LIMITED EQUITY HOUSING COOPERATIVES AS A MODE OF PRIVATIZATION

Duncan Kennedy
Leopold Specht

[Editors’ Synopsis: Building on the analysis in Kennedy’s previous paper, “Neither the Market Nor the State: Housing Privatization Issues,” the authors detail a concrete method for privatizing formerly public housing in cooperative form.]

This paper instantiates some of the ideas briefly developed in “Neither the Market Nor the State: Housing Privatization Issues,” in this volume. We describe a proposal that we made in 1990 to create housing cooperatives in one district in Budapest (District XIII). This proposal represents no more than a tentative suggestion. We both lack the specific technical and the local knowledge that would be necessary to write as experts. Further, we discuss only issues that seem likely to have a significant effect on the viability of the overall model of limited equity cooperatives. Actually implementing the model in a community that wished to privatize its public housing stock would, of course, require close attention to local laws and customary practices. Leopold Specht was the primary author of section II, Duncan Kennedy of sections I and III.

The goals of the proposal are:

1. to secure ownership rights of the current occupants of public housing;
2. to rehabilitate the existing housing stock;
3. to promote self-management by occupants, rather than state management;
4. to prevent the polarization of the stock into luxury, middle-, and low-income tiers; and
5. to promote neighborhood stability by stemming spirals of rapid gentrification or deterioration.

The proposal is liberal, or free-market in character; that is, it is an authentic form of privatization. It is liberal in several senses. First, it respects the property rights of current occupants of public housing. Second, the transition
to a private housing market would be entirely voluntary and based on the rights of joint-tenancy shareholders, rather than on public ownership. Third, the new system would respect freedom of contract, private property rights, and profit maximization. Finally, the state's participation in the new system would be minimal.

Although liberal, the proposed model seeks to retain a social interest in the urbanistically created surplus from future growth. Three aspects of the model reflect this goal: creation of a profit-oriented local development bank to make loans for rehabilitation, improvement, and expansion of the local residential housing stock; retention by the bank of an interest in the urbanistically created surplus; and use of the surplus to promote the housing goals of the locality.

I. The Proposal

The proposal is to privatize the District's publicly owned residential housing stock by giving the units to their occupants, organized in limited-interest joint tenancies. The District will transfer publicly owned units to the District Development Bank, and the Bank will in turn transfer them to the joint tenancies, with the limitation described below.

A. Organization in Joint Tenancies

Each joint tenancy will consist of a number of units, and will correspond to a single building, to a part of a large building, or to several small buildings sharing common facilities. Each current occupant will become the owner of one share in the joint tenancy, which will be governed by its shareholders.

The joint tenancy will own the building. It will receive title from the District Development Bank free of charge, in exchange only for entering into the limited-interest contract. The joint tenancy will pay neither rent, nor any kind of purchase price to the District. Every joint tenancy is entitled to a rehabilitation and improvement loan from the Bank. Ownership of a share entitles the owner to occupy the unit, to modify it, to lease it, to transfer it to children at death, and to sell his interest in it at any time, all subject to the regulations adopted by the joint tenancy.

The functions of the joint tenancy are:

1. to maintain and improve the common areas;
2. to adopt and enforce regulations governing the exercise of owner rights;
3. to represent the owners in their dealings with other private parties, the District and the District Development Bank, and the organization of joint tenancies.
All joint tenancies will be members of an organization of joint tenancies. It will be governed by majority vote of its members. Each member will pay a small annual fee for its support. The functions of the organization are to gather information, provide technical assistance, and represent the interests of the joint tenancies.

B. Self-management

The owners of the units in the joint tenancy are responsible for deciding how much maintenance, rehabilitation, and improvement to do, and who will do it. They are also jointly responsible for allocating the costs of maintenance, rehabilitation, and improvement among themselves, and for collecting and actually paying all expenses. The goal of the legal rules for organizing joint tenancy should be to give the joint tenancy power to decide by majority vote how to manage the building, with relatively little power of individual shareholders to require or prevent joint tenancy action. A joint tenancy that enters into a rehabilitation or improvement loan contract with the District Development Bank is obliged to adopt this internal organization, until the full repayment of the loan. A joint tenancy that chooses not to participate in the loan program can adopt any internal governance system it wishes.

C. Individual and Bank Interests in the Joint Tenancy

1. Sale of Units

The owner of a share in a joint tenancy is free to sell at any time. On sale of the unit, the owner is entitled to recoup from the market sale price the investment he has made in the unit. The owner's investment includes several components. The owner's initial investment is the gray market value of the unit at the time of entering into the joint tenancy (that is, the price that could be obtained from a successor tenant under the public housing regime), or the actual price paid if the tenant has bought the unit from the State. In addition to the initial investment, the owner's investment includes two other components: the cost of all improvements made to the property after the initial investment, and a return or profit on the sum of the initial investment plus the cost of improvements. This profit would be equal to the interest rate on savings deposited in a bank during the same period, or to the rate of inflation, whichever is greater. Thus, if the return on savings had been five percent throughout the period of investment, but the rate of inflation had been ten percent, the owner would receive his initial investment and improvements plus ten percent interest.

If the market sale price is less than the owner's investment, defined as the sum of the three items above, the owner is entitled to the full proceeds of
sale. But if the market sale price is greater than the owner's investment, the
owner is entitled only to recoup his investment, and to ten percent of the
excess of the market sale price over that investment. Thus, if the owner's
investment were one million forints, and the market sale price were two
million forints, the owner would receive one million one hundred thousand
forints.

Turning to the joint tenancy's interest, if the market sale price is less than
the owner's investment, the joint tenancy receives nothing from the sale. If
the market sale price is greater than the owner's investment, the joint tenancy
receives ten percent of the excess. Thus, in the example above, the joint
tenancy would receive one hundred thousand forints.

The joint tenancy should be obliged to deposit this money in the District
Development Bank, and to spend it only for rehabilitation or improvement
of the joint tenancy common areas, or to retire existing debt to the Bank
(thereby reducing monthly payments for all shareholders).

Finally, concerning the District Development Bank's interest, if the market
sale price is less than the owner's investment, the Bank receives nothing
from the sale. If the market sale price is greater than the owner's investment,
the District Development Bank is entitled to eighty percent of the excess.
Thus, in the example above, with an owner investment of one million forints
and a market sale price of two million forints, the District Development
Bank would be entitled to eight hundred thousand forints.

If the District Development Bank agrees to a sale at the market price, it
has no right to determine who the buyer shall be. If a sale occurs, the
Bank must devote its share of the proceeds to its program of loans for
rehabilitation, improvement, and expansion of the District's residential hous-
ing stock.

The District Development Bank will also retain, in the contract establish-
ing the joint tenancy, a right of first refusal for all units in the joint tenancy.
If the Bank decides to exercise its right of first refusal, it has two possible
courses of action. First, it could decide that the unit should be sold below
the market price, as part of the Bank's program to provide housing in this
neighborhood for people who cannot afford to pay the full market price.
The price to such a person would have to amount at least to the owner's
investment, his share of the surplus, and the joint tenancy's share of the
surplus. In the example above, the District Development Bank could not
sell the unit for less than one million two hundred thousand forints.

Alternatively, the Bank has the right to purchase the unit itself, at a price
covering the interests of the owner and of the joint tenancy, in order to
incorporate it into the limited social housing sector described below. Note
that this right, like the right to sell the unit at less than the market sale
price, arises only when the owner has decided to sell. The Bank has no right
to force a sale.
2. Leasing of Units

Some limitation on the owner’s right to lease his unit is necessary to prevent unit owners from appropriating the urbanistically created part of the market value of the unit. On the other hand, limitations on the owner’s right to lease may produce a black market in leased apartments. In practical terms, the compromise chosen for this point will probably have important consequences for the long run viability of the scheme as a whole. The compromise must fit the particular “housing culture” of the District. For example, a scheme that depends on the members of the joint tenancy to police illegal leases will work or not work according to the attitudes and practices that neighbors customarily adopt toward one another.

Here is a possibility: The leasing of units is permitted, subject to approval of the lessee through the same procedure that governs approval of new unit owners, but the leasing owner must share the rent with the joint tenancy and with the Bank, according to a formula that grants the owner a fair return on his investment in the unit, but reserves the bulk of the surplus over that amount to the other parties.

D. Protection of Gray Market Rights and Elimination of the Gray Market

The interest of an occupant of a unit who acquired it from the previous occupant by paying a gray market price is protected in two ways. First, his occupancy right is protected through ownership of a share in the joint tenancy. Second, his interest in the joint tenancy includes the gray market value of the unit as of the time of the establishment of the joint tenancy, or includes the value as determined according to one of the alternative formulae.

On sale of the unit, the share owner can recoup his investment, so long as the market sale price of the unit is greater than his interest. However, it is a crucial part of the proposal to halt all future gray market sales. The District should proceed immediately to register the current occupants of all units, thereby conclusively establishing who has occupancy rights.

In the future, the owner of a share can sell his unit only through the procedures established here. A private sale, at the market rate or at a gray market percentage of market, would defraud the joint tenancy of its ten percent share of the excess of the market price over the owner’s investment, and would defraud the District Development Bank of its eighty percent share of that surplus. Moreover, the joint tenancy has a right to approve or disapprove potential buyers (subject to rules against discrimination, described below). For this reason, a purported sale by a share owner to a private party in violation of the shareholder’s contractual agreement with
the joint tenancy must be legally void. Such a sale should be subject to being set aside whenever it comes to the attention of the authorities, regardless of how much time has passed. The unit sold fraudulently reverts to the ownership of the joint tenancy, subject to the rights of the District Development Bank.

An occupant of a publicly owned unit, who does not either buy the unit from the District under existing law, or join a joint tenancy, loses the right to resell the unit to another private party on the gray market. In the future, when a public housing tenant vacates his unit, it reverts to the District. Illegal occupants of public units should be evicted.

E. Loans to Joint Tenancies for Rehabilitation and Improvement

Every joint tenancy is entitled to receive a rehabilitation or improvement loan from the District Development Bank. In exchange, the joint tenancy must agree to the form of organization that we discuss below. The purpose of this form of organization is to promote joint tenancy self-management, and to assure the best possible use of the loaned funds.

The timing, the amount, and the repayment and interest conditions of the loan depend on two factors: the availability of funds to the Bank, and the condition of the units in the joint tenancy, with respect to the degree of deterioration and the level of comfort. Ideally, the Bank would make larger loans on more favorable terms to joint tenancies in more deteriorated buildings, and to joint tenancies in buildings with "no comfort" or "half comfort" (that is, buildings lacking all or some standard amenities such as indoor plumbing and central heating).

The joint tenancy is legally responsible for the repayment of the loan and interest. The security for the loan is the building. The loan would be in the form of a line of credit with the Bank.

The joint tenancy decides how to spend the rehabilitation and improvement loan, and how to supervise the work. Both the District Development Bank and the organization of joint tenancies will provide technical assistance in undertaking these tasks if requested. The Bank enforces the requirement that all loan funds be spent on rehabilitation or improvement of the property.

The sources of funds are foreign capital invested directly in rehabilitation and improvement loans through the Bank; foreign capital raised through the mortgage or sale of the District’s commercial property and development sites; and capital raised by the sale of residential units at market, including the Bank’s eighty percent share in the surplus over investment generated by the sale of joint-tenancy units, or the sale at market of units whose occupants have not joined joint tenancies or become owners under existing law.
F. Housing Allowances for the Poorest Families

The District should provide a housing allowance to families whose incomes are so low that they cannot afford the maintenance and loan repayment costs of living in a joint tenancy. The source of funds for the allowance should be the surplus of commercial rents over the District's cost in maintaining publicly owned commercial property. This source of revenue should be strictly tied to providing housing allowances, and not be incorporated in the general District budget.

G. Retention of a Limited Social Housing Sector

The District should retain a certain number of units in joint tenancies, and perhaps a small number of whole buildings. The units the District retains should be managed by the District as a fully public "social housing sector." These units should be reserved for individuals or families that are unable to manage their own housing affairs, including disabled, elderly, mentally ill, and socially disorganized households.

Through the Bank, the District may purchase units in joint tenancies, offered for sale voluntarily by their owners, at a price representing the cost to the Bank of exercising its right of first refusal. The joint tenancy in which such a unit is located has no right to prevent such a sale.

II. The District Development Bank

The District Development Bank would be created as a private financial institution, with majority control by the District, operating for profit with the goal of developing the District's residential housing stock through the system of limited-interest joint tenancies.

A. Goals and Activities

The Bank's goals are:

1. to amass and allocate capital for the development of the residential housing stock;
2. to create incentives for the creation and operation of limited-interest joint tenancies;
3. to recover and allocate the urbanistically created surplus from the growth of the District in such a way as to increase the residential housing stock, prevent the polarization of the stock between rich and poor, and preserve neighborhood stability.
The Bank has two primary activities. The first is to establish joint tenancies by transferring previously publicly owned buildings to their occupants, reserving an interest in the surplus of the future market sale price over the investment and interests of the unit owner and joint tenancy, and a right of first refusal. The Bank's second primary activity is making loans to joint tenancies for rehabilitation and improvement, and financing new construction in the joint-tenancy form. In addition, the Bank would perform several subsidiary functions, including providing a variety of financial and commercial services to joint tenancies in competition with private entities, or contracting for these services on behalf of joint tenancies (thereby increasing their bargaining power). These services would include insurance and real estate brokerage, and building operation.

The Bank's profit orientation means that its activities must be commercially sound in each area, and not based on state subsidies. The Bank is not an administrative agency, and has no regulatory power. Nor is it part of the state or municipal bureaucracy. It will make financial and other services available to the joint tenancies and others, at prices that allow it to cover its costs fully over time. More generally, it would influence the joint tenancies and the general development of the locality's housing stock through its choices in allocating capital and by providing incentives.

B. The Bank's Structure, Management, and Dividend Policy

The founders of the Bank would be the District government and (preferably) a foreign partner. After the Bank's establishment, the two founders would sell part of their shares so that there would be four types of shareholders:

1. the District's government;
2. the foreign partner (either a commercial bank or a foreign insurance company);
3. joint tenancies that wish to invest in the Bank's shares; and
4. individual owners of joint-tenancy units who wish to invest in the Bank's shares.

The District government would hold more than fifty percent of the shares. It would contribute occupied publicly owned units, for conversion to limited-equity joint tenancies, and would also contribute vacant publicly owned units, for conversion or sale at the market price. The foreign partner would hold approximately twenty percent of the shares, and would contribute money capital in hard currency. Joint tenancies would hold approximately twenty percent of the shares, and would contribute either in the form of money capital, or in kind (turning over the ownership of the building to
the Bank). Individual joint-tenancy unit owners would hold approximately ten percent of the shares, and would contribute either in the form of money capital or in kind.

There should be provision for change with respect to the participation of joint tenancies and individual owners. During the initial period after the founding of the Bank (for instance, for the first ten years), the system of participation should be fixed. But at a later point it might be desirable to increase the basic capital of the Bank by increasing the contribution of joint tenancies and individual owners. It should be possible to change the structure to accommodate this increase, and, if advisable, an eventual shift in majority control from the District to joint tenancies and individual unit owners.

Individual owners of units in joint tenancies would have the minority control rights that the Company Law allocates to a block of ten percent of the total shares. These rights would be granted even if all individual shareholders taken together do not represent ten percent of the shares of the Bank.

The District government and the foreign partner would have the right to representation on the Board of Directors and the Board of Supervisors. However, their representatives would not have a majority of the votes in either body.

If dividends are paid to shareholders, linear (pro rata) distribution would be the rule. The articles of association should contain a provision stating a preference for the reinvestment of profits in the development of the residential housing stock. It should require a qualified majority of the General Meeting to decide to pay a dividend to shareholders.

III. The Bank's Loan Program

Crucial to the success of our proposal is that it include a formula for allocating the Bank's residential housing development capital among buildings that consent to become joint tenancies. This formula should make sense on the assumptions that there is little or much capital available, and few or many buildings that are willing to become coops. The amount of capital available and the number of buildings that will convert are unknown, and will depend in part on the design and success of the program over time. Therefore, this initial formula should be regarded as decidedly provisional. As conditions change, the formula will have to change also.

The formula needs two components: one setting amounts of loans for different kinds of buildings, and a second setting an order of allocation of available funds. We assume that, other things being equal, the Bank will make a larger loan to a building of lower comfort level than to one of higher comfort level, and a larger loan to a building in a more deteriorated condition.
One approach would be to distribute the loans according to the time of application. But it might be much more useful to set up a determinate sequence of buildings or neighborhoods, and require their occupants to choose their form of organization according to the Bank's timetable, rather than their own. The reason for this is that the loan program has two goals. The first is to bring about the improvement of the stock from the bottom, that is, beginning with the units that are in the worst condition and have the lowest level of comfort. The second goal is to induce occupants of buildings with presently or potentially high market value to enter the joint-tenancy program, thereby securing the urbanistically created surplus to the Bank.

Both of these goals are necessary for the equitable distribution of the benefits of privatization. Specifically, both are necessary to prevent privatization of publicly owned housing from randomly distributing the windfall of a very valuable apartment to those families that happen to occupy units that have a good location, or are on the path of future development. These occupants are no more entitled to a sharp, unearned increase in their wealth than are occupants of units that are farther from the city center and structurally less desirable. Indeed, those who live in the less desirable units arguably have a greater claim to gain some benefit from privatization than those who are already well provided for.

The goals are to some extent in conflict. We can illustrate the conflict by looking at two extreme cases. At the upper extreme, there are buildings that are upper-income, in good condition, and have a high market value. At the other extreme, there are buildings that are in poor condition, are low-income, and have low market value. At the upper end, it will take a very large loan, but one that is not socially desirable, to induce the upper-income building occupants to enter a limited-interest joint tenancy. At the bottom end, incomes are low enough that the loss of the current maintenance subsidy, when moving from a low rent to a joint-tenancy regime, will make conversion unattractive. Adding the costs of a rehabilitation loan just makes the situation worse. For the upper group, it makes sense to go for the most extreme market solution; for the lower group, any amount of market system is more than they can afford.

If we allocate the loans building by building, adjusting the amount in each case to induce every unit to enter a joint tenancy, we would end up allocating most of the loan funds to a small number of upper-income families that already occupy excellent housing. The rest of the total loan funds would go to the great majority of middle-income occupants in middle-condition buildings. The low-income group would not participate at all.

On the other hand, if we adopt a single formula based on the condition and quality of the building, the number of buildings that convert to joint
tenancy will depend on how high the loan is. The best buildings with the highest value are likely to stay outside the system, unless it is possible to raise an unrealistically large amount of capital, and no amount of loans will make conversion attractive to low-income buildings. The conflict will be less extreme to the extent that some high-value buildings close to the center are in very bad condition and/or occupied by lower-income families, and some low-value buildings far from the center are occupied by middle- or upper-income families.

The District should take action to make the conflict less extreme by increasing the incentive for occupants of high-value buildings to convert to joint tenancies. The obvious way to do this is to eliminate or modify the present practice of selling units to occupants at fifteen percent of market (or less). The reason for doing this is that it is immoral for the State to distribute a large, unearned, wealth increase on the basis of the random fact of occupying a publicly owned unit with a high market value.

The fact that many of these occupants purchased their units on the gray market does not support giving them full ownership of their units for a fraction of market value. The reason for this is that the District's joint tenancy scheme guarantees them the present value of their gray market investment, as well as perpetual occupancy rights. There is no valid reason to give them more than this.

If it is not possible to eliminate the fifteen percent sales, it should be possible to slow them down, by administrative measures, or to modify the procedure by insisting on the full observance of all substantive and technical requirements of the law. To the extent such a policy of full enforcement of all the provisions of the law makes it much more difficult to buy at fifteen percent, occupants should be more willing to enter joint tenancies in exchange for reasonable development loans (plus protection of gray market investments and occupancy rights).

Another possibility is a compromise between the goals. This would require reestablishing two different loan formulae, one for low-market-value buildings and another for high-value buildings. But, the high-value formula should be less than necessary to induce all high-value buildings to enter the coop system, and the low-value formula should be more than is likely necessary to induce these buildings into the coop system.

It may be politically impossible to implement a proposal of this kind. The reason would be that it openly discriminates between buildings according to their market value, giving a larger loan to a higher-market-value building, even when it is in exactly the same condition as a low-market-value building. All the same, it would be desirable to effect such a discrimination, because it would increase the ability of the Bank to provide development loans in the future for low-market-value buildings. It would do this because it would
increase the number of high-value buildings in which the Bank holds an interest (eighty percent of the surplus of market value over occupant investment).

When units in these buildings are sold, the proceeds that go to the Bank become available for further development loans that would be targeted to low-value buildings. Moreover, this Bank interest will capture increases in urbanistically created value over the indefinite future, providing a perpetual fund for improvement of the housing stock.

Yet another compromise solution would be to begin with a single formula, granting relatively large loans for conversion, and to target these loans administratively to high-value buildings. When this targeted program has led to the conversion of many high-value units, the Bank would change the formula, reducing the amount of loans. It would then use these smaller loans to induce the lower-value buildings to convert to joint tenancies.

The procedure would be for the District to adopt a privatization program that proceeds, building by building, under a single formula. When a building is selected for privatization, the occupants have three choices:

1. enter the coop system in exchange for a loan determined according to the formula;
2. all occupants buy their units at fifteen percent, or whatever the existing law allows; or
3. give up their units to the Bank possibly in exchange for equivalent housing elsewhere.

Here it would be necessary to adopt some set of regulations governing how the occupants of the building vote in deciding which course to follow. It would be important to structure the regulation to give a preference for a joint-tenancy outcome. One way to do this would be to convert the building automatically to a joint tenancy (with a loan according to the formula) unless eighty percent of the occupants wished to purchase the building under the existing fifteen percent law. This would allow low-income occupants, who have no desire to move, and no funds available to pay for both higher maintenance costs and purchase-loan costs, to block the sale—as long as they make up more than twenty percent of tenancy. They would have a preference for the joint tenancy because of the absence of any initial cost of purchase, and the availability of a low-cost development loan. The joint-tenancy organization suggested in the Appendix would also give them some protection from a later decision by an upper-income building majority to greatly increase monthly charges in order to upgrade the building.

None of these proposals (eliminating or restricting sales at fifteen percent; adopting two formulas instead of one; implementing two formulas over time) will help draw the lowest-income occupants into the joint-tenancy
system. They can barely afford their current low rent; they could not afford the actual maintenance done on their units; they could not afford the carrying charges on anything but very small rehabilitation loans. To deal with this problem, we propose a combination of a housing allowances program, and retention of fully public housing units. The initiation of the joint-tenancy conversion program does not require the District to change its administration of units that remain public. But as the District’s total expenditures for maintenance are reduced by the conversion process, the cross-subsidy, from the excess of commercial rents over maintenance costs, will become available for concentration on low-income occupants and units.\textsuperscript{10}

The joint tenancy program may be worth pursuing to the extent of available loan capital, even if the relevant calculations\textsuperscript{11} show that relatively few high-value buildings can be converted. The reason for this is that future urban growth will cause large, unpredictable increases in value. If the District converts most of the currently low-value stock to limited-interest joint tenancies now, it will be able to direct the use of these certain, but spatially unpredictable, value increases when they occur. In other words, there is probably no “threshold” loan amount, or a threshold number of convertible buildings, below which the program is impractical or useless. Even a small program would be worthwhile, and a small program should not be much more expensive per building than a large one. Before extending this analysis to deal with the issues of housing allowances and the retention of a fully public “social housing sector,” we need some reaction to what has been done so far, and some idea of the feasibility of the different options we have outlined.

IV. The Internal Organization of the Joint Tenancies

This section discusses, although only in a very preliminary way, the important legal question of the internal organization of the limited-interest joint tenancies. When the occupants of a building decide they want to participate in the District’s program, they form a joint tenancy. If they wish to receive a rehabilitation loan from the District Development Bank, they have to agree to a particular organizational form. What should that form be?

In a general way, there are three very different models for the internal organization. The first model is based on maximum protection for the rights of individual unit owners at the expense of all other objectives. In this model, a single unit owner would be allowed power to require the joint tenancy to achieve a prescribed level of maintenance of common areas, to prevent the building from exceeding that level, to modify, lease, divide, or deteriorate his own unit without interference from the joint tenancy, and to take advantage of rigorous procedures, including judicial review, before the joint tenancy could evict him for nonpayment of charges or misconduct. Moreover,
there would be sharp limits on the extent to which the joint tenancy could regulate the behavior of its members with respect to the use of the apartment and common areas.

The second model is just the inverse of the first, locating much power in the joint tenancy over all these matters, so that a majority of the unit owners have a maximum ability to actually undertake self-management.

The third model locates the power neither in the individual unit owner nor in the majority of shareholders of the joint tenancy, but in an executive or management body. The virtue of this third model is that it retains the power of the joint tenancy, but relieves the unit owners from having to participate directly in decisions, like that to evict for nonpayment, that are likely to be controversial and unpleasant.

We do not believe that there is any form of internal organization that will eliminate all problems. Each form has its own serious weakness and vulnerability to abuse. Any practical form of organization must be a compromise between the three models. The compromise should be drawn with great attention to the particular characteristics of the group that will be bound by it. The Draft Charter of a Limited Equity Cooperative that we have included as an Appendix to this paper sets out one possible resolution of these issues, but as a starting point for discussion rather than a firm proposal.

Appendix

Draft Charter of a Limited-Equity Cooperative

A. The Association

1. The Association has legal personality:
   a. the Association owns the building or buildings;
   b. the Association consists of the shareholders:
      i. every unit owner, with one share apiece,
      ii. the District Development Bank, with one share;
   c. except for the DDB itself, no owner or lessee of a unit in another limited-equity cooperative established by the DDB can own a share representing a unit in this Association;
   d. the Association can be dissolved only by unanimous vote of the Association, including the DDB;
   e. except as specified in A(3)(ii) below, this Character can be modified only by unanimous vote of the shareholders, including the DDB.

2. The governing body:
   a. composed of one vote per unit (the DDB is not part of and has no vote in the governing body);
b. decision by majority vote of unit owners present except in the cases indicated below;
c. notice, quorum, and procedural requirements as specified in [the Act governing Cooperative Associations].

3. **Powers and rights of the governing body:**
   a. determination of expenditures for maintenance, rehabilitation, and renovation;
   b. power to borrow money for maintenance, rehabilitation, and renovation;
   c. determination of fees, charges, and assessments to unit owners to cover the obligations of the Association;
   d. right to ten percent of the excess of market price over investment on the sale of any unit;
   e. right to sell any unit that has no owner entitled to occupancy (for instance, as a result of foreclosure of the interest, death without succession by a "member of the immediate family" [see below], and so forth);
   f. approval of transfer of whole or part of unit ownership:
      i. approval of new unit owners,
      ii. approval of sublessees of a whole unit,
      iii. approval of rent-paying co-occupants,
      iv. approval of use of unit as security for loans;
   g. regulation of unit condition:
      i. required minimum maintenance by unit owner when it affects other units,
      ii. regulation of physical modification of units, as by internal subdivision, addition or modification of windows, enclosure of balconies, and so forth;
   h. regulation of conditions of occupancy, including:
      i. commercial or other nonresidential use,
      ii. number of occupants, unrelated occupants, children, pets, and so forth;

   [Alternative: At the time of adoption of the Charter, the Association adopts a set of regulations with respect to the matters in §§ (f), (g) and (h) above. Because the unit owners have entered the Association in reliance on these regulations, there should be a further Charter provision:]
   i. when they are incorporated into the Charter, the governing body can modify regulations under headings (f), (g) and (h) above only by a two-thirds vote of unit owners.

4. **The building committee:**
   a. the governing body shall elect a building committee for a fixed term, subject to removal at any time by the governing body;
   b. the building committee has legal power to act on behalf of the associa-
tion (make contracts, and so forth) in relation to legal entities external to the Association, but cannot bind the Association to anything but a "routine maintenance expense" without a prior vote of the governing body;
c. the building committee is responsible for the collection and payments of fees, charges, and assessments to unit owners to cover the obligations of the Association;
d. the building committee has power to enforce the regulations of the governing body against unit owners, subject to the specific provisions defining the rights of unit owners.

5. Limitations on the powers of the Association, the governing body and the building committee:
   a. no action shall be taken that is inconsistent with the rights of unit owners as specified below;
   b. no action shall be taken that is inconsistent with the rights of the District Development Bank as specified below.

B. The Rights of Unit Owners

1. The unit owner has the property rights over his unit specified in the [Act Governing Jointly Owned Apartment Buildings] except as expanded or limited by this Charter.
2. The financial interest of the unit owner consists of his investment, defined as initial valuation plus improvements, plus ten percent of market value in excess of investment.
3. The unit owner has the right at death to devise the unit to a member or members of his "immediate family," [as this term is defined... ] and such a devise is not subject to disapproval by the Association. The owner can devise his financial interest in any way consistent with the [Statute of Wills]. In the case of a devise to a person not a member of the "immediate family," the occupancy right and the right of sale pass to the Association. In the case of intestacy, the members of the "immediate family" inherit full ownership in the order specified in the [Act on Intestate Succession]. If there is no member of the "immediate family" entitled to the property, the financial interest passes according to the [Act on Intestate Succession], but the occupancy right and the right of sale pass to the Association.
4. The unit owner has the right to sell his unit at any time for any price, subject to the rights of the Association and of the District Development Bank as specified in this Charter.
5. The unit owner has the right to sublease his unit, to subdivide it, or to rent an undivided portion, in accordance with the following rules: [this EXTREMELY IMPORTANT provision needs to be worked out so as
not to defeat the whole scheme by the creation of a class of landlords of cooperative units].

6. With respect to the imposition of any sanction against him by the governing body or the building committee, a unit owner has the procedural rights specified in the [Act Governing Cooperative Associations].

7. After a decision by the governing body or building committee to impose a sanction on him, a unit owner has the right to [review by the Dispute Resolution Body of the District Development Bank]. That body shall resolve the dispute consistently with the mandate of the DDB to promote housing affordability and neighborhood stability.

8. In the event the governing body decides on expenditures above and beyond “normal maintenance” requiring an increase in fees, charges, and/or assessments that would “significantly reduce the affordability of the building,” any unit owner can appeal the decision to the [Dispute Resolution Body of the DDB]. That body shall resolve the dispute consistently with the mandate of the DDB to promote housing affordability and neighborhood stability.

9. In the event the governing body chooses a level of maintenance that threatens “to significantly reduce the quality of the building,” any unit owner can appeal to the [Dispute Resolution Body of the DDB]. That body shall resolve the dispute consistently with the mandate of the DDB to promote housing affordability and neighborhood stability.

10. Any unit owner can challenge any regulation or by-law (not part of this Charter) of the Association before the [Dispute Resolution Body of the DDB], which shall invalidate it if it is “unreasonable,” having due regard to the mandate of the DDB to promote housing affordability and neighborhood stability.

C. Rights of the District Development Bank

1. The DDB has the right to apply to court to place the Association “in receivership” in the event of mismanagement or abuse by the governing body or building committee.

2. The DDB has the right, on sale of a unit at the market price, to eighty percent of the excess of the market price over the investment of the unit owner.

3. The DDB has a right of first refusal of any unit offered for sale by the owner or by the Association.

4. The DDB has the right, if it chooses to purchase a unit from the owner or from the Association, to sell the unit below market price, and the governing body has no right of approval of the buyer.

5. The DDB has the right to lease any unit it owns at a rent of its choosing, and the governing body has no right of approval of the lessee; provided
that: if the DDB chooses to rent a unit that it owns, the tenant, and not
the DDB, shall exercise the rights of a unit owner in the governing body.

D. General Clauses

1. In the event of any dispute arising about the interpretation of this Charter,
the body adjudicating the dispute shall interpret this document so as to
protect and further the rights of the individual unit owners, the rights
of the Association as a whole, and the public interest, represented by
the DDB, in development of the housing stock, housing affordability,
and neighborhood stability.

2. Neither the Association, the governing body, nor the building committee
shall, by any act or omission, discriminate against a unit owner, or an
applicant for any form of occupancy of a unit, on the basis of race,
ethnicity, religion, gender, sexual orientation, physical disability, marital
status, or income.

3. Each signatory of this Charter agrees to abide by its provisions in good
faith. In the event of any dispute arising about the interpretation of this
Charter, the body adjudicating the dispute shall interpret the document
so as to prevent any party from acting otherwise than in good faith with
respect to its particular provisions and general spirit.

Notes

1. We are not using the term joint tenancy in any technical legal sense. We discuss
the possible legal forms of the joint tenancy below. See Section I. C., infra.

2. We discuss some of the important questions relating to the internal organization
of the joint tenancy in Section IV infra.

3. Another possibility would be to determine the gray market value as of a specified
date. Yet another would be to set the investment as key money paid to the
state, or a verifiable gray market payment to a private party, and allow for
improvements and interest from the date of first occupancy. We do not have
enough information to make a recommendation on this point.

4. See Section I. G. infra.

5. The Bank’s interest is as described above.

6. See Section IV. infra.

7. For the mechanics of such an allowance, see Raymond J. Struyk and Jozsef
Hegedüs. Integrating State Rental Housing with the Private Market: Designing
Housing Allowances for Hungary (Washington, D.C.: Urban Institute Press,

8. Further analysis of the design of the loan program requires information about
the actual composition of the stock, the quantity of loan capital that might be
available, and the political preferences and constraints under which the program will be carried out. The main questions to be answered or estimated would seem to be: (1) How are the existing buildings distributed according to market value? (2) For loans of different amounts, what proportion of buildings of different value would convert to joint tenancies? (3) Assuming either a single formula for all buildings, or different formulas for high- and low-value buildings, what would be the total cost of the whole loan program for different levels of conversion of the whole stock?

In addition to these matters, we need to have an idea of the distributive consequences of making large loans to induce high-value buildings to convert. Specifically, we need to know the correlation between market value and income of occupants, the correlation between market value and comfort level/deterioration, and the correlation between comfort level/deterioration and income. On the basis of this information, it should be possible to estimate roughly the trade-off between, on the one hand, inducing more high-value buildings to convert, and, on the other, distributing the loans equitably in terms of comfort level, building deterioration, and income level.

9. See note 8 supra.