

## Chapter 9

# Enforceability of the CLT's Preemptive Right

*Editor's note: This chapter was written by Deborah Bell, a professor in the University of Mississippi Law School. It was first published in 1991 by the Institute for Community Economics in the CLT Legal Manual, and is presented here without revision. In the view of the CLT Network, the chapter continues to provide a useful overview of the legal principles that affect the enforceability of the CLT's preemptive right to control the resale of CLT homes. Furthermore, as far as the CLT Network is aware, the enforceability of the CLT's preemptive right has not been denied by any court of law in the two decades since the chapter was first published.*

The preemptive right may well be the most crucial feature of the community land trust model. It is therefore important for organizers of CLTs to anticipate certain questions that may be asked about the legal validity of the preemptive right, and to be prepared to explain why the provision should be enforceable. This chapter discusses the importance of the provision, explains the source of questions about its legality, and outlines the reasons that it should be enforceable.

### The Importance of the Preemptive Right

The CLT's preemptive right is a right to purchase the home of a ground lessee for a price limited by a specified "resale formula" (see Chapter 12 regarding the design of specific formulas). The right of repurchase alone, even without the price limitation, is important because it permits the CLT to see that the new purchaser is one of the group the CLT was created to serve. Nonetheless, in some circumstances, the preemptive right would have little real effect without the price limitation. If a CLT is forced to repurchase a highly appreciated home at a market price, it will probably be unable to make the home affordable for another lower income person. In rapidly appreciating real estate markets, the CLT cannot achieve its goal of preserving affordability unless the preemptive right can be enforced at the limited price.

On a different level, the preemptive right to purchase at a limited price is important as an expression of the basic principle that underlies the CLT model: that land, as a finite resource, should not be used as a source of speculative gain; that increases in property value not attributable to an individual's effort should benefit the community as a whole and not the individual land owner. The preemptive right to purchase at a limited price is the implementation of this idea and the residents' expression of commitment to the concept.

### The Questions of Enforceability

Clearly, a model of ownership that limits resale prices so as to divide value between individuals and the community departs rather drastically from customary American patterns of land ownership. Organizers of land trusts may face questions from a variety of people about whether the preemptive right to purchase at a limited price can be legally enforced. Their questions are likely to focus on two aspects of the right: first, the fact that the limited price may be below market rate, and second, that the right does not expire

after a certain length of time but potentially goes on (from one lease term to another) forever.

The basis for the concern about the below-market price is that American law tends toward the view that the current owner of land should be able to do with it whatever she wishes, including selling it at any price, and that the one who transferred the property to her (here the CLT) may not put limits on her full ownership by limiting her rights of disposal. In legal jargon, this rule is called the “rule prohibiting unreasonable restraints on alienation.”

The concern about the length of the preemptive right stems from the view of American property law that one generation of landowners (the CLT) should not be able to create an interest in land (the preemptive right) that can be exercised at a distant time in the future. This view is embodied in the “rule against perpetuities.” Lay readers should not be intimidated by the legal language; the essence of the two rules is explained below, and many lawyers do not themselves understand the more technical aspects of the rules.

There are very sound and logical responses to these questions, the most significant of which is that the American property rules do not necessarily accomplish their stated purposes while the CLT actually does accomplish those purposes. More technical legal responses are also discussed in this chapter. In addition, certain cautionary measures are proposed for inclusion in CLT documents to reassure those with concerns about the validity of the preemptive right. An understanding of these materials is a valuable tool in planning and organizing a CLT, as well as an important part of the education process regarding land ownership and needed changes in the American land tenure system.

### **The Limited Price Preemptive Right and Restraints on Alienation**

One of the most basic tenets of Anglo-American property law is the “free transferability” of land. By the 1800s, English and American judges had developed a series of rules designed to ensure that the current owners of property could dispose of it as they chose, with few restraints imposed by the previous owner. The assumption was that it was socially and economically desirable for landowners to acquire absolute control over their property, and restraints imposed by previous owners were thought to be repugnant to the very nature of ownership. The specific policy reasons for this focus on full ownership were: (1) to prevent the concentration of wealth caused by transfer restrictions that the landed aristocracy placed on their property; (2) to encourage commerce by making land more freely transferable; and (3) to provide incentive for owners to improve and develop land by guaranteeing that they could recover their investment through unrestricted sale.

The policy favoring consolidated ownership in one person is today expressed in the rule prohibiting unreasonable restraints on alienation. Even indirect transfer restrictions, such as the CLT preemptive right, must be examined under the rule to determine the restriction's validity. Most courts look at the following factors, set out in the Comments to the Restatement of Property, to determine whether a particular restraint is reasonable: whether the restraint (1) protects a property interest of the one imposing the restraint; (2) accomplishes a worthwhile purpose; (3) is limited in time; (4) prohibits a transfer that the owner would be unlikely to make anyway; (5) only excludes a small number of potential transferees. The Restatement approach balances between interests of the previous owner and society in enforcing the restraint (factors 1 and 2) and the extent of the burden placed on transfer by the current owner (factors 3, 4, and 5). A restraint is invalid if it serves no

reasonable purposes or if the burden on transfer is so great that it outweighs the value of the restriction. In making this determination, it is important to consider the policy goals of wealth dispersal, economic development, and property improvement that underlie the rule.<sup>1</sup>

Application of the first two factors clearly shows that the CLT preemptive right serves a reasonable purpose. Without question, the right protects the CLT's interests; it is crucial to the actual operation of the land trust. The right also serves the repeatedly emphasized public goal of providing much needed affordable housing. On the other hand, it may be argued that the right does burden or inhibit transfer to some extent. The preemptive right certainly limits the number of initial transferees (factor 5) by requiring transfer first to the CLT or income-qualified persons; however, this fact alone is not likely to invalidate the right. A resident would not be discouraged from improving or selling simply because she was required to offer the house first to the CLT or income-qualified persons. In fact, depending on the specific resale formula involved, she may be more likely to improve or sell the property, having assurance of at least one potential buyer.<sup>2</sup>

It is the limited price aspect of the right that, at first glance, reduces the owner's incentive to transfer (factor 4). If she is limited to simply recovering her investment, rather than fully profiting from an increase in market value, the owner may hold the property rather than selling if she has no personal reason to move. She will not be motivated to sell by an increase in her property's market value that she cannot claim for herself. Thus, the argument would go, the price limitation does hinder free transferability of the property.

At this point in the analysis, it is instructive to recall exactly why free transferability is important. One of the reasons for encouraging transferability is to prevent concentration of wealth. The limited price preemptive right may actually accomplish this goal better than the rule against unreasonable restraints itself.<sup>3</sup> If property can always be bought by the highest bidder, a substantial number of people are completely excluded from ownership of property. By keeping the property available at a reasonable price, the CLT model disperses ownership and prevents concentration of property in the hands of the wealthy.

Another stated reason for the rule is that restraints on transfer may discourage improvement of property.<sup>4</sup> The limited price preemption should not discourage improvement because CLT resale formulas generally allow homeowners to recover the cost or value of improvements as part of the resale price, though specific formulas vary in the extent that they do so (see Chapter 12).<sup>5</sup> Furthermore, the CLT model should encourage improvement and prevent deterioration by putting residential property in the hands of owner-residents who have more incentive to fix up property than do absentee landlords. The promise of long-term security of tenure for residents may well be the best method for encouraging improvement of residential property.

The only remaining objection to the limited price preemption is that it will impede commerce because a resident will not have the special motivation to sell that is provided by increases in the market value of the home. There are two responses to this objection. First, the goal of encouraging commerce and economic development focuses on general commerce and not commerce with respect to one piece of property. While the price limitation may prevent a resident from selling a particular piece of property to the highest

bidder, it may improve commerce in general by decreasing housing costs and freeing up dollars for use in other markets. In addition, several courts have noted that where a limited price preemption was an essential part of the original transaction, it has encouraged commerce, because the original transfer might not have otherwise occurred.<sup>6</sup> This reasoning is certainly applicable to CLT transfers. The second response to the objection regarding commerce is that promotion of commerce is merely one of several societal goals, and must be balanced with other goals, including the need to provide adequate and affordable housing.

A review of the cases shows that limited price preemptive rights are generally upheld when they serve a legitimate purpose or promote significant public policies, and when the person giving the option received some benefit in return. Limited price rights that have been held unenforceable are those in which the person demanding the option had no legitimate interest in the property or where the only purpose was to restrain alienability.<sup>7</sup>

In summary, the preemptive right promotes significant interests of the CLT and society, while at the same time actually accomplishing the original purposes of the rule prohibiting unreasonable restraints – dispersing wealth, encouraging improvements, and promoting commerce by increasing the disposable income of its residents. To the extent that it places some limit on transfer of a specific piece of land, the burden is outweighed by the accomplishment of the goals of the CLT and societal housing goals.

### **The Indefinite Preemption and the Rule Against Perpetuities**

CLT organizers may also face questions regarding the duration of the preemptive right. The land trust resident is permitted to transfer the home and lease from generation to generation, and the preemptive right applies to decisions by later generations of residents to sell the property. Thus, the preemptive right is designed to continue in effect as long as the ground lease continues in effect.

As a part of the emphasis on “full” ownership by the current owner, English and American judges viewed with disfavor certain interests in land that would not take effect until long in the future. Future interests were believed to hinder free marketability, keeping property out of commerce. In addition, it was thought undesirable to let a past generation curtail the use and transfer of property in a present generation's hands (referred to as “Dead Hand Control”).<sup>8</sup> These policies found expression in the “rule against perpetuities,” which is one of the most confusing and frequently criticized of modern property rules. Unlike the more general rule prohibiting unreasonable restraints, the rule against perpetuities accomplishes its goal of free transferability only to a limited extent, by focusing on a very narrow range of future interests called “contingent” interests. Specifically, the rule requires that “contingent” interests must become “vested” within twenty-one years of a “life in being” or the interest is invalid.

Explaining the meaning of “contingent,” “vested,” and “life in being” is far beyond the scope of this chapter; it is sufficient to know that, under the traditional approach to the rule, a preemptive right to purchase is “contingent;” it was considered to “vest” when the current owner decided to sell, thereby triggering the operation of the right.<sup>9</sup>

Applying the old approach to the CLT model, the preemptive right violates the rule against perpetuities because it could become operative for the first time more than twenty-one years after the death of the original resident. It is quite conceivable that a home on CLT land could be passed from the first resident to her children, then to her

grandchildren, and that a grandchild would decide to sell the property more than twenty-one years after the original owner's death.

Recently, however, courts have begun to move away from holding that a preemptive right that extends beyond the perpetuities period is automatically void. Instead, they view the option as a possible restraint on alienation subject to the test of reasonableness discussed above.<sup>10</sup> The duration of the option then becomes simply one of the factors to be weighed in determining whether the benefits of the option outweigh its burden on commerce. These courts have frequently upheld perpetual options, stating that the rule against perpetuities was created with policy considerations in mind, and should be applied with those policies in mind. Thus, a preemptive right that does not hinder transferability or discourage improvement does not violate the rule.

Although no court has considered the validity of a CLT preemptive option, a review of recent cases illustrates the likelihood that it would be upheld. In every case involving cooperatives or condominiums, the litigated ownership models most closely resembling the CLT, courts have refused to set aside perpetual preemptive rights under the rule against perpetuities. They have emphasized that the rule against perpetuities developed at a time when condominium ownership was unknown, and have stated that the rule should not be mechanically applied but evaluated in light of the policies behind the rule:<sup>11</sup> "The law of property ... is not a mathematical science but takes shape at the direction of social and economic forces in an ever changing society, and decisions should be made to turn on those considerations."<sup>12</sup> In balancing the usefulness of preemptive rights against the possible harm of their use, courts have stressed the important public policy of providing affordable housing,<sup>13</sup> have noted that the preemptive right is a useful tool for establishing a protected residential community free from non-residential uses,<sup>14</sup> and have found that the ordinary preemptive right places little burden on transferability. In fact, even courts that have struck down preemptive rights in other contexts have recognized that condominiums involve unusual interests that need not be subjected to the rule against perpetuities.<sup>15</sup>

There is no reason why the same result should not be reached in an analysis of the CLT preemptive right under the rule prohibiting unreasonable restraints. As discussed above, the value of the CLT limited price right outweighs its burden on transferability. The only additional question to be addressed is whether the perpetual nature of the limited price right increases the burden to the extent that the benefit is outweighed. Again the only possible effect is the long-term availability of CLT property to the highest bidder. While this may perpetually limit commerce with respect to a particular piece of property, it may also permanently improve local commerce by increasing the buying power of a number of persons in the area who would otherwise be spending all their spare income on housing. In contrast to the negative effect on commerce of real estate speculation, the CLT right will have the positive effect of providing permanently affordable housing.

In summary, the preemptive right should not be held to violate the rule against perpetuities because (1) the modern approach is to analyze the right under the Restatement rule against unreasonable restraints, and (2) a balancing of the factors listed in the Restatement shows that the benefit to the CLT and society as a whole outweighs any burden imposed on transfer.

## Other Arguments

**Freedom of Contract.** Questions about both the durational and limited price aspects of the CLT preemptive right may also be answered by focusing on the voluntary nature of the arrangement. A number of courts have upheld options simply because it was clear that the party granting the option intended to create it, understood the agreement, and received something in return.<sup>16</sup> The fact that the land has since increased dramatically in value is not alone sufficient to make the option unfair.<sup>17</sup> This reasoning is equally applicable to the agreement between the resident and CLT. In exchange for the preemptive option, the resident has obtained assistance in purchasing housing, providing her with homeownership that might otherwise have been impossible.

**Rule Not Applicable to Preemptive Rights.** In some states it is not even necessary to reach the arguments above. The following approaches have been taken in various states, with the result that the preemptive right does not violate the rule against perpetuities.

- Some courts hold that the right is vested at the time it is created. In that case the rule against perpetuities is not violated because the rule simply requires interests to vest within the necessary period.<sup>18</sup>
- Some courts hold that the preemptive right is a contract right rather than a property right and does not come under the rule at all.<sup>19</sup>
- In a few states, legislatures have passed statutes that specifically authorize preemptive rights such as the CLT right.

Local counsel should be advised of these possibilities and requested to check the particular state's laws.

**Violation of the Rule Does Not Completely Invalidate Interest.** In a growing number of states, the approach to rule against perpetuities questions is to apply what is called the "wait and see" test.<sup>20</sup> Under this test, an interest is not completely invalidated because it might exceed the perpetuities period. Instead the court waits to see if the interest is actually exercised within twenty-one years of the appropriate measuring life. If it is, the interest is valid. Thus, even if a state follows the old rule of perpetuities with respect to preemptive rights, the CLT would be in no worse position than if it had originally designed an option to fit within the perpetuities period.

Other courts reach a similar result by finding that the parties intended that the interest not exceed the perpetuities period, and then imposing some reasonable time limit. Both of these methods indicate that courts are very reluctant to simply strike down any preemptive right that has a valid purpose and that the parties intended to create, even if it is designed to last forever. For these reasons, it is likely that an option such as the CLT right, which clearly serves overriding public interests, would be upheld.

## Protective Provisions

There are several measures that CLT organizers should take to ensure that the arguments set out above are effective, or that, if for some reason they are held invalid, their inclusion has not been damaging.

1. The purpose of the repurchase right and the public interests that it promotes should be emphasized in the lease. (See Model Ground Lease, Introductory ("Whereas") Section, and Section 10.1.)

2. The lease should very clearly document that the resident (a) understands and supports the purposes of the CLT; (b) has voluntarily entered into CLT ownership, realizing that the price limitation is a fair exchange for the CLT's provision of affordable housing; and (c) entered into the lease only after receiving a full explanation of the lease, including the resale agreement, and upon the independent and informed advice of counsel. Such a provision makes clear not only that the resident entered the contract freely, with a full understanding of its meaning, but also illustrates that the provision is substantively fair. (See Model Ground Lease, Article 1: Letters of Agreement and Attorney's Acknowledgement.)
3. The lease should make clear that the resident may recover her investment upon resale, including the value of improvements (to the extent that the particular resale formula allocates the value of improvements to the resident). A limited price preemptive right that does not account for the value of improvements would be more likely to be held violative of the rule prohibiting unreasonable restraints.
4. For protection in the unlikely event that the limited price aspect of the repurchase right is held unenforceable, the agreement should include a provision that the CLT will have a right of first refusal at the highest good faith offer received by the lessee if the repurchase option becomes unenforceable for any reason. (See Model Ground Lease, Section 14.5.)
5. The lease should provide that the CLT must exercise the preemptive right within a certain period of time or the right expires. Under the Restatement criteria for the reasonableness of a restraint, the durational factor may apply to the length of time for exercising the option after the owner decides to sell, as well as the actual length of time that the right exists. The Model Ground Lease affords the CLT forty-five days to elect to exercise its option (Model Lease, Article 10), a period shorter than some which courts have found reasonable under the Restatement.
6. The lease should provide that, in the event the preemptive right is held to violate the rule against perpetuities, the right will be limited to a time period not to exceed 21 years following the death of the last survivor of a specified group of "measuring lives." (See Revised Model Lease, Section 14.4.). It is of course possible to impose this time limitation from the outset and avoid any potential problems with the rule against perpetuities; however, because the perpetual aspect of the right is such a crucial aspect of the CLT, it is preferable to take the position that the rule does not apply to the CLT preemptive right for the policy reasons discussed in this chapter.

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<sup>1</sup> Comment to Restatement of Property 406.

<sup>2</sup> Courts have routinely held that a preemptive right in itself does not constitute an impermissible restraint. See Simes & Smith, *The Law of Future Interests*, Gray, *The Rule Against Perpetuities* 330 n.2, 61 Am. Jur. 2d 920. Comment to Restatement of Property 406.

<sup>3</sup> See *Gale v. York Center Community Cooperative, Inc.*, 171 N.E.2d 30 (Ill. 1961).

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<sup>4</sup> Some courts that have invalidated limited price options state that they have done so because the owner could not recover for improvements to the property. See e.g., *Iglehart v. Phillips*, 383 So.2d 610 (Fla. 1980).

<sup>5</sup> See *Gale*, *supra*.

<sup>6</sup> See *Emerson v. King*, A.2d 51 (N.H. 1978).

<sup>7</sup> See *Assoc. of Owners of Kukui Place v. Honolulu*, 742 P.2d 974 (Haw. 1987) (if policies promoted by the option outweigh those promoted by the rule, the option is enforceable).

<sup>8</sup> *Girard v. Myers*, 394 P.2d 678 (Wash. App. 1985) (no social importance).

<sup>9</sup> See *Alexander, The Dead Hand and the Law of Trust in the Nineteenth Century*, . L. Rev. 1189 (1985).

<sup>10</sup> See *Dukeminier, A Modern Guide to Perpetuities*, 74 Cal. L. Rev. 1867 (1986).

<sup>11</sup> *Shiver v. Benton*, 304 5.E.2d 257 (Ga. 1983); *Metro. Transp. Auth. v. Brukan Realty Corp.*, 479 N.Y.S.2d 646 (Supp. 1984); *Southeastern Pa. Transp. Auth. v. Philadelphia Transp. Co.*, 233 A.2d 15 (Pa. 1967); *Forderhouse v. Cherokee Water Co.*, 623 5.W.2d 435 (Tex. App. 1981).

<sup>12</sup> See *Cambridge Co. v. East Slope Investment Corp.*, 700 P.2d 537 (Colo. 1985); *Gale v. York Center Community Cooperative, Inc.*, 171 N.E.2d 30 (Ill. 1961); *Anderson v. So. East 72nd Street Condominiums*, 492 N.Y.S.2d 989 (Supp. 1985); see also *Association of Owners of Kukui Place v. Honolulu*, 742 P.2d 974 (Haw. App. 1987); *Chianese v. Culley*, 397 F. Supp 1344 (S.D. Fla. 1975).

<sup>13</sup> *Gale*, *supra*, 171 N.E.2d at 33.

<sup>14</sup> *Association of Owners*, *supra*.

<sup>15</sup> *Smith v. Mitchell*, 269 5.E.2d 608 (N.C. 1980).

<sup>16</sup> *Fenero Const. Co. v. Dennis Rante Corp.*, 498 A.2d 689 (Md. App. 1985).

<sup>17</sup> *Emerson v. King*, 394 A.2d 51 (N.H. 1978); *Edgar v. Hunt*, 706 P.2d 120 (Mont. 1985); *Izzo v. Brooks*, 435 N.Y.S.2d 485 (1980); *Smith v. Mithcell*, 269 5.E.2d 608 (N.C. 1980); *Lawsen v. Redmon Corp.*, 679 P.2d 972 (Wash. App. 1984).

<sup>18</sup> *Emerson*, *supra*; *Camalo v. Howard Johnson Co.*, 545 F. Supp. 395 (U.D. Pa. 1985).

<sup>19</sup> *Izzo v. Broades*, 435 N.Y.S.2d (1980).

<sup>20</sup> *Edgar v. Hunt*, 706 P.2d 120 (Mont. 1985); *Southeastern Pa. Transp. Auth. v. Philadelphia Transp. Co.* 233 A.2d 15 (Pa. 1967); *Robroy Land Co., Inc. v. Prather*, 622 P.2d 367 (Wash. 1980); *Stenke v. Masland Dev. Co.*, 394 N.W.2d 418 (Mich. App. 1986).