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# COVENANTS AND CONSTITUTIONS

*Richard A. Epstein*†

Covenants and constitutions: strange bedfellows, but more than alliteration unites them. In this brief paper I shall explore the relationship between them. In order to orient the discussion, my use of the term “covenants” includes all forms of servitudes, easements, and restrictions that one person can place on another’s lands. “Constitutions” are the documents that identify and entrench the fundamental law of a state or nation, on matters of both structure and individual rights.

At first blush, the two appear to be polar opposites. The law of covenants is the province only of a hardy band of real estate lawyers with the temerity to master a complex and imposing body of rules; vertical and horizontal privity; affirmative and negative covenants; matters in esse and in posse; the touch and concern requirement; notice, actual and constructive; and the ins-and-outs of recordation statutes. Constitutions, by contrast, are the province of us all, the stuff of Senate confirmation hearings, and speak to the eternal and universal truths that bind us into a nation.

Appearances can be deceiving, however, I believe that the law of covenants offers an intelligent blueprint for the analysis of constitutional principles. Covenants may govern party-walls and rights of way over back country roads. Their subject matter may be both well-defined and permanent, and they may bind as few as two parties. But there is nothing about the logic of covenants that restricts them to two-party transactions with simple objectives. Covenants are similar in this regard to corporations, which can be closed or public. There are no external limits on the number of parties who can participate in a contract or on the type of issues that it can govern. The logic of contracting is the logic of unanimous consent. As the number of parties to a system of covenants becomes greater and the issues involved more complex, the polar differences between covenants and constitutions diminish. The closer we look at these covenants, the more they look like mini-constitutions. The common

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† James Parker Hall Professor of Law, The University of Chicago. This paper is an expanded version of the remarks delivered to the Property Section of the American Association of Law Schools in Miami, January 8, 1987. I would like to thank Stewart Sterk for his valuable comments on an earlier draft of this paper.

literary image of a constitution as a social contract, or even a social covenant, has more literal truth than is often supposed.

## I COVENANTS

Let us set the stage for analysis with a short discussion of the function and purpose of covenants. To understand their critical role in modern land transactions, it is best first to envision the circumstances in which covenants have no more than peripheral importance. Thus suppose for the moment that land is a very cheap commodity that can be effectively utilized only if owned in fairly large quantities (say for grazing or farming). Under these circumstances, there may be very little need for any system of covenants at all. Each person can live side by side with his neighbor, and each can rejoice in exclusive ownership of an unencumbered fee simple absolute in possession. The operative principle is that good fences make good neighbors. But this simple property arrangement has its Achilles heel: two people cannot share a single resource.<sup>1</sup> In consequence there might be some underutilization of land. Nonetheless these losses are perhaps smaller than the costs necessary to correct them. Covenants are not cheap to draft and enforce, especially in the era before recordation. So long as transaction costs are positive, the set of efficient solutions cannot involve the realization of all possible gains from trade. Where the gains from trade are smaller than the sum of both sides' transaction costs, then the trade will not take place.

Now let us suppose that the value of land has increased dramatically, whether from an increased demand for farm produce, or from an increased demand for housing in an especially fashionable part of town. Under these circumstances, the balance shifts between the two costs identified above. The losses from the underutilization of land become very large, relative to the transaction costs of creating some legal system that allows more intensive use of the land, and the system of joint control and divided use that it requires. Once the costs of contracting become lower than the economic gains from contracting, we should expect to see voluntary contracts emerge. An increase in the frequency of covenants goes hand in hand with increases in underlying real estate values.

One question is what can the law do in order to minimize the losses from the underutilization of real property. At some macro-level, a wide range of public control devices can have enormous in-

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<sup>1</sup> For further discussion of this problem and the bilateral monopoly problems it creates, see Sterk, *Neighbors in American Land Law*, 87 COLUM. L. REV. 55 (1987).

fluence on land utilization: systems of zoning, rent control, and taxation are but three types of potent government regulation. But for this discussion on the law of covenants, I shall put those institutional tools aside, and concentrate solely on the private mechanisms of transfer involved in creating complex structures of divided ownership in real property, with reference here only to transactions between neighbors.<sup>2</sup>

Within this narrow focus, what the law can do is to try to reduce the transaction costs of the voluntary arrangements needed to exploit real estate within the confines established by law. The payoff here should be evident: the lower these costs, the more likely it is that private agreements can counteract even small underutilizations of real property. This tendency should be a general social good regardless of the market or regulatory determinants of land value, positive or negative.<sup>3</sup>

A number of legal and institutional developments have fostered desirable voluntary exchanges. It is worthwhile to spend time on two: recordation and common plan building schemes.

#### A. Recordation

The system of recordation is an indispensable aid for the effective use of any form of covenant. In the age before recordation, no one could be sure whether a restriction binding upon the immediate parties could also be enforced by or against third parties. The resulting uncertainty was very large, and it fed back into the initial willingness to control land by covenants. As land is permanent, it is only a matter of time before the original parties to the transaction sell their interests or die. Covenantees want to be able to make decisions about the construction of long-term improvements, but cannot do so if the protection that they have purchased can be defeated whenever the original covenantor makes a strategic sale to a third party who is then rid of the covenant. The covenantor, for his part, will not be able, *ex ante*, to command the highest price if he cannot assure the covenantee that his successor in title will be bound by the restriction in question. The first transaction itself may therefore abort, so that the subsequent purchaser is denied the benefit of the purchase that ties the acquisition of the land to acceptance of the

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<sup>2</sup> For more comprehensive efforts in this regard, see Ellickson, *Alternatives to Zoning: Covenants, Nuisance Rules, and Fines as Land Use Controls*, 40 U. CHI. L. REV. 681 (1973); Sterk, *supra* note 1.

<sup>3</sup> External forms of regulation need not reduce the value of land, but could well increase it. Thus a zoning ordinance that prevents the easy development of unimproved land will reduce the value of that land. Yet at the same time it will increase the value of competing lands that have already been developed. The case for or against zoning depends on the relative magnitudes of the shifts in value and the ways of finding them out.

servitude. The point remains true, moreover, even if no cash changes hands, as frequently happens when each party's consideration is a reciprocal covenant (such as a covenant not to build above a certain height).

The concern with binding strangers did not preclude the running of covenants before the rise of recordation statutes. Roughly speaking, the rule then was that covenants could only bind subsequent takers if they had notice, actual or constructive, of the covenant.<sup>4</sup> The uncertainties about notice were powerful enough that they doubtless precluded many useful transactions from taking place at all. With recordation, the problem of notice disappears in all but the most unusual case.<sup>5</sup> The covenantee simply records his interest in the appropriate deed or plot index; title companies then memorialize it on their own records; and all subsequent takers are now in position to assess the state of the title, and act accordingly, either by adjusting the purchase price for land to take into account the restrictions that benefit or burden it, or by not purchasing at all.<sup>6</sup> The work is all routine and ministerial—a notable social triumph of the humdrum.

In my view, the recording system renders unnecessary many of the arcane features of the law of covenants that might have made sense in the prior age.<sup>7</sup> The requirement that covenants "touch and concern" the land may well have made sense in an age before recordation; those covenants that did touch and concern the land were more likely to be detected by subsequent purchasers than those that were purely personal to the parties. Similarly, it might have been more difficult from an inspection of the premises to discover whether the seller had undertaken some affirmative obligation to a neighboring landowner. But now that the system of recordation is in place, the notice issue is typically solved in an explicit, sensible,

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<sup>4</sup> The modern law starts with *Tulk v. Moxhay*, 2 Ph. 774, 41 Eng. Rep. 1143 (Ch. 1848), which allowed restrictive covenants to run in equity against the purchasers who took with notice of them.

<sup>5</sup> Professor Alexander is more uneasy with recordation. See *infra* pages 910-14.

<sup>6</sup> The point was well understood in *Tulk*:

[T]he question is, not whether the covenant runs with the land, but whether a party shall be permitted to use the land in a manner inconsistent with the contract entered into by his vendor, and with notice of which he purchased. Of course, the price would be affected by the covenant, and nothing could be more inequitable than that the original purchaser should be able to sell the property the next day for a greater price, in consideration of the assignee being allowed to escape from the liability which he had himself undertaken.

2 Ph. at 777-78, 41 Eng. Rep. at 1144.

<sup>7</sup> See Epstein, *Notice and Freedom of Contract in the Law of Servitudes*, 55 S. CAL. L. REV. 1353 (1982).

and well-nigh decisive fashion, rendering unnecessary the need for the clumsy proxies that still survive in the law.

The limitation of valid covenants to those that touch and concern land, and the prohibition on affirmative obligations, are not, I believe, of much practical consequence, because there are very few persons who really would want as a business matter to tie either type of undertaking to the ownership of real property—who would want the assignee of a covenantor to prepare his income taxes? Even so, some famous institutional cases have turned on either or both these requirements. Thus the decision in *Neponsit Property Owners' Association, Inc. v. Emigrant Industrial Savings Bank*<sup>8</sup> was necessary to quell some residual doubt whether the obligation to pay money to a property owners' association touched and concerned the land, or fell afoul of New York's stringent rule against affirmative covenants.<sup>9</sup> Clearly no common ownership association could survive at all without these standard covenants, any more than a government could survive without any power to tax. Faced with the prospect of artificial limitations from the law of real covenants knocking out an essential form of self-governance—the connection to constitutions should be getting clearer!—the court held the covenants enforceable against an assignee with notice, without taking the more radical step of casting these archaic tests out of the common law of New York State. The result in *Neponsit* is a happy one, but it could have been better reached by jettisoning the older restrictions on covenants, now that recordation statutes are in place.

A contrary position on recordation and notice is taken by Professor Alexander in his provocative paper, *Freedom, Coercion, and the Law of Servitudes*.<sup>10</sup> His attack takes place on several levels and deserves an answer here. His most general argument is that one cannot assume that interested parties are rational or understand the terms found in covenants. “[P]eople *do* engage in irrational behavior.”<sup>11</sup> Stated in this form, the argument extends far more broadly than the law of covenants. Indeed, if treated as a general description of human conduct, it undermines the possibilities of any form of intelligent organization whatsoever. Under this view, private bargains are unacceptable because they are doomed by ignorance and exploitation. Yet by the same token, political solutions are doomed as well, because irrationality is hardly cured in a regime that requires imperfect actors to navigate the many pitfalls of collective ac-

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<sup>8</sup> 278 N.Y. 248, 15 N.E.2d 793 (1938).

<sup>9</sup> *Miller v. Clary*, 210 N.Y. 127, 103 N.E. 1114 (1913).

<sup>10</sup> Alexander, *Freedom, Coercion, and the Law of Servitudes*, 73 CORNELL L. REV. 883 (1988).

<sup>11</sup> *Id.* at 895.

tion. If people cannot contract intelligently, then how can they vote? The assumption of systemic irrationality is a general non-starter from which only universal skepticism follows. It does not serve as the foundation for any debate focused on the role of notice or on any other mid-level problem in the common law.

At a more specific level, Professor Alexander argues that the value of depending on a recordation system is overstated because gaps remain within the system of notice even when recordation is the norm. While recordation does afford notice in most cases, it does not do so in all. In some cases the rules of "inquiry notice" may require purchasers under common building plans to draw inferences of covenants that are not recorded in their own chain of title.<sup>12</sup> In other cases, the subsequent purchaser may be put on inquiry notice by the condition of the land itself.<sup>13</sup> These cases of inquiry notice do raise an important challenge to any system of recordation, for there is no doubt that on some occasions the law will impute notice to parties who had none in fact.

Nonetheless this objection has to be kept in perspective. It is critical to ask how large the number of cases involving inquiry notice is, relative to the total number of cases in question. As to covenants, my suspicion is that the number is small, if only because anyone smart enough to understand the law of inquiry notice is also smart enough to take the routine precaution of recording his interest.<sup>14</sup> It is well-nigh inconceivable today, where the developer invariably engages legal counsel, that there will be defective recordation of the covenants binding any large condominium or cooperative. In some sense, therefore, it would be possible to protect third parties across the board by demanding (as do race recordation statutes) perfect recordation in order to protect the original covenantee. This alternative has its costs as well: doubtless some persons with inquiry notice also have notice in fact, but will nonetheless be protected by the race statutes. To eliminate those costs, the rules of inquiry notice are designed to ferret out those cases where purchasers likely have actual notice, or at least "reason to know," of an unrecorded covenant.

It is an empirical question whether the effort to undo one sort of error (not binding those who have actual notice or reason to know of a covenant) only creates a greater error in the opposite di-

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<sup>12</sup> See, e.g., *Sanborn v. McLean*, 233 Mich. 227, 206 N.W. 496 (1925).

<sup>13</sup> See, e.g., *Miller v. Green*, 264 Wis. 159, 58 N.W.2d 704 (1953).

<sup>14</sup> For a comparison, see Langbein, *Substantial Compliance with the Wills Act*, 88 HARV. L. REV. 489 (1975) (testator's substantial compliance with Wills Act should suffice). Persons who are aware of the formalities required by the Wills Act can be expected not to exploit any residual loophole left by the noncompliance rule.

rection (binding those without actual notice). That question is probably pretty close, but the low popularity of pure race statutes, and the widespread sympathy for some inquiry notice rules, is entitled to at least a little respect on a matter where "hands-on" experience probably counts. Sometimes the rules of inquiry notice rightly exclude persons with actual notice. Professor Alexander's argument at best makes a case for race statutes. But it affords no reason to reject the general proposition that third party purchasers should not be bound by notice, especially when recorded. The existence of some small chinks in the system is only an inevitable reflection of the error that arises whenever transaction costs are positive.<sup>15</sup> It is not a reason to undo the system of covenants.

Professor Alexander's next argument turns on what, borrowing from Professor Mark Kelman,<sup>16</sup> he terms the "bundling" problem. "The promisor's successor may have bought the land even though she did not want it with the restriction because she was unable to control all of the theoretically available terms."<sup>17</sup> Yet this argument surely proves too much. No one party ever controls all theoretically available terms. Any bargain in any context requires each party to give up something of value in order to obtain something else. The engine driving all bargains is that each party attaches a higher subjective value to the goods received than she attaches to the goods surrendered. Yet to say this is to say that every contract of sale requires both sides to "bundle" some commodity which is "unwanted" with some other commodity that is desired. To prohibit such "bundling" would make it quite impossible to sell shoelaces with shoes or for a dealer to take a trade-in on a new car. It may well be that bargains would come out quite differently if everyone were prepared to endure the prohibitive costs of having separate contracts for each item under negotiation. But the logic of mutual benefit for the parties, which drives the institution of contract, is satisfied when goods are exchanged in bundles just as much as when they are bought and sold separately. The subsequent purchaser who takes with notice of the covenant is better off with the bundle than she is without the deal.

Of course it would be nice for Professor Alexander's successor if she could obtain the property without servitude: everyone prefers having more to having less. By the same token it would be nice for the original covenantor to obtain the higher price by selling the retained land free of the covenant. But alas, there are still the desires

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<sup>15</sup> For a further examination of recordation, see Baird & Jackson, *Information, Uncertainty, and the Transfer of Property*, 13 J. LEGAL STUD. 299 (1984).

<sup>16</sup> See M. KELMAN, A GUIDE TO CRITICAL LEGAL STUDIES 107-09 (1987).

<sup>17</sup> Alexander, *supra* note 10, at 894.

of the original covenantee, and his desires are wholly ignored if the transaction between covenantor and subsequent purchaser is permitted to deprive him of the benefit of his bargain. The general principle that contracts should not be allowed to bind strangers applies with as much force to covenants as it applies to goods. Where the successor in title does not have notice of a secret agreement between the original covenantor and covenantee, then she is the stranger who needs protection. But where she does have notice, then the stranger to the transaction is the original covenantor, done in by the joint machinations of the original covenantee and the subsequent purchaser. A rule that prevented the enforcement of these covenants generally would be an unmitigated disaster to subsequent purchasers as a class because it would remove from the market a large portion of the supply of affordable housing and land. Similarly, a rule that allows these covenants to be enforced, subject to the broad "discretion" of some future court,<sup>18</sup> introduces a degree of uncertainty that *ex ante* works against the interests of all concerned. And the same can be said of any rule that does not enforce covenants when conditions have changed sharply.<sup>19</sup>

Professor Alexander tries to buttress his two specific considerations with a third: the successor in title is really not a promisor at all. Taking a leaf from the earlier writings of Professor Rundell, he argues<sup>20</sup> that the "problem is not 'What can parties do with their own?' but 'What can parties to a promise do to persons who are not parties?'"<sup>21</sup> Professor Rundell then makes his argument in still more general terms:

To give to one a power to make another a promisor is, most of us would instinctively feel, a dangerous power. Is it the less dangerous because it is limited in its scope to the successors to property owned by the promisor? Probably so, but the limitation only makes it *less* dangerous. Certainly, no one has ever supposed that the owner of a chattel could make promises which would bind his successors merely because they were his successors.<sup>22</sup>

Rundell's argument fundamentally misunderstands what is at stake in the law of notice. The issue with covenants is not whether the covenantor can bind a total stranger, or even make promises to

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<sup>18</sup> See Alexander, *supra* note 10, at 893-94.

<sup>19</sup> See *infra* pages 919-21.

<sup>20</sup> Alexander, *supra* note 10, at 894-95.

<sup>21</sup> Rundell, *Judge Clark on the American Law Institute's Law of Real Covenants: A Comment*, 53 YALE L.J. 312, 314 (1944). Rundell wrote in response to Clark, *The American Law Institute's Law of Real Covenants*, 52 YALE L.J. 699 (1943), which was generally critical of the ALI's effort to preserve the older requirements of horizontal privity, and touch and concern.

<sup>22</sup> Rundell, *supra* note 21, at 314.

his covenantee that bind his successor. Rather, the issue is whether the successor in title, who takes with notice, has assumed that obligation himself with the voluntary decision to purchase the land. It is *both* the decision to purchase and the notice that constitute the consent, not either in isolation from the other. So long as the legal consequences of the transaction are spelled out in advance, it is not dangerous at all to say to the real estate purchaser that in order to buy the sweet, he must take it subject to the bitter. Quite the opposite, the law of recordation permits the parties to realize *gains* not otherwise obtainable, by having confidence in their transactions when these are sequential and not simultaneous. The general principle, that no two persons by contract can bind a stranger, is designed to curtail the social losses of destructive bargaining. If A and B could contract in ways that bound C, then we would see an endless cycle of contracts in which small groups of individuals would confiscate the wealth of others. The prohibition on theft, necessary to civilized society, could be circumvented by a simple private agreement. But once the so-called victim of the trade can protect himself by refusing to do business at all, or by altering the terms of the purchase price, then the endless cycle of theft and exploitation is stopped in its tracks. The basic insight of *Tulk v. Moxhay* is as valid today as it ever was.

#### B. Common Building Plans

The previous discussion shows how the rules of recordation help facilitate transactions that bind three or more persons. Recordation itself is not sufficient for that purpose and the law has also developed effective rules to allow covenants to be created that benefit and bind a large number of persons, such as the members of a subdivision, condominium, or cooperative. There is an evident transactional problem here if covenants can only exist between two persons in privity. The extent of the difficulty is fully revealed by a simple mathematical calculation. If there are  $n$  persons, then there must be pairwise contracts among all of them, so that:

$$\sum_{i=1}^n n-1$$

is the minimum number of separate contracts to bind everyone to everyone else. Alternatively, if it is possible for all persons to bind each other by dealing with a common party (usually the developer) who stands at the middle of the circle, then  $n$  contracts (one between each person and the developer) suffice to create a network in which all persons can be bound and benefitted by a set of reciprocal contracts.

Where  $n$  is very small, the transactional difference between the two methods of contracting is not significant. In order to contract with a common agent at the middle it is necessary to set up that agent but the costs of that institution can be spread only over a very small number of contracts. If the effort is to link only three people, there will have to be three contracts no matter whether they go around the sides of the triangle or through a fourth point at the middle. The system of three pairwise contracts, moreover, might be cheaper because the costs of setting up the common party at the center are avoided. As the numbers get large, as is typical with modern real estate when land becomes valuable, then there is a pronounced advantage to contracting through the central point. Thus for  $n$  equal to 100, the number of pairwise contracts required is, by the well-known formula:

$$\sum_{i=1}^n n-1 = n(n-1)/2, \text{ equal to } 4950,$$

while the number of contracts through the center is only 100. At that point it would long since have been cost effective to incur the heavy front-end fixed costs of instituting a central party through whom all individual landowners are able to contract. The marginal costs of adding a single new member to the group are low when governance runs through the center, but they would be astronomical if 101 new contracts have to be separately formed. In addition, the costs of maintaining the contract network are reduced as well, for no longer is it necessary to modify, for example, 4950 existing separate contracts. Instead it should be possible to make changes in one single master arrangement in accordance with predetermined decision rules.<sup>23</sup>

The law of covenants had an intuitive sense of the real economies of scale that have developed in this area. The rules for common building plans or schemes allow a promoter to insure that all purchasers of individual units stand in a position of perfect parity with one another, regardless of when they purchase their units, by inserting proper ("intent to run") language in the original deeds and faithfully recording all documents. The flexibility of this way of doing business should be manifest. The developer can now assure the first round of buyers that subsequent takers will be bound; thereafter, the developer can also assure subsequent rounds of buyers that prior takers are bound. Buyers can remain happily ignorant of the details of the scheme, precisely because it works so well. Over time, individual units may fluctuate in value, but these differ-

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<sup>23</sup> See the discussion of majority rule *infra* pages 921-24.

ences can be handled by adjustments in purchase price or financing terms without any alteration of the basic network of covenants.

In effect, the rules show the advantages of standard form contracts when there are a large number of parties. By reducing transaction costs, common building plans effectively allow vast numbers of individuals to make use of certain common areas or to benefit from the mutual restrictions and requirements on use. They become ever more important today when the high price of land makes the ideal of separate and self-contained ownership a luxury that few people who want glamor in the city or quiet at the beach can afford.

Professor Alexander sees in these rules some "particularly insidious form of coercion because it purports to effectuate private intentions rather than acknowledging that private volition is being sacrificed for the sake of some collective good."<sup>24</sup> But where is the coercion or sacrifice? Of coercion there is none, unless the discrete purchase or sale is infected with duress or fraud, issues that the ordinary law of contract can handle (as it has for ages). Of sacrifice there is none either: the system of sequential contracts will only go forward if, at *every* point in the chain, both parties to the contract think that they are better off with the agreement than without it. The constant effort to conflate close choices and hard bargains with coercion is of a piece with the effort to conflate agreement with theft, and scarcity with coercion. Of course there will be some transactions in which prospective consumers find themselves making close marginal calls; that is not evidence of coercion, but only of negatively sloped demand curves.

## II

### THE PROBLEMS OF GOVERNANCE: EXTERNALITIES, TRANSACTION COSTS, AND INTERGENERATIONAL EFFECTS

The combined effect of the recordation and building plan rules should by now be clear. Recordation is an effective way to control the externalities associated with covenants, while building plans reduce the cost of transacting among large numbers of covenantees. Nonetheless several related inquiries need still to be answered: Are there any externalities that recordation does not address? Are there any transactional difficulties that cannot be overcome by the principles of serial contracting made possible by the building plan rules? What implications do these difficulties have for the enforcement of covenants?

The most obvious way in which recordation systems control the

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<sup>24</sup> Alexander, *supra* note 10, at 896.

problem of externalities is to give notice to the rest of the world of the state of the title of any person whom a network of covenants binds or benefits. Within this framework, some might fear a different kind of externality: that the substance of that network of covenants will be in some way objectionable. This fear is misplaced, because the original developer (like the corporate promoter intent upon maximizing his profit from a venture) has all the right incentives to offer the ideal mix of burdens and benefits. If he offers inferior terms, then his return from sales will suffer because the price that he can command in the market for the units will be reduced. It seems clear from common practice that few developers think that their unit owners are happy with the limited "no invasion" type restrictions that are associated with the common law of nuisance. Nuisance-type prohibitions against noise, smells, and discharges remain part and parcel of any common ownership system, but they do not begin to exhaust the class of restrictions that are routinely included in any common real estate venture. Most planned developments contain detailed restrictions concerning height, decor, and maintenance. These restrictions may look byzantine to an outsider, but they are likely to make sense because the party who imposes them has everything to lose if they are made either too stringent or too relaxed.

Some have questioned whether there are certain kinds of externalities that the above analysis does not reach.<sup>25</sup> Here in particular three types should be discussed: monopoly, discrimination, and intergenerational effects—the last with reference to the doctrine of changed conditions.<sup>26</sup> All involve possible harms to third persons that might not be internalized by an original owner of the land. At this point, however, the discussion takes an important change in direction, for none of the concerns so raised is in any sense unique to the law of covenants (in the way that the privity restriction or the touch and concern requirement are). Instead, all three of these issues raise challenges that could in principle be lodged against any private contract, regardless of subject matter. The key to understanding them, therefore, is to regard them as part of the broader question of what limitations the law ought generally to impose on freedom of contract so as to protect third parties.

#### A. Monopoly

As regards monopoly, the source of the concern is that the sin-

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<sup>25</sup> See, e.g., Sterk, *Freedom from Freedom of Contract: The Enduring Value of Servitude Restrictions*, 70 IOWA L. REV. 615 (1985).

<sup>26</sup> *Id.* at 621-23, 643-44. The problem of intergenerational effects raises not only externality but also transaction cost issues. See *infra* pages 920-25.

gle developer of a large project may be able to exert some market power. The argument is always plausible with regard to land because it is an asset, fixed in location, that can have (almost by definition) only imperfect substitutes located some distance away. The question of monopoly power, however, generates different responses for different kinds of covenants. Those restrictions that are perfectly reciprocal (e.g., that relate to appearance and height) do not seem to raise any concerns under the monopoly model. If there is a monopoly problem in this context, it arises from the ability of the original developer (who may be protected by zoning restrictions on nearby parcels) to extract a monopoly price from his own purchasers. If some form of public control is found necessary, it need not be tied to the law of covenants. For in his effort to extract monopoly rents, the developer, as already observed, has every incentive to supply the ideal set of restrictions for all his parcels: he can maximize his monopoly return in this way. The proper types of response, therefore, are numerous. The law could place some restrictions on price, for which the risks of overreaction are manifest; it could limit the size of certain subdivisions under common ownership, but only at the cost of some arguable efficiencies in operation; or ideally, it could remove whatever legal restrictions block the entry of other developers into the local market.

The situation becomes much trickier where the restrictions in question are not reciprocal, but are designed to insure the exclusion of certain kinds of business from the development, such as when the developer agrees to let a second fast-food chain into his project only upon approval of the first.<sup>27</sup> This system raises an obvious problem for commercial developments where such covenants are important, but not for residential ones. Again there is nothing special about the analysis which depends upon the degree of market power exacted and the costs of introducing any remedy to set matters on their proper course. I shall not consider the point further here.

#### B. Antidiscrimination

Restrictive covenants have also been used to exclude persons from certain real estate developments because of their race or religion. As a matter of American constitutional and statutory law,<sup>28</sup> these covenants are now universally regarded as illegal, precisely because of their adverse effects on third parties. My purpose here is not to assess the desirability of the constitutional rules or statutes but only to stress again the general point. Any concern with antidis-

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<sup>27</sup> See, e.g., *Howard D. Johnson Co. v. Parkside Dev. Corp.*, 169 Ind. App. 379, 348 N.E.2d 656 (1976).

<sup>28</sup> See, e.g., *Shelley v. Kraemer*, 334 U.S. 1 (1948).

crimination is best attacked head on and does not raise any problems with restrictive covenants that are not also found, say, with employment or with housing generally. It is very doubtful, therefore, that any distinctive doctrine of covenant law can begin to reach this issue. Restrictive covenants of this sort touch and concern the land, are negative in effect, are clear as to both intent and meaning, and are capable of recordation. Yet all this only shows that the problem is better handled by other legal rules which have discrimination, race, and religion at their core, and not by the law of covenants.

### C. Intergenerational Effects: The Problem of Changed Conditions

The last possible source of externalities has to do with the intergenerational effects of a system of restrictive covenants. Within the traditional legal framework this problem is brought to the fore in connection with the so-called doctrine of changed conditions. This doctrine holds that a restrictive covenant is no longer enforceable, at least without modification, when the social and environmental conditions existing when the covenant was created no longer apply.<sup>29</sup> In effect the doctrine of changed conditions allows the courts to expunge covenants from the records, or at least modify their provisions, once the court determines that the covenants no longer serve the purposes for which they were first introduced. In one sense, therefore, the doctrine of changed conditions is a slightly more robust form of the doctrine of frustration of purpose as it exists in the general law of contract. But the doctrine of changed conditions has a more distinctive and coercive cast. Courts may invoke it to invalidate covenants notwithstanding the parties' express contractual intent to be bound in perpetuity unless released by contrary unanimous agreement.

The battleground here is a familiar one: should the doctrine of changed conditions operate as a plausible default rule or as a rule of public regulation? I have already taken the position that it should fill the former, and more modest, office once the recordation system gives all parties notice of the relevant conditions.<sup>30</sup> So long as all the original parties have themselves taken into account the need for

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<sup>29</sup> For defenses of the doctrine, see French, *Toward a Modern Law of Servitudes: Reweaving the Ancient Strands*, 55 S. CAL. L. REV. 1261 (1982); Reichman, *Toward a Unified Concept of Servitudes*, 55 S. CAL. L. REV. 1177 (1982); Sterk, *supra* note 25, at 652-54.

<sup>30</sup> See Epstein, *supra* note 7, at 1364-68, which is criticized in Sterk, *supra* note 25, at 634-635. Sterk notes, inter alia, that my general hostility to the doctrine of changed conditions should lead me to be hostile to many other doctrines of property law, including the prohibition on entails, the rule against perpetuities, and the rules on restraint of alienation. And they do. See Epstein, *Past and Future: The Temporal Dimension in the Law of*

future change it is highly unlikely that the legal system, which operates with very inexact knowledge of their private preferences and subjective costs, can find a rule that works better than the one that the parties themselves have agreed upon. In making this argument in *Notice and Freedom of Contract in the Law of Servitudes*,<sup>31</sup> I recognized that requiring that all such covenants be respected does lead to the problem of holdouts, but insisted that we take note of "what ownership means in the context of the fee simple absolute in possession, i.e., the right to hold out."<sup>32</sup>

This basic point that freedom of contract should govern is, I think, correct, but the matter of holdouts, and the bilateral monopoly problems they generate, does require more discussion than I gave it in 1982. Initially, as a descriptive matter, it is quite clear that the law does not always respect the holdout rights of an owner against the rest of the world. The power of eminent domain is designed, at least in cases of public use, to allow the state to force persons to surrender their private property provided it compensates them for their loss. Even in the private sphere there are some instances where, for example, a wrongdoer may be allowed to continue to maintain and operate a nuisance, so long as he pays his victim tort damages (another form of just compensation) for the property interest, thereby taking a "pollution easement."<sup>33</sup> For the most part, however, the ability of private parties to "take and pay" is sharply limited, for even in the nuisance cases injunctions are still the dominant judicial remedy as courts are concerned with what has been called the "private use of the eminent domain power."

The matter of restrictive covenants, however, involves a somewhat different issue. For here the effort to circumvent the private property interest (perhaps even without compensation) is made, not by an outsider, but by a party to the original transaction (or by his privy). Even within the consensual setting there is no uniform rule of specific performance as damages are the preferred remedy in a wide range of cases; indeed there is very extensive discussion of what rule is the ideal default in the contract setting.<sup>34</sup> The question is whether the specific protection of property interests should ex-

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*Property*, 64 WASH. U.L.Q. 667, 703 (entail), 710 (perpetuities), 713 (restraints on alienation) (1986).

<sup>31</sup> See Epstein, *supra* note 7.

<sup>32</sup> *Id.* at 1366. In a similar vein, see Rose, *Servitudes, Security, and Assent: Some Comments on Professors French and Reichman*, 55 S. CAL. L. REV. 1403, 1412 (1982) ("The right to 'hold out,' for whatever idiotic reasons, is an aspect of the right to hold property.").

<sup>33</sup> See, e.g., *Boomer v. Atlantic Cement Co.*, 26 N.Y.2d 219, 257 N.E.2d 870, 309 N.Y.S.2d 312 (1970).

<sup>34</sup> Bishop, *The Choice of Remedy for Breach of Contract*, 14 J. LEGAL STUD. 299 (1985); Kronman, *Specific Performance*, 45 U. CHI. L. REV. 351 (1978); Schwartz, *The Case for Specific Performance*, 89 YALE L.J. 271 (1979).

tend to the full range of covenants. In general, I think that the answer is that specific protection should often remain but only as one of a mixed bag of rules. The reasons for this conclusion should make the connection between covenants and constitutions even clearer.

Initially, it will be instructive to draw some distinctions between the small and large number cases. Where there are, for example, only two parties to a covenant, there is much to be said for the simple rule that protects it for all time and under all circumstances. Thus the normal right of way over a servient tenement is generally regarded as valid in perpetuity, just like the fee. To be sure, there can be limitations upon the easement by contract, but as a constructional matter, the safe preference is to resist the application of the changed circumstances doctrine and to enforce the easement so long as the holder of the dominant tenement has not abandoned its use. The holder of the servient tenement who wants release from the easement must purchase it at an agreed price.

The more difficult issues arise at the other end of the spectrum when the law of covenants is pressed into the service of modern condominium and cooperative associations. In this context, should the doctrine of changed circumstances have greater sway? As is so often the case, it is critical to distinguish between the *ex ante* and *ex post* effect of the rules. *Ex post* it is clearly in some people's interest to have the right to hold out. This right may be awkward to exercise when it is apparent that consent is withheld only to extract a profit from others but it may nonetheless still have real positive value. In many cases the covenant continues to be of some value to a covenantee. As there is no ready market value for the release of the covenant, the holdout can conceal his advantage taking as a defense the subjective value he enjoys in keeping the covenant alive. Others' inability to draw a clear operational line between subjective value (thought good) and holdout value (thought bad) is great enough in practice that the determined and subtle holdout artist has a good deal of room to maneuver before he is detected and perhaps disgraced.

From the *ex ante* perspective, however, the desirability of allowing holding out takes on a very different complexion. The developer will be able to command less total value from sales if the legal arrangements that he sells give rise to a substantial holdout risk some time in the future. We must assume that holdouts give rise to negative sum games, for if bargaining were costless no one would care about the problem. Confronting any holdout problems consumes administrative resources, and this necessarily reduces the total gains from removing covenants—assuming that it does not block

their removal altogether. The developer who can find a way to limit holdout problems will therefore be able to command a higher total price for the units that he sells than one who cannot. We should therefore expect him to take some effort in that direction, even if preventing the holdout problem from arising is itself a task that consumes resources. The gains from investing in legal structure are likely to be substantial.

Just such an effort is made in fashioning the rules whereby covenants can be modified or removed. The holdout problem occurs in its most extreme form when unanimous consent is necessary to release lands from the restrictions imposed by covenants. The problem is identical to that which any organization, governmental or voluntary, faces when it can pass a law or resolution only by unanimous consent. Most voluntary groups recognize this problem. In response to it, they provide *by original unanimous consent* for a set of decision rules that allows some fraction, usually a majority by legal interest or number, to reverse the original decisions. So long as it is not possible to forecast perfectly, some such discretion will be needed in any system of governance. Majority rule can be introduced into networks of covenants that are part and parcel of building plans, and frequently is. In some cases where the restrictions are largely negative in type, it may be possible for any party to the covenants, upon the signature of some fraction of the total units, to free his own unit from the restrictions in question. Thus we can find majority rule provisions for modification without government command. In other cases where the interdependence between the units is greater, it might be necessary for the party to run through formal deliberation in a forum provided for in the original agreements.

The connection between covenants and constitutions should now be explicit. In both cases the ultimate task is to protect individual rights to property without inviting excessive holdout problems. A rule that allowed a majority of unit owners to do whatever it pleased with regard to restrictive covenants in place would rightly be perceived as unfair: there would be too much scope for advantage taking. It would be quite unthinkable for the majority to be able to vote to release all its units from the force of the covenants while continuing to impose those covenants upon others; this would be indistinguishable from a corporation's majority shareholders voting a dividend for themselves and denying it to the minority, or from the majority of citizens voting to confiscate the property of some minority faction. But by the same token, any absolute protection of individual rights with an individual veto re-introduces the same problem of holdout that every system of collective governance wishes to overcome.

We therefore are driven to some mixed system of entrenched rights, compensation tests, and majority rule—all messy, and all necessary. The easy cases, as the law of eminent domain makes clear, are those where the majority votes to change the applicable covenants in a way that binds it equally with the minority. These are cases in which the collective decisions are likely to have a proportionate impact upon members of the majority and minority alike. The more suspicious cases are those where the change in legal protections have systematically and intentionally skewed effects. Here the disproportionate impact gives rise to the same concerns as are voiced with takings law generally.<sup>35</sup> The difficult cases are those that fall in between, where the disproportionate impact may be unintended and unavoidable, but is nonetheless substantial.<sup>36</sup>

The choices involved are both vexing and important, and I shall not try to choose in the abstract among veto rights, majority rule, compensation, and their many variations and combinations. Instead my point is more modest. So long as we know that the original owner of the property was aware of these difficulties, then the basic analysis still holds: there is no need for any public doctrine of changed conditions to limit the scope and effect of private covenants. The intermediate solutions found in the standard agreements are likely those that, in the long run, tend to minimize the total breakdown. In this light, it becomes all the more dangerous simply to invalidate a covenant on a wholesale basis, and thereby to ignore the explicit protections that the parties themselves have drafted, including those that allow for introducing some change in the existing structure.

Of course, the parties' inability to draft with perfect foresight and completeness necessarily means that courts will have to engage in some "interstitial legislation" in construing the terms of the basic agreement.<sup>37</sup> No set of agreements governs all contingencies and something has to be done to fill up the gaps. In many instances the theory of the "implied term" does reflect the standard usages of the parties to a transaction. In other cases, the implied term looks more like a judicial invention and less like an explication of the parties' intention. For example, we could say with some confidence that a court's construction of a homeowners' association provision was inconsistent with the parties' intention if it worked a systematic redis-

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<sup>35</sup> See *Armstrong v. United States*, 364 U.S. 40 (1960). I have discussed this point at length in R. EPSTEIN, *TAKINGS: PRIVATE PROPERTY AND THE POWER OF EMINENT DOMAIN*, ch. 14 (1985).

<sup>36</sup> Ellickson, *Cities and Homeowners Associations*, 130 U. PA. L. REV. 1519 (1982)

<sup>37</sup> See *id.* at 1535-39 for illustrations having to do with "rezoning" subareas within the association, changes in the financing charges for water connections, and restrictions against children's occupancy.

tribution among the association's members, because such rules, if explicit to the agreement, would reduce the total value of the units sold at the outset.<sup>38</sup> Again, the parallel to basic constitutional interpretation seems too clear to require much elaboration.

At bottom, the problems of homeowners' associations are identical to those of all long term relational contracts: how should the gaps be filled? While there is of necessity some role for judicial intervention, there is an important question as to how much. In one sense the argument turns on *who* can make the best decision about whether to change or enforce covenants.

In many instances this problem might be viewed as one of institutional competence: do parties by agreement have a better sense of what is going on than do courts? Without majority rule provisions, it could be suggested that courts may do a better job than the parties because courts' information is better, even if their incentive to get things right is weaker. But where the parties have internal governance structures in place, these tend to undercut the judicial advantage by allowing homeowners' associations to defer the time of collective choice until they have the needed information. While there is doubtless some small place for the doctrine of changed conditions to operate on agreements that are incomplete, it should have at best a tiny importance once governance structures are in place. Related to the matter of party competence is the problem of generations that always arises with long term contracts. Professor Sterk has voiced concern about the problem: "Because the present generation cannot know what preferences the future generation will have, and because there is no medium for exchange between generations, it is impossible to ascertain whether and to what extent social investment by the present generation will actually increase the utility of future generations."<sup>39</sup> His argument is a two-edged sword, for it also shows that there is a cost to *not* respecting the covenants in place when the future generation would have wanted them. All that we can know is that the present generation thinks that the future value of a common development will be maximized if it takes (as in practice it does take) an intermediate approach to the problem of changed conditions. The members of the present generation have incentives to worry about future value because they want to sell their units, or leave them by gift or bequest to their children. They are also aware of the difficulties of dealing with future uncertainty.

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<sup>38</sup> See *id.* at 1544. The prospect of redistribution introduces an added element of uncertainty that risk averse persons avoid and raises the prospect that additional sums will be spent to obtain uncompensated transfers. These two costs operate as a lien on the original units which can only reduce effective demand and, therefore, price.

<sup>39</sup> Sterk, *supra* note 25, at 636-37.

The governance structure they have created allows them to make the substantive decisions, not when they originally acquire the units from the developer, but at some later time when they have greater information about what should be done. Again, it is possible to accept some judicial intervention where the network of covenants is so incomplete as to lack a governance structure, but such intervention under the doctrine of changed conditions is much trickier, and more dubious where that governance structure is in place. With any majoritarian structure in place, the risks are less those of holdout, and more those of confiscation. In that environment, it is unlikely that the covenants that do remain are best removed even if conditions have changed. Invalidation of covenants should be a rare event where majority rule procedures are in place.

Now it may be said that, even if these points are correct, the problem of externality still remains, for the governance structure that is ideal for the covenantees may not be ideal for society at large. But here the concern is overstated. In the first instance, the covenants that are created here are not fully inalienable. Persons who want to leave the development are free to sell their units and thus to remove themselves from the network of covenants. The price they can collect will reflect in part the soundness of the governance structure that their purchasers will inherit. If these incentives are really insufficient to foster responsible decisionmaking, then there is an argument not only for overriding private agreements on the problem of changed conditions, but also for socializing all other forms of investment. The owner who decides not to repair his unit because he wants to take a vacation trip also imposes some costs on future generations. So does every public and private person who chooses consumption over investment. We allow individuals to choose between present and future precisely because they internalize both sets of gains and losses, which is what happens in the case of covenants. If the owner is not allowed to choose between repairs and vacations, then someone else will have to do so. Yet public officials are often more worried about re-election than they are about long-term preservation of property or wealth; unlike private owners, they are not disciplined by the knowledge that the value of their own holdings drops when they pay insufficient attention to future gains and losses—be they in routine maintenance or governance structures. Even if some public intervention were desirable, it is highly doubtful that it should come in the form of a sporadic interference with private governance arrangements. Instead, some shift in the general laws of taxation applicable to both ordinary residences and homeowners' associations would seem preferable.

The problem of future generations does not arise because of

any defect in the system of private ownership. It arises because long-term relational contracts cannot costlessly predict and control the future. It arises because it is never possible for unborn or minor children to have a full say today about their futures. The problems here are well known to any person who has ever lived in a condominium or cooperative but are only one side of the coin. There are also the gains that these arrangements offer. The system of private governance on balance works pretty well, if only because the only available alternative is highly discretionary public control, disciplined by neither the bequest motive nor the resale market. The doctrine of changed conditions should not become the entering wedge of a large-scale system of judicial control over private homeowners' associations.

### CONCLUSION

It should be evident in conclusion that covenants, far from being in opposition to constitutions, are really a special case of them. The central problem with both is to find a way to bind a large number of persons to a common plan for their mutual good extending over several generations. With covenants the system of private voluntary contract is often available because of the happy circumstance that a single person owned the property outright before initial subdivision and development took place. Given this initial distribution of property rights, a system of front-end voluntary exchanges that can consensually link persons together can also minimize serious back-end holdout problems that will necessarily arise in practice. Forming a public constitution is far trickier business, because unanimous front-end consent is never possible in the world of politics, so that the founders, like our Founders, must take some liberties with the system in order to produce a viable result. Indeed one area in which our Founders took the greatest liberties was with choosing the number of states needed to ratify our new Constitution.<sup>40</sup>

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<sup>40</sup> U.S. CONST. art. VII provides: "The Ratification of the Conventions of nine States shall be sufficient for the Establishment of this Constitution between the States so ratifying the Same."

A fair reading of the Articles of Confederation made it clear that they could be abrogated only by the unanimous consent of all the states. Once Rhode Island failed to show up, the remaining states could have gone home. But they stayed and drafted a new constitution that took effect when 9 of the 13 states ratified the constitution, but only, we are told, "between the States" that so ratified. This last concession allowed to dissenting states to stay outside the orbit of the new constitution, but it denied them the previous right to have everyone abide by the Articles of Confederation. Yet the ploy worked because the gains from union were too large, even for the original dissenter. For an account of the difficulties it raises, see the discussion in H. STORING, *WHAT THE ANTI-FEDERALISTS WERE FOR*, ch. I (1981).

We will understand far better what can go wrong with constitutions if we look first to see what analogous problems arise in the voluntary institutions of government that private covenants foster. We shall have some greater confidence in the soundness of our own constitutional order if we see in its uneasy mix of structural protections, voting rules, and entrenched individual rights the same array of devices that private parties have used in order to determine the fate of their own common ventures. The connection between covenants and constitutions is not only alliterative. It is also functional.