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**COMMUNITY ASSOCIATIONS AT MIDDLE AGE:
A New Bankruptcy Law and Other Proposals**

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**COMMUNITY ASSOCIATIONS AT MIDDLE AGE:
A NEW BANKRUPTCY LAW AND OTHER PROPOSALS**

Robert H. Nelson *

The first condominium in the United States, the Greystoke development in Salt Lake City, was built only 50 years ago, in 1962. Homeowner associations and cooperatives have been around much longer, but these three forms of American collective housing ownership as recently as 1970 represented only about 1 percent of U.S. housing. By 2010, however, there were more than 300,000 community associations housing more than 60 million Americans, 20 percent of the U.S. population. Between 1980 and 2000, half the new housing in the United States was built and organized under the private governance of a community association. The rise of community associations has been perhaps the leading development for American housing and local governance of the past half century.¹

As a more recent institution in American life, much of the public policy concern up to now has related to the manner of forming and then operating and maintaining community associations. The structure of community association governance is set in place by the land developer before there are any residents (“unit owners” in the language of the field). New buyers must then agree to the terms of this governance as a condition of purchase. After the development is completed and the housing units have been sold, the developer leaves and the unit owners take over the control and management of the association. There can be, however, a lengthy period of transition in which the developer is still holding and selling units, while other units have already been sold and occupied. Managing this transition fairly for both developers

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and unit owners can be a complicated affair.² Laws have had to be written and association rules devised to oversee the process of transferring final control from the developer to the unit owners.

As community associations move into middle age, however, new issues are demanding attention. Developers (in the writing of the founding documents) and policy makers now need to address more fully the question of the appropriate lifetime of a community association and how the middle and, potentially ending, stages might be handled. Should some failing community associations now go out of business altogether? How might this be accomplished? Should other community associations with major operating problems be reorganized? And, again, what is the best mechanism for accomplishing this?

I. Termination or Reorganization as an Option

One option that may become attractive for some community associations is outright termination. The association might be facing increasing difficulties in meeting its financial obligations; the revenues from assessments might not be enough to cover basic maintenance and other costs. If the infrastructure is deteriorating, there might be large capital costs that unit owners are not able to—or are not willing to—cover. The properties of the community association might deteriorate until they are no longer functional, possibly posing safety hazards and other problems. Having a large mortgage, some unit owners might walk away from their properties entirely rather than pay a large special assessment.

In other cases, the unit owners of a community association may simply have decided that it does not work for them.³ The internal politics may be dysfunctional, perhaps due to a lack of volunteer leadership, a large number of renters, or due to deeper structural reasons (the association may have diverse unit owners with widely varying and conflicting common service

interests and demands and who are never likely to agree).⁴ One option is for the unit owners to move out one by one. If enough owners are dissatisfied, however, it might make more sense to terminate the association altogether. A new association with new rules might be reconstituted, or in the case of a homeowners association the units might simply be transferred to individual ownership alone. Another possibility would be to sell everything in the association—all the individually and collectively owned properties alike—in one package to a developer. If the developer is willing to pay enough, this could even be a financially lucrative option for the association unit owners.

In the long run, community association terminations are most likely to reflect the simple reality of changing economic circumstances. As time passes, the original use of community association properties may become outmoded. When it was first built, for example, a community association of townhouses might have been well suited to its location, but a new subway stop could have opened nearby, radically altering the economic calculus. A large new apartment complex might now be much more profitable—creating land values multiple times higher per unit than the current townhouse values. Unit owners might be able to realize a large windfall gain by selling and moving out collectively. This would pose a new kind of transitional problem for community associations, including the termination of the existing association. As time goes by, and existing community associations age, more and more will become uneconomic for the sites they occupy. To date, there has been little planning and analysis of how an association might end its lifetime.

The Uniform Planned Community Act (UPCA) and the Uniform Common Interest Ownership Act (UCIOA), drafted in 1980 and 1982 by the National Conference of Commissioners on Uniform State Laws, contemplate the possibility of the outright termination

of a community association. These model state laws require a favorable vote of 80 percent or more of the unit owners, with further provisions specifying the fair treatment of unit owners during such a process. The UPCA and the UCIOA were adopted in part by several states but most states have chosen to tailor their own community association legal regimes. In any case, there have been few terminations of community associations in the United States based on a voluntary 80-percent vote of the unit owners.

The UPCA and UCIOA, moreover, contemplated the complete sale of the community association assets (including both individually and collectively owned properties) only in the case of a single building organized as a condominium. As land values change over time, however, there will also be homeowners associations with many individual homes (and “vertical” condominiums with multiple structures) that would find it profitable to sell out everything for a brand new form of land use at the site. In such cases, a whole new set of issues would have to be addressed including the appropriate decision making procedure to terminate the association, the speed and process of unit owner exit, and the allocation formula for distributing the total association sale proceeds among the unit owners.

Bankruptcy of Community Associations

In the near term, issues of reorganizing or terminating a community association are most likely to arise in the context of a bankruptcy filing. Association bankruptcies have been rare in the past, but the number of filings has been increasing in recent years with the sharp housing market downturn and the general deterioration in economic conditions. Bank foreclosures on unit owners in some parts of the country have been common leaving individual properties unoccupied for significant periods. Many associations have had trouble collecting assessments

from economically distressed residents. Overall, the financial health of many community associations has deteriorated sharply since 2007, posing real risks of bankruptcy in some cases.

Community associations have been particularly prominent in the fastest-growing states such as Florida, Arizona, Nevada, and California. It is in these same states where the housing market downturn has also been most severe. According to one 2010 estimate, two-thirds of all Arizona mortgage holders were “under water” (the amount of the mortgage was larger than the value of the property), creating an incentive for owners to simply walk away from their property. Also as of 2010, an estimated 10 percent of the unit owners in Arizona community associations had either abandoned their units or been forced out by foreclosures. Overall, as one observer found, there were a growing number of Arizona homeowners associations where “delinquencies have reached alarming proportions, placing some HOAs [homeowners associations] under serious threat of bankruptcy.”⁵

There is no good data source on the total numbers of community associations that have filed for bankruptcy. In Florida, however, media reports of bankruptcy filings have been appearing with growing frequency. In 2009, the Legacy Park community association filed for bankruptcy, owing partly to an unpaid debt of \$105,000 for cable television services provided by Comcast.⁶ In another Florida case, the Maison Grande condominium in Miami Beach, facing \$1 million in debts, and with 100 unit owners delinquent on their assessments, filed in 2009 for bankruptcy.⁷ This is just the tip of the iceberg in terms of potential community association bankruptcies in Florida, especially if the law of bankruptcy for community associations were to be clarified and otherwise improved. At one Florida law firm there were so many “association clients [who] have inquired about filing for bankruptcy” that the firm had launched a comprehensive study of the benefits and costs of bankruptcy.⁸

Although only a few community associations have so far filed for bankruptcy in Florida, the many more developers of new community associations have been going bankrupt. They have been hit by the severe housing market downturn in which a new Florida condominium unit expected to sell for perhaps \$200,000 in 2006 now might well bring in only \$75,000 (and in some cases as little as \$25,000). In such cases the developer of a new community association may have sold some of the association units but still been left with many others unsold before running out of money. Bankruptcy court trustees may combine the remaining unsold units for sale as a single package, using the proceeds to satisfy the demands of the creditors. For example, with the developer still owing more than \$22 million, a bankruptcy court in 2010 sold off more than 60,000 square feet of condominium unit space, 56 parking space reservations, and 15 storage areas in the 28-story Onyx on the Bay tower in downtown Miami. New firms have even emerged—one goes by the name “Condo Vultures”—specializing in the purchase of vacant units in severely distressed community associations in Florida.⁹

If bankruptcies of community associations themselves (rather than of the developers) become more widespread, it will be desirable to revisit and rewrite the bankruptcy laws to take account of the special circumstances of associations. Community associations at present are legally established as nonprofit corporations. As a result, they now file for bankruptcy under either the general provisions of Chapter 7 or Chapter 11 of the federal Bankruptcy Code, the former providing for complete liquidation of the corporation and the latter for its reorganization (and subsequent emergence from bankruptcy).¹⁰ The provisions of corporate bankruptcy law, however, are—reasonably enough—designed primarily for the circumstances of a private business corporation.¹¹ This can prove an awkward fit for a community association. The unit owners of a homeowners association, for example, are legally analogous to the share holders of a

business corporation. But the application of limited liability to homeowner association unit owners can be inappropriate; the homeowners association is not an entrepreneurial and profit seeking body but in fact functions more in the manner of a government serving the unit owners.

Bankruptcy analyst Kristin Davidson comments in a 2004 article that “the Bankruptcy Code is not equipped to address the unique characteristics and functions of community associations with excessive debt.” Under current bankruptcy proceedings as applied to community associations “in many states the law is inequitable; either residents are tremendously burdened by the associations debt, or creditors suffer from little to no recovery of the debt.”¹² Given the few previous cases and the complexity of the issues raised, there are few court precedents and widespread uncertainty exists as to the actual application of bankruptcy law to community associations. Some reorganization or liquidation options that would make the most sense for a bankrupt community association are not legally available to the bankruptcy court at present.

Davidson proposes that community associations should instead file for bankruptcy under Chapter 9 which applies to municipalities and other public governments. While it would help with some problems, however, this would create other new difficulties. This paper proposes below that a brand-new chapter of the bankruptcy law instead be written that is specifically designed for the circumstances of community associations. The paper also proposes other institutional changes outside bankruptcy that would facilitate the termination and reorganization of community associations as they face new economic and other challenges in middle age.

Before taking up such matters in greater detail, it will be helpful to provide some background by reviewing briefly the rise of community associations since the 1970s and their

unusual combination of private and public features. A community association is appropriately regarded as both a quasi-private and a quasi-public institution.

II. A Major Social Development

The rise of community associations since the 1960s has resulted in major changes in the character of American housing, property rights, and local government.¹³ Instead of public zoning, community associations shift much of the burden of regulation of neighborhood land use to a new private body, thus significantly altering the manner of designing, building, and regulating neighborhood development across the United States. In terms of property rights, community associations follow in the path of the spread of corporate ownership in the late nineteenth century which saw the transformation of American business from predominantly individual to predominantly collective ownership. We are now seeing a similar transition in the ownership of American housing from predominantly individual to—as it now seems will be the case in the future—predominantly collective ownership.

With the rise of community associations, much of local government in the United States is for practical purposes being decentralized to a neighborhood scale. Private management firms now often substitute for the past role of local public employees in overseeing neighborhood land-use regulation and the provision of common services. It is also a large new experiment in local democracy. Around 2 million Americans now serve—the terms are typically two to three years—on the boards of directors of community associations. For some of them this experience serves as a springboard into involvement with the wider American political process.

In the 1960s and 1970s, a neighborhood movement in the United States advocated transfer of many government responsibilities from counties and municipalities to individual

neighborhoods. The leading advocates at the time were proposing a reorganization of local government within the public sector. But this never happened. There was too much institutional resistance to such a basic change that would have affected so many existing local governments and their residents. Instead, and to many people's surprise, there was a successful private neighborhood movement. The shift of governing responsibilities to private community associations has been rapidly transforming the organization and the workings of local government in the United States, decentralizing it to the neighborhood scale and privatizing it.¹⁴

The Functioning of Community Associations

There are three kinds of community associations—homeowners associations, condominiums, and cooperatives—each of which has a different legal form. In a homeowners association, the unit owners individually own their homes and then also belong to the homeowners association which is a separate, nonprofit corporation that owns and manages the common areas. In a condominium, the common areas are owned by the unit owners as “tenants in common,” while each owner also holds a legal entitlement to occupy his individual unit. Some commentators believe that this legal difference may become important for bankruptcy purposes because in a condominium there is less legal separation of the unit owners from the association itself, and thus potentially less protection against liabilities for the financial and other obligations of the whole condominium association.¹⁵

As legally nonprofit corporations, much of the law of community associations derives from business corporation precedents. This extends to the significant role played by state governments (Delaware in the case of many business corporations) in setting the terms of corporate governance, extending to governing structure, voting procedures, and many other

matters. In states such as California and Florida, given the large numbers of community associations, the state legislature has been routinely modifying the state legal framework—at times seeming to make important changes almost every year. The overall trend has been towards increasing state oversight. In Nevada, for example, state laws in 1997, 1999, and 2003 made homeowners associations subject to the following new controls:

- Fines associations can levy are capped at \$100.
- Association boards must receive approval from their residents before starting litigation.
- Board elections must be held every two years and proxy votes during board elections are prohibited.
- Foreclosure based on nonpayment of fines is banned.
- Education for property managers is required.
- Annual meetings with announced agendas are required.
- A mechanism for recalling association board members must be in place.

Despite its private status, a community association functions in many ways like a form of government. The association has the power to levy “assessments”—amounting to a form of private taxation. Community associations can control the finest details of exterior property use such as house paint color, where a bush can be planted, whether a fence is allowable, the manner of lawn care, the parking of cars, and so on and so forth. This authority is all laid out in the “covenants, conditions, and restrictions” (the CC&Rs) that are the governing documents—in effect, the neighborhood “constitution”—to which the unit owners have agreed in advance. A community association can be as small as a single building or as large as a city of 50,000. But more typically it is of neighborhood size, around 200 to 400 housing units with a population of perhaps 500 to 1,000.

A community association will also usually provide certain common services. These may include garbage collection, street repair and lighting, and snow removal. Many associations also provide private security patrols. An estimated 10 to 20 percent of associations maintain a gate—

the so-called “gated communities.”¹⁶ The associations mow the lawns, trim the trees, and otherwise maintain the common areas belonging to the unit owners collectively. Many Americans may today want less government at the national level but at the neighborhood level they seemingly want more.

Associations frequently provide and oversee the use of recreational facilities such as swimming pools, tennis courts, and golf courses. Many of them now provide park areas and other open spaces for people to go for a walk, jog on a trail, or do some bird watching. Associations commonly sponsor public events such as community dinners, singles gatherings, or outside speakers. Basically, if a collective service mainly affects a single neighborhood, and there are no major economies of scale, it is increasingly likely that it is now being provided in the United States by a community association. The actual delivery, to be sure, may be by an outside private contractor who performs this service for a number of different associations.

Transforming Local Governance

The rapid spread of community associations does not mean that there is no longer a need for local government in the public sector. But in areas where community associations have proliferated, local public governments now mainly focus on matters with a wider territorial scope—such as sewer systems, water supplies, air pollution controls, arterial highways, and provision of criminal justice. Such local public government are also typically larger, often a center city municipality or a large and powerful county government in the suburbs.

For people living in the Northeast and Midwest, they are often surprised to learn of the large impact that community associations are having elsewhere in the United States on the American system of local governance. The Northeast and Midwest were mostly developed prior

to the 1960s, and thus many areas do not have many community associations (except for individual condominium buildings). In the newer and more rapidly developing parts of the South and West, however, community associations have become omni-present. In these places, including large parts of states such as Florida, Texas, Arizona, Nevada, and California, almost all new large development now comes with a community association. In California as of 2004, about 60 percent of all new housing in the state was being built with a community association.¹⁷

The large differences between the systems of local government in the older and newer parts of the United States are illustrated in table 1 below. According to the 2007 Census of Governments, the Chicago metropolitan area has 570 general-purpose local governments (excluding school and other special districts) in the public sector. The Detroit area has 215; St. Louis has 397; and Cleveland has 167. Of course, this is not true everywhere. The Buffalo metropolitan area has only 65 general-purpose local governments. That is partly because the Buffalo area has only 1.1 million people. And it never had any booming suburban development in the twentieth century. So its population is mostly fitted into a local governing structure inherited from the 19th and early 20th centuries with a dominant central city.

But with some such exceptions, the older parts of the United States fit a common pattern. In the suburbs, there are hundreds of public-sector municipalities—and including townships in some states—which provide the more localized services. Many of these small suburban municipal governments have only one or a few neighborhoods. In the central city, there are large consolidated municipal governments encompassing at least a few hundred thousand people, typically formed 100 or more years ago.

The pattern is much different in the South and West, however. Since the 1960s, Nevada has been the fastest-growing state (and also suffering disproportionately in the recent economic

downturn). The Las Vegas metropolitan area, with its 1.6 million people, has a grand total of six local governments in the public sector. There are only 19 municipalities in the entire state of Nevada, along with its 16 counties. Does this mean that Nevada residents have a special taste for large government at the local level, and dislike small government? The answer, of course, is the opposite. Nevadans have a strong liking for government at the neighborhood scale but are obtaining such decentralized governance privately through community associations. Indeed, Nevada is filled with many hundreds of community associations. They are playing the role there that small municipal governments in the public sector play in the Boston, New York, and Chicago suburbs—and in most of the rest of the suburban Northeast and Midwest. In the South and West, Nevada is an extreme case but similar patterns are found in many parts of these regions.

TABLE 1 – TOTAL GENERAL-PURPOSE LOCAL GOVERNMENTS (COUNTY, MUNICIPAL, OR TOWNSHIP), BY METROPOLITAN AREA, 2007

<u>Older Metropolitan Areas</u>	<u>Number of Local Governments</u>
Buffalo (1.2 million population)	65
Chicago (9.2 million)	570
Cincinnati (2.0 million)	253
Cleveland (2.9 million)	167
Detroit (5.5 million)	215
Milwaukee (1.7 million)	94
Minneapolis (3.0 million)	339
Philadelphia (5.1 million)	386
Pittsburgh (2.4 million)	464
St. Louis (2.6 million)	397
 <u>Newer Metropolitan Areas</u>	
Austin (1.2 million)	52
Las Vegas (1.6 million)	6
Orlando (1.6 million)	40
Miami (3.9 million)	106
Raleigh-Durham (1.2 million)	30
Phoenix (3.3 million)	35

San Diego (2.8 million)	19
Tampa (2.4 million)	39

Source: 2007 Census of Governments

In Florida, the Orlando metropolitan area, for example, has 2.1 million people and only 40 general purpose local governments. The Tampa metropolitan area has 2.7 million people and 39 local governments. Compare these figures to Cincinnati, whose metropolitan area has 2.2 million people and 253 local governments. Arizona is more like Nevada with only 90 municipal governments in the entire state. Shifting back to the Midwest, the State of Minnesota has a population similar to Arizona and has 854 municipalities. It also has 1,788 towns and townships, the functional equivalents of a municipality. There are 35 general-purpose local governments in the Phoenix metropolitan area (including 2 county governments), while the Minneapolis metropolitan area has 339 such governments.

Practical Implications

The increasingly private status has many practical implications for the conduct of local government. Voting rights are allocated in community associations on the basis of property ownership. Owning a unit in a community association in this respect is like owning stock in a business corporation. A common arrangement is one unit/one vote. If four adults share one unit, they get only one vote. One person with four units gets four votes. If I own a unit in Massachusetts where I spend the summer, and another unit in Florida where I spend the winter, I can vote in both places. A Norwegian can also vote if he owns a unit in Florida, whether or not he is a U.S. citizen, and independent of the actual amount of time he resides there.

Overall, unless constrained by state laws, the private status of community associations gives them wider freedom to innovate in a many areas of internal operations and governance. This reflects the fact that in general there are fewer legal and constitutional constraints on a private organization, as compared with a local government in the public sector. One area of difference is the application of rights such as freedom of speech and assembly. A community association can ban political signs on lawns, for example. It could deny the right to have a protest march. In general, constitutional rights that would apply in a public context may not apply within a community association.

I once learned about the greater flexibility of community associations from an experience of my own family. My father belonged to a community association in the Shenandoah Valley of Virginia. The association was having trouble passing an amendment to its founding documents, even though this was not controversial. It was simply that not enough unit owners were voting to meet the minimum vote requirement for passage. The association came up with a clever solution: convert the referendum into a lottery as well. Each ballot submitted became in effect a lottery ticket. The first prize was \$300, second was \$200, and third was \$100. (I heard about it because my father won the \$100 prize.) With this added incentive, more unit owners voted, and the amendment passed. It was a practical device to stimulate greater turnout, legal for a private community association but probably illegal for a local government in the public sector. (In the United States, a municipality is not supposed to pay people to vote in public elections.)

Consider another example where paying would probably be illegal publicly, but would be legal privately. Let us say a new convenience store wants to move into a neighborhood. A private community association in concept could sell rights to use a suitable location within the common areas. It would simply be another transaction such as occurs routinely in the buying

and selling of rights in the private sector. If some unit owners were adversely affected, the sale proceeds might be used in part to compensate them. In this way the whole neighborhood might benefit from easy access to a conveniently located store. While few (if any) such transactions have occurred to date, Yale law professor Robert Ellickson has long proposed the use of such methods as a way of resolving NIMBY conflicts internal to neighborhoods.¹⁸ In the public sector, however, this would probably be impossible even in concept. Changes in regulations to allow new uses are not supposed to be for sale, even in win-win situations where all parties benefit from and are agreeable to the transfer of rights.¹⁹

III. Proposed Institutional Reforms at Middle Age

With the rise of community associations in American life now dating back at least 40 years, it is appropriate to consider needed institutional changes that address problems identified by this experience. As suggested above, the prospect of more association bankruptcies, and the major deficiencies of bankruptcy law as applied to community associations, show the need for new attention to this area of the law. It would be part of a wider consideration of the possible means by which a community association might be reorganized or terminated.

Termination by Bankruptcy

As noted above, a community association can now file for bankruptcy under either Chapter 7 or Chapter 11 of the Bankruptcy Code. Under Chapter 7 as traditionally applied in the business sector, the liquidation of an entire corporation is contemplated. The properties of the corporation are assembled and then sold for as much as they can bring in. With the oversight of the bankruptcy court, the sale revenues are divided up among the various creditors of the

corporation to reflect the relative seniority of debt obligations. In a typical case, many creditors receive only partial compensation for the debts owed to them. Having a junior status, the stock holders of the corporation frequently receive nothing.

Legally, a homeowners association fits this corporate model. The homeowners association corresponds to the business corporation and the unit owners to the corporate shareholders. If a Chapter 7 bankruptcy were to occur, the association would then presumably be liquidated, the common areas and other common properties sold, and the unit owners would lose any rights in these common areas. Under provisions for limited corporate liability, the unit owners would presumably still be left with the possession of their individual homes.

This model, however, poses a number of difficulties in the case of homeowners associations. Many of the collective assets of the association itself may be difficult or impossible to separate from the individual units. What happens to an association street that is within the common areas and serves the unit owners living along this particular street? Would it have any sale value, other than to the owners, and who might otherwise buy it? Similarly, what about an association clubhouse, swimming pool, or tennis court that is surrounded by individually owned units? Some parts of the common areas might be suitable for development and have a significant value in a new use. But the highest value development of such areas might be incompatible with the existing homes. Even if the unit owners could be compelled to agree to a sale by their bankruptcy circumstances, would such incompatible development be allowed under public zoning laws? Such complications partly reflect the fact that a homeowners association serves in the role of a private government, as well as having similarities to a business corporation.

As compared with a public municipality, the private status of a community association makes for one large difference. If the functions and boundaries of a municipality become

outmoded, it would be difficult (if not impossible) to sell the municipal and individually owned properties collectively. A community association could in concept, however, opt for termination and the sale of all the association assets, including both collectively and individually owned properties. While a rare event to date, at least one such sale did occur recently in Seattle. The Laurelton Terrace condominium occupied six acres adjacent to the Children's Hospital and Regional Medical Center. Wanting to expand, the hospital agreed to pay \$93 million for the full set of Laurelton condominium properties, amounting to \$614,000 per unit owner—fully 2.5 times the recent average of \$241,000 in the individual sale of units. In a 2008 vote, 120 unit owners favored the package sale of all the condominium properties, 3 opposed it, and 12 did not vote. Until 1990, Washington state law required unanimity for such a transaction, but the state in that year enacted a law providing for such a termination of an association with a favorable vote of greater than 80 percent. This law, however, applied only prospectively to new associations. The state legislature, however, solved the problem by amending the law in 2008 to allow transactions such as the Laurelton sale to proceed.²⁰

In another case, the unit owners the Parker Place condominium in Wallingford, Connecticut opted for the termination of the association and the sale of all the units, as also authorized by state law with an 80 percent favourable vote. In this case, however, seeking to gain control over all the properties, a private developer had already bought up 80 percent of the association units in individual purchases. Then, exercising his rights under state law, in August 2008 he informed the remaining 22 unit owners, many of whom did not want to terminate the association, of his intentions. As his lawyer wrote, “as an owner of 80 percent of the units, my client can accomplish this without your cooperation or that of any other unit owners.”²¹

A Chapter 7 bankruptcy—with suitably revised bankruptcy laws—might be another vehicle for accomplishing a complete termination, and without such a high supermajority required. Not only the common areas but the individual units would be vacated and transferred to a new buyer who would redevelop the site in a brand-new use. Admittedly, this is a severe remedy that bankruptcy courts might be reluctant to impose unilaterally. Yet, there will be many circumstances such as the Seattle example where such “complete” termination might be workable or even economically desirable for everyone concerned. There might even be enough development value in a brand-new use to satisfy the creditors and to create a financial windfall for the unit owners. Society might benefit as well from the more efficient use of the land. Even when this is not the case, complete termination of a bankrupt association may be the only fair way to resolve the claims of the creditors while leaving some substantial amounts for the unit owners.

If all the properties of a community association are sold as a single package as part of a bankruptcy proceeding, a suitable rule will be required for determining the distribution of the proceeds among the creditors and the unit owners. This will be a matter presumably for a bankruptcy court to address. A fair distribution among unit owners will itself raise some difficult issues. The formula used to allocate voting shares in the association may not be appropriate for the purpose of allocating total sale revenues from all the association properties. Voting rights may be allocated as one per unit, for example, even though these units may now have significantly different sale values. Some unit owners may have made major improvements in their properties. Others may have let their properties run down? How would such matters be factored into the unit owner distribution formula?

Given the current absence of answers to such questions, and the uncertain legal prospects for a complete termination, very few (if any) community associations have pursued liquidation under Chapter 7 of the bankruptcy law. With legal clarification and a newly written chapter for community associations, many more might do so.

Reorganization of Community Associations

The limited number of community associations filing for bankruptcy to date have almost all done so under Chapter 11 which provides for the reorganization of a corporation and its eventual emergence from bankruptcy as a viable organization. Even in these cases, major uncertainties remain in the application of Chapter 11 to community associations. A key question is the extent to which unit owners are sheltered in a bankruptcy proceeding. Can, or should, a bankruptcy court require the unit owners to contribute to the final settlement with creditors by means of an assessment? If that is allowed, many unit owners might incur large and unexpected financial burdens, some of whom may not have the necessary financial resources themselves. If the unit owners are instead legally protected from such unit owner assessments (as their limited liability might be interpreted to require in the case of a homeowners association), the creditors may be denied any significant recovery on the debts owed them. The common areas of the community association may by themselves have limited sale value. Whether a bankruptcy court could order the sale of the common areas alone, and whether this would make any sense as a matter of sound land-use planning, are further unresolved questions at present.

A better solution might be to allow the creditors to take charge of the association, temporarily replacing some (or all) of the current board of directors with at least a majority of new members selected by the creditors (thus putting the association in a form of “receivership”).

The new creditor-dominated board might be authorized to operate the swimming pool, golf course, and other recreational facilities, potentially increasing charges for their use. It might do the same for the clubhouse, parking lots, and other possible sources of new revenue. Subject to the oversight of the bankruptcy trustee, unit-owner assessments might also be increased, using some of the funds for community association maintenance and operation, and some to pay off the association debts. When the creditors were paid off as required by the bankruptcy court, the full control of the board of directors would be returned to the unit owners.

It might be desirable, however, to revisit the operating rules and other elements of the CC&Rs. If the bankruptcy of the association was attributable in part to a poorly functioning set of association operating rules and procedures, the bankruptcy court might be authorized to reorganize the association, requiring the development of new rules and procedures. If, for example, past association limits on major new assessments (perhaps a requirement for a high supermajority vote of the unit owners) had resulted in the chronic underfunding and undermaintenance of the association infrastructure, the bankruptcy court might vacate these limits. Or, the bankruptcy court might order that an outside management firm be hired (for some limited time period) to handle some of the routine affairs of the association. Even the internal association rules for selecting and running the board of directors might be fair game in the bankruptcy proceeding. The goal would be to set in place a new set of association governing rules that would prevent the association from returning to bankruptcy in the future.

Other New Means of Termination and Reorganization

The advantage of bankruptcy is that, having reached the edge of disaster, bankruptcy law allows for—and even compels—radical solutions that might otherwise be prevented by various

existing institutional obstacles to change. It would be preferable in many cases, however, to take action before reaching such dire straights. One might suggest that community associations already have the authority to revisit their decision making and other governing rules and procedures. Most CC&Rs do allow for amendments to the founding documents of the association. As noted above, however, high supermajorities and other hurdles normally make such amendments difficult. Some community associations have sought to change specific restrictions relating to allowable uses of properties (parking rules, for example). But few community associations have ever undertaken a basic internal reorganization of their own system of governance, following their existing rules for amending their “constitution.”

Even when basic changes might be available and desirable, it would typically require a heroic entrepreneurial effort to bring them about within an association. The free-rider problem limits the incentives of any one unit owner to make such an effort. Thus, in practice, even when they have significant operating problems that may be widely recognized within a community association, the great majority of associations simply make do with the status quo.

A few associations, it might be noted, do have provisions in their founding documents to renew the terms of governance periodically. University Park, the oldest private community in Irvine, California, includes provisions in the CC&Rs requiring that the architectural review committee be reauthorized every 40 years. Absent a majority vote at that point of the unit owners, the association land-use restrictions automatically expire—as happened in 2008, partly because the association had barely been aware of this provision of its founding documents.²² In Florida, a 1963 law requires that certain community associations must renew their restrictions every 30 years, although there seems to have been little awareness of and enforcement of this legal requirement to date.²³

These procedures, however, are limited in their application and have arbitrary time frames. Recognizing that community association circumstances can change significantly, new state laws might be written to make it easier for community associations, acting on their own, to change their rules and procedures relating to termination and reorganization. The state might also oversee such changes to ensure that individual unit owners are treated fairly. Rather than a court proceeding, however, this would probably better be regarded as an administrative responsibility of a state agency charged with overseeing community associating affairs (many if not all states already have such agencies).

States might thus enact new laws to oversee the termination of an association. The state rules would clarify that termination options could include the package sale of the entire set of association properties, both those individually and collectively owned. Economic motives—the possibility of large gains in total unit owner values—would normally be the driving force. But strong dissatisfaction with the past internal workings of the association might also come into play. It might take a vote of 70 percent of the unit owners to commence an association process of “complete” termination. State law might specify certain criteria for an acceptable termination process, including fair treatment of all the unit owners in the distribution of the total revenues received in the sale process. The state would then either approve or disapprove the termination plan. Provision would be made for a high final vote of approval—perhaps requiring 80 percent of the unit owners in favor—before any actual complete collective sale of the association properties could occur.

New state laws might also be rewritten to facilitate the internal reorganization of a community association—as a more normal procedure before a crisis and potentially the extreme of bankruptcy is reached. A favorable vote of perhaps 60 percent of the unit owners might be

sufficient to initiate such a process and a 70 percent vote to give final approval. The full set of existing CC&Rs, often written long ago by the developer, might come under review. Many associations have tight restrictions that may no longer have the support of most unit owners. There are wide complaints about the “dictatorial” behaviour of some community association boards. The basic operating rules of the association could thus be revisited. The types of association decisions subject to a full vote of all the unit owners might be reconsidered. Procedures for collecting delinquent assessments and fines might be revised. Election procedures (use of proxy voting, for example) might come under review.

State laws for community associations assume that the association should be organized along the lines of a business corporation. The reality is, however, that a community association also performs many functions that are more like a local government. The scope for reorganization of community associations thus might also be extended to making more fundamental changes in the governing structure of the association.²⁴ Perhaps some associations would like a greater separation of powers internally—they might want the private equivalent of an elected “mayor” to manage the association “executive branch.” There could be wide freedom to innovate, borrowing as appropriate from both the business corporation and the local public governance models. Association board members are now volunteers but in some larger associations they might be paid in the future, including some outside board members who could bring valuable forms of expertise (at present board members are limited to unit owners).

Retrofitting Community Associations

The popularity of community associations in newly developing parts of the United States suggests that the association model might be extended more broadly to older areas of the

country. It might be desirable to establish new legal authority to allow the “retrofitting” of a community association in an existing neighborhood.²⁵ An older neighborhood, for example, that is now governed within a larger political jurisdiction might now decide that it wants its own neighborhood government. At present it could obtain its own government only through municipal incorporation at the neighborhood level, thus creating a neighborhood public government. With a change in state law, the range of choice might be expanded to also allow another option, incorporation as a private government—a community association—for this neighborhood. As discussed above, community associations have various advantages relative to public governments—even as they also have some disadvantages that could also be factored into the neighborhood’s analysis of its needs and its final choice of a new governing form.²⁶

As a new state law might provide, retrofitting a community association to an existing neighborhood might work as follows.²⁷ If a group of neighborhood property owners wanted to create their own new private community association, they would gather signatures on a petition. If enough neighborhood owners signed, neighborhood representatives and the existing local public government (normally of considerably wider geographic scope than the neighborhood) would work out a transfer agreement. It would cover streets (some of which might be turned over to the private association), local service provision responsibilities, divisions of regulatory authority, and other such matters. After that, and following the circulation of information to the public, the property owners in the neighborhood would vote. It might take say a vote of 80 percent of the property owners to form a new community association to govern the neighborhood.

Such retroactive establishment of new community associations might be particularly helpful in stimulating the redevelopment of poor inner city and other distressed older urban

neighborhoods. A community association in such an area could provide a whole new degree of security of persons and of investment. Given the new legal flexibility afforded by its private status, it might even put up gates and control entry—an inner-city gated community. If a distressed urban neighborhood could keep out potentially threatening elements, many of these neighborhoods might become much more attractive for redevelopment. If anyone now needs gates, it is not in the suburbs but in the inner cities. Investment might flood in.²⁸

A New Response to Kelo

The 2005 *Kelo* decision of the Supreme Court, involving the City of New London, Connecticut, highlighted some of the problems of urban land assembly. The use of eminent domain—approved by the court—is troublesome for a number of reasons. But it is still true that there is a need to assemble large urban parcels, potentially involving many ownerships, if coordinated private land development is to occur in older parts of many cities. Such land assembly, however, is difficult under the current land-use system. Individual properties normally have to be assembled one by one in an assembly process that can be long and cumbersome. There are also likely to be significant inequities among existing land owners. Speculators and the last holdouts often gain a disproportionate share of the ultimate total value of the land as an assembled package ready for redevelopment.

A possible solution would be to retrofit a community association for the express purpose of selling a whole neighborhood.²⁹ The association would in effect be created to be the new bargaining agent for the neighborhood property owners collectively. If they received a high enough offer from a land developer, and a sufficient supermajority of unit owners voted in favor of a sale, the association might then be sold off as a complete package of properties according to

wider rules for such a complete termination of an association. The problems of the current role of land speculators in purchasing individual neighborhood properties early in the process and the possible disproportionate gains from being a late holdout would be much reduced. The financial rewards to the average property owner in the neighborhood would be correspondingly increased. By facilitating the assembly of large parcels of urban land, newly comprehensive—as opposed to current piecemeal—private redevelopment would be significantly increased.³⁰ By such a process of “internalizing the externalities” in urban land development, the overall efficiency and aesthetic attractiveness of land use in America’s cities might be significantly enhanced.

As compared with use of eminent domain for land assembly, moreover, this proposal would have two major advantages. First, the sale price for the fully assembled package of land would be set by direct negotiations between the unit owners acting collectively and a potential developer. Second, the decision to accept or reject a developer offer would be made by the unit owners themselves. Under eminent domain, by contrast, a wider city or other public government acts unilaterally to make such decisions. It is understandable that neighborhood residents may be angry and upset, if they feel they have not been adequately compensated or simply do not want to move and are forced to do so by state coercion. A retrofitted community association would put such decisions on a collective voluntary private basis (although a limited minority of outvoted unit owners in the association could admittedly be forced to move out against their wishes).

At present, however, lacking such a procedure for the collective sale of whole neighborhoods, any such efforts would require unanimous consent of the property owners. Indeed, a few neighborhoods around the United States have attempted to organize themselves on a unanimous basis to sell their properties collectively. A handful have even succeeded. In 1988

in Arlington, Virginia, all 24 property owners in the Courtland neighborhood—located near a new subway stop—banded together to sell all their properties collectively to the Moyarta Corporation. By working together, they were able to double the existing values of their homes. But most such efforts have failed to win the necessary unanimous consent to create a collective bargaining body. Given the very high transaction costs, the great majority of neighborhoods that might have benefitted significantly from collective bargaining have never tried to organize themselves in the first place.

IV. Local Governance as an Economic Problem in “Industrial Organization”

A main advantage derived from the private status of a community association is the greater flexibility it introduces into the metropolitan land use system and its governance. It is easier to contemplate the complete termination or the major reorganization of a private local government, as compared with a public local government. When the government is private, market incentives can be brought into play in motivating and guiding such a process of governmental change. If some of the proposals made in this paper—which are dependent on a private status—are adopted, it would become easier to end the life of a community association and to commit the land to a brand-new set of uses with suitable new structures of private governance.

Many commentators have observed that local government in the United States, even when it is nominally public, actually functions more like a private activity.³¹ Zoning for many purposes is better regarded as a de facto collective property right than as a form of public regulation for the public good.³² Community associations make the private status official, thus giving private forces a greater ability to shape the system of local governance. Indeed, if local

governance is reconceived to be a private activity, the economics of local governance might be newly understood as an economic problem of “industrial organization,” employing analytical tools long applied by economists to the study of the steel, automobile, computer, and many other private industries.

Transaction Costs and Other Issues

In the ordinary business world, large corporations have typically won out over small firms in the market. These large business corporations are in effect small private “planned economies” based internally on central planning and management (although perhaps making use of market-like incentives). Since the pioneering work of Oliver Williamson in the 1970s, a “new institutional economics” has shed greater light on the transaction costs and other economic forces that can yield more or less vertical and horizontal integration within an industry.³³

In a metropolitan system of local governance, there are similar economic issues of transactions costs and economies of scale that will influence the desirability of various governmental outcomes. A larger unit of local government might be able to deliver services such as water and sewer at less cost. A big city may have access to various forms of specialized professional knowledge. A large city, however, might be at a significant disadvantage in other respects. It might be difficult to create a system of positive incentives that will serve to motivate a large city bureaucracy. Large city size will involve a greater diversity of citizens and thus greater divergences between service demands and the common levels of services typically provided city-wide. As a mayor of Chicago once declared in resisting a further expansion of city boundaries, “the ideal city is compact. With its area fully occupied, the care of all branches of administration can be applied to all sections expeditiously and well.” In response to any

proposals “to increase this territory” of Chicago, the appropriate response should be “instant and emphatic discouragement.”³⁴

Government at the scale of a small neighborhood also may not be ideal. The time burdens required for full democratic participation and other transaction costs of neighborhood governance may be large for each housing unit owner. Economies of scale in service delivery may be impossible to achieve. A neighborhood should be large enough to offer a self-contained physical environment of high quality. In general, there will be tradeoffs between various benefits and costs associated with larger and smaller sizes of neighborhoods and their governments.³⁵

In New York State, the village of Macedon addressed such issues in a study of the benefits and costs of dissolving its small public government. Some responsibilities might have been transferred to the wider town government in which the village was located. Other responsibilities might have been assumed by newly created special districts. Overall, the study estimated that property owners in Macedon could each save \$204 per year (for a representative home worth \$100,000) by terminating the village government and abolishing or redistributing its functions.³⁶ Following this study, however, the residents of the village voted 257 to 228 in a referendum against the termination proposal. In this case, the benefits of keeping a small village government closer to home apparently outweighed the potential financial gains of governmental consolidation in the minds of the voters.

A More Flexible Process of Local Adjustment

In an ordinary business corporation, each investor joins by purchasing shares. Later changes in the “citizenship” of a business organization are accomplished by buying and selling

the stock. One corporation thus can take over the physical assets of another corporation by buying out most of its stock holders. Mergers and acquisitions, along with divestitures, are a routine part of life in the American business world. All these ownership changes entail moderate transaction costs. Stockholders who disapprove of the way a corporation is being run can “exit” from the organization simply by selling their shares on Wall Street.

In principle, the “industrial organization” of the “business” of local government in the United States, like other “industrial” sectors, could also be determined by a process of competition in the marketplace. Ronald Oakerson, who in the mid 1980s directed a study of the structures of local governance across the United States for the U.S. Advisory Commission on Intergovernmental Relations (ACIR), takes this view. As Oakerson writes, “of central importance is the authority to create, modify, and dissolve [local service] provision units. The structure of the provision side—including the variety of provision units—depends on who can exercise this authority and under what conditions.”³⁷ In this way, a competitive process of selection of the fittest among many local governments of many possible sizes and types could drive the local governance system.

Oakerson argued that the ability to create new neighborhood-level institutions of local governance was a large missing element in the American system. As he explained, “what is essential is that small-scale communities have the capability to organize themselves to act collectively with respect to common problems. This requires that locally defined communities be able to self-govern, exercising the powers of government within a limited sphere—limited in terms of both territory and the scope of authority.” For many goods and services, they could best be “provided on a ‘neighborhood’ scale.”³⁸ At present, however, the governance structures of metropolitan areas in the United States “tend to preclude or inhibit the development of smaller,

nested provision units—neighborhood governments—within [wider city] boundaries.”³⁹ As a result, neighborhood forms of governance are often simply left out of the competition to determine the future metropolitan structure of local governance.

Oakerson said little about the major legal changes necessary to make the formation of new local governments much easier and to simplify the processes of boundary adjustment. Moreover, although Oakerson clearly recognized the growing importance of private community associations, he did not necessarily advocate them as the main preferred instrument of a newly flexible and competitive system of neighborhood governance. Yet, a large advantage of the community association with its private status is its greater ease of integration into a more market-like system of local governance. If the private constitution of a community association is properly written, it can allow for the routine expansion, contraction, termination or other modification of the community association and its boundaries, as a private business act and as economic circumstances change.

It would be helpful, for example, if more community association founding documents provided for private “divestitures” of appropriate subunits of the association, assuming a contiguous subgroup within a neighborhood wanted to leave. Legally, this should be easier to accomplish than the current rules that control the secession of a subunit from an existing municipal government in the public sector. There could be a well-defined process in community association documents for appropriate private “acquisitions” of new areas as well. If few community associations have thus far considered such matters, it is partly because the governance institution of the community association in the United States is still fairly new. As more and more community associations now reach middle age, attention should now shift to the

processes by which needed changes in the boundaries and organization of local private governance can be made.⁴⁰

In this manner, it would be possible to come closer to Oakerson's vision of a trial and error process to resolve the many tradeoffs among local governing forms.

There is no fully objective way of determining an appropriate set of provision units apart from the expressed preferences of local citizens for public goods and services. The ease with which a single provision unit can satisfy individual preferences decreases with the preference heterogeneity of the community. By the same token, the ability to satisfy diverse preferences increases with an increase in the number of provision units in a local public economy—at least up to some point. The creation of provision units is constrained by the expected transaction costs of organizing and operating an additional unit. Transaction costs include the costs of citizen participation. The choice is between greater preference satisfaction, obtained by creating an additional provision unit, and lower transaction costs. Citizens face a trade-off that only they can decide.⁴¹

Conclusion

Community associations represent a major American shift toward collective private ownership of housing, following in the path of the rise of the private business corporation 100 years ago. The laws overseeing the chartering, organizing, governing, and other aspects of business corporation workings have been significantly revised many times. It has been a case of gaining experience with corporate forms of business ownership and then responding to the problems and opportunities as they have been discovered by businessmen, researchers, and other observers. As more and more community associations now reach middle age, it is time in this area of collective property ownership as well for a full retrospective assessment and new state laws and other institutional initiatives in response to the problems and opportunities as they are identified.

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- ²⁶ Nelson (2008).
- ²⁷ Nelson (2006).
- ²⁸ See Norcross, McKenzie and Nelson (2008).
- ²⁹ Nelson and Norcross (2009).
- ³⁰ Michael Heller and David Hills make a similar proposal as a means of facilitating urban land assembly (although not framed as the retrofitting of a community association). Heller and Hills (2008).
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