchase, and all four relate directly to CC&R restrictions. Even when bundled with other characteristics like location, CC&R restrictions are a sufficiently important determinate of price that a majority of informed buyers will incorporate the benefits and costs of CC&R restrictions into an efficient market price.

The legal standard for enforcing CC&R restrictions, however, may limit the diversity of living arrangements that the market offers to property owners. If courts require leasing restrictions to be recorded in CC&Rs and enforce them as written, developers will compete for buyers on the basis of those restrictions, and consumers will be more likely to read the recorded CC&Rs and to select the living arrangements that optimize their well-being.[88] If courts impose external norms, such as substantive reasonableness, to limit the enforceability of leasing restrictions, developers will compete less vigorously for buyers on the basis of those restrictions, and consumers will tend to rely on the courts to protect them from any unusual restriction rather than investigating the content of CC&Rs themselves.

III. REASONABLENESS REVIEW

Commentators have analogized POAs to municipal governments, fiduciary trusts, business corporations, and closely held corporations;[89] however, courts generally analyze POA governance within the private law of servitudes and contracts. As a result, the focus of judicial inquiry is whether property owners consented to a disputed leasing restriction and whether that restriction is consistent with the bargain that property owners made by purchasing units in a CA. The enforcement of clearly stated leasing restrictions contained in recorded CC&Rs is both fair and efficient. Enforcement is fair because by the act of purchase, property owners unanimously consented to restrictions contained in the recorded CC&Rs, and enforcement is efficient because buyers had access to perfect information about the content of those restrictions and adjusted their willingness to pay

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88 Ellickson, *supra* note 7, at 1524 n.24.

89 Robert G. Natelson, *Consent, Coercion, and "Reasonableness" in Private Law: The Special Case of the Property Owners Association*, 51 OHIO ST. L.J. 41, 47-53 (1990) [hereinafter Natelson, *Reasonableness*].

accordingly. The enforcement of post-declaration leasing restrictions adopted by majoritarian amendment procedures or by a Board of Directors' vote is more problematic because consent to those restrictions is not unanimous[90] and buyers had imperfect information about the content of those restrictions at the time of purchase.[91] Judicial inquiry into the enforceability of post-declaration leasing restrictions may consist of review of both the procedural fairness of the restriction's adoption and the substantive fairness of the restriction itself.

Reasonableness is the majority rule for judicial review of CA leasing restrictions. When leasing restrictions are not contained in declaration CC&Rs, courts apply a reasonableness standard as a substitute for the actual consent of property owners. The object of the inquiry is to determine if a restriction "can be integrated into a hypothetical bargain."[92] The reasonableness standard involves both: (1) internal review in which courts analyze the consistency of a restriction with the provisions of the CC&Rs and the powers granted to the POA's Board of Directors; and (2) external review in which courts compare CA restrictions with external social norms, customs, and state legislation.[93]

Florida and California, which respectively comprise 20% and 18% of the national condominium market,[94] both apply the reasonableness standard to determine the enforceability of leasing restrictions. The reasonableness standard by definition requires a fact-specific inquiry;[95] however, the hierarchy of CA governing authority shapes the nature of judicial review in both jurisdictions. In Florida, leasing restrictions contained in the declaration CC&Rs are "clothed with a very strong presumption of validity which arises from the fact that each individual unit owner purchases his unit knowing of and accepting the restrictions to be imposed."[96] Post-declaration leasing restrictions are subject to less deferential review to de-

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[90] Purchasers in CAs have constructive notice of amendment procedures contained in declaration CC&Rs; however, knowledge of the amendment does not preclude right to notice of a restriction prior to purchase. Breene v. Plaza Tower Ass'n, 310 N.W.2d 730, 734 (N.D. 1981); *see also supra* note 78 and accompanying text.

[91] Schwartz et al., *supra* note 84, at 634 ("[W]hen a condition of imperfect information exists, decisionmakers should feel less constrained in substituting their view of what constitutes a fair exchange for the outcomes reached by private agreements.").

[92] Natelson, *Reasonableness*, *supra* note 89, at 44.

[93] Brower, *supra* note 10, at 232-34. For an example of external review, see Hidden Harbour Estates, Inc. v. Norman, 309 So. 2d 180, 182 (Fla. Dist. Ct. App. 1975) (upholding a CA restriction on alcohol consumption after finding that "restrictions on the use of alcoholic beverages are widespread throughout both governmental and private sectors; there is nothing unreasonable or unusual about a group of people electing to prohibit their use in commonly owned areas.").

[94] CAI FACTBOOK, *supra* note 1, at 18.

[95] BLACK'S LAW DICTIONARY 1293 (8th ed. 2004) (defining reasonable as "[f]air, proper, or moderate under the circumstances").

[96] Woodside Vill. Condo. Ass'n v. Jahren, 806 So. 2d 452, 457 (Fla. 2002) (quoting Hidden Harbour Estates, Inc. v. Basso, 393 So. 2d 637, 639-40 (Fla. Dist. Ct. App. 1981)).

termine whether they are "reasonably related to the promotion of the health, happiness and peace of mind of the unit owners."[97] In California, courts enforce restrictions as reasonable unless "they are wholly arbitrary, violate a fundamental public policy, or impose a burden on the use of affected land that far outweighs any benefit."[98]

A. *Florida*

Florida courts have recognized the promotion of owner-occupancy as a legitimate interest of CAs and have generally been deferential to leasing restrictions passed by CC&R amendment or Board of Directors' vote. In *Seagate Condominium Association v. Duffy*,[99] a Florida court upheld as reasonable an amendment to CC&Rs that prohibited all leasing absent undue hardship:

> Given the unique problems of condominium living . . . appellant's avowed objective—to inhibit transciency and to impart a certain degree of continuity of residence and a residential character to their community—is, we believe, a reasonable one, achieved in a not unreasonable manner by means of the restrictive provision in question. The attainment of this community goal outweighs the social value of retaining for the individual unit owner the absolutely unqualified right to dispose of his property in any way and for such duration or purpose as he alone so desires.[100]

As long as CAs adhere to the amendment procedures defined by their declaration CC&Rs, Florida courts are likely to enforce amendments containing leasing restrictions.

Florida courts have also been deferential to rules restricting leasing issued by CA Boards of Directors. Florida courts will enforce leasing restrictions adopted by a Board of Directors if: (1) the CC&Rs grant the Board at least a general rulemaking power; (2) the leasing restrictions do not contradict explicit provisions or reasonably inferable rights contained in the CC&Rs; and (3) the leasing restrictions themselves are reasonable.[101] In *Beachwood Villas Condominium v. Poor*, a Board of Directors enacted two rules restricting the leasing of units to terms greater than one month and to a maximum of six unit rentals per year.[102] The Board of Directors acted pursuant to a CC&R provision authorizing it to "from time to time, adopt or

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97 *Basso*, 393 So. 2d at 640. *See also* Nahrstedt v. Lakeside Vill. Condo. Ass'n, 878 P.2d 1275, 1297 (Cal. 1994).

98 *Nahrstedt*, 878 P.2d at 1287.

99 Seagate Condo. Ass'n, v. Duffy, 330 So. 2d 484 (Fla. Dist. Ct. App. 1976).

100 *Id.* at 486-87.

101 Beachwood Villas Condo. v. Poor, 448 So. 2d 1143, 1144 (Fla. Dist. Ct. App. 1984).

102 *Id.* at 1143-44.

amend previously adopted rules and regulations governing and restricting the use and maintenance of the condominium units . . . ."[103] The court upheld the rules as reasonable and within the Board's rulemaking power, seeking to preserve "unfettered the concept of delegated board management."[104]

Florida's deference to leasing restrictions adopted at all levels of the hierarchy of CA authority has the benefit of predictability; however, Florida law compromises protection of the property rights and reliance interests of the absentee owners who purchased CA units for their income generating potential. The Florida Supreme Court's response to that criticism is that purchasers are "on notice that the unique form of ownership they acquired" and are "subject to" and "bound by" subsequently adopted amendments and rules.[105] While that consent argument has appeal, it does not take into account that purchasers have imperfect information regarding future amendments or rules at the time of purchase. Without that information, purchasers who value the right to lease their units are unable to discount accurately the amount they are willing to pay for a CA unit, and as a result, allocation of housing will not be optimal.

B. *California*

California courts have modeled their judicial review of CA use restrictions on the Florida reasonableness standard.[106] However, California classifies leasing restrictions both as use restrictions and as restraints on alienation. The California Civil Code provides: "Conditions restraining alienation, when repugnant to the interest created, are void."[107] That statute requires courts to apply a reasonableness standard to both leasing restrictions contained in the declaration CC&Rs and restrictions subsequently adopted by CC&R amendment or Board of Directors' regulation.[108]

Like Florida, California recognizes the promotion of owner-occupancy as a valid justification for restricting or prohibiting leasing.[109] In *Oceanside v. McKenna*, the court upheld declaration CC&R provisions for an affordable housing development that required owners to occupy their units as

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[103] *Id.* at 1144 (quoting condominium by-laws).

[104] *Id.* at 1145. *See* Mohnani v. La Cancha Condo. Ass'n, 590 So. 2d 36, 37 (Fla. Dist. Ct. App. 1991) (applying the *Beachwood* test to hold that leasing restrictions issued by the CA's Board of Directors contradicted express terms of the CC&Rs and were therefore unenforceable).

[105] Woodside Vill. Condo. Ass'n v. Jahren, 806 So. 2d 452, 461 (Fla. 2002).

[106] Nahrstedt v. Lakeside Vill. Condo. Ass'n, 878 P.2d 1275, 1283-84 (Cal. 1994) (citing Hidden Harbour Estates v. Basso, 393 So. 2d 637, 639-40 (Fla. Dist. Ct. App. 1981)).

[107] CAL. CIV. CODE § 711 (West 2008).

[108] City of Oceanside v. McKenna, 264 Cal. Rptr. 275, 279 (Cal. Ct. App. 1989).

[109] *Id.* at 279-80.

principal residences and prohibited all leasing.[110] In its holding, the court emphasized that because the restrictions were recorded, the plaintiff "had constructive notice of the restriction on leasing and the requirement of owner occupancy."[111]

Case law concerning the enforceability of retroactively adopted leasing restrictions is limited; however, the quality of the procedures used to adopt restrictions may be determinative in a court's analysis. In *Ritchey v. Villa Nueva Condominium Association*, a POA amended its bylaws to prohibit occupancy by anyone less than eighteen years of age for more than a fourteen-day period.[112] The original POA bylaws provided that the bylaws could be amended by approval of 75% of the total value of the units, and the disputed amendments passed with 76% of the vote.[113] The court upheld the occupancy restrictions as reasonable because "at the time of [the plaintiff's] purchase, the [e]nabling [d]eclaration specifically provided that the bylaws could be amended, and that [the plaintiff] would be subject to any reasonable amendment that was properly adopted."[114]

In contrast, in *Rancho Santa Paula Mobilehome Park, Ltd. v. Evans*, the court declined to enforce a prohibition on subleasing adopted unilaterally by the manager of a mobile home park.[115] The court distinguished the case from *Ritchey* on two grounds: (1) the restriction limiting occupancy by children in *Ritchey* was less restrictive than a total prohibition on subleasing; and (2) the restriction in *Ritchey* was approved by 76% of the ownership instead of by the unilateral decision of a park manager.[116] The quality of the procedures used to adopt the restrictions was particularly influential in the court's holding: "There is a significant difference between submitting oneself to the future wishes of a community of which one is a part and in which one shares a general community of interest, and of being subject to future regulations imposed by a park owner who may or may not have goals in accord with homeowners and residents."[117]

In some cases, the California procedural inquiry may provide more protection for minority interests than the Florida standard; however, it achieves those protections at the expense of predictability. In order to value CA units accurately, prospective buyers must know both the content of leasing restrictions and the probability that they will be enforced. The California standard exaggerates the problem of imperfect information by creating an uncertain legal standard. In addition, by subjecting leasing restric-

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[110] *Id.* at 276-77.

[111] *Id.* at 280.

[112] Ritchey v. Villa Nueva Condo. Ass'n., 146 Cal. Rptr. 695, 698 (Cal. Ct. App. 1978).

[113] *Id.* at 697-68.

[114] *Id.* at 700.

[115] Rancho Santa Paula Mobilehome Park, Ltd. v. Evans, 32 Cal. Rptr. 464, 465 (Cal. Ct. App. 1994).

[116] *Id.* at 467.

[117] *Id.*

tions contained in declaration CC&Rs to reasonableness review, courts undermine the legitimate reliance of prospective buyers on the enforceability of recorded leasing restrictions, which are approved by unanimous consent and known with certainty. Judicial second-guessing of declaration CC&Rs frustrates the intentions of the parties and may encourage developers to defer to majoritarian amendment procedures, rather than to compete for prospective buyers on the basis of recorded leasing restrictions.[118] Consent to CC&R amendments and Board of Directors' rules is not unanimous, and information about the probability of future restrictions is imperfect. California's deference to majoritarian political processes, therefore, threatens both fairness and market efficiency.[119]

C. *Other Jurisdictions*

Case law regarding the enforceability of leasing restrictions in other jurisdictions is less well-developed, although Florida precedent is highly persuasive in many state courts. For example, in *Apple II Condominium Association v. Worth Bank and Trust Co.*,[120] an Illinois court explicitly adopted the Florida two-tiered mode of analysis for condominium restrictions. It held that leasing restrictions contained in declaration CC&Rs are presumptively valid, while leasing restrictions not contained in the CC&Rs must be "reasonably related to the promotion of the health, happiness and peace of mind of the unit owners."[121] The Illinois standard is likely more deferential than Florida's standard because Illinois treats amendments to declaration CC&Rs as presumptively valid, while Florida subjects CC&R amendments to reasonableness review.

Florida precedent also has been influential in the development of Ohio case law. In *Worthinglen Condominium Unit Owners' Association v.*

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[118] Aside from restraints on alienation, restrictions recorded in declaration CC&Rs receive deference from the courts. The California Supreme Court established the standard of presumptive validity for recorded restrictions to protect the reliance interests of the contracting parties and to promote legal certainty. Nahrstedt v. Lakeside Vill. Condo. Ass'n, 878 P.2d 1275, 1288 (Cal. 1994). The court noted: "Fewer lawsuits challenging such restrictions will be brought, and those that are filed may be disposed of more expeditiously, if the rules courts use in evaluating such restrictions are clear, simple, and not subject to exceptions based on . . . peculiar circumstances or hardships . . ." *Id.*

[119] *Contra* Paula A. Franzese, *Building Community in Common Interest Communities: The Promise of the Restatement (Third) of Servitudes*, 38 REAL PROP. PROB. & TR. J. 17, 42 (2003) ("[D]eliberately malleable constructs such as reasonableness and fairness [help to] vindicate members' legitimate expectations, protect against association overreaching, and honor the integrity of collective decision-making processes. . . . Reinvention of common interest communities requires that rigid rules yield to dynamic, fluid policies rooted in the resolve to restore trust, cooperation, and connection.").

[120] 659 N.E.2d 93 (Ill. App. Ct. 1995).

[121] *Id.* at 98 (citing Hidden Harbour Estates., Inc. v. Basso, 393 So. 2d 637, 640 (Fla. Dist. Ct. App. 1981)).

Brown,[122] an Ohio court cited *Seagate* for the proposition that condominium leasing restrictions are subject to reasonableness review.[123] The Ohio court formalized the Florida reasonableness inquiry based on the quality of the process used to adopt a leasing restriction. The Ohio standard requires courts to engage in a three-part analysis to determine whether a rule is valid. That test examines whether a rule is: (1) arbitrary and capricious; (2) discriminatory or evenhanded; and (3) made in good faith for the common welfare of the condominium owners.[124] Both *Apple II* and *Worthinglen* involved leasing restrictions adopted by CC&R amendments, so it remains unclear how much deference leasing restrictions adopted by a Board of Directors' vote receive under Illinois and Ohio law.

A minority of states, including Washington and North Dakota, have departed from Florida precedent with respect to leasing restrictions adopted after the recording of declaration CC&Rs. In *Shorewood West Condominium Association v. Sadri*,[125] the Washington Supreme Court held that "use restrictions appearing in unrecorded amendments to bylaws and not in the declaration are invalid."[126] Recorded CC&R amendments restricting leasing, however, likely would be enforceable in Washington. In contrast, North Dakota is hostile to all leasing restrictions not contained in the original declaration CC&Rs. In *Breene v. Plaza Tower Association*,[127] the North Dakota Supreme Court held: "a restriction adopted after the purchase of a condominium unit [is not] enforceable against the purchaser except through the purchaser's acquiescence."[128] North Dakota is unique in its protection of the reliance interests of condominium owners in recorded CC&R restrictions at the time of purchase; nonetheless, concern about retroactively applied leasing restrictions has influenced the drafting of two proposed uniform statutory alternatives to reasonableness review.

IV. STATUTORY ALTERNATIVES TO REASONABLENESS REVIEW

In order to better protect the reliance interests of property owners and to promote clarity in the law, the Uniform Common Interest Ownership Act ("Uniform Act") and the Restatement (Third) of Property ("Restatement") replace the fact specific reasonableness standard with universal rules for the enforceability of leasing restrictions.[129] Under both regimes, leasing restric-

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122 566 N.E.2d 1275 (Ohio Ct. App. 1989).

123 *Id.* at 1277.

124 *Id.* at 1277-78.

125 992 P.2d 1008 (Wash. 2000).

126 *Id.* at 1013.

127 310 N.W.2d 730 (N.D. 1981).

128 *Id.* at 734.

129 UNIF. COMMON INTEREST OWNERSHIP ACT § 2-105 (1994); RESTATEMENT (THIRD) OF PROP.: SERVITUDES § 6 introductory note (2000).

tions contained in declaration CC&Rs are presumptively valid. The Uniform Act prohibits subsequent leasing restrictions unless adopted by unanimous consent, and the Restatement employs a rule of narrow construction to determine whether the declaration CC&Rs authorize subsequently adopted leasing restrictions.

A. *Uniform Common Interest Ownership Act*

Variations of the Uniform Act have been adopted in seven states.[130] The Uniform Act requires the declaration CC&Rs to include "any restrictions . . . on alienation of the units, including any restrictions on leasing."[131] Amendments restricting leasing may be adopted only by unanimous consent of the property owners.[132] The Uniform Act's unambiguous legal standard for the enforceability of leasing restrictions protects property owners' reliance interests on leasing restrictions in force at the time of purchase and provides buyers with perfect information about the content of those recorded restrictions. The rigidity of leasing restrictions frozen at the time the declaration CC&Rs are recorded, however, may introduce allocative inefficiencies if property owners' preferences change. The requirement of unanimous consent for amendments gives every individual veto power over an amendment, creating a nearly insurmountable obstacle to the adoption of future leasing restrictions. Even when amendments produce clearly superior outcomes for all property owners, individual unit owners will have an incentive to hold out for additional payment in exchange for their forbearance from the exercise of their veto power. That bargaining dynamic introduces unnecessary transaction costs into the amendment process and likely prohibits CAs from adopting some efficient amendments regarding leasing restrictions.

Under the Uniform Act, the unanimous consent requirement for leasing restrictions enacted subsequent to the declaration CC&Rs may not be altered by contract.[133] This legislative interference with the freedom of contract of the parties may produce stability at the expense of satisfaction of consumer preferences because rational consumers value both stability and flexibility. An optimal legal standard would empower the contracting par-

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[130] In 1982, the Commissioners on Uniform State Laws promulgated the first Uniform Common Interest Ownership Act, which consolidated the Uniform Condominium Act, the Uniform Planned Community Act, and the Model Real Estate Cooperative Act. Statutes governing CAs in Alaska, Colorado, Minnesota, Nevada, West Virginia adopted substantial portions of the 1982 Uniform Act or one of its three predecessors. *See* UNIF. COMMON INTEREST OWNERSHIP ACT (1982). In 1994, the Commissioners promulgated the second version of the Uniform Act. Connecticut and Vermont adopted substantial portions of the 1994 Uniform Act. *See* UNIF. COMMON INTEREST OWNERSHIP ACT (1994).

[131] UNIF. COMMON INTEREST OWNERSHIP ACT § 2-105(a)(12) (1994).

[132] *Id.* § 2-105 cmt. 13.

[133] *Id.*

ties to determine their preferred balance of those competing values by allowing them to design their own amendment procedures and to define the substantive limits of those amendments.

The Uniform Act provides some relief from the inflexibility of the unanimous consent requirement by creating an exception for rules adopted by a Board of Directors to comply with the underwriting requirements for institutional lenders.[134] This provision allows the Board of Directors to save the POA from itself by overcoming the hold out problem when leasing policies threaten to cut off credit to prospective buyers. Precluding buyers from accessing funds from institutional lenders would significantly reduce the alienability of units by limiting the potential market to cash or alternatively financed buyers, and property values would decline appreciably.

B. *Restatement (Third) of Property: Servitudes*

The Restatement adopts a rule of narrow construction for CC&Rs allowing the contracting parties, rather than a legislature or a court, to determine the scope of permissible leasing restrictions. The default rule requires unanimous consent for amendments that "prohibit or materially restrict the use or occupancy of, or behavior within, individually owned lots or units."[135] Unlike the Uniform Act, the Restatement's default rule of unanimous consent does not override amendment procedures contained in the declaration CC&Rs.[136] Amendments containing leasing restrictions are enforceable if they are "expressly authorized by the declaration,"[137] which requires that the declaration CC&Rs define both the procedural and substantive parameters of permissible future use and occupancy restrictions. Two factual scenarios illustrate the express authorization requirement of the Restatement:

Scenario 1: The declaration CC&Rs of condominium development A are silent with respect to leasing restrictions but contain an amendment provision requiring future CC&R amendments to be ratified by two-thirds of all unit owners. The unit owners subsequently adopt, by more than a two-thirds majority, an amendment prohibiting all leasing in the development. Under reasonableness review, the amendment would be enforceable because it was adopted according to procedures contained in the declaration CC&Rs. Under the Restatement, the amendment would not be enforceable

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134 A Board of Directors may issue leasing restrictions not contained in the declaration CC&Rs only if "those rules are reasonably designed to meet underwriting requirements of institutional lenders who regularly lend money secured by first mortgages on units in common interest communities or regularly purchase those mortgages." *Id.* § 3-102(c)(3). *See supra* notes 53-56 and accompanying text.

135 RESTATEMENT (THIRD) OF PROP.: (SERVITUDES) § 6.10(3)(a) (2000).

136 *Id.* § 6.10 cmt. g.

137 *Id.* § 6.10(3).

because the original CC&Rs did not expressly authorize the future adoption of leasing restrictions.

Scenario 2: The declaration CC&Rs of condominium development B do not contain leasing restrictions but include an amendment provision authorizing the future imposition of leasing restrictions, including a prohibition on leasing, by CC&R amendments ratified by a two-thirds vote of all unit owners. Pursuant to that authority, the unit owners subsequently adopt an amendment, by the necessary two-thirds supermajority, prohibiting all leasing in the development. Under both reasonableness review and the Restatement, that leasing prohibition would be enforceable because its adoption was expressly authorized by the declaration CC&Rs.

The substantive authorization requirement of the Restatement puts buyers on notice of potential changes in a CA's leasing policy and limits the possibility of detrimental reliance on the policy in effect at the time of purchase. It also improves the quality of the information relating to the probability and scope of future leasing restrictions and enhances consent because buyers purchase CA units subject to defined substantive limits on future amendments. The Restatement's rule of narrow construction also applies to the rulemaking power of a Board of Directors. In the absence of explicit authorization to adopt use or occupancy restrictions, a Board's power under a generally worded rulemaking authority is limited to the maintenance of common property and the "prevention of nuisance-like activities."[138] Two additional factual scenarios illustrate the Restatement's treatment of leasing restrictions issued by a Board of Directors.

Scenario 3: The declaration CC&Rs of condominium development C, located in a resort town, are silent with respect to leasing restrictions, but they grant the Board of Directors authority to promulgate rules intended to promote the general welfare of the development's unit owners. A significant number of owners subsequently rent their units to vacationers for terms of a few weeks. Owner-occupants in the development complain about noise and harm to common areas caused by the renters. In response to those complaints, the Board of Directors issues a rule pursuant to its general rulemaking power to prohibit the leasing of any unit for a term of less than one year. Under reasonableness review, the Board of Directors' rule likely would be enforceable because it was intended to promote the general welfare of unit owners and was not inconsistent with leasing provisions contained in the declaration CC&Rs. Under the Restatement, a general rulemaking power would be insufficient to allow a Board of Directors to restrict leasing.

Scenario 4: The declaration CC&Rs of condominium development D, also located in a resort town, do not impose leasing restrictions, but they explicitly grant the Board of Directors the authority to regulate the terms of

[138] *Id.* § 6.7(3); *id.* § 6.7 cmt. b.

leases, including the duration of allowable leaseholds. The development experiences problems with short-term renters, and the Board of Directors votes to prohibit the leasing of any unit for a term of less than one year. That restriction would be enforceable under both reasonableness review and the Restatement because the declaration CC&Rs expressly authorized the Board of Directors to restrict the terms of leases.

Like the Uniform Act, the Restatement provides an exception from the rule of narrow construction for leasing restrictions necessary to comply with the underwriting requirements of institutional lenders.[139] When the level of owner-occupancy jeopardizes the availability of credit to prospective purchasers from institutional lenders, the reliance interests of the majority and minority directly conflict. The majority purchased units relying on the right to sell them in fee simple for fair market value, while the minority purchased units relying on the right to lease them. When those rights of alienation clash, it is appropriate for a Board of Directors, elected by the majority, to have the authority to enact leasing restrictions necessary to secure credit from institutional lenders and to preserve the marketability of units in fee simple.[140]

C. *Virtues of the Restatement*

CA governance must balance the interests of the majority of owners with the rights of the minority and adapt to the changing requirements of property owners over time. Protection of the reliance interests of the minority requires stable governing arrangements, while promotion of the majority's interests requires flexibility to accommodate changing circumstances. The requirements of stability and flexibility are necessarily in tension over the course of a CA's existence. The law must determine whether courts or contracting property owners are responsible for achieving the optimal balance.[141] The majority rule of reasonableness review chooses courts, while the Restatement empowers the contracting parties. Both sets of legal rules seek to preserve the intentions of the property owners, enforcing leasing restrictions only when owners have consented to them. Accordingly, under both standards, restrictions contained in the declaration CC&Rs are presumptively enforceable because property owners unanimously consent to those provisions at the time of purchase. Leasing restrictions, however, may be adopted at two points in time: (1) at the recording of the declaration CC&Rs; or (2) subsequent to the recording by political processes. Determining the enforceability of subsequent restrictions re-

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139 *Id.* § 6.7(2)(b).

140 *Id.* § 6.7 cmt. b.

141 *See generally* RESTATEMENT (THIRD) OF PROP.: (SERVITUDES) § 6 introductory note (2000).

quires a legal standard to define "what ought to be looked upon as a tacit consent, and how far it binds."[142]

The reasonableness standard interprets tacit consent broadly. Courts generally conclude that property owners have consented to leasing restrictions whenever they are ratified by an amendment procedure or issued pursuant to a general rulemaking power contained in the declaration CC&Rs. In contrast, the Restatement interprets tacit consent narrowly, enforcing leasing restrictions only when they are issued pursuant to express authorization contained in the declaration CC&Rs. Such express authorization defines both the amendment or rulemaking procedures and the substantive limits of future restrictions.

Both fairness and efficiency favor the Restatement's rule of narrow construction. Fairness demands that CA unit owners consent to the restrictions placed on the alienability of their property; explicit consent to future amendments with contractually defined limitations is preferable to tacit consent to any future amendment deemed reasonable by a court. Efficiency requires that prospective purchasers have accurate information regarding the content of future leasing restrictions at the time of purchase. The reasonableness standard's deference to CA political processes provides little guidance to buyers. Prospective owners must undertake the costly, if not impossible, task of determining the likely voting behavior of existing owners. They must then discount their willingness to pay based on the expected cost of redistributive policies. The uncertainty of this calculation limits the ability of the market to allocate housing properly. The efficient outcome is for buyers with similar preferences to purchase in the same CAs so that majority and minority interests do not conflict over fundamental property rights like the ability to lease CA units.[143] When those interests conflict, the minority must suffer under majoritarian rule or exit the CA. Because relocation involves high transaction costs, that result is inefficient and unfair.

In contrast, the Restatement provides prospective buyers with accurate information about the substantive limits on leasing restrictions, allowing the operation of the market to sort buyers more effectively into CAs that satisfy their preferences. For example, a prospective owner-occupant hostile to leasing will purchase a unit in a CA with declaration CC&Rs that contain leasing restrictions or authorize the future prohibition of leasing. In contrast, a prospective absentee owner will purchase a unit in a CA with declaration CC&Rs that do not contain leasing restrictions or authorize only minimal leasing restrictions, such as a requirement that the term of leases exceed one month. Allocation based upon perfect information at the time

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142 LOCKE, *supra* note 12, at § 119.

143 Patrick A. Randolph, Jr., *Changing the Rules: Should Courts Limit the Power of Common Interest Communities to Alter Unit Owners' Privileges in the Face of Vested Expectations?*, 38 SANTA CLARA L. REV. 1081, 1085 (1998) ("[T]he ability to rent one's unit in a common interest association ought to be viewed as one of the most fundamental of buyers' expectations.").

of purchase reduces conflict and the accompanying cost of litigation,[144] and it minimizes the probability of an aggrieved minority being forced to incur the significant transaction costs of exiting a development.

The Restatement encourages developers to draft declaration CC&Rs carefully to appeal to the market that would maximize the value of a development. Knowing that CC&Rs are enforceable as written, prospective purchasers would have a strong incentive to understand the CC&Rs and to adjust their willingness to pay accordingly. This interaction of buyers and developers would facilitate competition based on restrictive covenants and increase the diversity of living arrangements available to homeowners.[145] This diversity of arrangements made possible by the Restatement is likely superior to the housing variety achievable in a reasonableness jurisdiction even if two contractual innovations, a CA owners' bill of rights and a private takings clause, were more widely adopted.

1. Bill of Rights

Analogizing declaration CC&Rs to a constitution for a CA, Susan French advocates the inclusion of a bill of rights in the declaration CC&Rs to protect minority rights from majoritarian political processes.[146] Widespread inclusion of bills of rights would encourage developers to compete for different groups of prospective buyers and to increase the variety of options available to homeowners.[147] With regard to leasing restrictions, a bill of rights might read: "The association shall not adopt rules that prohibit transfer of any lot or unit, or require consent of the association for transfer of any lot or unit, for any period greater than [two] months."[148] The degree of protection afforded would vary based on the intended market for the CA. In reasonableness jurisdictions, the inclusion of a bill of rights would offer some protection to minority property owners from the otherwise expansive discretion of POAs under general amendment and rulemaking powers.

The Restatement's rule of narrow construction facilitates the goal of diverse living arrangements by transforming "islands of rights surrounded

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144 Nahrstedt v. Lakeside Vill. Condo. Ass'n, 11 Cal. Rptr. 2d 299, 312 (Cal. Ct. App. 1992) (Hinz, J., dissenting), *rev'd*, 878 P.2d 1275 (Cal. 1994) ("[E]ven limited or 'small' litigation undertaken pursuant to [a POA's] enforcement duty can be expensive. The money to pay for such litigation comes from mandatory fees paid by each and every property owner.").

145 Harvey Rishikof & Alexander Wohl, *Private Communities or Public Governments: "The State Will Make the Call,"* 30 VAL. U. L. REV. 509, 518 n.54 (noting that CC&Rs give a developer "the power to create a distinct lifestyle in a development, which the developer can use as a powerful marketing tool." (quoting MCKENZIE, *supra* note 18, at 128)).

146 Susan F. French, *The Constitution of a Private Residential Government Should Include a Bill of Rights*, 27 WAKE FOREST L. REV. 345, 350 (1992).

147 *Id.*

148 *Id.* at 352.

by a sea of governmental powers" in a reasonableness jurisdiction into "islands of governmental powers surrounded by a sea of individual rights."[149] Under the Restatement, by default, the POA has no power to restrict leasing unless explicitly authorized to do so. Instead of the enumerated rights of property owners, declaration CC&Rs would include the enumerated powers of the POA to restrict leasing. Enumerated powers would specify the procedural and substantive limits on leasing restriction. The procedural component could authorize future restrictions by either CC&R amendment or Board of Directors' rule and specify the voting requirements for both. The substantive component could disallow all leasing restrictions, set minimum limits on the term of leases, require Board of Directors' approval of tenants, or allow a blanket prohibition on leasing. Unlike reasonableness review, the Restatement would not allow developers to defer to judicial determinations of the scope of permissible leasing restrictions. The rule of narrow construction would require developers to address leasing restrictions in declaration CC&Rs and to encourage competition based on the content of those restrictive covenants. The result likely would be a greater diversity of living arrangements available to property owners even if bills of rights were widespread in reasonableness jurisdictions.

2. Private Takings Clause

A theoretical solution to the problem of redistributive policies in CA governance is a private takings clause which would reconcile "majoritarian flexibility and minority rights."[150] The clause would allow CAs to adopt restrictions only where the restrictions increased the aggregate well-being of homeowners by forcing the majority to compensate the aggrieved minority for their loss of valuable property rights. The compensation would be calculated "to leave the owner in a position of indifference between the taking by the government and retention of the property."[151] As a consequence, "[e]ach and every dollar of gain from social intervention is in principle uniquely appropriated to some individual by [takings clause] command, so the problem of rent-seeking and faction is fully counteracted."[152] Because aggrieved owners would be compensated for any future loss of property rights, prospective buyers would not have to discount their willingness to pay based upon their expectation of suffering from future redis-

[149] Randy E. Barnett, *Reconceiving the Ninth Amendment*, 74 CORNELL L. REV. 1, 37 (1988) (citing STEPHEN MACEDO, THE NEW RIGHT V. THE CONSTITUTION 97 (Cato Inst., rev. ed. 1987)) (internal quotation marks omitted).

[150] Ellickson, *supra* note 7, at 1535.

[151] RICHARD A. EPSTEIN, TAKINGS: PRIVATE PROPERTY AND THE POWER OF EMINENT DOMAIN 182 (1985).

[152] *Id.* at 199.

tributive policies. Prospective buyers might be willing to pay more because of the potential for future adoption of restrictions that would increase aggregate value to property owners.

Ordinarily, calculating the correct amount of compensation is a costly, if not impossible, task. Providing an owner with compensation that makes him indifferent to the taking requires payment for both diminution of market value and loss of subjective value. Subjective value by definition is not capable of objective quantification by a third party.[153] Robert Ellickson, the chief proponent of the private takings clause, proposes payment of a bonus "equal to what a 'reasonable person' in the claimant's particular life situation would lose in irreplaceable surplus" to serve as a proxy for lost subjective value.[154] Compulsory arbitration would determine the amount of the damages.[155] Ellickson admits that the bonus is a "crude estimate"[156] of actual damages, and the cost of administering the system is high.[157] As a result of those impracticalities, CAs have not adopted takings clauses, and courts have not imposed them as a matter of law.[158]

A compensatory award for a private taking may be more appropriate in the context of leasing restrictions than in the context of other use or occupancy restrictions. The fundamental problem of administering a private takings clause is the determination of an owner's subjective valuation of his property. Subjective value generally increases commensurate with the duration of occupancy in a home.[159] The owners most directly affected by leasing prohibitions, however, are absentee landlords who own their property as investments, not as residences. In the case of an absentee owner who does not subjectively value his property above the market price, full compensation requires only payment for the transaction costs involved in the sale of his property, which may no longer be leased, and for the impact of the leasing restriction on market price, which may be positive.

In reasonableness jurisdictions, judicial imposition of a private takings clause as a matter of law might reduce the negative impact of redistributive policies on minority property owners. Imperfections in the determination of damages, even in the context of leasing restrictions, and the requirement

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153 RANDY E. BARNETT, CONTRACTS: CASES AND DOCTRINE 123 (3d ed. 2003) ("The difference between the value of the price paid (the costs incurred) and that of the goal attained is called . . . profit. . . . Profit in this primary sense is purely subjective, it is an increase in the acting man's happiness. . . . A judgment of value does not measure, it arranges in a scale of degrees . . . . It is expressive of an order of preference and sequence, but not expressive of measure and weight.") (quoting LUDWIG VON MISES, HUMAN ACTION 97, 204-05 (rev. ed. 1963)).

154 Ellickson, *supra* note 7, at 1538.

155 *Id.* at 1536.

156 *Id.* at 1538.

157 *Id.* at 1535.

158 *Id.*

159 For example, a property owner may value relationships with neighbors, proximity to favorite local shops and restaurants, and memories in a home accumulated over time.

of costly arbitration limit the appeal of this alternative. The Restatement better safeguards the subjective value of property owners by empowering them to bargain for desirable terms rather than by allowing CA political processes to redistribute wealth and relying on third party arbiters to determine compensation for the resulting damages.

D. *Statutory Exceptions to the Rule of Narrow Construction*

In most situations, legal deference to the intentions of the parties through a rule of narrow construction will achieve fair and efficient results; however, the Restatement recognizes an exception to that rule to allow a Board of Directors to restrict leasing to comply with the owner-occupancy requirements of institutional lenders. Because of the financial interdependence of CA owners, additional statutory exceptions may be desirable to protect CAs from unforeseen problems with renters at the time declaration CC&Rs are recorded. Renters and absentee owners generally are less involved in the community aspects of CA living, and consequently, they are less susceptible to the informal social pressures that encourage prompt payment of dues and compliance with regulations. If renters are late paying their rent, financially motivated absentee-owners will not be anxious to pay out of pocket monthly POA dues. While unpaid dues create a lien on the property, initiating foreclosure proceedings imposes additional costs on the POA and further delays recovery by several months.[160]

Two possible statutory exceptions to the rule of narrow construction would be to grant the Board of Directors: (1) an approval right over tenants based on objective criteria; and (2) enforcement power directly against tenants for violations of POA rules and unpaid dues. An approval right based on objective criteria, like credit rating, would allow a POA to screen tenants by their financial capacity to pay rent and POA dues. Absolute approval rights over leasing are relatively common in condominium developments.[161] A more limited right would prevent the social screening common in cooperatives, but would advance the POA's legitimate interest in ensuring its

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160 Olin L. Browder, Jr., *Restraints on the Alienation of Condominium Units (The Right of First Refusal)*, 1970 U. ILL. L.F. 231, 231 (1970) ("The project depends upon the total collective response to charges for the maintenance of the common elements, although separately calculated and assessed, and in some respects upon the proper maintenance by unit owners of their respective property units. The normal provision for a high-priority lien to secure these obligations does not eliminate the need for some assurance of financially responsible unit owners.").

161 *See, e.g.*, Pacitti v. Seapointe Condo. Ass'n, 584 So. 2d 212, 212 (Fla. Dist. Ct. App. 1991) (quoting rules and regulations: "All rentals, leases and transfers require notification to, and approval of, the Board of Directors."); Le Febvre v. Osterndorf, 275 N.W.2d 154, 156 (Wis. Ct. App. 1979) (quoting bylaws: "In order to preserve high standards of maintenance and care and the other benefits from a low turnover of occupants, no unit may be rented without the prior written consent of the Board of Directors.").

financial stability.[162] Granting a POA direct enforcement power against a tenant is more likely to result in compliance with rules and prompt payment of dues than indirect enforcement by placing liens on the absentee owner's unit and by threatening to foreclose.[163] The Uniform Act, for example, extends a POA's power to enforce CA rules directly against tenants, and it grants the POA any enforcement powers for violation of rules that landlords would have under the terms of their leases. Both provisions introduce only minimal interference with the freedom of contract of the homeowners, and they may substantially reduce common problems associated with renters.

CONCLUSION

Millions of Americans enjoy the benefits of common property, social community, and superior ambience made possible by the enforcement of restrictive covenants in CAs. Particularly in high density developments like condominiums and cooperatives where neighborhood effects may be pronounced, stability of residency and high owner-occupancy rates are important to the maintenance of those public goods. Leasing restrictions may be necessary to preserve desirable community characteristics; however, they are "a fertile source of dispute"[164] because of the conflicting interests of owner-occupants, absentee landlords, and renters.

Fairness demands that property owners consent to significant restrictions imposed on their property, and efficiency requires that property owners have near perfect information about the content of restrictions so that they may adjust their willingness to pay based on the value of benefits they will receive. Prospective buyers unanimously consent to declaration CC&Rs and have perfect information about their contents at the time of purchase. Buyers choose the living arrangements that best satisfy their preferences and form optimal self-selecting communities. CAs may exist in perpetuity, however, and must be able to adapt to the changing preferences of property owners. Any political process for adopting leasing restrictions creates the potential for the majority to benefit itself at the expense of the minority, raising both fairness and efficiency concerns.

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[162] In addition to credit rating, legislatures might consider allowing additional objective criteria like a prospective tenant's criminal record. The current law regarding the validity of restrictions prohibiting residency by criminals under the reasonableness standard is uncertain. In 2001, a New Jersey court declined to rule on the merits of an amendment prohibiting residence in a CA by convicted sex offenders, but refused to enforce the provision on procedural grounds. Mulligan v. Panther Valley Prop. Owners Ass'n, 766 A.2d 1186, 1192-94 (N.J. Super. Ct. App. Div. 2001).

[163] Duncan R. McPherson, *Drafting Considerations for Community Association Documents*, 15 PROB. & PROP. 25, 27 (2001) ("The desire of an association to have increased powers to deal with tenants is often moderated by a concern that the association will be drawn into disputes that should be dealt with by the owner-landlord.").

[164] NATELSON, LAW OF POAS, *supra* note 4, at 158; *see also supra* note 8.

The legal standard determines whether courts or the parties themselves decide the parameters for future restrictions. The majority rule favors judicial decision-making by subjecting post-declaration leasing restrictions to reasonableness review. The application of an objective reasonableness standard is likely inappropriate to analysis of contractual living arrangements intended to appeal to the subjective preferences of CA property owners. In practice, courts are generally highly deferential to CA political processes, providing little protection to an aggrieved minority when the majority imposes leasing restrictions pursuant to an amendment procedure or general rulemaking authority contained in the declaration CC&Rs. The level of discontent among CA owners may evidence the failure of the current reasonableness standard to protect the property rights and legitimate expectations of CA property owners. Twenty-six percent of current members of POAs would not purchase another home in a CA,[165] and the restrictiveness of POA rules is the most common reason for dissatisfaction with CA ownership.

Adoption of the Restatement would likely improve CA owner satisfaction by enhancing the contractual rather than the political nature of CA governance. The Restatement creates a rule of narrow construction, which requires that to be enforceable, leasing restrictions must derive their authority from enumerated powers in the declaration CC&Rs. By requiring developers to define the scope of future restrictions when drafting the declaration CC&Rs, the Restatement facilitates the functioning of the CA housing market by providing prospective buyers with better information about the content of future restrictions. Owner-occupants will tend to purchase units in CAs that impose or authorize leasing restrictions, and absentee landlords will purchase units in CAs that do not authorize leasing restrictions. Forcing buyers to reveal their preferences at the time of purchase, rather than through subsequent amendments or Board of Directors' elections, protects the minority from unexpected redistributive policies and facilitates the efficient sorting of prospective buyers into compatible communities. The Restatement enhances fairness and efficiency by rejecting judicial reasonableness review in favor of property owners' consent.

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165 CAI SURVEY, *supra* note 82, at 12.

2008 National Lawyers Convention

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THE LATEST IN THE FINANCIAL SERVICES CRISIS: GOVERNMENT CONTROL V. THE FREE MARKET TRANSCRIPT

Mayflower Hotel, State Room, Washington, D.C.

Friday, November 21, 2008

WELCOME AND INTRODUCTORY REMARKS

HONORABLE DOUGLAS H. GINSBURG: Welcome to this afternoon's panel on the problems in the financial sector. We have a large number of panelists who are going to speak to us to get this kicked off. Each one's going to speak for five minutes, and it is my job to make good on that promise.

I am designated the moderator. I feel more like the impartial referee at a meeting of Christians and lions, but I am going to do my best to keep [the panelists] in line.

The credentials of our speakers are unsurpassed, and they are available to you in writing, so we are going to spend essentially no time telling you where they went to school, but I assure you they all went to school. I will tell you their present affiliations and the order in which we're going to hear from them.

We will hear first from Peter Wallison, who is a resident scholar at the American Enterprise Institute (AEI); then from Bert Ely, chairman of Ely & Company Consulting; and from John Taylor of the National Community Reinvestment Coalition (NCRC); and on my immediate left, Professor Todd Zywicki, George Mason University School of Law; then we will hear from Alex Pollock, also at AEI; and from Andrew Redleaf of Whitebox Advisors.[1]

With that said, I am going to start the stopwatch. If there are a few people who are old enough to remember a TV game show called "Beat the Clock," in which each person or contestant was given some absurd task to perform such as an egg-in-a-spoon walk and that sort of thing before the clock ran out, we are going to ask each of our speakers, in five minutes, to tell us what's happened, why, and what should be done about it.

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[1] Scott M. Polakoff, Office of Thrift Supervision, U.S. Department of Treasury, served as a panelist in this discussion but did not wish to publish his remarks at this time.

Peter, it's all yours.

PANELISTS' REMARKS

PETER J. WALLISON: Thank you, Your Honor. It's a pleasure to be here. Actually, I'm still going to school on what we're facing in this economy. I'm learning every day, and I'm not sure what I'm going to say today is my final view on the subject. But we have what is simply an extraordinary event—a series of events—unfolding before our eyes, and we can all learn a tremendous amount by thinking carefully about what this all means.

As a person who deals with policy, I want to make sure that we understand the essence of this crisis. The diagnosis of where we are and how we got here is exceedingly important because it's the diagnosis that produces what is ultimately the prescription. So, I hope you will all be thinking about how we got here and what you hear from the other people on the panel because that is really what is required to understand this crisis. I'm going to advance some ideas about what I think caused the problem we're in, and I hope I can do it within the, now, four and a half minutes that I've been given by His Honor.

My general view is that the problem we are facing today is almost entirely the result of government policy. There are five major elements that have made financial conditions worse today than anyone might have expected, but only because government policy forced our economy into positions that it would not have been in had that government policy not existed.

These are the five elements: the first is that the government has attempted to expand homeownership, but it has not done it in an honest way. I have no quarrel with that policy because there are a great many exogenous benefits that come from more people owning homes, but instead of providing for some kind of subsidy for people who could not otherwise afford a mortgage, the government manipulated the financial system.

In the case of banks, it used the Community Reinvestment Act (CRA), and in the case of Fannie Mae and Freddie Mac, HUD's rules on affordable housing loans, to force banks and Fannie and Freddie to acquire subprime and Alt-A loans. We now have trillions of dollars of those loans scattered through our banking system and the banking systems of the rest of the world. That is the central reason why there is concern about the stability, the quality of the assets, and maybe even the solvency of many of our largest banks and many of the banks around the world.

The second element is that the CRA, and to some extent Fannie Mae's and Freddie Mac's operations, caused a real change in the quality of underwriting for loans. In order to make loans to people who were not otherwise able to meet down payment and other standards, many new ideas—flexible ideas—were developed for mortgage lending: interest-only loans; adjustable-rate loans; negative amortization; and loans with no income test. In some cases, loans were made on the basis of the FICO score alone. All

of those things tended to depreciate, if you will, the quality of underwriting for mortgages and the quality of the mortgages themselves. Loans were made on the basis of reduced or no down payments. This reduced the equity that was behind a mortgage when someone bought a home.

The third element is an option to refinance which is allowed in our law almost everywhere. This is an unusual thing. It's not something that's a natural right; you don't always have an option to refinance without paying a premium. However, this idea is now imbedded in our law, and whenever interest rates go down or housing prices go up, people rush to refinance their homes. This also enables them, through cash-out refinancing, to draw equity out of their homes, to buy a boat, a second home, or whatever else it was that they may want. So, that also reduced the actual equity behind the mortgage.

The fourth element is a tax policy that allowed interest on home equity loans to be deductible. Now, as you know, unless you're in business, the interest that you pay on borrowing is not tax deductible. But if you're a homeowner and you have equity in your home, you can borrow against that and use it to buy a boat. Many, many people did that and again reduced whatever equity they were able to accumulate in their homes so that a very large number of the homes in the United States don't have any significant equity behind the mortgage.

Finally, the fifth and I think the final element is bank regulation. Under the Basel regulations, banks were required to hold only 4% capital against their mortgages whereas they have to hold 8% capital against a commercial loan. This difference gives banks an incentive to make and hold more mortgages than they might without the capital advantage. In addition, if a bank turns its mortgages into a pool backing mortgage-based securities, and holds those securities instead of the mortgages, it only has to hold 20% of the capital requirement, which is 1.6%, behind a portfolio of mortgage-backed securities.

So, you see what's happening here: the equity behind the home loan has been drawn out of the homes. The equity in the banks, which used to come from capital requirements for banks, has gradually been drawn out of the banks by regulatory policies. As a result, we have very little equity or capital in a system that is intended to protect the solvency of mortgages and even the solvency of banks. So, that's the cause of the problem, and it is solely the result, I think, of various government policies. So, that's the diagnosis. Now we get to the prescription, and that I'll leave to all of my colleagues.

Thank you.

BERT ELY: Thank you. I'm Bert Ely, and I'm very glad to be here with you today. You're going to hear from me some of what Peter said, and I'm going to go beyond it in some other ways.

What I'm drawing my remarks from is a paper that I'm working on called "Bad Rules Produce Bad Outcomes." This paper will address the underlying public-policy causes of the U.S. housing finance crisis.

The key thing I do in this paper is talk about what I call the collision between the physics of finance and human nature. What I do in this paper first is identify five human characteristics—five aspects of human nature—that have become particularly relevant with regard to the housing finance crisis. I'm just going to list those very briefly and then touch on, so far, eleven causes that I've identified of this crisis that lie in the public sector.

First of all, it's human nature for people to try to arbitrage the rules of the game; the more complex the rules are, the more arbitraging there will be. If there is ever an area of complex rules, it is in finance and in banking. The second aspect is that people tried to profit from a positive slope in yield curve. That is, short-term interest rates are usually lower than long-term interest rates. That ultimately is what set us up for the S&L crisis back in the 1980s, and it has been a factor in the current financial crisis. The third aspect concerns over extrapolating trends. [For example,] housing prices are going to go on forever; they'll never come back; the stock market will go up and up and up; or as we may now say, down, down, down, down. And then from that comes herd behavior, which we've certainly seen in the housing area. The final aspect is an excessive reliance on expert opinions such as those offered by the rating agencies. So, what I offer in this paper in looking at the eleven causes are, if you will, solutions and policy recommendations that build on those characteristics—those aspects of human behavior that we have to recognize.

Now, what do I see as these causes? First is the Internal Revenue Code, and not just on the housing side, as Peter talked about, but also on the corporate side. We have a tax system that encourages over consumption, discourages savings, encourages over leveraging by both households and businesses, and under encourages the accumulation of equity capital that is not debt capital. Consequently, we have an over-leveraged society in the business, banking, and the household sectors which is why we're in the problems we are and always end up in problems any time you have a downturn in asset values.

Second, as Peter also touched on, is banking regulation, particularly very detailed prescriptive and proscriptive regulation. Some will argue that the cause of this crisis is substantial deregulation of recent decades. I'd like to have people tell me what exactly that was. We still have a more highly regulated banking/financial system than we've had before, which created a lot of incentives for people to try to arbitrage around the system, creating what I call the world of shadow banking—that is, credit and remediation outside the banking system.

Third, we have policies that discourage maturity mismatching, which is particularly important in terms of providing stability and financing long-term fixed assets like home mortgages. Fourth is fair-value accounting.

Fifth is the fact that the credit default swaps that are increasingly seen as a problem oftentimes don't have an insurable interest behind them, and I would argue that that's really nothing more than gambling. The question should be raised as to whether a credit default swap is enforceable if there is no insurable interest. Sixth is fixed-price deposit insurance, specifically in terms of an under-pricing for risk that banks have accumulated. A lot of the bank failures today are among banks that were excessive in their risk taking. Seventh is the First Amendment protection for the credit rating agencies providing that they can't be sued for negligence. The accounting firms give opinions, and they get sued. Some of them even go bankrupt. The same should hold for the rating agencies. Eighth is government-sponsored enterprise, particularly Fannie Mae and Freddie Mac that Peter already talked about.

Ninth is the over promotion of homeownership. For a long time, the homeownership percentage in this country hovered around 64%. In recent years, it got pushed up to 69%, and that's when we saw the outburst of subprime lending. As one who is a longtime renter, I am frankly getting tired of being treated as a second-class citizen because I have voluntarily decided not to own a home. I hire good landlords. I think we need to be more respectful of rent.

Tenth is the Glass-Steagall Act, and the eleventh is monetary policy. There are a couple of others that I have been thinking about such as, in many states, non-recourse obligations on the part of homeowners who default on their mortgages.

With that, I will close it off. I look forward to our discussion and your questions.

Thank you.

[Applause]

JOHN TAYLOR: Good afternoon. The title of Bert's paper—and I love Bert—is "Bad Rules Produce Bad Outcomes." I read that paper, and I think there're a lot of good things in it. It also helped me create the title for my own paper, "Bad Rules Don't Produce Bad Outcomes, Bad People Do."

[Audience laughter]

I'm really borrowing that from the Second Amendment advocates. You know, "guns don't kill people, people kill people." So, for me, it wasn't the rules and regulations relative to our economy, but it was those people, again, who killed our economy. Those folks in the private financial services sector who abandoned or perhaps some of them who never had any ethical standards to begin with that led the mortgage industry down a path that promoted and encouraged deceptive and predatory lending.

The regulatory agencies—more people charged with ensuring fairness and ethical standards in the safety and soundness in our lending system—failed in their responsibilities. It was actually sad for me to watch the former Chairman of the Federal Reserve, Alan Greenspan, being grilled by members of Congress for his free market assumptions. In the end, a humbled Mr. Greenspan admitted that he had put too much faith in the self-correcting power of the free markets and had failed to anticipate the self-destructive power of wanton mortgage lending: "Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief."

Those segments of the mortgage industry that led us on this path to disaster were actually two of the most under-regulated, nontransparent, and unaccountable segments of the entire mortgage industry: independent mortgage companies and Wall Street institutions. The independent mortgage companies operated with little or no regulatory oversight. The CRA did not apply to them. By the way, depending on whose statistics you want to look at, whether it's the Federal Reserve's or others', you'll see that between 83% to 85% as much as 90% in some studies show the loans that are now problematic—these high cost [loans] that are going into foreclosure and are causing problems—were not CRA-generated loans. They were not done by CRA institutions. I'm surprised AEI doesn't understand this. Perhaps the story will change on this.

But the folks who did this were obviously not the typical banks and folks who were the mainstay of the mortgage industry at one time. So, these independent mortgage companies could market, almost unimpeded as history has shown us, one product after another to minority neighborhoods and another product to white neighborhoods. Banks were more scrutinized in this matter, and it's one of reasons why banks were relatively slow to embrace the subprime lending with its multiple-list layering. When they did follow the independent mortgage companies down the path to the spurious lending, they did so via their subsidy institutions—again, most of which were outside the purview of the CRA and its examiners.

Complex and sophisticated instruments for derivatives allowed for leveraging credit based on the layering of risk supported by an assumption of never-ending housing value inflation. Mortgage lending, historically one of the cleanest and safest loans made by the financial service sector, had its performance horizon revised from thirty years to three months. Lenders who worried about the long-term portfolio performance would be replaced by those who needed to have the borrower survive and make payments only for a few months. Short-term fees replaced long-term payoffs as the business model for the mortgage industry. The pipeline for such behavior was expanded by the investment banks—flush with capital—in search of any investment. Regulation? What regulation?

To be fair, there are other collaborators in this free market gone wild. Property appraisers did their part by adjusting property values according to

lender, broker, and seller desires rather than simply using their independent valuations, processes, and systems. In return, the appraiser got their fee and more business from that broker or lender. While the law required independence and arm's length transactions between appraisers and lenders, nearly 95% of all appraisers have admitted that they were regularly influenced to adjust home valuations by the broker or the lender. In many instances, the mortgage companies, like Countrywide Home Mortgage, owned the appraisal company that they used.

Independent mortgage brokers drove much of the malfeasant lending train, and in most states, getting a lender to offer mortgages was as easy as procuring a driver's license. Requirements relating to brokers, their own financial condition, credit history, criminal history, business history, and prior legal problems were nonexistent in most states. Education courses were offered—many online with little or no continuing education requirements. In most states, while brokers could be licensed in that state, they didn't need to have their principal business in that state. Almost no state gave brokers a duty or responsibility to secure and offer loans that were reasonably advantageous to the borrower. Few states had meaningful enforcement authority available that would have allowed them to rein in unscrupulous brokers. Regulation, oh regulation, where art thou?

Mortgage lenders knowingly collaborated with these appraisers and brokers to push mortgages that were layered with risk upon risk and with less documentation about the borrowers' financial ability by merely assessing the borrower's ability to repay the loan for only the first two or three years at which time the loan features reset. At loan closings, lenders had borrowers sign documents revealing negative amortization and promised the borrower that home-equity appreciation was a sure thing and that the road to salvation out of the current loan was via refinancing rates when the rates would be lower and their property value greater.

All this, they promised, would occur in less than two years. They assured the nervous borrowers with statements like "this is how you build wealth sooner; this is how everybody is doing it." In fact, in many instances, we found that they actually encouraged borrowers to take out a larger loan for a larger home and encouraged them to go look for something more than what they were even originally coming into the lender for. Regulation, oh regulation, where art thou?

Let's not dismiss the role of the rating agencies that willingly slapped AAA and AA and other ratings on these securities implying a level of integrity and due diligence even though such decisions were based solely upon the representations of the lender, the institution paying for these rating agency services. We believe these rating agencies substantially contributed to the housing foreclosure crisis in African-American and Latino communities by making public misrepresentations about the soundness and reliability of these subprime securities. Regulation, oh regulation, where art thou?

Finally, we have the investment banks telling the entire mortgage industry—to paraphrase and distort Emma Lazarus' great historic line, "Give me your tired, your poor, your huddled masses yearning to breathe free." Instead, from Wall Street investment firms we got, "Give me your pay-option adjustable-rate mortgages (ARMs), your no or low documentation pile of poorly written loans. Send me the wretched refuse of your teeming origination process. Send all these and more to me."

[Audience laughter]

In the end, we continue to learn several lessons from the mortgage meltdown. Chief among them is that there is a nexus between safe and sound lending and abusive lending. When greed and malfeasance are able to dominate the business sector and when middle-class and moderate-income lending abuses are ignored, we all lose. Today, the main culprits have sealed their own demise with all the major independent mortgage companies gone—AmeriQuest, Option One, New Century, Countrywide. So, too, are many of the major investment banks, either gone or reduced.

I'm going to leave out my stuff about Phil Gramm because I'm running out of time. We can talk about him another time, but I do want to close by just saying in the *Wealth of Nations*, Adam Smith tackled the question: what makes an economy grow? He spoke to the need of a free market with liquidity and free trade, but he was also emphatic about the rule of law—that the rule of law must be present to ensure the fairness and integrity of the market. Alan Greenspan, in his latest book *Age of Turbulence*, stated that reputation and the trust it fosters have always appeared to be the core requirements of market capitalism. The rule of law and trust were missing from the subprime mortgage lending industry during the years 2003 to 2007 when the majority of these deceptive and predatory loans were allowed to pollute the American mortgage market.

Still today, Congress has not acted to outlaw these practices, and I hope that the next administration will address this. I look forward to more discussion during the Q&A. Sorry for taking too much time.

[Applause]

PROFESSOR TODD J. ZYWICKI: We certainly live in historic times, by which I mean in the final month of the Bush administration, the *Washington Post* has finally found the cabinet official that they like: Hank Paulsen. He was recently praised for putting aside his close-minded ideology, waking up to the real world, and being more pragmatic in tackling the world as opposed to being a slave to free-market views.

But we're also in historic times, obviously, with the financial crisis. I used to refer to it as the subprime crisis, but the more I explore it, the more I realize it's really a mortgage crisis sort of situation. What I'm going to

talk about just briefly is three theories of foreclosures, what's going on, and in particular, what they tell us about the possibility for unintended consequences with respect to interventions in the mortgage market because what we'll see is these three different theories cut at cross purposes sometimes.

The three basic theories are: one, problems of local macroeconomic distress; second, particular problems with adjustable-rate mortgages; and third, a negative equity problem or what we could think of as a put option with respect to how consumers use the option to allow default and foreclosure. Basically, it turns out, if you look at how consumers actually behave over the long run and in the aggregate, they behave quite rationally which tells us something and warns us against the way we want to intervene.

So, the first problem we have is basically local macroeconomic distress. This causes foreclosures. The earliest surge in the foreclosure problem this time came from Michigan, Ohio, and Indiana; basically, where we've had long-standing macroeconomic problems. Whenever we have a natural disaster it leads to foreclosures. Now, one thing that's interesting about that is that when homes are underwater people are reluctant to move and relocate. So, one unintended consequence of trying to prevent foreclosures—which is a good in and of itself—may be setting back labor market mobility and the flexibility of people to move around in the economy. So, sometimes foreclosure does involuntarily what people don't want to do voluntarily, which is basically give up their house and move to a part of the country where the economy is growing and they can get a better job.

The second theory is basically adjustable-rate mortgages. I brought some handouts that didn't get handed out, so I'll just hold this up and maybe the camera can pick it up a little bit.

[Audience laughter]

Basically, this handout shows the trend over time. The top line is fixed-rate mortgages, and the bottom line is adjustable-rate mortgages or an aggregate sort of thing. What you notice is a couple things: first, there's a general downward trend since 1984; second, in general, there's about a 100 to 150 basis-point difference between adjustable-rate mortgages and fixed-rate mortgages. What does that mean? Basically, what it means is, if you get a fixed-rate mortgage, you have to pay the bank to bear the risk of interest rate fluctuations. Adjustable-rate mortgages you bear the risk.

Now, what does that mean? Over time, we note divergences between short-term interest rates and long-term interest rates. What we see is the consumers' response to those incentives, which is that as the spread between short-term interest rates and long-term interest rates increases, people flip from fixed-rate mortgages to adjustable-rate mortgages. This is a scenario that predates anything involving the subprime mortgages. If you look at this chart, what you see, for instance, is that 61% of the mortgages that were written in 1984 were adjustable-rate mortgages. In 1988, there were

58%. In 1992, there were about 50%. Consumers respond to the differences between adjustable-rate mortgages and fixed-rate mortgages.

So, why has this not been a problem in the past? Well, the reason it hasn't been a problem in the past is that adjustable-rate mortgages and short-term interest rates have dropped below fixed-rate mortgages, and fixed-rate mortgages have come down from the adjustable-rate mortgages over time. What happened this last time, though, was the Federal Reserve pushed adjustable short-term interest rates very low—artificially low—and fixed-rate mortgages stayed flat. What happened is, instead of fixed-rate mortgages coming down, adjustable-rate mortgages went back up, and all of the sudden, we've got an adjustable-rate mortgage crisis that's not just a subprime crisis.

So that if you look at the data for subprime mortgages, the top line is adjustable-rate mortgages for subprime. What you see is they take off over the past two years. The bottom line, which represents fixed-rate subprime mortgages, is basically flat. Fixed-rate subprime mortgages have not exhibited the same sort of problems as adjustable-rate mortgages. Now, that's partly because subprime borrowers who got fixed-rate mortgages were a marginally better risk than those who got an adjustable rate. But, what you see is, we've got an adjustable-rate mortgage problem when it comes to subprime mortgages—not a hybrid problem. The best empirical evidence we have indicates that it's not a problem of the short-term opening because those mortgages tended to refinance.

But if you look at the prime-rate mortgages, you see the same thing. Prime mortgages have behaved the same way as subprime, which is, we've got an adjustable-rate mortgage problem when it comes to prime mortgages. So, what you see is that foreclosures on prime adjustable-rate mortgages have risen 300% over the past couple years. Fixed-rate prime mortgages have been basically flat, so we do have something that is an adjustable-rate mortgage problem. In and of themselves, adjustable-rate mortgages aren't the problem, but when you put an adjustable-rate mortgage together with the monetary policy we had from 2000 to 2004, you get the problem that we have today.

The rest of the world has adjustable-rate mortgages with ten to fifteen year terms and no right to prepay. The United States is unique, as Peter suggested, in the kind of mortgages that it offers. There's nothing inherently problematic with adjustable-rate mortgages; it's just when you get this problem.

The final theory is basically the idea of a put option or negative equity with respect to homes. Basically, the idea here is that consumers can think of the option of default and foreclosure as a put option. If the house goes down in value such that it's worth less than the mortgage, consumers have the option of either continuing to pay the mortgage or giving it back to the bank. Now, what we know is that the places that have seen the highest foreclosure rates are also the places that have seen the largest drop in home

prices, so that basically the rise in foreclosures has matched the timing of the fall in home prices. So what we have is people basically calculating, "is it worth it to me to continue paying the loan when I'm $100,000 underwater, or do I walk away?"

Now, what we also know is that the value of that option is affected by either the cost or the benefit of exercising the option; for instance, a major reason why California and Arizona are huge outliers in foreclosure rates is because they have non-recourse laws. Anti-deficiency laws mean that the bank can only take the house back and can't sue for a deficiency. What we know is we've got a lot of empirical evidence that says that lenders foreclose at three or four times—at triple or quadruple—the foreclosure rate when house prices go down. Which raises a question, in my mind at least, which is, if the problem is California and Arizona's absurd laws involving debtor collection laws, why is it my problem? Why is it Washington's problem instead of Sacramento's problem? That is a threshold question I have. Why are we bribing people? Basically, what we're saying is that the only way we're going to persuade people into not walking away from their homes is by bribing them. That's a weird sort of problem.

So anyway, we've got these three problems, the adjustable-rate mortgages, the walk-away problem, and the put option. Obviously—a dovetail—we've got things tied up together, but it just shows the complexity of this problem and the possibility for unintended consequences that might arise from it.

Thanks.

[Applause]

ALEX J. POLLOCK: Ladies and gentlemen, the bubble was huge, and as we all know, we're mired in a terrific bust. All kinds of asset prices plummeting, famous financial firms failing, credit contracting, and bailouts bloating the government's balance sheet. In sum, we're in an extended financial panic. As described by David Ricardo over two centuries ago, "On extraordinary occasions, a general panic may seize the country . . . when everyone becomes desirous of possessing himself of the precious metals." We don't do that anymore; now it's cash and Treasury bills. Ricardo continues, "against such panic, banks have no security <u>on any system</u>."

We all know that no bank, even the most solvent bank, can survive a run, and a financial system made up of leveraged financial firms can equally not survive a run. This lack of security for leveraged financial firms against a generalized panic "on any system," as Ricardo says, is what triggers government intervention, of various kinds, including government deposit guarantees (so-called insurance) and bailouts.

The bubble, while it's on, is characterized by greatly increased debt and leverage. A period of success leads to the belief by all parties—

financial actors, regulators, politicians, theorists, competitors—that greater leverage and especially the use of short-term debt is safe. Of course, it turns out in the end that pushed to an extreme, it isn't. When the bust comes, everybody tries to "delever," as we say these days, which means to reduce debt and reduce the ratio of debt to leverage.

Ask yourself this question: how is it possible for everybody to delever, for all balance sheets to shrink at the same time? Imagine that the entire financial system is one big balance sheet, and ask yourself: how can that aggregate balance sheet shrink? You will come to the conclusion that it can't, at least, it can't without an asset price collapse and widespread debt deflation.

So, if the need of private balance sheets to shrink is to be confirmed, some other balance sheet has to expand. That's the government's balance sheet. This yin and yang between these two balance sheets, the private balance sheet delevering in a panic and the government balance sheet expending in a panic, is what we observe. This is why the Federal Reserve balance sheets, if we add all the Federal Reserve banks together, have increased from about $860 billion to over $2 trillion. That's why we have the Troubled Assets Relief Program (TARP) program and all these other interventions. That's why we have, in particular, one bailout I want to mention, which is the bailout of Fannie Mae and Freddie Mac. This is of course not an intervention in the private sector but an intervention to save a government intervention.

[Audience laughter]

Fannie Mae and Freddie Mac were interventions of 1938 and 1970, respectively, which didn't go away.

We should hope that these other interventions will be temporary and reversed in time because every intervention brings with it expanded government and—in particular—bureaucratic power. My favorite example of an intervention which did go away was the Homeowners Loan Corporation of the 1930s (whose authorizing legislation, by the way, which took three and one half pages of statutory text—I give that to all of you as a good example). The Act required that the directors shall proceed to liquidate the corporation when its purposes have been achieved. Unlike Fannie Mae and Freddie Mac, this is exactly what happened.

A second thing to be hoped for in these interventions is that the taxpayers, who are being made into involuntary investors in the equity of financial firms and in distressed debt, will be thought of and treated like investors to the greatest extent possible. I even have the notion that if the various bailout schemes, like the TARP, succeed in making a profit, which in my view they very well may, 100% of that profit should be returned to those citizens who actually do pay federal income taxes as a dividend.

[Audience applause]

As the last word, "Men's spirits are lifted when the times are prosperous, rich, and happy so that their pride and arrogance grow. Adversity chastens them and teaches them what should be done, but good fortune, which leads them to rejoice, usually makes them stray from right councils and clear thinking." That was true when Cato the Elder wrote it in the second century B.C., and it's true of bubbles and busts today.

Thank you.

[Audience applause]

ANDREW REDLEAF: This is a somewhat unusual circumstance for me. Normally, when I'm in a roomful of lawyers, half of them want me to shut up and be very guarded in what I say, and the other half want me to be loose lipped.

Everything the panel has said so far on housing, I basically agree with, and I think it's true—except for Bert's comment on credit default swaps—but it's all ancient history. It was last year's problem. It's still a problem, but we had a housing problem, and now we have a full-fledged financial crisis that began in September of 2008 pretty much with the failure of Lehman Brothers Holdings, Inc. (Lehman).

If you look at a graph or any other measure of financial conditions at the beginning of September 2008, we were bouncing along under the tightest financial conditions in modern history. Conditions may or may not have been tighter than in 1998, in the center of the long-term capital crisis, but they were tighter than in September 2001 after 9/11, tighter than in 2002 after the Enron-WorldCom Telecom bust, and tighter than in 1987 with that crash. Lehman was allowed to fail, and both business and consumer credit completely seized and dried up. Currently, less than 100 enterprises in America can seamlessly refinance their debt. The market price for everybody else is over 20%, probably 35%, pay level. You know, with that, no enterprise can pay and nobody can lend with the expectation of being paid back.

So, AAA commercial-backed mortgages are traded at over 20%, which means that the right cap rate for every commercial building in America is about 24%, 25%, or 26%, which is up in cap rate and down in value from about 7%. Every single building in America is underwater at fair market prices and—if this situation persists—every single building in America will change title from its current owners to some group of creditors. There's a massive sort of credit deflation going on, and that's the problem; it's no longer housing.

Allowing Lehman to fail is, I think by consensus, viewed as a terrible mistake, but it wasn't really something that happened in isolation. The Bear Sterns Companies, Inc. (Bear Sterns) and insurance companies came

upon problems in March. Maybe there was a classic "run on the bank" or maybe a solvency issue; who knows? What is known is that the Treasury Department really wanted the Bear Stearns transaction done at $2 per share instead of $10 per share because somebody had to be punished. Shareholders had to reap their just desserts in order to assuage the gods of moral hazard. Far be it that all the employees lose 92% of their total net worth, much less 98%, 99%, or 100%.

The government then told everybody that Bear Sterns had a book value of $89 the day the deal was sealed, or that they had failed. That number was certified and supported by the officers of the company under Sarbanes-Oxley but also actively or passively by the Securities and Exchange Commission (SEC) and any one of a number of regulators, none of whom have been called to account for it. But shareholders have to be punished. So, although $2 would have been better than $10, we did $10.

Now, the government tells private markets to recapitalize and raise money. The problem isn't that severe. In Bear Stern's case, there are only $30 billion worth of assets—7%, 8%, or 10% of their balance sheet—that are questionable that we don't really know. The government will take that and might make money on them. [The government said to] recapitalized the system, and the private market responded, buying $400 million of preferred stock from financial institutions. That stock had to really be preferred because companies didn't need more debt. Also, we know that equity was wiped out, so the private market came up with the only solution: something in between.

Fannie Mae and Freddie Mac were nationalized, and as a matter of policy choice, that $400 billion to financial institutions was wiped out. This was required to assuage the gods of moral hazard. A week later, Lehman failed and not only preferred shareholders but also bondholders and counterparties were punished because that's what moral hazard required. The government took an about-face a week later when American International Group (AIG) warned of failure because, if AIG had been allowed to fail, Merrill, Morgan Stanley, and most importantly, Goldman Sachs, surely would have failed as well, which was too much.

AIG was first rescued very punitively before the government changed its policy, using the TARP and the preferred stock offered to financial institutions. But the objective of these policies was still to punish the bad people. To those on the political left, a bailout of the auto industry, for example, couldn't be done because the executives had to be punished. The executives came to Washington in three separate private jets and wasted $60,000. If you favor the political right, the auto industry couldn't be bailed out because that would be comparable to Obama's support of the unions.

The gods of moral hazard, I would submit, have been assuaged enough. We now actually have to stop worrying about making micromistakes, picking winners and losers in the overall, winners and losers

among sort of specific companies, and we have to stop what is a massive credit deflation. Inflation and deflation are government policies and not a matter of the free markets. We have to get beyond blame and prevent the irregular transfer of every asset in the country from current holders to debt holders.

[Applause]

HONORABLE DOUGLAS H. GINSBURG: Well, there is a lot on the table. Shortly we are going to open this to your questions. Before we do that, I do want to allow a little bit of cross talk. Again, some of you may recall—this was on Saturday Night Live during the early '80s when we had a run of problems—a skit involving the representatives of labor, industry, agriculture, government, and so on, playing a panel game called "Pass the Buck." Each one had one minute to explain why it was the next one's problem.

We have had two different perspectives, actually one favorable perspective on the CRA, and at least one, maybe two, negative ones. I will let that issue be joined by itself. You do not need a provocateur for that, although I am interested in John Taylor's attempt to explain a variable by reference to a constant, namely greed.

[Audience laughter]

Putting that aside, the panel has focused primarily on causes, which I think has been a very useful exercise, and less on prescriptions, leaving us time for that.

Peter Wallison, you predicted this in 2004 and 2005. I reread your articles recently, predicting it with a level of precision that makes you a rather frightening person to be around.

[Audience laughter]

So my question to you is, to get us started on the next phase, what should we do in view of this? Your point was to examine the causes carefully so that the response is tailored to that. We have some difference of views on causes, but actually a lot of convergence as well. What are you going to tell us about the prescription? In particular, we have seen the government make more proposals than executions and adopt several different responses in the space of a mere couple of months. There is some suggestion that that vacillation is itself aggravating the situation. But putting aside the problem of inconstancy, what should we be doing?

We will go right down the line, one or two minutes each, and then turn it over to what I hope will be a patient bunch of lions waiting in the coliseum here.

PETER J. WALLISON: Thanks very much. I guess I set this up myself, didn't I?

Obviously, there are short-term and long-term solutions we want to deal with here. Right now the situation that we're in, I believe, can only be resolved if we take care of the mortgage problem at its base. I do believe that there will be many, many more failures, and as long as those mortgages and mortgage-backed securities are on the balance sheets of banks, we will have a weak and timid banking system. It will be very hard to get loans from banks. It will be very hard to have our economy grow, and we may end up having to continuously recapitalize banks.

I happen to be a believer in the original idea of the TARP program. I thought that the right thing to do was to buy the assets from the banks because if the assets continue to weaken after you bought them it's for the account of the government rather than the account of the banks. As long as they are weakening within the banks, we are just going to have to keep feeding capital to those institutions. That is the wrong policy, and one that has almost an endless series of losses associated with it.

So, we need a standardized program, as I see it, to address the mortgage problem. We can't do it one at a time. We can't do it by applying new bankruptcy law provisions to mortgages; we have millions of them out there that are going to be problematic. We need a standardized program that will reform and refinance the mortgages that are weak and get those mortgages under control. Once that happens and once there is a floor under the housing market, I think we will start to see a recovery.

Now, the long-term prospect is much, much more difficult in my mind because it gets into questions of housing policy and the things I addressed in my initial remarks. But one of the key questions here is how much the government is going to be involved in encouraging the expansion of homeownership in the United States. As I said, we have been spending, from my perspective, a lot of money on this. It's a worthwhile thing to do—to expand homeownership. But if it's to be done, it should be done through a government program that is based on taxpayer funding like most others, above board, with the ability to criticize it and the risks that are taken and should be taken by the government currently. What we have done in the past, through Fannie Mae and Freddie Mac and—I think also—through CRA, was place those risks on the banking system or on Fannie Mae and Freddie Mac which ultimately created the problems that we have today. So, if we're to do it, we should do it through some sort of subsidized down payment program.

HONORABLE DOUGLAS H. GINSBURG: Let's get CRA straightened out. It is true, is it not, that CRA is applicable only to financial institutions with deposit insurance?

PETER J. WALLISON: Yes.

HONORABLE DOUGLAS H. GINSBURG: I think we were told that they are therefore subject to safety and soundness regulations, the originators, right?

PANELISTS: Right.

HONORABLE DOUGLAS H. GINSBURG: So the loans that are originated by independent mortgage brokers are not subject to CRA?

PANELISTS: Right.

HONORABLE DOUGLAS H. GINSBURG: So is CRA really a part of the problem here?

PETER J. WALLISON: Yes. I think the fact that they are regulated and that banks are required to make loans that are safe and sound doesn't mean the loans are actually safe and sound. In fact, the regulations that the Clinton Administration adopted in 1993 essentially said to the banks, "You shall make these loans, and you shall make them under the penalties prescribed, and if the loans are not good loans, they ought to at least be flexible, and we'll deal with the problems in the future." But the loans were not all good loans.

HONORABLE DOUGLAS H. GINSBURG: John Taylor.

JOHN TAYLOR: AEI wants to keep this CRA discussion in front of things because they don't want to focus on the malfeasance of the industry. Let's face it; it's the private sector that brought us here, the unregulated institutions, the people most of whom have gone under because of this malfeasance. But CRA actually performed at or better than most market and most non-CRA regulated . . .

PETER J. WALLISON: Let me just put it to the audience this way. If those loans were going to be profitable loans for banks, you didn't need CRA.

JOHN TAYLOR: No, that's not true because what happens is it's easier for a bank to make a loan—I'll use a business example—to a corporation that is looking for $10 million than if they have ten small businesses come in each one wanting $1 million. It is, in fact, a more profitable enterprise to do the higher-end loan. But the law simply requires that you cannot ignore creditworthy people who have the ability to pay their mortgage just because they're lower on the economic spectrum. That's all it requires.

BERT ELY: On the CRA issue, I actually addressed this on this panel a few years ago when I was here, and I looked at the legislative history when the CRA was enacted. The CRA was premised on the idea that most bankers are dumb bigots. There is no data developed to support that because non-bigoted people are not going to discriminate against minorities, women, and what have you is smart bigots who are going to lend to anybody, despite what their personal preferences are.

What also concerns me about CRA is that it's part of a broader public policy emphasis of overstressing homeownership, and I think that overstressing homeownership is what we have to back away from. We must stop sanctifying it quite as much as we have in the past, while at the same time asking homeowners to have more skin in the game so that they are, in fact, a genuine homeowner and not a renter disguised as a homeowner.

JOHN TAYLOR: I'd like to explode that myth too. By the way, I want to point out that it takes six conservatives and libertarians to deal with one liberal.

[Audience laughter]

First up, on the issue of homeownership, you should know that these high-cost loans, these predatory loans, these loans that are toxic that have caused this market meltdown have very little to do with new homeownership. In fact, less than 10% of the loans that were made in that period of time—2003 through 2007 when the worst of the loans occurred—had nothing to do with helping, or Clinton's initiatives, or anyone's initiatives pushing people to homeownership.

It had to do with existing homeowners getting bigger homes, refinancing, home-equity lines of credit, taking the equity out and using it for consumer spending, and the willingness of the private-sector financial institutions, in particular mortgage companies, to be willing to put the cash on the table repeatedly and offer them more than they're asking for. That's what that was about.

HONORABLE DOUGLAS H. GINSBURG: Do you have any data on loan problems with mortgages originating from supervised institutions versus others?

PROFESSOR TODD J. ZYWICKI: I've not seen data on that particular topic.

HONORABLE DOUGLAS H. GINSBURG: All right. We will take a brief interlude for a door prize. Does anyone know what a Ninja loan is?

[Various responses]

No income, no job or assets. Very good. You would think that we had a null set, but it is not a null set.

[Audience laughter]

We will take our first question from the audience.

AUDIENCE PARTICIPANT: I'd like the panel to focus more on structural and procedural reforms that could deal with the larger problem in the long term. What we seem to have is not just a mortgage bubble, but a standard of living bubble, a super bubble as it were, like the ones that we saw in the tech bubble and even going back to the savings and loan crisis of the '80s. I've watched it through my life, and I've observed certain fundamental, underlying causes.

Milton Friedman once said that he was in favor of free markets but not of large organizations. Alan Greenspan seemed to have been shocked by the discovery that decision-makers in this field are not unitary decision-makers. They are aggregates of individuals, echelons, departments, and interdependent, co-dependent networks that often operate in conflict with one another. This is the so-called "agency" problem. I've observed, especially in larger organizations, how management can decide to act for its own benefit in ways that are contrary to the interests of the shareholders.

So what I would like to propose for your consideration is to revive the traditional grand jury system to engage in freewheeling investigations of any organization or network of organizations that is too big to fail, or too well connected to fail, that would not be so much trying to decide if they satisfied certain cut and dry accounting standards, in accordance with Sarbanes-Oxley. But this would be free to inquiry among anyone who might know, including the lower-level employees or with any business partners, if there are any problems they can foresee due to conflicts of interest. Then, bring the organizations forward so they can be exposed to everybody who is concerned.

HONORABLE DOUGLAS H. GINSBURG: All right. Let me ask if there's anyone who wants to comment.

PANELIST: Could you repeat the question?

[Audience laughter]

HONORABLE DOUGLAS H. GINSBURG: Todd.

PROFESSOR TODD J. ZYWICKI: I'll just say one thing. One of the things that bugs me about the way this has played out is that it's played out against the backdrop of the election season. I think one of the things that happened is that everybody is just running around looking for scapegoats and partial stories.

Lenders defrauded borrowers. Borrowers defrauded lenders. Wall Street screwed up. Government policies were bad. Monetary policy was bad. I mean this was a perfect storm of people screwing things up. I think some theories are more plausible than the others, but I think the big thing is trying to get in and look at all the various things that were going on. It's not just a matter of poor hapless borrowers getting screwed by lenders, or lenders getting screwed by borrowers, or all these different sorts of things. There were lots of things that came together here, and I think that if any of the bits and pieces had not gone as bad as they had, then this would not have been quite as bad as it is.

I do think one big issue—and John Taylor and some of the other panelists referred to it—is that the rating agencies do in fact play an unusually pivotal, nasty part in this. The rating agencies—you know, Moody's, Standard & Fitch & Poor's—who were willing to slap AAA ratings on this and allow this stuff to kind of get out of its cage such that people say a condominium gets foreclosed in Florida and Iceland's economy fails. I think that's the piece that turns it from a disaster to a catastrophe, if there's any piece.

HONORABLE DOUGLAS H. GINSBURG: One second. Bert Ely is up.

BERT ELY: I think we also have to realize that not only are there multiple causes and interconnected causes but also a lot of the roots of this go back many decades. The more I look at it, for instance, I see the 1986 Tax Act and its restriction on interest deduction to only interest on home mortgages as an underlying cause because after that point in time we saw a tremendous increase in indebtedness on homes. Also, perhaps only coincidentally, from 1986 until the present, the U.S. went from a slight creditor nation to the rest of the world to being in hock on a net basis to the rest of the world to the tune of about $2.5 trillion, which gets back to consumers' negative savings rate and the use of their homes as ATMs.

We have to drill way deep down and go way back in time to see the causes that changed the incentives that have gotten us to the point where we are, and that created the environment for the perfect storm.

HONORABLE DOUGLAS H. GINSBURG: Alex, briefly.

ALEX J. POLLOCK: On the metaphor of the "perfect storm," I was at a meeting the other day where that term was used and people kept referring

to the hundred-year storm. My comment was that the problem with hundred-year storms in financial systems is that they happen every twenty years.

[Audience laughter]

HONORABLE DOUGLAS H. GINSBURG: From the audience.

AUDIENCE PARTICIPANT: I've heard two points that do not seem to square with each other. In John Taylor's case, apparently he tells us, and to my relief, that this is really an upper-middle class problem and that all the minority and low-income loans are fine under CRA. So, at least we are not going to have a class or race dimension to this argument. I think what he really needs to say is that all the evil mortgage-backed securities that were lent so low to minorities did not serve them but took advantage of them, which just goes to the question of whether those loans should have been made at all, which at least Barney Frank admitted last week.

JOHN TAYLOR: The CRA loans are fine. It's the non-CRA loans to minorities. Just to be clear.

AUDIENCE PARTICIPANT: I believe, John, that what you said was that those other loans—or it may have been another panelist—were not made in service of those communities. So either one would have to logically say that they were not made to low-income and minority people, or that these were loans made to those communities whose people could not qualify for CRA loans, or there is no minority or low-income dimension here.

JOHN TAYLOR: The majority of loans, by the way, that we're talking about that are now toxic and having problems are to white people and to middle-income people.

HONORABLE DOUGLAS H. GINSBURG: That is not highly surprising, but the question is whether it is disproportionate.

JOHN TAYLOR: Yes, it is disproportionate. I'd say it is disproportionate that communities were targeted by the subprime, non-CRA lenders. So it's disproportionate compared to their percentage of the population.

HONORABLE DOUGLAS H. GINSBURG: In minority communities?

JOHN TAYLOR: By minority communities. Yes.

AUDIENCE PARTICIPANT: Peter Wallison, I wanted to take you on because you say, much as Sheila Bair actually, that it would be far too complicated to handle this all through bankruptcy and instead it has to be handled through a bureaucratic mechanism of the government buying all these securities and deciding how to readjust them. That, to me, simply seems to be a kind of bureaucratic burden shifting. It seems to me that bankruptcy is exactly the existing non ex post facto way that is constitutionally considered to address these problems.

So, I propose that we take a more small claims court approach to bankruptcy, and we accept that we have a system for dealing with this. Let government set the forum and not the solution.

HONORABLE DOUGLAS H. GINSBURG: Let me point out, this is the first person to have used the "B" word [bankruptcy]. Peter.

PETER J. WALLISON: I understand the argument about bankruptcy. I just do not believe that with millions of mortgages in trouble you can handle it through the court system. The court system is already clogged and putting it into the bankruptcy courts or bankruptcy masters throughout the country would take much too much time to straighten out the serious problems we have in the banking system. That's my principal problem there.

ANDREW REDLEAF: I think, at a macro level, there is a saying, "all debt is repaid either by the borrower or the lender." What actually has to happen is the private sector has to delever. Corporate-wise, that will happen pretty quickly. Consumer-wise, it's much harder. Deflation is immoral. It allows people to get rich by avoiding commerce. We need to have 5%, 6%, 7%, 8% inflation for four or five years, which will delever the consumer by 40% or 50%, with the Federal Reserve watching very carefully net credit creation, and that outstanding credit should not be allowed to rise during that period so that the consumer can delever. In one manner or another, loans are going to be repaid by some mix between the borrower and the lender. A little targeted inflation for the next few years is, I think, the best sort of solution.

HONORABLE DOUGLAS H. GINSBURG: One-minute history lesson. In the 1870s, in the panic of 1873—I think it was—the railroads, which had been recently built and highly leveraged, built into the West and were almost uniformly in default and bankruptcy. The similarity with the current situation is not great, but it has this in common: it was absolutely essential that the railroads continued to run because the crops had to come in or they would spoil in the field. The people in the East who consumed and the people in the West who produced were totally interdependent and linked by those railroads. The bankruptcy courts did step in. They invented something called receivers' certificates. They appointed receivers

who issued debt that was senior to all of the debt on the books, and they were reasonably successful in taking these huge reorganizations through a period of years.

This is not the same situation. Whether bankruptcy courts would be up to it now, I do not know. It is so international, there are so many players. But it is not the first time this kind of a challenge has arisen.

PROFESSOR TODD J. ZYWICKI: The big bankruptcy issue that's going on right now is whether or not bankruptcy judges will be allowed to strip down mortgages in bankruptcy. Basically, if your house is worth less than is owed under current law—and it's always been the law—and you want to keep your house, you have to pay the note as written. You can't write down the value of the mortgage to the value of the property. One of the proposals on the table is to allow them to do that as well as allowing judges to adjust the interest rate. That's what Peter Wallison was referring to.

Now, I think a couple of things are interesting about this. First, it would be a dramatic change in law that's never been allowed. Second, there's no such thing as a free lunch. Obviously, that's going to increase the risk of lending, and it's going to increase interest rates going forward for future borrowers, especially for those who are most likely to file bankruptcy.

Third, there's a question about the extent to which that is needed because—for various reasons I will not go into—it turns out that there's an ability to already strip off home equity loans that are completely underwater which I think takes care of some of the problems and—at least with some of the houses—does not require any change in the law.

Interestingly enough, for some reason we do not understand, homeowners who have the same loan-to-value (LTV), which is the amount they owe versus the total appraised value of the property, are more likely to default if they've got a home equity loan that has the same LTV than on just a purchase money loan.

But the final point on cram down is my concern that, with respect to Congress, it looks like something free. One of the problems we've created with the bailout is we've painted ourselves in a corner because it's so darn expensive and only moderately effective at best, and it forecloses other options because we've got less money to do other options.

So, my concern is that Congress is now looking around for less systematic systems for trying to do things that it does not have to pay for, and it's looking at cram down as one of these options. I'm not convinced it's a good option. Why? Because, number one, it only addresses some loans. Number two, I think it's going to create real incentives for people to file bankruptcy because it's going to allow them to strip down loans and then keep the value when it goes up on the back end. Third, it's going to drag in

a lot of non-mortgage debt along with it, such as credit card debt and car loans. All those sorts of things are going to get dragged in.

If it's a mortgage problem, come up with a mortgage solution; do not come up with a bankruptcy solution to a mortgage problem. I think this is a real Pandora's Box that they're potentially opening if they allow cram down of home mortgages.

HONORABLE DOUGLAS H. GINSBURG: Okay, we are going to take a very brief comment from Bert, then back to the floor for the next person who will bring in a new subject.

[Audience laughter]

BERT ELY: We have to realize two things. First of all, the Federal Reserve cannot create inflation. That I think is a pipe dream. The second thing is that home prices are still not at the bottom. This is the experience of the '80s down in the Southwest. We have to let home prices hit a floor, and then we need ownership of homes to shift into the hands of those who are willing owners of these homes. Frankly, there are a lot of people in homes that face foreclosure that frankly would be better off personally if they were out of the home, didn't own it any longer, and I'm not sure we're doing them any great service by trying to keep them in a home that they would be just as soon be better off not owning. So, we need to have the market clear, and then we will start to see the recovery in housing prices.

HONORABLE DOUGLAS H. GINSBURG: Thank you. Next topic.

AUDIENCE PARTICIPANT: I do, in fact, have a new topic: the incredibly destructive effect that fair-value accounting has had on the financial system. It just seems incredible that we're in month sixteen of the crisis and the SEC still has a task force looking at that. About a month and a half ago, we got clarifications that dealt with the worst aspects of fair value mark-to-market accounting, but of course, they are discretionary and have come sixteen months too late. Once the toothpaste is out of the tube, it's hard to imagine anyone having the nerve to take the litigation risk of writing assets back up.

But, now that we've discovered this was a colossal mistake, I guess the question is what are we to do going forward because it seems like it's been enormously destructive to the system.

ANDREW REDLEAF: I really disagree with the questioner. I think one serious aspect of the problem was a year ago, and I wrote about it. Merrill and other financial institutions were lying. At that point, they were solvent. I believe they were solvent. If they had sort of told the truth, they could've raised capital and gone on as ongoing concerns. It was the opacity

and dishonesty that majorly confounded the problem. I think there are two different points.

There are two standard definitions of solvency. One is your ability to pay bills as they come due, which should be the sort of operant definition that we use. Under their definition, certainly when they had access to the Treasury, Fannie and Freddie were solvent, and they actually had incredibly valuable businesses. The other definition of solvency is the value of your assets exceeding your liabilities, and in terms of handling institutions and pressures, we want to use the first definition of solvency and not the second, but we do want to actually know what the fair value of everybody's balance sheet is.

HONORABLE DOUGLAS H. GINSBURG: Peter.

PETER J. WALLISON: I agree with the comment that was made by the questioner. Fair-value accounting has, I think, been very destructive simply because there has not been an active market on which to base the mark-to-market judgments that are made. But I would mention one thing, Citibank announced that it was going to use the SEC clarification that was made on September 30, 2008, which I think was actually a reversal by the SEC, and that it was going to move many of its assets into held-to-maturity accounts and from trading into held for sale, which is the second category.

HONORABLE DOUGLAS H. GINSBURG: So it doesn't have to mark them down to current market.

PETER J. WALLISON: No, it doesn't have to mark them down to current market as it would with trading assets and it would also, to some extent, with its assets in the held-for-sale category.

In addition, and this is even more important, the International Accounting Standards Board (IASB)—they're the equivalent for Europe of Generally Accepted Accounting Principles (GAAP) and the Financial Accounting Standards Board (FASB) in the United States—allowed banks to do that sometime in early September 2008. In fact, in its financial statements after September 30, 2008, Deutsche Bank moved many of its assets into the held to maturity category, and its stock price rose 18% when it did. In other words, investors will understand the way assets have been marked, that they are marked excessively down because of this mark-to-market idea, and they will not rebel against it and say this is lying or this is management and manipulation.

HONORABLE DOUGLAS H. GINSBURG: Well, let me ask you this, Peter. Since the value of the asset and the asset itself do not change regardless of the accounting, is it that investors are somehow mesmerized

by the accounting or is it that the change in accounting is more assurance against government intervention?

PETER J. WALLISON: I don't know that it's the latter. We don't know what the assets are worth, and if you're going to look at one index, which is the market price, that could be a misleading index. The best index for determining what assets are worth is what their cash flows are.

HONORABLE DOUGLAS H. GINSBURG: Sure.

PETER J. WALLISON: Someone has to go in and look at the cash flows and value the assets based on discounting those cash flows. That's not what we have been doing. We've been expecting investors in the market who know nothing about the cash flows in these particular assets and are scared to death about what is in these portfolios to make a judgment about what these things are worth.

HONORABLE DOUGLAS H. GINSBURG: But they do not know any more when the bank switches the accounting, right?

PETER J. WALLISON: I think the only way you can interpret what happened with Deutsche Bank is that the market—the investors actually—did think that the assets had been written down too far. We don't know which ones or how many, but they did think it was true. When it was possible for Deutsche Bank to move some of these into a different category where they wouldn't be judged by market prices, the bank looked healthier and investors gave them credit for that.

HONORABLE DOUGLAS H. GINSBURG: I'm still mystified. If the bank seems to be undervaluing its assets, that looks like an investment opportunity to me unless it might be a trigger for the government to liquidate the bank.

PETER J. WALLISON: It could be, in fact, an investment opportunity for people, and people have hoped for that. But as long as you follow mark-to-market accounting, the assets are going to continue to decline in value in the market because the sales that are going on are by and large liquidation sales. These are sales where people are forced to sell or distress sales without any buyers. The people who are picking them up are vultures at very low levels. So, there is a downward spiral.

BERT ELY: One of the key reasons we have this is due to maturity mismatching of assets that are funded with relatively short-term liabilities. If an institution feels the market is just being too harsh in its valuation, then what it should do in the interest of its stockholders is to hang onto those

assets and ride through the price depression. In order to do that, however, it has to have liquidity in place. So, it's not just a matter of shifting assets from available-for-sale to hold-to-maturity but also of having the financing in place to be able to hold them to maturity.

What I hope comes out of the financial regulation and accounting revisions that are going to take place is a greater recognition of the need to reduce maturity mismatching. This will reduce a lot of these accounting problems.

HONORABLE DOUGLAS H. GINSBURG: Andrew, briefly, and then back to the floor.

ANDREW REDLEAF: I think the argument that there is no market is very often used as a crutch. There is a bid for every asset in the world. There is a price at which you can sell everything. It really comes down to, again, the second definition of insolvency. I think people are entitled to know what the fair market value is, what the bid is, what the offer is. However, if an entity can meet its bills—which is sort of a cash flow number—we don't want assets being seized and the dead weight loss of transfer that incurs. The idea is to not seize assets from people that are insolvent on a fair market value but can pay their bills.

HONORABLE DOUGLAS H. GINSBURG: Thank you.

AUDIENCE PARTICIPANT: I was just wondering what the panel thought should be done to fix the incentives and competence of the "rating agency triopoly."

HONORABLE DOUGLAS H. GINSBURG: The "rating agency triopoly," okay.

ALEX J. POLLOCK: This is an important topic. I wouldn't call it a "triopoly." Many people say "shared monopoly." Since you typically need two ratings, there is no competition. The rating agencies are clearly a central point in the whole unfortunate story of the bubble. The reason they are is a set of government actions by the SEC and the many other regulators that enshrined ratings from particularly designated rating agencies as regulatory requirements. These were even put into the so-called Basel II capital rules.

This set of regulations created a concentrated point of failure. In thinking about the design of any system, you may wish to avoid concentrated points of failure. The rating agencies became exactly such a point in the mortgage market.

Many people have pointed out that a rating agency that works for investors should have a better incentive structure than a rating agency that

works for the issuers of securities. I think it's a fair point. I think we ought to create and encourage, in every way we can, rating agencies that are paid solely by and owe their duty solely to the buyers of securities as opposed to the sellers of securities.

HONORABLE DOUGLAS H. GINSBURG: Sounds like a business opportunity also.

AUDIENCE PARTICIPANT: Wouldn't that create a free rider problem?

ALEX J. POLLOCK: I didn't say that you have to give your ratings to everybody, just people who pay for them.

AUDIENCE PARTICIPANT: All right.

HONORABLE DOUGLAS H. GINSBURG: John Taylor.

JOHN TAYLOR: I was actually going to make that last point that Alex made but also say that I think we have to find a way for these agencies to have a due diligence standard. In meeting with them and talking with them about this, I invariably get to a conversation where they sit back, and they say we're not a due diligence agency, and I always say: "Really?" "Did you know that most people think you are?" You see the AAA rating—or whatever the rating is—and you assume that what's happened is they've verified the information they've received from the people who are paying them. But they don't. They go on the face value of what they receive, and they are emphatic about not doing due diligence. I think that has to change.

HONORABLE DOUGLAS H. GINSBURG: Bert, go ahead.

BERT ELY: To go back to a point I made during my opening remarks, they have a First Amendment protection which effectively protects them against negligence. When they are paid by the issuer, they become part of the underwriting process. I would suggest to you that if the rating agencies could be sued for negligence when they have been paid by the issuer they would be much more conservative with the ratings they give out. I don't think they would even bother to rate, or try to rate, these very complex securities that are very much part of the problem.

Again, why should they be exempt, in a way that the Certified Public Accountant firms are not, when they give opinions on financial statements where they've been paid by the issuer of the financial statements?

HONORABLE DOUGLAS H. GINSBURG: Peter.

PETER J. WALLISON: I'm really troubled by the free rider problem that you mentioned. If a seller pays the rating agency, that's obviously a problem. But if the buyer pays the agency, anyone else can come in and buy the same securities without paying. So, there is a disincentive on the part of the buyer to hire a rating agency because that buyer is paying for everyone else. It's a very tough problem, and I've never been able to come to a satisfactory solution.

The only thing that seems to make sense to me is to require the rating agency to acquire some of the assets, some of the securities that are being sold, and hold those securities.

[Audience laughter]

HONORABLE DOUGLAS H. GINSBURG: Well, Peter, Alex's response was that they didn't have to publish what they rated.

PETER J. WALLISON: If you know someone's buying, then you know that there is probably a rating behind it. Those things leak out in any event. I agree with Alex from that point of view, but it is very hard to keep that kind of information confidential.

PROFESSOR TODD J. ZYWICKI: I just want to add, in a lot of this, simple error should not be left out of the equation. I think a lot of people on Wall Street did bad things, but I also think a lot of them just made mistakes. For instance, they extrapolated from a long history of how houses behaved in the prime markets to a whole set of new borrowers in the subprime market. To some extent, they may have just had bad models that they were dealing with that people are going to learn from. We need to divide out bad incentives from mistakes in thinking about these questions.

ALEX J. POLLOCK: "Error is more formidable than fraud. The losses to which a plausible manager in complete good faith would commit a bank are beyond comparison greater than those which the dishonest manager would strive to conceal." Walter Bagehot, 1873.

HONORABLE DOUGLAS H. GINSBURG: That was the same year, 1873.

[Audience laughter]

Okay, we're narrowing the focus now. Last question from the floor.

AUDIENCE PARTICIPANT: As far as the prescription goes, Peter Wallison has come out recommending acquiring troubled assets. I'd like

the remainder of the panel to comment on the desirability of that approach versus the approach that has been followed so far, which is injecting capital into selected trouble institutions. In that context, if you could also comment on the objection voiced by some that many of these so-called toxic mortgages have been sliced and diced and securitized and pooled to an extent that makes it infeasible to reacquire them.

HONORABLE DOUGLAS H. GINSBURG: John.

JOHN TAYLOR: Thank you for asking that question because, for me, one the most significant things that's been said here today is something that Peter said, and it also gives me an unusual opportunity to agree with something different from what AEI has said.

If AEI, NCRC, and a whole bunch of other folks are saying we've got to stop the bleeding, we're looking at somewhere between five and seven million more toxic mortgages that, if we don't do something, we will continue to see it undermine Wall Street securities and our economy as a whole. So, the most immediate thing beyond all the other things we've been talking about is that we've got to come up with a solution. Unfortunately, the voluntary solution that has been offered, Hope for Homeowners, has done eighty-six loans in the first two months of its existence.

I don't know if I need to say that again, but the point is that even within the administration you can tell there's a lot of disagreement. God bless Sheila Bair because she's had the courage to stand up and say we really need to do something more substantive. Unfortunately, it looks like this thing is going to be punted to the next administration. That's going to be two more months of increased foreclosure filings. This past month, we had 240,000 mortgage foreclosure filings, and that's the thirty-fourth consecutive increase of the previous month from the previous year. In other words, nothing has slowed down the mortgage foreclosure crisis. It continues to grow. According to Paulsen and Bernanke, in the next year alone we are looking at between two and two and a half million more foreclosures. That's more than we've had already. There's no question that something inordinate needs to happen.

It seems to me there are two remedies immediately available: one is the reverse auction; the other is what's been proffered by Professor Johnson from Harvard, who suggested that we use the eminent domain statute to acquire these toxic mortgages. Perhaps we should pay something more than fair market value, whatever that is, to sweeten it for the investors and work with the servicing banks. We need to get them to understand that this is the best deal you're going to see in perhaps ninety years. But acquire those homes so we no longer have to sit there waiting for voluntary action, waiting for one investor to move while the other one sits there waiting for that investor to move because they think that will turn the market.

We've got to grab these loans and get ahead, create the floor on this foreclosure crisis, and have meaningful modifications that keep working people able to pay on their loans. The new subset of folks that Alex Pollock identified are people who have not lost their job, are not divorced, are not in ill-health, who are still working at the same income, but whose homes are putting them underwater. Get those folks the kind of mortgages they should have had in the first place, and work with the industry, the private sector, and the government. The government can recoup whatever it puts into this over a period of time. If we don't do that on a grand scale, as Peter said, then we're going to continue to have this devastating pull-down on the economy that's going to hurt every other effort.

HONORABLE DOUGLAS H. GINSBURG: Did I hear a bell?

[Audience laughter]

Our time has run with three or four people on the panel who wanted to say something. We also had more questions from the audience. If someone doesn't throw us out of the room maybe you all can get together.

Please join me in thanking the panel.

[Applause]

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MINIMAL DETERRENCE: THE MARKET IMPACT, LEGAL FALLOUT, AND IMPENDING REGULATION OF CREDIT DEFAULT SWAPS

*Andrew M. Kulpa**

ABSTRACT

In the wake of the present financial crisis, some analysts assert that credit default swap (CDS) contracts played a leading role in the implosion of multiple companies and ultimately market destabilization itself. CDS agreements have been executed with greater frequency over the past few years due to the lack of regulation, nominal oversight, ease of execution, and ambiguous tax treatment. Such wide-scale utilization has prompted businesses, ranging from securities firms to banks to operating companies, to imbed CDS agreements into virtually every business operation. Settlement of these CDS agreements, coupled with a downturn in the economy, has crippled global financial markets. In response to political pressure to address the struggling economy, numerous state and federal agencies are attempting to regulate CDS agreements. However, many of the regulatory proposals do not effectively address the key problems associated with CDS agreements; indeed, many of the proposals threaten to eliminate the utility of CDS agreements entirely. Admittedly, an oversight system is necessary to increase the liquidity and transparency of CDS agreements while decreasing the systemic risk and aggregate leverage associated with these agreements. Only after analyzing parallel regulatory frameworks for other derivatives will government officials understand how to adequately implement a system for tracking and settling CDS agreements while preserving and enhancing their future utility.

I. INTRODUCTION

Public opinion is calling for a retaliatory strike against those who utilized the credit default swap (CDS) agreements that allegedly annihilated the financial markets. However, the appropriate response needs to be surgical and calculated to adequately address concerns about CDS markets. CDS agreements are two-party contracts with a promise to pay if an underlying condition is met, such as the default of a third-party company's bonds.

* Associate, Butzel Long, Detroit, Michigan. Vanderbilt University Law School, J.D. 2005; Wayne State University, M.B.A. 2004; University of Michigan, B.S. 2001.

They are primarily used by hedge funds, securities firms, banks, and insurance companies to offset the risk on bonds or loans issued by companies.[1] Many contend that these seemingly benign agreements have ruptured the financial system.[2] As the notional outstanding value of global CDS agreements was estimated between $54.6 trillion and $65 trillion,[3] those firms[4] who had large stakes in CDS agreements continue to feel the fallout.[5] Parties are beginning to build their ranks and establish their positions to litigate and regulate this massive market even though the government has spent years trying to keep CDS agreements regulation free.[6]

Litigation over CDS agreements has begun to hit the courts.[7] Although only a relatively small number of cases involving CDS agreements have been lodged thus far, these early filings may be indicative of the future as many players grasp for the remaining scraps of the financial market. To spearhead the fallout, as opposed to simply purchasing all CDS agreements hinging on default, state and federal government agencies are vying to regulate these agreements.[8] Both the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) have proposed creating a futures clearinghouse in order to improve market liquidity, create transparency, reduce systemic risk, and ultimately deleverage the infrastructure. State government agencies are also attempting to create some form of regulatory oversight because, as they see it, CDS agreements

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1 Nicholas Varchaver & Katie Benner, *The $55 Trillion Question*, FORTUNE, Oct. 13, 2008, at 136.

2 Warren Buffet referred to CDSs and other derivatives as "financial weapons of mass destruction." Karen Richardson, *Berkshire's Derivative Sales Rise*, WALL. ST. J., Nov. 5, 2007, at C3.

3 Varchaver & Benner, *supra* note 1 ("CDS are no mere artist's fancy. In just over a decade these privately traded derivatives contracts ballooned from nothing into a $54.6 trillion market. CDS are the fastest-growing major type of financial derivatives."); Jonathan R. Laing, *Defusing the Credit-Default Swap Bomb*, BARRONS.COM, Nov. 17, 2008, http://online.barrons.com/article/SB122671604643530511.html?mod=b_hpp_barrons_most_viewed_day ("According to the International Swaps & Derivatives Association, or ISDA, the outstanding 'notional' value of debt insured by these swaps soared from under $1 trillion in late 2000 to a peak around $62 trillion at the end of 2007."). *See also* Vikas Bajaj, *Surprises in a Closer Look at Credit-Default Swaps*, N.Y. TIMES, Nov. 5, 2008, at B5.

4 Money in CDS protection was held approximately 44% by banks, 32% by hedge funds, 17% by insurance companies, 4% by pension funds and 3% by mutual funds. *The Great Untangling*, ECONOMIST, Nov. 6, 2008, *available at* http://www.economist.com/finance/displayStory.cfm?source=hptextfeature&story_id=12552204.

5 *Burning Down the House*, ECONOMIST, May 5, 2009, *available at* http://www.economist.com/finance/displaystory.cfm?story_id=13240662 (describing the world's third-largest petrochemicals producer in the Netherlands filing for bankruptcy after using CDSs to complete a leveraged buyout of a rival firm).

6 *See infra* Section II(b).

7 *See infra* Section III(b).

8 *See infra* Section IV.

are similar to the insurance or gaming contracts that traditionally fall within the regulatory powers of the state.[9]

With so many agencies competing for regulatory control over CDS agreements, concise guidelines need to be established. Further, to rebuild trust and protect market participants, any system that is created for regulating CDS agreements needs to have clear oversight and accountability. The implemented solution should also reverse some of the damage that has been done while preserving the future utility of CDS agreements.

This article explores, in Part II, the background of CDS agreements including their growth, historical market treatment, and tax implications. Part III discusses the current market and legal issues surrounding CDS agreements. Part IV reviews the currently proposed regulators before assessing the practicality of their corresponding oversight regimes. Finally, Part V explores proposed recommendations and solutions to regulating CDS agreements.

II. THE GROWTH OF CREDIT DEFAULT SWAP AGREEMENTS

A CDS agreement is the most common form of a credit derivative;[10] it is a two-party contract with largely boilerplate terms.[11] The contract consists of two parts: (1) a payment by a buyer, which is similar to a premium; and (2) a promise by a seller to make a payment upon the occurrence of a specific event.[12] CDS agreements have been used primarily by hedge funds, securities firms, banks, and insurance companies to offset the risk on bonds or loans issued by companies.[13] Starting with almost zero market value, the volume of CDS agreements has nearly doubled every year since 2001.[14] The outstanding notional value of CDS agreements peaked at $62 trillion by the end of 2007.[15] There were a variety of factors that led to this astronomical change in the value and use of CDS agreements.

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9 *See infra* Section IV(a).

10 Eternity Global Master Fund Ltd. v. Morgan Guar. Trust Co. of N.Y., 375 F.3d 168, 171-72 (2d Cir. 2004).

11 Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1025 (2007).

12 *Id.* at 1023.

13 *Id.*

14 *See generally* Nelson D. Schwartz & Julie Creswell, *What Created This Monster?*, N.Y. TIMES, Mar. 23, 2008, *available at* http://www.nytimes.com/2008/03/23/business/23how.html (displaying two graphs entitled *Unchartered Territory* and *A Ballooning Market* showing the rise of market value of CDSs between 2001 to 2008 and CDS holdings across major private banks).

15 The notional quantity represents the amount of total insured coverage by CDS agreements. According to the International Swaps and Derivatives Association, the money at risk in the market is likely less than 2% of the outstanding notional value. Laing, *supra* note 3 ("In fact, the ISDA itself contends that the money at risk in the market, much of it collateralized, is likely just 1% to 2% of the

CDS agreements and other derivatives grew initially because of their utility in managing risk.[16] As globalization succeeded in increasing aggregate global wealth, the number of parties with money to invest exceeded the amount of low-risk and moderate-return devices available for purchase.[17] The world looked to the stability of the U.S. financial system and in particular the regular returns and growth of the U.S. real estate market as a viable investment source.[18] However, even with shrinking interest rates, eligible borrowers were already engaged in the mortgage market due to strict lending guidelines for residential property.[19] Wall Street investors took advantage of the intersection of these issues by taking prime mortgages[20] and subprime mortgages[21] and securitizing them, or grouping and selling them together as a single instrument,[22] to create more available mortgage-backed securities (MBS) on the market and to cater to the new investment dollars.

Although the MBS was not a new device,[23] the heavy use of subprime mortgages was novel, which caused some concern for investors. In turn, the use of CDS agreements escalated as a form of insurance to hedge the risk of these more exotic MBSs; the CDS agreements raised the MBSs' credit ratings and shielded the top-rated tranches from the risk of default.[24] CDS agreements became an inexpensive complement to MBSs as long as the housing market continued to expand.[25] Congress also fostered the

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outstanding notional value."). *See also* ANTULIO N. BOMFIM, UNDERSTANDING CREDIT DERIVATIVES AND RELATED INSTRUMENTS 68 (2005).

16 Michael S. Gibson, *Credit Derivatives and Risk Management* 1 (Fed. Reserve Board, Staff Working Paper 2007-47, May 22, 2007), *available at* http://www.federalreserve.gov/pubs/feds/2007/200747/200747pap.pdf.

17 Martin N. Baily, Robert E. Litan, & Matthew S. Johnson, *The Origins of the Financial Crisis,* FIXING FINANCE SERIES (Brookings Institute/Initiative on Business and Public Policy, Washington, D.C.), Nov. 2008, at 37, *available at* http://www.brookings.edu/~/media/Files/rc/papers/2008/11_origins_crisis_baily_litan/11_origins_crisis_baily_litan.pdf.

18 *Id.*

19 *Id.*

20 Prime borrowers are lower risk borrowers with credit scores above a certain limit who would typically take out residential mortgage loans with principal at a certain percentage below the appraised value of the house. Baily, et al., *supra* note 17, at 7.

21 Subprime borrowers are typically at a higher risk for default and were classically shut out of the mortgage markets because of such risk. *Id.*

22 *Id.*

23 MBSs pre-date the 1980s and combine similar loans into pools for resale. Partnoy & Skeel, *supra* note 11 at 1025.

24 Baily, et al., *supra* note 17, at 28.

25 National Association of Realtors, Housing Bubble Prospects, http://www.realtor.org/research.nsf/files/bubbleq&a.pdf/$file/bubbleq&a.pdf (last visited Apr. 17, 2009). *See also* National Association of Realtors, REAL ESTATE INSIGHTS 9, Dec. 2005, *available at* http://www.realtor.org/REIoutlook.nsf/files/DecemberREIfinal.pdf/$FILE/DecemberREIfinal.pdf.

growth of CDS agreements by passing legislation exempting CDS agreements from regulation that would otherwise provide a market buffer.

A. *CDS Agreements Cannot Insure the Future*

While CDS agreements may appear to be a form of "insurance" for an investment, they are carefully crafted to avoid the regulatory treatment associated with insurance contracts, including obligations such as minimal capital requirements.[26] In order to receive payment, the buyer of a CDS agreement need not suffer any loss or provide any evidence of any loss with respect to the reference entity underlying the CDS agreement.[27] Further, CDS agreements may fail the risk-shifting and risk-distribution requirements of insurance contract regulation.[28] While the structure of derivatives makes it possible for CDS agreements to shift and distribute risk, there is no indication that this has actually occurred with any regularity in the market.[29]

Since June of 2000, parties selling or buying CDS agreements relied upon an opinion from the New York Office of General Counsel (NYOGC) that a CDS agreement is not an insurance contract if any future payment under the CDS agreement "is not conditioned upon an actual pecuniary loss."[30] Consequently, the NYOGC validated the difference between CDS agreements and insurance contracts with regard to taxation, accounting, bankruptcy, and regulatory jurisdiction. Thus, CDS agreements can be traded without oversight or the need to have adequate capital to cover the payment if there is an underlying default.[31] The lack of insurance regulation also permits only nominal disclosure, allowing investors to formulate these agreements quickly by phone, email, or even instant message.[32] Finally, there is no requirement that parties own the underlying instrument for which they are entering the CDS agreement, resulting in massively leveraged companies.[33]

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26 Partnoy & Skeel, *supra* note 11, at 1050.

27 Aon Financial Products v. Societe Generale, 476 F.3d 90, 96 (2d Cir. 2007).

28 *See generally* Helvering v. LeGierse, 312 U.S. 531 (1941).

29 Ari Brandes, *A Better Understanding of Credit Default Swaps Used to Speculate*, 120 TAX NOTES 235, 244 (July 21, 2008).

30 *"Best Practices" for Financial Guaranty Insurers*, State of New York, Insurance Department, Office of General Counsel, Circular Letter No. 19 (Sept. 22, 2008), *available at* http://www.ins.state.ny.us/circltr/2008/cl08_19.pdf [hereinafter Circular Letter No. 19] (describing a prior opinion of the Office of General Counsel published June 16, 2000).

31 JAN JOB DE VRIES ROBBÉ & PAUL U. ALI, SECURITIZATION OF DERIVATIVES AND ALTERNATIVE ASSET CLASSES 20-21 (2005).

32 Varchaver & Benner, *supra* note 1, at 135.

33 FRANK J. FABROZZI, FIXED INCOME ANALYSIS 691 (2d ed. 2007).

B. *Allowed to Game the System*

CDS agreements also resemble gambling or gaming contracts. However, gaming contracts, much like insurance contracts, face strict governmental oversight.[34] CDS agreements are very similar to gaming contracts where two parties essentially bet on the outcome of an event in which they are not required to have an interest.[35] Gaming contracts are subject to state regulation including certain registration and reporting requirements.[36] However, Congress explicitly expressed its desire to preempt potential state regulation of CDS agreements that would mimick state gaming regulation.

In drafting the Commodity Futures Modernization Act of 2000 (CFMA), to reauthorize and amend the Commodity Exchange Act, Congress recognized the risks associated with regulating CDS agreements under the gaming rationale.[37] Congress prudently agreed to avoid inadvertent regulation. The CFMA specifically prevents state and local laws from regulating gaming contracts and bucket shops in the context of CDS agreements.[38] The CFMA also contains a savings clause providing that (1) neither transactions between parties nor hybrid instruments shall be void, voidable, or unenforceable and (2) no party shall be entitled to rescind or recover any payment with respect to any covered CDS agreement solely because of the failure of such instrument to comply with the terms of an exemption.[39] These provisions clearly remove CDS agreements from the scope of state regulation by one set of potential regulators. In addition, the CFMA also provides guidance to potential federal regulators.

In the CFMA,[40] Congress also expressly excluded CDS agreements from regulation under the Securities Act of 1933[41] and the Securities Exchange Act of 1934.[42] This was another specific carve out by the CFMA[43]

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[34] Richard Raysman & Peter Brown, *Cyber-Casinos: Gambling Meets the Internet*, 218 N.Y.L.J. 3 (Aug. 12, 1997).

[35] The court in Thompson v. Williamson, 58 A. 602 (N.J. Ch. 1904) stated:

A contract between a broker and his customer, whereby there is to be no other liability on either side than a settlement of differences, and under which the broker, as well as the customer, equally stand to gain or lose by the rise or fall of prices, and the parties have no other right or interest against each other under the entire contract than that resulting from the differences.

See also Raysman & Brown, *supra* note 34, at 3.

[36] *Id.*

[37] Commodity Exchange Act, 7 U.S.C. § 2 (2008).

[38] 7 U.S.C.A. § 16(e)(2) (West 2008).

[39] 7 U.S.C.A. § 27f (West 2008).

[40] Joseph A. Franco, *The Investment Company Act's Definition of "Security" and the Myth of Equivalence*, 7 STAN. J.L. BUS. & FIN. 1, 19 n.55 (2001).

[41] 15 U.S.C.A. § 77a et seq. (West 2008).

[42] 15 U.S.C.A. § 78a et seq. (West 2008).

[43] Commodity Exchange Act, 7 U.S.C.A. § 2(f) (2008).

that actually expanded the definition of a "security" under the 1933 and 1934 Acts but explicitly excluded CDS agreements.[44]

Despite these numerous carve outs from regulatory oversight, the SEC retained jurisdiction over any fraud claims arising from CDS agreements,[45] providing a route for regulation albeit using a post-mortem measure. Adding to the ambiguity of oversight, CDS agreements also enjoy unclear tax treatment.

C. *Uncharacteristically Taxing*

CDS agreements are not consistently classified as debt or equity, which has been problematic for financial reform and reporting.[46] The boom in CDS agreements has magnified this problem over the past few years. CDS agreements cannot be compared to other instruments because the underlying securities have inconsistent tax treatment.[47] Depending on the preparation form, CDS agreements may be viewed as either notional principal contracts or options for tax purposes.[48] Typically, the factors observed to determine the CDS agreement's tax treatment will hinge on the type of settlement and the triggering event set forth in the CDS agreements.[49] If an investor classifies the CDS agreement as a notional principal contract, payments on the CDS agreement are deductible as ordinary income.[50] However, if the payment is a termination payment, the tax treatment becomes uncertain.[51] Despite requests for clarification on these issues from the Department of Treasury and Internal Revenue Service (IRS), there has been no definitive response.[52]

The point that CDS agreements are not regulated as insurance agreements becomes more salient when the tax treatment of these contracts is considered from an insurance agreement angle. CDS agreements do not have the usual features of an insurance contract, such as risk-shifting and risk-distributing mechanisms and requirements to meet state definitions of

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44 David M. Schizer, *Balance in the Taxation of Derivative Securities: An Agenda for Reform*, 104 COLUM. L. REV. 1886, 1937 (2004).

45 Franco, *supra* note 40, at 19 n.55.

46 Schizer, *supra* note 44, at 1937.

47 *Id.*

48 JAMES M. PEASLEE & DAVID Z. NIRENBERG, FEDERAL INCOME TAXATION OF SECURITIZATION TRANSACTIONS 129 (3d ed. Cumm. Supp. No. 7, Frank Fabozzi Assoc. 2007) (1994).

49 David Z. Nirenberg & Steven L. Kopp, *Credit Derivatives: Tax Treatment of Total Return Swaps, Default Swaps, and Credit-Linked Notes*, 87 J. TAX'N 82, 90 (1997).

50 *Id.*

51 *Id.*

52 *See generally* Press Release, U.S. Department of Treasury, *Treasury and IRS Seek Information Regarding Credit Default Swaps in Order to Address Taxpayer Requests for Guidance*, July 19, 2004, *available at* http://www.treasury.gov/press/releases/js1794.htm.

insurance.[53] Additionally, the IRS has argued that the lack of a true loss by the holder of a CDS agreement makes the connection between these agreements and insurance contracts tangential.[54] Difficulty in establishing a consistent tax framework is exacerbated by the fact that financial forecasting for CDS agreements is inherently problematic.

In a CDS agreement, cash flows can be unpredictable[55] and influenced by the probability that the company or underlying obligation will default.[56] Higher premiums typically correlate with higher probabilities of default.[57] However, the initial investor models used to calculate the value of CDS agreements did not incorporate the effects of market turbulence and drastic changes in the economic landscape. Therefore, premiums and default risk were not appropriately correlated.[58] For example, in the aggregate, losses suffered by sellers should equal gains realized by buyers, as certain sectors are impacted more heavily than others. As corporate defaults increase, there is a corresponding increase in counterparty credit risk, which compounds the risk of multiple failures, essentially creating a domino effect.[59] Firms holding CDS agreements would consequently attempt to isolate the domino effect. However, risk from CDS agreements cannot be isolated because businesses typically entered into integrated CDS agreements; it would be like trying to untangle a spider web. These issues, taken together, make valuation especially difficult under present accounting rules because they create moving targets.

III. MARKET AND LEGAL TURMOIL

The lack of consistent treatment of CDS agreements from a regulatory and financial standpoint coupled with the large-scale use of CDS agreements and a resulting downshift in the economy have led to market turmoil and the beginning of what will most likely be a series of lawsuits.

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53 Brandes, *supra* note 29, at 243.

54 I.R.S. Bulletin No. 2004-52, Notice 2004-32 I.R.B. (Dec. 27, 2004), *available at* http://www.irs.gov/pub/irs-irbs/irb04-52.pdf.

55 Anthony P. Hanlon, *Proposals for Reform of Hedge Fund Regulation* 32 (April 24, 2002), *available at* http://www.law.harvard.edu/programs/pifs/pdfs/tony_hanlon.pdf (unpublished LLM Written Work Requirement Paper for Harvard Law School).

56 DAVID BOBERSKI, CDS DELIVERY OPTIONS 44 (Bloomberg Press 2009).

57 *Id.*

58 INTERNATIONAL MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT 37 (Bernan Press 2008).

59 *Id.* at 17.

A. *CDS Agreements and the Deterioration of Corporate America*

Debate regarding the current causes of this financial downturn continues to rage, but many parties have cited exposure to CDS agreements as a key reason for the fall of storied financial enterprises.[60] The most pronounced example of a company following the CDS market into collapse is that of American International Group (AIG).[61] AIG drafted CDS agreements for many companies to "insure" against the default of a variety of MBSs; however, as real estate prices tumbled following the collapse of the residential real estate market, the market for MBSs also declined.[62] As a result, AIG was required under current accounting rules to immediately mark down the value of its portfolio of MBSs.[63] The investment losses reduced AIG's capital reserves and ultimately led to a downgrade in AIG's debt rating, which triggered collateralization requirements under their CDS agreements.[64] AIG ultimately failed to produce the estimated $100 billion required to cover their CDS agreement exposure.[65] Fearing that AIG was too embedded in the American economy and that its collapse would devastate the market, the U.S. government intervened to stabilize AIG.[66]

AIG is not the only company to fall into distress as a result of CDS exposure. CDS agreements drove Lehman Brothers, Bear Stearns, and Countrywide Mortgage into financial instability;[67] losses on their investments in complex MBSs created positions of defaults on their CDS agreements.[68] As a result of the chain of events involving CDS exposure, Barclays has largely acquired Lehman Brothers' obligations and JP Morgan and Bank of America have acquired Bear Stearns and Countrywide Mortgage, respectively.[69] While there have not been direct ties to AIG's CDS agreements and pending lawsuits, this is not the case with other enterprises' uses of CDS agreements.

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60 Laing, *supra* note 3.

61 *Review of the Role of Credit Derivatives in the U.S. Economy: Hearing Before the H. Comm. on Agric.*, 110th Cong. 1 (Oct. 15, 2008), *available at* http://agriculture.house.gov/hearings/110.html [hereinafter *Credit Derivatives Hearing*] (statement of Erik R. Sirri, Dir. of Div. of Trading and Mkts., SEC).

62 *See generally* David Paul, *Credit Default Swaps, the Collapse of AIG and Addressing the Crisis of Confidence*, THE HUFFINGTON POST, Oct. 11, 2008, http://www.huffingtonpost.com/david-paul/credit-default-swaps-the_b_133891.html.

63 *Id.*

64 Carol J. Loomis, *AIG: The Company that Came to Dinner*, FORTUNE, Jan. 19, 2009, at 73.

65 Paul, *supra* note 62.

66 Loomis, *supra* note 64, at 73.

67 Craig Pirrong, *The Clearinghouse Cure*, 31.4 REGULATION MAGAZINE 44, 50 (Cato Institute), Winter 2008-2009 [hereinafter Pirrong, *The Clearinghouse Cure*].

68 *Id.* at 50.

69 *Id.*

B. *Legal Exposure*

Excessive use of CDS agreements along with dried up capital markets have led to new legal action. The first lawsuit involved VCG Special Opportunities Master Fund, Ltd. (VCG), a Florida hedge fund.[70] VCG claimed breach of contract and unjust enrichment against both Citibank, N.A. (Citi) and Wachovia Bank, N.A. (Wachovia) in two different suits. VCG alleged that each of the banks improperly collected the value of collateralized debt obligation (CDO) write downs from VCG by falsely claiming that the CDOs had defaulted.[71] Citi and Wachovia had insured their CDOs by buying CDS agreements from VCG. The contractual terms and the downward movement in the daily mark-to-market value of the underlying notes required VCG to deposit additional sums as collateral.[72] VCG questioned this obligation and sought clarification from the banks; however, it continued to act and ultimately deposited $9.96 million on a $10 million swap.[73] The court ultimately dismissed VCG's action, noting that the banks and VCG were sophisticated parties.[74] VCG's mistaken understanding about its obligations under a CDS agreement did not relieve it[75] from its contractual obligations.[76]

In another case, Merrill Lynch sued for a declaratory judgment that it had not breached its CDS agreement with XL Capital Assurances, Inc. (XL Capital) by purchasing additional protection on a specific bond issue.[77] XL Capital counterclaimed, alleging that Merrill Lynch had committed an anticipatory breach of the agreement in making certain assignments.[78] Merrill Lynch entered into six new CDS agreements with XL Capital which included certain voting rights that Merrill Lynch was obligated to assign to XL Capital.[79] In reality, Merrill Lynch assigned the CDS agreements to XL Capital and a third party.[80] The court addressed whether Merrill Lynch's

70 VCG Special Opportunities Master Fund Ltd. v. Citibank N.A., 594 F. Supp. 2d 334, 340 (S.D.N.Y. 2008); Wachovia Bank, N.A. v. VCG Special Opportunities Master Fund, Ltd., Case No. 1:2008cv05655 (S.D.N.Y. 2008).

71 *Id.*

72 *Citibank N.A.*, 594 F. Supp. 2d at 338.

73 *Id. See also* Complaint at 1, 594 F. Supp. 2d at 338 (No. 08 CV 01563).

74 *Id.* at 344.

75 *Id.*

76 Arguably, this case arose as a last ditch effort to recover capital since nearly 40% of VCG's $50 million under management was held by Citi and Wachovia. Thom Weidlich, *Citigroup Didn't Cheat Fund on Swap, U.S. Judge Rules*, BLOOMBERG.COM, Nov. 6, 2008, http://www.bloomberg.com/apps/news?pid=20601127&refer=law&sid=aZm3E9LSFECQ.

77 Merrill Lynch Int'l v. XL Capital Assurance, Inc., 564 F. Supp. 2d 298, 299 (S.D.N.Y. 2008).

78 *Id.* at 305.

79 *Id.* at 301-03.

80 *Id.*

dual assignment amounted to anticipatory breach of contract and whether the doctrine of adequate assurance applied where XL Capital had sought assurances from Merrill Lynch that it did not intend to breach its contract with XL Capital.[81] The court rejected XL Capital's anticipatory breach argument, holding that, while there was a dual assignment of one of the tranches, Merrill Lynch never prevented itself from complying with its obligations to XL Capital and had the opportunity to take certain actions in lieu of breach if a conflict were to arise.[82] Further, the court rejected the assurances argument in the context of CDS agreements because it lacked applicability under the New York Uniform Commercial Code; however, even if applicable, the court stated that Merrill Lynch's assurances were sufficient.[83] The most important takeaway from the Merrill Lynch case is the judicial assurance that defenses are available where a CDS agreement is not honored[84] and that courts will not give special treatment to CDS cases because of the market conditions—these are financial contracts between sophisticated parties and will be litigated as such.

IV. TOO MANY WHITE KNIGHTS COMING TO THE RESCUE

As demonstrated, these recent CDS cases involved classic contract doctrines because there is no specific regulatory regime for CDS agreements. Currently, CDS agreements operate in a bilateral, over-the-counter (OTC) market.[85] However, the general public has demanded regulatory reform in the wake of the market fallout. Many states and federal agencies have suggested reforms, but not all proposals address the primary needs of a CDS market while preserving the device's usefulness.

CDS agreements are financial tools with a specific purpose. Over-regulation may eliminate their utility altogether. Upon observing how CDS agreements are utilized, there are three primary areas that need to be addressed when considering impending regulation. First, regulators need to acknowledge the high levels of counterparty risk currently in the system. Second, regulators must attend to the complete lack of transparency for CDS agreements.[86] Third, regulators have to address the reasons for leverage that has grown to astronomical levels for the parties involved.

The current market turmoil exemplifies how high counterparty risk can be detrimental. The risk that a counterparty might fail to fulfill its obliga-

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81 *Id.* at 305-06.

82 *Id.*

83 *Merrill Lynch*, 564 F. Supp. 2d at 305-06.

84 *Id.*

85 *Credit Derivatives Hearing*, *supra* note 61, at 1 (statement of Erik R. Sirri, Dir. of Div. of Trading and Mkts., SEC).

86 *Id.*

tions under a CDS agreement when joined by a large, irregular financial event can create a domino effect where there is insufficient liquidity to hedge appropriately or to deliver on a CDS agreement when required.[87] In 2005, the Federal Reserve and the International Swaps and Derivatives Association (ISDA)[88] adopted a procedural device requiring parties to inform their counterparty within days of a novation and to identify the new counterparty.[89] However, widespread losses and other market factors made this process ineffective because capital and replacement parties were often unavailable. While this may be considered a worst-case scenario, it is still a contingency that policymakers need to address in developing a regulatory scheme to prevent a repeat of the current economic crisis.

The lack of transparency in the CDS market has led to a high level of systemic risk.[90] Systemic risk is an economic event, outside normal market swings, that triggers a failure or chain of significant losses in financial markets or institutions, resulting in an increase in volatility, an increase in cost of capital, and a decrease in the availability of capital.[91] The classic example of systemic risk is a banking panic, commonly referred to as a "run on the bank." During a banking panic, many individuals withdraw cash from a bank over a short period of time.[92] Systemic risk is frequently offset by market transparency and government regulation.[93] In 1934, the Federal Deposit Insurance Corporation and various other modern central banking policies largely eliminated the systemic risk associated with a "run on the bank."[94] However, the government does not regulate or require transparency in the CDS market.

The lack of transparency in the CDS market increased systemic risk by reducing the ability of regulators and private enterprises to monitor exposure by market participants.[95] Two primary forms of transparency exist: public trading transparency and regulatory transparency. One example of

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87 Peter E. Haagensen, Director of Derivative Counterparty Management for Deutsche Bank AG London, Counterparty Risk Management of Derivatives, Paper Presentation at the Int'l Monetary Fund Expert Forum on Advanced Techniques of Stress Testing: Applications for Supervisors, in Washington, D.C. (May 2-3, 2006).

88 The International Swaps and Derivatives Association, Inc. is an organization representing participants in the derivatives industry and has over 800 member institutions from 56 countries on six continents. *See* About ISDA, http://www.isda.org (last visited Apr. 17, 2009).

89 PAUL C. HARDING, A PRACTICAL GUIDE TO THE 2003 ISDA CREDIT DERIVATIVES DEFINITIONS 167-69 (2003).

90 Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 218 (2008) [hereinafter Schwarcz, *Systemic Risk*].

91 *Id.* at 204.

92 Nicholas T. Chan, Mila Getmansky, Shane M. Haas, & Andrew W. Lo, *Systemic Risk and Hedge Funds* 1 (MIT Sloan Sch. of Mgmt., Working Paper No. 4535-05, 2005), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=671443.

93 *Id.* at 20.

94 *Id.* at 1.

95 Schwarcz, *Systemic Risk*, *supra* note 90 at 228.

public trading transparency is an open market setting like a public exchange. An example of regulatory transparency is a banking system where disclosure may be opaque to the public but known to regulators.[96] Each type of transparency has a unique set of advantages and disadvantages.

Adding public trading transparency to a financial system may increase the informational efficiency or the amount of freely available data, which can improve transaction price efficiency as well as cause prices to converge more quickly.[97] Conversely, high levels of transparency may increase the bid-ask and other spreads because the public market removes the need to compete for order flow. Thus, while informationally efficient, public trading transparency impacts transactional efficiency.[98]

Regulatory reporting allows investors to make informed decisions based on an agency verification of asset measures and required reserves.[99] This system is less transparent in the traditional sense of publicly available data; some commentators question the underlying performance of the firm and reactions to its stability when regulatory disclosure is the only level of transparency for the system.[100] Other studies have shown that less transparent markets may become more informationally efficient for investors by preventing data overload.[101]

While different levels of transparency provide varying degrees of comfort to different types of investors, the government has failed to institute either a public or regulatory transparency system in the case of CDS agreements. A byproduct of this failure is the investors' inability to quantify the impact on the market and identify parties with direct or indirect exposure. Additionally, the lack of transparency creates an inability to establish appropriate metrics for capital adequacy and liquidity.[102] Adding some level of public or regulatory transparency to an orderly and mandatory system would not only encourage information equality in the system but also allow capital markets to operate more efficiently.

An over-leveraged system is another cause for concern. Leverage is the use of borrowed funds, rather than equity, to finance one's position.[103] A highly leveraged company is one with a large amount of debt compared

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96 FINANCIAL SECTOR GOVERNANCE 425-26 (Robert E. Litan et al. eds., Brookings Institute Press 2002).

97 Robert Bloomfield & Maureen O'Hara, *Market Transparency*, 12 REV. OF FINANCIAL STUDIES 5, 28 (1999).

98 *Id.* at 29.

99 Robert M. Bushman, *Bank Transparency, Loan Loss Provisioning Behavior, and Risk-Shifting* 2 (University of North Carolina-Chapel Hill Kenan-Flagler Sch. of Bus., Working Paper, 2007), *available at* http://public.kenan-flagler.unc.edu/faculty/bushmanr/Bank_Transparency_Loan_Loss_Provisioning_Behavior.pdf.

100 *Id.*

101 Bloomfield & O'Hara, *supra* note 97, at 29.

102 Schwarcz, *Systemic Risk*, *supra* note 90 at 228.

103 Sean M. Donahue, *Hedge Fund Regulation*, 55 CLEV. ST. L. REV. 235, 238 (2007).

to its equity positions. Leverage is not inherently bad, but since systemic risk is caused by unpredictable events, an effective way to prevent the drastic impact of negative shifts in the economy is to limit the amount of leverage in the system.[104] Leverage must be adequately observed so that market participants can calculate the risk associated with such additional leverage and subsequently demand higher payments.[105] In addition to tying risk to payment, which is a fundamental issue in any investment, addressing leverage in the CDS market can reduce both the risk of firm failure due to CDS exposure and the probability of a chain of subsequent failures.[106] Keeping counterparty risk, transparency, and leverage in mind, it is prudent to observe some of the currently proposed regulatory regimes.

A. *Regulation as Insurance*

Prior to 2009, CDS agreements were not regulated like insurance contracts.[107] The argument that government should not treat CDS agreements as insurance contracts hinges on the June 2000 opinion of the State of New York Office of General Counsel (NYOGC).[108] The NYOGC opinion letter addressed a fairly narrow question involving buyers who did not suffer economic losses and not all CDS agreements generally.[109] The State of New York has taken the first steps to reverse this position in their Circular Letter No. 19, dated September 22, 2008.[110]

Circular Letter No. 19 states that the NYOCG will be reviewing its June 2000 opinion because it did not consider certain forms of CDS agreements and that such omissions "will be rectified and addressed in a forthcoming opinion."[111] The prevailing attitude with the issuance of Circular Letter No. 19 is that the New York Insurance Department (NYID) will require sellers of CDS agreements to be licensed insurance providers in the state.[112] Nevertheless, Circular Letter No. 19 only applies to CDS agreements that are structured more similiarly to traditional insurance contracts, where buyers hold—or reasonably expect to hold—a "material interest" in

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104 *Id.* at 249.

105 Thomas Schneeweis, Editorial, *Dealing with Myths of Hedge Fund Investment*, 1 J. ALTERNATIVE INVESTMENTS 11, 12 (1998), *available at* http://cisdm.som.umass.edu/research/pdffiles/hedgefundmyths.pdf.

106 Schwarcz, *Systemic Risk*, *supra* note 90 at 239.

107 *See infra* Section II(a).

108 Funding Agreement Securitizations, State of New York Office of General Counsel (Apr. 18, 2000), *available at* http://www.ins.state.ny.us/ogco2000/rg004181.htm (informal opinion representing the New York State Insurance Department).

109 *Id.*

110 Circular Letter No. 19, *supra* note 30, at 1.

111 *Id.* at 7.

112 *Id.*; N.Y. INS. LAW § 1102 (McKinney 2008).

the underlying referenced obligation of the CDS.[113] This leads to the still open-ended question of what constitutes a reasonable expectation of holding the material interest. While the NYOGC has not provided an opinion on this part, the State of New York has specified that it will not regulate "naked credit default swaps," which are CDSs in which the buyer has no insurable interest.[114] Yet, the general intent of Circular Letter No. 19 was for the State of New York to regulate at least some CDS agreements as insurance contracts.

The New York insurance action has done little to address the primary regulatory problems with CDS agreements. First, the NYID is responsible for regulating *insurance businesses* in the State of New York rather than the corporations, CDS dealers, or hedge funds that primarily use CDS agreements. Thus, this form of state regulation fails to address counterparty risk.[115] Second, the NYID does not have the general authority to increase the transparency of CDS agreements or to ultimately lower systemic risk on a broad scale.[116] Finally, since this regulation requires a party to own the underlying obligation in conjunction with the CDS agreement before facing regulatory scrutiny, it does not substantially affect leverage issues to provide meaningful protection to market participants. While the New York proposal may have the best of intentions, it overlooks the most salient points of CDS regulation and is simply too narrow in scope to be truly effective.

B. *Regulation by the Securities and Exchange Commission*

The SEC publicly stated that it wants to regulate CDS agreements.[117] In contrast with the announced policy of the State of New York, the SEC has proposed a regulatory scheme that targets "naked" CDS transactions.[118] In December of 2008, the SEC took action in conjunction with the Federal Reserve, the Federal Reserve Bank of New York, the CFTC, and the U.K. Financial Services Authority to introduce a proposal for the creation of a

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[113] Circular Letter No. 19, *supra* note 30, at 7.

[114] Press Release, State of New York, *Governor Paterson Announces Plan to Limit Harm to Markets from Damaging Speculation* (Sept. 22, 2008), *available at* http://www.ny.gov/governor/press/press_0922081.html.

[115] *See generally* Welcome To The New York State Insurance Department's Information Center, http://www.ins.state.ny.us/hp97wel.htm (last visited Apr. 17, 2009).

[116] *Id.*

[117] Tessa Moran, *SEC Chairman Urges Congress to Provide Authorities to Regulate CDS Markets*, FORBES.COM, Sept. 23, 2008, *available at* http://www.forbes.com/afxnewslimited/feeds/afx/2008/09/23/afx5459275.html.

[118] *Id.*

central counterparty clearinghouse (CCP) for the CDS market.[119] In a CCP, the clearinghouse or market buys the derivative through a process known as novation.[120] A CCP involves an intermediary, unlike a typical bilateral agreement. In a bilateral agreement, there is a contract between a seller and a buyer and the seller suffers the risk of the buyer's default.[121] In a CCP, the clearinghouse acts as a third-party intermediary (like a guarantor) and is substituted as a counterparty for either the buyer or the seller in the CDS agreement; if the buyer defaults or the underlying event triggers the due date of the contract, the CCP pays the seller the required amount.[122] The SEC's action in conjunction with a diverse array of agencies primarily highlights the scope of the task at hand.[123]

Pursuant to Section 206A of the Gramm-Leach-Bliley Act, which excludes from the definition of "security" both non-security-based and security-based swap agreements, the SEC is prohibited from acting directly to regulate the CDS agreements.[124] However, the SEC asserts that a regulated CCP to clear CDS transactions would promote efficiency, reduce risk among the participants, and address liquidity issues.[125] The SEC further argues that market participants could net positions in similar instruments to net gains and losses across different instruments while reducing redundant notional exposures and promoting the more efficient use of resources for managing CDS positions.[126]

The SEC proposal is poised to address the primary market issues brought about by the lack of CDS regulation. The SEC proposal addresses counterparty risk by substituting the credit of the clearinghouse for the credit of the counterparty while creating some transparency that would allow for adequate benchmarking.[127] The CCP also regulates markets where the CDS buyer does not own the underlying obligation as well, which should reduce leverage. The primary problem with the SEC proposal, then, is that the SEC is statutorily prohibited from regulating the CDS market.[128]

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[119] Order Granting Temporary Exemptions Under the Securities Exchange Act of 1934 in Connection with request of LIFFE Administration and Management and LCH.Clearnet Ltd. Related to Central Clearing of Credit Default Swaps, and Request For Comments, Exchange Act Release No. 34-59164, File No. S7-34-08, 74 Fed. Reg. 139-01, 2009 WL 7532 (F.R.), at 139 n.1 (Dec. 24, 2008), *available at* http://www.sec.gov/rules/exorders/2008/34-59164.pdf [hereinafter SEC Release No. 34-59164].

[120] Pirrong, *The Clearinghouse Cure*, *supra* note 67, at 45.

[121] *Id.* at 46.

[122] *Id.*

[123] SEC Release No. 34-59164, *supra* note 119, at 139 n.7.

[124] Gramm-Leach-Bliley Act of 1999 § 206(a)(5), 15 U.S.C. § 78c (2006) (as incorporated into the Exchange Act § 3(a)(4)(B)(ix)).

[125] SEC Release No. 34-59164, *supra* note 119 at 140.

[126] *Id.* at 140 n.13.

[127] *Credit Derivatives Hearing*, *supra* note 61, at 3 (statement of Walter Lukken, Acting Chairman, CFTC).

[128] *See* Gramm-Leach-Bliley Act, *supra* note 124.

Thus, it has made its proposal largely to Congress to assume the authority, but it is not currently empowered to regulate the CDS market.

C. *Regulation by the Commodity Futures Trading Commission*

Like various state agencies and the SEC, the CFTC is also vying for the ability to regulate CDS agreements.[129] The CFTC made a proposal similar to that of the SEC; the key difference, however, is that the CFTC has made it very clear that it can regulate the CDS market without further legislation.[130] The CFTC is seeking to establish a central clearinghouse with the following attributes:

(1) appropriate membership standards and continuing oversight of members;

(2) collection of position reports from large traders;

(3) daily mark-to-market of all open positions;

(4) collection of an appropriate amount of performance bond...;

(5) periodic stress-testing of open positions;

(6) an ability to liquidate all of a market participant's open positions quickly; and

(7) availability of other financial resources for use by the clearinghouse to cover any member default.[131]

The CFTC clearinghouse proposal, like the SEC's CCP proposal, could simultaneously reduce counterparty risk and systemic risk while promoting transparency. The CFTC also proposes market requirements such as minimum capital requirements that could affect the overall system leverage. Unlike the SEC and NYID proposals, the CTFC has the regulatory experience to implement such a regime.[132]

V. RECOMMENDATIONS

A number of factors should be evaluated before implementing a new derivatives market, including (1) the general structure of the agency charged with CDS agreement oversight; (2) the expected economic consequences of the regime's plan to address the CDS agreement problems; and (3) the effects of CDS regulation on the long-term use of such instruments.

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[129] *See generally Credit Derivatives Hearing*, *supra* note 61 at 5 (statement of Walter Lukken, Acting Chairman, CFTC).

[130] 7 U.S.C. 1 § 7a-1 (2007) (enacting 12 U.S.C. § 4422, which governs the clearing of derivative instruments and prohibits the operation of a clearing organization unless registered with the CFTC or the SEC).

[131] *Credit Derivatives Hearing*, *supra* note 61, at 5 (statement of Walter Lukken, Acting Chairman, CFTC).

[132] Gramm-Leach-Bliley Act, *supra* note 124.

The creation of a central clearinghouse may be a good solution for CDS accountability going forward. Before discussing the specifics of the system, however, it is appropriate to first consider a parallel to clearinghouses for another type of derivative—the U.S. Futures Exchange.

The futures clearinghouse provides a good metric for evaluating a CDS clearinghouse. In the futures clearinghouse, regulators have the ability to structure their risk management system to coincide with current market conditions by specifying minimum margins and creating a liquid market for members.[133] These checks and balances may be considered nominal when those dealers using the system are already managing their counterparty risk. However, these checks and balances would change the nature of the current bilateral, over-the-counter CDS market.[134] Under the current unregulated system, the participants essentially shift their risk to the whole market, as well as the risk of ultimate failure of any given party. When only small players are involved this is not a problem, but when the party in question is a company of the scale of AIG, the results can be catastrophic. In a clearinghouse structure, binding capital requirements limit the probability that a member will fail in a down market such as the present, and further mechanisms can be put into place to absorb the failure of individual members.[135]

The next question is, who will be charged with regulating the CDS market, whether by means of a clearinghouse or otherwise? Due to the national scope of CDS agreements, a federal agency is the most logical choice to build the structure for CDS regulation. Neither the SEC nor the CFTC is charged with correcting this apparent market shortfall,[136] but like the NYID and other state agencies, both are vying for the opportunity to do so. Additionally, four separate exchange systems have given independent presentations to host the CDS clearinghouse once the regulatory issues clear.[137] While the SEC is lobbying to treat CDS agreements as securities, the CFTC is in the best position to address the matter efficiently in light of its previous experience in derivatives markets.[138] This does not mean the

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[133] R. Bliss & C. Papathanassiou, *Derivatives Clearing, Central Counterparties and Novation: The Economic Implications* 7 (Working Paper Mar. 8, 2006) *available at* http://www.ecb.int/events/pdf/conferences/ccp/BlissPapathanassiou_final.pdf.

[134] *Id.*

[135] *Id.*

[136] *Credit Derivatives Hearing*, *supra* note 61, at 1 (statement of Walter Lukken, Acting Chairman, CFTC).

[137] LIFFE, the CME Group, Intercontinental Exchange, and Eurex have presented proposals to operate the CDS clearinghouse. *See* Matthew Leising, *Fed Sets Deadline for Details on Backing Credit Swaps*, BLOOMBERG.COM, Oct. 28, 2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=aGBsXjRyeav8&refer=home.

[138] The Division of Clearing and Intermediary Oversight of the Commodity Futures Trading Commission is responsible for the oversight of market intermediaries, including derivatives clearing organizations, financial integrity of registrants, customer fund protection, stock index margin, sales practice

SEC has no role to play, but in fact, calls for SEC influence to spearhead the process and shape policies. The scope of state agencies' operations are simply too narrow. Because CDS agreements can act on a global basis, the burden imposed by CDS regulation on a state level would impose restrictions that are too onerous and costly to be effective.

One must also observe present market conditions in the context of an oversight system. The financial markets are facing the major issue is credit lockup. Congress enacted the Troubled Asset Relief Program (TARP) to open up lines of credit for consumer and commercial lending.[139] One of the other major reasons for the continued credit lockup is related to the lack of trust in inter-bank lending.[140] It is theorized that a centralized clearinghouse will address this issue by reducing the fear of default.[141] When comparing a proposed CDS clearinghouse to other similar futures markets, the largest futures clearinghouses traded a record 2.2 billion derivative contracts in 2007 and exercised a twice-daily "mark-to-market" process in an attempt to avoid compounding losses.[142] Moreover, no U.S. futures clearinghouse has ever defaulted on its guarantees.[143] This provides a good observation of how a clearinghouse can alleviate the probability of default and ultimately help reestablish market trust by substituting the market credit for the participants' credit.[144] A clearinghouse may also help alleviate some of these concerns vis-à-vis transparency and liquidity requirements. Finally, the clearinghouse could provide a benchmarking system to all parties to value the outstanding CDS agreements already in the market. While the clearinghouse method addresses some current problems, it poses additional concerns.

Any clearinghouse system implemented must preserve some of the utility of CDS agreements. CDS agreements became popular because they were easy to execute and lacked regulation. The utility of these instruments may be lost with the institution of a centralized system. This argument

reviews, foreign market access by intermediaries, and National Futures Association activities related to intermediaries. *See* About the CFTC, http://www.cftc.gov/aboutthecftc/index.htm (last visited Apr. 17, 2009).

139 Edmund L. Andrews, *U.S. Shifts Focus in Credit Bailout to the Consumer*, N.Y. TIMES, Nov. 13, 2008, at A1.

140 *Monetary Policy and the State of the Economy: Hearing Before the H. Comm. on. Fin. Servs.*, 110th Cong. 8 (2008), *available at* http://www.house.gov/financialservices/hearing110/ht022608.shtml (statement of Nouriel Roubini, Prof. of Econ. at Stern Sch. of Bus., New York Univ. and Chairman of RGE Monitor).

141 Pirrong, *The Clearinghouse Cure*, *supra* note 67, at 45-46.

142 *Credit Derivatives Hearing*, *supra* note 61, at 4 (statement of Walter Lukken, Acting Chairman, CFTC).

143 Matthew Leising, *Peterffy Says CME Group Credit Swap Plan Puts Billions at Risk*, BLOOMBERG.COM, Oct. 11, 2008, http://www.bloomberg.com/apps/news?pid=20601110&sid=a2pK9HrK58_Y.

144 *Credit Derivatives Hearing*, *supra* note 61, at 3 (statement of Walter Lukken, Acting Chairman, CFTC).

against regulation can be counter-balanced with evidence of market fallout and the number of parties that lost on unregulated CDS agreements. An oversight regime, while making CDS agreements nominally more difficult to execute and subject to regulation, could ultimately enhance the aggregate value and utility of CDS agreements.

Another issue is that any party acting to clear the agreements will most likely need credit and risk controls in excess of other derivative clearinghouses because of the short-term effects of the instruments on the market.[145] This enhanced market protection will be a cost of doing business for CDS holders, which may get extraordinary pushback during a time when capital is very short.[146] A final issue with a clearinghouse system in contrast to an over-the-counter system arises in light of the highly customized agreements.[147] The clearinghouse model does not handle customized and infrequently traded agreements with the same efficiency as standard CDS agreements. However, one option would be to carve out an exception for the existing custom CDS agreements in the proposed clearinghouse regime.

There must be a clear balance between the utility of CDS agreements and the costs of a regulatory regime. Without conducting a wholesale revision of the cross-regulation of the SEC, banking system, and commodities market, the CFTC should be charged with implementing and overseeing a CDS clearinghouse. Its vast experience in derivatives regulation would be essential to a rapid and wholesale installation. The CFTC needs to conduct adequate due diligence in bidding and partnering with a clearinghouse company based on such a company's past experience in similar installations. CDS agreements, while having some different flavors, are still derivatives which can be ably managed by several credit-worthy, well-funded clearinghouse companies suitable to become partners with the CFTC in regulating the CDS market.

The clearinghouse would provide a centralized risk management system for both regulated and over-the-counter CDS agreements. The clearinghouse could help build the market for existing contracts while carving out a specific exception for custom CDS agreements, which are estimated to account for 10% to 20% of the CDS market.[148] While building a direct

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145 Pirrong, *The Clearinghouse Cure*, *supra* note 67, at 46.

146 *Id.*

147 Highly customized agreements have already been proposed by Collin Peterson, a House of Representatives member from Minnesota, to allow CFTC to exempt certain agreements that are too customized to be cleared. Matthew Leising & Shannon D. Harrington, *Credit Swaps Industry Says Limits Would Hamper Market*, BLOOMBERG.COM, Jan. 29. 2009, http://www.bloomberg.com/apps/news?pid=20601110&sid=aWuHY2JsDEaM.

148 Ryan Graff, *CME Urges Exchange-Based Market for Credit Default Swaps*, NW. U. MEDILL REPORTS-CHICAGO, Oct. 14, 2008, *available at* http://news.medill.northwestern.edu/chicago/news.aspx?id=100773 (quoting Terrence Duffy, Executive Chairman of the Board of CME Group, who told members of the Senate Committee on Agriculture, Nutrition and Forestry that an exchange system could standardize 80% to 90% of CDSs).

and transparent market for the standardized agreements, it would also enable the use of clearinghouse data to better evaluate price positions on those non-standard CDS agreements. This type of system would permit private regulation of market participants by the clearinghouse in terms of liquidity and other financial metrics as well as governmental oversight by the CFTC in terms of alleged wrongdoing and audits. Of course, there will be regulatory and market hurdles to overcome, but the CFTC was in a similar situation with regard to energy markets following the collapse of Enron in which market innovation and exotic products resulted in the demand for regulation based on then existing rules that were not crafted to handle such devices.[149]

Enron's derivatives trading was largely over-the-counter and unregulated, but following the company's implosion, a significant number of energy derivatives are now cleared through regulated clearinghouses, which arguably reduced systemic risk and provided regulators with access to insight into the market.[150] The post-Enron regulation also provides an interesting parallel to the proposed CDS clearinghouse since trading is split between an over-the-counter market and a regulated clearinghouse.[151] Based upon analysis by the U.S. Government Accountability Office, even during a time of large purchasing and price volatility driven by a number of global events, the regulated energy derivatives clearinghouse with an over-the-counter carve out has helped to encourage price discovery in both markets based on current information, large market participation, and market transparency.[152]

Creating a combined clearinghouse and over-the-counter market for CDS agreements provides benefits on multiple levels. With the coordination of the CFTC, such a system will allow for a higher level of market transparency in combination with market regulation. This transparent system would allow those running the clearinghouse as well as the CFTC to set rules based on market conditions as they evolve. This type of system can preserve some of the utility of CDS agreements while enhancing liquidity and reducing systemic risk. Of course, it will take time to build data by which the over-the-counter devices can be properly evaluated; regardless, it will provide a starting point by which the market gears can begin to move.

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149 Susan C. Ervin, *CFTC Regulation of Energy Derivatives: An Overview*, 2002 A.B.A. SEC. BUS. L. REP. 1-12, *available at* http://www.abanet.org/buslaw/corporateresponsibility/clearinghouse/02annual/37/ervin.pdf (report before the American Bar Association Committee on Futures Regulation: The Aftermath of Enron: More Regulation or Continued Deregulation).

150 *Credit Derivatives Hearing*, *supra* note 61, at 4 (statement of Walter Lukken, Acting Chairman, CFTC).

151 *Hearing Before the Subcomm. on Gen. Farm Commodities and Risk Mgmt. of the H. Comm. on Agric.*, 110th Cong. 4 (2007), *available at* http://agriculture.house.gov/hearings/110.html (statement of Orice M. Williams, Dir. of Fin. Mkts. and Cmty. Inv., U.S. Gov't Accountability Office).

152 *Id.*

VI. CONCLUSION

Policymakers have fought for a variety of reasons to keep CDS agreements unregulated and as past experience has shown, the over-the-counter, self-regulated market resulted in a catastrophe. Government officials have identified CDS agreements as a leading cause of the current financial meltdown. CDS agreements continue to be useful tools for creating diversity and hedging some risk, but their unpredictable tax treatment, lack of oversight, and the inability to account for their financial statement implications creates the need for a more organized system.

Since CDS regulation is a main focus for those involved in this round of market fallout, many state and federal government agencies desire to be the central institution that shapes the regulations to save the system. While state agencies like the NYID have good intentions to put CDS agreements within their scope of responsibility, they do not have the structure or legal reach to properly govern these devices. Regulation by a state agency would further diminish the efficacy of CDS agreements and add many layers of unnecessary cost and complexity to their use, which could ultimately eliminate their effectiveness entirely. Further, treatment of CDS agreements as insurance contracts could have adverse and unintended tax consequences. The SEC and CFTC are better poised to institute one of their proposed clearinghouse policies to regulate CDS agreements.

Clearinghouses can provide a multitude of benefits to the public. The clearinghouse system will provide for a liquid market where parties may operate. By increasing transparency, the clearinghouse would reduce systemic risk and may lead to more adequate metrics for capital adequacy. This may reduce the leverage in the system and avoid future cataclysmic results that Americans are presently experiencing from Wall Street to Main Street. Further, a regulatory system will help sort out the present crisis by creating a market conducive to benchmarking. Both the SEC and CFTC have regulatory hurdles to overcome, but the CFTC is well poised to institute futures market regulation as authorized by Congress and proven through experience.

Investors created CDS agreements to provide some level of certainty and offset risk in an otherwise uncertain financial world. Unfortunately, the market grew too large too fast and by its unregulated nature had much more far-reaching implications than could have been foreseen. While CDS use has been curtailed and the details are still being sorted out, a regulatory regime is necessary going forward to avoid a repeat of the present problem.