THE REAL ESTATE COVENANT AS COMMONS:

INCOMPLETE CONTRACT REMEDIES OVER TIME

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I. INTRODUCTION

Real estate covenant regimes are a form of common pool resource in which property owners retain ultimate ownership but contractually surrender some rights to the use of their land into a commons. The pooled rights generate surplus (additional value from the exchange) for the owners.[1] This article will explore the efficiency of legal rules protecting covenants, applying three perspectives: the property/contract interface, incomplete contracts and common pool resource literatures. Efficiency will be considered at two points: (1) when the initial investment decision is made (ex ante in law-and-economics terminology), and (2) at a later point (ex post) when a new use would be higher-valued and the covenant should be modified or terminated.

Covenants are interests along the property/contract interface: promises with respect to the use of land. Doctrinally, these contractual interests may be characterized as real covenants, equitable servitudes, or occasionally even easements, but for purposes of this article, I will follow common parlance and refer to all promises relating to land use as "covenants."[2]

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[1] In an effort to make the article more accessible, I have tried to write in plain English, with references to law-and-economics terminology added for the benefit of specialists.

[2] Academics prefer the term "servitudes," J. E. Stake, *Land-Use Doctrines*, *in* NEW PALGRAVE DICTIONARY OF LAW AND ECONOMICS 437 (Peter Newman, ed., 1998) [hereinafter Stake, *Land-Use Doctrines*]; RESTATEMENT (THIRD) OF PROPERTY, SERVITUDES (1998). But practitioners usually talk about "covenants." The Restatement uses "servitudes" to refer to covenants, easements, and other permanent restrictions on the use of land. While negative easements are, in effect, a covenant to permit the use of land for a specific purpose, easements are generally simple rights of passage rather than use restrictions, and will therefore not be considered in this article. At common law, the default rule is that

As discussed in Part III.A, the choice between property or contract status is determined by which will maximize investment while minimizing the sum of holdout and transaction costs on renegotiation. When investment incentives predominate, this favors property status protected by property rules. When the later risks of high transaction costs and holdouts predominate, this favors contract status, which allows easy breakage protected by liability rules. Because real estate is an investment-intensive asset class, covenants are generally given property status and governed by property rules protected by injunctions. The investment induced by the property status of generates an expectation of surplus for each unit owner; when these rights are defeated, the result may be demoralization leading to underinvestment.[3]

The incomplete contracts literature, discussed in Part III.B, looks at the remedies the parties would design to maximize both efficient investment and efficient renegotiation or breach.[4] Applying a nontechnical version of incomplete contracts theory, this article will determine whether the legal rules applied in practice are efficient. It will look at the choice of property rules: injunctions versus private-ordered remedies such as fines, forced sale, or self-help, and will apply recent work on erosion rules[5] – rights that diminish if unenforced – to look at the impact of transaction costs on investment.

The common pool resource literature, as discussed in Part III.C, examines governance as a solution when the holdout risk is too high to justify property rule protection of a shared investment, but the investment incentives are too important for liability rule treatment.[6] Viewing common pool resources and covenant regimes as a form of collective property, this article will examine how community association governance structures and remedies regimes reduce transaction costs, and the effect this has on inducing efficient investment in the short term as well as efficient termination in the long term.

The primary conclusions are, as discussed in Part IV, first, that the courts should give greater respect to the private ordering of remedies, such as fines, self-help, and expulsion for most covenant violations. These

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real covenants do not run with the land, but parties routinely contract around this, Stake, *Land Use Doctrines*, *supra* note 2, so this article will assume that all covenants run with the land.

[3] Frank Michelman, *Property, Utility, and Fairness: Comments on the Ethical Foundations of "Just Compensation" Law*, 80 HARV. L. REV. 1165 (1968). *See* discussion *infra* text at note 81.

[4] The recent incomplete contracts literature on the design of remedies for nuisance and covenants is Lucian Arye Bebchuk, Ex Ante Investments and Ex Post Externalities, unpublished manuscript (Dec. 2001), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=297091 [hereinafter Bebchuk, Ex Ante Ex Post]; Lucian Arye Bebchuk, *Property Rights and Liability Rules: The Ex Ante View of the Cathedral*, 100 MICH. L. REV. 601 (2001) [hereinafter Bebchuk, *Ex Ante Cathedral*]; Rohan Pitchford & Christopher M. Snyder, *Coming to the Nuisance: An Economic Analysis from an Incomplete Contracts Perspective*, SSRN Stanford/Yale Jr. Faculty Forum Paper No. 01-17 (February 16, 2001).

[5] Omri Ben-Shahar, *The Erosion of Rights by Past Breach*, 1 AM. L. & ECON. REV. 190-238 (1999).

[6] For a synthesis of the common pool resource literature, see ELINOR OSTROM, GOVERNING THE COMMONS: THE EVOLUTION OF INSTITUTIONS FOR COLLECTIVE ACTION 29-57 (1990).

remedies provide lower-cost enforcement than the current regime of injunctive relief and limit the inefficient erosion of covenant regimes. Second, as discussed in Part V.A, over decades, covenant regimes are likely to be inefficiently rigid, a problem made worse because the rise of the community association has radically lowered enforcement costs. This results in an anticommons[7] where fragmented control prevents transfers of property to more efficient uses. Third, as discussed in Part V.B.1-3, to combat this, courts should use mixed property-liability rules in the form of supercompensatory damages for major use violations occurring more than 40 years after creation of the covenant regime. Supercompensatory damages would limit demoralization from defeated investment expectations (if contract status protected by a liability rule applied) or of excessive performance of an uneconomic promise (if property status protected by injunctive relief applied). Fourth, as discussed in Part V.B.4, courts should be more willing to allow consensual releases of individual lots from covenant regimes.

Finally, Part V.C discusses affirmative covenants, which are more contract-like than negative covenants, in that they involve expenditures by the covenantor that can potentially generate unlimited losses. Yet a breached affirmative covenant may demoralize a covenantee who made a substantial investment based on it, as with a promise to install a sewer system. Here, too, mixed property-liability rule damages (adjusted for the covenantor's greater risks) can balance the initial and later incentives of the covenantor and covenantee.

II. REAL ESTATE COVENANTS: A BRIEF HISTORY

In the beginning, there was nuisance law. When the use of one property was so noxious as to interfere with the use of another property, courts found a nuisance and usually barred it with an injunction.[8] This addressed only extreme situations, however, and with the rise of large-scale upper-income residential real estate development and the segregation of land uses in beginning in late 17th century England and the 19th century United States, developers and residents began to find this inadequate. An elite single-family residence derived part of its value from being in a neighborhood of similarly elite homes. Its value could be diminished by something that did not rise to the level of a nuisance: a stable, factory, or working class tenement. In those pre-zoning days, developers created a private-ordered solution to maximize their sale prices: agreements running with the land that permitted only residential use, imposed setbacks from the

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[7] Michael Heller was the first to analyze the anticommons in depth. Michael A. Heller, *The Tragedy of the Anticommons: Property in the Transition from Marx to Markets*, 111 HARV. L. REV. 621 (1998) [hereinafter Heller, *Anticommons*]. *See* discussion *infra* Part V.A.

[8] The earliest form of the tort dates back to the 13th century, with injunctive relief becoming available by Edward III's 14th century reign. W. PAGE KEETON ET AL., PROSSER & KEETON ON THE LAW OF TORTS (5th ed. 1984) § 86.

street leaving generous yards, and forbade uses like tanneries or saloons.[9] In effect, these were contractually created nuisances, preventing property development that common law nuisance would have permitted.[10]

As another method of maximizing value, early developers began to provide amenities. One of the first was London's Bloomsbury Square, a semi-public park, in 1660.[11] But because a simple negative pledge would not maintain these amenities, community associations developed,[12] beginning with Gramercy Park in New York City (developed in 1831, the park is held in trust for the surrounding owners who control the trust) and Louisburg Square in Boston (developed in 1842, the first true community association).[13] Throughout this article, the area covered by a covenant regime will be referred to as a "subdivision." The governing body, if any, will be referred to as a "community association," and the owners of properties subject to covenant regimes will be referred to as "unit owners."

Community associations continued to develop through the creation of St. Louis' late 19th century private streets, and early planned town experiments such as Radburn, New Jersey and Sunnyside, Queens. They received a further boost from the first condominium statute, Puerto Rico's, and federal tax subsidies that encouraged even those who could not afford freestanding homes to purchase condominium interests.[14] Community associations greatly expanded after the mid-1960s as condominium statutes spread. Also in that period, developers created the new organizational form of the planned unit development, in which owners got a fee simple absolute and the community association ran the common elements.[15] Community

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[9] Tulk v. Moxhay, 41 Eng. Rep. 1143 (1848). In 17th and 18th century London, most of the great estates were entailed or held in trust, and parcels of land could not be sold in fee. Thus, land use in upscale developments was restricted through covenants in long-term ground leases that ran from the tenant to the aristocratic landlord, rather than through the mutual covenants among fee owners that developed in the 19th century. *See* JOHN SUMMERSON, GEORGIAN LONDON 39-40 (Peregrine/Penguin ed. 1978). *See also* F. Frederic Deng, *Ground Lease-Based Land Use System Versus Common Interest Development*, 78 LAND ECON. 190 (2002) (relative efficiency of ground leases and covenants related to bundled provision and consumption of services, and to degree of mobility).

[10] The classic article on the difference in regulation by nuisance, covenant and zoning law is Robert C. Ellickson, *Alternatives to Zoning: Covenants, Nuisance Rules, and Fines as Land Use Controls*, 40 U. CHI. L. REV. 681 (1972) [hereinafter Ellickson, *Alternatives to Zoning*].

[11] Edward Jones & Christopher Woodward, A GUIDE TO THE ARCHITECTURE OF LONDON 15, 17, 100 (1983). In Bloomsbury Square and other early London developments, it appears that the aristocratic developer kept the square in the middle of the development unleased, developing it as a park in order to maximize the rents on the surrounding houses. Summerson, *supra* note 9, at 40-41.

[12] Developments with collective control of common elements and use restrictions are referred to by many names, some of which have different legal structures, such as common interest developments, condominiums, cooperatives, and planned unit developments. *See* Amos B. Elberg, Note, *Remedies for Common Interest Development Rule Violations*, 101 COLUM. L. REV. 1958 (2001).

[13] EVAN MCKENZIE, PRIVATOPIA 9 (1994).

[14] *See* Henry Hansmann, *Condominium and Cooperative Housing: Transactional Efficiency, Tax Subsidies, and Tenure Choice*, 20 J. LEGAL STUD. 25 (1991).

[15] *See* McKenzie, *supra* note 13. Another form of community association is cooperative apartment housing. Its first appearance in New York City, where it remains the most popular form, occurred in 1881. In cooperative apartment housing, a corporation owns the property and enters into long-term leases with its unit holders, who are also the sole corporation owners. Andrew S. Dolkart, *Cooperatives, in* THE ENCYCLOPEDIA OF NEW YORK CITY 280 (Kenneth T. Jackson, ed. 1995). The

associations were also used for commercial properties with multiple owners and shared common elements, such as shopping centers and office and industrial parks. By 1998, 14.7% of the housing stock in the U.S. was controlled by community associations – over 60% in the Los Angeles and San Diego metropolitan areas.[16] In the 50 largest metropolitan areas, more than 50% of new housing was built subject to controls by neighborhood associations.[17]

Nineteenth century covenants usually ran only a paragraph or two. However, in the 20th century, with the increasing scale of development and the decreasing cost of documentation (word processors, faxes, Federal Express, e-mail, and legions of real estate lawyers), covenants expanded like the waistline of a McDonald's habitué, sometimes running hundreds of pages long and setting out detailed relationships (e.g., type of use, setbacks, physical appearance, pets, noise, landscaping, and even whether cars can be kept in the driveway). They are called by various names in addition to covenants, including Master Deeds, Declarations of Condominium and CCRs (for Covenants, Conditions and Restrictions), and may appear in those documents or be incorporated by reference from community association by-laws, board resolutions, or rules and regulations. Doctrinally, however, if the ultimate source of authority is a covenant (for example, a board resolution bars on-street parking based on powers created in the covenant), the requirement is enforced as a covenant regardless of where it appears. In this article, both the simple and complex versions of agreements binding land will be referred to as covenants, regardless of which document they appear in or whether they are enforced by injunction, fine, or another remedy.

III. COVENANTS AS LONG-TERM RELATIONAL INTERESTS: THREE PERSPECTIVES

Covenants are ongoing relational interests[18] that generate shared surpluses – in other words, the mutual restrictions make each party's land more valuable than unrestricted land would be.[19] Three strands of literature shed light on the efficient rules for enforcing covenants, looking at the

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doctrinal issues presented by cooperative apartment leases differ from those affecting owners of fee interests. As a result, this article will primarily discuss condominiums and planned unit developments, where the owners have fee interests that are subject to recorded covenants.

[16] Steven J. Eagle, *Privatizing Urban Land Use Regulation: The Problem of Consent*, 7 GEO. MASON L. REV. 905 (1999); CLIFFORD J. TREESE, COMMUNITY ASSOCIATIONS FACTBOOK 19 (Frank H. Spink, ed.); McKenzie, *supra* note 13, at 120.

[17] Eagle, *supra* note 16, at 829.

[18] The concept of relational interests comes from an early contribution to the incomplete contracts literature, Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089 (1981).

[19] *See* Lee Anne Fennell, Contracting Communities, U. of Tex. L. & Econ. Res. Paper No. 017; U. of Tex. Law, Pub. L. Res. Paper No. 59, at 11-13 (2003), *at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=487986 (last visited on March 30, 2003) [hereinafter Fennell, Contracting Communities] (reciprocal land use controls aim to produce premium ambience that adds subjective and monetary value).

balance of investment incentives, holdout risks, and transaction costs. This part of the article examines the theoretical literature and where real-world covenants fit into it.

A. THE PROPERTY/CONTRACT INTERFACE

An outpouring of recent literature has identified factors determining whether property or contract status should apply to a given interest, and tested the factors against existing doctrine. To synthesize the findings, the choice between property and contract – the legal regime for the ownership and transfer of assets – should maximize an owner's initial efficient (ex ante) investment, while minimizing later (ex post) losses from the owner's failure to trade, due to holdouts (failure to trade the property to a higher-valued use) and transaction costs.[20] The losses include externalities, where an owner who engages in a conflicting use does not trade to a higher-valuing user, and therefore does not eliminate the conflict, because of strategic bargaining (a holdout risk), excessive subjective value (a holdout risk), or excessive transaction costs.[21] In a broad sense, every holdout *is* an externality, since the owner's failure to efficiently trade inflicts an opportunity cost on higher-valuing potential users.[22] Thus, the higher the holdout risks and transaction costs are relative to the value of the owner's investment, the greater the cost of the owner's failure to efficiently renegotiate, and the more contract-like the treatment of the owner's interest, as illustrated in the following diagram:

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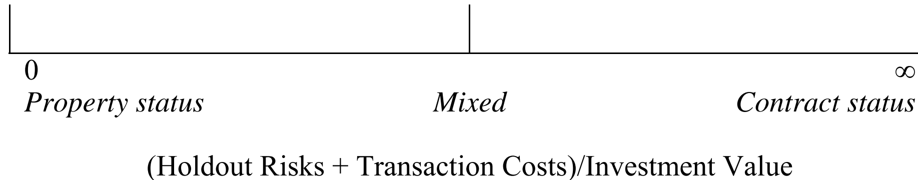
[20] *See* Carol M. Rose, *The Shadow of The Cathedral,* 106 YALE L.J. 2175, at 2182-88 (1997) [hereinafter Rose, *Shadow*] (choice between property and contract, and between property and liability rules, arises from the need, in creating property interests, to balance between encouraging investment and preventing strategic bargaining and holdout costs); Carol M. Rose, *Canons of Property Talk, or, Blackstone's Anxiety*, 108 YALE L.J. 601, 626 (1998) [hereinafter Rose, *Canons of Property*] (property rights needed to support investment incentives); Richard A. Epstein, *A Clear View of The Cathedral: The Dominance of Property Rules*, 106 YALE L.J. 2091 (1997) [hereinafter Epstein, *Clear View*] (property status should apply unless there is holdout risk); Richard A. Epstein, *Holdouts, Externalities, and the Single Owner: One More Salute to Ronald Coase*, 36 J. L. & ECON. 553, 557, 569-71 (1993) [hereinafter Epstein, *Holdouts*] (level of protection of property interest depends on whether risk of externalities or holdouts is greater); Patricia Danzon, *Comment on Epstein, "Holdouts, Externalities, and the Single Owner: One More Salute to Ronald Coase,"* 36 J. L. & ECON. 587, 592 (1993) (transaction costs may prevent efficient trade); Jeffrey E. Stake, *Toward An Economic Understanding of Touch and Concern*, 1988 DUKE L.J. 925, 972 (1988) [hereinafter Stake, *Touch and Concern*] (whether covenants run with land depends, in part, on transaction costs, possibilities of opportunistic behavior, and accountability problems).

[21] *See* Steven N. S. Cheung, *The Structure of a Contract and the Theory of a Non-Exclusive Resource*, 13 J. L. & ECON. 49, 45-50, 66-70 (1970) (externalities result when excessive transaction costs prevent the delineation of property rights). *Cf.* YORAM BARZEL, ECONOMIC ANALYSIS OF PROPERTY RIGHTS (2d ed. 1997) (property rights defined up to the point where, given transaction costs, it is efficient to do so).

[22] This derives from Ronald Coase's insight that conflicting use problems are reciprocal. R.H. Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1, 13; Daniel A. Farber, *Parody Lost/Pragmatism Regained: The Ironic History of the Coase Theorem*, 83 VA. L. REV. 397, 417-18 (1997). Free rider problems are a variation on the holdout theme: a unit owner refuses to contribute her share to a common project that benefits all, such as maintenance of common elements in a community association.



Property rights exist when maximizing investment is most important. They (1) include the right to possess and use property and exclude others,[23] (2) are generally enforced by property rule remedies such as injunctions or punitive damages that in theory are severe enough to eliminate all violations,[24] and (3) generally bind an owner's successors and assigns forever.

Contract status applies when holdout risks or transaction costs at a later date are high. In a contract, A and B are known to each other and are in an agreed-on legal relationship where they share control over an asset. This sounds counterintuitive, in that many contracts involve a simple exchange of money for goods, and each party has sole physical control of its asset until the exchange, and mere dollar liability if it fails to perform. But the contract rights themselves are a shared asset, in which the parties pool their promises and specify their payoffs on performance or breach. The shared nature of the asset disappears only on completion of the contract, when each party receives an exclusive property interest in what the other has

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[23] As with pornography, people know a property right when they see it, but have a hard time defining it. Property rights include the right to exclude. *See* Thomas W. Merrill, *Property and the Right to Exclude*, 77 NEB. L. REV. 730 (1998) [hereinafter Merrill, *Property and the Right to Exclude*]; Thomas W. Merrill & Henry E. Smith, *The Property/Contract Interface*, 101 COLUM. L. REV. 773 (2001) [hereinafter Merrill & Smith, *Property/Contract Interface*]; Thomas W. Merrill & Henry E. Smith, *What Happened to Property in Law and Economics?*, 111 YALE L.J. 357 (2001) [hereinafter Merrill & Smith, *What Happened?*]; J. E. Penner, *The "Bundle of Rights" Picture of Property*, 43 UCLA L. REV. 711 (1996) (property tied into exclusive rights in thing). *But cf.* Rose, *Canons of Property*, *supra* note 20 (no absolute right to exclude). Property rights also include the related right to possession. *See* Richard A. Epstein, *Possession as the Root of Title*, 13 GA. L. REV. 1221 (1979); Carol M. Rose, *Possession as the Origin of Property*, 52 U. CHI. L. REV. 73 (1985). Several commentators argue that where more than one owner is involved, property rights also include governance rights. *See* David Haddock & Lynne Kiesling, *The Black Death and Property Rights*, 31 J. LEGAL STUD. S545 (2002); Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387 (2000) [hereinafter Hansmann & Kraakman, *Organizational Law*]; Henry E. Smith, *Exclusion Versus Governance: Two Strategies for Delineating Property Rights*, 31 J. LEGAL STUD. S453 (2002) [hereinafter Smith, *Exclusion Versus Governance*]. But governance arrangements more properly belong in the contract box, since they are agreements on how to administer property. *See infra* Part III.C. For treatments of property as a bundle of rights, see Barzel, *supra* note 21; Thomas C. Grey, *The Disintegration of Property,* 22 NOMOS 69 (J. Roland Pennock & John W. Chapman eds., 1980) (property has no independent significance as analytical category).

[24] The foundation of the property/liability rule literature is, of course, Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972).

delivered, or on termination by breach.[25] On breach, B can terminate A's interest on payment of liability rule (compensatory) damages.[26] For example, if Kellogg's contracts to sell Wal-Mart a million boxes of corn flakes, Kellogg's has possession of the cornflakes and a right to payment for them, Wal-Mart has the right to obtain the corn flakes on payment of the purchase price, and either can break the agreement on payment of compensatory damages to the other. In relational contracts dealing with longer-term arrangements, the parties may create ongoing governance structures like boards of directors.[27] Table 1 summarizes the difference between idealized property and contract regimes, although these categories get muddied in the real world.

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[25] *Cf.* Rose, *Shadow*, *supra* note 20, at 2182-88 (contracts are property interests subject to an option and "the whole meatball" reunifies on payment of damages after breach), and at 2186 n.49 (real estate contracts of sale create shared interest in property until closing of sale).

[26] Rose, *Shadow*, *supra* note 20 (if risk is of externality inflicted on owner or of owner's impaired investment, property rule applies; if risk is of holdout by owner, liability rule applies). Property/liability rule theory has recently generated a large literature. *See* Ian Ayres, *Protecting Property with Puts*, 32 VAL. U. L. REV. 793 (1998); Ian Ayres & J.M. Balkin, *Legal Entitlements as Auctions: Property Rules, Liability Rules, and Beyond*, 106 YALE L.J. 703 (1996) (liability rules are superior when asymmetric information, preventing efficient bargaining, outweighs moral hazard created by inadequate investment incentives); Ian Ayres & Eric Talley, *Distinguishing Between Consensual and Nonconsensual Advantages of Liability Rules*, 105 YALE L.J. 235 (1995) [hereinafter Ayres & Talley, *Distinguishing Advantages*]; Ian Ayres & Eric Talley, *Solomonic Bargaining: Dividing a Legal Entitlement to Facilitate Coasean Trade*, 104 YALE L.J. 1027 (1995) [hereinafter Ayres & Talley, *Solomonic Bargaining*] (liability rules are superior when adverse selection, preventing efficient bargaining, outweighs moral hazard created by inadequate investment incentives); Epstein, *Clear View*, *supra* note 20; Richard A. Epstein, *Protecting Property Rights with Legal Remedies: A Common Sense Reply to Professor Ayres*, 32 VAL. U. L. REV. 833 (1998); Louis Kaplow & Steven Shavell, *Do Liability Rules Facilitate Bargaining? A Reply to Ayres and Talley*, 105 YALE L.J. 221 (1995); Louis Kaplow & Steven Shavell, *Property Rules Versus Liability Rules: An Economic Analysis*, 109 HARV. L. REV. 713, 733 (1996); James E. Krier & Stewart J. Schwab, *Property Rules and Liability Rules: The Cathedral in Another Light*, 70 N. Y. U. L. REV. 440 (1995); Robert P. Merges, *Contracting into Liability Rules: Intellectual Property Rights and Collective Rights Organizations*, 84 CAL. L. REV. 1293 (1996) [hereinafter Merges, *Collective Rights Organizations*]; Robert P. Merges, *Toward a Third Intellectual Property Paradigm: Comments: of Property Rules, Coase, and Intellectual Property*, 94 COLUM. L. REV. 2655 (1994).

[27] Governance structures are discussed as common pool resources in Part III.C.

Table 1: The property/contract interface: characteristics of interests in the two regimes

Property	**Contract**
Protecting investment more important	Preventing holdout more important
Exclusive possession	Shared governance until completion of transaction
Enforceable by injunctive relief or punitive damages	Enforceable by compensatory damages
Low transaction costs for renegotiation	High transaction costs for renegotiation
Default rule: binds successors and assigns	Default rule: successors and assigns not bound unless expressly assume

To illustrate the analysis, assume that we are creating a legal system for a two-party world where Atlantic and Boomer own adjacent parcels of land and exchange residential-use covenants. Let's turn first to the investment versus holdout issue. As the importance of investment increases, Boomer's interest will become more property-like, since she will not invest large sums of money to improve an asset if Atlantic can destroy its value.[28] Real estate is an expensive, long-term fixed asset where investment is important: building a house is not like consuming a pack of chewing gum.[29] Thus, assuming no holdout risks and low transaction costs, Boomer will get property rule protection to prevent Atlantic from creating an externality as a byproduct of Atlantic's normal activity (Atlantic sets up a cement manufacturing plant that blows smoke on Boomer's property).[30] To the

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[28] *See* Epstein, *Clear View*, *supra* note 20 (takings risk); Kaplow & Shavell, *supra* note 26 (takings risk); Rose, *Shadow*, *supra* note 20 (investment disincentives). *See also* Cowherd Development Co. v. Littick, 238 S.W.2d 346, 350 (1951); Lakeshore Estates Recreational Area, Inc., v. Turner, 481 S.W.2d 572, 575 (1972); Booker v. Old Dominion Land Co., 49 S.E.2d 314 (1948) (all expressly considering investment incentives created by covenants).

[29] Of course, the pack of chewing gum is also protected by a property interest, but that is because it is cheap to negotiate for the transfer of the chewing gum. Kaplow and Shavell, *Property Versus Liability Rules*, *supra* note 26. The issue is not whether the level of investment is the sole explanation for property, but whether it provides part of the explanation.

[30] Boomer v. Atlantic Cement Co., 257 N.E.2d 870 (1970). *See* Epstein, *Holdouts*, *supra* note 20 (externalities). *Cf.* Danzon, *supra* note 20 (each side can create externalities for the other); Thomas J. Miceli et al., *The Property-Contract Boundary: An Economic Analysis of Leases*, 3 AM. L. & ECON. REV. 165 (2001) (lease is a contract that is also form of property dividing rights between landlord and tenant; where lease provides for minimal landlord services, danger of each destroying other's interest results in mix of property and liability rules).

extent that covenants raise Boomer's investment value, they need property-rule protections even though they are promises.

If, however, the property protection is too strong and Atlantic is the higher-valuing user of Boomer's land, Boomer may hold out for the entire surplus from a renegotiation and Atlantic will not proceed, leaving the land in a lower-valued use.[31] At some point, the more efficient legal rule will limit the property protection – Boomer's veto over trade – and allow Atlantic to take Boomer's property interest on payment of compensation – in effect, a contractual remedy. A taking under the U.S. Constitution's Fifth Amendment on payment of just compensation is an example.[32] Because of the need to obtain agreement from many owners – major use amendments usually require supermajority or even unanimous consent – covenant regimes greatly increase the difficulty of obtaining consent for major changes, which locks in the specified uses. Paradoxically, this increased holdout risk with respect to changes adds stability within the subdivision, thereby increasing the incentives of owners to invest.[33]

High transaction costs may also make it impossible for Boomer and Atlantic to conclude an otherwise efficient transaction. As Henry Hansmann and Reinier Kraakman have observed, it may be difficult to identify all the rights holders and verify their rights.[34] The cost of defining

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[31] Epstein, *Holdouts*, *supra* note 20.

[32] U. S. CONST., amend. V.

[33] Alan Schwartz and Joel Watson show that complex contracts raise renegotiation costs and thereby generate efficient investment incentives. Their example focuses on sophisticated parties negotiating one-on-one, although it could also apply to asset-partitioned enterprises like corporations. Alan Schwartz & Joel C. Watson, Economic and Legal Aspects of Costly Recontracting, Yale Law School, Law & Economics Working Paper No. 242 (2000), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=224444 (last visited 4/23/03). Abraham Bell and Gideon Parchomovsky suggest that multiple veto rights, with resulting high transaction costs to reunify them, can preserve valuable common pool resources like parks. Abraham Bell & Gideon Parchomovsky, Of Property and Anti-Property: The Perverse Virtues of Transaction Costs and Anticommons, U of Penn. Inst for Law & Econ Research Paper 03-04 (2003), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=387520 (last visited on March 30, 2004). *See also* Yeon-Koo Che & Donald B. Hausch, *Cooperative Investments and the Value of Contracting,* 89 AM. ECON. REV. 125 (1999) (if there are no externalities created by an agreement, value is added by making renegotiation difficult); Shi-Ling Hsu, *A Two-Dimensional Framework for Analyzing Property Rights Regimes*, 36 U.C. DAVIS L. REV. 813, 831 (2003) (increased holdout risk created by multiple rightholders protects against negative externalities). *Cf.* Hanoch Dagan & Michael A. Heller, *The Liberal Commons*, 110 YALE L.J. 549, 577-78 (2001) (easy exit from commons encourages lax care of resource); Hansmann & Kraakman, *Organizational Law*, *supra* note 23, 434-35 (exit limits make it harder for owners to opportunistically withdraw from firm and to thereby destroy value for remaining owners). *But cf.* Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211 (1995) (praising easy exit from "thick relationships" (relational contracts) as means of correcting overoptimism bias); Merrill & Smith, *Property/Contract Interface*, *supra* note 23 (mandatory rules imposed when there are many people subject to a complex legal regime and renegotiation is hard, as for buyers of units unit subject to a covenant regime). *See infra* Part V.A for a discussion of unanimity and supermajority requirements.

[34] *See* Henry Hansmann & Reinier Kraakman, *Property, Contract and Verification: The Numerus Clausus Problem and the Divisibility of Rights*, 31 J. LEGAL STUD. S373 (2002) (verification costs); Heller, *Anticommons*, *supra* note 7. In contrast, in traditional commons such as those controlling fisheries or grazing areas, it is often easy to identify the small number of locals with rights.

rights is also important: as discussed below, in a relational contract, it will not be cost-effective to specify all possible permitted and prohibited behaviors in every state of the world. In addition, as Thomas Merrill and Henry Smith have noted, there is a cost to understanding the content of the rights created by A and B's agreement. Even experienced lawyers may struggle to interpret complex documents; lay people may find them incomprehensible. The more people who are bound by complex documents, the higher the total cost of understanding and the higher the likelihood that many people will fall short.[35] There are also administration costs in monitoring and enforcing compliance after the initial investment, renegotiation costs when the original contract is no longer efficient, and enforcement costs when the covenant is breached.

Covenant regimes and, in particular, community associations, reduce these costs, thereby helping to justify property-like status. Verification costs – the costs of determining the universe of relevant owners – are usually low, as indicated by cases where courts insist that each unit owner be served.[36] Covenant rights are relatively cheap to define because a developer typically creates them from boilerplate without negotiation.[37] While a subdivision may have potentially thousands of unit owners, community associations reduce the cost of understanding covenant regimes because (1) they are recorded, (2) a broker or lawyer in the transaction will often make a simplified disclosure about them when the covenantee acquires its unit, and (3) when there is a community association, the association's board of directors and professional managers will

[35] *See* Merrill & Smith, *Property/Contract Interface*, *supra* note 23; Merrill & Smith, *Whatever Happened?*, *supra* note 23; Henry E. Smith, *The Language of Property: Form, Context, and Audience* (unpublished manuscript; forthcoming Stanford Law Review) (Dec. 2002). *See also* Eric Rasmusen, A Model of Negotiation Not Bargaining: Explaining Incomplete Contracts, Harv. John M. Olin Ctr. for L. Econ. & Bus., Disc. Paper No. 324 (May 2001) (reading costs). In the first article of their series, Merrill and Smith argued that the common law limited the number of possible real property interests in order to limit the information cost of third parties in understanding them, but this was hard to reconcile with the phenomenal complexity of fee interests subject to covenants, air rights deals, leases, and the like, and they later adopted the more sophisticated model in *The Property/Contract Interface*. *See* Thomas W. Merrill & Henry E. Smith, *Optimal Standardization in the Law of Property: The Numerus Clausus Principle*, 110 YALE L.J. 1 (2000) [hereinafter Merrill & Smith, *Numerus Clausus*].

[36] *See, e.g.*, Karner v. Roy White Flowers, Inc., 527 S.E.2d 40 (N.C. 2000) (dismissing case for failure to serve all unit owners); Booker v. Old Dominion Land Co., 49 S.E.2d 314 (Va. 1948) (requiring service of all unit owners). *Cf.* Knox v. Streatfield, 79 Cal. App. 3d 565 (1978) (dismissing class action for insufficient similarity of claims, and thus implicitly holding that each unit owner's rights could be identified and tried separately).

[37] See *infra* text at Part IV.B.2. George G. Triantis, The Efficiency of Vague Contract Terms, U. Va. L. & Econ. Res. Paper No. 02-7 (2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=311886 (last visited on January 13, 2003), notes that parties will only specify rights up to the point where, at the time the contract is drafted, the rights are believed to add value to contract performance and performance can be verified by a court. On the difficulty of specifying everything, see Schwartz & Watson*, supra* note 33, which suggests that the higher the initial contract costs, the more likely the parties are to shift to simple forms. *Id.* at 5. Covenants, however, use complex forms despite their relatively high cost. The cost is reduced through the use of boilerplate, through governance structures that fill in the gaps, and because the cost is spread across many unit owners. On governance, see text *infra* at note 59.

communicate the covenant regime's requirements.[38] Similarly, community association managers and boards, as repeat players, develop expertise. They can efficiently monitor and enforce covenant compliance, in addition to coordinating renegotiation of the subdivision's rules and level of services, for example by voting a maintenance fee increase.[39] Community owners can spread the administration and enforcement costs among the unit owners as a kind of insurance.[40] Taking the example of enforcement costs, assume a subdivision with 100 units and a setback covenant. If the covenantee violates the setback covenant, this may cause a decrease in value, including demoralization costs, of $1 per unit for each of the other 99 units, or $99 total. But an individual unit owner would be willing to spend only $1 to litigate the covenant violation, even though the subdivision owners as a whole should be willing to spend $99.[41] The community association can assess each unit owner $1 for a litigation reserve, within each owner's value, and have enough to fund the litigation.

B. INCOMPLETE CONTRACTS

The incomplete contracts literature is a theoretical examination of the payoffs that parties would design for themselves to maximize efficiency if, at the time of formation, they could not specify all future states of the world but had freedom to specify enforceable remedies.[42] Scholars attempt to specify the investment and holdout effects of remedies under long-term

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[38] In *Numerus Clausus*, Merrill and Smith argue that property status applies when there are well-defined rightholders with easy-to-understand rights of exclusion and many people are bound. Contract status applies when fewer people are bound; greater customization is permitted. Merrill & Smith, *Numerus Clausus, supra* note 35. In *The Property/Contract Interface,* they argue that in borderline situations, courts place heavier reliance on notice and mandatory rules. Merrill & Smith, *Property/Contract Interface*, *supra* note 23. Covenants — binding a relatively large number of people with contracts that are often complex, are a borderline situation, and court treatment of them follows Merrill and Smith's analysis. Property status generally applies, with some modifications: notice (a recorded covenant) is required to bind unit owners, and courts apply mandatory rules to limit egregious actions by covenantees. *See* text *infra* Parts IV.B.3. and V.A.

[39] The renegotiation of minor use changes is more likely to be successful than the renegotiation of major use changes. *See infra* Part V.A. *See also infra* note 163 and accompanying text.

[40] This is a form of asset partitioning, with the covenant regime a real estate asset partitioned off from the fee and governed by a community association that is better able to police it. *See* Hansmann & Kraakman, *Organizational Law*, *supra* note 23.

[41] *Cf.* Haddock & Kiesling, *supra* note 23 (as costs of enforcing property rights rose due to population collapse following 14th century Black Death, enforcement diminished); Merges, *Collective Rights Organizations*, *supra* note 26, at 1324-26 (creation of enforcement technologies); Smith, *Exclusion Versus Governance*, *supra* note 23 (governance as strategy to maximize efficient use of land); Henry E. Smith, *Semicommon Property Rights and Scattering in the Open Fields*, 29 J. LEGAL STUD. 131 (2000) [hereinafter Smith, *Semicommons*] (monitoring costs).

[42] *See* Eric A. Posner, *Economic Analysis of Contract Law After Three Decades: Success or Failure?*, 112 YALE L.J. 829 (2003), which is the best discussion of the connection between the contracts literature in legal scholarship and the incomplete contracts literature in economics scholarship. The best recent surveys of the incomplete contracts literature are Patrick W. Schmitz, *The Hold-Up Problem and Incomplete Contracts: A Survey of Recent Topics in Contract Theory*, 53 BULLETIN OF ECONOMIC RESEARCH 1 (2001); Alan Schwartz, *Incomplete Contracts*, *in* NEW PALGRAVE DICTIONARY OF LAW AND ECONOMICS 277 (Peter Newman, ed., 1998) [hereinafter Schwartz, *Incomplete Contracts*].

contracts, with results similar to those in the property/contract interface literature.

While this literature is highly abstract, we can once again get a concrete sense of it through the lens of contracts for the sale of manufactured goods. While some exchanges of rights are simultaneous (cash for a box of corn flakes) and don't require contracts at all, others require investment in expectation of future performance by the other side. For example, Kellogg's may build a breakfast cereal factory in order to service the cereal needs of Wal-Mart's new Supercenters, which sell groceries as well as more traditional department store fare. This creates the potential for strategic behavior by the party that has promised to buy the products resulting from the investment. After Kellogg's builds the breakfast cereal factory, Wal-Mart can threaten to buy from General Mills unless Kellogg's cuts the agreed-on cereal price by 75%. If Kellogg's agrees, its expected profits turn to losses; if Wal-Mart departs, Kellogg's will have excess capacity and no alternative buyers. In a world of zero transaction costs, the parties could specify efficient remedies for this and every other every possible contingency, and thus could protect investment incentives while permitting efficient breach, but this would be too expensive in the real world (hence, the name "incomplete contracts").[43] The literature usually prescribes property rule remedies, such as injunctions or quasi-punitive damages, as the most efficient way to protect investments in incomplete contract relationships.[44]

In contrast to the incomplete contracts literature's emphasis on investment in anticipation of performance, the traditional contracts literature focuses on events after the contract is made if performance is no longer efficient, such as appropriate incentives for efficient breach and for the victim's post-breach mitigation.[45] From the perspective of the classic ex post contracts literature, if Wal-Mart breaches the cereal purchase contract with Kellogg's, Wal-Mart must pay the difference between the contract price and the amount for which Kellogg's is able to re-sell the cereal. Expectation damages will efficiently limit losses from the perspective of the time of breach, but may reduce the investment level below what is efficient.[46] Law and economics scholars have also explored related themes, such as how to induce the parties to take appropriate amounts of precaution (i.e., appropriate investment) in relying on the contract, and a gradual unification of the two literatures is underway.[47]

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[43] See *infra* Parts IV.B.2 and V.A. The literature suggests other reasons for not specifying, as well. Schwartz, *Incomplete Contracts*, *supra* note 42. Making matters even more difficult, there is no agreed-on definition of the term "incomplete contract" in the literature. *See* Schmitz, *supra* note 42.

[44] *See infra* Part IV.

[45] Many of the contracts discussed in the traditional literature are incomplete as well.

[46] *See* Bebchuk, Ex Ante Ex Post, *supra* note 4. *See also* Bebchuk, *Ex Ante Cathedral*, *supra* note 4.

[47] Posner, *supra* note 42. *See also* Robert Cooter, *Unity in Tort, Contract, and Property: The Model of Precaution*, 73 CAL. L. REV. 1 (1985) (goal in tort, property and contract law is to encourage both sides to take efficient precautions; considers investment in anticipation of performance); Steven Shavell, *Damage Measure for Breach of Contract*, 11 BELL J. ECON. 466-90 (1980). Other traditional

Real estate covenants, despite their dense contractual detail, are really a form of incomplete contract that cannot specify all contingencies. Each unit owner is a covenantor who promises to restrict the use of her unit (for example, a common setback requirement), in exchange for identical promises from the other unit owners. Each unit owner is, at the same time, a covenantee who invests based on the benefit of the mutual restrictions.[48] For example, if (1) the covenantor promises to make only residential use of her land, (2) the covenantee builds a $500,000 house next door in reliance on the residential use promise (assume that the level of investment is optimal), but (3) the house would be worth only $250,000 if the covenantor violates the covenant by building a gas station, then (4) if there is no remedy for the violation, the covenantor can threaten to violate the covenant and extract money from the covenantee. Knowing this, the covenantee will underinvest, reducing the value of its unit below the optimal level.

If, in the previous example, the covenantee expected that its efficient $500,000 investment would result in a house whose ultimate value (subjective and market, including anticipated appreciation from holding the property for several years before resale) would be $1,000,000, but the covenantee was entitled to only lost market value damages of $250,000, then the damages remedy effectively strips the covenantee of its upside. Knowing this, the covenantee will not invest the full $500,000.

Assuming that the covenant induces an efficient level of investment by the covenantee, it should be protected by a property rule (an injunction or punitive damages) that will give the covenantee the full value of its

contract measures, such as restitution and reliance, also have effects on precaution, but they are beyond the scope of this article.

[48] The incomplete contracts literature identifies three types of investments: selfish (the owner invests to increase its own value, as when a factory owner invests in new equipment that will cut its production costs); cooperative (the owner invests to increase value for its contractual counterparty, as when a clothing factory owner expands its production capability in order to sell to Wal-Mart); and hybrid (the owner makes a combination of cooperative and selfish investments). *See* Che & Hausch, *supra* note 33; Schmitz, *supra* note 42. While a few covenants are purely cooperative (covenantor and covenantee are the sole parties; covenantor promises covenantee to build only for residential use), mutual covenants are far more common, and are a special case of hybrid investment: an exchange of covenants in which property owner A restricts its own use (a cooperative investment) in exchange for similar promises from property owner B, thus allowing property owner A to increase its investment (a selfish investment).

investment by preventing a violation.[49] Courts generally do this,[50] but as Rohan Pitchford and Christopher M. Snyder suggest, this legal regime is efficient only if the covenantee's initial investment is efficient: it may be inappropriate to protect the covenantee's initial investment with a property rule if a subsequent, more valuable investment would justify the violation of a covenant (in Pitchford and Snyder's terminology, this is the question of whether to protect the first or second mover).[51] If the covenantee is always protected by a property rule, it will capture the entire gain from the violating covenantor's investment: the covenantor will be unable to violate the covenant without the covenantee's permission, and as a result, the covenantee will have a hammerlock in any negotiations. The covenantor will not make any profit from violating, which means that, even if the covenantor's use is more efficient, it will inefficiently underinvest and not proceed. This will freeze existing uses.

For example, assume that the covenantee has a $500,000 house protected by a residential use covenant burdening the adjoining lot, that the covenantee has no subjective value in excess of the $500,000 price, and that the covenantor would like to build a shopping center on the adjoining lot that will generate surplus of $2,000,000. If the covenantee can get an injunction to stop the construction of the shopping center, then the covenantee can hold out unless it receives nearly the entire $2,000,000. Faced with no share of the surplus, the covenantor will inefficiently fail to develop the shopping center.

The real world appears to confirm the investment inducement thesis of the incomplete contracts literature: according to one study, people pay a 35% premium to live in a development with a covenant regime.[52]

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[49] *See* Aaron S. Edlin & Alan Schwartz, Optimal Penalties in Contracts, Yale L. & Econ. Res. Paper No. 267; Yale Pub. L. Res. Paper No. 27; U.C. Berkeley Pub. L. Res. Paper No. 108, at 18-26 (2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=354781 (last visited on Jan. 8, 2003) (Chicago-Kent Law Review, forthcoming) (demonstrating this for cooperative and selfish investments, and therefore implicitly for hybrid ones). *See also* Lucian Arye Bebchuk, An Incomplete Contracts Approach to Contractual Restrictions and Covenants, (Apr. 2000) [hereinafter Bebchuk, Covenants] (consent rights in long-term contracts improve investment incentives); John H. Barton, *The Economic Basis of Damages for Breach of Contract*, 1 J. LEGAL STUD. 277 (1972) (early discussion of investment incentives created by damages rules). For a summary of the property/liability rule issue from an incomplete contracts perspective, see Schmitz, *supra* note 44, and Schwartz, *Incomplete Contracts*, *supra* note 42.

[50] *See* Part IV.A *infra*. Although affirmative covenants are a partial exception, see Part V.C *infra*. *See also* Restatement (Third) of Property, Servitudes, § 8.3 (1998).

[51] *See* Pitchford & Snyder, *supra* note 4.

[52] Wayne S. Hyatt, *Common Interest Communities: Evolution and Reinvention*, 31 J. MARSHALL L. REV. 303 (1998) (citing LLOYD BOOKOUT, JR., TRENDS AND INNOVATIONS FOR MASTER PLANNED COMMUNITIES (1998)). *See also* Robert G. Natelson, *Consent, Coercion, and "Reasonableness" in Private Law: The Special Case of the Property Owners Association*, 51 OHIO ST. L.J. 41, 74 n.157 (1990) (citing S. WILLIAMSON & R. ADAMS, DISPUTE RESOLUTION IN CONDOMINIUMS 55-56 (1987)) (in Florida study, 92% of unit owners said that rules and regulations protecting their lifestyle induced their purchase). At the same time, most people neither read nor understand their covenants. *See infra* Part IV.B.2.

Although it may be coincidence, the explosion of community associations, with their improved enforcement ability, began in the 1970s, just as nuisance rules became less property-like in their

However, this does not mean that the level of investment induced is efficient. Lucien Bebchuk has explored efficient nuisance rules when both property owners arrive next to each other simultaneously and renegotiation is easy, finding that no single rule – either a property or liability rule favoring one side or the other – can provide full efficiency both at the time of the initial investment and at a later point when renegotiation is efficient. Instead, he suggests, the least inefficient rule will depend on the value of the different activities and the ease of harm reduction, which will again be hard to determine in advance.[53]

C. COMMON POOL RESOURCES

At times, the holdout risk may be too high to justify property rule protection of a shared investment, but the investment incentives may be too important for liability rule treatment. The common pool resource literature, which addresses shared property interests, offers a partial solution. Elinor Ostrom suggests that groups can maximize the value of common pool resources through governance structures enforcing defined legal rights and remedies.[54] Thus, a successful common pool resource dwells along the property/contract interface, in which a commonly held resource (property) is controlled by formal or informal governance arrangements (contract). Real-world common pool resource regimes, like the arrangements created by incomplete contracts theory, attempt to approximate an optimal remedies regime. But, where incomplete contracts theory attempts to specify all remedies up front, common pool resource regimes employ governance mechanisms to adjust as the environment changes.

In a classic common pool resource, such as a fishery or grazing area, the resource exists and the question is how best to maximize near-term use while preserving long-term value. Some common pool resource regimes, such as irrigation systems or oil fields, may also require considerable capital investment up front. If the common pool resource (popularly known as a commons) is not effectively governed, then, as an open access

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protection of victims' investment. In that same decade, *Boomer v. Atlantic Cement Co*., 257 N.E.2d 870 (1970), began a trend permitting the violator to keep the entire profit from the nuisance-generating activity if it paid liability rules damages.

[53] Bebchuk, Ex Ante Ex Post, *supra* note 4. Bebchuk observes that his analysis can be extended to covenant breaches, but his primary example is nuisance litigation between a resort and a factory, where are no prior agreements between the parties. He concludes that the more important it is to avoid under-investment by the factory in its selfish investment, the more one should lean toward a property rule benefiting the factory. The more important it is to avoid under-investment by the resort in its selfish investment, the more one should lean toward a property rule benefiting the resort.

With respect to the factory's investment in reducing harm, a property rule protecting the resort (as opposed to a property rule protecting the factory) will be superior: the factory property rule will lead to zero investment in harm reduction by the factory, while the resort property rule will lead to a positive (though still-sub-optimal) investment.

With respect to the resort's investment in reducing harm, a property rule protecting the resort will lead to sub-optimal harm reduction, while a property rule protecting the factory will lead to excessive investment. *Id.* at 34-35. Bebchuk suggests that full efficiency can be obtained through fines paid to third parties rather than to the victim of the violation.

[54] OSTROM, *supra* note 6.

resource, it is subject to the tragedy of the commons: each user will maximize his individual gain from the use of the resource, more will be drawn from the resource than is sustainable, and the resource will ultimately collapse.[55] This is a common problem in fisheries, but, despite fashionable prophecies of eco-catastrophe, doom is not inevitable.[56] There can be a comedy of the commons, where individuals join in successful common pool resource regimes that efficiently balance current use against long-term value.[57]

A covenant regime, when it gets beyond a simple promise from one owner to another and into an exchange of promises, is a common pool resource. Before the covenant regime is imposed, each member of the covenant regime starts with a fee simple absolute whose bundle of rights includes an unfettered right of use. Part of that right to unfettered use gets sliced away and contributed to the covenant regime in the form of use restrictions.[58] This reduces the externalities that one parcel can inflict on another and benefits all. The covenant regime is "owned" by all of the owners subject to it.[59]

These split interests can improve efficiency. Each unit owner is the best judge of how to customize its unit internally to maximize its value – one homeowner can create bathroom floor made of a bank of flat-screen TVs tuned to the Home Shopping Network, while another can install a velvet Elvis tapestry on the living room wall with genuine cubic zirconiums on Elvis' jacket. At the same time, the covenant regime polices against externalities that will, on average, reduce value for all.[60] This is a latter-day version of Henry Smith's medieval semicommons, in which English peasants cultivated private strips of land that were used as a commons for cattle grazing at certain times of the year. Modern covenants have a spatial, rather than temporal, split.[61]

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[55] *See* OSTROM, *supra* note 6.

[56] The classic prophesy of doom, itself doomed by confusion between open access resources (no controls at all) and common pool resources (a group retains control) is Garrett Hardin, *The Tragedy of the Commons*, 162 SCIENCE 1243 (1968). BJORN LOMBORG, THE SKEPTICAL ENVIRONMENTALIST (2002), offers a scathing critique of what he calls "the litany" of imminent environmental disaster.

[57] Carol Rose, *The Comedy of the Commons: Custom, Commerce, and Inherently Public Property*, 53 U. CHI. L. REV. 711 (1986) (managing common pool resources creates surplus).

[58] *See* Fennell, Contracting Communities, *supra* note 19, at 12-15 (illustrating slicing of interests).

[59] *See* Richard A. Epstein, *Covenants and Constitutions*, 73 CORNELL L. REV. 906, 925-26 (1988) [hereinafter Epstein, *Covenants*]; Richard A. Epstein, *Past and Future: The Temporal Dimension in the Law of Property*, 64 WASH. U.L.Q. 667 (1986) [hereinafter Epstein, *Past and Future*]; Smith, *Exclusion Versus Governance*, *supra* note 23, at S456 (all citing covenants and community associations as instances of governance regimes); Robert C. Ellickson, *Property in Land*, 102 YALE L.J. 1315 (1993) [hereinafter Ellickson, *Property in Land*] (landowners contractually create commons regimes and governance institutions to limit externalities). *Cf.* Merges, *Collective Rights Organizations*, *supra* note 26 (organizations such as ASCAP create common pool interest in intellectual property by splitting off the authority to sell from the ownership interest).

[60] When a community association exists, in addition to preventing unwanted uses, it often adds value by managing the common areas, but this function is beyond the scope of this article.

[61] Smith, *Semicommons*, *supra* note 41. Several commentators have noted the potential efficiency of split interests in real property. *See* Barzel, *supra* note 23, at 6, 64 (transfer of subsets of rights will produce more efficient use up to the point where they are exceeded by transaction costs); Robert C.

Ostrom, after synthesizing hundreds of studies, identified several factors that led to successful common pool resource regimes:

1. Clearly defined boundaries
2. Congruence between appropriation and provision rules and local conditions
3. Collective-choice arrangements
4. Monitoring
5. Graduated sanctions
6. Conflict-resolution schemes[62]

The semicommons and other traditional common pool resource regimes were the product of tightly knit traditional groups that had developed norms to regulate themselves.[63] In contrast, the covenant regime common pool resource is a creature of express contract. It is usually created from the *tabula rasa* of a single parcel of land held by a developer who subdivides it,[64] and it brings together total strangers. Because these

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Ellickson, *Cities and Homeowners Associations*, 130 U. PA. L. REV. 1519 (1982) [hereinafter Ellickson, *Cities*]; Ellickson, *Property in Land*, *supra* note 59; Michael A. Heller, *The Boundaries of Private Property*, 108 YALE L.J. 1163 (1999) [hereinafter Heller, *Boundaries*]; Merrill, *Property and the Right to Exclude*, *supra* note 23; Francesco Parisi, Entropy in Property, Geo. Mason L. & Econ. Working Paper No. 01-14 (2001), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=264315 (last visited Jan. 8, 2003) (forthcoming, Am. J. Comp. L.) [hereinafter Parisi, Entropy]; Francesco Parisi, The Asymmetric Coase Theorem: Dual Remedies for Unified Property, Geo. Mason L. & Econ. Res. Paper No. 01-13 (2001), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=264314 (last visited Nov. 8, 2003) [hereinafter Parisi, Asymmetric Coase Theorem]; Norbert Schulz, Francesco Parisi & Ben DePoorter, Duality in Property: Commons and Anticommons, Geo. Mason L. & Econ. Res. Paper No.00-32; and U. Va. L.-Econ. Res. Paper No. 00-16 (May 2000), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=224844 (last visited April 23, 2003); Rose, *Canons of Property*, *supra* note 20.

[62] OSTROM, *supra* note 6, at 90. Ostrom mentions two other factors of less importance here: (1) minimal recognition of rights to organize; and (2) for common pool resources that are part of larger systems, nested enterprises. The first is not an issue because American property law routinely permits the formation of covenant regimes. The second is rarely an issue because covenant regimes generally stand alone rather than being part of large systems. Supporting Ostrom on the latter point, empirical work shows that residents of centralized community associations controlling large quasi-towns such as Reston, Virginia and Columbia, Maryland are less satisfied with architectural controls than residents of decentralized associations that have more localized control. RAYMOND J. BURBY, ENVIRONMENTAL AMENITIES AND NEW COMMUNITY GOVERNANCE: RESULTS OF A NATIONWIDE STUDY 14 (Center for Urban and Regional Studies, Univ. N.C. 1974).

[63] James M. Acheson, *Management of Common-Property Resources*, *in* ECONOMIC ANTHROPOLOGY 351 (Stuart Plattner ed., 1989); OSTROM, *supra* note 6, at 29-57; GLENN G. STEVENSON, COMMON PROPERTY ECONOMICS: A GENERAL THEORY AND LAND USE APPLICATIONS (1991) (Swiss mountain grazing commonses).

[64] For discussions of proposals to create community associations in older neighborhoods with fragmented ownership — a far more difficult task — see Steven J. Eagle, *Privatizing Urban Land Use Regulation: The Problem of Consent*, 7 GEO. MASON L. REV. 905 (1999); Robert C. Ellickson, *New Institutions for Old Neighborhoods*, 48 DUKE L.J. 75 (1998) [hereinafter Ellickson, *New Institutions*]; Robert H. Nelson, *Privatizing the Neighborhood: A Proposal to Replace Zoning with Private Collective Property Rights to Existing Neighborhoods*, 7 GEO. MASON L. REV. 827 (1999). *See also* OSTROM, *supra* note 6 (decades-long negotiations to set up regional water rights and irrigation agreement among existing farmers).

strangers will lack communal norms and place less value on having a good reputation (there is no value to a good reputation if no one knows you), there is a greater risk of opportunism.[65] When governed by community associations, however, covenant commons meet many of Ostrom's criteria for success: real estate has clear boundaries and is easy to monitor. Its long-term nature and high value (a house is many Americans' largest asset, and a commercial real estate asset can be worth hundreds of millions of dollars) encourages investment in community associations, which characteristically offer monitoring services and a vehicle for collective choice and conflict resolution.[66] And, as we will see, many community associations make use of graduated sanctions.[67]

IV. INVESTMENT EFFECTS OF EXISTING DOCTRINE: REMEDIES IN THE NEAR TERM

The property/contract interface, incomplete contracts, and common pool resource literatures collectively suggest that, for purposes of inducing efficient initial investment, covenants are best protected by a mixture of property rules and graduated sanctions, and that ongoing governance structures like community associations make for efficient administration and calibration of remedies. This section examines real-world covenant remedies doctrine and its economic effects in inducing investment.[68]

A. INJUNCTIONS

Courts generally enforce a negative covenant by issuing an injunction in favor of the covenantee without seriously balancing its benefit to the covenantee and harm to the covenantor.[69] This legal regime – a property

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[65] On the importance of reputational sanctions in common pool resource regimes, see OSTROM, *supra* note 6, 94-100. Over time, community norms will develop within subdivisions as neighbors get to know each other and become more interested in developing good reputations. For an introduction to the growing norms literature, see Robert C. Ellickson, *Law and Economics Discovers Social Norms*, 27 J. LEGAL STUD. 537 (1998); Robert C. Ellickson, *The Market for Social Norms,* 3 AM. L. & ECON. REV. 1 (2001). For evidence that newcomers with less concern for reputation are more likely to transgress local norms, see the classic Shasta County study, Robert C. Ellickson, *Of Coase and Cattle: Dispute Resolution Among Neighbors in Shasta County*, 38 STAN. L. REV. 623 (1986). Given the easy entrance and exit from covenant regimes, however (all you have to do is buy or sell a house in the subdivision), there will be a constant flow of unsocialized strangers. This is one reason that many covenant regimes prohibit renters, who tend to stay for a shorter time than owners and are associated with a higher number of rule violations and impaired market position. Natelson, *supra* note 52, at 73-74 and nn.150, 155 (citing empirical studies).

[66] *See* Merges, *Collective Rights Organizations*, *supra* note 26 (high-valued intellectual property rights led to the development of ASCAP, BMI, and other collective rights organizations, which developed enforcement technologies to police those rights).

[67] *See infra* Parts IV.B.1, IV.B.3.

[68] Efficient rules at a later date, when holdout risks and transaction costs may dominate, are discussed *infra* Part V.

[69] *See* RESTATEMENT (THIRD) OF PROPERTY, SERVITUDES, § 8.3 (1998); Susan F. French, *Toward a Modern Law of Servitudes: Reweaving the Ancient Strands*, 55 S. CAL. L. REV. 1261, 1301-02 (1982). A few cases claim to balance the interests, but really do not. *See, e.g.*, Gey v. Beck, 390 Pa. Super. 317 (1990); New Jerusalem Baptist Church, Inc., v. City of Houston, 598 S.W.2d 666 (1980); Liu v.

rule – permits the covenantee to insist on its full market and subjective value in exchange for permitting a violation, and thus supports investment incentives.[70]

Property rule protection creates a holdout risk by giving the covenantee incentives to act opportunistically by obtaining an injunction of little value to her but of great cost to the covenantor – for example, forcing the removal of a house that encroaches on a setback line by one inch.[71] Several related doctrines limit the covenantee's possible opportunism, including waiver (the covenantee tolerated the violation),[72] laches (failure to enforce in a timely way), a balancing of equities for negligent minor encroachments, and, of greatest significance for our discussion here, changed conditions (so many violations that the covenant was effectively abandoned).[73] If any of these are found, the court will refuse to protect the covenantee with a property rule injunction. Instead, it will apply a liability rule and grant damages equal to the covenantee's difference in market value with and without the covenant. This effectively transfers the entire surplus from breaking the covenant to the covenantor, and, in practice, often goes beyond to give the covenantor a virtual property rule (since courts frequently award low or zero damages).[74]

Dunnigan, 25 Md. App. 178 (1975) ($6,000 spent on home office in violation of covenants not enough to tilt balance in favor of nonenforcement). An injunction is always available against an intentional violation. Walker v. Vaughn, 491 S.W.2d 489 (1973) (where intentional exterior wall appearance violation, covenant enforced despite covenantor's $1,500 investment); Gey (requiring removal of road from cul-de-sac); Liu (additional $9,000 spent after covenantor becomes aware of opposition to violation). *But see* Frazier v. Deen, 470 S.E.2d 914 (1996) (upholding unauthorized covenant waiver, without payment of damages, where higher-valued houses on larger lots would add value). Damages for past violations are rarely granted in addition to injunctive relief. RESTATEMENT (THIRD) OF PROPERTY, SERVITUDES § 8.3 cmt. b (1998).

[70] This is consistent with Carol Rose's suggestion that cumulative, increasing externalities should be protected against by property rules. Since covenants contractually define externalities, the same reasoning would apply to the cumulative effect of multiple covenant violations. *See* Rose, *Shadow*, *supra* note 20, at 2193. *Cf.* Uriel Reichman, *Judicial Supervision of Servitudes*, 7 J. LEGAL STUD. 139 (1978) [hereinafter Reichman, *Judicial Supervision*] (allowing covenants to be broken on payment of compensatory damages, i.e., a liability rule, may result in multiple violations).

[71] *See* Ian Ayres and Kristin Madison, *Threatening Inefficient Performance of Injunctions and Contracts*, 148 U. PA. L. REV. 45 (1999) [hereinafter Ayres & Madison, *Inefficient Injunctions*]. In law and economics terminology, this sort of opportunism is referred to as acting strategically. Many covenants, however, cover lifestyle issues where the covenantor's cost of compliance would be minimal. The covenantee would not be able to extract money from the covenantor inefficiently by threatening to get an injunction over a no-cars-in-the-driveway covenant.

[72] *See, e.g.*, Frazier v. Deen, 470 S.E.2d 914 (1996) (upholding unauthorized covenant waiver, without payment of damages, where higher-valued houses on larger lots would add value); Morris v. Nease, 238 S.E.2d 844 (1977) (chiropractor's conversion of residence).

[73] *See* Reichman, *Judicial Supervision*, *supra* note 70. *See, e.g.*, Gunnels v. N. Woodland Hills Community Ass'n, 563 S.W.2d 334 (1979) (where changed conditions exist, court will not enforce restrictive covenant if a great disproportion between harm and benefit from injunctive relief).

[74] *See* Ellickson, *Cities*, *supra* note 61, at 1535; French, *supra* note 69, at 1317; Reichman, *Judicial Supervision*, *supra* note 70 (courts grant property rule protection to either covenantor or covenantee); Michael J.D. Sweeney, Note, *The Changing Role of Private Land Restrictions: Reforming Servitude Law*, 64 FORDHAM L. REV. 661 (1995). *But see* Hostler v. Green Park Development Co., 986 S.W.2d 500 (1999), in which the covenantor, the aptly named Lawless Homes, built 41 houses on property that was supposed to be used as a common recreation area; as damages, the covenantee got the

As Omri Ben-Shahar has noted from a theoretical perspective and Wayne Hyatt from a practitioner's perspective, use-it-or-lose-it erosion rules encourage covenantees to rigidly enforce their covenants and to sue frequently and early, even when the violation is value-adding.[75] But since enforcement will not be perfect and covenantors can expect to pay minimal damages if they win, covenantors are encouraged to violate when covenantee enforcement is lax. If enough people violate the covenants and pay compensatory damages, the covenant regime will unravel.[76]

Given the danger of erosion of its rights, the covenantee will invest up to the point where the expected gains from the investment are equal to the expected losses (including enforcement costs) after a covenant violation.[77] To put this algebraically, if:

I_{CEE} = covenantee's ex ante investment

P_{NI} = probability that no injunction will issue following covenantee's violation

V_{CEE} = expected value of covenantee's investment

D_I = covenantee's uncompensated lost market value damages

D_D = covenantee's uncompensated demoralization damages

D_S = covenantee's uncompensated subjective damages

C_{CEE} = covenantee's litigation cost,

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covenantor's purchase price for the land, so, in effect, the covenantor paid for the land twice. Injunctive relief requiring removal of the houses would have caused a major economic loss.

[75] *See* Ben-Shahar, *supra* note 5, at 227-29, 235; Hyatt, *supra* note 52, at 314; James L. Winokur, *Choice, Consent and Citizenship in Common Interest Communities* [hereinafter Winokur, *Choice, Consent*], *in* COMMON INTEREST COMMUNITIES: PRIVATE GOVERNMENTS AND THE PUBLIC INTEREST, 87, 119-120 (Stephen E. Barton & Carol J. Silverman, eds., 1994) [hereinafter, Barton & Silverman, COMMON INTEREST COMMUNITIES]. The frequent lawsuits may have the advantage of clarifying the interpretation of the covenants. Edward J. Janger, *Muddy Property: Generating and Protecting Information Privacy Norms in Bankruptcy* (2003) (forthcoming, 44 WM. & MARY L. REV. 1801).

[76] *See* Ben-Shahar, *supra* note 5, at 193-94, 220-23. The faster that non-enforcement results in the erosion of the legal right, the greater the enforcement costs (as the rights-holder is forced to sue) and the lower the value of the right-holder's investment. *Id. See also* Nahrstedt v. Lakeside Village Condo. Ass'n, 878 P.2d 1275, 1289 (1994) (deferring to community association board and enforcing fine because, otherwise, result will be multiple lawsuits and demoralization of other unit owners). A California Dept. of Real Estate study of California community associations in STEPHEN E. BARTON & CAROL JANET SILVERMAN, COMMON INTEREST HOMEOWNERS' ASSOCIATIONS MANAGEMENT STUDY, 23 (1987) [hereinafter BARTON & SILVERMAN, CALIFORNIA STUDY] found that due to litigation expense, associations often yield to violations rather than prosecute, with the result that 41% of associations reported at least one type of major violation (including nonpayment of maintenance fees). *Cf.* Dagan & Heller, *supra* note 33, at 576-77 (easy exit from commons encourages lax care of resource); OSTROM, *supra* note 6, at 186-87 (empirical evidence that inadequate sanctions leading to unraveling of common pool resource regimes).

[77] This an intuitive corollary of Ben-Shahar's irrelevance theorem, which holds that a an erosion rule will encourage opportunism by a potential violator, but that this will be perfectly balanced by the rights-holder's incentives to take anti-erosion measures. *Cf*. Ben-Shahar, *supra* note 5, at 235 (erosion affects rights-holder incentive to make investments in reliance on legal protection of right).

then:

$$I_{CEE} = [(1 - P_{NI}) * V_{CEE}] + [P_{NI} * (V_{CEE} + D_I - D_D - D_S) - C_{CEE}]$$

In other words, the covenantee looks at the probability that it will prevail ($1 - P_{NI}$) and multiplies that probability by the covenantee's expected value if it invests (V_{CEE}). The covenantee also looks at the probability that the covenantor will prevail (P_{NI}) and calculates the covenantee's expected value under that scenario ($V_{CEE} + D_I - D_D - D_S$), consisting of the covenantee's expected value assuming no violation, plus any lost market value damages awarded, less uncompensated demoralization and subjective value.

The lost market value damages (D_I) (akin to expectation damages under a liability rule) include the average subjective value for all prospective covenantees.[78] Lost subjective value is notoriously hard to assess in tort cases, as when finders of fact evaluate pain and suffering damages. But in the real estate context, subjective elements have a market value based on what the average person would pay for a house in that condition. One empirical study found that condominiums with covenants that permit cats to stay in apartments raise value, but covenants that permit dogs lower value.[79] It is harder to determine the actual level of individual subjective harm – something that the covenantee will be tempted to lie about. Assume that singer/actress Jennifer Lopez owns a house that she covers with magenta imitation leather siding, in violation of her upscale subdivision's color and materials covenants. This may traumatize her next-door neighbor, British architect Lord Norman Foster, who can only tolerate modernist glass-and-steel structures, but Lopez's other next-door neighbor, blind singer/composer Stevie Wonder, may remain blissfully unconcerned. By not counting individual subjective value in their determination of

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[78] D_I damages are not added to the equation if the covenantee sues successfully because they are generally not awarded if an injunction is granted, and would be modest, since they would apply only to the period between the dates of the violation and the injunction. *See supra* note 69.

[79] *See* Roger E. Cannaday, *Condominium Covenants: Cats, Yes; Dogs, No*, 35 J. URB. ECON. 71-82 (1994). Restrictions on renting out units also increase value. *See* BARTON & SILVERMAN, CALIFORNIA STUDY, *supra* note 76, at 7. Also, New York City condominiums, which allow unit owners to sell their apartments without community association consent, command a 15% premium over comparable cooperative apartments where the covenants give the community association a veto over sales. Michael H. Schill et al., The Condominium v. Cooperative Puzzle: An Empirical Analysis of Housing in New York City (Furman Center for Real Estate and Urban Policy Working Paper (2003), *available at* http://www.law.nyu.edu/realestatecenter/condo_coop.pdf (last visited on May 6, 2003). There is also evidence in the zoning context that homeowners pay a premium to live in predominantly single-family communities. Robert C. Ellickson, *Suburban Growth Controls: An Economic and Legal Analysis*, 86 YALE L.J. 385, 423 n.98 (1977) [hereinafter Ellickson, *Suburban Growth Controls*] (citing William J. Stull, *Community Environment, Zoning and the Market Value of Single-Family Homes*, 18 J.L. & ECON. 535 (1975)). This suggests that the market would also award a premium for single-family house covenants. In the tort situation, there is no ready market for others willing to bear a personal injury. Hence, separate pain and suffering damages are needed.

damages,[80] fact finders limit error, but at the expense of undercompensation in individual cases, which is why D_S is subtracted from the covenantor's damages in the event of a successful breach.

Another damages element is the demoralization caused by limiting property interests (D_D). The concept, introduced by Frank Michelman, refers to the devaluation of investment incentives when a property interest is taken.[81] Determining the scope of demoralization is not easy: for example, if the New York Court of Appeals permits a covenant violation in a subdivision in that state, the value of all New York covenants is reduced.

As with subjective value, however, there is a reasonably good marker for demoralization damages: the increased value of the covenantor's property if the covenant is violated. This is a disgorgement measure.[82] A covenantee would have less reason to feel that its property interest had been destabilized if it were paid all the profits from the covenantor's new use.[83] Thus, if the covenantor's property were worth \$100 with the covenant and \$300 without the covenant, the covenantee would be compensated for most or all of its demoralization damages if it received: (1) its lost market value damages (which, as we have seen, would include the average subjective value loss), (2) any above-average subjective value, and (3) the difference between the market value of the highest and best use of the covenantor's property without and with the covenant.

If the covenantee brings suit, it must be prepared to pay litigation costs (C_{CEE}). Courts will often award litigation costs to successful covenantees, but for simplicity of analysis here, I will assume that each side bears its own costs.[84] Algebraically, the earlier equation reduces to:

$$I_{CEE} = V_{CEE} + P_{NI} * (D_I - D_D - D_S) - C_{CEE}$$

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[80] *But see* Andrews v. North Coast Development, Inc., 526 P.2d 1009 (Or. 1974), where the court incorporated the plaintiff's estimate of value, implicitly including subjective value, presumably because the court thought it reasonable.

[81] *See* Michelman, *supra* note 3. *See also* James R. Atwood, Note, *An Economic Analysis of Land Use Conflicts*, 21 STAN. L. REV. 293, 302 (1969) (applying Michelman's demoralization theory to nuisance). Michelman suggested that demoralization costs be compensated only when they exceeded settlement costs, but Natelson has observed that in community associations, those costs will ordinarily be low, so that demoralization damages would ordinarily be due. Natelson, *supra* note 52, at 81.

[82] On disgorgement, see E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 12.20a (2d ed. 1998).

[83] Michelman used a measure that, while more precise in theory, would be impossible to apply in the real world: (1) the dollar value of disutilities to losers and their sympathizers from the realization that loss will not be compensated; and (2) the present value of lost future production caused by demoralization of uncompensated losers, their sympathizers and other disturbed observers. *See* Michelman, *supra* note 3, at 1214-16.

[84] If the covenantee is awarded its litigation costs with probability x, the covenantee will multiply C_{CEE} by (1-x) — the percentage of C_{CEE} that the covenantee remains responsible for — thus adjusting C_{CEE} downward. The covenantor would look at the probability that it would have to pay double litigation costs and adjust C_{COR} upwards, thus reducing its incentive to invest in a violation. Ben-Shahar makes the related point that the parties will take their probability of success into account in assessing the rate of erosion. Ben-Shahar, *supra* note 5.

In other words, the covenantee will invest up to the point where $1 of investment will generate $1 of additional value, plus compensated damages and minus uncompensated damages and enforcement costs. But while the investment decision is made on acquisition before the covenantor's violation, the decision to initiate a lawsuit is made at the time of violation. Rearranging the equation, we can see that at the time of violation, the covenantee will invest in a lawsuit up to the following point:

$$C_{CEE} = V_{CEE} - I_{CEE} + P_{NI} * (D_I - D_D - D_S)$$

Assuming that the covenantee's value and damages – (1) the value of the covenantee's property with the benefit of the covenant; (2) the amount of investment; and (3) the market value, uncompensated demoralization and uncompensated excess subjective value damages – are all fixed for a given violation by the covenantor, the covenantee will invest in litigation to reduce the probability of non-enforcement (P_{NI}) only up to the point where a dollar of litigation costs reduces the covenantee's expected loss ($P_{NI} * (D_I - D_D - D_S)$) by a dollar. This parallels the way that the negligence rule induces precaution in the tort area.[85]

Thus, although injunctive relief is usually available (and its cost factored into the initial investment decision), it may not pay for the covenantee to litigate against any given small violation.[86] Lax enforcement, however, raises the probability of non-enforcement (P_{NI}) and the probability that a court will find changed conditions, waiver, or laches, decreasing the value to the covenantee. The covenantee would factor into its damages estimate the effect, if it fails to sue, on future violations and on future decreases in value to the property.[87]

When there are multiple covenantees in a subdivision, the covenantee's temptation toward lax enforcement is compounded by collective action problems, since a covenantee who sues will bear the entire cost of the lawsuit, while the other covenantees will be free riders who get the

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[85] *See* Cooter, *supra* note 47 (goal in tort, property, and contract law is to encourage both sides to take efficient precautions).

[86] *See* Natelson, *supra* note 52, at 73 (litigation costs will tend to be high compared to the losses from small violations). Because of courts' rigorous standards for the changed conditions doctrine, accumulations of small violations rarely collapse the covenant regime, instead leading to slow deterioration of the subdivision. *See infra* Part V.A.

[87] Similarly, Ben-Shahar shows that the rightholder will enforce up to the point where the marginal value of the enforcement equals the marginal cost of the lawsuit. The rightholder will invest more to prevent breach where the violator's breach destroys the value of the rightholder's asset (as opposed to merely failing to deliver promised goods). *See* Ben-Shahar, *supra* note 5, at 218. *Cf.* Reichman, *Judicial Supervision*, *supra* note 70 (allowing covenants to be broken on payment of compensatory damages, i.e., a liability rule, may result in multiple violations); OSTROM, *supra* note 6, at 186-87 (empirical evidence that undetected rule violations in common pool resource regimes increase the probability of rule-breaking by others).

benefit.[88] This partly explains the rise of community associations, which reduce collective action problems by compelling the sharing of the cost: a unit owner who fails to pay the assessment for the covenant litigation has a lien put on her property.[89] As previously noted, community associations also increase the probability of enforcement by reducing the cost of suit per unit owner, and by cumulating the damages suffered by all unit owners – raising the amount that the association should be willing to spend on a suit and therefore reducing the value of the violation to the covenantee.[90]

The covenantor, knowing the covenantee's likely enforcement pattern, will invest in a covenant-breaching use up to the point where its gain equals the litigation costs plus its losses in removing the offending use if it loses the suit.[91] Stated algebraically, if:

P_{NI} = probability that no injunction will issue following covenantor's violation,

V_{COR} = expected additional value of covenantor's land from violation,

D_I = liability rule damages owed by covenantor if no injunction issues,

I_{COR} = covenantor's investment in violating the covenant (e.g., cost of construction of encroaching house),

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[88] *See generally* MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION (1971); Mancur Olson, *Collective Action, in* 1 NEW PALGRAVE DICTIONARY OF ECONOMICS 474 (John Eatwell et al., eds., 1998); TODD SANDLER, COLLECTIVE ACTION: THEORY AND APPLICATIONS (1992). An idea of the problem can be found in the captions of the covenant lawsuits, many of which have dozens of parties. *See, e.g.*, Federoff v. Pioneer Title & Trust Co., 798 P.2d 387 (1990) (9 plaintiffs, 57 defendants, 1 intervenor); Karner v. Roy White Flowers, Inc., 527 S.E.2d 40 (2000) (all lot owners must be joined); Booker v. Old Dominion Land Co., 49 S.E.2d 314 (1948) (requirement to join all lot owners within 500 feet and publish newspaper advertisement).

[89] The free rider problem is not eliminated. Community association officers are often bitter that nonparticipating unit owners are unappreciative of their administrative efforts.

[90] *See supra* text at note 41.

[91] *See* Ben-Shahar, *supra* note 5, at 221-22. Ben-Shahar proves an irrelevance rule under certain assumptions: that the violator's and the rightholder's efforts will ordinarily cancel out, since the violator will violate up to a point just short of where it becomes worthwhile for the rightholder to sue. If the harm caused by the violation is below the rightholder's enforcement cost, the rightholder loses more by suing than not suing, and, in the real world, it will not sue. *See supra* note 76.

Covenant regimes should suffer a relatively low level and slow pace of erosion where they are enforced by community associations. First, Ben-Shahar's basic example is a contract in which the violator promises to deliver a certain amount of goods, and, as a result of an erosion rule, delivers less. The only loss is in the transaction itself. But the covenantee will invest in enforcement, even if litigation would be more expensive than the immediate harm caused by the specific violation, when cumulative violations would destroy the value of the rightholder's unit and the covenant regime. *See supra* note 87; Ben-Shahar, *supra* note 5, at 218 (more general observation of the same point). Second, and consistent with the erosion theory, by reducing enforcement costs per unit, a community association will lower the violator's ability to fly under the radar screen of the covenantee's enforcement costs. Third, the relatively cheap availability of injunctions (as opposed to the expense of proving expectation damages or of satisfying an injunction balancing test) will cut the cost of enforcement and raise the covenantor's risk of loss from violations requiring investment, since the violator may not only have to give up its gains from violation (Natore Nahrstedt had to get rid of her cats) but may be left worse off than when it began (violation of a setback requirement results in injunction requiring removal of already-poured foundation).

P_R = probability that covenantee will pursue legal remedies,
C_{COR} = covenantor's litigation cost,

then the covenantor will invest in a violation up to the point where the marginal value of the violation equals the marginal cost. In other words, it will invest up to the point where:

$$I_{COR} = [P_{NI} * (V_{COR} - D_I)] + [(1- P_{NI}) * - I_{COR}) - (P_R * C_{COR})]$$

That is the point where the gain from a successful violation (V_{COR}), less the lost value damages (D_I) and less the litigation costs if the covenantee brings suit (P_R * C_{COR}) equals the investment. If the violation is unsuccessful, then, with the probability that the covenantee will succeed (1-P_{NI}), the covenantor will gain no value from the violation, but will incur its costs of investment in the violation (I_{COR}). This reduces to:

$$I_{COR} = \frac{(P_{NI} * (V_{COR} - D_I)) - (P_R * C_{COR})}{2 - P_{NI}}$$

In other words, as the probability of nonenforcement (P_{NI}) rises toward 1, the covenantor will be willing to invest more in violations, since it will be able to keep a higher percentage of the value of its violation. However, the covenantor's prospective gain from a violation will usually be low because, given the ready availability of the property rule remedy to the covenantee, the probability of a successful violation (P_{NI}) is low and the probability that the covenantor will incur litigation costs (P_R) is high.

To summarize the covenantor's and covenantee's investment incentives, the property rule will ordinarily deter a violation unless the covenantee does not bring suit because (1) the probability of nonenforcement is too high and damages on nonenforcement are too low, or (2) the covenantee's litigation cost exceeds the damage caused by the violation. To the extent that the covenantee does not bring suit, the covenantor's expected litigation costs drop (in other words, (P_R * C_{COR}) in the covenantor's equation becomes less negative), reducing the covenantor's costs and increasing the value of its investment in a violation.

By making injunctions the almost exclusive relief for covenant violations, the legal rule encourages the covenantor's speculative breach when it can violate with low investment (for example, violating a no Christmas lights after January 1 restriction). If the covenantee prevails, the covenantor merely has to remove the violation, possibly pay small liability rule damages for the period of the breach and, sometimes, pay the covenantee's attorneys' fees. This could lead to a ratcheting down of the covenant regime, as there are more unchallenged low-investment breaches

over time, although the covenantee, knowing this, will step up its enforcement.[92] Since it is not cost-effective to stop all violations in the real world,[93] the covenantee will not get the full benefit of its investment, and will therefore underinvest.

B. PRIVATE-ORDERED REMEDIES

1. *Effect of Private-Ordered Remedies on Investment and Enforcement*

This incentive for covenantors to speculate on low-investment violations generates costly litigation. As a result, covenant regimes governed by community associations have imposed private-ordered remedies, such as fines, expulsion, and self-help, which enable covenantees to enforce covenants without going to court. These graduated remedies are similar to those used in successful common pool resource regimes. Without graduated remedies, common pool resource regimes unwind, either through multiple violations as members conclude that only patsies comply, or through rebellion against draconian enforcement.[94]

Community associations make frequent use of graduated fines – in 30% of cases in a 1987 study. The fines were at a liability rule level (i.e., compensatory) for any given day when a violation continues, but increased incrementally to property rule levels for uncured violations. The 1987 study found that the median fine was $50, with most between $25-$100. Only 2% associations reported imposing fines greater than $200.[95] In the leading case of *Nahrstedt v. Lakeside Village Condominium Ass'n, Inc.*, Natore Nahrstedt was assessed a total of $50,000 – modest fines accruing over a lengthy period – for violating a no-pet clause with her three cats.[96]

Provisions permitting associations to expel covenant-violating members by forcing a sale of their unit are common in Illinois, but there

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[92] On the covenantor's step-up in enforcement, see *supra* note 91. Low-investment violations operate as information forcing about the value of the covenants: the covenantee defends them if they are worthwhile, but otherwise the right transfers to the covenantor. *Cf.* Ayres & Talley, *Solomonic Bargaining,* supra note 26.

[93] Empirical evidence confirms that community associations let some violations go by. BARTON & SILVERMAN, CALIFORNIA STUDY, *supra* note 76, at 23.

[94] *See supra* Part III.C; OSTROM, *supra* note 6, at 94-100, 186-87. In addition, graduated remedies will include communications short of sanctions. *See* Elinor Ostrom et al., *Covenants with and Without a Sword: Self-Governance is Possible*, 86 AM. POL. SCI. REV. 404 (1992) (experimental evidence showing that sanction plus communication creates closer to optimal compliance than either alone); BARTON & SILVERMAN, CALIFORNIA STUDY, *supra* note 76, at 23 (75% of community associations sent violator a letter and 49% spoke to violator personally; only 30% levied fines).

[95] *Id.*

[96] 878 P.2d 1275 (1994). *See also* Park Vill. W. Ass'n ex rel. Canter v. Sugar, No. 98-00631, 1999 WL 1441926, at *5-6 (Mass. Super. Ct. Dec. 8, 1999) ($13,704.45 for dog violation); Stewart v. Kopp, 454 S.E.2d 672 (N.C. Ct. App. 1995) ($100/day for noncomplying French doors, cumulating to $2900). These large fines may be consistent with an exception to Ben-Shahar's irrelevance theorem: that the violator may breach too much or too little if it imperfectly anticipates the probability of suit. *See* Ben-Shahar, *supra* note 5, at 221-22. Extending Ben-Shahar's idea, covenantors should breach too much if they underestimate the probability or efficacy of enforcement — for example if the fines accumulate too gradually, or the unit owners do not understand that they are enforceable.

appear to be no cases construing them.[97] California, New York, and Ohio courts have permitted the remedy of expulsion from cooperative apartments for covenant breach, but cooperative apartment unit owners are technically tenants, and, doctrinally, landlords have always been able to terminate the leases of tenants who violate lease covenants.[98] This is different from forcing the sale of a fee interest, given Blackstone's classic doctrine of a landowner's absolute dominion.[99]

Many covenant regimes also provide for covenantee self-help for covenant violations, though this remedy has not generated any court cases.[100] Under self-help, the covenantee can cure the covenantor's violation and charge the covenantor for the cost of cure, supported by a lien. In *The Glen, Section I Condominium Ass'n, v. June*, where a community association blocked a deadbeat unit owner's driveway, the court assessed damages against the association for interfering with the unit owner's rights.[101] While not a covenant case, *The Glen* suggests that courts

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[97] *See* Michael C. Kim, *Involuntary Sale: Banishing an Owner from the Condominium Community*, 31 J. MARSHALL L. REV. 429 (1998). Expulsion is also available (though rarely used) in Japan. *See* Tsuneo Kajiura, *Condominium Management in Japan*, *in* Barton & Silverman, COMMON INTEREST COMMUNITIES, *supra* note 75, at 247-74. Lawyers in Maryland and New Jersey tried to obtain expulsion for covenant breach — one under a common law nuisance theory — but in each case the offending unit owner departed before they obtained a judgment. *See* e-mail to Condo Lawyers listserv from mmannes@mhmpalaw.com re Self-help or expulsion for covenant breach (June 4, 2002) (on file with author); e-mail from Michael S. Karpoff re Eviction of Unit Owner (June 4, 2002) (on file with author). *See also* Plaintiff's Brief in Support of Its Application for Injunctive Relief, Harrowsgate Condominium Association v. Marcia Braunfeld (N.J. Super. Ct., Nov. 29, 2000) (no docket number; Michael S. Karpoff, attorney); e-mail to Condo Lawyers listserv from TerryLeahy@aol.com re Duty to stop racial hostility (Dec. 2, 2002) (on file with author) (increasingly aggressive enforcement steps, including motion for injunctive relief, force racial harasser from subdivision). Fines, when high enough, can effectively expel violators. Natore Narhstedt, unwilling to give up her cats to the last, sold her unit and moved after finally losing her case. *See* Karen E. Klein, *Fur Flies in Culver City Cat Fight*, L.A. TIMES, Mar. 5, 1995, at K1.

[98] *See* Sun Terrace Manor v. Municipal Court, 33 Cal. App. 3d 739 (1973); 40 W. 67th St. v. Pullman, 100 N.Y.2d 147 (2003); Gvozdanovic v. Woodford Corporation, 742 N.E.2d 1145 (2000). The New York court technically destroyed the value of the proprietary lease to the unit owner, although the owner was allowed to stay in his apartment through the conclusion of the appeal to New York's highest court, and the co-op agreed to pay any surplus to Pullman. David W. Chen, *Co-ops Win Right to Evict Tenants Without First Taking Court Action*, N.Y. TIMES, May 14, 2003, at B3. Even if forfeiture were permitted, the unit owner is likely to have a mortgage (technically a loan secured by a pledge of cooperative corporation shares), and, under typical loan documents, after termination of the unit owner's proprietary lease, the cooperative corporation would be required to issue an equivalent substitute proprietary lease to the lender at no charge. The lender would then sell the unit, and the unit owner would probably be entitled to any surplus above the loan amount, although the surplus might be minimal in a distress sale.

[99] *See* Rose, *Canons of Property, supra* note 20.

[100] Uriel Reichman, *Residential Private Governments: An Introductory Survey*, 43 U. CHI. L. REV. 253, 271-72 (1976); Uriel Reichman, *Toward a Unified Concept of Servitudes*, 55 S. CAL. L. REV. 1179, 1257 (1982) (advocating judicially supervised self-help). Natore Nahrstedt's community association cut off her hot water, though whether this was technically due to the covenant violation itself or to her failure to pay the fines resulting from the covenant violation is unclear. *See* Klein, *supra* note 97.

[101] 344 N.J. Super. 371 (2001). In contrast to New Jersey, North Carolina permits the denial of services to unit owners who violate covenants. Patrick K. Hetrick, *Of "Private Governments" and The Regulation of Neighborhoods: The North Carolina Planned Community Act*, 22 CAMPBELL L. REV. 1, 50-51 (1999); N.C. GEN. STAT. 47F-3-102(12). Community associations elsewhere have used utility

will limit self-help when it inflicts harm on the covenantor greatly exceeding the harm of the covenant violation, although they would presumably be receptive to self-help that cures the violation.

If we go back to our equations, then, assuming that the initial investment promoted by the covenant regime is efficient, private ordering of remedies is more efficient than an injunction regime. As we saw, the covenantee will invest in remedies up to the following point:

$$C_{CEE} = V_{CEE} - I_{CEE} + P_{NI} * (D_I - D_D - D_S)$$

Looking first at a fine regime, the fines may be at a liability rule level for a short-term violation, but they can accumulate to property rule levels. Thus, the amount owed for lost market value damages (D_I) increases, reducing the covenantee's loss. Self-help and expulsion, in contrast, will operate by sharply limiting the covenantee's uncompensated demoralization (D_D) and excess subjective value (D_S) damages: when the problem is cured, these damages are limited to the dates between violation and cure. All three remedies lower the probability of nonenforcement (P_{NI}), because the community association can eliminate most violations without going to court. The less loss after exercising remedies, the more the covenantee will be willing to invest in enforcement, further reducing the value of a violation to the covenantor.[102] The probability of loss will be further reduced because, if the community association files a lien to collect fines or unreimbursed self-help expenditures, it will ordinarily notify the unit owner's mortgagee. The unit owner's mortgagee ordinarily makes uncured liens a default, and will police covenant compliance by threatening to foreclose. Given that the mortgagee's loan will typically be many times larger than the size of the association's lien and will provide for default interest on uncured breaches, the unit owner may face large mortgagee penalties for noncompliance even before the association begins a formal lawsuit. Thus, the mortgagee's interest is a form of asset partitioning that polices covenant compliance, just as it polices financial covenant compliance in the commercial world.[103]

Viewed from the perspective of efficient investment, the covenantee will also invest more in its unit up front. As we saw earlier,

$$I_{CEE} = V_{CEE} + P_{NI} * (D_I - D_D - D_S) - C_{CEE}$$

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shutoffs to enforce the payment of delinquent assessments, but as in *The Glen*, this strategy has hazards. *See* e-mail from D.T. Scarborough III to Condo Lawyers listserv re Water Shut-off to Delinquent Owners (July 31, 2002) (on file with author).

[102] *See supra* Part IV.A.

[103] *See* Hansmann & Kraakman, *Organizational Law*, *supra* note 23. Community association liens generally come behind mortgages in priority, but mortgagees nonetheless want them removed.

With the increased fines (D_I) or with the cure of the violation obtained under the self-help or expulsion remedies, the covenantee loses less from uncompensated demoralization damages (D_D) and excess subjective value damages (D_S). In addition, there is a reasonable chance that enforcement costs (C_{CEE}) will be reduced as well because the covenantor, faced with a reduced value for its violation, will be less likely to violate. Even if the covenantor violates, C_{CEE} is likely to drop because enforcement is less costly. Usually, it is not necessary to go to court. Even if the covenantee has to foreclose a lien on the covenantor's property in order to collect a fine, this will usually be cheaper than fact-specific injunction litigation. Thus, under a private-ordered regime, the covenantee will invest up to a point close to where the marginal cost of its investment is equal to its marginal value.

Private ordering will also reduce the covenantor's incentive to invest in a violation. As previously noted, the covenantor will invest until:

$$I_{COR} = \frac{(P_{NI} * (V_{COR} - D_I)) - (P_R * C_{COR})}{2 - P_{NI}}$$

In a private-ordered fine regime, lost market value damages (D_I) increase compared to an injunctive regime, since the fines are higher than the liability rule damages that courts typically assess. This reduces the covenantor's profit from a successful violation, and will often completely remove it. The probability that the covenantee will pursue remedies (P_R) increases as well, along with the expected defense cost to the covenantor, because fines may make a resort to litigation unnecessary and will help fund any required litigation cost. However, the covenantor's litigation cost (C_{COR}) decreases if there is rapid enforcement or no litigation.[104]

Self-help and expulsion operate differently on the covenantor's incentives, but with the same result. When self-help restores the status quo before, it operates like a private injunction with minimal enforcement costs (merely the cost of hiring a contractor and sending a bill to the covenantor): this reduces the value of a violation to the covenantor (V_{COR}).[105] Self-help is often used in common pool resource regimes: for example, destroying the lobster pots of a fisherman who poaches on someone's territory.[106] In an expulsion, the covenantee effectively exercises a call option that forces the covenantor to accept the fair market value of its unit in exchange for its property right. This is similar to an application of Calabresi and

[104] Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties, and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach,* 77 COLUM. L. REV. 554, 579-89 (1977), argue that supercompensatory remedies amount to a promisor insuring a promise against breach when the victim has a high subjective value.

[105] When covenantees go beyond restoration and use self-help to deprive the covenantor of unrelated uses of its property, self-help is the equivalent of a fine, as in *The Glen*, 344 N.J. Super. 371 (2001). *See also supra* note 101 and accompanying text.

[106] *See* OSTROM, *supra* note 6.

Melamed's Rule 4 reverse liability rule (nuisance victim is entitled to an injunction if it pays the nuisance generator's lost value);[107] the difference is that a third party, not the covenantee, generally does the buying. In so doing, the covenantor's gain from violating the covenant (V_{COR}) is reduced by (1) depriving the covenantor of any above-average subjective value of its unit, (2) the transaction costs of the sale (such as brokerage fees), (3) if a rapid sale timetable creates a distress sale, a loss on the difference between fair market value and the sale price, and (4) demoralization of the covenantor's investment from forced sale.

So, from the point of view of the covenantee's initial investment, given costly enforcement and undercompensatory liability rule damages, a fine regime is ideal if the fines are set high enough to deter all violations within a brief time after they are assessed,[108] and self-help and expulsion are effective if they are always pursued.

2. *Complex Covenants and Ignorant Covenantees*

The private ordering of residential covenants is efficient only in an efficient market with competing developers and informed consumers. This happy picture largely reflects reality soon after the covenant regime is created, but covenants probably tend toward inefficient tightness.[109] Developers usually create the initial covenant regimes. Because they expect to control the community association in the initial stages (before sales are complete), they have the incentive to load the covenants with pro-association language, some of which may be unconscionable. Expecting to sell all the parcels in their projects, developers will innovate in the covenants only if the resulting increase in sales price will exceed the cost of innovation (this will often be the case if the novel covenant regime can be marketed, as with a senior living restriction), or if the change provides them with additional control or protection against liability.[110] Even if developers want to innovate, lenders and secondary market agencies that understand the risks and benefits of existing terms may balk: the holders of the loans will be investors in the project for a longer term than the

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[107] *See* Calabresi & Melamed, *supra* note 24.

[108] High-income covenantors with high subjective value for their violations may not be deterred, however. Jay Weiser, *Measure of Damages for Violation of Property Rules: Breach of Confidentiality*, 9 U. CHI. L.S. ROUNDTABLE 75, 107-11, 113-14 (2003) [hereinafter Weiser, *Measure of Damages*].

[109] *Compare* Fennell, Contracting Communities, *supra* note 19, at 28-44 (detailed treatment of potential sources of inefficiency) and Parisi, Entropy, *supra* note 61, at 39, 79 (arguing that rational owners will discount loss of value of land caused by excessive fragmentation and that there will be less fragmentation when property rule protection is available; implicitly, this suggests that property owners will use covenants, protected by property rules, to fragment legal rights efficiently), *with* Epstein, *Covenants*, *supra* note 59, at 917 (covenants are generally efficient), *with* James L. Winokur, *The Mixed Blessings of Promissory Servitudes: Toward Optimizing Economic Utility, Individual Liberty, and Personal Identity*, 1989 WIS. L. REV. 1 [hereinafter Winokur, *Mixed Blessings*] (lots of skepticism).

In commercial covenants, the parties are more likely to be sophisticated and invest in understanding their rights, which may account for the relatively small number of commercial covenant cases. But see Unit Owners Ass'n of Buildamerica-1 v. Gillman, 292 S.E.2d 378 (1982), discussed *infra* note 131 and accompanying text.

[110] Fennell, Contracting Communities, *supra* note 19, at 32.

developer, and will have a fixed return with limited upside from risky innovations that have not been interpreted by settled case law.[111] This is an example of Marcel Kahan and Michael Klausner's economics of boilerplate.[112]

There is probably less incentive for innovation in boilerplate for residential associations – at least for boilerplate dealing with the long-term governance of the development – than in the commercial real estate world, where the higher unit values justify greater customization.[113] Residential buyers rarely read the language, usually lack the sophistication to understand its implications, and often buy without review by counsel.[114] They will tend to be overoptimistic that they will have no conflicts with the community association and will tend to believe that boilerplate doesn't matter.[115] Thus, Natore Nahrstedt bought her California condominium without realizing that its no-pet clause barred her three cats.[116] Even those buyers who review residential covenants will generally only conduct their examination after they have reached agreement on price and signed a binder or contract, by which time they are psychologically committed to the deal. All of this undermines the arguments made by Anthony Kronman, Alan Schwartz, and Thomas Ulen that knowledgeable buyers will choose

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[111] *See* Winokur, *Choice, Consent*, *supra* note 75, at 98-99 nn.30-31 (documents are highly standardized, in part due to secondary mortgage market pressure). The quality of the covenants is therefore policed by asset partitioning. *See* Hansmann & Kraakman, *Organizational Law*, *supra* note 23. The value of the unit is split between the lender (who has a mortgage securing a stream of interest payments) and the unit owner (who holds the equity piece). The lender has an incentive to monitor the quality of the covenant regime and whether it is likely to end. Where an inferior covenant regime reduces unit value, mortgage lenders will reduce loan amounts or charge higher interest rates. This, in turn, would reduce unit sale prices and, therefore, the developer's initial profit.

[112] *See* Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or 'The Economics of Boilerplate')*, 83 VA. L. REV. 713 (1997)).

[113] *See* Winokur, *Choice, Consent*, *supra* note 75, at 98-99 nn.30-31.

[114] *See* Natelson, *supra* note 52, at 62 n.97 (discussing empirical evidence, including contrary evidence that where disclosure is mandated, there is some understanding of provisions); Barton & Silverman, COMMON INTEREST COMMUNITIES, *supra* note 75, at 137-39 (only 27% of residential unit owners read covenants closely); Winokur, *Choice, Consent*, *supra* note 75, at 99 n.32, 100 n.34; Fennell, Contracting Communities, *supra* note 19, at 36-44. *See also* Eisenberg, *supra* note 33, at 243-44 (failure to read form contracts in other consumer settings); Rasmusen, *supra* note 35 (inefficient for individual employee to heavily negotiate restrictions in an employment contract). *But cf.* Joyce Palomar, *The War Between Attorneys and Lay Conveyancers — Empirical Evidence Says "Cease Fire!"*, 31 CONN. L. REV. 423 (1999) (buyers appear not to be disadvantaged in states where counsel is not employed, presumably because brokers explain risks).

[115] *Cf.* Eisenberg, *supra* note 33; Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1524 (1998); Robert A. Hillman & Jeffrey J. Rachlinski, Standard-Form Contracting in the Electronic Age (2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=287819 (last visited on Feruary 15, 2002) (all discussing overoptimism bias).

[116] *See* Elberg, *supra* note 12, at 1963. Lack of knowledge about the covenant terms leads to a high frequency of violations. Barton & Silverman, COMMON INTEREST COMMUNITIES, *supra* note 75, at 137-39 (evidence that unit owners read covenants only after they are cited for violations).

the most efficient remedies and, therefore, private ordering should be respected.[117]

Nor is a tradeoff between price and terms likely to be fully effective. Alan Schwartz and Louis Wilde have argued that in ordinary sales of goods, an informed minority of consumers can generate competitive terms.[118] In the real estate covenant context, buyers may prefer a lower price or fast closing to ideal covenant terms, but they may simply be unable to price the value of hundreds of covenant terms.[119] If identical units are being sold in two identical developments, except that one 100-page covenant regime has a 15-foot setback restriction amendable by a 2/3 vote, and the other prohibits storage sheds and is amendable by a 3/4 vote, which should the unit owner pay more for?

While almost all consumers will remain uninformed about the details, residents appear to prefer developments with covenant schemes, and unit owners of developments with inefficient covenant regimes will be less happy. Buyers in new developments can often police covenant quality by visiting developers' prior projects,[120] even if they don't attribute problems to inefficient covenants. A buyer may be more likely to perceive an inefficiently lax regime, where everything looks unkempt. An inefficiently tight regime may be like a Roach Motel, where the buyer is lured in by the immaculate appearance, only to discover after closing that covenant enforcement is draconian and the only way to exit is through a sale that will require finding a new home and incurring brokerage fees. Thus, developers may have an incentive to innovate to create excessively tight covenant regimes, as long as their own interests are protected.[121] This is consistent with Schwartz and Wilde's suggestion that the presence of informed

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[117] *See* Anthony T. Kronman, *Specific Performance*, 45 U. CHI. L. REV. 351, 357-58 (1978) (advocating private choice and noting that parties will prefer specific performance for unique items); Alan Schwartz, *The Myth that Promisees Prefer Supracompensatory Remedies: An Analysis of Contracting for Damage Remedies*, 100 YALE L.J. 369, 371-72 (1990) [hereinafter *Contracting for Damage Remedies*] (private choice will usually be efficient); Thomas S. Ulen, *The Efficiency of Specific Performance: Toward a Unified Theory of Contract Remedies*, 83 MICH. L. REV. 341 (1984) (specific performance efficient where low renegotiation costs or where high subjective value).

[118] *See* Alan Schwartz & Louis L. Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387 (1983). *But see* R. Ted Cruz & Jeffrey J. Hinck, *Not My Brother's Keeper: The Inability of an Informed Minority to Correct for Imperfect Information*, 47 HASTINGS L.J. 635 (1996) (unlikely that there will be a sufficient number of informed consumers); Eisenberg, *supra* note 33, at 243-44.

[119] *See* Natelson, *supra* note 52, at 63.

[120] *See, e.g.*, the websites for residential developers, Del Webb, http://www.delwebb.com, Kaufman & Broad, http://www.kbhome.com, and Toll Brothers, http://www.tollbrothers.com, which identify prior projects (all visited Feb. 20, 2003). *See also* Gennari v. Weichert Co. Realtors, 148 N.J. 582, 592 (1997) (purchaser has broker visit developer's prior projects to assess quality of construction).

[121] See Epstein, *Covenants*, *supra* note 59, at 917, for a similar argument. New York City cooperative apartment buildings, which generally prohibit resale without community association approval, are an example of excessively tight covenants: they sell at a 15% discount to condominium apartments without similar restrictions. *See* Schill et al., *supra* note 79.

consumers may have little effect in long-term contracts, given the universal human difficulty of predicting future preferences.[122]

Even though some efficient innovation in covenant terms takes place in new developments, outdated covenants in older developments will remain on the books. The developer by then has long since sold out, while the overwhelming majority of unit owners are passive and unlikely to push for efficient changes.[123] If a developer were to put in covenant provisions allowing easy amendment over the long term, this might scare off unit owners who underestimate the future need for change.[124] And the cost of determining and documenting all possible future permutations of the covenant regime may exceed the discounted present value of doing so. Thus, as discussed in more detail at Part V.A below, market incentives may not generate covenants that will be efficient over the long term.[125]

3. *Excessive Enforcement of Private-Ordered Remedies*

Covenantees may excessively use private-ordered remedies due to opportunism (moral hazard in law and economics terminology), or excessive subjective value. While property/liability rule theory makes all property rules equivalent – injunctions and private-ordered remedies, such as fines, self-help, or expulsion – they are different in the real world. Injunctions encourage covenantee opportunism only where the covenantor's cost of compliance greatly exceeds the covenantee's value, and the covenantee believes that it can extort a payoff from the covenantor.[126] Self-help and expulsion, like injunctions, may cause the covenantor disproportionate pain, but will not ordinarily line the covenantee's pocket,[127] and they will presumably be limited by doctrines

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[122] *See* Schwartz & Wilde, *supra* note 118, at 1453 n.114. *See also* Eisenberg, *supra* note 33, at 251-53; Barton H. Thompson, Tragically Difficult: The Obstacles to Governing the Commons, Stan. L. & Econ. Olin Working Paper No. 187 (2000), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=236031 (last visited February 10, 2002).

[123] *See* Barton & Silverman, COMMON INTEREST COMMUNITIES, *supra* note 75. But when conditions become bad enough, unit owners will become active to vote in a new slate of directors or take other action. Thus, in *Nahrstedt,* unit owners brought in a new slate of directors that stiffened enforcement of the no-pet rule. *See* Elberg, *supra* note 12, at 1963. In 40 W. 67th St. v. Pullman, 100 N.Y.2d 147, (2003), one shareholder was so obnoxious that 70% of the unit owners voted to expel him. The level and type of participation appears to be fairly similar to the level of participation in electoral politics — people get energized to throw the rascals out only in exceptional situations.

[124] *See* Heller, *Boundaries, supra* note 61, at 1184-85; Fennell, Contracting Communities, *supra* note 19, at 33-36 (homeowner risk aversion). The usual method for flexibility has been to require supermajority votes for change, Epstein, *Covenants, supra* note 59, at 919-21 (developers will face reduced purchase price if their covenant regimes create substantial holdout risk in future), or to provide an automatic renewal provision that at least theoretically gives unit owners the ability to terminate inefficient covenants. *See infra* note 163 and accompanying text (survey of termination provisions).

[125] I was once in a negotiation where the businesspeople and lawyers consciously made this decision, and, as a result, made the covenants perpetual. *See generally infra* Part III.B.

[126] *See* Ayres & Madison, *supra* note 71.

[127] If a self-help remedy applies, the covenantee could demand above-market reimbursement or order unnecessary work, but, unlike a fine, this is unlikely to lead to huge covenantor payment obligations. There are apparently no self-help cases arising out of excessive charges or unnecessary work.

similar to those limiting injunctions. In contrast, property rule fines increase opportunism risk by giving the covenantee an incentive to claim a breach (or even to induce one), in order to obtain supercompensatory damages. Excessive damages will cause covenantors to underinvest.[128]

Fine regimes limit opportunistic enforcement in several ways. When an association enforces the fines, any gain will be spread thinly among the unit owners,[129] and directors and other unit owners may themselves fear being the victims of excessive fines in the future. The covenantor can always choose to comply before the amounts rise excessively, and, if the fines exceed the value of the covenantor's equity, the covenantor can walk away from the property and permit the association to foreclose, limiting its losses.[130] This may, however, impose a substantial unjustified loss when the covenantor's home is his principal asset. The same may be true in commercial covenant regimes: in *Unit Owners Ass'n of Buildamerica-1 v. Gillman*,[131] an association imposed huge fines for a questionable garbage truck violation in the hope of driving a trash-hauling business out of an industrial subdivision. The Virginia Supreme Court responded by interpreting its condominium statute to bar imposition of fines by associations completely and instead requiring a lawsuit by the association against the unit owner.[132]

As we have seen, however, banning fines and generating more lawsuits will raise the covenantee's enforcement cost for policing covenant violations, and increase the number of speculative violations by the covenantor.[133] The benefits of private ordering could be better obtained, while still limiting covenantee opportunism, if courts monitored fines or other remedies under a business judgment rule.[134] New York, California,

[128] This may be amplified if covenantors fear that damages will be assessed erroneously. *See generally* John E. Calfee and Richard Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards*, 70 VA. L. REV. 965 (1984); Richard Craswell & John E. Calfee, *Deterrence and Uncertain Legal Standards*, 2 J.L. ECON. & ORG. 279 (1986); Weiser, *Measure of Damages*, *supra* note 108, at 100-01, 106-12, 115-16 (2003) (effect of assessment and enforcement error on property rules). For purposes of this article, I will assume that the assessment of property rule damages is always correct.

[129] This may be a real-world variation of Bebchuk's proof that, for efficiently allocating incentives between parties, government fines are better than regimes where one or the other party gets the entire benefit. *See* Bebchuk, Ex Ante Ex Post, *supra* note 4, at 35. However, Bebchuk's salutary result will not occur if the association's directors or professional managers think of the community association as an entity, since in that case they will regard the fines as generating more money for its reserve fund.

[130] Because real estate is usually heavily mortgaged and post-foreclosure deficiencies are rarely pursued, as a practical matter, the covenantor's equity is all that is at risk. If the association forecloses, the mortgagee is likely to foreclose as well, and typical covenants provide that the mortgagee would not be liable for the covenantee's unpaid fines.

[131] 292 S.E.2d 378 (Va. 1982).

[132] New Jersey and Indiana have taken similar stances. Walker v. Briarwood Condo Association, 274 N.J. Super. 422 (1994); Rajski v. Tezich, 514 N.E.2d 347 (1987). As in Virginia, these bans on fines are based on language in the state common interest community or condominium statutes.

[133] *See supra* Part IV.A.

[134] *See* Hyatt, *supra* note 52, at 354-55 (finding de facto business judgment rule); Natelson, *supra* note 52, at 87 (level of consent and level of loss to violator should determine whether business judgment or reasonableness rule applies, with business judgment rule generally applying to decisions on common property and common finances); Jeffrey A. Goldberg, Note, *Community Association Use*

and Florida have endorsed variations of this rule, refusing to second-guess reasonableness in ordinary cases.[135]

Even a business judgment rule will be imperfect, given the lack of unit owner sophistication in residential community associations, the potential for high emotions and the difficulty even in commercial developments of anticipating all scenarios.[136] The unconscionability literature suggests that reasonable remedies, even if slanted towards the drafter, should be enforced, since courts are in a poor position to determine which terms are efficient, compared to developers and association boards.[137] Outrageous remedies should not be given such deference, as when the primary motivation for imposition of the remedy is opportunism or malice.[138]

Restrictions: Applying the Business Judgment Doctrine, 64 CHI.-KENT L. REV. 653 (1988) (advocating business judgment rule); Note, *Judicial Review of Condominium Rulemaking*, 94 HARV. L. REV. 647 (1981) (advocating reasonableness test); Vincent DiLorenzo, *Judicial Deference to Management Decisions in Planned Unit Developments,* PROBATE AND PROPERTY, Jan./Feb. 2001, at 20 (advocating business judgment rule).

[135] New York calls its rule a business judgment rule, Levandusky v. One Fifth Ave. Apt. Corp., 553 N.E.2d 1317 (1990); 40 W. 67th St. v. Pullman, 100 N.Y.2d 147 (2003), while California applies a reasonableness standard to the same effect, Nahrstedt v. Lakeside Village Condo. Ass'n, 878 P.2d 1275 (1994). Florida's reasonableness standard offers less deference to decisions made under covenants adopted by the board, as opposed to the initial covenants or covenants later adopted by the unit owners. Hidden Harbor Estates, Inc. v. Basso, 393 So.2d 637 (1981). There is less clarity in other states that have applied reasonableness standards. North Carolina's statute incorporates a reasonableness standard, but limits fines to $150 per day. *See* Hetrick, *supra* note 101, at 50-51; N.C. GEN. STAT. ANN. 47C-3–102(a)(11). Massachusetts permits reasonable fines. Katharine N. Rosenberry, *Home Businesses, Llamas and Aluminum Siding: Trends in Covenant Enforcement*, 31 J. MARSHALL L. REV. 443, 475 n.297 (1998). See also the following cases holding fines reasonable (without discussing whether a business judgment rule is being applied): Liebler v. Point Loma Tennis Club, 40 Cal. App. 4th 1600 (1995) ($50/day when unit owner permits outsiders to use tennis court); Spratt v. Henderson Mill Condo. Ass'n, 481 S.E.2d 879 (1997) ($25/day for prohibited lease); Stewart v. Kopp, 454 S.E.2d 672 (1995) ($100/day for alterations clause violation). *But see* McLain v. Anderson, 933 P.2d 468 (1997) (refusing to enforce $25/day fine for excessive number of horses; court gives no deference to architectural committee). *Cf.* Ellickson, *Alternatives to Zoning, supra* note 10, at 773-74 (advocating fines as a way of more efficiently regulating nuisance).

[136] On the difficulty of assessing all contingencies in commercial liquidated damages provisions, see Eric L. Talley, Note, *Contract Renegotiation, Mechanism Design, and the Liquidated Damages Rule*, 46 STAN. L. REV. 1195, 1198 (1994). *See also* incomplete contracts discussion *supra* Part III.B.

[137] *See* Richard Craswell, *Property Rules and Liability Rules in Unconscionability and Related Doctrines*, 60 U. CHI. L. REV. 1 (1993); Richard Epstein, *Unconscionability: A Critical Reappraisal*, 18 J.L & ECON. 293 (1975); Alan Schwartz, *A Re-examination of Nonsubstantive Unconscionability*, 63 VA. L. REV. 1053, 1064-65 (1977) (all arguing for limited court intervention to overturn unconscionable terms due, in part, to difficulty of court doing a better job). *But see* Todd D. Rakoff, *Contracts of Adhesion, An Essay in Reconstruction*, 96 HARV. L. REV. 1173, 1203 (1983) (contracts of adhesion should be presumptively unenforceable); Michael I. Meyerson, *The Efficient Consumer Form Contract: Law and Economics Meets the Real World*, 24 GA. L. REV. 583 (1990) (courts should incorporate only terms that consumers would have agreed to had they been explained); Michael I. Meyerson, *The Reunification of Contract Law: The Objective Theory of Consumer Form Contracts*, 47 U. MIAMI L. REV. 1263 (1996). Form contract opponents give little consideration to the blizzard of litigation that their proposals would generate.

[138] Kalenka v. Taylor, 896 P.2d 222 (1995) ($1000/day excessive for violation of covenant provisions dealing with screening construction, pets, and landscaping; exes in post-divorce squabble); Nahrstedt v. Lakeside Village Condominium Ass'n, 878 P.2d 1275, 1287 (1994) (judicial supervision will still apply where harm disproportionate to benefit). In 40 W. 67th St. v. Pullman, 100 N.Y.2d 147

Some courts and commentators have suggested that community association fines should be enforced only if they would satisfy the common law liquidated damages test: hard to estimate at the time of contracting and reasonable at the time of breach.[139] The liquidated damages rule awards an estimate of expectation damages – the lost market value from the breach, which works where no substantial initial investment is required. For example, there are no subjective or demoralization damages if Kellogg's refuses to deliver 200,000 boxes of corn flakes to Wal-Mart. By protecting against the promisee's opportunistic attempt to get excessive damages, in a setting without substantial investment, the liquidated damages rule encourages efficient breach and enables renegotiation when performance is inefficient.[140] Those virtues do not fully apply to covenant breaches, where the failure to include demoralization and above-average subjective damages underprotects the covenantee's investment incentives[141] and encourages the covenantor's opportunism.[142]

While it is easy to reject the liquidated damages test, it is difficult to estimate fine amounts for many types of violations of varying severity under unforeseen circumstances over long periods of time. If fines are too low, then violators with high subjective values may simply pay them, treating them as the equivalent of a liability rule. One-size-fits-all fines may be draconian for minor offenses, although, perversely, the failure to tailor the levels of fines to harm led the Court in *Rajski v. Tesich* to overturn

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(2003), the court gave greater deference to the community association's business judgment when it applied procedural protections: a supermajority of cooperative apartment shareholders voted to expel the offending member. *See also* Craswell, *supra* note 137. *Cf.* Stewart E. Sterk, *Minority Protection in Residential Private Governments*, 77 B.U. L. REV. 273, 319 (1997) (risk-averse unit owners will want protection from association action).

[139] *See* Kalenka v. Taylor, 896 P.2d 222 (1995) (claims sound in contract theory); Rajski v. Tezich, 514 N.E.2d 347 (1987) (applying liquidated damages test); Elberg, *supra* note 12.

[140] Talley, *supra* note 136, argues that the liquidated damages rule encourages efficient renegotiation by limiting the spread between the promisee's actual damages and the liquidated damages amount. This is correct when the breach victim can negotiate a payment from the breacher and then cover under the contract. Here, there is no market to cover in — it is expensive and time-consuming for a covenantee to sell her unit and buy one in a development where covenants are enforced. In addition, under a liquidated damages regime, the covenantee could find few developments where covenants *were* enforced, because covenantors everywhere could opt out on payment of the damages.

The other major justification for the penalty doctrine is that without it, prospective violators will engage in a wasteful race to signal that they are reliable partners, and, as a result, efficient breach will be discouraged. *See* Talley *supra* note 136, at 1217-18. Given that the covenants are developer-created and that unit owners have little need to signal their reliability by accepting extravagant remedy clauses (and, in fact, do not understand them when entering into them), this seems irrelevant.

[141] *See supra* Part IV.A. Edlin & Schwartz, *supra* note 49, observe that expectation damages provided by a liquidated damages rule will be insufficient to protect cooperative and selfish investments. As discussed *supra* note 48, covenantees make both kinds of investments (the combination is a hybrid investment) when buying into a covenant regime. *See also* Natelson, *supra* note 52, 83-84 (courts will tend to underassess damages caused by a violation because they will look only at current damages rather than long-term demoralization). *Cf.* Kronman, *supra* note 117; Schwartz, *Contracting for Damage Remedies*, *supra* note 117; Ulen, *supra* note 117 (all contending that private-ordered remedies are superior); Eisenberg, *supra* note 33, at 234-35 (enforce if well thought-out in advance).

[142] *See supra* Part IV.A.

a penny ante $10/day fine regime.[143] This effectively blessed rapid erosion of the covenant regime by minor breaches.

A reasonable fine schedule would consider the average market value loss in the development from a violation.[144] The cumulativeness of the fines and the covenantor's ability to cure limit the arbitrariness: the covenantor is encouraged to cure small violations early, larger ones later, and all eventually.

V. LONG-TERM ISSUES

A. THE COMMONS AS ANTICOMMONS: WHY COVENANTS MAY NOT EFFICIENTLY CHANGE

As previously discussed, covenants are probably efficient in the real world over a few decades: because of their long life and high capital investment as a proportion of value, the initial real estate uses are relatively stable.[145] The consequences of freely enforcing property rules may be less efficient over time, because the highest and best use of an area may change unpredictably over decades – the issue of whether to protect the first or second mover.[146] Thus, at the time of the initial investment, the developer may allocate land for residential use along a main road that later turns commercial, as on Wilshire Boulevard in Los Angeles, Grand Avenue in Detroit, and the Boston Post Road in Fairfield, Connecticut.[147]

As covenant regimes age, what was originally a commons may become an anticommons that vetoes more efficient uses and is nearly impossible to change.[148] Covenant regimes may create externalities in the same way that

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[143] 514 N.E.2d 347 (1987). *But cf.* Ayres & Talley, *Solomonic Bargaining*, *supra* note 26. They praise untailored damages — damages not precisely calibrated to harm — for forcing trade, but, in the case of covenant fines, the untailored damages would prevent trade.

[144] This would require adjusting the fine level over the years to reflect inflation or deflation. Some multiplier would also be needed for enforcement error. *See* Calfee & Craswell, *supra* note 128; Craswell & Calfee, *supra* note 128; Keith N. Hylton and Thomas J. Miceli, Should Tort Damages Be Multiplied? (May 2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=314920 (advocating multiplier of 2 for torts) (last visited on April 27, 2003).

[145] During huge booms, uses may change more quickly. During Manhattan's decades of explosive growth — it went from a 33,131 population in 1790 to a 2,331,542 population in 1910 — residential neighborhoods subject to covenants sometimes changed their uses within 15 years. Nathan Kantrowitz, *Population*, in THE ENCYCLOPEDIA OF NEW YORK CITY, *supra* note 15, at 923; Charles Lockwood, MANHATTAN MOVES UPTOWN (1976). *See also* Amerman v. Deane, 30 N.E. 741 (1892) (refusing to enforce no-tenement covenant in Manhattan's San Juan Hill neighborhood due to rapidly changing uses).

[146] *See* Fennell, Contracting Communities, *supra* note 19, at 25-28 (preference misalignments over time); Pitchford & Snyder, *supra* note 4.

[147] *See* Atlas Terminals, Inc. v. Sokol, 203 Cal. App. 2d 191 (1962); Redfern Lawns Civic Ass'n v. Currie Pontiac Co., 44 N.W.2d 8 (1950); Cappello v. Ciresi, 691 A.2d 42 (1996).

[148] *See* Heller, *Boundaries*, *supra* note 61, at 1184-85, 1198 (vetoes by associations); Winokur, *Mixed Blessings*, *supra* note 109 (proposing to limit enforcement powers, after a few decades, only to homeowners in immediate vicinity of changed use). *Cf.* Stake, *Land-Use Doctrines*, *supra* note 2, at 441; Stake, *Touch and Concern*, *supra* note 20 (both arguing that touch and concern doctrine limits holdout risks when parties seek to change covenants); Fennell, Contracting Communities, *supra* note

large-lot zoning removes land from possible high-intensity uses and increases costs for the less well-off.[149] The incomplete contracts and liquidated damages literatures observe that a contract between two parties may be so strongly protected by property rules that a third party will be deterred from entering (i.e., inducing an efficient breach), even when this would maximize wealth. The reason is that the covenantee, with veto power, can hold out and capture the entire surplus from the changed use.[150] But if there are only two owners in the covenant regime, in the real world, they can often renegotiate an acceptable division and work out a trade.[151]

19, at 52 (covenants may create aesthetic anticommons for unit owners within association). On the anticommons, see generally Heller, *Anticommons*, *supra* note 7.

[150] For the incomplete contracts literature, see Bebchuk, Ex Ante Ex Post, *supra* note 4; Bebchuk, *Ex Ante Cathedral*, *supra* note 4; Pitchford & Snyder *supra* note 4 (property rule protecting an investment discourages an efficient future clashing use). For the liquidated damages literature, see Talley, *supra* note 136 (summarizing literature); Tai-Yeong Chung, *On the Social Optimality of Liquidated Damages Clauses: An Economic Analysis*, 8 J.L. ECON. & ORG. 280 (1992); Kenneth W. Clarkson et al., *Liquidated Damages v. Penalties*, 1978 WISC. L. REV. 351; Edlin & Schwartz, *supra* note 49 (supercompensatory damages may result in use of market power to deter entry); Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554, 592 (1977). *See also* Dagan & Heller, *supra* note 33, at 599 (excessive exit taxes in commons regime may overdeter); William J. Stull, *Land Use and Zoning in an Urban Economy*, 64 AM. ECON. REV. 337, 346 (1974) (mathematical proof that residents will oppose efficient zoning change unless they can capture all gains). *But see* Epstein, *Covenants*, *supra* note 59, at 925 (arguing that third parties will be protected from externalities because covenantees will exit from inefficient covenant regimes by selling their units, but not explaining why covenantees would sell when they benefit from the inefficiencies). Lee Fennell has also noted the links between the commons/anticommons and property/liability literatures. *See* Lee Fennell, Common Interest Tragedies, U of Tex. L., Law and Econ. Res. Paper No. 005, at 54-55 (2003), *available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=474380* (last visited Apr. 18, 2004) (forthcoming, NW. U. L. REV.) [hereinafter Fennell, Common Interest Tragedies].

[151] *See* Hoffman and Spitzer, *Experimental Tests of the Coase Theorem with Large Bargaining Groups*, 15 J. LEGAL STUD. 149, 151 (1986) (multiparty negotiations are likely to lead to an agreement with up to 38 negotiators); Epstein, *Covenants*, *supra* note 59, at 919-22 (advocating no intervention in two-party negotiations); Hsu, *supra* note 33, at 854 (private property efficient where number of affected parties small). *But see* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 3.9 (5th ed. 1998) (bilateral monopoly and huge surplus may result in negotiation breakdown); Gregory S. Alexander, *Freedom, Coercion, and the Law of Servitudes*, 73 CORNELL L. REV. 883, 899-900 (1988) (bilateral monopoly in servitude negotiations creates "pathology of choice"); Ayres & Madison, *Inefficient Injunctions*, *supra* note 71 (bilateral monopoly and huge surplus may result in negotiation breakdown); Julia D. Mahoney, Perpetual Restrictions on Land and the Problem of the Future, UVA Law & Economics Research Paper No. 01-6 and UVA School of Law, Public Law Research Paper No. 01-11 (Dec. 2001), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=291537 (last visited Apr. 18, 2004) (conservation easements may inefficiently persist due to strong preferences of easement-holding conservation organization); Parisi, Entropy, *supra* note 61, at 44 n.86 (conservation easements as fragmentation preventing use change); Schmitz, *supra* note 42 (summarizing theoretical work showing that when two parties control an asset and payoffs can be realized outside their relationship, bilateral veto power is never optimal); Elberg, *supra* note 12, 1987-90 (danger of strategic or uninformed behavior by community association boards).

As covenantees multiply, the result is what Francesco Parisi calls entropy: an excessive fragmentation of property interests (here, split between unit owner possessory interests and the covenant commons use controls) that cannot be reunified because of excessive renegotiation costs and holdout risks.[152] The entropy/anticommons problem is probably increasing, given the rapid expansion over the last three decades of community associations that can enforce covenant regimes at relatively low cost.[153] Before the rise of community associations, as a subdivision aged, it often moved down in value. Individual owners were likely to have less money to litigate, and faced collective action and free rider problems in getting their neighbors to participate, meaning that inefficient covenants might be ignored.[154] Community associations' improved enforcement abilities are not matched by comparable improvements in the ease of renegotiation, however. While a community association reduces the number of entities with whom the covenantor must negotiate down to one, community associations are less likely than an individual covenantee to efficiently release the covenant.[155]

A community association is a single entity, but, as a common pool resource governance structure, doesn't fully act like one in its decisionmaking due to collective action problems. Unit owners with high

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[152] *See* Parisi, Entropy, *supra* note 61, at 26 nn.54, 27 (entropy results when closely complementary aspects of property are dismembered; demonstrating a tendency toward entropy because the initial cost of fragmentation (as in the creation of a covenant regime) is far less than the cost of reunification); Parisi, Asymmetric Coase Theorem, *supra* note 61, at 10-12 (mathematical proof of entropy theory); Heller, *Boundaries, supra* note 61, at 1184-85. *See also* Danzon, *supra* note 20, at 592.

[153] *See* text *supra* at note 16.

[154] *See supra* Part IV.A; Medearis v. Trustees of Meyers Park Baptist Church, 558 S.E.2d 199 (2001) (gradually collapsing covenant regime). In 19th century Manhattan, covenants went unenforced as commercial development swept up the island. There were virtually no community associations, with the partial exception of Gramercy Park. *See supra* note 13. And with rapidly improving building technology and changing architectural fashion, higher-income owners, who could have afforded to sue, preferred to trade their older homes for newer ones uptown. *See* Lockwood, *supra* note 145 (Vanderbilts abandon Midtown for Upper East Side after Fifth Avenue uses change to retail); Christopher Gray, *Streetscapes: 299 Madison Avenue*, N.Y. TIMES, Dec. 6, 1998, at RE5 (wealthy families in turn-of-the-20th-century Murray Hill, Manhattan, sue to enforce covenants against commercial encroachment and then abandon area to move to Upper East Side). In Houston, many neighborhoods subject to covenants have gradually accumulated violations, although in recent years the city government has started enforcing the covenants. Weiser, *Zoned Out*, *supra* note 149.

[155] *See supra* note 163 and accompanying text; Heller, *Boundaries*, *supra* note 61, at 1185 (community associations may result in governance failures resulting in locked-in low-value uses). In theory, community associations are more likely to efficiently release covenants than covenant regimes with many property owners and no community association, but, in reality, they virtually never do so. *See infra* note 163 and accompanying text. Without a community association, each unit owner can hold out, and, at the end of the negotiations, a covenantor may not have enough surplus left to justify proceeding with the higher-valued use. While Richard Epstein and Carol Rose have praised this as the essence of property, they acknowledge that a proposed change in land use patterns is likely to give rise to holdouts. Richard Epstein, *Notice and Freedom of Contract in the Law of Servitudes*, 55 S. CAL. L. REV. 1353, 1366-67 (1982); Carol M. Rose, Comment, *Servitudes, Security, and Assent: Some Comments on Professors French and Reichman*, 55 S. CAL. L. REV. 1403 (1982). Recognizing these problems, Epstein later favored limiting holdout risks, Epstein, *Holdouts, supra* note 20, and praised supermajority voting in the covenant setting as a device to reduce holdouts. Epstein, *Past and Future*, *supra* note 59, at 694-99.

subjective value – particularly residential owners close to the changed use and therefore more directly affected by it – will have more intense preferences if they want to continue their prior residential use after the adjacent use changes, and may persuade the required minority of community association members to stop an efficient change.[156] More distant unit owners may clash with close-by owners over their shares of the proceeds, and all unit owners will be subject to the endowment effect, in which people demand more to sell their personal possessions than they would pay to acquire them.[157] Unit owners may have different preferences for current income (from a negotiated release from the covenant) and future income (from the sale of the unit benefited by the covenant) and apply different discount rates. Any board member intrepid or foolhardy enough to seek significant use changes will face free rider problems: he will spend enormous time persuading the various interests and earn the lasting enmity of opponents,[158] but will get only a fraction of the increased value. Even if the community association can work out its problems, unit lenders will have little upside from changed uses, and will either demand the lion's share of any payment (reducing the unit owners' incentive to modify the covenant) or refuse consent altogether. Collective action problems are greatly reduced in commercial community associations, where subjective value is minimal, the number of owners is typically smaller, and the higher value per unit will justify more negotiation, but they still exist.

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[156] *See* Natelson, *supra* note 52, at 73-75 (unit owners are risk-averse, and changes to covenant scheme will cause unrest); Ellickson, *Cities*, *supra* note 61, at 1535 (high administrative cost of compensating for wealth-creating takings by associations); Bebchuk, *Covenants*, *supra* note 49 (mathematical proof of blackmail risks when consent required); Andreas Flache, *Individual Risk Preferences and Collective Outcomes in the Evolution of Exchange Networks*, 13 RATIONALITY & SOC'Y 304 (2001) (mathematical proof that risk-aversion reduces willingness to find new, higher value trade partners and encourages people to stay in suboptimal relationships). *Cf.* Gideon Parchomovsky & Peter Siegelman, Selling Mayberry: Communities and Individuals in Law and Economics, U. of Penn. L. Sch. Inst. for L. & Econ., Res. Paper 03-08 at 63 (2003), *available at* http://ssrn.com/abstract_id=405081 (Mar. 30, 2004) ("hold-ins" with high subjective value chose not to sell despite buyout resulting from severe nuisance in Ohio). *But see* Natelson, *supra* note 52, at 84, 86-87 (in theory, few holdout problems; low negotiation costs for associations).

[157] *See generally* Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1483-84 (1998) (citing Daniel Kahneman et al., *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325 (1990)). The extra compensation demanded due to the endowment effect would be part of the demoralization damages suffered from an involuntary transfer. *See* Jeffrey J. Rachlinski & Forest Jourden, *Remedies and the Psychology of Ownership*, 51 VAND. L. REV. 1541, 1545 (1998) (homeowners in Boomer v. Atlantic appealed, seeking injunctive relief rather than damages, because right to refuse to sell one's property is critical psychological component of ownership). On demoralization, see *supra* text at notes 81-83.

[158] Things get nasty even over more minor matters. Barton and Silverman found that 44% percent of community association boards reported that within the previous year, the board members or board were personally harassed, subjected to personal accusations, threatened with a lawsuit, or actually sued by a member. Carol J. Silverman & Stephen E. Barton, *Public Life and Private Property in the Urban Community*, *in* COMMON INTEREST COMMUNITIES, *supra* note 75, at 93 n.16 (citing BARTON & SILVERMAN, CALIFORNIA STUDY)

Many community associations permit use changes by supermajority vote, which reduces rather than eliminates the holdout problem.[159] The more waivers that a community association permits, the more likely a court is to find changed conditions and deny enforcement to the covenant.[160] This erosion rule will make a community association reluctant to agree to even an efficient waiver, for fear of undermining other, still efficient covenants.[161] And when community associations have tried to efficiently release sub-areas of their subdivisions, their actions have usually been overturned by courts fearing that one group of unit owners will oppress another.[162]

The real world appears to confirm the stickiness of covenant regimes. Of 6,600 community associations represented by 14 lawyers surveyed in 14 states, the vast majority had perpetual or automatically renewed covenants, only 0.7% were terminated by vote or expiration, and only 0.7% had enacted covenant revisions creating major use changes.[163]

Community associations with supermajority voting provisions are more likely to be able to efficiently change minor lifestyle and use covenants. Because the use changes are less dramatic and more likely to affect a large number of unit owners at the same time, subjective values in retaining

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[159] Robert Ellickson and Richard Epstein have praised supermajority voting. Ellickson, *Cities*, *supra* note 61, at 1533, 1536 (advocating supermajority rule for wealth-creating amendments, but unanimity requirement for wealth-shifting amendments); Epstein, *Past and Future*, *supra* note 59; Epstein, *Covenants*, *supra* note 59, at 924-25.

[160] *See infra* notes 165-169 and accompanying text. It is not clear whether courts would be less inclined to enforce a covenant if an association were to enact, by regular procedures, frequent amendments.

[161] *See supra* Part IV.A. S*ee, e.g*., Diefenthal v. Longue Vue Management Corporation, 561 So.2d 44 (1990) (neighbors do not sue when house museum in tony New Orleans residential neighborhood violates residential use covenants through afternoon fundraising parties; partial waiver found). *Cf.* Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765 (1996) (grain merchants prefer industry arbitration to court system because of fear that UCC course of dealing rules will result in undesired waivers).

[162] *See* Montoya v. Barreras, 473 P.2d 363 (1970) (discussing danger of opportunism); Lakeshore Estates Recreational Area, Inc., v. Turner, 481 S.W.2d 572 (1972); Ridge Park Home Owners v. Pena, 544 P.2d 278 (1975); RICHARD R. POWELL & PATRICK J. ROHAN, POWELL ON REAL PROPERTY § 60.10[1] (1968); Ellickson, *Cities*, *supra* note 61, at 1536. *But see* Duffy v. Mollo, 400 A.2d 263 (1979) (release recognized; 24-year enforcement delay arguably constituted waiver). Courts would probably enforce partial releases if expressly provided in the covenants. Cowherd Development Co. v. Littick, 238 S.W.2d 346 (1951); Ridge Park Home Owners v. Pena, 544 P.2d 278 (1975) (both overturning partial release because not expressly provided for).

[163] *See* Jay Weiser, Survey of Covenant Regime Renewal and Termination (e-mailed to Condo Lawyers listserv beginning Feb. 13, 2003), and responses (Apr. 19, 2003) (on file with author). The survey covered 6,600 out of an estimated national total of 205,000 community associations, although if two lawyers had each represented the same associations at different times, some overlap in the associations surveyed is conceivable. If anything, the number of terminations is overstated, because many terminations are immediately followed by a re-formed covenant regime. *Id.*; Condo Lawyers listserv thread re Termination of Condo (Feb. 21-24, 2003) [hereinafter Condo Lawyers listserv] (on file with author). For the 205,000 figure regarding community associations, see Treese, *supra* note 16, at 19. This is consistent with Robert Ellickson's earlier informal inquiry of a few leading practitioners, which also suggested that termination virtually never occurs. See Ellickson, *New Institutions*, *supra* note 64, at 81 n.25, and Natelson's review of literature suggesting extreme conservatism among unit owners, Natelson, *supra* note 52, at 74 n.157.

existing uses are likely to be lower. For example, with the trend toward entrepreneurship and telecommuting, many more people in a subdivision will want to work from home, creating pressure to change strict residential use covenants. Or, as technology changes and a subdivision ages, a supermajority of homeowners may be amenable to superseding a wood roof shingle requirement when good-looking fiberglass shingles become available.[164] If the association does not agree to efficient changes, however, the losses will be relatively modest.

The changed conditions doctrine, an erosion rule, provides a narrow escape valve for inefficient covenants when the covenantor does not reach a negotiated settlement with the covenantee. Changed conditions render covenants unenforceable only when the covenant regime has collapsed, as evidenced by large numbers of violations within the subdivision.[165] Under these conditions, the covenant will create few investment incentives, while the holdout risks from continued enforcement will be high. Courts will not find changed conditions when only a small percentage of the parcels in the subdivision have violations.[166] Courts will even disregard a large number of small violations, grandfathering in the violations while enforcing the covenant against new violators,[167] or determine that the violation is permissible because waiver, estoppel, laches, or abandonment modified the covenant.[168] There is sometimes lip service to looking at conditions on

[164] *Cf.* Fink v. Miller, 896 P.2d 649 (1995) (attempt to permit fiberglass shingles in place of wood).

[165] *See, e.g.*, Antis v. Miller, 524 So.2d 71 (1988); Medearis v. Trustees of Meyers Park Baptist Church, 558 S.E.2d 199 (2001). Most courts do not balance the benefit to the covenantor against the harm to the covenantee, in contrast to their approach to other types of injunctions. *See supra* note 69 and accompanying text. *See generally* Heller, *Boundaries*, *supra* note 61, at 1184-85 (changed conditions doctrine may be too weak to prevent community associations from locking land into low-value uses); Reichman, *Judicial Supervision*, *supra* note 70; Eisenberg, *supra* note 33, at 259 (changed conditions doctrine due to limits of cognition); Parisi, Entropy, *supra* note 61, at 28-31; Parisi, Asymmetric Coase Theorem, *supra* note 61, at 34 (identifying doctrines that limit asymmetric transaction costs); Ben-Shahar, *supra* note 5, at 227-29 (erosion doctrines as means of efficiently adjusting land use); Reichman, *Judicial Supervision*, *supra* note 70, at 157-59 (servitudes should be enforced only when they add value). *See also* N.Y. RPAPL 1951(1) (codified changed conditions provision). *But see* Epstein, *Covenants*, *supra* note 59, at 919-23 (proposing to limit changed conditions doctrine to a default rule).

[166] *See, e.g.*, Save The Prairie Soc'y v. Greene Dev. Group, 752 N.E.2d 523, (2001); Holmquist v. D-V, Inc., 563 P.2d 1112 (1977) (7 violations out of 108 lots); Allen v. Forbess, 345 So.2d 950 (1977) (2 current violations out of 26); Steiger v. Lenoci, 733 A.2d 1192 (1999); Wilcox v. Timberon Protective Ass'n, 806 P.2d 1068 (1991) (10 of 412); Rieck v. Virginia Manor Co., 380 A.2d 375 (1977) (12 of 134); Garden Oaks Bd. of Trustees v. Gibbs, 489 S.W.2d 133 (1972) (10 of 180); Swenson v. Erickson, 998 P.2d 807 (2000). *But cf.* Antis v. Miller, 524 So.2d 71 (1988) (changed conditions where violations on 23 lots occurred for more than 20 years); Dierberg v. Wills, 700 S.W.2d 461 (1985) (no changed conditions where 2 violations/waivers out of 5 lot). *But see* Shippan Point Ass'n, v. McManus, 641 A.2d 144 (1994); Landen Farm Community Serv. Ass'n, v. Schube, 604 N.E.2d 235 (1992); Santora v. Schalabba, 2002 WL 1160202 (2002); Fink v. Miller, 896 P.2d 649 (1995).

[167] *See, e.g.*, Francis v. Rios, 350 F. Supp. 1130 (1972) (30 violations); Ortiz v. Jeter, 479 S.W.2d 752 (1972) (beauty shop, freight office, credit collection agencies, and cattle selling business are trivial; therefore drive-in grocery enjoined). Natore Nahrstedt had to pay huge fines, while other owners were allowed to keep their pre-existing cats. Elberg, *supra* note 12.

[168] *See, e.g.*, Moore v. Serafin, 301 A.2d 238 (1972) (mausoleum); Diefenthal v. Longue Vue Management Corporation, 561 So.2d 44 (1990); Mackey v. Griggs, 61 S.W.3d 312 (2001) (restaurant parking lot); Perry-Gething Found. v. Stinson, 631 N.Y.S.2d 170 (1995) (laches); Landen Farm

properties adjacent to the subdivision – a good measure of efficient use – but courts effectively disregard this.[169]

The changed conditions doctrine is similarly unhelpful when covenants are efficient for most of a subdivision, but render certain parcels almost valueless. As previously noted, parcels at the edge of older residential subdivisions may sit on roads that have turned commercial. Or a residential subdivision may have been developed with large-lot covenants in the hope of creating an upscale development, but the market shifts or zoning changes, and only denser development is economic on the remaining parcels. In these cases, too, in determining changed conditions, courts usually refuse to look outside the subdivision or at what zoning and building regulations permit.[170] Instead, they often subscribe to a domino theory, arguing that if the residential covenants governing the outer tier of lots along a commercial street fall, the entire covenant regime will inevitably collapse, and Ho Chi Minh will be dancing in the cul-de-sacs.[171] This makes little sense from a real estate perspective, since development pressures will concentrate along a commercial strip rather than moving

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Community Serv. Ass'n v. Schube, 604 N.E.2d 235 (1992) (basketball hoops). *But cf.* Fink v. Miller, 896 P.2d 649 (1995) (no waiver of wood shingle requirement).

[169] *See, e.g.*, Exch. Nat'l Bank v. City of Des Plaines, 336 N.E.2d 8 (1975) (court purportedly considers changes in surrounding area, but changes within subdivision are more important); Knolls Ass'n v. Hinton, 389 N.E.2d 693 (1979) (change in neighborhood irrelevant); Redfern Lawns Civic Ass'n v. Currie Pontiac Co., 44 N.W.2d 8 (1950) (changes outside subdivision irrelevant); Ortiz v. Jeter, 479 S.W.2d 752 (1972) (little weight to businesses outside the subdivision). *Cf.* Sandstrom v. Larsen, 583 P.2d 971 (1978) (giving no weight to high building in surrounding neighborhood; no changed condition permitting violation of height restriction within subdivision). Sometimes, when conditions have changed in part of a subdivision, courts will look at only the unchanged part of the subdivision. Daniels v. Area Plan Comm'n, 125 F.Supp.2d 338 (2000); Cappello v. Ciresi, 691 A.2d 42 (1996); Atlas Terminals, Inc. v. Sokol, 203 Cal. App. 2d 191 (1962); Corner v. Mills, 650 N.E.2d 712 (1995); Scott v. Owings, 223 Pa. Super. 481 (1973) (considers only immediate neighborhood within subdivision).

[170] *See, e.g.*, Atlas Terminals, Inc. v. Sokol, 203 Cal. App. 2d 191 (1962); Redfern Lawns Civic Ass'n v. Currie Pontiac Co., 44 N.W.2d 8 (1950); Cappello v. Ciresi, 44 Conn. Supp. 451 (1996); Ortiz v. Jeter, 479 S.W.2d 752 (1972) (road turns commercial); Federoff v. Pioneer Title & Trust Co., 798 P.2d 387 (1990) (development pursuant to covenants unprofitable after municipal regulations change); Corner v. Mills, 650 N.E.2d 712 (1995); Daniels v. Area Plan Comm'n, 125 F.Supp.2d 338 (2000); Independent American Real Estate, Inc., v. Davis, 735 S.W.2d 256 (1987); Lebo v. Johnson, 349 S.W.2d 744 (1961); Booker v. Old Dominion Land Co., 49 S.E.2d 314 (1948). But see these cases releasing covenants due to conditions outside the subdivision or due to changed municipal regulations: Johnson v. H.J. Realty, 698 So.2d 781 (1997) (land no longer has value under auto dealership restriction); Downs v. Kroeger, 200 Cal. 743 (1927); Duffy v. Mollo, 121 R.I. 480 (1979) (distinguishable because of waiver); Esso Standard Oil Co. v. Mullen, 200 Md. 487 (1952) (distinguishable because many lots within subdivision never built on or unrestricted); Zimmerman v. Seven Corners Development, Inc., 654 N.Y.S.2d 523 (1997) (damages are only remedy when zoning change prohibits development in accordance with covenant); Hunter v. Pillers, 464 S.W.2d 939 (1971) (distinguishable because no general plan for subdivision and no proof of diminution in value).

[171] *See, e.g.*, Atlas Terminals, Inc. v. Sokol, 203 Cal. App. 2d 191 (1962); Elliott v. Jefferson County Fiscal Court, 657 S.W.2d 237 (1983); Morris v. Nease, 238 S.E.2d 844 (1977). Texas courts are especially fond of the domino theory, perhaps because Lyndon Johnson haled from that state. Independent American Real Estate, Inc., v. Davis 735 S.W.2d 256 (1987); Lebo v. Johnson, 349 S.W.2d 744 (1961); Ortiz v. Jeter, 479 S.W.2d 752 (1972) (road turns commercial).

perpendicular to it.[172] The domino theory makes more sense when it comes to barring more intensive uses in the heart of the subdivision, such as multifamily housing in an area subject to single-family covenants.

To summarize, over time, covenant regimes are likely to result in externalities for third parties, who may be foreclosed from opportunities such as commercial use by the covenants, and for unit owners for whom the covenants are no longer efficient. The growing presence of community associations, with their improved enforcement technology, increases the likelihood. As a result, covenantee investment incentives are likely to be overprotected, given the holdout risk and transaction costs of making a change. The common law doctrines to limit these externalities are inadequate. The next section proposes a doctrinal change to permit efficient covenant breach.

B. THE MIXED PROPERTY-LIABILITY RULE SOLUTION

Many inefficient covenants could be eliminated without destroying the covenantees' investment incentives if covenantors were allowed to break major use covenants after 40 years, upon payment of supercompensatory damages under a mixed property-liability rule. With damages above compensatory (liability rule) damages but below the punitive (property rule) levels that would preclude all violations, a mixed property-liability rule would permit efficient use changes by high-valuing covenantors.[173] This section will first discuss the proposed mixed property-liability rule, then discuss the 40-year date after which full property rule protection lapses, contend that the rule should be mandatory, and argue that

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[172] Wilshire Boulevard is nearly completely commercial from downtown Los Angeles to the Pacific Ocean, but residential neighborhoods, some upscale like Beverly Hills, thrive beyond the commercial strip. In the Hancock Park area, the blocks immediately adjacent to Wilshire Boulevard have been redeveloped with multifamily houses, many presumably in violation of single-family covenants — arguably the collapse of the residential covenants on Wilshire Boulevard made the adjacent blocks undesirable for single-family use. However, single-family houses, some spectacular, remain the predominant use on either side of the band of multifamily development. *See* DAVID GEBHARD & ROBERT WINTER, LOS ANGELES: AN ARCHITECTURAL GUIDE 186-87 (1994).

[173] Bebchuk and Ellickson have suggested the equivalent of mixed property-liability rules to eliminate inefficient holdouts and permit use changes. *See* Bebchuk, Ex Ante Ex Post, *supra* note 4. *See also* Bebchuk, *Ex Ante Cathedral*, *supra* note 4; Ellickson, *Cities*, *supra* note 61, at 1538 (community association that enacts use change harming unit owner should pay reasonable person's surplus in that life situation). *Cf.* Kaplow & Shavell, *supra* note 26, at 756-57 (mixed property-liability rules optimal in narrow circumstances). In earlier work, Ellickson did not consider demoralization costs. Robert C. Ellickson, *Alternatives to Zoning: Covenants, Nuisance Rules, and Fines as Land Use Controls*, 40 U. CHI. L. REV. 681, 736 (1972) (nuisance generator should pay lost market value plus lost subjective value); Ellickson, *Suburban Growth Controls*, *supra* note 79, at 469 (landowner deprived of efficient use of land by grossly inefficient growth controls should be entitled to lost market value damages). *Cf.* Dagan & Heller, *supra* note 33, at 599 (exit from commons should be permitted on payment of cost of ameliorating community breakup); Eisenberg, *supra* note 33, at 251-53 (in thick long-term relationships, allow easy exit on fair terms); French, *supra* note 69, at 1317 (advocating increased use of damages as remedy for violation, and termination of covenants on payment of "fair compensation"); Sweeney, *supra* note 74, at 693-96 (advocating modification of covenants on payment of damages, apparently intending liability rule measure); Elberg, *supra* note 12 (advocating liability rule damages).

covenantees should be permitted to release individual parcels from covenant regimes.

1. *Permissibility of and Damages for Violation*

Mixed property-liability rules should apply to major covenant violations, affecting setbacks, use or density, that are most likely to cause externalities – parties who have the highest value for the land and would trade for it but for the existence of the covenants. Before permitting a covenant to be released pursuant to a mixed property-liability rule, the increased market value of the covenantor's parcel from the covenant violation should be significantly higher – at least 300% of the combined decreased value of the covenantees' parcels. In other words, if the covenantees collectively lost $100 from the covenant violation, the covenantor would be entitled to buy them out only if the market value of the covenantor's property increased by at least $300 as a result of the violation. There should also be a minimum gain in value before the covenantees' expectations are demoralized, and before the covenantees incur the transaction costs of assessing and allocating the damages – perhaps $100,000. If the covenantor meets the conditions for breaking the covenant, the covenantor should receive its lost market value damages and 50% of the net surplus attributable to the violation. When covenants are broken, covenantees should be required to mitigate. These suggested rules will be explained in detail below.

Requiring gains from trade at a 300% level in order to violate the covenant would minimize opportunistic violations by covenantors who hope that a court will either refuse to issue an injunction or underassess damages;[174] if the court finds a lower level of surplus from the violation, it would simply apply an injunction. For example, if a family with children seeks to move into a senior living development and both uses have the same market value, there would be no surplus, and an injunction would issue. If the use by families with children has a much higher value, then there is an externality and the covenant should be broken.[175]

The rule requiring the covenantee to receive 50% of net surplus would eliminate bilateral monopoly problems resulting in holdouts while largely protecting the covenantee's investment incentives.[176] Bilateral monopoly seems to have been the concern in *Blakeley v. Gorin*, an aberrational case where the court permitted the multimillion dollar Boston Ritz-Carlton hotel to violate an alleyway light easement for the benefit of the covenantee's neighboring Back Bay residential row house by constructing a bridge between buildings, even though neither changed conditions nor waiver

[174] *Cf.* Fennell, Common Interest Tragedies, *supra* note 150, at 79-80 (inefficiency if damages for breaking covenants set at wrong level). On covenantor opportunism, see *supra* Part IV.A.

[175] *Cf.* Ellickson, *Suburban Growth Controls*, *supra* note 79, at 400 (when a suburb has close substitutes, municipal antigrowth controls generally will not raise home values within the suburb), 494 (if use change would result in much higher aggregate value of land, municipal antigrowth control is likely to be grossly inefficient).

[176] This is a rough and ready approximation of the Nash bargaining solution.

existed. The court applied a liability rule, however, leaving the covenantee with a less pleasant property and uncompensated demoralization damages, and, as a result, inadequate investment incentives.[177]

In contrast, the mixed property-liability rule allows the higher-valuing covenantor to break the covenant. But the rule, awarding the covenantee its lost market value plus 50% of the net surplus, will protect the covenantee's investment incentives by approximating what it would have received under a negotiated deal without holdout problems. This rule will usually be value-adding for all parties (i.e., Pareto-optimal), and, experimental evidence suggests, will reduce uncompensated demoralization.[178] It will have the added advantage of being relatively simple for courts to administer. To use a numerical example, assume that on a lot subject to a residential covenant, the covenantor builds an auto showroom, the covenantee loses $100 in market value and the covenantor's increased value from the violation would be $1,500. Under the rule proposed here, the net surplus would be $1,400 ($1,500 increased value less $100 lost market value). The covenantee would be entitled to mixed property/liability rule damages of $800 ((a) $100 liability rule damages plus, (b) half of the $1400 surplus, or $700). After paying the damages, the covenantor would be left with $700 of surplus.

Let's explore the covenantor's and covenantee's incentives under the rule. At first glance, it gives the covenantor reasonably appropriate investment incentives, since it can break the covenant without getting held up. It must share in the surplus from its higher-valued use (which, in incomplete contract terms, reduces its investment incentives below the optimum), but it still gets a substantial portion of the surplus – $700 in our hypothetical.[179] Where the increase in value from breaking the covenant is huge, as in *Blakely* – probably 10,000% or more in that case – the 50% surplus split might under-reward the covenantor and cause it to underinvest. This can be limited in several ways. First, surplus should be measured by considering the value of the covenantor's property in its current use unencumbered by the covenant – not the value of the covenantor's property after completion of the redevelopment. This would reflect the higher redeveloped value, discounted for development costs and

[177] 313 N.E.2d 903 (1974). The court was influenced by heavy government involvement in the redevelopment of the area, including three agencies with power to permit bridging of alleys in Back Bay. Id. at 913. *Cf.* Hostler v. Green Park Development Co., 986 S.W.2d 500 (1999) (awarding breaching covenantor's purchase price as measure of damages for covenant breach); Frazier v. Deen, 470 S.E.2d 914 (1996) (upholding developer's unauthorized covenant waiver, without payment of damages, where higher-valued houses on larger lots would add value to subdivision).

[178] In one study, holders of real property interests protected by mixed property-liability rule damages (higher than liability rule but not so high as to prevent all trade) displayed a minimal endowment effect, while holders of real property interests protected by injunctive remedies displayed a significant endowment effect. Rachlinski & Jourden, *supra* note 157, at 1574-76.

[179] *See* Fennell, Contracting Communities, *supra* note 19, at 26-27 (damages on breaking of covenant forces covenantor to consider costs and compensates losers from covenantor's gains from "giving"). *Cf.* Abraham Bell & Gideon Parchomovsky, *Givings*, 111 YALE L.J. 547, 550 (2001) (each type of taking produces corresponding type of giving).

risks: the new use may never get built, or, if it does, it may not be successful (in contrast, if surplus is measured by the redeveloped value of the covenantor's property, the covenantor will be taking most of the risk, but getting only half the reward). Second, the surplus could be capped at some percentage of the loss – say 1,000% – though this might cause demoralization to the covenantee. Third, appraisers could determine how much surplus the owners of lower-valued property typically obtain in negotiated sales of fee interests to extremely high-valuing users (e.g., urban row houses that are sold as part of an assemblage for an office building), and use that as a measure for capping the damages.[180] The third alternative would be more precise than the second, but would make litigation more complex.

The covenantee's investment incentives are more distorted. Because the covenantee's damages are limited to lost market value plus 50% of the surplus, the covenantee's investment incentives are partially protected – like the covenantor, the covenantee can't get the whole ball of wax, but can get approximately what it would receive in a negotiation. If the covenantee has above-average subjective value, however, its incentives will be further reduced because a portion of the surplus, instead of covering demoralization damages and supporting investment incentives, becomes a compensatory payment for the above-average subjective value. For example, if the covenantee would suffer $100 of lost market value damages and $200 of above-average subjective value losses, and the total surplus from breaking the covenant is $500, then under the proposed rule, the covenantee would receive only $350 in damages ($100 plus $250, the latter equal to half the surplus from breaking the covenant), which would leave the covenantee with $50 of uncompensated demoralization damages. As previously discussed, this is not a catastrophe because the lost market value damages will, on average, correctly compensate all covenantees.[181]

The rule will also give covenantees an incentive to overinvest, because the covenantor picks up 100% of the lost market value damages. The covenantee may overinvest because, to the extent it builds more lavishly than is justified by the potentially changing neighborhood, the covenantor will compensate the covenantee for the lost market value on breach of the covenant. Taking our earlier example, assume that the road bordering the residential subdivision is turning commercial, the covenantor's increased value from a violation is $1,500 and the covenantee is trying to decide on whether to do a 10,000 square foot expansion of her McMansion. If the covenantee's house is worth $300 with the covenant intact and without the expansion investment, but is worth $200 with the covenant violated, the covenantee has $100 lost market value damages. If the covenantee builds the 10,000 square foot expansion, assume that the house is worth $700 with the covenant intact and $200 with the covenant violated. In other words, in

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[180] It would be difficult for appraisers to determine how much surplus covenantees usually get for trading their covenant rights, since these rights are rarely modified and trade in them appears to be nearly nonexistent. *See supra* note 163 and accompanying text.

[181] *See supra* at notes 78-80 and accompanying text.

the hypothetical, the entire additional investment is wasted. The covenantee will receive damages of $1,000 ($500 lost value damages plus half the surplus, ($1,500- $500)/2 = $500) if it invests, in contrast to $800 if it efficiently did not invest ($100 lost value damages plus half the surplus, or ($1,500-100)/2 = $700). The covenantee's inefficient investment reduces the covenantor's share of the surplus from $700 if the covenantee invests efficiently to $500 if the covenantee invests inefficiently. Since the covenantor can look forward to less surplus, it will invest less.

Lost market value damages create a further distortion, given that under the proposed rule, the covenant cannot be broken unless the surplus exceeds 300% of the damages. The more the covenantee overinvests, the higher the surplus needed to break the covenant, and the higher the potential holdout risk. Using the previous example, if the covenantee's lost market value damages are $100, only a $300 surplus is needed. If the covenantee overinvests and its lost market value damages are $500, a $1,500 surplus is needed.

Despite its distortions, the mixed property-liability rule regime would create better incentives than the existing regime in which the alternatives are a property rule injunction in favor of the covenantee (covenantee gets 100% of surplus) or property rule protection of the covenantor (through application of changed conditions, waiver or similar doctrines, covenantor gets 100% of surplus). As Bebchuk suggests, virtually any rule ends up distorting someone's investment incentives.[182] For example, if the covenantor can breach on payment of half the surplus to the covenantee, but does not have to pay lost market value damages to the covenantee, the covenantee may suffer demoralization and the covenantor will have no incentive to take precaution.[183] Since (1) the covenantee's investment was likely initially efficient, (2) we cannot predict whether the covenantor or covenantee's use will be the more efficient down the line, and (3) the covenantor bought into a regime that granted the covenantee discretion over the covenantee's investment, then it seems reasonable to create a damages rule that lets the covenantee decide on the correct level of investment.

In the real world, market incentives will cause the covenantee to take some precaution against overinvestment. If the covenantee does a 10,000

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[182] *See* Bebchuk, Ex Ante Ex Post, *supra* note 4. However, Bebchuk's proof is limited to cases where renegotiation is easy. *Cf.* William Rogerson, *Efficient Reliance and Damage Measures for Breach of Contract*, 15 RAND J. ECON. 39, 39-41 (1984) (specific performance, reliance, and expectation damages in contracts all produce inefficiently high investment when renegotiation is possible). For a complex mechanism that will not distort incentives under certain assumptions, *see* Pitchford & Snyder, *supra* note 4. As we have discussed in *supra* Part V.A, in a covenant setting with multiple parties, negotiation is difficult and can approach impossibility.

[183] Assume again that the road bordering the residential subdivision is turning commercial and that the covenantor's increased value from a violation is $1500. Assume further that the covenantee will suffer $200 lost market value damages from the violation and that the covenantor could eliminate them by taking precaution costing $100. Under the revised rule, if the covenantor takes no precaution, it receives half the surplus (($1500-$200)/2 = $650). If the covenantor takes precaution, it pays for 100% of the precaution, but receives only half the surplus and is worse off ((($1500-$100)/2) - $100 = $600).

square foot expansion of her McMansion next to the covenantor's lot located on a road turning commercial, she will be compensated for excess market value losses only if the covenantor breaks the covenant along the commercial road. If the covenantor does not break the covenant, then the covenantee may not get the full value of her investment in the expansion if the covenantee tries to sell to another residential user. As compared to the selling covenantee, the buying covenantee may be risk-averse and not want to buy a lawsuit,[184] and may also have a lower subjective value for a house next to a lot where the covenants may soon be broken. This will be especially true if the covenantee has built beyond the standard in the subdivision (e.g., the expansion creates a 20,000 square foot McMansion in a neighborhood of 10,000 square foot McMansions).

The covenantee's precaution incentives at the time of violation will be improved by imposing a mitigation obligation similar to the one imposed in a typical contract. For example, if the covenantee does not plant $10 worth of shrubbery to block the view of the covenantor's trucks, thereby foregoing an opportunity to reduce the covenantee's lost market value damages by $60, the court should decline to award the damages that should have been mitigated.

The requirement that the covenantor pay lost market value damages encourages appropriate precaution by the covenantor to reduce the covenantee's lost market value, as it does in a more typical contract setting.[185] The covenantor will often be in the best position to do so, since the covenantee's investment is largely fixed at the time of violation, while the covenantor can still plan its investment. For example, the covenantor, developing a supermarket on a parcel protected by a residential use covenant, might locate the loading dock on the side of the retail building rather than in the back, minimizing the covenantee's lost market value damages from noise. In contrast, transaction costs would often prevent the covenantee from bargaining for an efficient level of precaution. It would be difficult for a homeowner to draw up and negotiate a set of architectural plans for a relocated supermarket loading dock.

A mixed property-liability rule regime would give low-valuing covenantors less incentive to speculate on the violation of a major use covenant than the current regime, since a violation would result in a substantial damages claim rather than a return to the status quo.[186] The covenant regime would become like a store with a "you break it, you own it" type of rule.

Courts have tended to underassess damages in changed conditions cases, which is consistent with what appears to be a more general tendency

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[184] *See* Natelson, *supra* note 52, at 73-75 (unit owners are risk-averse).

[185] *See* Cooter, *supra* note 47.

[186] *Cf.* Thomas W. Merrill, *Property Rules, Liability Rules, and Adverse Possession*, 79 NW. U.L. REV. 1122, 1144 (1985) [hereinafter Merrill, *Adverse Possession*] (requiring bad faith adverse possessor to pay liability rule damages would discourage speculative violations in hope of getting the property free). If the covenant regime already provides for fines, expulsion, or self-help, the incentive to speculate may already be low. *See supra* Part IV.B.

to underassess damages.[187] They can determine the level of damages with relatively low error, since real estate appraisers make lost market valuations all the time. There will be inevitable spreads in value resulting from a battle of experts,[188] which will leave room for efficient trade as parties bargain in the shadow of the damages rule.[189]

Under a mixed property-liability rule, the covenantee cannot seek an inefficient injunction in the hope of being able to capture the lion's share of the surplus from the changed use, since the rule would cover only high-value violations and the covenantee's share would be capped at 50%.[190] While there will be an incentive to opportunistically induce a violation and collect the supercompensatory damages, this can be limited. The covenantee should not be entitled to damages if there is waiver, estoppel, laches, or abandonment, since the finding means that the covenantee placed little value on the covenant. Where changed conditions exist, the covenantee should still be entitled to lost market value damages, which will often be small, since property protected by a weakly enforced covenant regime may have little more value than property with no covenant.[191] If changed conditions are found, the covenantee should not be entitled to demoralization damages: there is no reason to protect a covenantee's expected profits from a major use change when the covenantee has not valued its covenant rights enough to enforce them.

While the mixed property/liability rule will flush out high-valuing covenantors, it may not permit covenantees with extremely high subjective values to keep their covenant regimes intact.[192] If the violation would cause the covenantee lost market value damages of $100 and above average subjective loss of $500, and the covenantor's violation will generate a $300 surplus, then the covenantee will not be content with the covenantor's $250 payment under the proposed rule ($100 lost market value damages + (($300-$100)/2) = $250). In theory, the covenantee will instead offer to pay the covenantor not to violate. The offer would be between $151 ($1 more than the covenantor's share of the surplus from the violation) and $599 ($1 less than the covenantee's market and subjective losses from the violation). Few covenantees are likely to have subjective values this high,

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[187] *See supra* note 74. *See also* A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis*, 111 HARV. L. REV. 869, 887–88, 888 n.45 (1998) (citing empirical studies finding underassessment of damages in medical malpractice, oil spill, and fraud areas). On the need for a multiplier to adjust for this, see *supra* note 144.

[188] *See* Michael Rikon, *"What's It Worth — Who Wants to Know?": The Valuation of Real Property in Litigation*, 16 PROB. & PROP. 20 (2002).

[189] *Cf.* Ayres & Talley, *Solomonic Bargaining*, supra note 26 (uncertainty of result in litigation will encourage efficient trade).

[190] A covenantee might still seek inefficient injunctions for minor violations that would be costly for the covenantor to remove. *See* Ayres & Madison, *Inefficient Injunctions*, *supra* note 71. However, common law balancing of equities for negligent or innocent minor encroachments limits this. *See supra* note 69 and accompanying text.

[191] *See supra* notes 71-74 and accompanying text; Sweeney, *supra* note 74, at 695.

[192] *Cf.* David Schap, *The Nonequivalence of Property Rules and Liability Rules*, 6 INT'L REV. L. & ECON. 125, 129 (1986) (advocating property rules when victim has subjective damages that are hard for court to value).

but where they do, they will be reluctant to trade because of the risk of multiple takings: buying out one covenantor's right to violate the covenant may not prevent (and may even encourage) violations by covenantors on adjacent parcels.[193]

It makes sense to disregard above-average subjective value when multiple covenantees create collective action problems.[194] There is more reason to incorporate above-average subjective value in single-covenantee cases. Even there, however, if above-average subjective value is disregarded, the gains from trade due to forced transactions under the mixed property-liability would probably be greater than the lost subjective value of most high-valuing covenantees, due to the size of the required surplus under the proposed rule. And there would be the added benefit of inducing the covenantee to take precaution.

For example, where the covenantee is an environmental organization, a negative covenant to keep land undeveloped probably has an extremely high subjective value for the covenantee. If the mixed property-liability rule applies, the covenantee would be unlikely to buy the covenantor off because of the risk of multiple takings. But, if the covenant is broken, society might be spared the externalities created when present-day decisions make land permanently undevelopable despite changing land use needs, as Julia Mahoney has noted.[195] In King City, California, near Monterey, land trusts to preserve farmland have worsened a housing shortage by forcing development into remote areas where utilities and municipal services are more expensive to provide.[196] If the covenant is broken, the organization would gain additional capital to pursue its goals elsewhere – similar to the land swaps that some organizations already make. Furthermore, if covenant violations are allowed, these organizations would have incentives to take precaution by purchasing the fee interest in land they want to protect, rather than accepting an easement. The added capital investment of a fee interest, in contrast to the fractional interest represented by a covenant, would force the organizations to more fully internalize any externalities from the conservation of the parcel.

Property rules (or private-ordered rules such as fines, expulsion, or self-help) should continue to apply to violations of ordinary rules and regulations of the covenant regime where the primary use continues – for example, no-pet clauses, appearance requirements for paint colors, or bans on parking cars in driveways. As noted above, for these low-value

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[193] The risk of multiple takings of an interest is one justification for applying a property rule rather than a liability rule. The danger of multiple takings would reduce the covenantee's initial desire to invest. *See* Kaplow & Shavell, *supra* note 26, at 767–68; Rose, Shadow, *supra* note 20. *Cf.* Fennell, Common Interest Tragedies, *supra* note 150, at 74 (unit owner with high subjective value may be unable to overcome transaction costs and holdouts even if unit owner is higher-valuing than other owners).

[194] *See supra* Part V.A.

[195] *See* Mahoney, *supra* note 151.

[196] *See* Queena Sook Kim, *A Farmland Trust Checkmates Developers*, WALL ST. J., Nov. 13, 2002, at B1. *Cf.* Ellickson, *Suburban Growth Controls*, *supra* note 79, at 402-03 (growth controls force development into other areas).

violations, the covenantee's investment incentives predominate, and holdout risks and transaction costs are lower, particularly where supermajority voting makes change easier.[197] This proposed split between property rules for minor covenant violations and mixed property-liability rules for major use changes finds an analogy in commercial mortgage prepayment premiums, which also involve a long-term relational contract requiring investment (there, by the lender). In that body of law, the lender is entitled to property rule protection under ordinary circumstances (it can bar prepayment completely or condition prepayment on payment of a supercompensatory prepayment premium), but the protection is removed (replaced by a mixed property-liability rule of compensatory damages plus foreclosure for nonpayment) when it creates an externality. The externality occurs when the borrower is in bankruptcy and, but for the supercompensatory prepayment premium, there would be surplus proceeds above the mortgage debt (principal, interest, and compensatory prepayment premium) available for junior creditors.[198]

2. *Time When Mixed Property-Liability Rule Applies*

By requiring covenant regimes to be in place for 40 years before the mixed property-liability rule becomes available, covenantees' investment interests will be protected, while involuntary termination can only occur after most of the value of the initial investment has dissipated. Other real property interests also use time limits to reduce holdouts and transaction costs resulting from fragmentation, such as the rule against perpetuities[199] and adverse possession.[200]

As previously noted, the developer's initial covenant regime is likely to be relatively efficient.[201] Thus, few externalities will be generated in the early years unless the developer makes a radically bad choice, and, in that case, the developer will often retain control of the community association, with the power to modify the covenants.[202] Although it is possible to argue for a mixed property-liability rule even in the early years if the covenantor's surplus from a changed use is high enough, it is doubtful that the externalities will outweigh the disruption to investment expectations. In other words, a covenantee would invest less in a brand-new development if a tank farm can spring up next-door one year later, even if

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[197] *See supra* note 164 and accompanying text.

[198] *See* Dale A. Whitman, *Mortgage Prepayment Clauses: An Economic and Legal Analysis*, 40 UCLA L. REV. 851, 906 (1993); John C. Murray, *Prepayment Premiums: A Bankruptcy Court Analysis of Reasonableness and Liquidated Damages*, 105 COM. L.J. 217 (2000). *Cf.* Merrill & Smith, *Property/Contract Interface*, *supra* note 23, at 833-34 (security interests are along property/contract interface).

[199] *See* Parisi, Entropy, *supra* note 61, at 45. Many states limit corporate options to purchase to 21 years under the rule against perpetuities, regardless of the parties' contractual arrangements. *See, e.g.*, Symphony Space, Inc., v. Pergola Properties, Inc., 646 N.Y.S.2d 641 (1996).

[200] *See* Merrill, *Adverse Possession*, *supra* note 186.

[201] *See supra* Part IV.B.2 and accompanying text.

[202] *See* Condo Lawyers listserv, *supra* note 163.

supercompensatory damages are paid.[203] Another way of looking at this is that the average subjective value for enforcing the covenants will be highest in the near term. The mixed-property-liability rule's reduction of speculative violations is also of low value in the near term, since there will be relatively few of them in the early years of an efficient covenant regime.

The 40-year transition date would allow the initial investment in improvements to depreciate down to virtually zero, meaning that the covenantee's initial investment incentives would be minimally impaired if the covenant is broken. For residential property, the 40-year break date will limit owners' subjective value losses during their personal life cycles: a 25-year old couple who move into a subdivision with a new covenant regime would be 65 years old with different needs when the covenants can be broken 40 years later. Given that households live in their homes a median of seven years,[204] it is likely that the couple would have moved to a new house by then.

A 40-year period would round off the current Internal Revenue Code real estate depreciation schedule of 39 years for nonresidential real estate used for business purposes. Although the IRC real estate depreciation schedule has fluctuated wildly over time, depending on Congress' desire to stimulate investment, the 39-year schedule was set to reflect economic reality and is more ascertainable and stable than the alternatives.[205] Even if the 40-year break date overprotects residential covenants, given the covenantee's investment incentives, it is better to err on the side of making the breakpoint too late. The 40-year period is not a perfect date for the transition, since different real estate asset classes or buildings systems will depreciate at different rates, and neighborhood uses will change unpredictably, but it is better than trying to arrive at a date case-by-case.

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[203] *See supra* note 184 (discussion of risk-aversion).

[204] Robert Freedman, *Thumbs-up from Buyers and Sellers,* REALTOR MAGAZINE, June 2000, at 50, *available at* www.realtor.org (last visited May 12, 2004).

[205] I.R.C. § 168 (c) (C.C.H. 2003). In 1993, Congress adjusted the useful life of nonresidential real property to 39 years because the previous 31.5-year period, in effect since 1986, resulted in depreciation allowances "larger than the actual decline in value of the property." Omnibus Budget Reconciliation Act of 1993, P.L. 103-66, H. CONF. REP. NO. 103-111, at 625 (1993), *reprinted in* 1993 U.S.C.C.A.N. 378, 856.

There are other possible measures to determine the date when investment incentives have been satisfied and covenants may be efficiently broken. They are not readily available, however, and would therefore be hard to apply as legal rules. The American Institute of Certified Public Accountants merely requires that real estate be depreciated based on useful life, without setting specific useful lives for different asset classes. *See* American Institute of Certified Public Accountants, Issues Papers, Depreciation of Income-Producing Real Estate (November 1, 1981). Accountants select these based on their personal research. *See* Record of telephone conversation with Steven Lilien, Professor, Stan Ross Department of Accountancy, Zicklin School of Business, Baruch College (Feb. 2003) (on file with author). It might theoretically be possible to look at the length of mortgage terms, since the availability of financing drives most real estate investment, but these vary by asset class (30 years is frequent for single-family homes, while commercial mortgages are usually much shorter), and the term of the mortgage does not predict its average life — the average length of time that a mortgage will be in force before being prepaid or otherwise paid off. Statistics for mortgage average life are proprietary to lenders, and mortgage average life in any event moves with the direction of interest rates: as rates rise, fewer people will prepay their existing low-rate mortgages, causing average life to rise.

Arguably, a shorter period should apply to residential property, since the Internal Revenue code assigns a 27.5 year useful life to residential property held for investment, but this accelerated depreciation is probably a tax subsidy for residential construction – there is little reason to believe that residential property depreciates nearly 33% faster than nonresidential.[206]

From a present value perspective, 40 years out, the balance of investment incentives against holdout risk and transaction costs also changes. For a purchaser in year 1, the prospect of a mixed property-liability rule beginning to apply in year 40 will not seriously affect investment incentives. For example, $100 in 40 years at a 5% discount rate has a present value of $14.20; at a 10% discount rate, the value is only $2.21.[207] If the initial covenantee sells in year 20, however, the purchaser/new covenantee will face a more significant impact if the covenant is broken in year 40: from the perspective of year 20, $100 of value at the break date at a 5% discount rate has a present value of $37.69, although at a 10% discount rate the value is only $14.86. Given that the proposed rule overprotects covenantee investment incentives and that it is desirable to encourage covenantee precaution, the impact on investment incentives as the break date approaches should be bearable.[208] Thus, as the covenant regime ages, it will become more attractive to buyers with below-average subjective values who view the potential use change as an opportunity for profit. This will make use transitions easier.

Of course, the incentives created by the rule will affect covenantee behavior only if covenantees understand that covenant breakage will be permitted on payment of mixed property-liability rule damages. But even if many unit owners fail to understand the rule,[209] lenders will.[210] The

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[206] I.R.C. §168 (c) (C.C.H. 2003). The legislative history is silent on why the 27.5-year period was chosen, although it states that residential property includes manufactured homes. Tax Reform Act of 1986, P.L. 99-514, H. CONF. REP. NO. 99-841, at II-40 (1986), *reprinted in* 1986 U.S.C.C.A.N. 4075, 4128. That category, in turn, would include mobile homes that depreciate rapidly. Alex Berenson, *A Boom Built Upon Sand, Gone Bust: Trailer Owners and Conseco Are Haunted by Risky Loans*, N.Y. TIMES, Nov. 25, 2001, at § 3. Manufactured homes are relatively uncommon in subdivisions subject to covenant regimes, so, to the extent that the 27.5-year figure is supposed to provide an average across the class, this would lower the class average useful life below the actual average for subdivision units.

[207] One 2002 estimate put the capitalization rate for New York City cooperative and condominium apartments, a possibly overheated housing market, at 5%. Nationally, luxury rental apartment buildings were selling for capitalization rates of 6-7%. *See* Stephanie Fitch, *Is Your Home Overvalued? How to Price Your Home*, FORBES, June 10, 2002, at 228. Since a discount rate is the implicit interest rate used to create a present value of a future income stream (the future loss from a covenant violation in the example in the text of this article), while a capitalization rate is the implicit interest rate earned on a present investment based on current income, they are roughly equivalent. This suggests that a 5-10% discount rate for losses from future covenant violations is currently reasonable.

[208] *See supra* note 181 and accompanying text.

[209] *See supra* notes 114-117 and accompanying text.

[210] As with the initial creation of the covenants, *supra* note 111, asset partitioning gives lenders an incentive to monitor the level of compliance with the covenants. For residential projects with relatively small loans on units, monitoring will often be too expensive except when the time comes to refinance an existing loan or to make a new one. At that point, a lender will charge a higher interest rate for loans secured by units where the end of the covenant regime would reduce unit value. *See generally* Hansmann & Kraakman, *Organizational Law*, *supra* note 23.

initial financing of residential units will be relatively unaffected, since many unit owners will have long-term self-amortizing loans that run 30 years: by the time the 40-year no-break period runs, these loans will be paid off. In fact, many loans are prepaid early, particularly in falling interest rate environments. As the 40-year break date approaches in an area where use changes are imminent, lenders may begin underwriting based primarily on the value of the real estate with the covenant broken, heavily discounting the potential payment of damages if a violation ultimately takes place. Unlike the unit owner, the lender has little upside from receiving damages, since its recovery is capped by its loan amount plus interest and prepayment premiums, and it will be unwilling to take risks on the determination of the amount. In addition, permanent lenders prefer to avoid prepayments.[211] As a result, where covenant breakage appears likely, the availability of financing for outdated uses will shrink through rising rates, more rapid amortization schedules, or higher loan to value ratios. Lenders will further reduce their risk by checking use trends in the area surrounding the subdivision, which is ordinary good underwriting even in the absence of covenants. Thus, the proposed rule would harness the lending market to discourage overinvestment in covenant regimes.[212] Commercial mortgages generally have shorter terms than residential ones, but the overall impact of the rule should be similar: lenders also become more reluctant to provide leasehold financing as the end of the lease term approaches.[213]

One proposed alternative to the mixed property-liability rule and to the doctrine of changed conditions – having covenants expire after 30 years unless a supermajority renews them – would be less efficient.[214] Property owners who benefit from externality-creating covenant regimes – usually most of the owners in a development – will vote to renew, since they get the benefits. This would lead to inefficient overinvestment unless the property owners could negotiate for a renewal requiring a sharing of the proceeds if the use changes, but, as we have seen, collective action problems make this unlikely.[215]

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[211] *See* Kurt Eggert, *Held Up In Due Course: Predatory Lending, Securitization, and the Holder In Due Course Doctrine*, 35 CREIGHTON L. REV. 503 (2002). Threatened condemnation or rezoning can create a similar chill on financing.

[212] This will not be perfect, since, as discussed *supra* in Part V.B.1, the availability of lost market value damages will still encourage the covenantee's overinvestment.

[213] For a statute requiring life insurers to amortize their equity investments and loans based on the remaining term of leaseholds, see N.J. STAT. ¶17B:20-1(b) & (c) (Lexis 2003).

[214] *See* Sweeney, *supra* note 74, at 691-93 (advocating 30-year time limit except for historic preservation covenants, small subdivisions, and planned communities, but permitting renewal). *See also* Winokur, *Mixed Blessings*, *supra* note 109, at 78-84 (advocating 20-year covenant time limit, except that up to 10 parcels in a violating parcel's immediate area would remain able to enforce the restriction). Winokur's proposal would create collective action problems for efficient surviving covenants, since, in the absence of a community association, the 10 unit owners may be unable to agree on litigating to keep the covenant, and there may be too few unit owners to effectively spread the cost of the litigation.

[215] *See supra* Part V.A. Of the associations covered in the survey, 35% had automatic renewal provisions and 0.7% had fixed termination dates, yet actual terminations were rare. *See supra* note 163.

A court implementing the mixed property/liability rule should do it for all covenant regimes existing at the time or in the future, without a transition period. As Jeffrey Stake notes, because real estate interests are so long-lasting, they are inherently hard to change without creating distortions. A prospective application of the rule would generate transitional costs and reduce the value of the improved state of the law[216] by leaving large numbers of externality-generating covenant regimes in place.

Since the proposed rule would exchange covenant rights for cash, courts should interpret existing mortgage documents to give mortgagees a security interest in the covenantees' mixed property-liability rule damages, similar to the interest that mortgagees usually expressly take in condemnation proceeds. Otherwise, covenantees will receive a windfall and mortgagees' investment incentives will be impaired.[217] Covenant amendments – even substantial ones – should not extend the 40-year period, since they would be used as a mechanism to extend covenants indefinitely.

3. *Mandatoriness*

The mixed property-liability rule should be mandatory rather than a default rule. As previously noted, the developer's incentive in designing the covenant regime will be to maximize the sale price. This will often mean maximizing long-term externalities, since covenantees will pay a premium for excluding uses that they dislike.[218] Nor are market forces likely to lead the developer to choose another regime. Because a liability rule regime would be likely to reduce the sale price (lenders would likely reduce loan amounts), the developer would find it unattractive unless the developer herself wanted to break the covenants at a low price that would underprotect the covenantees' investments.[219] Such opportunism is not unheard of,[220] but is uncommon because when the highest and best use of parcels is uncertain, the developer can carve them out of the development, leaving the option to put them back in the future. The developer would be unlikely to propose a mixed property-liability rule both for the reasons

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[216] *See* Stake, *Land-Use Decisions*, *supra* note 2, at 438.

[217] If the new rule were adopted, mortgagees would immediately modify the boilerplate for new loans to take a security interest in any damages paid to the covenantee from a covenant violation.

[218] *See supra* note 79.

[219] Existing practice, in which developers have effectively chosen injunctive property rule regimes, is not a perfect guide to what they would choose in a completely private-ordered market. Because courts have sometimes been hostile to fines above liability rule level and courts rarely order punitive damages, developers could reasonably assume that their choice is between an injunctive property rule and liability rule damages, without other alternatives.

[220] *See* Wessel v. Hillsdale Estates, Inc., 266 N.W.2d 62 (1978) (developer's marketing materials promised 4.35 acre park and recreational area, but location was not specified in covenants; developer sought to build houses on promised land, leaving 50 by 80 foot concrete slab for park and recreation purposes); Cordogan v. Union Nat'l Bank, 380 N.E.2d 1194 (1978) (developer developed commercial property in area surrounding residential subdivision, then claimed changed conditions as a result of his activities).

described in the analysis of the liability rule and because risk-averse buyers could be frightened off by its novelty.[221]

4. *Releases of Selected Lots from Covenant Regime*

By permitting consensual releases of selected parcels from the covenant regime at any time, courts would ease renegotiation, since the parties could add value to a parcel without wrecking an entire, otherwise functional, covenant regime. As previously noted, in the few cases decided on the issue, some courts have refused to accept any release that does not apply to all lots.[222] Partial releases could allow opportunism by a developer who still controls the association, or by a majority of shareholders seeking to exploit a minority. To limit this, courts could create a safe harbor for releases in exchange for payment of the mixed property-liability damages proposed here. A court could supervise the allocation of damages payments among unit owners by applying one of the recent proposed fairness tests for covenant modifications by associations, although a detailed discussion of them is beyond the scope of this article.[223]

C. AFFIRMATIVE COVENANTS

To induce purchases, a developer may promise to perform certain acts in the development, rather than merely barring undesirable uses through negative covenants. Many affirmative covenants will have high subjective value for the covenantee – a unit owner who moves into a development called Masters Golf Estates will be very upset if the developer fails to put in a golf course. Under incomplete contracts theory, violation of these affirmative covenants will have a similar effect on the covenantee's investment as violation of negative covenants: in both cases, the covenantor's potential violation will cause the covenantee to underinvest.

But the covenantee's potential loss is lower than in negative covenants. For negative covenants, the covenantee has bought its unit (made its selfish investment, in incomplete contracts terminology), and the covenantor's violation reduces the value of that investment. When affirmative covenants are violated, the covenantee often has some ability to mitigate. If the developer of Masters Golf Estates runs into financial trouble, a covenantee

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[221] *See* Natelson, *supra* note 52, at 73-75 (unit owners are risk-averse; changes to covenant scheme will cause unrest).

[222] *See supra* note 162.

[223] *See* Ellickson, *Cities*, *supra* note 61, at 1532-33 (unanimity rules for wealth-shifting amendments, supermajority rules for wealth-creating amendments); Natelson, *supra* note 52, at 70-71 (pareto-optimality standard for reviewing community association decisions, including compensation for unit owners who are disproportionate losers from otherwise efficient decisions); 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, 1131 (1998) (6-part test balancing impact on subdivision against effect on community association processes, with deference to community association processes). *See also* Epstein, *Covenants*, *supra* note 59, at 922-26 (permit partial releases on majority vote, subject to checks developed by marketplace forces contained in organizing documents, and with judicial protection against exploitation of disproportionately harmed unit owners only in limited instances, such as partial releases).

may be able to join another golf club nearby. The subjects of many affirmative covenants, however, are capital or high-management items, and covering for them is unlike buying widgets in the open marketplace. A community association is unlikely to have the resources or expertise to run the subdivision's golf course itself.[224] The less likelihood that the covenantee can perfectly mitigate, the greater the reduction in the covenantee's initial investment.

From the covenantor's perspective, affirmative covenants, in comparison to negative covenants, present a higher holdout risk relative to investment value. A bad negative covenant can leave land undevelopable, but a bad affirmative covenant can generate unlimited losses for the covenantor – for example, a golf club that can never be profitable because the unit owners' average income level is lower than expected. A covenantee protected by an injunction will have an incentive to demand the entire surplus created by a renegotiation, and multiple covenantees will have collective action problems in addition. If a developer is required to make continuing wasteful investments to comply with affirmative covenants even if the development goes sour, then the developer will either reduce its initial investment below or raise its price above the efficient level (the latter to insure itself against damages), and thus will develop too few subdivisions.[225] The developer can limit this underinvestment effect by using a shell entity,[226] and possibly by rejecting the affirmative covenant as an executory contract in bankruptcy.[227]

[224] *See* Oceanside Community Ass'n v. Oceanside Land Co., 147 Cal. App. 3d 166 (1983) (run-down golf course); Woodlands Golf Ass'n v. Feld, 429 So.2d 846 (1983) (right to apply for golf club membership).

[225] *See* Ayres & Madison, *Inefficient Injunctions*, *supra* note 71. *See also* the following cases denying specific performance and limiting relief to damages for violations of affirmative covenants. Oceanside Community Ass'n v. Oceanside Land Co., 147 Cal. App. 3d 166 (1983) (obligation to restore and operate money-losing golf-course; money damages plus lien awarded); Woodlands Golf Ass'n v. Feld, 429 So.2d 846 (1983) (denial of right to apply for golf club membership); Speer v. Erie R. Co., 68 N.J. Eq. 615 (1905) (covenantee rejects two reasonable offers by covenantor to construct alternative to grade crossing, instead demanding expensive alternative). *But cf.* City of New York v. Delafield 246 Corp, 662 N.Y.S.2d 286 (1997) (failed development acquired through foreclosure, subject to affirmative covenants; value-adding affirmative covenant enforced).

[226] *See* Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1 (1996).

[227] The ability to reject an affirmative covenant in bankruptcy is not settled law. Negative real estate covenants are treated as property interests and cannot be rejected as executory, while pure contracts can be. *See* Janger, *supra* note 75 (articulating general rule); George W. Kuney, *Further Misinterpretation of Bankruptcy Code Section 363(f): Elevating In Rem Interests and Promoting the Use of Property Law to Bankruptcy-Proof Real Estate Developments*, 76 AM. BANKR. L.J. 289 (2002) (proposing test for when covenants should be rejectable); Basil H. Mattingly, *Sale of Property of the Estate Free and Clear of Restrictions and Covenants in Bankruptcy*, 4 AM. BANKR. INST. L. REV. 431 (1996) (covenants should be rejectable). There appear to be no cases in which a developer has tried to reject an affirmative covenant in bankruptcy, but courts are split on the analogous issue of whether unit owners in residential subdivisions are dischargeable in bankruptcy from personal liability for post-petition community association assessments if they abandon their units. An obligation to pay assessments, contained in the CCR or a similar document, is a form of affirmative covenant. *See* Alfred Q. Ricotta, Comment, *Community Associations and Bankruptcy: Why Post Petition Assessments Should Not Be Dischargeable*, 15 BANK. DEV. J. 187 (1999).

Courts generally apply property status, granting specific performance when failure to perform the affirmative covenant would severely damage the covenantee's investment and the covenantee cannot practically mitigate, as when a railroad fails to construct a promised crossing[228] or a developer fails to put in sewer lines.[229] But where mitigation is possible and there is a high risk of accumulating losses to the covenantor, affirmative covenants are more likely to receive contract-like remedies that will induce more efficient precaution and mitigation by the covenantee.[230] In *Oceanside Community Ass'n v. Oceanside Land Co.,* the court applied a fine-like mixed property-liability rule: a charge of $10 per unit owner per month ($9,320) against the covenantor, for failure to maintain a golf course, that became a lien in favor of the association.[231]

Other real estate interests involving a debtor's continuing obligations receive mixed property-liability rule treatment in bankruptcy. A bankrupt landlord can reject a lease and be released from its obligation to provide services, but the tenant (the equivalent of our covenantee) can continue in possession and has a claim for damages for the value of the services. *See* 11 U.S.C. § 365 (h) (2003). Possession plus damages is a mixed property-liability rule. On supercompensatory prepayment premium clauses in mortgages, see *supra* note 198 and accompanying text.

[228] *See* Flege v. Covington & Cincinnati Elevated Ry. & Transfer & Bridge Co., 91 S.W. 738 (1906) (specific performance requiring railroad to repair retaining wall running from covenantee property level down to level of tracks; perhaps repair by covenantee would disrupt operation of railroad). *But cf.* Post v. West Shore R. Co., 26 N.E. 7 (1890) (denying specific performance of obligation to construct road in impractical location, but granting specific performance of efficient obligation to construct crossing under railroad plus damages).

[229] *See* Paley v. Copake Lake Dev. Corp., 463 N.Y.S.2d 910 (1983); Strauss v. Estates of Long Beach, 176 N.Y.S. 447 (1919) (discussing homeowner's investment incentives based on promise of sewer); Nisbet v. Watson, 251 S.E.2d 774 (1979). *But see* Paley, 463 N.Y.S.2d at 912 (Weiss, J., dissenting) (arguing that septic tank or municipal hookup are alternatives to developer-installed sewer).

[230] One reason is that courts will find it more costly to monitor compliance with affirmative, as opposed to negative, covenants. *See* Oceanside Community Ass'n v. Oceanside Land Co., 147 Cal. App. 3d 166 (1983). *But cf.* City of New York v. Delafield 246 Corp, 662 N.Y.S.2d 286 (1997) (enforcing affirmative covenant to install street improvements including sewers where current owner had acquired property in a foreclosure sale, even though covenantee was entitled to surety bond proceeds and covenantee had construction expertise to mitigate; covenantee was City of New York, which had issued a zoning permit based on promise).

[231] 147 Cal. App. 3d 166 (1983). *Oceanside* applies a mixed property-liability rule because the monthly fine level per unit owner ($10) is probably below the actual monthly value of having a fully functioning golf course, while the accumulated fines would eventually exceed the value of the golf course parcel. According to the court, it would have taken $200,000 to do a cheap restoration of the golf course, or about two years worth of fines. The golf course parcel owner had acquired the parcel at a foreclosure sale, and was unlikely to want to invest this. The unit owners had previously tried and failed to maintain the golf course. The result, if the value of the restored golf course would be less than $200,000, is that the golf course parcel owner would try to negotiate with the unit owners for a release of the affirmative covenants, with the parties splitting the surplus created by the release. If the covenantee is given a lien to secure the performance of the affirmative covenant and ultimately tries to foreclose to enforce it, the covenantee may never see the foreclosure proceeds because the covenantor's lender would have probably begun its own foreclosure and the terms of the mortgage may well exempt the lender from performance of the affirmative covenants after it takes title.

See also Louisville, N.A. & C. Ry. Co. v. Sumner, 5 N.E. 404 (Ind. 1886) (applies sub rosa weak property-liability rule by expansively interpreting the availability of consequential damages; railroad failure to build fence and depot; injunction not sought; damages awarded for cost of fence, lost value of land due to absence of depot and consequential damages for animals killed); Post v. West Shore R. Co., 26 N.E. 7 (1890) (applying idiosyncratic mixed property-liability rule by granting (1) specific

The mixed property-liability rule suggested to protect negative covenants should be adjusted for affirmative covenant violations. On violation of an affirmative covenant, the covenantee will suffer four types of losses: (1) the difference between (a) the covenantee's cost of performing a substitute, and (b) the cost to the covenantee if the covenantor had performed its promised act (an expectation measure); (2) if the covenantee cannot perfectly mitigate, the difference between the covenantee's market value with the affirmative covenant performed and with the covenant violated, with whatever level of mitigation is available (also expectation-like); (3) any above-average subjective damages; and (4) demoralization damages. If the covenantee could perfectly perform a substitute under (1), there would be no drop in market value under (2) nor a loss under (3).

The additional demoralization damages (4) reflect the surplus from the covenantor's savings from nonperformance after paying the expectation and lost market value damages to the covenantee. To parallel the 50% split of surplus proposed for negative covenants, the covenantee could get half of the covenantor's cost savings from nonperformance. Assume that the covenantor violated an affirmative covenant to provide sewer service (the cost of which was included in the covenantee's purchase price), and that (a) the covenantee paid the covenantor $1,000 to buy the property assuming that there would be a sewer system, (b) the covenantor had to spend $200 installing a septic tank, (c) the property value with the septic tank is $900, (d) the covenantor would have suffered a $300 loss from installing the sewer line, and (e) the covenantee had $0 above-average subjective damages. Then the covenantee would be entitled to damages of (1) the $200 septic tank installation charge, (2) the $100 loss in value of the property, and (3) $150 of the covenantor's savings (surplus) from failing to install the sewer line. Where the covenantor's violation is opportunistic, however – for example, the covenantor is not financially distressed when it fails to put in a sewer system, but merely wants to cut corners after having induced the covenantee's investment – a property rule should apply, with the court ordering specific performance.[232]

As in the case of negative covenants, the mixed property-liability rule would induce precaution from the covenantor and covenantee. The covenantee will not have its investment expectations fully satisfied, inducing it to take greater care in choosing a covenantor as a contracting partner.[233] It is likely that the covenantee will pay more attention to affirmative covenants – amenities like swimming pools will often be

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performance of efficient obligation to construct crossing under railroad and, (2) damages in lieu of specific performance of obligation to construct road in impractical location). *But cf.* St. Louis, I. M. & S. Ry. v. Sanders, 121 S.W. 337 (1909) (railroad failure to construct levee; injunction not sought; damages limited to cost of constructing levee, not consequential damages, since landowner could have mitigated by constructing levee herself.)

[232] *See, e.g.*, Wessel v. Hillsdale Estates, Inc., 266 N.W.2d 62 (1978) (developer promises 4.35-acre park, but plans to put in 50 x 80 foot concrete slab).

[233] A residential covenantee may be unlikely to perceive the difference between remedies regimes at the time of its investment, but lenders will. *See supra* Part IV.B.2.

incorporated into the marketing materials – than to negative ones, and it can fairly easily exercise precaution about the developer's ability to perform its affirmative covenants by checking out the developer's past projects.[234] The covenantor, who in this context is likely to be a sophisticated developer, will take precaution and invest more in performance, since it must pay part of the covenantee's demoralization costs, and is therefore unable to simply cut its losses, pocket the savings, and move on to the next deal.

The mixed property-liability rule must be mandatory rather than a default rule because of the developer's incentive to make the affirmative covenant regime as favorable to itself as possible. Once again, the expectations of uninformed residential buyers are at risk of being defeated if the covenantor can limit its remedies, considering the high leverage and frequent bankruptcies of developers and the high investment of residential unit owners. While much of the price savings from a liability rule would be passed on to the covenantee in a competitive market (in effect, providing covenantees with less insurance against violations), it is doubtful that unsophisticated covenantees will be able to balance this against potential future losses if the affirmative covenants are violated.[235] Lenders, however, might limit the use of a liability rule by restricting their lending.

VI. CONCLUSION; FUTURE RESEARCH

The existing regime protecting covenants – a property rule in favor of either the covenantee or the covenantor – does not create ideal investment incentives. It should be supplemented by greater deference to private-ordered remedies such as fines, expulsion, and self-help. And violations should be permitted, after the passage of 40 years, on the covenantor's payment of supercompensatory damages to the covenantee. This will help reduce externalities from covenant regimes that lock in uses that are no longer the best for the land.

The actual effects of covenant remedies and association enforcement practices have not been studied in detail. I have conducted a survey that empirically tests whether the level of enforcement and choice of remedy affects unit value, and will publish the results in a subsequent paper.

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[234] *See supra* note 120.
[235] *See supra* Part IV.B.2.