Prime Property Institutions for a Subprime Era: Toward Innovative Models of Homeownership

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Abstract

This Essay breaks new ground toward contractual and institutional innovation in models of homeownership, equity building, and mortgage enforcement. Inspired by recent developments in the affordable housing sector and in other types of public financing schemes, this Essay suggests extending institutional and financial strategies such as time- and place-based division of property rights, conditional subsidies, and credit mediation to alleviate the systemic risks of mortgage foreclosure. It proposes two new solutions. Alongside a for-profit shared equity scheme that would be led by local governments, the Essay also outlines a private market shared equity model, one of “bootstrapping home buying with purchase options.” The Essay thus offers a broad theoretical basis for major developments in the key economic and legal institution of homeownership.

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Introduction

The subprime crisis has vividly demonstrated the risks of relying on rising market values to prevent debt from surpassing the value of the security, as well as showing the severe collective action problem embedded in the securitization of mortgage-backed loans.1

However, the recent turn of events raises even more fundamental questions about the way in which land-related property rights and credit markets are designed. This Essay seeks to break new ground toward contractual and institutional innovation in models of homeownership, equity building, and mortgage enforcement that may overcome some of these drawbacks.

Numerous scholarly endeavors have been made to correct the failures of the market.2 In a recent article, Eric Posner and Luigi Zingales identify the broad-based deadweight loss of foreclosures, and call for a renegotiation between the homeowner and the mortgagee in cases of negative equity (when the amount of the debt exceeds the home value), but without making any of the contracting parties worse off or increasing the systemic cost of credit.3 They thus suggest a plan by which a household, located in a ZIP code where house prices have dropped more than a certain threshold below their peak, would have a right to obtain a mortgage reduction to the current value of the home in exchange for a certain percentage of the future appreciation of the house above the current level.4

We view Posner and Zingales’s model of binding together mortgage restructuring with a shared equity scheme as holding great potential for reforming the market, and we develop this idea more extensively in this Essay to include both the public and private sectors. Moreover, whereas Posner and Zingales’s model focuses on the ex post scenario of mortgage default, we construct in this Essay innovative models for housing development and finance, ones that would ex ante address the broader prospects and perils of the real estate market and the legal institution of homeownership.

In so doing, the Essay builds particularly upon institutional insights obtained by analyzing two innovative forms in current real estate development and finance. First, community land trusts (CLTs), which are non-profit community organizations that supply affordable housing based on long-term shared equity, divided ownership schemes.5 Second, tax increment financing (TIF), in which a local government, working through a subsidiary agency, designates an area for for-profit development or redevelopment, incurs

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2 See, e.g., Todd J. Zywicki & Joseph Adamson, The Law & Economics of Subprime Lending, 80 U. COLO. L. REV. 1 (2009) (analyzing the reasons for the crisis, and calling to regulate the mortgage market so as to curb abusive practices, while preserving the benefits of high levels of homeownership, especially among young, low-income, and minority households).
4 Id. at 589-96.
5 See infra Part II.
up-front expenditures (e.g., land assembly, public infrastructure), and issues revenue bonds that are paid back over time by earmarking future incremental increases in property taxes in the designated area.\(^6\)

These two forms substantially diverge, and may even be considered outright opposites. CLTs are designed to perpetually maintain housing units at below-market affordable prices. Conversely, TIF districts rely on stimulating market value appreciation following the area’s redevelopment as the raison d’être of the project, thereby enabling the agency to repay the bonds. However, each of these forms offers broader-based institutional lessons that, suitably adapted, enrich the range of design options for the conventional for-profit housing sector.

Our Essay has two main objectives. First, it offers a tentative outline for a type of a CLT/TIF hybrid in the form of a For-Profit Shared Equity (FPSE) development model that would allow consumers to acquire full homeownership through a gradual, two-phase purchase and finance process. Second, it illuminates a broader range of issues that typify the current for-profit real estate development and finance market, by pointing to instances of institutional myopia and refutable conventional wisdom. Among these topics, we address the insufficient design alternatives for building equity from zero, an all-or-nothing approach to homeownership, and inefficient risk-shifting in case of mortgage foreclosures. These insights in turn play an important role in suggesting general institutional and legal design principles that go beyond the suggested CLT/TIF hybrid and may inspire improvements to existing private market products in the real estate industry.

In the Essay, we identify the local government as a potential protagonist in devising different forms of institutional innovations. As Part I explains, US local governments currently play an established role in the real estate industry having broad powers in land use regulation and ongoing reliance on property taxation as their most prominent own-revenue resource. We argue that local governments can also play a systematic role in other issues that up until now have generally been considered to be within the realm of either individual and market activity or of higher-level government policy and finance.

As a low-level entity that nevertheless enjoys established powers of collective action, the local government can engage in a variety of activities that would provide better access to credit from financial institutions, efficient risk management at the local level, diversity of property formations, and front- and back-end taxation tools for both facilitating real estate development and internalizing government-created local benefits. Parts II and III of the Essay thus elaborate on the institutional and legal features of CLTs and TIFs, respectively, and shed light on ways in which local governments could take on a more central role in designing innovative models of homeownership and housing finance.

Our Essay, however, does not solely advocate growing intervention by local government. More fundamentally, it seeks to inform private entrepreneurs about real estate development possibilities that they might have viewed skeptically until recently, but which may gain currency in the aftermath of the mortgage crisis. Specifically, our suggested CLT/TIF hybrid scheme may inspire both entrepreneurs and middle-class and above private consumers to adopt new market products which would allow for a gradual, multi-phase purchase of homeownership. Such concepts can create better opportunities for developing and disseminating property models that have been traditionally associated

\(^6\) See infra Part III.
with low-income households, while at the same time addressing the persistent failures stemming from irresponsible lending, inefficient risk deflection, and over-fragmentation of interests that have often plagued real estate markets.

Thus, following the detailed discussion of our suggested for-profit shared equity scheme in Part IV, we present in Part V an alternative private model, which we entitle “bootstrapping home buying with purchase options.” This model, too, builds on key institutional insights learned from the CLT/TIF settings, but applies them to an innovative, private contractual framework. This variety demonstrates that the theoretical and institutional analysis offered in this Essay could be appealing and useful for both advocates of public intervention in the supply of for-profit housing and those who remain loyal to developing private market, non-subsidized products. As such, the Essay offers a broad theoretical basis for systematic innovation in the key economic and legal institution of homeownership.

I. Local Government Stakes in Housing Development and Finance

Government involvement in real estate development and finance is an intricate and multifaceted field that cannot be comprehensively surveyed within the scope of this Essay. One can, however, discern a quantitatively and qualitatively different form of involvement in the non-profit vis-à-vis the for-profit housing sector throughout US history.

The non-profit sector has seen different generations of government involvement, most prominently on the federal level, starting with European-inspired direct construction of public housing as of the 1930s, subsidies for privately-developed affordable housing as of the 1950s, Section 8 demand-side housing vouchers for tenants as of the 1970s, and new mixed-income projects in which government subsidizes private developments that set apart a number of units at below-market prices. The constant changes in government policy are not unique to the US. A 2007 survey of the 27 EU member states demonstrates the enormous changes in these countries since housing began to systematically emerge as a social issue in the mid-nineteenth century. West European countries have come a long way from the direct provision of public housing to working classes and later on to socio-economically disadvantaged groups, with East European countries making their own dramatic shifts from the socialist era of predominantly state-owned rental housing. Whereas few generalizations are equally applicable to all European states, one can identify a number of general trends in recent decades, such as the decentralization of housing policy from the state to local governments and gradual privatization of existing social housing stock, alongside more recent government commitments to promote the construction of new affordable housing units, including through public-private partnerships. See CECODHAS (European Social Housing Observatory), HOUSING EUROPE 2007: REVIEW OF SOCIAL, CO-OPERATIVE AND PUBLIC HOUSING IN THE 27 EU MEMBER STATES (2007).
about the “fiscalization” of zoning and other land use decisions. This means that local land use regulators that attach great weight to the public revenue/public expenditure tradeoff systematically turn their land use powers into a primary fiscal tool. Such interconnectivity may have implications that go beyond the fate of the specific project turning into potential extra-territorial implications, such as in cases of “exclusionary zoning.”

This land use fiscalization policy may have a systematic property design effect on the institutional configuration of the for-profit housing sector. A leading example is the highly favorable treatment that residential community associations (RCAs) or “private communities” have been receiving from local governments, to the extent that cities such as Las Vegas now mandate that every new residential development must be governed by an RCA, thus facilitating growth and increased tax revenues with minimal public expenditures.

Conversely, government involvement in the mortgage market has chiefly taken place at the federal level. Starting in 1934—with the mortgage insurance programs of the Federal Housing Administration (FHA); followed by the establishment of Fannie Mae in 1938 and Freddie Mac in 1970 to supply liquidity to the mortgage market by buying mortgages from lending institutions; the Home Mortgage Disclosure Act of 1975 (HMDA), aimed also at more effectively targeting public spending to poor areas so as to stimulate private investment; and up to the retaking of Fannie Mae and Freddie Mac in 2007 and the massive purchase of “toxic” mortgage-related securities under The Emergency Economic Stabilization Act of 2008—federal law and policy have been playing the chief governmental role in what is largely considered a national real estate credit market. The latest measure taken to date to alleviate the effects of the mortgage crisis has been the 2009 Home Affordable Modification Program, under which the

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9 See WILLIAM A. FISCHEL, THE HOMEVOTER HYPOTHESIS: HOW HOME VALUES INFLUENCE LOCAL GOVERNMENT TAXATION, SCHOOL FINANCE, AND LAND-USE POLICIES 184–206 (2001). The term “exclusionary zoning” refers to land use regulation that seeks to indirectly monitor the socioeconomic composition of residents, especially by zoning out residents with relatively low income but with high demand for public services such as schools or welfare. A minimum-lot-size requirement is a quintessential example of exclusionary zoning. Since the property tax in the US is ad valorem, that is, based on a certain fraction of the property’s value, such a regulatory demand would generally keep out, through the price mechanism, low-income families that would have decreased the average property tax base. For the broad-based societal implications of “exclusionary zoning,” see, e.g., Richard Briffault, Our Localism: Part II—Localism and Legal Theory, 90 COLUM. L. REV. 346, 365–74, 382–84 (1990); Sheryl D. Cashin, Localism, Self-Interest, and the Tyranny of the Favored Quarter: Addressing the Barriers to New Regionalism, 88 GEO. L.J. 1985, 1993–95 (2000) (pointing to the ever-present, even if currently implicit, racial motives for exclusionary zoning); Richard Thompson Ford, The Boundaries of Race: Political Geography in Legal Analysis, 107 HARV. L. REV. 1841, 1894–97 (1994) (same).


federal government provides partial fund matching to reduce homeowners’ monthly mortgage payments.\(^{13}\)

States engage, of course, in their own modes of controlling, directly or indirectly, different aspects of the for-profit housing sector, including the promulgation of general real property laws, mortgage foreclosure statutes, landlord-tenant law, recordation and taxation of transactions, fair housing acts, and so forth.\(^{14}\)

The 2007-08 crisis raised fundamental concerns not only about the appropriate scope and content of the above-mentioned government intervention, e.g., should government intervene more extensively, and how, in the real estate credit market to prevent allegedly predatory lending. Moreover, it questioned the prevailing institutional division of labor among different levels of government, and the sustainability of prevailing taxonomies between the for-profit and non-profit sectors in designing law and policy.

Focusing on local governments, recent empirical research demonstrates that high mortgage foreclosure rates are a problem not only for individual homeowners, lending institutions, holders of mortgage-backed securities, and national-level agencies such as Fannie Mae or Freddie Mac. Foreclosures also harm neighbors by reducing the value of nearby properties, especially when the aggregate rate of physically-adjacent foreclosures crosses a certain threshold, and this in turn reduces local governments’ tax bases way beyond tax delinquency for foreclosed assets.\(^{15}\)

The identification of substantial jurisdictional public effects of what is allegedly a private market issue does not, however, dictate a single type of solution. More coercive regulatory intervention in the market may not necessarily result in more efficient provision of housing or finance. Instead, local governments may opt for an advisory, mediatory, or otherwise non-coercive role in broadening the possibilities for homeowners. According to one such suggestion, municipalities could serve as a conduit for matching homeowners and investors for the purpose of home equity insurance against fluctuations in local home values or for selling off their upside potential.\(^{16}\) Further institutional innovations may be inspired by existing types of development.

The Essay seeks to explore some of these mechanisms. We start by analyzing Community Land Trusts (CLTs), which show impressively low foreclosure rates even though their beneficiaries are low-income people. We identify the organizational and

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\(^{13}\) US Department of Treasury, Home Affordable Modification Program Guidelines (2009), accessed at: http://www.ustreas.gov/press/releases/reports/modification_program_guidelines.pdf (visited, July 16, 2010). Under this program, the borrower first has to reduce payments on mortgages to 38% Front-End Debt to Ratio (DTI). The US Treasury then matches further reductions in monthly payments, dollar-for-dollar, with the lender/investor, down to a 31% Front-End DTI. The program’s success has been questioned, however, since it has been implemented only with a small fraction of borrowers. The federal government is currently designing yet another initiative, aimed at encouraging delinquent borrowers to shed their houses through a “short sale,” in which the property is being sold for less than the balance of the mortgage, based on a self-binding real estate valuation commissioned by the lender. See David Streitfeld, Program to Pay Homeowners To Sell at a Loss, N.Y. TIMES, Mar. 8, 2010, at A1.

\(^{14}\) For the dominance of state law and regulation in these topics, see generally Abraham Bell & Gideon Parchomovsky, Of Property and Federalism, 115 YALE L.J. 72, 74–75 (2005) (discussing differentiation and even competition over property regimes among different jurisdictions);

\(^{15}\) Jenny Schuetz, Vicki Been, and Ingrid Gould Ellen, Neighborhood Effects of Concentrated Mortgage Foreclosures, 17 J. HOUSING ECONOMICS 306 (2008); Posner & Zingales, supra note 3, at 575-76.

contractual features that make this possible, with a view to transplanting some of these features to other markets and policies.

II. The Growth of Community Land Trusts (CLTs)

A. The Institutional and Legal Features of CLTs

One type of housing development in which local governments have been playing a growing role in the past few years is Community Land Trusts (CLTs). As of 2010, there are over 240 CLTs, which include more than 6,000 housing units across the US.\(^\text{17}\)

The CLT is a community-based, non-profit organization that acquires land for the purpose of retaining perpetual ownership in it to facilitate affordable housing. The individual homeowner leases the land for a long period of time (typically, 99 years) and becomes the owner of the building erected on the land. The lease agreement on the land divides the property bundle between the individual and the CLT both during the tenancy and upon its transfer by inheritance or resale. Thus, for example, the homeowner must occupy the land as her primary residence, may not sublease the land without the CLT’s consent, is required to receive permission for major capital improvements, and is obligated to properly maintain the building.\(^\text{18}\)

To keep the land available for affordable housing in perpetuity, when the homeowner decides to sell the housing unit, the CLT repurchases the property or monitors its direct transfer from seller to buyer, but in both cases ensures that the resale price is restricted to a set formula. Although there are several generic approaches to setting the resale price, with many variations for each and potential combinations, the most prevalent mechanism in CLTs is one of appraisal-based formulas. These formulas establish the resale price of the house by adding to the original price a certain percentage (typically, 25 percent) of any increase in the home’s market value.\(^\text{19}\) The declared goal of this resale formula is to divide the gains from market appreciation, so that the exiting homeowner receives a “fair” return on her investment, while concurrently granting future income-eligible

\(^{17}\) See John Emmeus Davis, Origins and Evolution of the Community Land Trusts in the United States, in THE COMMUNITY LAND TRUST READER 1, 3 (J.E. Davis ed., 2010) (hereinafter: “Davis, 2010”). In addition, much of the information included in this Part is based on conversations and correspondence with Michael Brown, Burlington Associates in Community Development, LLC; John Davis, Burlington Associates in Community Development, LLC; Allison Handler, Executive Director, Portland Community Land Trusts; and Roz Greenstein, Lincoln Institute of Land Policy. We thank all of them for their help.


\(^{19}\) Other methods include indexed formulas, which link upward adjustments in the original purchase price to a specific index such as the Consumer Price Index (CPI) or the Area Median Income (AMI). Yet other formulas are “itemized,” meaning that the price is adjusted by adding or subtracting specific factors such as the value of owner-made capital improvements; maintenance, repairs, and depreciation; or inflation adjustments. While self-standing, itemized formulas are quite rare, some measure of itemization (e.g., owner-made improvements) usually accompanies the more prevalent appraisal-based formulas. See Burlington Associates in Community Development, LLC (hereinafter: “Burlington Associates”), Community Land Trust Resource Center: Comparing the Four Major Approaches to Resale Formulas, 2005, accessible at: http://www.burlingtonassociates.net/resources/ResaleFormulaComparisons.pdf (visited, July 16, 2010).
homebuyers “fair” and “affordable” access to this housing unit. Since the formula establishes a value “ceiling” and not a “floor,” the homeowner is nevertheless exposed to the economic risks resulting from declining property values or deterioration in the asset’s condition such that the formula-determined price may not be guaranteed.

Another intriguing institutional facet of the CLT concerns its governance structure. The CLT is typically an open-membership organization for all those that live within the wider geographic area that the CLT defines as the relevant “community.” It is governed by a tripartite board: one-third of board members are representatives of the leaseholders/homeowners; one third are elected representatives of other community residents outside the CLT; and the final third are co-opted by the first two-thirds, with some of these seats often being reserved for local government representatives, private lenders, and other major players.

CLTs are welcomed by local governments as a means to foster effective, long-term aid to needy families. In 2006, the City of Irvine, California, set up the Irvine Community Land Trust (ICLT), with the purpose of establishing nearly 10,000 CLT housing units by 2025. More broadly, in a growing number of CLTs, the entire one-third of “external” board members is now affiliated with and appointed by the local government.

The main reason for our focus on CLTs is the low foreclosure rates that CLT units experienced even after the subprime crisis, even though CLT units are intended by design for, and are in fact used by, low- and moderate-income families. At the end of 2008, CLT homeowners had a foreclosure rate of 0.52 percent, compared with the significantly higher national rate, estimated by the Mortgage Bankers Association in early 2009 at 3.3 percent. As discussed below, these figures can be attributed not only to the typically lower up-front prices of CLT housing units, but also to dynamic front- and back-end measures taken by CLTs aimed at mitigating the risks of insolvency and avoiding inadequate foreclosure procedures.

We identify four broad institutional features of CLTs that point to their success in combining issues of property configuration, access to credit, and risk management.

1. Affordability through Unbundling of Rights and Subsidies

The property product designed by CLTs is located at an interim point along the landownership/lease continuum. It divides the bundle of property rights between the

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21 Davis, 2006, supra note 20, at 64-65.

22 Lehavi, Mixing, supra note 18, at 199-202.


individual homeowner and the land trust in an innovative manner, rather than opting for the conventional “own all or nothing” strategy.26

Because of the unique property structure of CLTs, which means that homeowners do not acquire the land, buyers pay much less upfront, typically in the 25-30 percent range.27 In addition, buyers usually enjoy a subsidy on their purchase price, their monthly rent, or both. CLTs tend to provide greater subsidies when the land is donated to them. In contrast, when the CLT has to acquire the land, some of these acquisition costs are typically passed on to consumers. This additional cost could be reflected in the up-front price of the housing unit, or, more typically, in the monthly lease fee that is collected by the CLT. As a matter of public policy and as part of the actual incentive structure for potential homeowners, the subsidies offered by the CLT for the home or the monthly rent payments must be substantial enough to justify the legal and economic limits placed on CLT homeowners during and after their tenure.28 At the same time, the pairing of subsidies with the unique property structure of the CLT makes this mechanism superior to other types of public housing assistance.

2. Credit Mediation

In mediating and facilitating a loan agreement for the house vis-à-vis lenders, the CLT assists by narrowing down informational asymmetries between the parties to the loan agreement, and by better assessing ex ante the financial ability of the borrower to pay back the loan. This is done typically by requiring homeowners to undergo training and orientation, and by explaining to banks (1) that the collateral for the CLT home purchase mortgage is the leasehold estate—the value of house improvements plus the value of the leasehold interest in the land—and (2) the favorable loan-to-value ratio in CLT leasehold mortgages (since the CLT’s write-down of the home purchase price is regarded as equity).29

Although the CLT is not a direct party to the loan agreement, it typically retains a privilege to step in, in case of mortgage default, to forestall the foreclosure process for a few months in order to work with the borrower to avoid foreclosure, to take over the borrower’s interests, or to remove the resale restrictions in case of foreclosure or the taking of the deed in lieu. As a result, local banks, who become engaged in repeat play vis-à-vis the CLT, are more willing to originate mortgages at lower interest rates.30

3. Prevention of Insolvency

CLTs play a preventive or “backstopping” role in mortgage defaults not only during the pre-leasehold negotiation, but also throughout the tenure period. Since the leaseholders pay the CLT a monthly lease fee, and since homeowners typically default on the

26 We do not discuss here the largely anachronistic estate system, which still exists in the US and in other common law countries, but has lost most of its importance in the modern era. Conventional housing in the US is currently governed by the fee simple, which grants full ownership in both the land and the home. See JESSE DUKEMINIER ET AL., PROPERTY 185-96 (7th ed. 2010)
27 See sources in supra note 17.
29 See sources in supra note 17.
30 See id.
mortgage only after failing to make other types of payments, the lease fee payment serves as a potential “alarm device” that warns the CLT in advance if the homeowner is nearing default on her mortgage loan.

Whereas at this stage the CLT is formally entitled to terminate the lease and evict the lessee from the land, it may work either to adjust the leasehold scheme vis-à-vis the borrower, or—if this is impracticable—to purchase the home from the borrower, bring the account current vis-à-vis the lender, and place a lien on the property for the amount of that payment, which is then recouped at resale.31

4. Lower Cost of Insolvency

Finally, in case of insolvency that triggers action by the lender, the CLT may take a number of steps to prevent court foreclosure, including exercising its prerogative to take over the homeowner’s interests (which is in fact a right of first refusal over the home). Even in cases of formal foreclosure, the CLT still owns the underlying land and thus has a strong bargaining power vis-à-vis the lender or any future buyer of the home.32 Since the model CLT ground lease allows the CLT to charge market-rate rent if the eventual homeowner is not an otherwise eligible low-income household, in a few real cases of foreclosures, the new homeowners voluntarily agreed to re-impose the CLT resale restrictions in exchange for being charged below-market lease fees.33

Put differently, the CLT structure alleviates the “anticommons” fear that may be embedded in splitting ownership between the land and the house.34 This is so in the sense that the CLT has leverage to repurchase the specific home in case of foreclosure, or to otherwise prevent a “checkerboard” scenario, in which a number of foreclosures in a CLT area will create a divide among CLT and non-CLT homes, a significant issue also for the ongoing collective governance of the entire CLT development.35

31 See id.
32 One may wonder about the incentives of lenders to lend when considering this power. Two factors may be important. First, CLTs are repeat players, so that they have incentives not to behave opportunistically in any particular deal. Second, US lenders, especially local ones, may be under regulatory pressure to lend to low-income mortgage applicants. At the same time, the low foreclosure rates in CLTs may encourage lenders to keep engaging in such lending as compared to the perils of conventional markets.
33 This was the case, for example, in a number of instances involving the Burlington Community Land Trust in Burlington, Vermont. We thank John Davis for this information.
35 The problem of over-fragmentation of property rights is one of the major practical impediments to the development and redevelopment of land, at times necessitating the use of government coercion through the power of eminent domain. But the scope of this power remains a highly controversial issue. Thus, following the U.S. Supreme Court’s decision in Kelo v. City of New London, 545 U.S. 469 (2005), which validated the use of coerced land assembly through eminent domain for purposes of “economic development” as meeting the “public use” requirement of the Takings Clause, many states passed legislative reforms limiting to various extents the use of this power. See Edward J. Lopez, Pass a Law, Any Law, Fast! State Legislative Responses to the Kelo Backlash, 5(1) REV. L. ECON. 101 (2009). But under the latter approach, the problem of “anticommons” would remain intact. For proposals to create new mechanisms to curb eminent domain abuse while at the same time preventing an “anticommons” deadlock, compare Michael Heller & Roderick Hills, Land Assembly Districts, 121 HARV. L. REV. 1465 (2008) (calling to subject the group of landowners to a majority rule in deciding whether to accept a buy-out offer) with Amnon Lehavi & Amir N. Licht, Eminent Domain, Inc., 107 COLUM. L. REV. 1704 (2007) (suggesting
B. CLT Lessons for the For-Profit Market

Some of the central institutional features of CLTs may be adapted into general design principles that might be instrumental in enriching the range of options in the for-profit housing and finance market, thus better addressing some of its imminent problems.

1. Equity Building

The ex ante partitioning of rights in a CLT between the housing unit and the land parcel enables consumers to better build equity from zero. Unlike the dynamics of high-leveraged loans that were available through the subprime market, the CLT model allows low-income families with little or no equity to enjoy the benefits of tenure security and internalization of house improvements at a more favorable loan-to-value ratio. At a later stage, once the homeowner has paid back the loan and accrues more capital, she can choose whether to sell the CLT home and buy into conventional homeownership at a different location, or to channel the additional capital to another activity that she deems to be more valuable than the residual value of regular homeownership. Resorting to a useful terminology in the literature, homeowners in CLTs can choose the extent to which they would like to separate the “homeownership as consumption” component from the “homeownership as investment” one (i.e., the “gamble” on the property future value), which in conventional homeownership are inherently intertwined.36

Although under the typical resale formula, the CLT homeowner is exposed to some extent to the upside potential of market value rise (i.e., the percentage of the property appreciation that she keeps to herself), as well as to the downside (to the extent that declining property values attach to the housing unit or the leasehold rights), it is clear that the up-front costs of buying into the “investment” component and the consequent exposure to exogenous risks are more moderate in CLTs than in regular homeownership. This allows the CLT homeowner to build and invest equity more gradually, while at the same time retaining the flexibility to re-bind consumption and investment, should she decide to sell the CLT unit and move on to conventional homeownership.

We argue that the mechanism of gradual equity building along a certain time horizon can be conceptually extended in the context of the for-profit market to the same physical asset. Consider, for example, an innovative development model that would allow a homeowner at first stage to purchase the home only and take a loan against it, and then entitle her, after repaying this portion of the loan, to purchase the residual portion of the asset (the land, future development rights, and any other attributes that attach to full-scale ownership) and to take a new loan against it. Such an option would, however, have to consider an entire array of issues pertaining to the interim period (i.e., who holds the land rights during this timeframe), as well as to the possibility of continuous asset

36 See Lee Anne Fennell, Homeownership 2.0, 102 NW U. L. Rev. 1047, 1054-63, 1070-88 (2008) (hereinafter: “Fennell, Homeownership”) (suggesting a scheme by which landowners would transact with commercial investors. These investors would ensure homeowners against “offsite” risks such as general market trends resulting in decline in their home values, and may also possibly retain a share in any “offsite” asset value appreciation).
fragmentation and potential deadlock if the second stage of purchase does not materialize. In part IV, we suggest a tentative institutional solution, focusing mainly on the role that local governments could play to provide a viable organizational and financial framework, and we argue that this model could also support private contracting in this area, as explained in Part V.

2. Internalizing Risks and Prospects within the Local Community

Two prominent lessons of the subprime crisis have been the “moral hazard”37 and the bargaining problems embedded in mortgage-backed securities. Moral hazard was caused because the risk was shifted away from the original parties to the loan and on to national and international investors who had poor information about the risks and prospects for each loan. Bargaining difficulties emerged because securitization made it harder to renegotiate in case of market decline and default.38 In particular, it made it impossible to internalize the effects of foreclosure decisions on neighboring properties and the community.

Whereas we do not rule out the benefits of bundling rights to different debts (e.g., in Special Purpose Vehicles (SPVs) that pool together yielding financial assets such as mortgage-backed loans, credit card accounts, or auto loans in a separate legal entity),39 and we recognize the potential sense behind geographical risk diversification by a provider of mortgage-backed loans, outright alienation from the local basis of mortgages may easily result in suboptimal risk management, as shown by the current crisis. This is so especially because a significant number of foreclosures within a certain geographical area results in substantial adverse externalities to local governments and neighboring residents—a cost that tends to be disregarded by remote lenders.40

Conversely, CLTs are committed to internalizing both risks and prospects within the relevant local area—which can be flexibly designed to include a single neighborhood, multiple neighborhoods, a city, or an entire metropolitan area. This means that the CLT tripartite board structure represents a broad range of interests within the community beyond CLT residents and immediate neighbors, but it is nevertheless not detached from the local basis of CLTs. Accordingly, CLT managerial decisions, e.g., about which projects to develop, terms of leasehold contracts, resale formulas, and which modes of action to pursue in case of insolvency or foreclosure, are bound to consider the broader-based effects of such instances on the “community.”

Admittedly, given their governance structure, CLTs may suffer an opposite bias. Being dominated by local interests and partly by debtors themselves, CLTs might be tempted to defer foreclosures in hard times, being slow to accept the change in market conditions, at least up to the point of exhausting their endowment. In this sense, although

37 The problem of moral hazard occurs when the behavior of a person changes after the purchase of insurance, so that the probability of loss or the size of the loss increases, because of the insuree’s indifference to the loss. See ROBERT COOTER & THOMAS ULEN, LAW & ECONOMICS 53 (5th ed. 2008).
39 For these financial structures, see Steven L. Schwarcz, The Alchemy of Asset Securitization, 1 STAN. J.L. BUS. & FIN. 133, 134-44 (1994) (describing how securitization works and how companies benefit from it).
40 See sources in supra note 15.
CLTs show very low incidence of default and foreclosure, their numbers are somewhat hard to interpret, given the presence of capital (land) and labor (volunteering) donations, as well as possibly favorable regulatory treatment by municipalities, in addition to the newness of the experience.

With these caveats in mind, the potential benefits of the CLT structure might be reflected in a potential adaptation of the role of local governments in housing finance. Like CLTs, local governments have a clearer incentive to consider the broader-based effects of inefficient risk deflection and consequent high foreclosure rates on the local real estate market and, moreover, on the local economy. Local governments may thus be more prone to intervene to prevent distress, e.g., by subsidizing credit ex ante or stepping in, in case of mortgage delinquency, to prevent the snowball effect of foreclosures. In parallel, local governments are generally motivated to internalize a portion of the upside effects resulting from the collective action, such as by increased tax revenues in case of market value rise. To the extent that a CLT-inspired institutional structure could be devised, which would systematically motivate local governments to better internalize both such negative and positive effects, the current scope of local government activity in the provision of housing supply and finance could be made more effective. Part IV of the Essay presents the institutional role that local governments could play in what we term For-Profit Shared Equity (FPSE) real estate developments.

As for potential lessons for private developers, and the inspiration that they could derive from CLTs, we do recognize that the governance of CLTs, let alone of broader-based institutions, may involve substantial costs and be unsuited to the market. For example, CLTs are arguably administratively lean, enjoy subsidies, and focus on the purpose of providing affordable housing. But potential adaptations of CLT features to the for-profit market and the increasing involvement of government agencies may make CLT-like institutions more costly to operate. We address some of these concerns in Parts IV and V, when we analyze the potential expansion of for-profit shared-equity institutional structures to public agencies or to private entrepreneurs through new contractual models for housing finance.

3. The Scope for Greater Variety of Contractual Structures

The current for-profit mortgage market has been built around a standard model of unified homeownership in which owners-borrowers purchase both the land and the building and bear the whole economic risk of the purchase: they purchase an inseparable bundle of consumption and investment services. CLTs show that there might be utility in developing new formulas that allow homebuyers to separate these consumption and investment components of homeownership, tailoring their purchase decisions more closely to their means and, more generally, to their financial profile.

Furthermore, assuming a public policy of favoring affordable homeownership, CLTs are starting to demonstrate, in the context of non-profit housing, that an innovative

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41 See text accompanying supra note 25.
42 See Fennell & Roin, supra note 16, at 147-50 (portraying the high stakes that local governments have, in effect, in foreclosures rates within their territories).
43 For the centrality of ad valorem (value-based) property taxation in the economy of local governments, and the effect this has on their policy-making, as well as on the fundamental concepts of homeownership, see Amnon Lehavi, The Taking/Taxing Taxonomy, 88 TEX. L. REV. 1235, 1266-1275 (2010).
institutional structure may not only aid needy families, but can also alleviate the risk of mortgage insolvency and address actual foreclosures effectively, thus making some of the CLT’s features attractive also to for-profit lenders, especially to local banks that are better acquainted with a specific development. This means that a richer array of alternatives, expanded to the for-profit sector, might potentially promote the interests of lenders, borrowers, government, and other affected stakeholders.

4. Difficulties of Divided Ownership

A potential deterrent of formulas resembling the CLT model is that market participants may be reluctant to divide ownership, such as allocating among different persons the ownership of land and building, or granting purchase options to lenders, as suggested in Part V below. Thus, for example, in questioning the potential merits of CLTs, Robert Ellickson argues that any legal design, based inherently on a long-term lease rather than on full-scale homeownership, would result in higher ongoing transaction costs between the landowner and the tenant, who are situated in a bilateral monopoly.

More broadly, the reluctance toward the division of ownership seems to be based on the fundamental concerns rooted in the *numerus clausus* doctrine: multiplicity of property rights may discourage trade, especially when these are designed in a very specific fashion. In our case, the exceptionality of divided ownership could hinder subsequent trade in land or mortgages, therefore deterring the introduction of such formulas.

Let us first examine the logic of the *numerus clausus* doctrine and then review some other innovations in divided ownership, to illustrate that there is scope for introducing innovative arrangements in this area without hindering trade.

According to the *numerus clausus* principle, which is explicit in civil law systems but also highly indicative of the Anglo-American one, only certain forms of property rights are recognized as such by the legal system, thus preventing private parties from exercising their otherwise nearly unbound transactional freedom to shape their legal relationships. Current theory seeks to ground such design limits in “optimal standardization,” that is, balancing economic and social demand for different types of property interests against the need to economize on information costs imposed on third parties that have to accommodate to such diversity, in view of the *in rem* nature of property rights.

This, however, does not necessarily mean that recognized types of property rights included in the “closed list,” such as ownership, should essentially adhere to a single

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44 Some of these mortgagees hold these loans in their portfolio, while others sell these loans on the secondary market or to state/local housing authorities. We thank Michael Brown for this information.


47 See Thomas W. Merrill & Henry E. Smith, OPTIMAL STANDARDIZATION IN THE LAW OF PROPERTY: THE NUMERUS CLAUSUS PRINCIPLE, 110 YALE L. J. 1, 24-42 (2000). But this approach has had its critics. Henry Hansmann and Reinier Kraakman argue that third party considerations might require contracting parties to effectively publicize nonstandard arrangements, alongside the employment of other types of verification rules, but that these considerations do not justify an overall ban by the legal system on creating new and efficient proprietary forms. Henry Hansmann & Reinier Kraakman, PROPERTY, CONTRACT, AND VERIFICATION: THE NUMERUS CLAUSUS PROBLEM AND THE DIVISIBILITY OF RIGHTS, 31 J. LEGAL STUD. 373, 395-409 (2002).
blueprint, i.e., an indivisible fee simple interest in both the land and the home. At the same time, for new models that “rearrange” ownership, leasehold, mortgage, servitudes, etc. to become formally institutionalized, the new format needs not only to become de facto familiar to various stakeholders, but should also be supported by enabling legislation and regulation to allow actors such as lenders to fully understand the nature of the property configuration and the type of collaterals, and consequently to be willing to extend credit. We argue that such systematic changes may, and do, take place when the introduction of innovative design models is shown to effectively address new or adapted patterns of market demands. In this sense, although the numeros clausus principle imposes a structural constraint, it should not be understood as blocking dynamism and innovativeness.

An early example of a “non-conventional” housing form, which started in the US in the late nineteenth century and has been applied in both the non-profit and for-profit sectors, is cooperative housing (co-op). The cooperative corporation is the owner of the building, and each shareholder of the co-op corporation is entitled to a proprietary lease in a unit within the building (typically for 99 years). Since the purchaser of a co-op unit actually purchases shares in the corporation, when she borrows money for this purchase, the mortgage is secured by a pledge on the shares. In addition, most co-op corporations also borrow money secured by a mortgage on the real property (“blanket mortgage”), so that the owner of a co-op unit makes two types of periodic payments: one on her own mortgage, and another for her pro rata share in the co-op mortgage. Co-ops are still prevalent in the “affordable housing” sector, and are persistent also in New York City’s luxury market because of their stronger control over tenant selection.

This co-op arrangement was made popular by private initiative alone. In contrast, condominiums became an established property phenomenon only after the different states had passed enabling statutes during the 1960s, and the FHA had started to provide mortgage insurance for this type of tenure as of 1961. The demand for enabling statutes resulted from the need to incorporate into property law the then-innovative legal structure, by which the condominium owner owns her unit in fee simple absolute but shares a pro rata undivided interest in the common elements (inner streets, parks, joint facilities) as a tenant in common with the other condominium owners. Within about a decade after these Acts, condominium developments started to emerge as the most prevalent form of multi-family buildings across the US.

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48 For actual and normative differences that exist in the design of “recognized” property rights in various social contexts or for different types of resources, see, respectively, Hanoch Dagan, *The Craft of Property*, 91 CAL. L. REV. 1517, 1558-70 (2003) (discussing “institutions of property” ranging from those regulating arm-length market transactions to marital property); Amnon Lehavi, *The Property Puzzle*, 96 GEO. L. J. 1987, 1997-2000 (2008) (noting that different values implicate the ordering of rights to various resources).

49 Nestor M. Davidson, *Standardization and Pluralism in Property Law*, 61 VAND. L. REV. 1597, 1600-02 (2008) (portraying numeros clausus as “the common framework through which legal systems define and mediate property interests,” thus enabling dynamism and change in the closed list’s content over time).


51 Id. at 277-78.

52 See Henry Hansmann, *Condominium and Cooperative Housing: Transactional Efficiency, Tax Subsidies, and Tenure Choice*, 20 J. LEGAL STUD. 25, 26-30 (1991). We do not refer here to the potential comparative advantages of condominiums over cooperative housing, and vice versa—an issue which has been addressed to some extent in the literature. See Hansmann, supra; Schill et al., supra note 50. Our intention here is
A third type of common interest community, the RCA—a planned-unit development that is governed by a homeowners’ association—has also become a roaring success throughout the US, following state-enabling legislation and general judicial support for the RCA’s governance mechanisms. The core of the community property governance lies in the conditions, covenants, and restrictions (CC&Rs) included in the RCA’s governing documents. These reciprocal obligations, recognized as equitable servitudes, control and regulate commonly-owned assets and amenities as well as the use of privately-owned housing units. Beyond enforcing CC&R pre-fixed provisions, the association is empowered to make managerial decisions, lay down rules, and even amend at times the governing documents without the need for unanimous homeowners’ consent.53

The lessons deriving from these types of innovative institutional design of housing development and finance are, first, that models that deviate from the “classic” fee simple homeownership have merit not only in the affordable housing sector, but also in the for-profit market, in which consumers have a genuine choice among property forms and may moreover attach a market premium to certain types of developments that involve some level of shared ownership and governance. Second, as a matter of both economic reality (i.e., the potential of a new institutional product to penetrate the market) and legal design, any type of “bottom-up” innovativeness must not only take firm root among consumers, lenders, and governmental agencies, but also usually gain top-down authorization and support to overcome economic and legal hurdles. This has been vividly demonstrated in the essentiality of enabling legislation for both condominiums and RCAs.

In principle, private entrepreneurs or local governments looking to design innovative property regimes that divide homeownership property rights along a certain time horizon could resort to types of defeasible estates or future interests in the Anglo-American legal system or to existing types of legal trusts for the interim periods during such multi-phase housing projects. However, it seems that for such new housing patterns to become widespread and clearly identifiable to developers, consumers, financiers, and other third parties, new legislation would have to be tailored to the specific traits of such projects, so as to address not only property aspects but also special tax considerations that may be involved in a multi-stage model of real estate purchase.

This need may be even more acute in civil law systems, which are traditionally detached from the fragmentary estate system and have aimed at designing ownership as a “unified box.”54 In legal reality, property rights in land in civil law countries are less “pure” than conventionally depicted. Spain, for example, legally enables separating the ownership of land from that of buildings erected on it (“derecho de superficie”), as is also the case with the Erbbaurecht in Germany.55 And yet some initiatives to use this separation in affordable housing have been viewed unfavorably by potential buyers as

only to show that innovative housing forms are not being blocked outright simply because of the *numerus clausus* principle.


54 See John Henry Merriman, *Ownership and Estate*, 48 TUL. L. REV. 916, 927 (1974) (explaining that under the Romanic theory of property, the “box of ownership” contains rights, “including that of use and occupancy, that to the fruits or income, and the power of alienation”).

producing “imperfect” or “crippled” rights. Thus, since CLT-like schemes do not fit comfortably within the property forms that are widely known and understood by developers, consumers, and third parties, an enabling top-down reform would probably be essential to make such innovativeness and competition among property forms in the market viable and effective.

III. Tax Increment Financing (TIF) Development

We now move on to examine a different kind of development or redevelopment scheme, which might be used as a complement to CLT-like initiatives: the Tax Increment Financing (TIF) district. Although municipalities have always resorted to policy tools aimed at fostering local economic development, TIF schemes have dominated since their origination in California in 1952.

A TIF scheme enables a redevelopment corporation, which is a subsidiary of the local government, to incur expenses, including up-front costs of assembling land and setting up public infrastructure, and to issue revenue bonds that are paid back over time by earmarking future incremental increases in property taxes within the designated area. This means that throughout the period, until the bonds are paid in full (typically around twenty years from issuance), the redevelopment agency does not have to share the incremental revenues with all other taxing agencies that regularly receive a share of the property taxes (such as counties, school districts, and special service districts).

The redevelopment agency typically enters into agreements with different developers for the sale of land and its development in accordance with the redevelopment scheme. In states such as California, redevelopment agencies are entitled at times to participate directly with the developer in the profits of the project, beyond the receipt of taxes. This may be so when the parties disagree on the value of the land because of differing estimates about the project’s future economic value so that part of the payment is deferred to actual performance. The agency’s participation in the project’s cash flow allows it to recover expenditures, such as for parking and highway interchanges, which could not have been recouped as part of the price of the land.

TIFs have also, however, been a source of controversy. Critics argue that TIFs often do not generate net municipality-wide gains that could not have been otherwise

56 For the lengthy process of learning to accept the CLT model, with its “unusual characteristics of ownership,” as a legitimate option in the American real estate industry, see Davis, 2010, at 26-39.
60 For the legal validity of TIFs, see, for example, In re Request for Advisory Opinion on Constitutionality of 1986 PA 281, 422 N.W.2d 186, 191–96 (Mich. 1988) (rejecting the argument that TIF is a constitutionally impermissible diversion of school districts’ tax funds under Michigan law). Some states do, however, limit the ability of redevelopment agencies to receive all tax increments generated from the project’s area. See, e.g., DAVID F. BEATTY ET AL., REDEVELOPMENT IN CALIFORNIA 212–18 (3d ed. 2004) (describing such mitigating constitutional and statutory provisions in California).
attained, but are used merely to shift existing economic activity to the TIF district, so that the alleged gains are offset by negative impacts on non-TIF parts of the municipality. Other research does point to genuine appreciations within TIFs.

Regardless of disputes over the cost-effectiveness of local government action in certain TIF districts, the TIF scheme relies on institutional traits that place local governments in a unique position to provide real estate markets with the benefits of collective action, while at the same time being better attuned to local characteristics, the interconnectivity among different projects, and the public/private interplay within a defined geographical area. We do not claim, of course, that local governments are inherently superior to either private entrepreneurs or to state or federal agencies in crafting any type of development and finance scheme. Our basic assumption is that private developers are generally more efficient producers of for-profit housing units for conventional homeownership or the renting market. But we do suggest that local governments, low-level collective action, and the property tax mechanisms can be employed more broadly to provide new design options.

A. Low-Level Collective Action and Securitization

The work of municipal-level entities such as redevelopment agencies in undertaking the collective action of assembling land, providing public infrastructure, and accessing upstart credit by issuing earmarked municipal bonds, can be adjusted to different types of development configurations. Nevertheless, attention should be paid to the potential abuse of such powers, e.g., in the coercive use of eminent domain for the hidden purpose of rent-capturing at the expense of landowners. This fear should not entirely block the potential for innovativeness. It should, however, inspire an effort to constrain by legislative provisos new schemes involving local governments as entrepreneurs, direct or indirect financiers, or developers.

61 In many states, including California, the legal authority to set up a TIF district hinges on the “but for” criterion, meaning that the local government is able to demonstrate that the private investment in the designated TIF area would not have occurred “but for” the stimulus provided by public investment. See Jan K. Brueckner, Tax Increment Financing: A Theoretical Inquiry, 81 J. PUB. ECON. 321 (2001).

62 See Michael Dardia, Subsidizing Redevelopment in California 29 (1998), accessible at http://www.ppic.org/main/publication.asp?i=70 (visited, July 16, 2010) (noting that where an increase in tax revenue is due to general trends in the real estate market, TIFs act as involuntary subsidies from counties and school districts to cities); Richard F. Dye & David F. Merriman, The Effects of Tax Increment Financing on Economic Development, 47 J. URB. ECON. 306, 307 (2000) (arguing that competitive government bidding could be a zero-sum game with gains to some, offset by losses to others); Weber, supra note 59, at 63 (noting studies showing evidence that a positive effect on growth in property value in TIF districts is offset by a negative impact in non-TIF districts of the same city).

63 See Brent C. Smith, If You Promise to Build it, Will They Come? The Interaction between Local Economic Development Policy and the Real Estate Market: Evidence from Tax Increment Finance Districts, 37 REAL ESTATE ECONOMICS 209 (2009).

64 See sources in supra note 35. See also Daniel B. Kelly, The “Public Use” Requirement in Eminent Domain Law: A Rationale Based on Secret Purchases and Private Influence, 92 CORNELL L. REV. 1, 18–31 (2006) (arguing that the ability of secret buying agents to overcome holdout problems associated with assembling large tracts of land mitigates private parties’ need for eminent domain).
Special focus should be given here to the ability of local governments to build equity through the use of specific-revenue municipal bonds. In examining the pros and cons of securitization in the real estate market, municipal bonds do seem to be an attractive option for risk management, since their scope is not too small to result in financial breakdown following a small number of foreclosures, but not too dispersed to create a kind of subprime, inefficient risk-deflecting. Moreover, to the extent that the collective debt of the agency can be conceptually and legally separated to some extent from debts incurred for individual housing units, i.e., in the collateral for the loans, such collective bonds could actually be combined with the extension of additional credit to developers and consumers.

B. The Development Planning Function of Taxes

The TIF mechanism points to the multi-faceted development potential of taxes, not merely as a passive incident in an existing private economic activity, but also as a full-fledged planning tool that allows local governments to create incentives for development and to diversify the sources of equity by seemingly reversing the order of events: obligating part of the future stream of public revenues up front as a market-reliable mechanism for raising private capital. However, as is the case with government collective action, such innovative use of tax mechanisms should tread the fine line between not sticking stubbornly to a conservative view of taxing as future contingent capital, and not rushing into \textit{ex ante} adventurous gambles on this source of revenue at the expense of the taxpaying general public. This design principle is especially challenging in the context of \textit{ad valorem} property taxation, since it relies on what is allegedly exogenous to both government and individual actors: the price equilibrium of the real estate market, influenced also by extra-local variables.

Accordingly, the use of tax innovation to create new types of development and finance models should always identify the optimal scale of economic stakeholding, e.g., whether chief risks and prospects should be managed at the local or sub-local (neighborhood) level, the type and scope of the public collateral for the up-front equity raising, and how future prospects and risks would be shared between the government and private developers or consumers upon actual implementation of the project. With these considerations in mind, we borrow some of the institutional features of TIF districts for our design of a new tentative model for housing supply and finance, which we now present.

IV. A Public Suggested Model: For-Profit, Shared Equity (FPSE) Development

As stated at the outset, the various institutional insights from both CLTs and TIFs suggest possibilities for creating two new types of financial and legal design models. Part IV

\begin{footnotesize}
\begin{itemize}
\item For the way these municipal bonds work, in the land development context, see BEATTY ET AL., \textit{supra} note 60, at 233-241.
\item For the tax mechanism as a chief planning tool for local governments, see sources in \textit{supra} note 8.
\item For the principles and mechanisms of \textit{ad valorem} property taxation in the US, see generally JOAN YOUNGMAN, \textit{LEGAL ISSUES IN PROPERTY VALUATION AND TAXATION: CASES AND MATERIALS} (1994).
\item See Fennell & Roin, \textit{supra} note 16 (discussing “understaking” and “overstaking” of the various actors in residential choices and outcomes, both within the boundaries of local governments and beyond them).
\end{itemize}
\end{footnotesize}
describes a model for innovative public initiatives, and Part V will develop an application for the private sector.

At this point, it is important to emphasize once again that, even if our suggested model involves a public initiative, this does not stem from any sort of general proposition by which the public sector is superior to the private market in developing and financing housing. In general, we are inclined to believe it is the other way around. Our model below is based, rather, on an “institutional engineering” perspective, which seeks to take advantage of existing mechanisms and institutions that are currently available to the public sector and to local governments in particular, and explores the possibilities of adapting them to a different setup. Any similar economic and legal engineering devices developed through private institutions would be truly commendable. The model developed below should thus be seen as a general invitation for institutional innovativeness and not as praise for the public sector as such.

That said, what we entitle a For-Profit, Shared Equity (FPSE) scheme seeks to integrate some of the key features of CLTs and TIFs, and designates an important role to local government in facilitating this type of development. Under the FPSE, a development agency, which is a subsidiary of the local government, would acquire land and approve a detailed land use plan for development. These up-front costs would be covered by the issuance of bonds and secured by the revenue stream of property taxes in the manner detailed below.

The FPSE would involve two main phases. During the first stage (which starts at time 0), buyers would be entitled to purchase the building and a market-rate, long-term leasehold on the land. The buyer would be able to approach any commercial lender and take a mortgage loan that would be secured by the value of the building and the leasehold. At this stage, the development agency maintains ownership of the land and entitlement to all future development rights.

If at any time during the first stage the homeowner fails to pay the mortgage or the leasehold rent, the development agency would have the right to step in, in a similar manner to CLTs, including a right to evacuate the homeowner or to purchase the house from the borrower and bring the loan current vis-à-vis the lender.

At the end of the first stage’s designated period, $t$, (which could typically be somewhere between five and ten years), if the homeowner is able to demonstrate to the development agency that she is meeting her contractual commitments to both the agency and the lender, she would be entitled to exercise an option to purchase the residual components: i.e., fee simple on the land, entitlement to future development rights, and all other rights that attach to fee simple ownership (the “Residual Ownership”).

We suggest that whereas the option would be legally granted at time 0, its price would be determined at time $t$ and would be set at the difference between the asset’s full market price and the current value of the rights that are already held by the FPSE homeowner at this point. In case of disagreement between the parties, the price of the option for the purchase of the Residual Ownership would be set by third party arbitration, the procedural terms of which would be determined in advance by statute. Whereas the option would be of some value at time 0, because it would grant the home buyer the right of first refusal to purchase the Residual Ownership at time $t$ for an objective market value (rather than for a price subjectively agreed to by the development agency), such an option’s value at time 0, before any specific investments are made by the home buyer (such as, for example, having friends and schooling children in the neighborhood), would
be low, so that it does not impinge on the affordability of the original FPSE transaction. Setting the exercise price at the market level also makes the option as profitable in downturns as in upturns.

There are two possible outcomes depending on the ability and willingness of the homeowner to exercise the option:

- If the homeowner decides to exercise the option, she would be entitled to take a second loan against this residual collateral with any commercial lender. As with the first loan, the development agency would be entitled to intervene in cases of mortgage default.
- Conversely, if at the end of the first stage, the homeowner is solvent but nevertheless declines the option, the development agency would be granted a right of first refusal of its own to repurchase the home and the leasehold upon any instance of resale by the homeowner. In addition, the agency would elect whether to retain the Residual Ownership, or to sell its rights onwards to a third party, including the said right of first refusal on the home and the leasehold.

Consider Martha, who contemplates whether to buy a conventional home in the market, or an otherwise identical house in a FPSE project, both located in the city of Summerville. The price of a regular home is $100,000. The price of the FPSE home is $60,000, reflecting the fact that during stage 0, Martha doesn’t have to buy the Residual Ownership components—including the land—which are valued in the market at $40,000. Assuming, for simplicity, a 10% interest rate, no debt amortization, and a $10,000 down payment, the annual interest paid on the mortgage would decrease from $9,000 to 5,000 when moving from a conventional transaction into a FPSE. The difference would provide for the rental fee and would provide a smoother path into homeownership, alleviating the risk of insolvency.

The decision regarding the second stage, which starts at time $t$, should also implicate the tax revenue scheme, which secures the bond that had been issued upfront by the development agency. One possible scheme could be that during the set first stage, the development agency would be entitled to receive all property taxes from the asset that are paid by the homeowners. If at the second stage the homeowner exercises the option, the municipal development agency would be entitled to receive exclusively from then onwards only the incremental property tax for the duration of the bond, as with TIFs, but the pre-development tax baseline would be allocated among the different taxing jurisdictions (including counties, school districts, and special service districts). If the homeowner does not exercise the option, the development agency would be able to continue receiving all tax revenues from the asset up to the duration of the bond, unless it passes on the Residual Ownership to a private purchaser during the term of the bond.

Moreover, the entitlement of the development agency to receive all property taxes if the homeowner fails (willingly or unwillingly) to exercise the option, and the dependence of the agency on tax revenues to pay back the bonds, provide incentives for the local government to act promptly and effectively against homeowners/leaseholders who fail to pay either the monthly rent payment or the mortgage, and to avoid lengthy foreclosures proceedings and/or long-term vacancy or abandonment of the property, shifting the property to more efficient use as fast as possible.

Overall, the FPSE system would provide an additional option to current development and finance formats. In essence, it would grant prospective homeowners a better
opportunity to gradually build equity and to make a reasoned decision about the investment of incremental capital to purchase the Residual Ownership at the end of the first stage. Accordingly, the potential deviation from a conventional ownership model need not result in excessive over-fragmentation of rights in the asset, once mitigating measures such as a right of first refusal are introduced.

Moreover, the fact that the development agency would select the type of housing covered by the FPSE system precludes the possibility that homeowners’ individual decisions might defeat its goals. In other systems that also attempt to increase affordability and reduce homeowners’ risk, homeowners may react by purchasing bigger houses, ending up with more or less the same level of risk of insolvency. This would not be the case under the FPSE because the development agency would be selecting the size of houses included in the designated development project.

In so doing, the FPSE model would be better able to systematically attain two different but related social policy goals: (1) increasing the affordability of housing in the for-profit sector by breaking up the property’s purchase into two distinct stages (buying the home at time 0 and deciding only later whether to exercise the Residual Ownership option at time $t$); and (2) lowering the level of insolvency risk as compared to currently conventional homeownership models in the for-profit sector.

From the local government’s perspective, an FPSE-like model allows it to engage in an economically feasible plan to foster growth and to monitor, at least for first purchasers of properties within the development area, against the ill-effects of badly regulated lending (with respect to, for example, the volume of lending being provided to subprime borrowers) and negative, community-wide externalities of concentrated mortgage foreclosures, while at the same time improving the incentives for the local government to act more efficiently in both its regulatory and fiscal capacities. Even if such schemes are not feasible for all kinds of local governments, the possibilities of designing new models that borrow some of these institutional insights from both the for-profit and non-profit sectors can reinvigorate the real estate market and expand consumers’ genuine choices, especially in separating the consumption and investment components in housing decisions.69

V. Private Suggested Model: Bootstrapping Home Buying with Upturn Options

The core feature of CLTs–providing affordability without increasing the risk of default–could be usefully introduced into private home buying contracting. This could be achieved by lowering down-payments and granting options to lenders, in a manner that would decrease the chances of default and foreclosure in an economic downturn. Observe that CLTs develop their strategy by: (1) allocating to the CLT initial ownership of the land and most elements of home appreciation; (2) contracting several conditional options, which include, at least, an option for the CLT to intervene in case of default; and (3) managing a complex contractual arrangement by which the CLT selects and monitors purchasers, administers the prices of land and rentals, and performs sophisticated default-avoidance procedures.

At its core, the CLT strategy is grounded in sharing in the increased value that homes reach during economic upturns in order to finance partial homeownership. It is unclear

69 Fennell, Homeownership, supra note 36, at 1054-63, 1070-88.
what the cost of CLTs’ activities is and, consequently, to what extent they need subsidies to operate. However, whatever the level of these subsidies, a pure unsubsidized for-profit solution would likely have to be institutionally simpler to be self-sustainable in the market.

Private markets could achieve a similar “bootstrapping” effect by granting lenders (or other agents) an option to buy the home in economic upturns. The value of this option would therefore finance better access conditions for home purchasers. It would lower down-payments or debt, possibly setting the level of debt below the minimum value that the home is expected to reach in a recession, thereby minimizing exogenous default.

To explain how the system might work, let us use the graphical tool often used in finance to represent options. Figure 1 depicts the conventional home purchase arrangement in which the purchaser borrows to buy the home. The horizontal axis represents the value of the home, which is assumed to be a random variable with distribution $\delta_1$. There is a positive probability of default when home value is lower than $L_1$, the amount of debt, this probability being graphically represented by the gray area in Figure 1. The vertical axis also represents the value of the home, with the different functions representing the accumulated values (with the total being represented by a 45° line), and the areas between the functions representing the value achieved by each party (lender and borrower), which vary with home value.

In turn, Figure 2 represents a highly stylized version of the CLT model, in which (1) the CLT owns the land; (2) the buyer borrows $L_2$ (lower than $L_1$, as CLT buyers do not buy the land) and (3) purchases the building, acquiring also a lease on the land. Buyers also (4) get an option to sell their rights to a subsequent buyer receiving a certain fraction (typically 25 percent) of the appreciation in the home’s market value. Parameters in Figure 2 are set so that the probability of default is zero considering $\delta_2$, the probability distribution of the value obtained by the purchaser when entering the deal. This is only a minor exaggeration of the common prudent practices followed by CLTs. Obviously, the complex contractual structure defining a CLT can make the equity portion greater or smaller to compensate for, respectively, greater or smaller down-payments.

Lastly, Figure 3 represents a possible purely private arrangement in which the purchaser buys the home, financing it with a loan $L_3$ plus the present value of a call option granted to the lender or a third party (not necessarily private), to be exercised at strike price $X_t$ in a future moment $t$. The home value distribution in this case is the same as in Figure 1. The value of the option is driven by the substantial positive probability that the home value will be above $X_t$ (the gray area to the right of the distribution). This positive probability should make the initial purchase considerably more affordable, by lowering either the down-payment or the loan.

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70 For the legal structure of options implicating property rights, and a useful guide to “call options” (options to buy) versus “put options” (options to sell) in this context, see IAN AYRES, OPTIONAL LAW: THE STRUCTURE OF LEGAL ENTITLEMENTS 1-38 (2005).

71 Under the appraisal-based formula, appraisals are typically done for the building alone, not for the combined value of the land and the building. Some CLTs, however, appraise the value of both the land and the building, use a ratio to determine how much of the property’s value is owned by the homeowner, and then apply the said percentage to the appreciation. See Burlington Associates, supra note 19.

72 We assume that the 25 percent appraisal-based resale formula does not have a further ceiling that is applied to extraordinary increases in value.
This third system would therefore provide affordability and at the same time limit the investment component in home buying. Its main cost would result from the fact that, in order to make homes affordable, the call option would need to be valuable and, therefore, the strike price would need to be low enough, so that the option would often be exercised, triggering eviction or renegotiation of a similar agreement at time $t$.

However, the system would offer a substantial advantage to the conventional arrangement: renegotiations would take place in times of bonanza instead of ruin and with homeowners receiving a substantial amount of money (the difference between $X_t$ and $L_3$), which they could use to buy the same or a different home.

Nonetheless, as explained up to here, the system would provide little incentive for homebuyers to invest in their property. The option facilitates bargaining at time $t$ but discourages any home-specific investment by buyers, including home maintenance; investments could easily be expropriated at moment $t$ by the option holder. Therefore, a necessary but incomplete palliative is for the contract to deduct verifiable maintenance expenses from the option strike price. This element would be somewhat reminiscent of the repurchase formulas in CLTs. In addition, to encourage a more balanced renegotiation at $t$, the buyer could retain an option to repurchase the home at a later time, let us say $2t$ at strike price $X_{2t}$. In case the holder of the first option decides to exercise it at $t$, the previous buyer would be evicted, paid $X_t - L_3$ and given an option to buy the house at time $2t$ at price $X_{2t}$. Parties could obviously renegotiate such a repurchase as early as time $t$, thus avoiding eviction in the first place.

This secondary option should not be of much value at time 0, as it is conditional on two consecutive upturns in the market in the two periods under consideration. Its introduction in the original contract would somewhat reduce but not eliminate the affordability provided by the system. However, it would be valuable at time $t$, in case the first option is being exercised, and generally before $t$, when the market goes up and exercise of the first option becomes likely. This should at least provide buyers with better incentives to invest in the home.

Our scheme is partly similar to the “shared-appreciation mortgage” developed in the US during the late 1970s and also sold in the UK in the 1990s, in which borrowers pay back both the loan and all or part of the interest with a share of the future increase that the value of the property may enjoy at the end of the loan period. The two models differ substantially, however, in several respects, making our scheme generally more flexible.

First, our model allocates to the lender the whole of the appreciation above a certain threshold, if she exercises the call option at time $t$, enhancing both affordability and simplicity in the design and implementation of the transaction. As in shared-appreciation mortgages, the principal of the loan is an unconditional obligation, so that if the property’s value decreases, the borrower would still owe it. However, under our model the exercise price of the option can be set up low enough to make it very unlikely that the value of the home will be lower than that of the loan.

Second, our scheme does not require third-party appraisals, something that might hamper other schemes such as shared-appreciation mortgages, given the difficulties of

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such appraisals, as hinted by Andrew Caplin et al.\textsuperscript{74} The simpler structure of our model would facilitate valuation and make both mortgages and options attractive to the secondary markets. Shared-appreciation mortgages might also suffer from adverse selection and moral hazard problems which, to be cured, require even more complex structures, such as a gradually-increasing “shared-equity rate” in favor of the lender, as proposed by Caplin et al.\textsuperscript{75}

Finally, our suggested model may, at first glance, create unease in view of the possibility that the homebuyer would have to evacuate if the lender decides to exercise the call option and the homeowner does not exercise her own repurchase option. But the shared-appreciation mortgage may inadvertently cause much harsher results. Under such a scheme, at the end of the loan period, the borrower would have to pay back a substantial lump-sum amount reflecting the paper-gain appreciation, when she would typically have little liquidity. This would force the homeowner-borrower to either take a new conventional loan to cover the original one or sell the house to a third party to meet her obligation. This would typically result in the same threat of evacuation, but also with excessive searching, negotiation, and transaction costs with third parties. Conversely, under our model, the two parties are already well acquainted, and can start renegotiating way in advance of time $t$. Moreover, in our model, it is the lender—and not the borrower—who has to generate the financial resources to exercise the call option, if she so elects.

Conclusion

The US housing industry is in dire need of institutional innovativeness for alternative development and finance schemes—ones that do not systematically result in the ill effects of irresponsible lending, inefficient risk-shifting, and high foreclosure rates that have broader-based snowball effects for local economies.

Building on empirical observations from the non-profit sector, and identifying more general institutional design principles—such as unbundling of property rights, gradual equity building, conditional subsidies, internalizing of risks and prospects within the local community, and employment of tax mechanisms to foster development--this Essay delineates the legal and economic contours of two new solutions, which could be applied for restructuring both public initiatives and private contracting. In so doing, the Essay makes a major step toward developing innovative legal models of homeownership, ones that would be sustainable and enduring for both downturn and upturn eras in the American economy.

Our two proposals overcome some of the common defects in alternative systems. In particular, both are superior to mere provision of information to home buyers in that information alone is insufficient when--for whatever reason, including market and political failure--incentives are intrinsically unsound. In such cases, no amount of information would improve the outcome--a change of incentives is needed. Our two proposals set out exactly to work such a change in both the public and private spheres.


\textsuperscript{75} Caplin et al., 2007, \textit{supra} note 73, at 10-14.
Figure 1: Distribution of claims under conventional home buying with mortgage financing
Figure 2: Distribution of claims under a CLT arrangement
Figure 3: Distribution of claims under mortgage financing with buyer selling an option to purchase at strike price $X$. 

![Diagram showing the distribution of claims under mortgage financing with a buyer selling an option to purchase at strike price $X$. The diagram includes labels for accumulated claims' values, option, equity, loan, and the home value $X$. The diagram illustrates how claims are distributed between the option and the equity, and how the loan is superimposed on the distribution.]

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Equation 1: $L_3$ 

Equation 2: $\delta_1$