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## **NINE INTO ELEVEN: ACCOUNTING FOR COMMON INTEREST COMMUNITIES IN BANKRUPTCY**

*C. Scott Pryor*\*

### ABSTRACT

*Ever more Americans live in a common interest community such as a homeowners' association or condominium. Common interest communities restrict the uses owners may make of their property but provide benefits to the owners. The community association pays for these benefits by levying assessments on the owners' property. Common interest communities offer a wide variety of benefits that can be divided into two sorts: public and private. Local municipalities typically provide public benefits at taxpayer expense; private entities usually afford private benefits at the consumer's expense.*

*Like both public and private entities, common interest communities can experience the problem of financial distress. The ultimate solution to financial distress is relief under the Bankruptcy Code. Private entities are eligible for relief under chapter 11; public entities—municipalities—are eligible for relief under chapter 9. Chapter 9 affords municipalities significant protections compared to private entities under chapter 11 because of the irreducible political sovereignty of municipalities. Nonetheless, even though common interest communities also provide public goods, they are eligible for relief only under chapter 11 and thus lack the protections afforded by chapter 9.*

*Chapter 11 of the Code should be amended in two ways to afford common interest communities some of the benefits of chapter 9. Specifically: (1) the standard of the best interests of creditors in a proposed chapter 11 plan of reorganization should not be evaluated against a hypothetical chapter 7 liquidation; and (2) a common interest community should be able to cram down its plan without regard to retention by the community of its assets. Without these amendments, common interest communities in financial distress*

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*and their members will be less likely to reorganize, and the cost of providing public goods will revert to the local community and its taxpayers.*

## INTRODUCTION

Throughout the past century, the American civic landscape has been increasingly populated by a previously unknown form of property ownership: the common interest community (“CIC”). In a CIC, the sizes of individual lots may be smaller than those in developments that are not common interest communities, but the common areas are certainly greater in the CIC.<sup>1</sup> CICs take three forms: condominiums, homeowners’ associations, and cooperatives.<sup>2</sup> Three features of CICs are most salient to those who live in them. The first feature is the vesting of title to common areas of a residential development in an association that property owners control.<sup>3</sup> Title to the common areas is not given to the public but is instead vested in a non-profit corporation.<sup>4</sup> This association, in turn, is controlled by the community’s property owners, not by local municipal government.

The second notable feature is that the community’s property owners are bound to the benefits and burdens of association ownership of common property by means of easements and covenants, generically known as equitable

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<sup>1</sup> See WAYNE S. HYATT & SUSAN F. FRENCH, COMMUNITY ASSOCIATION LAW: CASES AND MATERIALS ON COMMON INTEREST COMMUNITIES 4 (2d ed. 2008):

Open spaces that would have been parceled out among individual lot owners under Euclidian zoning became common property in planned unit developments, and recreational facilities that previously would have been provided by municipal governments and owned by the public became private property provided by the developer.

<sup>2</sup> For the legal definition of a common interest community see the RESTATEMENT (THIRD) OF PROPERTY: SERVITUDES § 1.8 (AM. LAW INST. 2000):

A “common interest community” is a real-estate development or neighborhood in which individually owned lots or units are burdened by a servitude that imposes an obligation that cannot be avoided by nonuse or withdrawal

(1) to pay for the use of, or contribute to the maintenance of, property held or enjoyed in common by the individual owners, or

(2) to pay dues or an assessment to an association that provides services or facilities to the common property or to the individually owned property, or that enforces other servitudes burdening the property in the development or neighborhood.

<sup>3</sup> See *infra* text accompanying notes 13–18.

<sup>4</sup> HYATT & FRENCH, *supra* note 1, at 4 (“The almost universally adopted solution was to vest title to the common areas and facilities to the home owners, as tenants in common, or in an association controlled by the home owners.”).

servitudes.<sup>5</sup> The relationship between a property owner and the association is thus tied to the legal fact of ownership of property in the community, not contract among the members of the community.<sup>6</sup> Finally, a CIC's property owners pay the association's costs of maintaining the common areas and services through the power of assessment, which is vested in the association, founded upon the servitudes, and buttressed by a lien and the power of foreclosure in the event of nonpayment.<sup>7</sup>

The origins of the contemporary panoply of CICs<sup>8</sup> can be traced to Ebenezer Howard's early twentieth century book, *Garden Cities of To-Morrow*.<sup>9</sup> Howard's utopian vision of municipal socialism found itself transformed in the American context into private ownership of one's residence with community ownership of "common areas."<sup>10</sup> Each of the particular forms of CIC has its own unique historical and legal structure,<sup>11</sup> but important for this

<sup>5</sup> *Id.* at 13 ("The legal device developers use to create common interest communities is the servitude, a generic term that includes both easements and covenants.").

<sup>6</sup> *Id.* at 14 ("The critical feature of a servitude is that the burdens and benefits run with the land. Subsequent purchasers of property in the community have the same rights and responsibilities as the original purchasers.").

<sup>7</sup> *Id.* ("Normally, the servitudes also give the association powers to assess the members to provide for community facilities and services.").

<sup>8</sup> The law and legal scholars use the label "common interest community" as a catch-all for these sorts of associations; political scientists lean toward "common interest development." See, e.g., Evan McKenzie, *Rethinking Residential Private Government in the US: Recent Trends in Practices and Policy* 3, Conference on Private Communities and Urban Governance: Theoretical and Comparative Perspectives, Gazit-Global Real Estate Institute (June 14–15, 2015) [hereinafter McKenzie, *Recent Trends*], [http://evanmckenzie.wikispaces.com/file/view/israel\\_mckenzieppr.061415.pdf](http://evanmckenzie.wikispaces.com/file/view/israel_mckenzieppr.061415.pdf); see also Andrea Boyack, *Common Interest Community Covenants and the Freedom of Contract Myth*, 22 J.L. & POL'Y 767, 768 n.1 (2014) (reviewing common interest community terminology).

<sup>9</sup> EBENEZER HOWARD, *GARDEN CITIES OF TO-MORROW* (1902).

<sup>10</sup> See generally EVAN MCKENZIE, *PRIVATOPIA: HOMEOWNER ASSOCIATIONS AND THE RISE OF RESIDENTIAL PRIVATE GOVERNMENT* 4–8 (1994) (summarizing early twentieth-century adaptation of Howard's "garden city" concept into the American context). See also Wayne S. Hyatt, *Common Interest Communities: Evolution and Reinvention*, 31 J. MARSHALL L. REV. 303, 318–20 (1998) (summarizing history of residential community associations in America).

<sup>11</sup> Generally, homeowner associations own the common areas in such a community while the residents of the community own the physical structure and front and back yards of the structures in which they reside. Condominium ownership of the structure and land is by tenancy in common with each resident owning only the space of their unit. In a cooperative, each resident owns stock in the cooperative from which they lease their units. The Uniform Common Interest Ownership Act (2014) defines these forms of common interest ownership. See UNIF. COMMON OWNERSHIP ACT § 1-103(10), (12), (25) (NAT'L CONFERENCE OF COMM'RS ON UNIF. STATE LAWS 2014). Definitions.

In this act

(10) "Condominium" means a common interest community in which portions of the real estate are designated for separate ownership and the remainder of the real estate is designated for common ownership solely by the owners of those portions. A common

Article are the three common features described above plus a fourth, uncommon one: the possibility that the association will experience financial distress.<sup>12</sup>

The typical common law mechanism for creating a CIC is through equitable servitudes, popularly known as conditions, covenants, and restrictions (“CC&Rs”), which are imposed on the land from the community’s inception.<sup>13</sup> “Running with the land,” CC&Rs bind current and future property owners regardless of any particularized assent.<sup>14</sup> In addition, the association can, through its board, enact additional rules that are equally binding on its members.<sup>15</sup> As a practical matter, the community association, not individual property owners, exercises the power to enforce the CC&Rs.<sup>16</sup> CICs thus exercise powers analogous to local public governments. Indeed, the scope of

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interest community is not a condominium unless the undivided interests in the common elements are vested in the unit owners.

(12) “Cooperative” means a common interest community in which the real estate is owned by an association, each of whose members is entitled by virtue of the member’s ownership interest in the association to exclusive possession of a unit.

(25) “Planned community” means a common interest community that is not a condominium or a cooperative. A condominium or cooperative may be part of a planned community.

<sup>12</sup> See MCKENZIE, *supra* note 10, at 3 (listing similar set of commonalities among common interest communities).

<sup>13</sup> James L. Winokur, *The Mixed Blessings of Promissory Servitudes: Toward Optimizing Economic Utility, Individual Liberty, and Personal Identity*, 1989 WIS. L. REV. 1, 3:

Often called conditions, covenants, and restrictions (“CC&R’s”), such residential restrictions typically take the form of real covenants and equitable servitudes that bind for several decades, or even permanently, not only the original creating parties but their successors in interest. They are usually reciprocally enforceable among residence owners within a subdivision or condominium project and also by the homeowners or condominium association.

<sup>14</sup> See RESTATEMENT (THIRD) OF PROPERTY: SERVITUDES § 2.5 (AM. LAW INST. 2000) (“A servitude may be created to burden or benefit any estate in land or another servitude.”). As elaborated in the Comments to that section,

*a. Rationale.* Servitudes can be created to burden both present possessory estates and future estates. Likewise, they can be created to benefit present and future estates. The owner of a present estate has the power to create a servitude burdening the present estate in favor of a future estate in the same land, and in favor of a present or future estate in other land. The owner of a future estate has the power to burden that estate in favor of the holder of the present estate in the same land, and in favor of a present or future estate in other land.

*Id.* § 2.5 cmt. a.

<sup>15</sup> See Susan F. French, *Making Common Interest Communities Work: The Next Step*, 37 URB. LAW. 359, 364 (2005) (“[Common interest communities] are different from cities and corporations in that their restrictions, rules, and regulations are often much more invasive.”).

<sup>16</sup> See Boyack, *supra* note 8, at 768 (“These covenants and rule form the private law of the community, and generally courts will grant injunctions or specific performance to enforce such regulations.”).

the CC&Rs and subsequent rules the association makes can cover an extraordinary range of activities beyond the jurisdiction of municipalities<sup>17</sup> and free of federal constitutional limits.<sup>18</sup>

Given their unique legal structure, CICs occupy a peculiar middle space between private entities and public ones.<sup>19</sup> Their legal form is commonly a private non-profit corporation, but their purpose includes providing public as well as private goods.<sup>20</sup> Like their municipal analogues, CICs provide public goods, such as roads, streetlights, and security, as well as shared amenities like swimming pools, parks, and open areas.<sup>21</sup> Like private organizations, CICs often provide private goods ranging from yard care to luxury clubhouses.<sup>22</sup>

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<sup>17</sup> See, e.g., French, *supra* note 15, at 364 (“CAs are different from cities and corporations in that their restrictions, rule, and regulations are often much more invasive.”).

<sup>18</sup> See generally MCKENZIE, *supra* note 10, at 129 (“[T]he association can impose certain standards of behavior on residents and anyone who visits the property. Taken as a whole, these powers permit the regulation of a wider range of behavior than any within the purview of a public local government.”). Only the courts of New Jersey have applied the state constitution to limit the powers of common interest community associations. See, e.g., *Comm. for a Better Twin Rivers v. Twin Rivers Homeowners’ Ass’n*, 929 A.2d 1060 (N.J. 2007) (noting that application of the constitution of New Jersey does not require state action).

<sup>19</sup> French, *supra* note 15, at 361 (2005) (“Community associations occupy a space that lies somewhere between public governments and private businesses or associations.”). In short, like cities, common interest communities are more than a mandatory coercive locus of civil governmental activity.

<sup>20</sup> *Id.* at 362–63:

Community associations (“CAs”) are similar to public governments in that:

- CAs manage communal property they own, which may include the streets, parks, and other types of “public” property within the community.
- CAs enforce land use restrictions included in the CC&Rs. These restrictions may be very similar to those in zoning and design control ordinances adopted by local governments.
- CAs adopt rules and regulations governing use of property within the CA. Rules governing use of common property within the CA may be very similar to ordinances adopted by local government.
- CAs levy assessments on property in the community to support their operations. Like local property taxes, CA assessments are generally secured by a lien that may be foreclosed in the event of default.
- CAs may provide services such as utilities, street maintenance, snow removal, recreational activities, and security patrols that either substitute for, or supplement, services that would otherwise be provided by local government.

Majority rule in some form generally governs much of the decision making in CAs as it does in local government.

<sup>21</sup> See generally TRACY M. GORDON, PUB. POLICY INST. OF CAL., *PLANNED DEVELOPMENTS IN CALIFORNIA: PRIVATE COMMUNITIES AND PUBLIC LIFE* 3 (2004) (listing range of services provided by a majority of common interest communities in the United States including snow removal, swimming pools, clubhouse, garbage collection, as well as street cleaning and lighting).

<sup>22</sup> *Id.* at 13 (listing lawn care and clubhouse services).

Yet, like both public municipalities and private organizations, CICs can experience financial distress.<sup>23</sup> Sometimes the distress follows a natural disaster if the community association was underinsured.<sup>24</sup> Other times, a community finds itself with insufficient funds as expenses of care for common areas like roads, roofs, and swimming pools increase with age.<sup>25</sup> In addition, a national economic recession or deteriorating local economy, leading to a collapse of real estate values, can cause owners to fail to pay their assessments.<sup>26</sup>

Private action usually provides the tools to resolve such distress. Sometimes state law can enhance private action. Yet in other situations, those tools will be inadequate. The power to compel payment of association debts under state law with tools like garnishment of association reserves does not take into account the effect on third parties—the owners of private property in the community. The association, and not the owners of property in the community, is the object of the collection action even though it is the owners who will ultimately pay. At this point, when private and state action end, bankruptcy law begins.

The recent history of chapter 9 municipal bankruptcies has largely come to an end. Names like Jefferson County,<sup>27</sup> San Bernardino,<sup>28</sup> Stockton,<sup>29</sup> and Detroit<sup>30</sup> once dominated accounts of the Great Recession. Each municipal bankruptcy was larger than the one before it, but now, thanks to low interest

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<sup>23</sup> See generally TYLER P. BERDING, *THE UNCERTAIN FUTURE OF COMMUNITY ASSOCIATIONS* (2005), [http://www.berding-weil.net/pdf/uncertain\\_future.pdf](http://www.berding-weil.net/pdf/uncertain_future.pdf) (describing the sources of systemic financial distress under the rubric of “the theory of obsolescence”).

<sup>24</sup> See *infra* text accompanying notes 78–81 (describing effects of 1994 Northridge earthquake on condominium community).

<sup>25</sup> See BERDING, *supra* note 23, at 31 (“As the public sector has delayed maintenance, many private association boards are also watching streets, pools, balconies, siding and clubhouses slowly deteriorate while their reserve funds contain half or less of the money needed to eventually fix them.”).

<sup>26</sup> *Id.* at 32 (“The economy has helped exacerbate the problem . . . and the impact on real estate across the nation could be substantial.”).

<sup>27</sup> See Barnett Wright, *One Year Ago Jefferson County Emerged from Bankruptcy. Did Wall Street Fleece the County Commission?*, AL.COM (Dec. 3, 2014, 8:00 AM), [http://www.al.com/news/birmingham/index.ssf/2014/12/one\\_year\\_later\\_jefferson\\_count.html](http://www.al.com/news/birmingham/index.ssf/2014/12/one_year_later_jefferson_count.html).

<sup>28</sup> See Ryan Hagen, *San Bernardino Bankruptcy Reaches ‘Beginning of the End’*, THE SUN (May 30, 2015, 3:33 PM), <http://www.sbsun.com/government-and-politics/20150530/san-bernardino-bankruptcy-reaches-beginning-of-the-end>.

<sup>29</sup> See generally C. Scott Pryor, *Municipal Bankruptcy: When Doing Less is Doing Best*, 88 AM. BANKR. L.J. 85 (2014) [hereinafter Pryor, *Municipal Bankruptcy*].

<sup>30</sup> See generally C. Scott Pryor, *Who Pays the Price? The Necessity of Taxpayer Participation in Chapter 9*, 24 WIDENER L. REV. 81 (2015) (discussing Detroit’s chapter 9 bankruptcy).

rates and a steadier American economy, municipal insolvency has disappeared from the twenty-four-hour news cycle.<sup>31</sup>

Yet the fundamental causes of municipal financial distress remain. Apart from local factors driving a municipality into chapter 9,<sup>32</sup> two systemic factors are common to municipal bankruptcy: debt overhang<sup>33</sup> and declining revenues.<sup>34</sup> Debt overhang describes the situation in which a city finds it impossible to borrow because of the large amount of existing debt. A prospective lender is unwilling to advance new funds because its loan will simply pay down existing debt.<sup>35</sup> The obligations that give rise to municipal debt come from two sources. The first source comes from benefits—pension and health care principal among them—promised to retired employees.<sup>36</sup> The second source of debt overhang is simple over-borrowing.<sup>37</sup> Declining revenues, the second factor common to municipal bankruptcies, can be attributed to de-industrialization, deregulation, the continuing effects of suburban flight, and reduction in federal funding.<sup>38</sup> Less revenue, combined with ever-higher financial obligations, drove Stockton and Detroit into chapter 9.<sup>39</sup> While bankruptcy added nothing to either city's revenue, both reduced their debt overhang by reducing retiree benefits and shrinking their bond debt.

Beginning in the late 1990s, CICs started to suffer from the effects of financial distress. Unlike municipalities, however, the typical causes of

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<sup>31</sup> Puerto Rico's financial distress continues to make the news, but the Commonwealth is not a municipality and has no recourse to bankruptcy law. *See, e.g.*, *Puerto Rico v. Franklin Cal. Tax-Free Tr.*, 136 S.Ct. 1938 (2016).

<sup>32</sup> *See, e.g.*, Randle B. Pollard, *Feeling Insecure—A State View of Whether Investors in Municipal General Obligation Bonds Have a Mere Promise to Pay Or a Binding Obligation*, 24 WIDENER L.J. 19, 33 (2015) (describing Jefferson County's \$3.14 billion sewer bond debt).

<sup>33</sup> Vincent S.J. Buccola, *An Ex Ante Approach to Excessive State Debt*, 64 DUKE L.J. 235, 278 (2014) ("The primary virtue of Chapter 9 . . . lies in its capacity to eliminate debt overhang by reducing a distressed municipality's liabilities over the objections of holdout creditors.").

<sup>34</sup> *See id.* at 236 ("The economic slump following the 2008 housing-market implosion, exposed the precarious financial position of many American states [in addition to the city of Detroit]. Declining real property values and employment levels combined to erode the tax base.").

<sup>35</sup> *See* David A. Skeel, Jr., *States of Bankruptcy*, 79 U. CHI. L. REV. 677, 687–88 (2012).

<sup>36</sup> *See* Pryor, *Municipal Bankruptcy*, *supra* note 29, at 88 (describing excessive retiree pension and health benefit obligations of city of Stockton).

<sup>37</sup> *Id.*

<sup>38</sup> *See generally* Phillip Longman, *Why the Economic Fates of America's Cities Diverged*, THE ATLANTIC, (Nov. 28, 2015), <https://www.theatlantic.com/business/archive/2015/11/cities-economic-fates-diverge/417372/> (describing variety of factors that have caused rise of income inequality in America).

<sup>39</sup> *See* WAYNE H. WINEGARDEN, PAC. RESEARCH INST., *GOING BROKE ONE CITY AT A TIME: MUNICIPAL BANKRUPTCIES IN AMERICA* 4, [https://www.pacificresearch.org/fileadmin/documents/Studies/PDFs/2013-2015/MunicipalBankruptcy2014\\_F.pdf](https://www.pacificresearch.org/fileadmin/documents/Studies/PDFs/2013-2015/MunicipalBankruptcy2014_F.pdf) (describing factors that lead to recent large municipal bankruptcies).



financial problems for CICs do not include debt overhang. Rather, some CICs have experienced financial difficulties through the combination of reduced revenues and increased operating expenses.<sup>40</sup>

For example, the useful life of many of the structures that make up a community—condominiums and townhomes—is around forty years.<sup>41</sup> Without sufficient reserves,<sup>42</sup> maintenance expenses of many CICs will begin to increase and assessments with them. Deteriorating community infrastructure and increasing assessments lead first to an exodus of owners and then to falling property values.<sup>43</sup> If left unchecked, a vicious cycle of worsening community services, increasing assessments, falling property values, and, ultimately, unpaid assessments can drive a community into insolvency.

Most of these communities struggle through their distress unilaterally through a combination of raising assessments and reducing services.<sup>44</sup> When such tools prove inadequate, a CIC's creditors can use state law tools such as garnishment of bank accounts to compel payment.<sup>45</sup> Garnishment of a community's reserve and operating accounts will ultimately reduce the value of private property in the community because maintenance will be deferred. Unlike municipalities, however, federal bankruptcy law does not provide an effective means by which to address the financial distress of CICs. The Bankruptcy Code (the "Code") should be amended to do so.

This Article will proceed in three parts. Part I addresses the rise and current place of CICs in the larger scheme of municipal governance. Part II surveys the failure of current state and federal law to assist CICs in financial distress.

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<sup>40</sup> See JULIA LAVE JOHNSTON & KIMBERLY JOHNSTON-DODDS, CAL. RESEARCH BUREAU, CRB 02-012, COMMON INTEREST DEVELOPMENTS: HOUSING AT RISK? 1 (2002), <https://www.library.ca.gov/crb/02/12/02-012.pdf>:

Some CIDs professionals argue that the largest issue facing CIDs is that associations are not adequately saving for future maintenance expenses. Aging CIDs will find themselves without the necessary funds to replace deteriorated components and maintain the quality of their buildings. This could cause economic hardship for CID residents in the form of added costs and could lead to blighted neighborhoods.

<sup>41</sup> See BERDING, *supra* note 23, at 17 (concluding that four stages of the devolution of a common interest community "can occur over a life span of up to perhaps forty years").

<sup>42</sup> *Id.* at 25 ("Overall, for the 687 associations surveyed, the average percent funded was only fifty-four percent. This means that these associations have approximately half of the capital that they should currently have to fund their reserves adequately.")

<sup>43</sup> JOHNSTON & JOHNSTON-DODDS, *supra* note 40, at 1.

<sup>44</sup> See BERDING, *supra* note 23, at 15.

<sup>45</sup> *Id.*

Finally, Part III suggests some changes to the Code to balance the rights of creditors with the place of CICs in the contemporary political economy.

## I. WHENCE COMMON INTEREST COMMUNITIES?

### A. *Meeting the Growing Demand for Public Goods*

The history of CICs has been described at length elsewhere.<sup>46</sup> Briefly, CICs provide members with what most would consider to be public goods. Except for some libertarians for whom the concept of public goods is a null set,<sup>47</sup> the boundary of public goods is hotly contested.<sup>48</sup> The briefest account is that public goods are those that the market will not supply because the number of users cannot be constrained.<sup>49</sup> In other words, public goods answers the question of what to do about the problem of collective action. Rather than developing a theoretical definition of public goods, however, it is simpler to describe what goods American municipalities commonly supply.<sup>50</sup> At the very least, public goods include those vital to the protection of life and property (police, fire, and zoning) and public enlightenment (education and museums), as well as public ownership of property necessary to provide those goods.<sup>51</sup> Many municipalities provide more goods than these, but as CICs have grown, these communities have come to supply many of these goods as well.<sup>52</sup>

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<sup>46</sup> See MCKENZIE, *supra* note 10, at 7–12.

<sup>47</sup> See generally ROBERT NOZICK, ANARCHY, STATE, AND UTOPIA (1974).

<sup>48</sup> See generally Russell Hardin, *The Free Rider Problem*, STAN. ENCYCLOPEDIA OF PHIL. (May 21, 2003), <http://plato.stanford.edu/archives/spr2013/entries/free-rider>.

<sup>49</sup> See C. Scott Pryor, *Who Bears the Burden? The Place for Participation of Municipal Residents in Chapter 9*, 37 CAMPBELL L. REV. 161, 171 (2015) [hereinafter Pryor, *Who Bears the Burden?*] (“The failure of the market to deliver goods for which providers cannot be assured of payment (or the power to exclude those who do not pay) justifies their provision by government . . .”).

<sup>50</sup> See NANCY BURNS, *THE FORMATION OF AMERICAN LOCAL GOVERNMENTS: PRIVATE VALUES IN PUBLIC INSTITUTIONS* 47–48 (1994) (describing growth of service-delivery model of municipal government in the middle of nineteenth century including provision of water, gas, electricity, streetcars, sewage treatment, and more).

<sup>51</sup> See Pryor, *Who Bears the Burden?*, *supra* note 49, at 170.

<sup>52</sup> The increase in the supply of public goods at the local level first accelerated with the rapid growth of special improvement districts in the late nineteenth century. See BURNS, *supra* note 50, at 10 (“Special districts provide many of the services that we often associate with municipalities. Indeed, the services once supplied by cities are increasingly supplied by special districts.”). Unlike common interest communities, however, special districts can seek relief under chapter 9 of the Code. See 11 U.S.C. § 101(40) (2012) (“The term ‘municipality’ means political subdivision or public agency or instrumentality of a State.”); 2 COLLIER ON BANKRUPTCY ¶ 101.40[2] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2016).

Following the growth of special districts in the late nineteenth and early twentieth centuries, and occurring in tandem with the growth of public-private partnerships,<sup>53</sup> the number of CICs rapidly increased beginning in the 1960s.<sup>54</sup> CICs initially took root in regions where urbanization had been limited—notably the Sunbelt States—because that is where the post-World War II housing boom began.<sup>55</sup> Nonetheless, in many parts of the United States, CICs have become the norm for new construction, even in regions with lower growth and more traditional municipal government.<sup>56</sup> Today, ever more Americans are receiving ever more goods from CICs.<sup>57</sup>

### B. *On the Cheap*

From a municipal government perspective, CICs present an opportunity to shift some of the responsibility of providing public goods onto a private, “voluntary” association. Municipal governments have only been too pleased to

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<sup>53</sup> The impetus for creating so-called public-private partnerships and for promoting common interest communities is the desire of traditional public forms of local government to reduce the burden on the tax-paying (and voting) public. See Orlando Lucero, *Public-Private Partnership Projects: Insuring the Lender's Lien Priority and Ensuring that Contractors Are Paid*, 27 PROB. & PROP., Jan./Feb. 2013, at 52, 53 (“A public-private partnership describes a variety of different legal structures whereby a governmental entity and a private business interest invest together to develop an essentially public project or improvement, such as an airport, prison, government office building, toll road, high-speed railway, water facility, or sewer facility.”). Whether such entities are eligible for relief under chapter 9 has been contested. See generally Michael J. Deitch, Note, *Time for an Update: A New Framework for Evaluating Chapter 9 Bankruptcies*, 83 FORDHAM L. REV. 2705, 2711–13, 2731 (2015). CICs differ from many public-private partnerships, however, because they provide a more expansive and heterogeneous array of goods. See *infra* text accompanying notes 51–64.

<sup>54</sup> See Casey Perkins, Note, *Privatopia in Distress: The Impact of the Foreclosure Crisis on Homeowners' Associations*, 10 NEV. L.J. 561, 561 (2010) (“Homeowners’ associations gained prominence in the United States in the second half of the twentieth century.”); see also MCKENZIE, *supra* note 10, at 11 (“There were fewer than five hundred such homeowner associations in 1964. By 1970 there were 10,000 homeowner associations; . . . and by 1992, there were 150,000 associations . . .”). That growth has continued. See EVAN MCKENZIE, BEYOND PRIVATOPIA: RETHINKING RESIDENTIAL PRIVATE GOVERNMENT x (2011) [hereinafter, MCKENZIE, BEYOND PRIVATOPIA] (“[T]he number of common interest housing developments in the United States has continued to grow . . . to almost 300,000 . . .”).

<sup>55</sup> See MCKENZIE, *supra* note 10, at 11 (“Such housing developments are concentrated in the sunbelt states [because] . . . a great deal of new housing has been built in the sunbelt in the past few decades, and that new housing increasingly is CID [common interest development] housing.”).

<sup>56</sup> See MCKENZIE, BEYOND PRIVATOPIA, *supra* note 54, at x (“Some local governments have embraced this concept to the extent of refusing to permit any other kind of residential construction.”).

<sup>57</sup> See JOHNSTON & JOHNSTON-DODDS, *supra* note 40, at 12:

CIDs allow homeowners to tailor local services to their needs and to have more control over those services. In a diverse society, CIDs offer homeowners a sense of stability not only by regulating behavior, but also by attempting to maintain high property values. Edward Blakely, who wrote an extensive book on gated communities, argues, “Local governments have walked away from addressing civil decline, but the neighborhood association prevents all that.”

let CICs, whose membership is “voluntary,”<sup>58</sup> assume responsibility for providing goods whose taxpayer funding would be compulsory if supplied by a municipality. Indeed, down-sizing the scope of municipal services has been a lesser-noticed factor that has buffered some cities from financial peril.<sup>59</sup> CICs have reduced the demand on the public fisc by providing individuals with a wide range of erstwhile (or even growing) public goods and services.<sup>60</sup> Thus, it should come as no surprise that local governments have been only too happy to shift the cost of at least some of these goods to private developers and their successors in CICs.<sup>61</sup>

Shifting the cost of public goods from traditional municipalities became strategically important because of political changes at the federal level in the 1980s. Through the 1960s and 1970s, various federal programs directed increasing levels of funding to a variety of urban initiatives.<sup>62</sup> Matters changed substantially with the election of Ronald Reagan, after which federal funding for local government was reduced by 35%.<sup>63</sup> Municipalities themselves became responsible for a larger portion of the goods they were supplying just as the fruits of suburbanization and tax revolts were making it much more difficult for municipalities to continue meeting the costs of those goods.<sup>64</sup>

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<sup>58</sup> See MCKENZIE, *supra* note 10, at 25 (“Legal fictions to the contrary . . . , CID membership is not voluntary for the many residents who are there because of price, location, or limited options.”).

<sup>59</sup> See Pryor, *Who Bears the Burden?*, *supra* note 48, at 171–74 (permitting reduction of municipally-provided public goods but only to the point where tax revenues would be reduced).

<sup>60</sup> See Kristin L. Davidson, Comment, *Bankruptcy Protection for Community Associations as Debtors*, 20 EMORY BANKR. DEV. J. 583, 585 (2004) (“Community associations have taken over many responsibilities typically associated with municipalities . . . . As trends of privatization increase and community associations are given more responsibilities originally associated with governmental services, residents will continue to expect the same rights and services they receive in the public realm.”).

<sup>61</sup> See MCKENZIE, BEYOND PRIVATOPIA, *supra* note 54, at x (“[I]n many places the driving force behind the spread of common interest housing is no longer just developers but local government, too.”).

<sup>62</sup> See generally BURNS, *supra* note 50, at 61–62 (describing substantial increase in federal involvement in municipal initiatives under Kennedy and Johnson administrations).

<sup>63</sup> See *id.* at 64 (“In creating block grants out of categorical ones, the Reagan administration reduced local government funding by 10–35%.”); see also MCKENZIE, BEYOND PRIVATOPIA, *supra* note 54, at 67 (“Beginning in the late 1970s and early 1980s the Reagan administration . . . questioned the assumptions underlying the provision of many services by local governments and advocated privatization measures that put more functions on a fee-for-service, voucher, or other market-like basis.”).

<sup>64</sup> See MCKENZIE, BEYOND PRIVATOPIA, *supra* note 54, at 67:

But post-World War II big cities, with comprehensive general-purpose governments that presided over strong local economies, soon faced a series of structural challenges. Suburbanization shrank the urban middle class, which left in large numbers. Globalization enlarged the scope of economic competition, and deindustrialization robbed cities of their manufacturing base. . . . Organized tax resistance made it hard for cities to raise revenues through conventional taxation.

Mandating construction of new residential housing in the form of CICs has grown as more cities have experienced political resistance to increasing taxation.<sup>65</sup> In other words, encouraging CICs has allowed local public governments to shift some of their functions to private entities.<sup>66</sup> Indeed, CICs can provide municipal government with the best of both worlds: an increased tax base and reduced demand for municipal services, at least at their outset.<sup>67</sup>

Private entities that provide traditional public goods may provide more or better versions of those goods, at least for those who can afford the monthly fees. This improvement in goods for some, however, may also reduce the range and quality of public goods available to those who cannot pay.<sup>68</sup> In any event, the long-term stability of the current blend of public and private local governments is uncertain.<sup>69</sup> Local public governments have tied themselves to the success (and, consequently, the possible failure) of the myriad private “governments” provided by CICs by the very mandates they have imposed.<sup>70</sup>

A few CICs have collapsed. In some instances, the local municipal government has intervened and resumed provision of critical public goods to members of the now-defunct private community.<sup>71</sup> More often, CICs simply stop providing most of the goods and services they were created to provide.<sup>72</sup>

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<sup>65</sup> See McKenzie, *Recent Trends*, *supra* note 8, at 3–4 (“In many metro areas, cities began to require that all new housing construction must be in CIDs, in order for local governments to receive a tax windfall, with more property taxes and fewer services to provide.”).

<sup>66</sup> See Boyack, *supra* note 8, at 779–80:

Municipalities quickly perceived the benefit of creating taxable housing that provided its own community maintenance framework (including snow removal, paving, and in some cases even fire and safety. Because of this ability to privatize public function, local governments have actively encouraged the spread of CIC form as a way to privately finance community services.

<sup>67</sup> MCKENZIE, *BEYOND PRIVATOPIA*, *supra* note 54, at x (“Many municipalities have discovered that private communities are cash cows, because their resident pay property taxes but do not require a full share of local government services.”).

<sup>68</sup> See *id.* at xiv (“The existing forms of common interest communities rely too heavily on the economic and noneconomic resources of homeowners. . . . Coupled with the lack of institutional support from state and local governments, this places the future of many CIDs in doubt.”).

<sup>69</sup> See *id.* (“A problem is emerging: significant numbers of CIDs are failing to carry out their basic responsibilities or becoming insolvent. When this happens, they become burdens on the larger communities of which they are a part.”).

<sup>70</sup> See *id.* at 20 (“[T]he reliance of local governments on CID housing to finance the public costs of development is problematic. It means that many municipalities are wedded to the continued proper functioning of particular developments . . .”).

<sup>71</sup> See *id.* at 85–88 (summarizing serious financial challenges that have afflicted over fourteen common interest communities).

<sup>72</sup> See BERDING, *supra* note 23, at 25–27 (describing chronic underfunding of community reserve accounts, which leads to deferred maintenance and in turn reduced community-supplied goods).

Yet even this solution to financial distress affects public governments as the value of their tax base declines with the diminishing value of CICs. Declining property values in CICs inevitably translates into declining local tax revenues.

## II. FAILURES OF THE LAW

State law does not sufficiently consider the middle space occupied by CICs. By treating a creditor's action against an association as only a typical bilateral collection matter, state law fails to account for the interests of third parties: the private property owners in the community.<sup>73</sup> Even bankruptcy law, which increases the number of stakeholders whose interests must be considered, fails to balance the legitimate interests of owners and the association itself against those of creditors.

### A. *Failure in the Courts*

Few reported cases deal with CICs in financial distress. A review of a sample of them—outside and inside bankruptcy—reveals the current limitations of state and federal law.

#### 1. *State Receivership Cases*

Gaining the appointment of a receiver under state law is the ultimate weapon in a creditor's toolkit of coercive collection powers. Given the common law's policy of first-come-first-served when it comes to creditors' rights,<sup>74</sup> it should be no surprise that the law generally fails to account for the effect of those rights on third parties. In the usual case, collection of a judgment may affect the relationships between the judgment debtor and its stakeholders, but those effects are attenuated in the case of a typical commercial enterprise.

The situation is different, however, where the third party has a large stake in the debtor and is particularly acute when those stakeholders are bound to the

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<sup>73</sup> For analysis in another context of the shortcomings of classifying creditors into only two sorts, voluntary and involuntary, see C. Scott Pryor, *The Missing Piece of the Puzzle: Perspectives on the Wage Priority in Bankruptcy*, 16 AM. BANKR. INST. L. REV. 121, 146–49 (2008) [hereinafter Pryor, *The Missing Piece of the Puzzle*] (discussing tort claimants and employees as examples of creditors effectively unable to adjust prices in terms of their debtors' creditworthiness).

<sup>74</sup> See HAROLD REMINGTON, A TREATISE ON THE BANKRUPTCY LAW OF THE UNITED STATES 17 (1908) (“[I]t was the reign of the old common law whose fundamental maxim, translated into popular language, is ‘first come first served.’”).

judgment debtor by the law of property as well as by contract. On the one hand, in an ordinary prospective contractual relationship, each party can take into account the possibility that before receiving performance, a creditor of the other party may deploy the power of the law to collect its claim. If that happens, the risk that one party will not receive the performance promised by the other increases. A prospective contract party should thus adjust its price. While prospective contract parties may fail to take account of this sort of risk, or improperly price it if they do, at least they can.

On the other hand, like the residents of an insolvent municipality,<sup>75</sup> the ability of prospective owners in a CIC to recognize such a risk or to price it is weak.<sup>76</sup> The nature of financial risks is difficult to perceive in the complex terms of CC&Rs and even more difficult to price without thorough evaluation of the community's financial statements. Moreover, the cost of the after-the-fact alternative—exit from the CIC—can be prohibitively high.<sup>77</sup>

A case involving a California condominium association<sup>78</sup> demonstrates the clash of bilateral collection law with multilateral CIC law. As a result of the 1994 Northridge earthquake, a condominium association needed extensive work to rehabilitate its property and hired a building contractor to perform the necessary services.<sup>79</sup> The association had property insurance and retained what ultimately became its judgment creditor as an independent adjuster to negotiate with its insurer. The insurer eventually paid \$1.4 million, but the association refused to pay the adjuster its contractual 10%. The adjuster sued and recovered a judgment of nearly \$200,000.<sup>80</sup> When the association still did not pay, the judgment creditor obtained a writ of execution and sought to levy on the association's assessments.<sup>81</sup> The association in response claimed an

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<sup>75</sup> See Pryor, *Municipal Bankruptcy*, *supra* note 29, at 103 (“When compared with corporate borrowers and their shareholders . . . the exit rights of [municipal] taxpaying residents are much more expensive.”).

<sup>76</sup> For criticism of the alternative of presumed built-in market protection for certain classes of contract parties see Pryor, *The Missing Piece of the Puzzle*, *supra* note 73, at 149.

<sup>77</sup> Pryor, *Municipal Bankruptcy*, *supra* note 29, at 104 (“Most limiting of all is the high cost to taxpayers of escaping increasing tax burdens . . . [T]hey must sell their real property, an expensive proposition . . .”); see also MCKENZIE, *BEYOND PRIVATOPIA*, *supra* note 54, at 56 (“[T]he ability to move away when an owner becomes dissatisfied is not as unrestricted as might appear. Most states require sellers of homes, and often the association as well, to disclose to potential buyers all potential liabilities, including pending special assessments and litigation.”).

<sup>78</sup> *James F. O’Toole Co. v. L.A. Kingsbury Court Owners Ass’n*, 23 Cal. Rptr. 3d 894 (Cal. Ct. App. 2005).

<sup>79</sup> *Id.* at 895.

<sup>80</sup> *Id.*

<sup>81</sup> *Id.*

exemption under California law on the ground that all of its regular assessments were free from execution because they were necessary for essential services.<sup>82</sup> The judgment creditor argued, and the trial court agreed, that the “judgment was an ‘extraordinary expense.’”<sup>83</sup> Although the association “had ‘the power to levy an *emergency assessment* to satisfy’” the judgment, the members of the community refused to impose one on themselves.<sup>84</sup> To break the stalemate, the judgment creditor obtained the appointment of a receiver with the power to levy a special assessment.<sup>85</sup>

On appeal, following a lengthy analysis of recent changes to California law, the appellate court held that the business judgment rule did not protect the decision of the association’s board not to impose a special assessment,<sup>86</sup> and that, in the face of the association’s intransigence, the trial court was correct to appoint a receiver to do so.<sup>87</sup> While nothing in the record indicates any grounds for sympathy for the members of this community, nothing in the court’s opinion suggests that any potential hardship community members may face should be taken into account. Thus, collection law remains a bilateral affair in the CIC context, even where states have otherwise highly-legislated CICs.

## 2. *Bankruptcy Reorganization Cases*

In contrast to state collection law, bankruptcy law is fundamentally multilateral.<sup>88</sup> The reorganization powers afforded debtors by the Code

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<sup>82</sup> See CAL. CIV. CODE § 1366(c) (West 2013) (repealed 2014). Levy of Assessments; limitation on increases; exemption; delinquent assessments; interest

(c) Regular assessments imposed or collected to perform the obligations of an association under the governing documents or this title shall be exempt from execution by a judgment creditor of the association only to the extent necessary for the association to perform essential services, such as paying for utilities and insurance. In determining the appropriateness of an exemption, a court shall ensure that only essential services are protected under this subdivision.

The Uniform Common Interest Ownership Act does not provide such an exemption.

<sup>83</sup> *L.A. Kingsbury Court Owners Ass’n*, 23 Cal. Rptr. 3d at 896.

<sup>84</sup> *Id.* The trial court ordered the association “to convene a meeting of the individual condominium owners . . . to consider and provide for a meaningful emergency assessment so as to satisfy” the judgment. *Id.* (quoting the trial court).

<sup>85</sup> *Id.*

<sup>86</sup> *Id.* at 901 (“[T]he Association’s refusal to impose a special emergency assessment was not a ‘business decision’ of the sort to which the courts must defer . . .”).

<sup>87</sup> *Id.* at 902 (“[T]he trial court correctly ordered the Association to impose a special emergency assessment and, in light of the Association’s refusal to do so, correctly decided to appoint a receiver to carry out the court’s order.”).

<sup>88</sup> See CHARLES JORDAN TABB, *THE LAW OF BANKRUPTCY* 4 (3d ed. 2014):



especially reflect the communitarian aspect of bankruptcy law.<sup>89</sup> The unique middle space occupied by CICs, however, does not fit neatly into the current bankruptcy scheme. For example, ordinary commercial enterprises in terminal financial distress can be liquidated under chapter 7. In practice, though, CICs cannot be liquidated under either state law<sup>90</sup> or bankruptcy law.<sup>91</sup> In lieu of liquidation, commercial enterprises can be reorganized under chapter 11. As we will see, however, chapter 11 is largely ineffective for CICs.

Chapter 11 permits a debtor to reorganize its debts by reducing their amounts and extending their payment terms without the consent of each of its creditors. Of course, chapter 11 also includes a variety of protections for non-consenting creditors. Two such protections, expressed in terms of requirements for confirmation of a plan of reorganization, have proved to be especially problematic for CICs in bankruptcy: the best interests test and the absolute priority rule.

*a. The Best Interests Test*

Every chapter 11 plan of reorganization must surmount several obstacles to be confirmed.<sup>92</sup> Of significance for CICs is § 1129(a)(7)(A)(ii) of the Code, the so-called best interests test.<sup>93</sup> To pass this test, the debtor must prove that any

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When the debtor is insolvent, however, and has multiple creditors, state collection law fails to serve the interests of the creditor body as a whole. . . . Those who come later in time will get nothing. As a matter of distributive justice, this all-or-nothing result leaves much to be desired. Instead, the more equitable result when all creditors cannot be paid in full is for the creditors to *share* the debtor's property on a *pro rata* basis . . . .

<sup>89</sup> See H.R. REP. NO. 95-595, at 220 (1977), as reprinted in 1978 U.S.C.C.A.N. 5963, 6179 (“The purpose of a business reorganization case . . . is to restructure a business’s finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders.”).

<sup>90</sup> See UNIF. COMMON INTEREST OWNERSHIP ACT § 2-118(a) (NAT’L CONFERENCE OF COMM’RS ON UNIF. STATE LAWS 2014) (“[A] common interest community may be terminated only by agreement of unit owners of units to which at least 80 percent of the votes in the association are allocated, or any larger percentage the declaration specifies . . . .”). Even then, liens and claims of creditors against the association devolve to the units of the erstwhile association. *Id.* § 2-118(h):

Following termination of a condominium or planned community, creditors of the association holding liens on the units . . . may enforce those liens in the same manner as any lien holder. All other creditors of the association are to be treated as if they had perfected liens on the units immediately before termination.

<sup>91</sup> See *infra* text accompanying note 96.

<sup>92</sup> See 11 U.S.C. § 1129(a)(1)–(16) (2012) (listing sixteen criteria for confirmation of a chapter 11 plan of reorganization).

<sup>93</sup> *Id.* § 1129(a)(7):

objecting creditor will get at least as much under the plan as it would have received had the debtor been liquidated under chapter 7.<sup>94</sup> Proof of the value of a hypothetical liquidation and comparison to the plan's projections for the future can be challenging even in the bankruptcy of a typical commercial enterprise.<sup>95</sup> Application of the best interests test to a non-profit CIC has divided the courts because the Code prohibits the involuntary liquidation of a not-for-profit enterprise.<sup>96</sup> In light of the legal characteristics of CICs, questions of valuation remain unanswered. Should the best-interests baseline be zero because the community cannot be compelled to liquidate? Should the community peremptorily be deemed to fail the test because there is no liquidation value against which to measure payments under the plan? Or should the virtual indestructibility of a common interest community (and its power to assess) set the best interests bar at the present value of an infinite stream of assessments?

The experiences of two condominium associations—the Mandalay Shores Cooperative Housing Association and the Oak Park Calabasas Condominium Association—exemplify the challenges of the best interests test for CICs. The Mandalay Shores Cooperative Housing Association generated forty reported

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With respect to each impaired class of claims or interests—

(A) each holder of a claim or interest of such class—

(i) has accepted the plan; or

(ii) will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 . . . .

<sup>94</sup> *Id.*

<sup>95</sup> See TABB, *supra* note 88, at 1123–24:

The plan proponent must introduce concrete evidence of the likely estate assets that would be available for distribution in chapter 7 and their value, as well as a comprehensive assessment of the estimated claims in each class. In many cases a fairly detailed financial analysis will be necessary, although the courts recognize that constructing the hypothetical liquidation is not an exact science and must in part be based on reasonable assumptions and best guesses.

<sup>96</sup> 11 U.S.C. § 303(a) (“An involuntary case may be commenced only under chapter 7 or 11 of this title, and only against a person, except . . . a corporation that is not a moneyed, business, or commercial corporation . . . .”); see also TABB, *supra* note 88, at 151–52:

Eleemosynary institutions, such as “churches, schools, and charitable organizations and foundations” . . . have long enjoyed an exemption from involuntary bankruptcy. Note, though, that the actual Code language . . . is not narrowly restricted to charitable institutions . . . . For example, a country club would seem to qualify as an institution free from the threat of involuntary bankruptcy.

decisions in multiple courts over the course of its existence.<sup>97</sup> The association's story began when a number of tenants of a luxury apartment complex on the Gulf Coast of Florida formed a non-profit cooperative to purchase the building where they lived.<sup>98</sup> The members capitalized the association with contributions totaling \$1 million.<sup>99</sup> When the association failed to purchase the building, some of its members demanded a refund of their contributions.<sup>100</sup> They sued when the association failed to pay them.<sup>101</sup> The association then filed for relief under chapter 11 and ultimately proposed a plan that would pay the class of disgruntled former members \$900 each.<sup>102</sup> The bankruptcy court reviewed the plan for compliance with the Code and concluded that it satisfied the best interests test.<sup>103</sup> While acknowledging that the association could not be compelled to liquidate, the court observed that it could choose to do so, but, if it did, the priority claim in favor of the Internal Revenue Service generated by the loss of the association's tax-exempt status would eliminate any payment to the members.<sup>104</sup> The hypothetical chapter 7 liquidation would pay creditors zero; thus, a payment of \$900 under the chapter 11 plan satisfied the best interests test.

On the other hand, a condominium association in California found the best interests test to be an insuperable barrier to confirmation in *In re Oak Park Calabasas Condominium Ass'n*.<sup>105</sup> The Oak Park Calabasas Condominium Association filed for relief under chapter 11 to address payment of a judgment in excess of \$7 million.<sup>106</sup> Given the small value of the assets owned by the association—worth less than \$1 million—virtually any distribution to its judgment creditor (after payment of priority expenses) would be more than what it would receive in the event of a liquidation of those assets.<sup>107</sup> Even so,

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<sup>97</sup> See, e.g., *Chase Manhattan Bank v. Mandalay Shores Coop. Hous. Ass'n*, (*In re Mandalay Shores Housing Coop. Hous. Ass'n*), 21 F.3d 380 (11th Cir. 1994); *In re Mandalay Shores Coop. Hous. Ass'n*, 63 B.R. 842 (N.D. Ill. 1986); *Mandalay Shores Coop. Hous. Ass'n v. Pierce*, 667 F.2d 1195 (5th Cir. 1982); *Eichhorst v. Mandalay Shores Coop. Hous. Ass'n*, 653 So.2d 421 (Fla. Dist. Ct. App. 1995).

<sup>98</sup> *In re Mandalay Shores Ass'n*, 22 B.R. 202, 203 (Bankr. M.D. Fla. 1982).

<sup>99</sup> *Id.*

<sup>100</sup> *Id.* at 204.

<sup>101</sup> *Id.*

<sup>102</sup> *In re Mandalay Shores Coop. Hous. Ass'n*, 53 B.R. 609, 610–11 (Bankr. M.D. Fla. 1985).

<sup>103</sup> *Id.* at 615.

<sup>104</sup> *Id.* (“The payments in settlement would not result in the onerous tax consequences that a liquidation would entail. . . . [T]here is serious doubt that in a voluntary Chapter 7 case . . . liquidation would permit any payment to any creditors, because of the possible tax priority claim.”).

<sup>105</sup> 302 B.R. 665 (Bankr. C.D. Cal. 2003).

<sup>106</sup> *Id.* at 666.

<sup>107</sup> See *id.* at 673 n.35.

the plan proposed to pay 100% of the judgment creditor's claim over the course of twenty years, albeit with interest running on the unpaid balance at only 1.82% instead of the California judgment rate of 10%.<sup>108</sup> The bankruptcy court found, however, that even this 100% plan was not in the best interests of the judgment creditor. Unlike a liquidation of a commercial enterprise, chapter 7 would not bring the activities of the association to an end. California law requires that the association perform a variety of tasks and gives it the power to collect assessments in perpetuity to pay for such tasks.<sup>109</sup> Thus, in situations where the association's power to assess exceeds what is needed to perform its duties, the creditor is entitled to that excess until it is paid in full at the state law rate of interest.<sup>110</sup> Anything less would not be in the best interests of an objecting creditor.<sup>111</sup>

California condominium law governed the duties and powers of the association in *In re Oak Park Calabasas*. There is no reason to assume the result would be different in other states. While the mandates of the Uniform Common Interests Ownership Act ("UCIOA")<sup>112</sup> are substantially less detailed than what California law imposes, UCIOA nonetheless requires an association to maintain the community's common elements<sup>113</sup> and to collect assessments to do so.<sup>114</sup> Thus, unless dissolved, the association must assess the units of the

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<sup>108</sup> See *id.* at 667.

<sup>109</sup> *Id.* at 673 n.35 ("Since the HOA cannot be liquidated and it or its alter ego must continue to operate, there will be a source of repayment for creditors even after the trustee administers and distributes all assets of the estate.").

<sup>110</sup> *Id.* at 674 ("[I]t is clear that a confirmable plan must provide for full payment of ECC's claim with 10% interest and with accrued and unpaid interest being added to the principal every 10 years.").

<sup>111</sup> *Id.* at 674–75:

While [the unpaid balance on the judgment at the conclusion of the plan] will not be worth what it is [today], it still would have substantial value, particularly since it can't be discharged in bankruptcy and will be supported by a stream of payments into the future. . . . I do not need to find the exact value of what [the judgment creditor] retains, for under any scenario [it] does not receive or retain under the Plan as much as it would under a chapter 7 liquidation.

<sup>112</sup> See generally UNIF. COMMON INTEREST OWNERSHIP ACT, prefatory note. The National Conference of Commissioners on Uniform State Laws promulgated the latest iteration of model legislation with respect to common interest communities in 2008. The 2008 text has been adopted in only three states (Connecticut, Delaware, and Vermont), *Common Interest Ownership Act (2008)*, UNIF. LAW COMM'N, [http://www.uniformlaws.org/Act.aspx?title=Common Interest Ownership Act \(2008\)](http://www.uniformlaws.org/Act.aspx?title=Common+Interest+Ownership+Act+(2008)) (last visited Feb. 19, 2017) (displaying enactment status map), but earlier versions form the basis of legislation in many other states.

<sup>113</sup> UNIF. COMMON INTEREST OWNERSHIP ACT § 3-107(a) (NAT'L CONFERENCE OF COMM'RS ON UNIF. STATE LAWS 2014) ("[T]he association is responsible for maintenance, repair, and replacement of the common elements . . .").

<sup>114</sup> *Id.* § 3-115(b) ("[A]ll common expenses must be assessed against all the units in accordance with the allocations set forth in the declaration . . .").

members of the community in perpetuity to pay a judgment against the association.<sup>115</sup> The present value of this perpetual stream of assessments thus establishes the floor of a creditor's best interests.

*b. The Absolute Priority Requirement*

Ordinary plan confirmation under § 1129(a) is premised on the affirmative (albeit weighted<sup>116</sup>) vote of each class of creditors whose claims are impaired.<sup>117</sup> Individual creditors can raise the best interests test, but if a CIC passes that test, and the class of the objecting creditor (and each other impaired class) has assented, the plan can still be confirmed.<sup>118</sup> Even if an entire class of creditors votes against the plan, however, it may still be confirmed, but only if the association can meet the additional strictures required for cramdown under § 1129(b).<sup>119</sup> While rarely employed under any circumstance, cramdown represents the final opportunity for a community in distress to reorganize over the objection of a class of impaired creditors.

In addition to satisfying the best interests test, cramdown imposes two more requirements on a plan: (1) it must not “discriminate unfairly” between classes; and (2) it must be “fair and equitable” with respect to each impaired class.<sup>120</sup> The standard that the plan be fair and equitable is further specified by

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<sup>115</sup> See *Id.* § 3-115(d) (“Assessments to pay a judgment against the association may be made only against the units in the common interest community at the time the judgment was entered, in proportion to their common expense liabilities.”).

<sup>116</sup> 11 U.S.C. § 1126(c) (2012):

A class of claims has accepted a plan if such plan has been accepted by creditors . . . that hold at least two-thirds in amount and more than one-half in number of the allowed claims of such class held by creditors . . . that have accepted or rejected such plan.

<sup>117</sup> *Id.* § 1129:

- (a) The court shall confirm a plan only if all of the following requirements are met:
  - (8) With respect to each class of claims or interests—
    - (A) such class has accepted the plan; or
    - (B) such class is not impaired under the plan.

<sup>118</sup> *Id.* To be confirmed under § 1129(a) of the Code, a plan must meet a number of standards in addition to being in the best interests of creditors. Of those, a finding of feasibility is often the most significant barrier. See *Id.* § 1129(a)(11) (“Confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor . . .”).

<sup>119</sup> *Id.* § 1129(b).

<sup>120</sup> *Id.* § 1129(b)(1):

[I]f all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court . . . shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and

the requirement of “absolute priority” that bars any class junior to the objecting class from “receiving or retaining” anything on account of its claim or interest.<sup>121</sup> In other words, if an objecting creditor will not be paid in full under a plan, those who have an ownership interest in the debtor are not permitted to keep it.

Another pair of cases illustrates the perils of cramdown for a CIC. The chapter 11 bankruptcy of S.A.B.T.C. Townhouse Association is an example of an unsuccessful effort to cram down a class when the members of the community would retain their membership in the association.<sup>122</sup> In that case, the CC&Rs that created the community undermined the possibility of reorganization.<sup>123</sup> The S.A.B.T.C. Association sued its developer, and the developer filed a counterclaim. While the association lost on its claim, the developer prevailed on its counterclaim. The court ultimately entered a judgment against the association for over \$270,000.<sup>124</sup> Although Florida law would have permitted the association to levy a special assessment on its owners to pay the judgment, its bylaws (created by the defendant-developer) required a two-thirds vote of its members, and even then the purpose of the assessment could be only for capital improvements.<sup>125</sup>

Caught between the proverbial rock and a hard place, the association filed a chapter 11 petition and proposed a plan to pay the developer approximately \$30,000.<sup>126</sup> The developer voted against the plan,<sup>127</sup> and the association sought to cram it down.<sup>128</sup>

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equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

See generally Pryor, *Municipal Bankruptcy*, *supra* note 29, at 114–15.

<sup>121</sup> 11 U.S.C. § 1129(b)(2)(B):

With respect to a class of unsecured claims—

- (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property . . . .

See generally Pryor, *Municipal Bankruptcy*, *supra* note 29, at 115.

<sup>122</sup> *In re S.A.B.T.C. Townhouse Ass’n*, 152 B.R. 1005 (Bankr. M.D. Fla. 1993).

<sup>123</sup> See *id.* at 1007.

<sup>124</sup> *Id.*

<sup>125</sup> *Id.* (“The funding of the Reserve Accounts is mandatory. The monies held in the Reserve Accounts may only be used to pay for necessary capital improvements and may be used for no other purpose.”).

<sup>126</sup> *Id.* at 1008. The association obtained this money from 15 (out of 121) association members who, not having paid their assessments in 1983 or 1984, were asked by the association’s director and secretary to voluntarily contribute to the fund. *Id.* at 1010–11.

<sup>127</sup> *Id.* at 1008.

<sup>128</sup> *Id.* at 1006. (listing debtor’s Motion to Cram Down as a matter currently before the court).

The developer objected to the cramdown plan because the members of the association—a class of putative interests junior to the developer’s judgment—would retain their rights to the community’s common areas in violation of the absolute priority rule.<sup>129</sup> The court agreed that the proposed plan violated the absolute priority rule and found that the plan could not be confirmed.<sup>130</sup> Thus, while limits on special assessments imposed by the CC&Rs made it possible to satisfy the best interests test for a consensual confirmation, those same limits made it impossible for the association to satisfy the absolute priority rule for cramdown over an objecting class of creditors.

The bankruptcy court for the Middle District of Florida, in the final portion of its 1985 *In re Mandalay Shores*<sup>131</sup> opinion applied the absolute priority rule to the association (rather than to the association members as individuals). The plan at issue, which proposed to pay only \$900 to each member that demanded a refund, also provided that the association would retain the funds contributed by its other members. This, the court concluded, violated the absolute priority rule because the association would ultimately retain property on account of its ownership interest, even though its objecting creditors were not paid in full.<sup>132</sup>

### B. What if Chapter 9?

When faced with extraordinary financial distress, if its state permits it, a municipality may seek relief under chapter 9 of the Code.<sup>133</sup> Chapter 9 draws

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<sup>129</sup> See *id.* at 1011 (“In the instant case, the members retain the \$5,983.47 [value of the common area] enhancement to their units . . .”). Some courts have concluded that members of an association do not “receive or retain” anything within the meaning of § 1129(b)(2)(B)(ii) after confirmation. See, e.g., *In re Gen. Teamsters Warehousemen & Helpers Union Local 890*, 225 B.R. 719 (Bankr. N.D. Cal. 1998) (holding that the absolute priority rule inapplicable to labor union); *In re Indep. Vill., Inc.*, 52 B.R. 715 (Bankr. E.D. Mich. 1985) (holding that the absolute priority rule inapplicable to non-profit debtor with no members). But see *In re Eastern Me. Elec. Coop., Inc.*, 125 B.R. 329 (Bankr. D. Me. 1991) (finding that the absolute priority rule applies when members of reorganized cooperative would retain right to recover capital).

<sup>130</sup> *In re S.A.B.T.C. Townhouse*, 152 B.R. at 1011.

<sup>131</sup> *In re Mandalay Shores Coop. Hous. Ass’n*, 53 B.R. 609 (Bankr. M.D. Fla. 1985).

<sup>132</sup> *Id.* at 615:

The plan also contemplates that MSCHA’s interest be recognized and MSCHA will retain, on account of such interest, property, the funds remaining after the plan is consummated. Thu, it is clear that this plan is not fair and equitable and does discriminate unfairly and, therefore, does not meet the test for confirmation under § 1129(b)(1).

<sup>133</sup> 11 U.S.C. § 109 (2012):

- (c) An entity may be a debtor under chapter 9 of this title if and only if such entity—  
(2) is specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law . . . ;

heavily from the reorganization provisions of chapter 11, but a fundamental principle—the irreducible political sovereignty of municipalities—curtails the similarities between the two chapters.<sup>134</sup> This principle manifests in two significant differences. First, chapter 9 excludes the internal “political or governmental powers” of a municipality from the jurisdiction of the bankruptcy judge. In addition, creditors cannot coopt the municipal power to tax for their benefit.<sup>135</sup> Second, chapter 9 bankruptcies cannot be converted to chapter 7 cases and, therefore, municipalities that file for bankruptcy relief cannot be liquidated. These and other differences between chapter 11 and chapter 9 reflect a recognition that municipalities should not be treated as ordinary business entities seeking to reorganize. Rather, together with broad limits on the power of bankruptcy courts to interfere with the internal governmental affairs of municipalities, chapter 9 recognizes that the common good of civil government may trump the collective private goods of that government’s creditors.

The irreducible political sovereignty of municipalities eliminates liquidation as a means of resolving chapter 9 bankruptcies. In the context of the best interests test, the baseline for comparison cannot be what creditors would have received under a hypothetical chapter 7. Instead, best interests are measured against the maximum revenue that the municipal government is willing to raise. And, because the bankruptcy judge cannot interfere with the internal “political or governmental powers” of the municipalities, a judge who believes that more tax revenue could be generated ultimately is left with only two choices: either (1) confirm the sub-optimal plan; or (2) dismiss the chapter

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Municipalities are limited in their ability to file for bankruptcy relief by state law; many states condition and a few prohibit municipalities’ ability to file for chapter 9 relief. *See Municipal Bankruptcy State Laws, GOVERNING: THE STATES AND LOCALITIES*, <http://www.governing.com/gov-data/state-municipal-bankruptcy-laws-policies-map.html> (last visited February 18, 2017). *See generally* 2 COLLIER ON BANKRUPTCY, *supra* note 52, ¶ 109.04[3][b].

<sup>134</sup> *See generally* Pryor, *Municipal Bankruptcy*, *supra* note 29, at 114.

<sup>135</sup> 11 U.S.C. § 904:

Notwithstanding any power of the court, unless the debtor consents or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with—

- (1) any of the political or governmental powers of the debtor;
- (2) any of the property or revenues of the debtor; or
- (3) the debtor’s use or enjoyment of any income-producing property.



9 case.<sup>136</sup> Thus, in a chapter 9 case, application of the best interests test is less an invitation to negotiation than to a high-stakes game of chicken.<sup>137</sup>

Cramdown in chapter 9 also differs from its chapter 11 analogue.<sup>138</sup> While the form of cramdown under chapter 9 tracks the requirements of chapter 11, its substance is substantively modified. Unlike a commercial enterprise eligible for chapter 11 relief, a municipality has no owners. In other words, there is no class of residual interests to which to apply the absolute priority rule. As long as no junior class of creditors is paid over an objecting senior creditor, the absolute priority test is satisfied even though the municipality continues to provide public goods for its residents. The absolute priority rule in chapter 9 applies only among creditors; citizens with remaining rights to public goods and services do not pose an absolute priority problem and do not prevent confirmation of the plan.

What if CICs could seek relief under chapter 9? Assuming that chapter 9 applied to the CIC debtors described above,<sup>139</sup> meeting the best interests standard in *In re Mandalay Shores* would be unaffected. Satisfaction of the simplified chapter 9 best interests test is all but certain in cases where the debtor has met the more stringent chapter 11 standard established in *In re Mandalay Shores*.

It is not clear, however, that the condominium association in *In re Oak Park Calabasas* could pass the chapter 9 best interests test. On the one hand, the bankruptcy court could not condition confirmation on payment of the present value of an infinite stream of maximal assessments because it cannot

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<sup>136</sup> 11 U.S.C. § 930. See generally Pryor, *Municipal Bankruptcy*, *supra* note 29, at 123 (comparing the result of inconsistent incommensurable policies embedded in chapter 9 to game of Chicken).

<sup>137</sup> I have written elsewhere about the similarities between chapter 9 and the game of chicken:

Two cars racing toward each other are the prototypical format for the game of Chicken. The first driver to turn aside is a “chicken” or coward. The winner who has driven straight ahead is confirmed in his vainglory. Of course, if neither turns aside both drivers die, albeit with a reputation for extraordinary toughness. In chapter 9, the sociopathy of two players of Chicken who would rather die than swerve are replaced by the rational calculators of bond insurers and representatives of retirees. Even though the judgment of sophisticated parties can be wrong, the possibility of a precedent-setting loss should be enough to cause at least one party to stop before the brink.

Pryor, *Municipal Bankruptcy*, *supra* note 29, at 123. Of course, individual bankruptcy judges can strongly encourage recalcitrant parties to compromise toward a just result, but such efforts will be sporadic and inconsistent without a clear statutory framework.

<sup>138</sup> See 11 U.S.C. § 901(a) (failing to incorporate § 1129(b)(2)(C)).

<sup>139</sup> See *supra* text accompanying notes 97–132.

intervene in a municipality's comparable taxing powers. The court can, however, dismiss a chapter 9 case when it concludes that the revenue-generating efforts of a municipal government fall short by so much that the creditors could do better under state law. Coercive collection of claims against a city is problematic;<sup>140</sup> in contrast, *James F. O'Toole Co.*<sup>141</sup> demonstrates that state-empowered collection from a CIC is possible. It thus seems unlikely that the result in *In re Oak Park Calabasas* would have changed even if the association had been treated as a municipality with recourse under chapter 9.

Had they qualified as debtors under chapter 9, the debtors in both the *In re S.A.B.T.C. Townhouse* and the *In re Mandalay Shores* should have satisfied the requirement of absolute priority and therefore successfully crammed down their plans. Municipal residents do not own a residual interest in their cities, and their entitlement to continued municipal services are not property. Creditors thus cannot block cramdown of a plan that pays them less than owed merely because the municipality continues to own public property and to provide public goods to its residents. Comparable continued ownership of common areas by a common interest association and continued access to those areas by members of the community, no matter how valuable, would not violate chapter 9's absolute priority rule.

### III. CHANGES TO THE CODE

In individual and businesses cases, bankruptcy law provides additional tools when a load of debt exceeds a debtor's ability to repay. Given the middle space CICs occupy between businesses and municipalities—providing goods to consumers that select them to all members—solving the problem of their financial distress likewise occupies a space between what bankruptcy law provides for ordinary business enterprises and for municipalities.<sup>142</sup> Even when CICs undertake traditional municipal functions, however, CICs are not eligible for relief under chapter 9.<sup>143</sup> Seeking to reorganize under chapter 11 as it

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<sup>140</sup> See Clayton P. Gillette, *Bondholders and Financially Stressed Municipalities*, 39 *FORDHAM URB. L.J.* 639, 640–53 (2012) (describing techniques used by municipalities to avoid paying creditors).

<sup>141</sup> *James F. O'Toole Co. v. L.A. Kingsbury Court Owners Ass'n*, 23 *Cal. Rptr. 3d* 894 (Cal. Ct. App. 2005).

<sup>142</sup> See Davidson, *supra* note 60, at 631 (“Although courts recognize the unique functions of community associations and the intermediate role they facilitate between residents and the surrounding localities, current law fails to address a wide range of possible solutions for community associations with excessive debts.”).

<sup>143</sup> For a purposeful argument that common interest communities should be entitled to relief under chapter 9 see Davidson, *supra* note 60 at 625–30. Regardless of its substantive merits, however, the comment fails to account for the change effected by the Bankruptcy Reform Act of 1994 that amended the language of Code

currently stands, however, creates a risk that the quasi-municipal power of assessment will be transferred from the community to its creditors. Further, a CIC's ability to control its fate in a chapter 11 reorganization could be hindered significantly if the association or any of its members continue to receive any public goods, creating an absolute priority problem and preventing cramdown.<sup>144</sup>

Unlike municipalities, CICs are not public entities clothed with the vestiges of state sovereignty. In addition, CICs provide private as well as public goods.<sup>145</sup> The broad limits on bankruptcy courts' power with respect to the internal governance of a CIC are thus unwarranted. In applying chapter 9 treatment to CICs, therefore, the bankruptcy court should retain the power to confirm a plan proposed by the creditors of a CIC.<sup>146</sup>

The source of income for CICs is generally limited, often exclusively, to assessments on units in the community.<sup>147</sup> Owners of property within the community are personally liable to pay their assessments,<sup>148</sup> and their property is subject to a lien to secure that liability.<sup>149</sup> Assessments are normally devoted to paying for the ongoing maintenance of the community's assets and funding a reserve for large, anticipated expenditures.<sup>150</sup> A downward spiral ensues if the assessments—or their collection—fail to meet the community's needs.<sup>151</sup>

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§ 109(c)(2) to require specific state authorization for a municipality to seek relief under chapter 9. No state has specifically authorized CICs within its borders to do so.

<sup>144</sup> See *supra* text accompanying notes 122–30.

<sup>145</sup> See *supra* text accompanying notes 19–21.

<sup>146</sup> Section 941 allows only a municipal debtor to file a plan. 11 U.S.C. § 941 (“The debtor shall file a plan for the adjustment of the debtor’s debts.”).

<sup>147</sup> See Perkins, *supra* note 54, at 565 (“Normally, HOAs fund their operations through the imposition of assessments.”); Davidson, *supra* note 60, at 595 (“As the association’s only source of income, the financial strength and stability of the community requires unconditional payment of assessments.”); see also Pryor, *Who Bears the Burden?*, *supra* note 48, at 88 (“Local governments have added fees, user charges, and special assessments to real estate taxes to supplement their revenue.”).

<sup>148</sup> See Davidson, *supra* note 60, at 595 (“Residents are obligated to pay the assessments because the obligations run appurtenant to the land.”). While there was some question in the early twentieth century whether the covenant associated with a common interest community “ran with the land,” both the developing common law and statutes have made clear that property owners have a personal obligation to pay assessments. See, e.g., RESTATEMENT (THIRD) OF PROPERTY: SERVITUDES § 8.3 (AM. LAW INST. 2000); UNIF. COMMON INTEREST OWNERSHIP ACT § 3-102(a)(2) (NAT’L CONFERENCE OF COMM’RS ON UNIF. STATE LAWS 2014).

<sup>149</sup> See UNIF. COMMON INTEREST OWNERSHIP ACT § 3-116(a).

<sup>150</sup> Some such expenses are more frequently anticipated than others. See generally McKenzie, *Recent Trends*, *supra* note 8, at 11 (detailing the disastrous effects of the Northridge earthquake on three condominium communities).

<sup>151</sup> *Id.*:

Indeed, the pattern of events that typically follows—increasing assessments, a greater number of owners who fail to pay, subsequent foreclosures, reduced property values, and thus even higher assessments—has been called a “death spiral.”<sup>152</sup> State law provides no solution to this state of affairs.

Congress should refine the best interests test to permit financially distressed CICs to repay their debts and maintain services necessary to preserve the value of community members’ property.

Comparison to a chapter 7 liquidation for a common interest community is inappropriate for two reasons. First, as not-for-profit entities, common interest communities cannot be liquidated at the behest of their creditors.<sup>153</sup> The Code embodies a public policy protecting charitable, non-profit organizations from involuntary bankruptcy.<sup>154</sup> Section 303 of the Code prohibits creditors from seeking the involuntary bankruptcy of entities that are not “moneyed, business, or commercial” corporations.<sup>155</sup> CICs fall in this category of entities protected from involuntary bankruptcy. While they can be liquidated, it can only be as a result of the voluntary choice of the CIC. Comparison of a CIC’s chapter 11 plan to the results of a chapter 7 liquidation—a state of affairs creditors cannot compel—is thus inappropriate.

Nor may the court convert the chapter 11 case of a CIC to one under chapter 7 without the debtor’s consent.<sup>156</sup> Second, CICs provide public goods and, therefore, should not be liquidated for the same reason that municipalities cannot be liquidated—because preservation of the public goods and services

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Losing a substantial part of the assessment stream quickly becomes disastrous for associations, especially small ones, because the burden of paying for the association’s common operating expenses and reserves falls on fewer people. Assessments must be increased . . . . This in turn increases the likelihood that some of the remaining owners will be unable to handle the increased assessments, and so it goes . . . .

<sup>152</sup> See Trevor C. Pinkerton, Comment, *Escaping the Death Spiral of Dues and Debt: Bankruptcy and Condominium Association Debtors*, 26 EMORY BANKR. DEV. J. 125, 125 (2009) (“This parade of horrors creates a circular ‘death spiral’ of dues and debt, where high delinquency n dues payment lead to increased assessments, which produces even more delinquencies.”).

<sup>153</sup> See *supra* text accompanying note 96.

<sup>154</sup> H.R. REP. NO. 95-595, at 322 (1977), as reprinted in 1978 U.S.C.C.A.N. 5963, 6179.

<sup>155</sup> 11 U.S.C. § 303(a) (2012); see also TABB, *supra* note 88, at 150 (“Note, though, that the actual Code language (a ‘corporation that is not a moneyed, business, or commercial corporation’) is not narrowly restricted to charitable institutions . . . .”).

<sup>156</sup> 11 U.S.C. § 1112(c).

provided by the debtor outweigh the interests of creditors in repayment through liquidation.<sup>157</sup>

CICs' provision of traditionally public goods and services differs from that of municipalities in two significant ways. First, CICs often provide both private and public goods to their members. Second, after local governments successfully shift the provision of certain public goods to CICs, many of them go on to provide a level of services in excess of what public choice theory, state law, or historical practice would require.<sup>158</sup>

The middle space occupied by CICs nonetheless should be reflected in a best interests test that tracks chapter 9. Courts should rely on state law to determine the appropriate baseline of public goods that a reorganized CIC debtor must continue to provide to members. State law relevant to defining the duties of CICs is, however, underdeveloped.<sup>159</sup> Thus, the Code should provide a standard, rather than a rule, to guide courts' best interests test analysis.<sup>160</sup>

Finally, the practical indissolubility of CICs demands a modified absolute priority rule. Except where members of a community exercise a power to dissolve granted by state law,<sup>161</sup> they cannot avoid retaining the status of members of the community association. In addition, state law and the obligations imposed by the CC&Rs entail retention of assets by the association. A CIC should be able to cram down a plan even if the community

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<sup>157</sup> For an account of the results of a collapse of a townhome common interest community see JOHNSTON & JOHNSTON-DODDS, *supra* note 40, at 26:

As Franklin Villa declined, it pulled the surrounding neighborhoods down with it. In 1998, the Franklin Villa neighborhood had the highest reported number of violent crimes in the city, the highest number of residential burglaries, the most reports of child and spouse abuses, and the second highest number of assaults. As a result, the Sacramento Housing and Redevelopment Agency (SHRA) became involved in trying to improve the neighborhood. SHRA spent ten years trying to work with Franklin Villa's five HOAs to address the crime issues and improve the neighborhood. They finally determined that the only solution was to purchase the property and dissolve the homeowner associations.

<sup>158</sup> See generally Pryor, *Who Bears the Burden?*, *supra* note 49, at 167–72.

<sup>159</sup> See UNIF. COMMON INTEREST OWNERSHIP ACT § 3-107(a) (NAT'L CONFERENCE OF COMM'RS ON UNIF. STATE LAWS 2014).

<sup>160</sup> See Pryor, *Municipal Bankruptcy*, *supra* note 29, at 124 (“The court should preserve as much flexibility as possible to drive the parties to an unhappy consensus.”).

<sup>161</sup> See, e.g., UNIF. COMMON INTEREST OWNERSHIP ACT § 2-118(a) (“[A] common interest community may be terminated only by agreement of unit owners of units to which at least 80 percent of the votes in the association are allocated, or any larger percentage the declaration specifies, and with any other approvals required by the declaration.”).

will continue to provide public goods to its members after the plan is confirmed. Thus, the absolute priority rule for CICs should track chapter 9.

#### CONCLUSION

Even though CICs provide public goods and, in many cases, reduce the overall burden on the public fisc, they are not municipalities. This means that, with respect to a chapter 11 bankruptcy of a CIC, the baseline of comparison for the best interests test is not the maximum the elected leaders of the association are willing to impose on the members of the community. Rather, the baseline for purposes of the best interests analysis is the maximum that can be extracted from members of the CIC by raising their assessments. In other words, if dues *can* be raised, they *must* be raised to a level sufficient to pay the creditors in full. Failing submission of such a plan, the bankruptcy court can either confirm a competing creditor-sponsored plan that increases assessments or, alternatively, dismiss the case.

Members of an insolvent CIC thus find themselves in the worst of all worlds. Were they shareholders in an ordinary business corporation, neither they nor their property would have any liability to the corporation's creditors. As owners of property in a CIC, however, the same result does not obtain. First, the community provides its property owners with public goods and services *and* the community has the power to assess dues that are secured by liens against their property. Thus, any equity the members have in their property is at risk. Second, not only do unpaid dues consume owners' equity from below, increasing dues devalue their property from above. Ever-higher rates of assessment for community debts reduce the market value of property in the community. Unlike municipalities, whose sovereign status insulates taxpayers from at least some of the risk of municipal insolvency, current bankruptcy law provides no similar protection for the property-owning members of a CIC.

Resolving these problems will require changes to existing bankruptcy law. These changes will not be extensive but will produce two results: (1) no longer subjecting CICs to a best interests test based on a hypothetical chapter 7 liquidation; and (2) permitting cramdown without regard to the community's ability to retain its assets and members' rights to continue receiving public goods. Together with a statutory definition of CIC, these modest changes to the Code will more effectively balance the interests of creditors against those of communities and their members.

APPENDIX

PROPOSED NEW AND AMENDED PROVISIONS FOR THE BANKRUPTCY CODE

Bankruptcy Code § 101( ) The term “common interest association” means the entity organized under State law to carry out the duties provided in the declaration creating the common interest community.

Bankruptcy Code § 101( ) The term “common interest association case” means a case filed under chapter 11 of this title in which the debtor is a common interest association.

Bankruptcy Code § 101( ) The term “common interest community” means real estate described in a declaration with respect to which a person, by virtue of the person’s ownership of a unit, is obligated to pay for a share of real estate taxes, insurance premiums, maintenance, or improvement of, or services or other expenses related to, common elements, other units, or other real estate described in the declaration.

Bankruptcy Code § 1129(a)(7)(A) except in a common interest association case, each holder of a claim or interest of such class—

Bankruptcy Code § 1129(b)(b)(2)(C) Except in a common interest association case, with respect to a class of interests—

Bankruptcy Code § 1129(f) In a common interest association case, the court shall confirm a plan if—

- (1) The plan complies with sections 1129(a)(1), 1129(a)(2), 1129(a)(3), 1129(a)(4), 1129(a)(5), 1129(a)(6), 1129(a)(7)(B), 1129(a)(8), 1129(a)(9), 1129(a)(10), 1129(a)(11), 1129(a)(12), and 1129(a)(13); and
- (2) With respect to each impaired class of claims or interests—
  - (A) each holder of a claim or interest in such class—
    - (i) has accepted the plan; or
    - (ii) the plan is in the best interests of creditors.

- (3) Notwithstanding section 510(a) of this title, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan if the requirements of section 1129(b)(1), section 1129(b)(A), and section 1129(b)(2)(B) are met.