

9-23-2015

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Recommended Citation

Peter W. Salsich, Jr., *Response to Christopher Odinet, Super- Liens to the Rescue? A Case Against Special Districts in Real Estate Finance*, 72 WASH. & LEE L. REV. ONLINE 181 (2015), <https://scholarlycommons.law.wlu.edu/wlulr-online/vol72/iss1/8>

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Response to Christopher Odinet, *Super-Liens to the Rescue? A Case Against Special Districts in Real Estate Finance*

Peter W. Salsich, Jr.*

Professor Odinet's excellent article, *Super-Liens to the Rescue? A Case Against Special Districts in Real Estate Finance*,¹ calls attention to the increasing use, and the attendant risks, of special taxing districts to finance infrastructure for private residential developments. He focuses on a specific type of special district, what he terms the "development special district," in examining the pressures brought to bear on American local governments in the aftermath of the recent housing crisis and the Great Recession.²

A complex, ten-page hypothetical, reminding one of the intricate fact patterns law students often confront on final exams, introduces Professor Odinet's topic.³ A fictitious couple, Henry and Claire, purchased a home during the early stages of development of Beau Chateaux, a large, upscale, and gated community. Beau Chateaux offered a range of services and amenities paid for by the proceeds of bonds issued by a statutorily

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1. Christopher K. Odinet, *Super-Liens to the Rescue? A Case Against Special Districts in Real Estate Finance*, 72 WASH. & LEE L. REV. 707 (2015).

2. *See id.* at 723–25

In the wake of these events, political tolerance for centralized decision-making—and spending—has declined significantly. In its place has been a rise of an intense focus on cities and local governments. But municipalities have, in many ways, a heavier yoke to carry in the wake of the financial downturn [L]ocal government decision-making has been steered precariously toward the creation of more and more special taxing districts as an instrument for economic, financial, and cultural viability, which has, in turn, served as an invitation for abuse and poor policymaking.

3. *Id.* at 709–18.

authorized, city council-created governmental entity called a “development special district.” The development special district had been created at the request of Beau Chateaux’s developer. Its boundaries were co-terminus with Beau Chateaux. Its three-person board, selected by the developer and appointed by the city council, had the authority to issue bonds backed by the power of the special district to impose special assessments and property taxes on homeowners in Beau Chateaux.

Henry and Claire purchased their home at the top of the recent housing boom and did not notice that many of the lots remained vacant. When the Great Recession hit in 2007–2008, people stopped buying homes and lots in Beau Chateaux. Neither could the developer honor its obligations, nor could the development taxing district, which had issued a large number of bonds to finance the development’s infrastructure and amenities. After the developer declared bankruptcy, Realty Bank, which had financed the developer’s land acquisition, filed foreclosure proceedings. The bondholders also began foreclosure proceedings, setting up a duel for priority status. Beau Chateaux’s troubles mirrored those of the real estate market nationally, leaving millions of borrowers facing foreclosure:

As part of the special district legal structure, the nonpayment of special assessments charged against the parcels within the development—much like with traditional real property taxes—created a lien on the individual lots. These in turn could be foreclosed upon like any other security device. And, also like real property taxes, this lien—although the product of an entirely private enterprise, used entirely for profit, and the financing of which was controlled by the developer—is accorded superpriority over and above any pre-existing security rights . . . [including Realty Bank’s first mortgage] and, when foreclosed, would wipe out and completely destroy the lien of the bank.⁴

Henry, Claire, and the other residents of Beau Chateaux realized they were in trouble when both the bondholders and the bank took them to court over the relative priority of the two sets of liens. The foreclosure proceedings became wake-up calls for the residents, as they began to understand that not only was title to

4. *Id.* at 715 (internal citations omitted).

their homes in jeopardy, but also that the unfinished and neglected development infrastructure—streets, sidewalks, community park, community center, and golf course, as well as the large number of vacant houses and lots—was casting a pall over the value of their homes and those in adjoining neighborhoods.

Professor Odinet argues that widespread use of special taxing districts by private residential real estate developers played a major role in the housing collapse and resulting foreclosure crisis during the Great Recession. In his view, private developer use of special taxing districts led to four adverse results: (1) developer overextension of the special taxing districts, (2) producing substantial ripple effects in surrounding communities, (3) resulting in excessive subordination of residential mortgage loans, and (4) causing traditional real estate lenders and the residential secondary mortgage market to curtail sharply residential lending, particularly in lower-income neighborhoods.⁵

Development special districts are a variation of traditional special taxing districts commonly used to finance public infrastructure, such as water and sewer facilities or fire protection services for a relatively large area like a municipality or a county. He notes that special taxing districts have spread from one fire protection district in Rhode Island in 1797 to “roughly as many special districts as there are counties, townships and cities across the United States combined.”⁶

Professor Odinet explains that, while development special districts usually are established by local governments, they typically are organized to serve private residential developments governed by homeowners associations and cover much smaller areas within sponsoring municipalities and counties. Development special districts give private, profit-motivated developers access to the tax-exempt municipal bond technique as a financing mechanism for infrastructure to serve self-contained residential developments, including upscale, gated communities. Because of the Federalism principle limiting the ability of one

5. *Id.* at 718–21.

6. *Id.* at 736.

level of government to tax the income of another level of government, interest income on municipal bonds and notes is not taxable. Thus, the cost of borrowing money to finance residential development may be 1%–2% less through development special districts than through private lending sources. Bonds and notes typically are retired through payments made by residents receiving the benefits of development special district financing, usually through special assessments on their residential property.

Professor Odinet’s concern is the relative priority that should be granted these bonds and notes. He sharply criticizes state enabling legislation that grants development special district bonds and notes superpriority status over senior residential mortgage loans provided by banks to enable developers to acquire land in the first place. Superpriority status, in his view, can lead to several unintended consequences, including taking mortgage lenders’ property without just compensation, destabilizing the conventional mortgage market, causing the secondary mortgage market to shy away from purchasing residential mortgages within a development special district, and creating “a substantial negative effect on fundamental market fairness.”⁷

Odinet believes development special districts “have the potential to serve a valid purpose” if they are limited to financing the “development of areas that would otherwise be cut off from the lending market.”⁸ But he worries that cities will find the lure of potential economic development bonanzas “too tempting.” Professor Odinet believes “cities have become ravenous for new forms of tax revenues,” primarily because of the substantial loss in local revenue cities have suffered since the Great Recession as a result of significant declines in property values, along with severe cuts in federal and state financial assistance to local governments.

Odinet discusses reform possibilities, including a contractual mechanism requiring developers to obtain consent of first priority mortgage lenders before creating a development special district, and legislation restricting the use of development special districts

7. *Id.* at 758–78.

8. *Id.* at 740.

to projects which “could not occur without public support”⁹ and which would serve to “ameliorat[e] an economically depressed or underserved area.”¹⁰ The contract approach has a “major drawback,” in that local governments create development special districts and cannot be bound by private contract without their approval. He is wary of a legislative approach because he believes that state and local legislatures are unlikely to “truly evaluate each development special district request with a discerning eye.”¹¹

Professor Odinet settles on a recommendation that courts use the doctrine of equitable subordination “to police situations whereby special district liens were used in overreaching ways to the prejudice of the pre-existing rights of third parties”¹² He proposes a “two-step process” in which courts, using market analyses, economic studies, and risk analyses, would first determine whether the developer could have received financing through “traditional channels and achieved the same result as he did using the special district.”¹³ If the answer was yes, development special district liens “should be subordinated to the rights of the pre-existing mortgagee.”¹⁴ If the answer is no, the court should then move to the second part of the test to determine whether the developer could show through “substantiated evidence” that the project would provide “tangible benefits to an economically distressed area.”¹⁵ “[D]oes the development bring jobs, blight improvement, or other economic benefits to an area that is in need of investment, resources, and opportunity?”¹⁶ If the answer to this question is yes, “the superpriority of the special district lien should be respected.”¹⁷

9. *Id.* at 784.

10. *Id.*

11. *Id.* at 780–84.

12. *Id.* at 785.

13. *Id.* at 786.

14. *Id.*

15. *Id.* at 787.

16. *Id.*

17. *Id.* at 786–87.

Describing his approach as a “balancing of interests,” Professor Odinet compares it to long-standing federal bankruptcy court practice and the state court doctrine of unconscionable contracts. He asserts that in both situations, courts play an important role in balancing interests of competing creditors, as well as debtors.¹⁸

Professor Odinet’s approach merits careful consideration. Certainly the courts can, and should, police public debt transactions when interests of private parties are implicated. But has he overreacted in one direction to correct an overreaction in the other direction by cities and states before and during the Great Recession? He raises a basic policy question: to what extent should states authorize local governments to use public borrowing powers in the pursuit of private investment, and in the process provide superpriority status to special district liens that may prejudice the rights of prior mortgage lenders and other pre-existing creditors? To answer that policy question, he turns to the courts and the doctrine of equitable subordination previously noted.¹⁹ But courts are not supposed to make policy; their role is to resolve disputes that may arise out of the application of a given policy. Courts play a vital role in guarding against excessive favoritism and misuse of taxing and spending powers. But judges, for the most part, are appointed, not elected. They do not represent the people affected by use, or abuse, of development special districts.

We elect legislators to debate and resolve policy questions. We should not turn our backs on the legislative process because of excessive, and perhaps unwise, legislative decisions during a period of severe economic pressure and panic. Policy is established through the weighing and balancing that is the essence of the legislative process. The democratic ideals of inclusion and consideration of all relevant interests, and the necessary compromises by representatives of those interests, are fostered through the legislative process. It may be messy, but it is the essence of our democracy.

18. *Id.* at 788–90.

19. *See supra* note 5 and accompanying text (explaining the adverse results of private developer use of special taxing districts).

Professor Odinet's proposed test can be applied to the legislative process. State enabling legislation can limit city council authority to create development special districts by requiring the council to make a legislative finding that projects supported by development special districts provide "tangible benefits to an economically distressed area."²⁰ The same burden can be placed on a developer to provide "substantiated evidence," including "actual data and tangible evidence to support realistic projections as to the benefits that will accrue to the target area."²¹

The term "substantiated evidence" suggests evidence introduced by persons who testify under oath and are subject to cross-examination, a procedure which is not a formal part of the local legislative process. But the more informal nature of city council meetings certainly does not prohibit sharp questioning of witnesses and close examination of data presented by those witnesses. Most municipalities have access to professional analysis of development proposals, either from their own staff or by contract with private planning firms or higher level governmental organizations (county or state). Granted, the track record for local government scrutiny of development special district requests has not been stellar, as Professor Odinet notes.²² But their past record does not mean that local government officials cannot be trusted to provide proper scrutiny of development proposals, particularly if proper guidance is given to those officials in state enabling legislation.

As Professor Odinet chronicles, special districts arose in response to a variety of demands for infrastructure funding in situations where the general taxing power of cities and counties had been restricted, often reacting to some type of actual or perceived overspending. Because special districts are created as separate and distinct units of local government, they receive their own taxing and spending authority and limitation.²³ By authorizing the establishment of special districts, states enable the development and maintenance of public infrastructure,

20. Odinet, *supra* note 1, at 787.

21. *Id.*

22. *Id.* at 784.

23. *See id.* at 740 (explaining the independent nature of special districts).

without requiring that infrastructure to compete for funding with agencies and projects of general-purpose governmental entities within whose borders the infrastructure may be located.²⁴ As a result, the total taxing and spending authority for public projects within the geographic boundaries of a city or county is increased, often by a considerable amount.

Professor Odinet devotes a substantial portion of his article to a discussion of what he believes are the unintended consequences of extensive reliance on development special districts.²⁵ His concerns that granting superpriority status to development special district bonds can undermine vested property rights, destabilize conventional real estate lending, and have “a substantial negative effect on fundamental market fairness”²⁶ deserve serious attention. But these concerns can be dealt with in the legislative process.

Elected officials can, and should, make taxing and spending decisions. These decisions are subject to traditional constitutional requirements that funds be used for public purposes.²⁷ The courts should not be called upon to judge the effectiveness or wisdom of a particular project. That judgment is better left to the legislature for two reasons: (1) such decisions require a careful weighing and balancing of a number of factors, including the relative priority to be given a particular project and the likelihood that the project will produce the results sought; (2) voters expect the legislature, rather than the judiciary, to make the required judgments.

In this context, the judiciary’s job is threefold: resolve disputes regarding (1) the constitutionality of a particular statute, (2) the legislature’s authority to enact the statute in question, and (3) the applicability of a statute to a particular

24. *See id.* at 735 (noting that “cities often compete with one another for the same projects” without special districts in place).

25. *Id.* at 758–78.

26. *Id.* at 773.

27. For evidence that courts are not necessarily better protectors of the public purse, witness the judicial evolution of the Fifth Amendment’s “Takings” Clause requirement of a “public use” from *Berman v. Parker*, 348 U.S. 26 (1954) (upholding use of eminent domain and subsequent transfer of acquired property to private persons in order to eliminate slums and blight) to *Kelo v. City of New London*, 545 U.S. 469 (2005) (noting that acquisition of property and transfer to private entities for economic development serves a proper public purpose).

situation. Whether the statute in question is good or bad policy should be left to the legislature.

Professor Odinet apparently does not believe that local and state legislators are up to the task of making effective policy judgments regarding development proposals seeking public subsidies:

When cities and municipalities are being pushed to drive economic growth and to spur new jobs and investment, there is little chance that local government decision makers—much less state legislators—will truly evaluate each development special district request with a discerning eye With so many economic and political pressures facing cities today in terms of their role in the economic recovery, it is of little doubt that every development special district request would meet whatever criteria or narrow purpose the lawmaker could craft.²⁸

He cites “pressures put on American cities post the Great Recession”²⁹ and “the effects of the economic crisis on local governments.”³⁰ These pressures were, and continue to be, extraordinary. In part, though, these pressures exist because of modern tax and expenditure limitations, such as Proposition 13 in California.³¹

State and local governments are not perfect by any measure. Elected officials at all levels of government are subject to intense pressures to favor one or another interest group. Development special districts are a product of the private developer interest group. They can, and do, serve useful purposes. But their access to superpriority status for their liens needs to be regulated, as Professor Odinet rightly argues.

We disagree on the proper approach to this regulation. I believe it can be accomplished by modifying state enabling legislation as discussed above, rather than further hamstringing state and local legislators with a required judicial proceeding, which Professor Odinet advocates. Involving the courts in protracted analyses of the prospects for success of particular

28. Odinet, *supra* note 1, at 784–85.

29. *Id.* at 784 n. 427.

30. *Id.* at 785 n. 428.

31. CALIF. CONST., art. XIII A (1978, as amended in 1986 and 2000).

public-private infrastructure-based development proposals risks turning the courts into super-legislative bodies in which lawyers and judges replace voters and legislators. Perhaps I am naive, but I believe state and local legislative bodies are up to the task of regulating development special districts, if given proper instructions in the enabling legislation.