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Fighting the Undead: Why States Should Use Forced Vesting to Kill Zombie Mortgages

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FIGHTING THE UNDEAD: WHY STATES SHOULD USE FORCED VESTING TO KILL ZOMBIE MORTGAGES

Abstract: Following the financial crisis, many home mortgage borrowers found themselves living in properties encumbered by debt that far exceeded their value. The result was an increase in mortgage default rates, followed by a wave of foreclosures as lenders scrambled to minimize the financial damage to their investments. From the wreckage, a new creature emerged that threatened to devastate borrowers who believed that foreclosure was their chance for a fresh start: the zombie mortgage. With a spike in lenders failing or declining to foreclose on properties, borrowers were unexpectedly facing an unwanted burden of homeownership that would cause them and their communities severe distress. As states and courts began to fight back, the number of zombie mortgages declined. Yet to this day, zombies can be found across the country and the risk that more will rise is quite real. This Note argues that a potential solution is for state legislatures to enact forced vesting provisions. Specifically, this Note evaluates the potential effect of such laws through a law and economics lens and concludes that such provisions would be beneficial.

INTRODUCTION

The 2008 financial crisis sent real estate prices plummeting, as home values dropped and borrowers of home mortgages began defaulting on payments.[1] Rising default rates led to increases in foreclosures as lenders attempted to take back the homes from defaulting borrowers.[2] Often times, borrowers who believed that foreclosure meant they would lose their homes simply chose to walk away and allow their lenders to repossess the property.[3] With a declining demand for houses, however, there were fewer willing buyers in the market, leading to foreclosures that banks never completed.[4] As a result, borrowers unknowingly retained the titles to their homes, assuming all the liabilities that came with continued

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[1] *See* FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 391–92 (2011) [hereinafter FINANCIAL CRISIS INQUIRY REPORT] (describing how home values fell and providing a graph that shows the decline in value of household assets).

[2] *Id.* at 402.

[3] Andrea Clark, Comment, *Amidst the Walking Dead: Judicial and Nonjudicial Approaches for Eradicating Zombie Mortgages*, 65 EMORY L.J. 795, 801 (2016).

[4] *See* JACK P. FRIEDMAN ET AL., REAL ESTATE HANDBOOK 1–2 (8th ed. 2013) (noting how home sales declined) [hereinafter REAL ESTATE HANDBOOK]; Clark, *supra* note 3, at 801–02 (explaining that lenders sometimes decided not to complete foreclosures).

home ownership.[5] This led to an increase in what has become known as a zombie mortgage: a property in terrible condition that is not being taken care of by the borrower or the lender and to which the borrower still has legal title.[6]

To understand the reasoning behind the now-accepted term "zombie mortgage," one only needs to look at the traditional conception of a "zombie."[7] In the context of mortgages, that idea is accurate: a title to property that simply will not die, resulting in the decaying remains of what used to be a home.[8] These homes are usually unappealing to the eye and are visibly unkempt.[9] Although television shows like *The Walking Dead* might suggest removing the head to kill a zombie, killing zombie mortgages may be better left to the heads of state legislatures.[10]

Part I of this Note discusses how the 2008 financial crisis led to an increase in zombie mortgages and discusses current relevant law.[11] Part II of this Note examines how bankruptcy courts introduced the concept of forced vesting—compulsorily giving title to lenders—to deal with zombie mortgages and how state statutes have attempted to resolve the issue.[12] Part II also introduces the law and economics perspective as a viable lens to examine the problem.[13] Part III of this Note uses a law and economics approach to evaluate why state legislatures should consider using forced vesting to prevent the rise of future zombies mortgages and examines the financial incentives of borrowers and lenders from a tax perspective.[14]

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[5] Clark, *supra* note 3, at 802. These liabilities include state property taxes and the costs of maintaining the home, as well as mortgage obligations. *Id.*

[6] *Id.* at 795. *See generally* Andrea Boyack & Robert Berger, *Bankruptcy Weapons to Terminate a Zombie Mortgage*, 54 WASHBURN L.J. 451 (2015) (discussing zombie mortgages); David P. Weber, *Zombie Mortgages, Real Estate, and the Fallout for the Survivors*, 45 N.M. L. REV. 37 (2014) (same); Amanda McQuade, Comment, *The Antidote to Zombie Foreclosures: How Bankruptcy Courts Should Address the Zombie Foreclosure Crisis*, 32 EMORY BANKR. DEV. J. 507 (2016) (same).

[7] *See Zombie,* MERRIAM-WEBSTER DICTIONARY (online ed.), https://www.merriam-webster.com/dictionary/zombie [https://perma.cc/SA6C-96QQ] (providing definitions such as "a will-less and speechless human" and "a person held to resemble the so-called walking dead").

[8] *See* Barbara Liston, *More Than 300,000 Homes Are Foreclosed "Zombies," Study Says*, REUTERS, Mar. 28, 2013, https://www.reuters.com/article/us-usa-housing-zombies/more-than-300000-homes-are-foreclosed-zombies-study-says-idUSBRE92R0YQ20130328 [https://perma.cc/Y7GF-2MWU] (mentioning the unsightly nature of properties with zombie mortgages); *see also* Kathy Welsh, *Schneiderman to Address Problem of "Zombie Properties*,*"* HUDSON VALLEY NEWS NETWORK, Feb. 16, 2015, https://hudsonvalleynewsnetwork.com/2015/02/16/schneiderman-address-problem-zombie-properties [https://perma.cc/88XK-YMT8] (depicting a house with rotting paint, broken windows, and a boarded up door).

[9] *See* Welsh, *supra* note 8 (describing the state of a house with a zombie mortgage).

[10] *See* Morgan v. Comm'r, 309 U.S. 78, 80–81 (1940) (stating that state law initially determines one's property rights); *The Walking Dead* (AMC television broadcasts Oct. 31, 2010-Present).

[11] *See infra* notes 15–94 and accompanying text.

[12] *See infra* notes 96–167 and accompanying text.

[13] *See infra* notes 96–167 and accompanying text.

[14] *See infra* notes 168–233 and accompanying text.

I. THE RISE OF THE ZOMBIE MORTGAGE

The financial crisis devastated the U.S. housing market, sending home prices plummeting to approximately one-third of their previous value.[15] Sales of new single-family homes dropped dramatically, eventually accounting for only a fraction of the number of sales in 2005.[16] The decline in home values led to properties that were worth substantially less than their mortgages.[17] By 2010, nearly one quarter of all mortgaged homes had mortgages with outstanding debt that was higher than the home value.[18] As the default rate rose, foreclosures began rising as well, with over two percent of all U.S. households having at least one foreclosure filing against them in 2009.[19] In that year nearly ten percent of all mortgages were delinquent by at least one payment.[20]

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[15] *See* FINANCIAL CRISIS INQUIRY REPORT, *supra* note 1, at 391–92 (finding that home values fell by 32% from the height of the housing bubble in 2006 to their lowest point in 2009 after the burst); Atif Mian et al., *Foreclosures, House Prices, and the Real Economy*, 70 J. FIN. 2587, 2587 (Dec. 2015) (finding that the decline in housing prices was 35%). *See generally* S&P DOW JONES INDICES, S&P CORELOGIC CASE-SHILLER U.S. NATIONAL HOME PRICE NSA INDEX, http://us.spindices.com/indices/real-estate/sp-corelogic-case-shiller-us-national-home-price-nsa-index [https://perma.cc/P6UL-C24W] (graphing the trends in the prices of single-family homes with the highest point prior to the crash occurring in 2006 and the lowest point post-crash in 2012).

[16] *See* REAL ESTATE HANDBOOK, *supra* note 4, at 1–2 (stating that sales declined 46% from 2005 to 2010).

[17] Cem Demiroglu et al., *State Foreclosure Laws and the Incidence of Mortgage Default*, 57 J. L. ECON. 225, 225 (2014). Homes with values less than their mortgages are said to have "negative equity" or to be "underwater." *See* FINANCIAL CRISIS INQUIRY REPORT, *supra* note 1, at 403–04 (discussing the drop in home values). The number of homes with negative equity is considered by many to be the most significant predictor of mortgage default. *Id.* at 403. Second in significance is borrowers experiencing financial hardship or lenders increasing mortgage payments, causing payments to become unaffordable for borrowers. *Id.* at 402–03.

[18] FINANCIAL CRISIS INQUIRY REPORT, *supra* note 1, at 403–04. The proportion of homes with underwater mortgages varies across states. *See id.* at 404 (showing a shaded map of the United States with different shades corresponding to different percentages of underwater mortgages). States with the highest proportion of underwater mortgages in 2010 were Nevada, Arizona, California, Michigan, and Florida, with Nevada having the highest proportion at 67%. *Id.* at 403–04.

[19] *Id.* at 402. The foreclosure rate had long been below 1%, but the filing rate rose following the crisis and reached as high as 2.2% in 2009. *Id.* This increase in mortgage delinquencies led to an increase in the average length of foreclosure from nine to fifteen months. Kyle F. Herkenhoff & Lee E. Ohanian, *The Impact of Foreclosure Delay on U.S. Employment* 2 (National Bureau of Economic Research, Working Paper No. 21532, 2015), https://www.nber.org/papers/w21532.pdf [https://perma.cc/MX7H-D74P]. Since then, the average length of foreclosure had been on a steady increase. *533,813 U.S. Properties with Foreclosure Filings in First Six Months of 2016, Down 11 Percent from a Year Ago*, REALTYTRAC, (July 13, 20016), https://www.realtytrac.com/news/midyear-2016-foreclosure-market-report [https://perma.cc/EU8E-4SNL]. By mid-2016, the average length was 629 days. *Id.*

[20] *See* FINANCIAL CRISIS INQUIRY REPORT, *supra* note 1, at 402 (stating that one in every eleven mortgages was at least a single payment behind). Lenders were visibly reluctant to renegotiate better terms with borrowers by decreasing payments. *See* Adelino et al., *Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures and Securitization*, 60 J. MONETARY ECON. 835, 835 (2013) (discussing lender opposition to renegotiation). In fact, fewer than 2% of significantly overdue

A. The Rise of the Zombie Mortgage and the Concept of "Forced Vesting"

A mortgage becomes a zombie when a property is legally owned by the borrower but had long been "abandoned," leaving behind the decrepit remains of what used to be a home.[21] This occurs when a lender stops the foreclosure process on a property that the borrowers had vacated, leaving the empty home behind.[22] In such situations, because the foreclosure sales are never finalized, borrowers will have unknowingly retained title to the homes and, along with it, all obligations and liabilities that accompany the property and the mortgage.[23] During the financial crisis, plummeting home values and high default rates spelled trouble for the lending community, as the costs of foreclosing on certain properties outweighed the potential returns.[24] This prompted many lenders to stop their pursuit of foreclosures, never completing the process.[25]

The spike in foreclosures resulted in multiple zombie properties, with one report claiming that there were over 300,000 abandoned homes by 2013.[26] Of those abandoned homes, about 44,000 were classified as zombie properties in the third quarter of 2013.[27] Most often, these zombie mortgages were prevalent in low-income areas where property values are lower.[28] Eventually, lenders retaliated against the spread of zombie properties and began selling them at a

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mortgages received a sizable reduction to their mortgage obligations, whereas 8% received only a miniscule reduction. *Id.* at 851.

[21] Clark, *supra* note 3, at 795. *See generally* Boyack & Berger, *supra* note 6; Weber, *supra* note 6; McQuade, *supra* note 6. "Abandonment" here refers to the common use of the term, which has a different meaning in a legal sense. *See* Eduardo M. Peñalver, *The Illusory Right to Abandon*, 109 MICH. L. REV. 191, 196 (2010) (explaining that there is a difference between the use of "abandon" in personal and legal contexts).

[22] Clark, *supra* note 3, at 801–02. Many homeowners, in the honest belief that their homes were going to be lost, chose to simply walk away and abandon their homes, leaving the properties to lenders. *Id.* Lenders will often not even give notice to borrowers that a foreclosure has been cancelled. *Id.* at 802. Currently, lenders appear to have no legal obligation to notify borrowers of such cancellations. *Id.*

[23] *See id.* at 802 (explaining that, even though the borrower may have abandoned the home long ago, if the foreclosure never concludes, a borrower remains liable for all taxes and fees associated with the property, as well as his or her original mortgage obligations).

[24] *See id.* at 801–02 (explaining how lenders evaluate potential costs and revenues in foreclosure settings).

[25] *Id.*

[26] *See* Liston, *supra* note 8 (providing data on the number of homes abandoned subsequent to foreclosure in 2013). The problem was especially prevalent in Florida, which contained over 90,000 abandoned properties in 2013. *Id.* Kentucky, with less than 1,000 homes in foreclosure in 2013, still had more than half of them abandoned. *Id.*

[27] *Vacant Property Rate Increases from a Year Ago in 54 Percent of U.S. Local Housing Markets in Q3 2017*, ATTOM DATA SOLUTIONS (Oct. 24, 2017), https://www.attomdata.com/news/risk/2017-u-s-residential-vacant-property-zombie-foreclosure-report [https://perma.cc/DJN4-QENF] [hereinafter *Vacant Property Rate*]; *see* Clark, *supra* note 3, at 795 (describing zombie properties).

[28] U.S. GOV'T ACCOUNTABILITY OFFICE, MORTGAGE FORECLOSURES: ADDITIONAL SERVICED ACTIONS COULD HELP REDUCE THE FREQUENCY AND IMPACT OF ABANDONED FORECLOSURES 14 (2010).

rapid pace.[29] By the end of 2017, their presence had been reduced to approximately 14,300.[30] Although the number of zombies has diminished, those that remain have significant effects on their surrounding neighborhoods and communities.[31] Homes located near these zombie properties are subject to declines in value, and neighborhoods may suffer increased crime rates.[32]

While zombie mortgages spread, the concept of "forced vesting" arose in bankruptcy courts as individuals sought relief from their financial woes.[33] Bankruptcy's fresh start policy is one of the cornerstones of the Bankruptcy Code, which allows honest, financially distressed individuals to discharge certain debts.[34] Some bankruptcy courts have allowed a debtor to forcibly vest title in a home to a creditor over the creditor's objection under a Chapter 13 bankruptcy plan, which is a plan establishing a debtor's three-to-five-year repayment schedule.[35] After the fallout of the financial crisis, this idea developed

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[29] Diana Olick, *Wiping Out Housing's 'Zombies': Banks Sell Off Foreclosed Remnants of Crash*, CNBC (Sep. 8 2016), https://www.cnbc.com/2016/09/08/wiping-out-housings-zombies-banks-sell-off-foreclosed-remnants-of-crash.html. The conditions of some of these homes were so terrible that they sold for miniscule amounts. *See id.* (giving an example of a property in Atlantic City that reportedly sold for $3,000).

[30] *Vacant Property Rate*, *supra* note 27.

[31] Weber, *supra* note 6, at 40. The poor condition of zombie properties may imply that neighborhoods are unsafe, causing declines in property values. *See* Boyack & Berger, *supra* note 6, at 452 (discussing safety issues and effects on property values); Marissa Weiss, *Attack of the Zombie Properties*, 47 URB. L. 485, 487 (2015).

[32] Weber, *supra* note 6, at 45. The abandoned homes may invite squatters, drug use, and other crimes like arson and theft. Weiss, *supra* note 31, at 487.

[33] *See, e.g*, *In re* Tosi, 546 B.R. 487, 489 (Bankr. D. Mass. 2016) (denying a plan that forcibly vested title in a lender); *In re* Sagendorph, No. 14-41675-MSH, 2015 WL 3867955, at *1, *2 (Bankr. D. Mass. June 22, 2015), *rev'd*, *In re* Sagendorph, 562 B.R. 545 (D. Mass. 2017) (allowing a debtor to forcibly vest title in a lender); *In re* Zair, 535 B.R. 15, 17 (Bankr. E.D. N.Y. 2015), *rev'd*, HSBC Bank USA, N.A. v. Zair, 550 B.R. 188 (E.D.N.Y. 2016) (confirming a plan that vested title in a lender); *In re* Stewart, 536 B.R. 273, 274 (Bankr. D. Minn. 2015) (approving a plan that vested title in a lender because the lender failed to object); *In re* Williams, 542 B.R. 514, 517 (Bankr. D. Kan. 2015) (denying a debtor's motion to confirm a plan vesting title in a lender); *In re* Watt, 520 B.R. 834, 835–36 (Bankr. D. Or. 2014), *vacated* Bank of New York Mellon v. Watt, No. 3:14-CV-02051-AA, 2015 WL 1879680 (D. Or. Apr. 22, 2015) (confirming a plan that vested title in a bank over the bank's objection); *In re* Rosa, 495 B.R. 522, 523 (Bankr. D. Haw. 2013) (approving a Chapter 13 plan that vested title in a mortgagee because the mortgagee did not object).

[34] Marrama v. Citizens Bank of Mass., 549 U.S. 365, 367 (2007) (citing Grogan v. Garner, 498 U.S. 279, 286–87).

[35] *See supra* note 33 and accompanying text (tracking the development of the concept of forced vesting as part of a bankruptcy). In a Chapter 13 bankruptcy, a debtor files for bankruptcy and develops a plan in which they will pay creditors over the course of three to five years. *Chapter 13—Bankruptcy Basics*, U.S. COURTS, http://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-13-bankruptcy-basics [https://perma.cc/R6ZC-5Z84]. A plan is "confirmed" upon the bankruptcy court's approval. *Id.* Debtors keep their property and, if the plan is successfully followed, will receive a discharge of their outstanding debts. *Marrama,* 549 U.S. at 367. Sections 1322 and 1325 of the Bankruptcy Code govern the confirmation of Chapter 13 plans. *See* 11 U.S.C. §§ 1322, 1325 (2016); *In Re Sagendorph*, 562 B.R. at 547. Section 1322(a) lists the required elements of the plan and (b) lists what the plan "may" have. § 1322(a)–(b). In terms of vesting, Section 1322(b)(9) permits a

through the bankruptcy system, becoming more aggressive with time as bankruptcy courts began confirming plans over the express objections of lenders.[36] Courts have not viewed the case for forced vesting in Chapter 13 bankruptcies favorably on appeal.[37] Nonetheless, some of those courts have expressed understanding of the situations of individuals who resorted to bankruptcy for relief.[38]

B. An Overview of Foreclosure

Foreclosure occurs when a borrower, usually faced with some sort of financial hardship, stops making monthly mortgage payments, prompting the lender to initiate action to take possession of the home and sell it to satisfy the money owed.[39] Foreclosure is based in state law, which determines the legal process that a lender must follow to properly take someone's home.[40] The differences in state law are generally classified in two different categories: judi-

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plan to contain a provision vesting property in a debtor or another party. *Id.* § 1322(b)(9). Section 1325 provides the requirements that a bankruptcy plan must meet to be confirmed. *Id.* § 1325(a). There are three ways in which a Chapter 13 plan may treat claims secured by a property interest. *Id.* § 1325(a)(5). The third potential way for a plan to treat such a claim is for the debtor to "surrender" the property to the claim holder. *Id.* § 1325(a)(5)(C).

[36] For a series of cases tracking the development of bankruptcy courts' increasingly permissive responses to forced vesting, see *In re Sagendorph*, 2015 WL 3867955, at *4 (holding that the Bankruptcy Code permits a debtor to vest title in other entities and that federal bankruptcy law overcomes state law concerns as to such provisions); *In re Stewart*, 536 B.R. at 276, 278 (holding that because the lender did not object to the provision, the borrower could execute a quitclaim deed transferring title to the lender); *In re Watt*, 520 B.R. at 839 (ruling that although the lender objected to the provision, the Bankruptcy Code allows debtors to vest title to property in other entities, and the plan may therefore be confirmed over the objection); *In re Rosa*, 495 B.R. at 525 (ruling that a borrower's provision transferring title to the lender in the Chapter 13 plan was permissible because the lender's lack of objection constituted acceptance). Other bankruptcy courts have refused to permit an interpretation of the Bankruptcy Code that permits forced vesting. *See In re Tosi*, 546 B.R. at 493–94 (explaining that surrender and vesting are two separate sets of legal relationships to property and allowing a debtor to forcibly vest title to a lender would be inconsistent with the Bankruptcy Code); *In re Williams*, 542 B.R. at 521 (expressing that allowing such a provision would violate a lender's rights under state law).

[37] *See generally In re Sagendorph*, 562 B.R. 545 (reversing the bankruptcy court's allowance of forced vesting); *Watt*, 2015 WL 1879680 (D. Or. Apr. 22, 2015) (holding that the bankruptcy court's allowance of forced vesting was improper).

[38] *See In re Sagendorph*, 562 B.R. at 558 (noting that forced vesting is an appropriate response to the financial crisis and aligns with the idea of bankruptcy's equitable nature). Although the district court understood the reasoning and policy of the bankruptcy court, it held that, even if forced vesting may be desirable, the statutory language of § 1322 and § 1325 prohibits such provisions. *Id.* at 554–55. The court left the question open of whether other provisions of the Bankruptcy Code could achieve the same result. *Id.* at 558.

[39] *See* FINANCIAL CRISIS INQUIRY REPORT, *supra* note 1, at 402; FRANKIE ORLANDO & MARSHA FORD, THE COMPLETE GUIDE TO LOCATING, NEGOTIATING, AND BUYING REAL ESTATE FORECLOSURES 41 (2d ed. 2016).

[40] *See* Mian, *supra* note 15, at 2594; *Mortgage Law: Judicial vs. Non-Judicial Foreclosure*, THE LAW DICTIONARY, https://thelawdictionary.org/article/mortgage-law-judicial-vs-non-judicial-foreclosure [https://perma.cc/D6PC-L6UC] [hereinafter *Judicial vs. Non-Judicial Foreclosure*].

cial and non-judicial foreclosures.[41] The majority of states are non-judicial foreclosure states.[42]

1. Judicial Foreclosure States

Judicial foreclosure states require the lender to go through the court system to foreclose on a property.[43] Typically, these are states where lenders secure their interest in a borrower's home with a mortgage.[44] In these states, the foreclosure process is initiated when a lender files a complaint with the court.[45] The lender then bears the burden of proving that it has a right to foreclose on the property.[46] After the filing of a complaint, the court conducts a foreclosure hearing and, if the lender is successful, issues a judgment in favor of the lender indicating that it may proceed with the foreclosure.[47] The date for the sale is then set and the public is notified, after which the property is sold to the highest bidder.[48]

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[41] *Foreclosure Laws and Procedures by State*, REALTYTRAC, https://www.realtytrac.com/real-estate-guides/foreclosure-laws [https://perma.cc/AXH6-AR3P] (providing a chart of the fifty states and District of Columbia and indicating whether each uses judicial foreclosures, non-judicial foreclosures, or both). There appears to be disagreement over the proper classification of Massachusetts. *Compare id.* (listing Massachusetts as only a judicial foreclosure state), *with* JOHN RAO & GEOFF WALSH, NAT'L CONSUMER LAW CENT., FORECLOSING A DREAM (2009) (listing Massachusetts as a non-judicial foreclosure state). RealtyTrac justifies its classification of Massachusetts as a judicial foreclosure state because the state requires that a lender obtain a judgment from the Land Court before the property is sold. *Massachusetts Foreclosure Laws*, RealtyTrac, https://www.realtytrac.com/real-estate-guides/foreclosure-laws/massachusetts-foreclosure-laws [https://perma.cc/D8E5-DGNQ].

[42] ORLANDO & FORD, *supra* note 39, at 44.

[43] *Judicial vs. Non-Judicial Foreclosure*, *supra* note 40.

[44] ORLANDO & FORD, *supra* note 39, at 44. In these states, a borrower signs both a note indicating a promise to pay the lender and signs a mortgage, which secures the debt by giving the lender a lien on the property. *Judicial vs. Non-Judicial Foreclosure*, REALTYTRAC, https://www.realtytrac.com/real-estate-guides/foreclosure/judicial-vs-non-judicial-foreclosure [https://perma.cc/UXA7-SGQP].

[45] ORLANDO & FORD, *supra* note 39, at 44. The complaint will contain information concerning the amount of money the lender is owed, the missed payments, and why the absence of payments should be cause to allow the lender to sell the property. Mian, *supra* note 15, at 2594.

[46] Demiroglu, *supra* note 17, at 228. In fact, in 2010, three large lenders whose employees illegally provided inaccurate information on mortgage documents stopped foreclosures in judicial foreclosure states because judges would not be willing to approve foreclosure sales of homes with erroneous mortgage documents. Andrew Martin & David Streitfeld, *Flawed Foreclosure Documents Thwart Home Sales*, N.Y. TIMES (Oct. 7, 2010), https://www.nytimes.com/2010/10/08/business/08frozen.html [https://perma.cc/EZ55-M4AB]. The lenders' actions were spurred by the fact that judicial foreclosure states require a judge's approval prior to a foreclosure sale. *Id.* Although the problem of inaccurate mortgage paperwork may have also been prevalent in non-judicial foreclosure states, in those states a judge is only involved when a borrower sues the lender, which is uncommon because borrowers often lack the funds to sue. *Id.*

[47] ORLANDO & FORD, *supra* note 39, at 44. Borrowers may, of course, respond to the complaint and attempt to triumph over the lender in court. *Judicial vs. Non-Judicial Foreclosure*, *supra* note 40.

[48] ORLANDO & FORD, *supra* note 39, at 44.

Foreclosures in judicial foreclosure states typically take longer to process and are costlier than in non-judicial foreclosure states.[49] It is common for judicial foreclosure states to have right of redemption laws as well, giving homeowners the opportunity to take back their property post-sale within an allotted period of time if they are able to come up with the funds.[50] These redemption rights vary by state and can last for up to one year after the foreclosure sale.[51]

2. Non-Judicial Foreclosure States

Non-judicial foreclosure states do not require the lender to go through the court system to foreclose on a property.[52] In these states, lenders use deeds of trust as opposed to a mortgage to secure their interest in the property.[53] The deed of trust has a "power-of-sale clause" which allows a lender to bypass the court system and initiate the foreclosure proceedings by giving notice to the borrower and by calling for the trustee to sell the property if the borrower does not rectify the situation.[54] In these states, the burden of proof shifts to the borrower to show that the lender may not foreclose on the property.[55] Non-judicial foreclosure states typically have higher rates of foreclosure, as it often takes less time and money to foreclose because the court system is not involved.[56]

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[49] *See* Demiroglu, *supra* note 17, at 228 (finding that as of 2014, the average length of the foreclosure process in judicial foreclosure states from beginning to end was twenty months).

[50] ORLANDO & FORD, *supra* note 39, at 44; Michael J. Gomez, *Bankruptcy and the Tax Impact of Foreclosure for Consumer Debtors*, 30 CAL. BANKR. J. 73, 78 (2009). If the previous homeowner is successful, he or she may buy the property back from whomever bought it at the foreclosure sale. ORLANDO & FORD, *supra* note 39, at 44. Although the buyer is compensated for the purchase price when a previous homeowner exercises a right of redemption, the buyer may lose money spent on repairs, because the homeowner is not required to pay for those supplemental expenditures. *Id.* The homeowner may have to pay other fees associated with maintaining the property, but these costs do not include improvements made to the property. *Id.* at 44–45.

[51] *Foreclosure Laws and Procedures by State*, *supra* note 41. The redemption period varies widely by state. *See id.* (listing the redemption periods for all fifty states and the District of Columbia). For example, New Jersey only gives a period of ten days, while Kansas gives 365 days. *Id.* Some judicial foreclosure states, like Pennsylvania, do not provide for any redemption period, so a resident has no guaranteed right to buy back the property. *Id.*

[52] *Id.*; *Judicial vs. Non-Judicial Foreclosure*, *supra* note 40.

[53] ORLANDO & FORD, *supra* note 39, at 44. A deed of trust differs from a mortgage in that it adds a trustee, who holds title to the property until the debt is paid. *Two Important Differences Between a Mortgage and Deed of Trust*, THE LAW DICTIONARY, https://thelawdictionary.org/article/two-important-differences-mortgage-deed-trust [https://perma.cc/ZDR9-DVF3]. Because the trustee has title to the property, the trustee may sell the property for the benefit of the lender without court approval. *Id.*

[54] *Judicial vs. Non-Judicial Foreclosure*, *supra* note 44.

[55] Demiroglu, *supra* note 17, at 228. Although non-judicial foreclosure states do not require court involvement, the borrower may still bring an action against the lender to attempt to stop the foreclosure from taking place. *Judicial vs. Non-Judicial Foreclosure*, *supra* note 40.

[56] *See* Mian, *supra* note 15, at 2596 (charting the ratio of foreclosures to delinquent mortgages in all fifty states and the District of Columbia). The data indicate that the states with the highest ratios were typically non-judicial foreclosure states. *Id.*

These states may also have redemption laws.[57] In fact, Tennessee, a non-judicial foreclosure state, has an exceptionally long redemption period of two years, during which homeowners have the opportunity to get back their property.[58]

Although the likelihood of default does not vary among borrowers in judicial and non-judicial foreclosure states, the latter nonetheless have a higher rate of foreclosure.[59] Data from 2005–2011 indicate that, six months after being considered "seriously delinquent," nearly 20% of borrowers lost their homes in non-judicial foreclosure states as compared to less than 3% of borrowers in judicial foreclosure states.[60] Moreover, after eighteen months of delinquency, less than 25% of borrowers in non-judicial foreclosure still had title to their homes as opposed to over 40% of borrowers in judicial foreclosure states.[61]

C. An Overview of Tax Law and Its Relation to Foreclosure

The Internal Revenue Code ("IRC") has certain provisions that are relevant to the discussion of foreclosure.[62] Sections 1 and 11 list the tax rates for individuals and corporations, respectively.[63] Section 61, which defines gross income, includes both "gains derived from dealings in property" and "income from discharge of indebtedness"—i.e., forgiven debts that are considered "income"—in gross income.[64] Section 108, however, provides some instances in which income from the discharge of indebtedness may be excluded from gross income (and thus not taxed), including when the discharge occurs within bank-

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[57] *Foreclosure Laws and Procedures by State*, *supra* note 41.

[58] *See id.* (showing that Tennessee has a redemption period of 730 days—a year longer any other state's redemption period).

[59] Mian, *supra* note 15, at 2596–99.

[60] Kristopher Gerardi et al., *Do Borrower Rights Improve Borrower Outcomes? Evidence from the Foreclosure Process*, 73 J. URB. ECON. 1, 7–8 (2013). The disparity decreases after the six-month mark. *Id.* "Seriously delinquent" means that the borrowers have missed a substantial amount of payments. *Id.* at 7.

[61] *Id.* at 7–8. During delinquency, borrowers make no payments on their mortgage, so those in judicial foreclosure states are more likely to live rent-free for a longer period of time. *Id.* at 7.

[62] *See* 26 U.S.C. §§ 1, 11, 61, 108, 121, 166, 1001, 1011, 1012, 1016 (2018) (referring to various rules that affect taxable income). These provisions require the inclusion of certain items in gross income, allowable exclusions from gross income, and the calculation of gain in a sale or exchange of property. *Id.*

[63] *Id.* §§ 1, 11.

[64] *Id.* § 61(a)(3), (11). The statutory language makes it clear that the list of items that may be included in gross income is not an exclusive list. *Id.* § 61(a). The Supreme Court has construed this language broadly, finding that Congress did not place any limitations in this provision of the Internal Revenue Code ("IRC"). Comm'r v. Glenshaw Glass, 348 U.S. 426, 429–30 (1955). The Court recognized that Congress's choice of language was meant to allow for taxation of all gains except for those explicitly exempted. *Id.* at 430. "Income from discharge of indebtedness" is essentially debt one owes that is "forgiven, cancelled, or otherwise discharged," thereby constituting income in the amount of the discharged debt. Colonial Sav. Ass'n & Subsidiaries v. Comm'r., 854 F.2d 1001, 1004 (7th Cir. 1988).

ruptcy or when the borrower is insolvent.[65] Section 121 lays out when borrowers may exclude income from the sale or exchange of their principal residence.[66] Section 166 explains when businesses (such as lenders) may deduct bad debts, being debts that become "worthless within the taxable year," from their taxes.[67] Finally, Section 1001 provides the formula for calculating the gain or loss from a disposition of property, such as a sale or other transfer.[68]

Foreclosure may raise tax consequences for a borrower.[69] For federal tax purposes, two classes of mortgages are relevant: recourse and nonrecourse mortgages.[70] Recourse mortgages are mortgages that permit a lender to pursue a borrower for any remaining amount owed after proceeds from the foreclosure sale are applied to the debt.[71] Nonrecourse mortgages only permit a lender to foreclose on a borrower's home, but not to pursue the borrower personally for any outstanding debt owed.[72] In general, borrowed money, like a mortgage, does not constitute taxable income to the borrower because there is an offset-

[65] 26 U.S.C. § 108(a). This section also allows for the exclusion from gross income of the discharge of "qualified principal residence indebtedness" that occurred prior to January 1, 2018, or resulted from a written agreement entered into prior to that date. *Id.* "Qualified principal residence indebtedness" is debt incurred in buying or improving a taxpayer's main residence and secured by the home, but not in excess of $2,000,000. *Id.* §§ 108(h)(2); 163(h)(3)(B).

[66] *Id.* § 121(a). The limit on the allowed exclusion is $250,000 for single taxpayers and $500,000 for married taxpayers filing jointly. *Id.* § 121(b). Moreover, to be eligible for the exclusion, the borrower must have used the home as his or her primary residence for at least two of the five years prior to the sale or exchange. *Id.* § 121(a).

[67] *Id.* § 166(a).

[68] *Id.* § 1001(a). The computation for gain is the amount realized minus the adjusted basis in the property. *Id.* This section defines the amount realized as the value of all money and property received by the seller in the sale or exchange. *Id.* § 1001(b). Basis in property under § 1012 is the cost that the seller originally paid to acquire the property. *Id.* § 1012(a). Taxpayers are able to adjust their basis in property for expenditures incurred in relation to the property. *Id.* § 1016(a). The result is the taxpayer's adjusted basis in the property. *See id.* § 1011(a) (defining adjusted basis as the basis from § 1012 adjusted as allowed by § 1016).

[69] Brad Cripe & Katrina Mantzke, *Tax Implications of Mortgage Foreclosures*, 84 PRAC. TAX STRATEGIES 324, 324 (2010).

[70] *See id.* (distinguishing between recourse and nonrecourse mortgages). State property laws may affect whether a mortgage is recourse or nonrecourse. *Id.* at 325. For example, in jurisdictions where laws prohibit lenders from pursuing borrowers for outstanding debt after foreclosure, mortgages must be nonrecourse. *Id.*

[71] Gomez, *supra* note 50, at 76.

[72] *Id.*

ting obligation to pay the amount back.[73] Nonetheless, a foreclosure sale is treated as a sale or exchange of property and, therefore, is a taxable event.[74]

In the case of nonrecourse mortgages, the borrower's amount realized from the foreclosure is the entire remaining debt, regardless of the property's value.[75] Thus, the borrower must recognize a gain of the amount of the mortgage minus the amount the borrower invested to buy and maintain the property, known as the "basis."[76] A borrower may be able to avoid including the gain in income to the extent it is not over $250,000.[77] Foreclosures on properties with recourse mortgages, on the other hand, require a two-prong analysis.[78] Because recourse mortgages mean that the borrower may still be personally liable for a deficiency, a lender may choose to pursue any remainder owed after the sale or forgive the debt.[79] If the lender chooses to forgive the remaining amount, then that amount will be considered income from the cancellation of debt.[80] Therefore, a borrower may have taxable income if the sale price ex-

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[73] *See* Comm'r v. Tufts, 461 U.S. 300, 307 (1983) (explaining that a loan is not income because the taxpayer must pay the amount back); Martin J. McMahon, Jr. & Daniel L. Simmons, *A Field Guide to Cancellation of Debt Income*, 63 TAX LAW. 415, 417 (2010) (clarifying that, although a loan increases the borrower's assets, this increase is countered by the corresponding obligation to pay it back); *see also Glenshaw Glass*, 348 U.S. at 431 (defining income as "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion"). Loans do not qualify as accessions to wealth due to the offsetting obligation to repay them. McMahon & Simmons, *supra*.

[74] Medlin v. Comm'r, 86 T.C.M (CCH) 141 (2003) (citing Helvering v. Hammel, 331 U.S. 504 (1941)); Cripe & Mantzke, *supra* note 69, at 327.

[75] McMahon & Simmons, *supra* note 73, at 427. This is the same treatment given to sales of property encumbered by debt in which the buyer agrees to take on the debt as part of the purchase. *Id.* "Amount realized" is defined by the IRC to include the amount of money received on the disposition of a property. 26 U.S.C. § 1001(b).

[76] Katherine M. Hetherington & Timothy R. Hurley, *Selling Principal Residence When Debt Exceeds Fair Market Value*, 90 PRAC. TAX STRATEGIES 52, 58 (2013). For example, if a lender forecloses on a borrower's home with an outstanding nonrecourse mortgage of $100,000 and an adjusted basis of $50,000, the amount realized to the borrower is the entire $100,000. *See id.* (providing examples of amount realized and gain from foreclosures with nonrecourse mortgages). The gain to the borrower would be the amount realized in excess of the adjusted basis, or $50,000. *See id.* (specifying that gain is the amount realized minus the adjusted basis).

[77] *See* 26 U.S.C. § 121. Borrowers must have used the home as their principal residence for a total of two years within the preceding five-year period prior to the foreclosure to qualify for this exclusion. *Id.* If borrowers in the above example had met this requirement, they would be able to exclude the $50,000 of gain. *See* Hetherington & Hurley, *supra* note 76 (explaining how to calculate a borrower's basis).

[78] Hetherington & Hurley, *supra* note 76.

[79] *See* Gomez, *supra* note 50, at 76 (explaining that because the maximum a lender can recover in foreclosure is the value of the home, recourse mortgages allow lenders to pursue any remainder in debt); Hetherington & Hurley, *supra* note 76, at 53 (explaining that when a lender decides to eliminate or lessen the borrower's remaining debt after foreclosure, the borrower must recognize income from the cancellation of debt).

[80] *See* Gomez, *supra* note 50, at 74–75. Some states have anti-deficiency statutes that prohibit lenders from pursuing borrowers for deficiencies after the foreclosure sale. Cripe & Mantzke, *supra* note 69, at 325. Although the borrower still "owes" the deficiency, if a state statute prohibits collec-

ceeds the basis, and, further, may have to recognize cancellation of debt income if the lender forgives any remaining deficiency.[81] The borrower may exclude from income the gain from the foreclosure sale of the home under Section 121 and similarly exclude the gain from the cancellation of debt under Section 108.[82]

In 2007, faced with the aftershock of the financial crisis as borrowers began to default, Congress passed the Mortgage Forgiveness Debt Relief Act, which amended Section 108.[83] This provision allowed individual borrowers who defaulted on their mortgages to exclude up to $1,000,000 that would otherwise have counted as income from the cancellation of debt.[84] The Act expired at the end of 2009 but Congress extended it several times.[85] Currently, the provision applies only to debts forgiven before the start of 2018 or to debts that were entered into by written agreement prior to that date, and the law has yet to be extended again.[86]

D. Using Law and Economics to Attack the Problem

Law and economics is a lens through which one may analyze the effect of legal rules.[87] A key assumption in this area is that the introduction of legal rules will affect people's behavior.[88] This is predicated on the assumption that

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tion of that debt, then that amount will still constitute cancellation of debt income, because the borrower no longer needs to pay the deficiency. Gomez, *supra* note 50, at 74–75.

[81] Hetherington & Hurley, *supra* note 76, at 58. For example, if a lender forecloses on a borrower's home with a recourse mortgage of $100,000 and an adjusted basis of $30,000 and the home only sells for $50,000, then there is a two-step analysis in calculating tax liability. *See id.* First, because the foreclosure sale price is in excess of the adjusted basis by $20,000, the borrower would realize that differential in gain. *See id.* If the lender then chose to forgive the remaining $50,000 of debt, the borrower would realize that $50,000 in cancellation of debt income. *See id.*

[82] *See* 26 U.S.C. §§ 108(a) (listing instances in which cancellation of debt is not included in gross income, such as if the debt is qualified principle residence indebtedness discharged before January 1, 2018), 121(a) (explaining that, to exclude gain from the sale of property, the borrower must have used the home as a principal residence for two of the preceding five years).

[83] *Id.* § 108(a)(1)(E); McMahon & Simmons, *supra* note 73, at 467.

[84] 26 U.S.C. § 108(a)(1)(E); McMahon & Simmons, *supra* note 73, at 467. This only applies to "qualified principal residence indebtedness." *Id.*

[85] Hetherington & Hurley, *supra* note 76, at 54.

[86] *See* 26 U.S.C. § 108(a)(1)(E) (specifying that, in order for the forgiveness of a debt to be eligible for exclusion up to $2,000,000, a debt must have been cancelled prior to the beginning of 2018 or stem from a contract entered into before 2018). So far, the IRS website has not been updated to indicate that this provision will be extended. *Home Foreclosure and Debt Cancellation*, INTERNAL REVENUE SERV. (Dec. 11, 2018), https://www.irs.gov/newsroom/home-foreclosure-and-debt-cancellation [https://perma.cc/5CUA-B2HW].

[87] DAVID D. FRIEDMAN, LAW'S ORDER: WHAT ECONOMICS HAS TO DO WITH LAW AND WHY IT MATTERS 8 (2000). *See generally* NYU School of Law, *The Forum: The Method Behind the Madness (1): Explaining Law and Economics*, YOUTUBE (Nov. 3, 2014), https://www.youtube.com/watch?v=2cFTiSeM4cA [https://perma.cc/Q5J6-ZUEU] (documenting a presentation by Max E. Greenberg, a contracts professor at NYU School of Law, on the topic of law and economics).

[88] NYU School of Law, *supra* note 87.

people act rationally to further their self-interest.[89] This does not necessarily mean that every individual engages in some numerical cost-benefit analysis (although they might), but rather, that people make decisions based on a broad understanding of whether such decision will benefit or hurt them.[90]

Much of modern law and economics can be attributed to what has become known as the "Coase Theorem."[91] Stated simply, this proposition stands for the idea that by disregarding transaction costs, the original legal assignment of property rights between two conflicting parties would be irrelevant because both would be able to reach an efficient bargain as to the property's use.[92] Of course, in the real world, transaction costs are often high, which may cause market inefficiency.[93] In this case, laws may be formulated to achieve the efficient result that would have been reached without those costs.[94] Because bargaining in a transaction bears costs, such as legal fees, this Note disregards those costs and examines how rational lenders and borrowers would respond to financial incentives and bargain over legal rules that affect the use of a home in foreclosure to avoid a zombie mortgage.[95]

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[89] FRIEDMAN, *supra* note 87, at 8. Rationality in this context does not mean that people make the morally "right" choices—one might "rationally" engage in illegal activities because his or her abilities make that choice the most logical option. *See id.* (discussing how thieves may choose their profession due to their unique set of abilities).

[90] *See id.* (elaborating that rationality does not mean that a criminal necessarily calculates the percentage chance he or she has of being caught, but, rather, chooses to break the law because it fits the criminal's skill set or abilities).

[91] FRANCESCO PARISI, THE LANGUAGE OF LAW AND ECONOMICS 47 (2013). In 1960, Ronald Coase, a British economist, published "The Problem of Social Cost" in the University of Chicago Law School's Journal of Law and Economics. Ronald Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1 (1960); JEFFREY L. HARRISON, LAW AND ECONOMICS IN A NUTSHELL 2 (6th ed. 2016). Coase was an Economics professor at the University of Chicago Law School and editor of the Journal of Law and Economics from 1964 to 1982. *About Ronald Coase*, THE RONALD COASE INST. (Feb. 3, 2018), https://www.coase.org/aboutronaldcoase.htm [https://perma.cc/C7BE-B99L]. Coase's influential work in the discussion of property rights and transaction costs led to him winning the Nobel Prize in Economics in 1991. *Id.*

[92] Coase, *supra* note 91, at 8; RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 10 (8th ed. 2011). Coase had expressed his opposition to the formulation of his ideas as a theorem because he believed many scholars misinterpret the concept. The University of Chicago, *Ronald Coase: Centennial Coase Lecture*, YOUTUBE (Apr. 20, 2012), https://www.youtube.com/watch?v=DIrftpTfyYQ&t=2455s [https://perma.cc/9V4C-GKGP]. Coase explained that a world without transaction costs does not exist and describing the world as such is fallacious. *Id.* Rather, Coase stated, one should disregard transaction costs in a particular transaction, rather than the world as a whole, to properly apply his proposition. *Id.*

[93] Coase, *supra* note 91, at 15.

[94] Richard A. Posner, *Utilitarianism, Economics, and Legal Theory*, 8 J. LEGAL STUD. 103, 109 (1979).

[95] *See infra* notes 98–236 and accompanying text.

II. Federal Law May Not Be the Optimal Solution to the Problem: A Discussion on the Desirability of State Law

A. The Problem with Forced Vesting in Bankruptcy

Bankruptcy courts that have addressed forced vesting are split on whether a debtor may forcibly vest title to a creditor in a Chapter 13 plan and focus on two provisions of the Bankruptcy Code in their analysis: sections 1325(a) and 1322(b).[96] The split may be illustrated by examining two bankruptcy court decisions from Massachusetts that reach opposite conclusions.[97] The *In re Sagendorph* decision used both sections to justify forced vesting as part of a Chapter 13 plan.[98] Section 1322(b)(9) allows a plan to vest property in an entity, and Section 1325(a)(5)(C) provides that a debtor may surrender secured property to the holder of the security interest under a plan.[99] The bankruptcy court noted that surrendering property to a party is a preliminary step in vesting title to that party, and held that forced vesting was statutorily authorized by the Bankruptcy Code, even if it violated state law, in accordance with bankruptcy's fresh start policy.[100]

The *In re Tosi* decision took a divergent approach to the *Sagendorph* analysis.[101] In *Tosi*, the debtor attempted to include a provision in his plan that would vest title in his mortgaged property to his lender if the debtor failed to sell his home within three months of confirmation of the plan.[102] The court examined whether the proposed plan may be viewed as one that surrenders property to the lender under § 1325(a)(5)(C).[103] The court found that surrender is meant to allow a lender to use all of its property rights in the home.[104] Vest-

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[96] *See* 11 U.S.C. §§ 1322, 1325 (2012) (listing what a plan shall and may include).

[97] *Compare In re* Sagendorph, No. 14-41675-MSH, 2015 WL 3867955, at *1, *4 (Bankr. D. Mass. June 22, 2015), *rev'd*, *In re* Sagendorph, 562 B.R. 545 (D. Mass. 2017) (ruling that surrender is a preliminary step in vesting), *with In re* Tosi, 546 B.R. 487, 494 (Bankr. D. Mass. 2016) (holding that forced vesting is not compatible with the Bankruptcy Code).

[98] *In re Sagendorph*, 2015 WL 3867955, at *4.

[99] 11 U.S.C. §§ 1322, 1325.

[100] *In re Sagendorph*, 2015 WL 3867955, at *4–5. The court stated that Congress would not have included both provisions in the Bankruptcy Code if it meant for vesting to be synonymous with surrender. *Id.* at 4. The court also noted that, although Massachusetts does not allow for transfer through forced vesting, federal law supersedes state law, and thus permits such a transfer. *Id.* (citing Butner v. United States, 440 U.S. 48, 55 (1979)).

[101] *See Tosi*, 546 B.R. at 495 (finding that forced vesting is not permitted).

[102] *Id.* at 489. In this case, the court granted the lender relief from the automatic stay so that it could initiate foreclosure proceedings on the property. *Id.* at 491. The automatic stay occurs in bankruptcy and prevents a debtor's creditors from enforcing any liens they have on the debtor's property. 11 U.S.C. § 362(a)(4). Here, the debtor did not object to the lender foreclosing on the property but requested that, if the plan was confirmed and the foreclosure did not occur within three months of confirmation, title would still vest in the lender. *Tosi*, 546 B.R. at 491. The court rejected the debtor's proposal. *Id.* at 496.

[103] *Tosi*, 546 B.R. at 491.

[104] *Id.* at 493.

ing, however, effectively changes the lender's legal relationship with the property, thus depriving it of some of the rights it has as a mortgagee, such as the right to foreclose.[105] Therefore, the court held that surrender and vesting could not both be invoked in the plan because doing so would be inconsistent.[106]

Courts have not viewed the case for forced vesting during Chapter 13 bankruptcies favorably on appeal, instead holding that forced vesting is inconsistent with the Bankruptcy Code.[107] Still, district courts sympathetic to the financial situations of debtors with underwater homes have voiced support for the possibility of enabling forced vesting through other provisions in the Bankruptcy Code.[108] Some commentators on the subject have made similar suggestions.[109] Another has called for Congress to amend the Bankruptcy Code to make forced vesting possible.[110] Regardless of the potential solutions available in bankruptcy and their potential desirability, they are nonetheless contingent on filing for bankruptcy.[111] Borrowers with mortgages in excess of their homes' values filed for bankruptcy after the properties had already become encumbered by more debt than they were worth.[112] Bankruptcy reform may

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[105] *Id.*

[106] *Id.* at 494.

[107] *See In re Sagendorph*, 562 B.R. at 558; Bank of N.Y. Mellon v. Watt, No. 3:14-CV-02051-AA, 2015 WL 1879680, at *1, *7 (D. Or. Apr. 22, 2015).

[108] *In re Sagendorph*, 562 B.R. at 558.

[109] *See* Boyack & Berger, *supra* note 6, at 473 (advocating for the use of § 363 sales to eradicate zombie mortgages); Kate E. Nicholson, *A Future for Forced Vesting? Developments in Case Law and an Alternative Approach*, 2017 ANN. SURV. OF BANKR. LAW 14 (advocating for the use of the § 1325(a)(5)(B) cramdown provision to fix the problem). A "cramdown" describes when a Chapter 13 plan is confirmed over a creditor's objection, and that creditor receives a stream of payments that equal the value of the claim. *See* Till v. SCS Credit Corp., 541 U.S. 465, 469 (2004) (describing cramdown provisions under the Bankruptcy Code and their implications); *see also* Mark J. Thompson & Katie M. McDonough, *Lost in Translation:* Till v. SCS Credit Corp. *and the Mistaken Transfer of a Consumer Bankruptcy Repayment Formula to Chapter 11 Reorganizations*, 20 FORDHAM J. CORP. & FIN. L. 893 (2015) (discussing cramdowns under Chapter 13 and analyzing how courts have applied the *Till* decision to Chapter 11); Jay A. Kroese, Note, *Undersecured Residential Mortgage Cramdown Under Chapter 13: Receiving the Attention of Both the Supreme Court and Congress*, 18 J. CORP. L. 737, 741 (1993) (providing an example of a cramdown provision in a Chapter 13 plan and how it applies to home mortgages).

[110] *See* McQuade, *supra* note 6, at 534 (calling for Congress to amend the Bankruptcy Code).

[111] *See* 11 U.S.C. § 109(e) (describing the requirements to be eligible to be a debtor under Chapter 13 of the Bankruptcy Code).

[112] *See, e.g*, *In re Tosi*, 546 B.R. at 489 (denying a plan that force vested title in a lender); *In re Sagendorph*, 2015 WL 3867955, at *2; *In re* Zair, 535 B.R. 15, 17 (Bankr. E.D.N.Y. 2015), *rev'd*, HSBC Bank USA, N.A. v. Zair, 550 B.R. 188 (E.D.N.Y. 2016) (confirming a plan that vested title in a lender); *In re* Stewart, 536 B.R. 273, 274 (Bankr. D. Minn. 2015) (approving a plan that vested title in a lender because the lender failed to object); *In re* Williams, 542 B.R. 514, 517 (Bankr. D. Kan. 2015) (denying a debtor's motion to confirm a plan vesting title in a lender); *In re* Watt, 520 B.R. 834, 835–36 (Bankr. D. Or. 2014), *vacated Watt*, 2015 WL 1879680 (confirming a plan that vested title in a bank over the bank's objection); *In re* Rosa, 495 B.R. 522, 523 (Bankr. D. Haw. 2013) (approving a Chapter 13 plan that vested title in a mortgagee because the mortgagee did not object).

solve problems with existing zombie mortgages but does not prevent the zombie from rising.[113]

B. Eliminating the Cause of the Problem Through State Law

Although issues concerning property implicate both state and federal law, state law initially determines one's rights and interests with respect to property.[114] Federal law becomes relevant when a federal statute, such as the Bankruptcy Code, affects property rights or interests.[115] For purposes of this discussion, federal law is not relevant because state law determines the initial rights to property that one may hold in a transaction.[116]

The current responses by states to the zombie mortgage problem vary depending on each state's perception of the issue's severity.[117] In New York, legislatures issued laws introducing duties on lenders prior to foreclosure, including maintaining the property and reporting abandoned properties to a registry.[118] Conversely, Portland, Oregon's legislature did not view zombie mort-

[113] *See, e.g.*, *In re Tosi*, 546 B.R. at 489 (involving a property that was already in an unfavorable condition); *In re Sagendorph*, 2015 WL 3867955, at *2 (same). Because bankruptcy would only be applicable to those who actually file for it, forced vesting would only be applicable if a zombie mortgage already existed on the property at issue. *See, e.g.*, *In re Tosi*, 546 B.R. at 489 (involving a plaintiff who filed for bankruptcy); *In re Sagendorph*, 2015 WL 3867955, at *2 (same).

[114] *See* Drye v. United States, 528 U.S. 49, 54 (1999) (noting that state law provided that a spendthrift trust was shielded from creditors); *Butner*, 440 U.S. at 55 (stating that property interests stem from state law); Morgan v. Comm'r, 309 U.S. 78, 80–81 (1940) (stating that state law creates certain rights); *see also* Mian, *supra* note 15, at 2588 (explaining how state law creates a distinction between judicial and non-judicial foreclosure states that affects the lender/borrower relationships with respect to a home).

[115] *See Drye*, 528 U.S. at 54 (explaining how the IRC determines whether a state-provided right is considered a property right, or even considered property itself, for purposes of § 6321 of the code). Section 6321 provides that a failure to pay taxes may lead to a federal government lien against the taxpayer's property. 26 U.S.C. § 6321 (2017). The *Drye* case has been subject to some criticism that it undermines state sovereignty. *See* Timothy R. West, Drye v. United States*: Limiting the Traditional State Right to Define Property*, 69 UMKC L. REV. 909, 909–10 (2001).

[116] *See, e.g.*, MASS. GEN. LAWS ANN. ch. 183 (West 2018) (listing laws that deal with the alienation of land).

[117] *See, e.g.*, Jim Redden, *Wheeler Pauses Hales Campaign to Foreclose on 'Zombie' Homes*, PORTLAND TRIB., Jan. 4, 2018, http://pamplinmedia.com/pt/9-news/382786-270773-wheeler-pauses-hales-campaign-to-foreclose-on-zombie-homes [https://perma.cc/CT4F-34PN] (discussing approaches of cities in Oregon); Michelle Conlin, *Special Report: The Latest Foreclosure Horror: The Zombie Title*, REUTERS (Jan. 10, 2013), https://www.reuters.com/article/us-usa-foreclosures-zombies/special-report-the-latest-foreclosure-horror-the-zombie-title-idUSBRE9090G920130110 [https://perma.cc/59JH-X6VQ] (discussing approaches of cities in Ohio); Ben Lane, *New York Announces New Requirements for Maintenance of Zombie Homes*, HOUSINGWIRE (Sept. 28, 2016), https://www.housingwire.com/articles/38149-new-york-announces-new-requirements-for-maintenance-of-zombie-homes [https://perma.cc/22RH-DSLM] (discussing approaches of cities in New York).

[118] Lane, *supra* note 117. Lenders in New York have an obligation to report their efforts at maintaining these properties to the New York Department of Financial Services ("NYDFS"). *Id.* Upon the NYDFS's finding that a lender failed to maintain a property, the department may issue fines of $500 per day for each property in violation. *Id.* The law proved to be no mere threat, as one lender was

gages as a priority, and the city discontinued its attempts to get rid of them.[119] Cities in Ohio took a much harsher approach to dealing with the problem by penalizing borrowers if they fail to remedy the problems associated with their abandoned properties.[120] These responses all deal with zombie mortgages after one is already present, however, rather than addressing the initial cause of the problem.[121]

Much of the shock to borrowers who find out they have title to these properties stems from their belief that they had "abandoned" the property.[122] Borrowers who abandon their homes often do so for economic reasons because their debt exceeds the home's equity.[123] Although they may believe that they abandoned their homes, based on a layperson's interpretation of abandonment, that term actually has legal significance.[124] State statutes determine what constitutes legal abandonment of a property, which may permit the state to act to maintain the property, but does not relinquish the owner's title to the proper-

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fined $119,000 for not maintaining a property for 238 days after it had been registered as abandoned. Ben Lane, *NYDFS Hits PHH with Six-Figure Fine for Failing to Maintain Single Zombie Home*, HOUSINGWIRE (Sep. 28, 2016), https://www.housingwire.com/articles/42089-nydfs-hits-phh-with-six-figure-fine-for-failing-to-maintain-single-zombie-home [https://perma.cc/FHE3-SBYU]. Some homes are in such terrible condition that banks may even choose to fund demolition, rather than making attempts to sell the property. *Capital Region Land Bank Approves Demolition of Niskayuna "Zombie Property*,*"* CBS6ALBANY (Dec. 21, 2017), http://cbs6albany.com/news/local/capital-region-land-bank-approves-demolition-of-niskayuna-zombie-property [https://perma.cc/H32N-JAQL]. The condition of the home was the result of a long foreclosure action, preventing the property from being fixed or sold. *Id.* A 2016 report showed that New York had one of the highest numbers of zombie mortgages, second only to New Jersey. Kelsey Ramírez, *Strong Housing Market Helps Reduce Lingering Foreclosure Inventory*, HOUSINGWIRE (May 19, 2016), https://www.housingwire.com/articles/37068-strong-housing-market-helps-reduce-lingering-foreclosure-inventory [https://perma.cc/HHD6-ZNXE]. At the time of the article, there were over 3,300 zombie properties in New York, surpassed only by the approximately 4000 properties in New Jersey. *Id.*

[119] Redden, *supra* note 117. Whereas former Mayor Charlie Hales pushed for more pressure on landlords to maintain their properties through the threat of foreclosure, Mayor Wheeler did not regard it as a priority, noting the costs and length that are involved. *Id.*

[120] *See* Conlin, *supra* note 117 (noting that some cities impose probation and even jail time for borrowers who fail to maintain their properties).

[121] *See* Redden, *supra* note 117 (discussing Oregon's approaches to zombie mortgages); Conlin, *supra* note 117 (discussing Ohio's approaches to zombie mortgages); Lane, *supra* note 117 (discussing New York's approaches to zombie mortgages).

[122] *See* Conlin, *supra* note 117 (explaining that a large cause of the rise in zombie mortgages was that borrowers abandoned their homes expecting to lose them).

[123] *See* Lior Jacob Strahilevitz, *The Right to Abandon*, 158 U. PA. L. REV. 355, 363 (2010) (explaining that properties that do not have a positive value, i.e., properties that would sell for less than the owners owe on their loans, will probably be abandoned by the owners). In fact, in a case study of New York, researchers found that nearly all abandoned real estate was encumbered by debt that exceeded the property's value. *Id.* This suggests that borrowers chose to default on their mortgages when their home values plummeted. *See* FINANCIAL CRISIS INQUIRY REPORT, *supra* note 1, at 403 (explaining that the most significant factor in a borrower's decision to default is "negative equity").

[124] *See* Peñalver, *supra* note 21, at 196 (explaining that there is a difference between the use of "abandon" in personal and legal contexts).

ty.[125] Although one may physically abandon a home, one may not abandon legal title to the home in the same way.[126] For example, In *Pocono Springs Civic Association, Inc. v. MacKenzie*, a married couple attempted to convince the Superior Court of Pennsylvania that their extensive actions of refusing to pay taxes and continuous attempts to sell their land constituted an abandonment of property.[127] Pennsylvania law dictates that abandoning title can only occur when an owner willingly gave up "all right, title, claim, and possession."[128] The *Pocono* court held that Pennsylvania law did not allow for the abandonment of property to which owners have title.[129] Thus, there is a distinction between abandoning a home and abandoning title to a home in the context of zombie mortgages.[130]

The incentives of both lenders and borrowers in the realm of foreclosures and abandonment are largely economic.[131] Borrowers choose to default when the mortgage debt exceeds their home's value and lenders choose to stop foreclosure when doing so would be less costly than completing it.[132] Economic incentives may encourage states to establish laws dealing with foreclosures or

[125] *See, e.g.*, KY. REV. STAT. ANN. § 426.205 (West 2012) (describing abandonment as occurring when the property has not been legally occupied for 45 consecutive days and two or more elements are met from a list of factors relating to the property's blighted appearance); Abandoned and Blighted Property Conservatorship Act, 68 PA. STAT. AND CONS. STAT. ANN. §§ 1103; 1105 (West 2016) (providing that property is abandoned when, among other factors, its appearance is unsightly, it drives down property values, and becomes a danger to the public); WASH. REV. CODE. ANN. § 6.13.050 (West 1987) (providing that a home will have the presumption of being abandoned if the owner has been absent for at least six months, unless the owner files a declaration that he or she has not abandoned the property); WIS. STAT. ANN. § 846.102 (West 2017) (providing a list of factors that courts must consider in determining whether a property is abandoned, including its physical appearance and its dangerousness to the public).

[126] Boyack & Berger, *supra* note 6, at 455 (explaining that only a title transfer can stop liabilities and obligations from accruing on the home).

[127] Pocono Springs Civic Ass'n, Inc. v. MacKenzie, 667 A.2d 233, 234 (Pa. Super. Ct. 1995). Beginning in 1986, the MacKenzies had made a variety of attempts to rid themselves of the property. *Id.* at 448. Among other things, they (1) tried to gift the property; (2) stopped paying property taxes, resulting in two failed attempts by the Tax Claim Bureau to sell the land; (3) expressly indicated their desire to abandon the land; and (4) refrained from visiting or maintaining the land for nearly nine years. *Id.*

[128] *Id.* (citing Commonwealth v. Wetmore, 447 A.2d 1012, 1014 (Pa. Super. Ct. 1982)).

[129] *Id.* at 236.

[130] *See* Boyack & Berger, *supra* note 6, at 455 (stating that abandonment does not remove legal liabilities and obligations from homeowners); *supra* note 125 and accompanying text (providing examples of how states define abandonment).

[131] *See* FINANCIAL CRISIS INQUIRY REPORT, *supra* note 1, at 403 (stating that the most significant predictor of mortgage default for borrowers is when a home has negative equity, i.e. when the debt owed on the mortgage exceeds the value of the home); Clark, *supra* note 3, at 801–02 (explaining that lenders typically stop foreclosure proceedings when the costs outweighed the returns that foreclosing and selling the property would bring).

[132] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 28, at 15 (explaining how lenders conduct an analysis to determine whether foreclosure is worthwhile); *supra* note 131 and accompanying text (explaining the incentives for borrowers and lenders to default and foreclose).

abandoned properties.[133] Pennsylvania, for example, enacted the Abandoned and Blighted Property Conservatorship Act in 2009 in response to the adverse economic consequences of these properties.[134] The statute sets forth a five-part inquiry as to whether a property is abandoned and there is a need for a conservator to temporarily take over and manage the property.[135] A key element is that the "abandoned" property cannot be in foreclosure.[136] So, for zombie properties in which a foreclosure is no longer pending because a lender has stopped it, this prong is seemingly met.[137] Although a conservatorship can address the problems resulting from an abandoned and decaying home, the homeowner's financial problems may remain, as the statute expressly states that homeowners are still liable for all monetary obligations such as taxes and mortgage payments, whether they arose before or after the conservator's ap-

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[133] *See, e.g.*, tit. 68, § 1102 (recognizing the detrimental effect that these abandoned properties have on communities and noting the need to appoint a conservator to maintain the property); Save New Jersey Homes Act of 2008, N.J. STAT. ANN. § 46:10B-37 (West 2019) (explaining how foreclosure effectively deprives homeowners of their most significant assets and discussing the adverse economic effect that a foreclosure has on surrounding properties), *repealed by* N.J. STAT. ANN. § 46:10B-48 (creating a sunset provision in 2008 to render the Save New Jersey Homes Act of 2008 inoperative on January 1, 2011). Whatever the effects of the Home Act were, they were not sufficient in dealing with zombie mortgages, because New Jersey remains the state with the highest number of them. *See* Ramírez, *supra* note 118 (noting that New Jersey had just over 4000 zombie mortgages as of May 2016).

[134] *See* tit. 68, § 1102 (explaining the economic purpose behind the Act). The statute indicates that these properties diminish the values of neighboring properties. *Id.* Pennsylvania's legislature saw that communities have an important economic role in the state. *Id.* As such, if a conservator is appointed, that party will be responsible for preventing further harm to the property so that it may have some economic value in the future. *Id.*

[135] *Id.* § 1105. A conservator is an individual or entity tasked with bringing the abandoned home into conformity with all municipal requirements with respect to homes. *Id.* §§ 1105–1106. Under the statute, a nongovernmental entity with the oldest lien on the home (often the lender that provided the original mortgage) is given the first opportunity to be appointed the home's conservator by a court. *Id.* § 1105. Upon refusal or a lack of ability to become conservator by such a lienholder, the statute then considers appointing nonprofit corporations and governmental units as conservators. *Id.* Once appointed by a court, the conservator may obtain a lien against the property for the costs incurred in preserving and maintaining it. *Id.* Before a conservator can be appointed, a "party in interest" may request that a specific conservator be appointed. *Id.* § 1104. "Parties in interest" may include the property's owner, lienholders, or neighbors within 2,000 feet. *Id.* § 1103. Appointment of a conservator depends on the home being abandoned. *Id.* §§ 1103, 1105. According to the statute, a building must have been unoccupied for a minimum of twelve months, the owner must not have sold the property (in good faith), the property must not be in foreclosure, the owner must not have acquired the property within the prior six months, and a the building must satisfy a fifth prong in which at least three elements must be met. § 1105. These elements include consideration of whether the home (1) has become a "public nuisance," (2) needs significant maintenance and has not been maintained within the past year, (3) is not suitable for people to reside in it, or (4) attracts illegal activities. *Id.*

[136] *Id.* § 1105 More specifically, the home cannot be in foreclosure by "an individual or nongovernmental entity." *Id.* Therefore, it may be that governmental foreclosures would not be subject to this statute. *See id.* (omitting governmental entities).

[137] *See id.* (stating that a home is not abandoned if it is subject to a foreclosure); Clark, *supra* note 3, at 801–02 (explaining that zombie properties arose when lenders stopped foreclosure proceedings).

pointment.[138] Thus, Pennsylvania's statutory solution does not extinguish the liabilities incurred by borrowers who are bitten by a zombie mortgage.[139]

Wisconsin has also enacted legislation to deal with abandoned properties that were subject to mortgages.[140] The statute provides that a mortgage holder who wishes to foreclose on an abandoned property may bring an action to do so upon a finding that the property is "abandoned" as defined by the statute.[141] Upon a finding of abandonment, the court may authorize the lender to foreclose and sell the property.[142] In 2015, in *Bank of New York Mellon v. Carson*, the Supreme Court of Wisconsin construed the statute to require the lender to sell the property within a statutorily prescribed time frame.[143] The court looked to legislative history indicating that abandoned properties decrease property values and thus lower communities' tax revenues.[144] It mentioned that absent

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[138] Tit. 68, § 1107. The statute gives the conservator an ownership interest in the property as well as legal control over it (permitting the conservator to carry out his or her duties), but does not give the conservator title to the property, which is actual legal ownership of the property. *See id.* (mentioning that the conservator does not get title); Boyack & Berger, *supra* note 6, at 455 (explaining how changing who holds title to a property will shift who is responsible for the liabilities).

[139] *See* Boyack & Berger, *supra* note 6, at 455 (explaining that the homeowner is not excused from mortgage payments and liabilities).

[140] *See* WIS. STAT. ANN. § 846.102 (explaining the that process lenders may go through to enforce their liens if the property has been abandoned).

[141] *Id.* The statute also notes that, along with mortgage lenders, cities, towns, villages, and counties where the abandoned property is located may also bring an action. *Id.* Establishing abandonment involves analyzing a list of factors and determining if they apply to the property at issue. *Id.* Some of the factors include damaged or missing doors or windows, the prevalence of trash on the property, two or more reports to police that illegal activity is occurring on the property, and an overall lack of safety of the property. *Id.*

[142] *Id.*

[143] Bank of N.Y. Mellon v. Carson, 859 N.W.2d 422, 429 (Wis. 2015). In *Carson*, a lender filed a foreclosure action against a borrower who had already abandoned the home after defaulting on mortgage payments. *Id.* at 424. After the lower court entered judgment in favor of the lender to foreclose, the lender did not sell or maintain the property, and municipal fees began accumulating to the borrower. *Id.* at 425. The borrower then filed suit, asking the lower court to amend the judgment to require the lender to sell the property five weeks after the amended judgment, as required under the statute's language. *Id.* The statutory language provides that the court shall enter judgment and the plaintiff can satisfy the judgment in one of two ways. WIS. STAT. ANN. § 846.102. It also provides that the plaintiff shall hold a sale that may take place after five weeks from entry of judgment or it shall release the mortgage lien and vacate the foreclosure judgment. *Id.* The court denied the request, stating that the statute did not allow the court to do so. *Carson*, 859 N.W.2d at 425. On appeal, the appellate court reversed the decision and the lender appealed to the Supreme Court of Wisconsin. *Id.* at 425–26. The state supreme court found that the statutory language allowed courts to require a sale to take place. *Id.* at 429. It reasoned that, because the statute uses "shall" and "may" in the same section, the legislature must have intended them to have different meanings, supporting the notion that "shall" is a mandatory provision. *Id.* at 428. The court then evaluated whether the statute allowed it to require the sale to occur within some time limit and found that it did. *Id.* at 429. The lender argued that another Wisconsin statute gives a lender five years to sell the property. *Id.* at 429–30. The court disagreed, holding that the statute indicated that the legislature wanted sales to move quickly. *Id.* at 430.

[144] *Id.* at 430–31. The court stated that allowing five years for a sale to take place would undermine the legislative intent backing the statute. *Id.*

time constraints, lenders would be able to leave properties in a state of legal uncertainty.[145] Nonetheless, the statute presupposes that a property is already abandoned and in unfavorable condition.[146] Although such a statute may be an example of a proper response to the effect of zombie mortgages, it does not do much to prevent the emergence of zombie mortgages altogether.[147]

The root of the problem lies within the relationship between the borrower and the lender, since they are the parties subject to the mortgage agreement.[148] Given the strong economic incentives that guide both parties in their respective decisions to default or foreclose, both would be inclined to agree upon alternative arrangements if their economic interests were better served by doing so.[149] Of course, if transaction costs are too high, an efficient bargain may not result.[150] By disregarding these costs, it is possible to examine what an efficient outcome would look like and by extension, discover laws that would achieve that result.[151] These laws would overcome the need for judicial oversight because such oversight would not impact the efficient outcome.[152] Where parties

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[145] *Id.*

[146] *See* § 846.102 (requiring that the property be abandoned and listing physical factors that contribute to a finding that the property is abandoned).

[147] *See id.* (requiring the property to be abandoned). The requirement that the property already be in an unfavorable state causes the statute to apply to properties with mortgages that can already be classified as zombie mortgages, rather than preventing zombie mortgages from arising in the first place. *See id.*; Clark, *supra* note 3, at 795 (explaining how zombie mortgage occur when abandoned properties are not foreclosed upon).

[148] *See* FINANCIAL CRISIS INQUIRY REPORT, *supra* note 1, at 402–03 (describing how borrowers defaulted on their loans and how lenders increased foreclosures during the financial crisis).

[149] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 28, at 15 (discussing the equity analyses that lenders perform before deciding whether or not to foreclose); Coase, *supra* note 91, at 8 (discussing the optimal and efficient outcomes that may result through bargain).

[150] *See* Coase, *supra* note 91, at 15.

[151] *See* Guido Calabresi, *Transaction Costs, Resource Allocation and Liability Rules—A Comment*, 11 J.L. & ECON. 67, 69 (1968) (discussing how certain rules may result in efficient market outcomes).

[152] *See* Coase, *supra* note 91, at 8 (discussing how bargaining in some scenarios would not need court involvement)*; see, e.g.*, Boomer v. Atl. Cement Co., 26 N.Y.2d 219 (N.Y. 1970); JEFFREY L. HARRISON, LAW AND ECONOMICS: POSITIVE, NORMATIVE AND BEHAVIORAL PERSPECTIVES 160 (2d. ed. 2007) (discussing *Boomer* and how it may illustrate the Coase Theorem). In *Boomer*, a cement company's operations resulted in pollution of some nearby land. 26 N.Y.2d at 222. The landowners filed suit against the company, seeking an injunction to prevent it from continuing to pollute. *Id.* The Court of Appeals of New York framed the issue as a question of whether the court should use an injunction to resolve a private matter or should make its decision based on public policy. *Id.* The court noted that public concerns with air pollution might be dealt with through regulation by federal and state governments. *Id.* Nonetheless, the court distinguished policy-oriented regulation and private lawsuits. *Id.* at 223. The court further stated that it is uncommon for courts to decide these private cases on the basis of public desires that exceed the rights and issues in the lawsuit. *Id.* Moreover, it noted that pollution regulation would require a balancing of the economic effects of regulation and the effect of pollution on public health, something that is not within the scope of a court. *Id.* The court stated that pollution issues as a whole should be left for governments to deal with, whereas private litigation resolution is to be done through the judicial system. *Id.* It concluded that the injunction

with economic incentives place values on certain rights, there is potential for bargain regardless of judicial intervention.[153]

C. Establishing the Right of Forced Vesting Through Legal Rules

The initial question that states must consider in assigning rights is to whom to assign the right, or "entitlement."[154] Moreover, upon deciding to whom a right should be allocated, states must then provide a mechanism to enforce those rights.[155] There are at least two viable ways of enforcing these entitlements: through property rules and through liability rules.[156] In enforcement of a right using property rules, one who wishes to infringe on the right would need to pay the right holder to purchase the ability to do so.[157] If rights enforcement is accomplished using liability rules, then an infringer who acts

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would be granted until the company paid the plaintiffs the amount of the permanent damages that had been calculated by the lower court. *Id.* at 228.

[153] *See Boomer*, 26 N.Y.2d at 222, 225 (stating that in the case, the plaintiffs had stipulated that they would have accepted $185,000 in damages to end the dispute). The cement company's investment in the factory was over $45,000,000 and it employed over 300 people. *Id.* Absent the court's decision, if the landowners were entitled to prevent all activities that polluted their properties, the parties may well have entered into an agreement under which the company would pay the landowners $185,000, because the company valued using the factory (and continuing to pollute) much more than the cost of paying a settlement to the landowners. *See* POSNER, *supra* note 92, at 63–64 (providing an example in which two parties may bargain rather than litigate an issue). On the other hand, if the right to pollute were initially assigned to the factory, the factory would continue polluting and would only be motivated to stop in exchange for a payment that exceeded its $45,000,000 investment. *See* HARRISON, *supra* note 152, at 146. In either case, the result would be that the factory could continue polluting indefinitely, because either (1) it pays the plaintiffs permanent damages, preventing any future action against the factory for polluting, or (2) it has the initial right to pollute and the plaintiffs are unable to pay $45,000,000. *See id.* (explaining how the market may overcome the court's determination).

[154] *See* HARRISON, *supra* note 152, at 191 (introducing entitlements in the context of the Coase Theorem). When faced with two parties in conflict, a state must either decide which party it wishes to assign a right or be content with allowing the side with more resources to win. Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1090 (1972). For example, in the context of a polluter and those affected, a state will either assign a right to pollute to the polluter or a right to a clean environment to those who would otherwise have been affected by pollution. *Id.*

[155] Calabresi & Melamed, *supra* note 154, at 1090.

[156] *Id.* at 1092.

[157] *Id.* This approach requires the least amount of government involvement. *Id.* After the right is assigned, the parties are free to contract to ascertain a fair value for which one may purchase the right. *Id.* Such rules are observable in well-established property laws such as easements, which a property owner may sell to another party, granting that party the right to use some portion of the property for a defined purpose. *See generally* John W. Fisher, II, *A Survey of Easements in West Virginia*, 112 W. VA. L. REV. 637 (2010) (explaining that landowners may expressly grant other parties an easement over their land).

against the right will have to pay the right holder some value, as determined by a court after the infringement has occurred.[158]

1. Property Rules to Protect Forced Vesting

States seeking to implement forced vesting provisions in their laws may find property rules desirable because of the potential for bargaining between lenders and borrowers to resolve mortgage conflicts.[159] The act of a borrower forcibly vesting title in a lender would trigger financial consequences for both parties.[160] Perhaps most significant are the tax implications associated with transfers of property.[161] Under current laws (without forced vesting), lenders are vehemently opposed to taking title to the properties subject to mortgages because title carries with it the obligation to maintain the home.[162] Therefore, a forced vesting provision with a corresponding ability for borrowers to waive that right during a foreclosure would induce bargaining.[163] This is because, if lenders believed receiving title to property would be financially unfavorable, they would be willing to negotiate with borrowers to not exercise that right of transfer.[164]

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[158] Calabresi & Melamed, *supra* note 154, at 1090. This approach requires more state involvement because of the need to determine the value of the destroyed entitlement. *Id.* Unlike with property rules, parties do not contract for the removal of the rule, but rather, the state imposes its own valuation. *Id.*

[159] *See id.*; Coase, *supra* note 91, at 9 (discussing how bargaining may achieve the most desired result).

[160] *See* 26 U.S.C. §§ 1, 11, 61, 108, 121, 166, 1001, 1011, 1012, 1016. For borrowers, gains derived from dispositions of property or discharge of indebtedness will constitute gross income. *See id.* § 61(a). For lenders, transfers of title in their name would cause them to be liable for the obligations associated with the property. *See* Weber, *supra* note 6, at 37 (discussing how title makes one liable for associated costs with respect to the property).

[161] *See* 26 U.S.C. § 61(a) (stating that gains from dealings in property are gross income); § 166(a) (allowing deductions for business debts that become worthless).

[162] *See Tosi*, 546 B.R. at 489 (explaining that the lender did not want to take title to the property); *Sagendorph*, 2015 WL 3867955, at *1 (indicating that the lender objected to taking title to the property).

[163] *See* Calabresi & Melamed, *supra* note 154, at 1092 (explaining how property rules would allow one to waive the right in an exchange).

[164] Clark, *supra* note 3, at 801–02 (discussing how lenders analyze the costs and revenues they would receive from continuing with a foreclosure or stopping a foreclosure and explaining how that influences their decision to continue or not). Presuming that lenders act rationally—which, in this case, is the presumption that they act based solely on financial incentives—bargaining for a better financial outcome under this proposed scheme would be intuitive. *See* FRIEDMAN, *supra* note 87, at 8 (discussing how economics and the idea that people will act rationally in response to legal rules is a proper way to evaluate how certain laws will influence behavior). Because businesses must act rationally to be successful, this is a proper presumption to make. The University of Chicago, *supra* note 92 (discussing how businesses act rationally).

2. An Alternative Approach: Liability Rules

Another option in protecting entitlements is the concept of a liability rule.[165] States that do not wish to give borrowers the right to forcibly transfer property to a lender may alternatively opt to give communities a right to be free from the nuisances caused by unmaintained homes.[166] In such a case, lenders who fail to maintain homes would have to compensate the affected neighboring homeowners.[167]

III. LAW AND ECONOMICS PRESENTS A LENS THROUGH WHICH STATES MAY EXAMINE HOW TO PREVENT ZOMBIE MORTGAGES

A. The Justification for the Applicability of Law and Economics to the Borrower-Lender Relationship

Law and economics provides a lens to examine how two rational actors can reach an efficient result through bargaining.[168] State legislatures in part concerned with the economic effect of these properties on the surrounding communities have enacted statutes to deal with zombie mortgages after they arise.[169] Therefore, the implementation of state forced vesting laws to prevent the rise of zombie mortgages would be desirable to encourage lenders and borrowers to bargain.[170] Law and economics presents a lens through which this can be accomplished.[171]

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[165] *See* Calabresi & Melamed, *supra* note 154, at 1092 (discussing liability rules).

[166] *See* Weiss, *supra* note 31, at 487 (noting that zombie mortgages foster the belief that a neighborhood is unsafe and drive down property values); Calabresi & Melamed, *supra* note 154, at 1092 (noting that violators of liability rules must pay damages). These properties often attract squatters and become the sites of illegal activities like drug use and arson. Weiss, *supra* note 31, at 486.

[167] *See* Calabresi & Melamed, *supra* note 154, at 1092 (discussing how liability rules would impose penalties on those who violate a right that is protected by such a rule).

[168] *See* FRIEDMAN, *supra* note 87, at 8 (discussing rationality); Coase, *supra* note 91, at 8 (discussing efficiency).

[169] *See, e.g.*, Abandoned and Blighted Property Conservatorship Act, 68 PA. STAT. AND CONS. STAT. ANN. §§ 1101–1111 (West 2016) (responding to the growing problem of abandoned homes in Pennsylvania and explaining how they have negative effects on the communities); Save New Jersey Homes Act of 2008, N.J. STAT. ANN. § 46:10B-37 (West 2019) (explaining how foreclosure effectively deprives homeowners of their most significant assets and discussing the adverse economic effect that a foreclosure has on surrounding properties), *repealed by* N.J. STAT. ANN. § 46:10B-48 (creating a sunset provision in 2008 to render the Save New Jersey Homes Act of 2008 inoperative on January 1, 2011).

[170] *See* FRIEDMAN, *supra* note 87, at 8 (discussing how rational actors bargain); Coase, *supra* note 91, at 8 (discussing how an optimal result may occur through bargain).

[171] *See* FRIEDMAN, *supra* note 87, at 8 (discussing how rational actors respond to laws and how this lens is appropriate to evaluate how laws should be implemented). *See generally supra* note 87 (giving an overview of the economic approach to law and its potential applications).

The borrower-lender transaction is one where this approach is appropriate.[172] The common criticisms of the idea that people behave rationally can be overcome in this particular transaction.[173] On the one hand, a lender is motivated to profit from a foreclosure and does not behave irrationally in deciding whether or not to foreclose.[174] On the other hand, there is the merited argument that people are not the rational actors economists assume they are.[175] Nonetheless, by disregarding transaction costs, the issue may be resolved by imagining a borrower represented by a lawyer for the purpose of meeting the rationality requirement.[176] Lawyers, after all, are themselves transaction costs in a deal.[177] A lawyer behaves rationally on behalf of a client because that is part of a lawyer's duty to clients.[178] Lawyers are bound to act in their client's best interests by the nature of their jobs and by professional and ethical rules.[179] Effectively, a borrower's lawyer in a borrower-lender transaction stands in the shoes of the borrower client.[180] The result is then a borrower-lender transaction with two rational parties.[181]

B. Establishing a New Property Right for Borrowers

Taking the approach that the borrower and lender would act rationally in a deal with no transaction costs, one may evaluate how they would act in the

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[172] *See* FRIEDMAN, *supra* note 87, at 8 (discussing how rational actors may be influenced to act in response to certain laws).

[173] *See* The University of Chicago, *supra* note 92 (discussing how businesses act rationally); *see also* FINANCIAL CRISIS INQUIRY REPORT, *supra* note 1, at 403 (discussing how having negative equity in their houses has influenced borrowers to choose to default based on financial incentives).

[174] University of Chicago, *supra* note 92; *see* U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 28, at 15 (discussing how lenders perform an equity analysis before foreclosure).

[175] *See* University of Chicago, *supra* note 92 (noting that people do not necessarily consistently behave rationally and may occasionally engage in irrational conduct, at least as rationality is understood from an economic perspective).

[176] *See* POSNER, *supra* note 92, at 10 (discussing how disregarding transaction costs allows one to examine how parties bargain over property rights).

[177] *See* David M. Driesen & Shubha Ghosh, *The Functions of Transaction Costs: Rethinking Transaction Cost Minimization in a World of Friction*, 47 ARIZ. L. REV. 61, 62 (2005) (noting that people hire and pay lawyers to deal with problems or help with business decisions).

[178] MODEL RULES OF PROF'L CONDUCT r. 1.1 (AM. BAR ASS'N 2014) (stating that lawyers must be competent and prepared and possess all knowledge and skills that are reasonably needed to represent a client).

[179] *See id.*

[180] *See id.* r. 2.1 (stating that lawyers must consider their client's needs in terms of economic and social factors that matter to the client).

[181] *See* FINANCIAL CRISIS INQUIRY REPORT, *supra* note 1, at 403 (discussing how borrowers may plan to default based on financial incentives); FRIEDMAN, *supra* note 87, at 8 (discussing rationality among actors in a bargain and efficient outcomes and the interaction of law and rational actors); The University of Chicago, *supra* note 92 (discussing how business decisions are largely rational).

presence of certain, clearly defined property rights.[182] Property rights are initially determined by the state.[183] Moreover, state legislatures have the opportunity to determine what policies they wish to implement for their communities.[184] Therefore, it is possible that a solution to the zombie problem may be found in state legislatures.[185] Bankruptcy courts introduced the idea of transferring title to property without a lender's consent when their inaction with respect to a foreclosed property resulted in a zombie mortgage.[186] Law and economics may be a viable lens through which a state might consider establishing a new property right: the right of a borrower to forcibly vest title in a lender upon the lender's continuous neglect of the property resulting in the accumulation of fees and costs.[187]

The rise in zombie mortgages after the 2008 financial crisis has shown what may result when lenders do not complete foreclosures on homes that borrowers abandoned in reliance on the belief that their homes were lost.[188] Implementing a property right that gives borrowers this power to vest property in lenders may have the effect of encouraging bargaining between borrowers and lenders in a foreclosure situation.[189] The effectiveness of this approach is, of

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[182] *See* POSNER, *supra* note 92, at 10 (discussing how parties may bargain over the use of property).

[183] Butner v. United States, 440 U.S. 48, 55 (1979)*;see also*, Mian, *supra* note 15, at 2588 (explaining how state law creates a distinction between judicial and non-judicial foreclosure states that affects lender/borrower relationships with respect to a home).

[184] *See, e.g.*, Conlin, *supra* note 117 (discussing approaches that Ohio municipalities have taken to combatting zombies); Lane, *supra* note 117 (discussing New York's policy aimed at zombie mortgages); Redden, *supra* note 117 (discussing the shift in Portland's stance on zombie mortgages to considering them as a lesser priority than before).

[185] *See, e.g.*, Conlin, *supra* note 117 (discussing the policies Ohio municipalities implemented in response to zombie mortgages).

[186] *See, e.g*, *In re* Tosi, 546 B.R. 487, 489 (Bankr. D. Mass. 2016) (disallowing forced vesting); *In re* Sagendorph, No. 14-41675-MSH, 2015 WL 3867955, at *1, *2 (Bankr. D. Mass. June 22, 2015), *rev'd*, *In re* Sagendorph, 562 B.R. 545 (D. Mass. 2017) (interpreting the Bankrptcy Code to allow forced vesting); *In re* Zair, 535 B.R. 15, 17 (Bankr. E.D.N.Y. 2015), *rev'd*, HSBC Bank USA, N.A. v. Zair, 550 B.R. 188 (E.D.N.Y. 2016) (allowing forced vesting title in a lender); *In re* Stewart, 536 B.R. 273, 274 (Bankr. D. Minn. 2015) (allowing forced vesting because the lender did not object); *In re* Williams, 542 B.R. 514, 517 (Bankr. D. Kan. 2015) (disallowing forced vesting as part of a plan); *In re* Watt, 520 B.R. 834, 835–36 (Bankr. D. Or. 2014), *vacated* Bank of N.Y. Mellon v. Watt, No. 3:14-CV-02051-AA, 2015 WL 1879680 (D. Or. Apr. 22, 2015) (allowing a plan to forcibly vest title in a lender over its objection); *In re* Rosa, 495 B.R. 522, 523 (Bankr. D. Haw. 2013) (discussing the possibility of vesting title in a lender as part of a Chapter 13 plan).

[187] *See supra* note 186 and accompanying text (illustrating the origination of forced vesting in bankruptcy courts); *see also* POSNER, *supra* note 92, at 10 (explaining how parties may bargain over the use or allocation of property rights).

[188] *See generally* Boyack & Berger, *supra* note 6; Clark, *supra* note 3, at 801; McQuade, *supra* note 6; Weber, *supra* note 6.

[189] *See generally* Coase, *supra* note 91 (discussing transaction costs and how disregarding them would indicate what the efficient outcome would be).

course, contingent on allowing the free transfer of the proposed right.[190] By disregarding transaction costs, an efficient solution may exist where both the lender and the borrower are in a better position.[191]

1. Forced Vesting with Nonrecourse Mortgages

A borrower considering default on a nonrecourse mortgage faces the possibility of realizing the entire value of the outstanding debt on the home as a taxable gain.[192] If a lender completes the foreclosure, gain to the borrower would be the amount realized less the adjusted basis of the home.[193] The borrower would then be able to exclude up to $250,000 from taxes if the requirements under the IRC are met.[194] Because zombie mortgages are typically associated with low-value homes, it is likely that the gain would typically be under $250,000.[195] Upon a borrower's default, a lender would have to determine whether the costs of foreclosure and the expected revenue from selling the home would make foreclosure worthwhile.[196] When lenders foreclose on a home subject to a nonrecourse mortgage, but only conduct an analysis and discover that foreclosure is no longer worth the cost after the borrower has already left, then a zombie mortgage may rise.[197]

In zombie mortgage scenarios, mortgage penalties, as well as maintenance costs and taxes, accrue to the titleholder, which is typically the homeowner.[198] Lenders may refuse to negotiate with the borrowers at this point, disclaiming any responsibility for the home.[199] If a forced vesting provision exist-

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[190] *See* Calabresi & Melamed, *supra* note 154, at 1092 (discussing how legislatures may statutorily allow for property rights to be transferred).

[191] Coase, *supra* note 91, at 2.

[192] McMahon & Simmons, *supra* note 73, at 427.

[193] Hetherington & Hurley, *supra* note 76, at 58.

[194] *See* 26 U.S.C. § 121(a)–(b) (2017) (requiring that the home be used as the borrower's principal residence for two of the preceding five years and limiting the exclusion to $250,000 for single filers and $500,000 for joint filers).

[195] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 28, at 14 (explaining that abandoned properties subject to foreclosure are typically in low-income neighborhoods with already low property values).

[196] *Id.* at 15. Even if a lender pursues foreclosure, doing so could still be a lengthy process. Herkenhoff & Ohanian, *supra* note 19 (noting that after the financial crisis, foreclosures increased in duration from an average of nine to fifteen months).

[197] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 28, at 17 (explaining that lenders were more likely to discontinue foreclosure proceedings when homeowners abandoned the foreclosed properties).

[198] *See* Conlin, *supra* note 117 (discussing how one homeowner's mortgage debt jumped from approximately $60,000 to over $80,000 and how another homeowner was liable for $1,000 in water and garbage disposal bills as well as the potential for $30,000 in demolition costs if the city decided to pursue destruction of the abandoned home).

[199] *See id.* (explaining how one bank refused to accept a deed to the house and has refused to let the owner sell the home for less than the value of the debt). In fact, commentators have argued that a major issue behind the foreclosure crisis was that lenders were often hostile to the idea of renegotiat-

ed in state law, then borrowers would be able to overcome lenders' unwillingness to negotiate by transferring title to lenders.[200] Given lenders' financial incentives, the presence of such a provision in state law would be a factor in their analysis of costs.[201] In a situation where a lender's cancellation of foreclosure has created a zombie mortgage, the former borrowers would be inclined to transfer the title to lenders.[202] Knowing this, lenders subject to a forced vesting provision would have an incentive to prevent a zombie mortgage from arising in the first place, because they would risk being subject to the liabilities and fees associated with holding title to the property.[203] The result would be two-fold: first, lenders would have the incentive to conduct the foreclosure cost analysis before foreclosing to evaluate whether sale of the home would be worthwhile.[204] Second, lenders may be inclined to decrease the mortgage to match the value of the home.[205] If a lender were to offer such a modification, borrowers who agree to continue making the reduced mortgage payments would potentially bear a small additional tax burden from the "income" of having their debt reduced, and lenders would receive a tax deduction for "writing off" the uncollectable portion of the debt.[206] Thus, borrowers that

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ing mortgages. Adelino et al., *supra* note 20, at 835. Over a six-year period from 2005 to 2011, lenders only renegotiated approximately 10% of mortgages that were past due. *Id.*

[200] *See* Boyack & Berger, *supra* note 6, at 455 (discussing transfers of title and corresponding legal obligations); *supra* note 187 and accompanying text (illustrating the journey of forced vesting in bankruptcy and discussing how bargaining may result in efficient outcomes).

[201] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 28, at 15 (speaking of "projected" costs and profits).

[202] *See* Boyack & Berger, *supra* note 6, at 455 (giving an overview of zombie mortgages and discussing how the only way to stop property liabilities from accruing in one's name is to transfer title to the property). Borrowers in this situation would have strong tax incentives to transfer title to the lender. *See* 26 U.S.C. § 121 (allowing exclusion of $250,000 or $500,000 of gain from the disposition of property, depending on one's filing status). Because zombie mortgages are usually in areas with lower property values, it is reasonable to conclude that the vast majority would not involve gains greater than the permitted exclusion. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 28, at 14 (discussing the financial position of communities with abandoned foreclosures).

[203] *See* Clark, *supra* note 3, at 797 (describing the lender practice of halting foreclosure proceedings to avoid being responsible for maintaining the property and paying the necessary costs inherent to foreclosure).

[204] U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 28, at 15 (explaining the process of analyzing the costs and prospective revenue to lenders who are considering foreclosing on a home). Because the proposed forced vesting provision would raise the risk of increased costs to lenders if they failed to maintain the home, it would be a factor in their decision to foreclose. *See id.* (discussing lenders' considerations of foreclosure costs).

[205] *See* FINANCIAL CRISIS INQUIRY REPORT, *supra* note 1, at 403 (explaining that the primary reason for default is when mortgage debt exceeds the value of a borrower's home). Because borrowers are most likely to default when their mortgages are "underwater" (meaning that the home is worth less than the mortgage debt), they would likely continue making payments once the debt matched the value of their homes. *See id.* at 403–04 (discussing underwater mortgages).

[206] *See* 26 U.S.C. § 1 (listing the rates at which different levels of income are taxed); § 11(b) (imposing a flat tax of 21% on corporations); § 61(a)(11) (listing cancellation of debt as includable in gross income); § 108(a)(1)(B) (allowing exclusion of income from gross income if the individual has

would otherwise default due to negative equity considerations would continue paying the remainder of the mortgage and lenders would recoup some of their investment by collecting on the remaining debt over the life of the modified mortgage.[207] Though borrowers may incur a small tax liability, it may be rational for them to accept this modification because it might be substantially less expensive than moving to another home.[208]

2. Forced Vesting with Recourse Mortgages

Considering the effects of forced vesting provisions on recourse mortgages requires a two-prong analysis because gains to the borrower from the transaction are bifurcated into two parts: (1) gain from the disposition of the property and (2) potential gain if the lender forgives any remaining debt.[209] In a recourse mortgage, if a home has outstanding debt in excess of its value, a lender who successfully forecloses on it has the right to pursue the borrower for the

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more debts than assets); § 166 (allowing corporations to deduct debts that become worthless from their taxable income). The median household income in the United States is approximately $56,000. Proctor et al., *Income and Poverty in the United States: 2015*, U.S. CENSUS BUREAU (Sep. 13, 2016), https://www.census.gov/library/publications/2016/demo/p60-256.html [https://perma.cc/6NHJ-BZJD]. Because most zombie mortgages occur in areas of lower-income, it is most likely that borrowers affected by the problem have income at or lower than that level. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 28, at 14 (discussing the low-income status of these borrowers). Therefore, the majority of the income for heads of households may likely be taxed at 12%, with a portion being taxed at 22%. *See* § 1 (listing income between $13,600 and $51,800 as being taxed at 12%, and anything more up to $82,500 being taxed at 22%). For example, if a borrower had an annual income of $40,000 and had $10,000 of debt cancelled, that $10,000 would constitute gross income and, at a 12% tax rate, would constitute $1200 of tax liability. *See* §§ 1, 108 (discussing gross income and cancellation of debt income). The lender would then deduct that $10,000 as a worthless or "bad" debt. *See* § 166(a)(1) (allowing a deduction for business bad debts). Under the 21% tax rate, the lender would save $2100 in taxes. *See* § 11(b) (stating that the corporate tax rate is 21%).

[207] *See* FINANCIAL CRISIS INQUIRY REPORT, *supra* note 1, at 403 (explaining that borrowers with underwater mortgages tend to default on their homes). By extension, if a borrower's mortgage was reduced to match the home's value, there would be a lower likelihood of default. *See id.* (explaining how borrowers may often plan to default in cases of underwater mortgages).

[208] *See* FRIEDMAN, *supra* note 87, at 8 (discussing rationality); FINANCIAL CRISIS INQUIRY REPORT, *supra* note 1, at 403 (discussing how financial incentives are the primary reason for mortgage default). As of January 2019, the median sale price of a home was $317,200. *Median Sale Price for New Houses Sold in the United States*, FEDERAL RESERVE BANK OF ST. LOUIS, https://fred.stlouisfed.org/series/MSPNHSUS [https://perma.cc/3PFX-X3MR?type=image]. Moreover, mortgage loans typically require down payments, which may range from 3–20%. Teresa Mears, *First-Time Buyers: How Much Down Payment Do You Really Need These Days?*, U.S. NEWS (Jan. 20, 2016), https://realestate.usnews.com/real-estate/articles/first-time-buyers-how-much-down-payment-do-you-really-need-these-days [https://perma.cc/Q85X-4VDP].

[209] *See* Hetherington & Hurley, *supra* note 76, at 75 (explaining that borrowers may be subject to both gain and cancellation of debt income, depending on lender actions); *see also* Gomez, *supra* note 50, at 76 (explaining that, because the maximum a lender can recover in foreclosure is the value of the home, recourse mortgages allow lenders to pursue the borrower for any remaining debt).

remaining debt, or to forgive the debt.[210] As with nonrecourse mortgages, if the sale price exceeds the borrower's basis in the home, there will be gain recognition to the extent of the difference.[211] The same provisions in Section 121 of the IRC would allow the borrower to exclude recognition of up to $250,000 of gain.[212] The difference between recourse and nonrecourse mortgages, however, is that if, after the sale of the house the lender is still not made whole on the mortgage, the lender could pursue the borrower for the remaining amount borrowed.[213] If a zombie recourse mortgage exists, borrowers that invoke the right to forcibly vest title to the lender may indeed relieve themselves of maintenance obligations and other fees.[214] There is, however, another piece to the puzzle: even if borrowers can shift those extra costs onto lenders, if borrowers still have outstanding debt following the foreclosure sale, lenders may pursue them to recover those costs and any other amounts remaining on the mortgage.[215]

Because of the costs discussed above, the threat of forced vesting may not be as effective in encouraging a lender to renegotiate a recourse mortgage as a nonrecourse mortgage.[216] The effectiveness of the threat would depend on the onerousness of state taxes and fees associated with property ownership, which can differ widely.[217] The problem is financial uncertainty: lenders would know

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[210] *See* Gomez, *supra* note 50, at 76 (explaining that, because the maximum a lender can recover in foreclosure is the value of the home, recourse mortgages allow lenders to pursue the borrower for any remaining debt).

[211] Hetherington & Hurley, *supra* note 76, at 58.

[212] *See* 26 U.S.C. § 121 (allowing taxpayers to exclude up to $250,000 of gain for single filers and $500,000 for joint filers).

[213] *See* Hetherington & Hurley, *supra* note 76, at 75 (explaining that lenders have a choice as to whether to pursue the borrower for a deficiency).

[214] *See* Boyack & Berger, *supra* note 6, at 455 (stating that borrowers cannot abandon their legal obligations without transferring title to another party). These obligations may cost thousands of dollars to cure. *See* Conlin, *supra* note 117 (describing an instance where code violations resulted in fines over $4000).

[215] *See* Gomez, *supra* note 50, at 76 (discussing recourse mortgages). Lenders choose to abandon foreclosure proceedings when costs exceed revenues. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 28, at 15 (discussing cost and revenue analysis). Their incentives are essentially strictly economic. *See id.* If borrowers were to exercise rights that impose extra costs on lenders, such as maintenance fees, lenders would have the incentive to pursue the borrower to recover those costs as opposed to forgiving the debt. *See* Clark, *supra* note 3, at 801–02 (explaining that lenders stop foreclosure proceedings when costs exceed revenues); Gomez, *supra* note 50, at 76 (discussing recourse mortgage).

[216] *See* Gomez, *supra* note 50, at 76 (explaining the economic incentives of borrowers and lenders in scenarios of forced vesting and recourse mortgages).

[217] *See* John S. Kiernan, *2018's Property Taxes by State*, WALLETHUB (Feb. 27, 2018), https://wallethub.com/edu/states-with-the-highest-and-lowest-property-taxes/11585 [https://perma.cc/YBN7-QCWM] (listing real estate taxes across all states). Hawaii, for example, has the lowest average real-estate tax rate at 0.27%. *Id.* New Jersey, on the other hand, has the highest average real estate tax at 2.40%. *Id.* This may be a significant reason as to why New Jersey was plagued with more zombie mortgages than any other state. *See* Ramírez, *supra* note 118 (stating that New Jersey had over 4,000

that cancelling a foreclosure and not incurring maintenance costs could subject them to the forced vesting provision, and borrowers would face the potential for subsequent recourse—that is, lenders may seek repayment of the remaining debt—if borrowers exercise the forced vesting provision.[218] If, at the time that the borrower is considering forced vesting, the liabilities on the property exceed the outstanding debt, borrowers would be incentivized to forcibly vest title to their lenders.[219] Another risk that lenders face in pursuing borrowers for money is the possibility that borrowers would file for bankruptcy, leaving lenders with the expense of having pursued the debt but little or no recovery of those funds.[220]

The solution to the uncertainty lies in creating certainty through bargain.[221] Lenders do not want title to the property and borrowers may be subject to lenders seeking financial recourse against them.[222] Thus, in exchange for the borrower waiving the right to forcibly vest title in the future, the lender should switch the mortgage from recourse to nonrecourse and decrease the outstanding debt to match the value of the home.[223] This change from recourse to nonrecourse is not a taxable event and will not subject either party to tax costs.[224]

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zombie mortgages in 2016). Moreover, maintenance fees and costs can vary widely and may be difficult to predict. *See* Conlin, *supra* note 117 (giving examples of a $300 fee for lawn maintenance, a $1,000 fee for water and garbage service, and a $4,185 fee for municipal code penalties).

[218] *See* Hetherington & Hurley, *supra* note 76, at 75 (explaining that lenders may pursue borrowers for the remaining debt); Conlin, *supra* note 217 (discussing the fees associated with zombie mortgages).

[219] *See* Hetherington & Hurley, *supra* note 76, at 75 (explaining that monetary liabilities associated with recourse mortgages include subjecting borrowers to both gain and cancellation of debt income, depending on lender actions); Gomez, *supra* note 50, at 76 (explaining that monetary liabilities associated with recourse mortgages include the ability of lenders to pursue the borrower for any remaining debt). Because the outstanding debt would be less than the liabilities, the rational choice would be to choose the option that costs the least, being forced vesting. *See* FRIEDMAN, *supra* note 87, at 8 (elaborating on rationality).

[220] *See generally In re Rosa*, 495 B.R. 522 (indicating that the debtor filed for bankruptcy after her home had almost no equity and she could hardly afford mortgage payments).

[221] *See* POSNER, *supra* note 92, at 10 (explaining how parties may bargain over the use or allocation of property rights).

[222] *See Tosi*, 546 B.R. at 490 (indicating that the lender objected to accepting title to the home); Gomez, *supra* note 50, at 76 (explaining that lenders may choose to pursue borrowers for deficiencies after foreclosure).

[223] *See* Calabresi & Melamed, *supra* note 154, at 1092 (explaining bargaining over property rules).

[224] *See* Treas. Reg. § 1.1001-3(e)(5)(ii)(B)(2)(i) (2013) (stating that modifying a debt from recourse to nonrecourse is not a "significant modification" for tax purposes if certain criteria are met, and thus is not subject to taxation). Regulation 1.1001-3 gives a set of rules for determining whether modifying a debt instrument counts as an exchange of property—which would be a taxable event. *Id.* § 1.1001-3(a)(1). In general, a significant modification is treated as an exchange under Section 1001 of the IRC. *Id.* § 1.1001-3(b). Moreover, a change from recourse to nonrecourse debt *is* generally treated as a significant modification. *Id.* § 1.1001-3(e)(5)(ii)(A). If, however, the modification to a debt instrument still secures the initial collateral (in this case, the home) and does not constitute a change in payments, then it is not a significant modification, is thus not an exchange, and thus not taxable. *Id.* § 1.1001-3(e)(5)(ii)(B)(2)(i).

The amount of the mortgage debt that is cancelled will constitute cancellation of debt income for the borrower and a tax deduction for the lender.[225]

C. An Alternative Approach: Liability Rules for Communities

States not wishing to enact the proposed laws may still consider enacting a liability rule to protect communities from the financial consequences of zombie mortgages.[226] Such a rule would give the community a right to be free from lenders neglecting a property after stopping foreclosure.[227] This is similar to the idea of the lender as a "polluter" and the community as the group being affected by the pollution.[228] Lenders who infringe on the community's right to be free from dilapidated abandoned houses and their effects would be subject to penalties to compensate the community for the resulting damage.[229] Although enactment of such a liability rule might be a way to minimize the negative effects that lenders impose on communities, it would require more oversight.[230] A legislature or court may have to calculate damages in the event that both parties disagree on their extent.[231] Moreover, before damages may be assessed, the zombie mortgage, the creature that forced vesting can prevent, would already have to exist.[232] Although the damages-based approach may be

[225] *See* 26 U.S.C. § 1 (listing the various tax rates); § 11(b) (using a flat tax of 21% on corporations); § 61(a)(11) (stating that gross income includes cancellation of debt income); § 108(a)(1)(B) (allowing an insolvent individual to exclude a certain amount of income from being taxed); § 166 (allowing for corporations to deduct worthless debts from income).

[226] *See* Calabresi & Melamed, *supra* note 154, at 1092 (discussing how states can protect an entitlement through liability rules).

[227] *See id.* (stating that holders of entitlements protected by liability rules have the right to the entitlement up until it is destroyed and compensation is paid).

[228] *See, e.g.*, Boomer v. Atl. Cement Co., 26 N.Y.2d 219 (N.Y. 1970) (involving a cement company whose pollution caused damage to neighboring communities). The court ultimately held that the cement company could purchase the plaintiffs' right to clean air for the amount of permanent damages the pollution caused. *Id.* at 228.

[229] *See id.* at 225 (discussing how the polluter could potentially pay the landowners for the overall negative economic effect the pollution had on their properties).

[230] Calabresi & Melamed, *supra* note 154, at 1092 (stating that liability rules require the state to determine the amount that is to be paid in compensation). Of course, if the opposing parties were in agreement as to how much the damage was worth, they could settle the matter through private bargaining rather than disputing the amount. *See Boomer*, 26 N.Y.2d at 225 (noting that the plaintiffs stipulated they would have accepted $185,000 to settle the lawsuit); HARRISON, *supra* note 152, at 160 (explaining how bargaining could have resulted in no need for the court's determination in the *Boomer* case).

[231] *See* Calabresi & Melamed, *supra* note 154, at 1092 (discussing state valuation of damages).

[232] *See id.* (explaining that liability rules would result in damages when a party violated the entitlement, or right, being protected by the rule). If an entitlement to be free from the "pollution" of zombie mortgages existed, it would only be broken if the lender actually allowed a zombie mortgage to arise. *See id.* (discussing violations of liability rules).

desirable to protect communities, such an approach would not fully solve the problem of zombie mortgages.[233]

CONCLUSION

The 2008 financial crisis and the wave of unfinished foreclosures that followed brought zombie mortgages into the national spotlight. Borrowers who abandoned their homes in response to foreclosure actions by lenders thought their titles had died with the foreclosure. When lenders did not complete foreclosure proceedings, borrowers remained liable for their mortgage liabilities and other fees and costs associated with not maintaining the property. The result was the zombie mortgage, a property that is blighted and rotting, causing issues for borrowers and surrounding communities. Bankruptcy courts introduced the idea of allowing these financially distressed individuals to transfer title to their lenders without the lender's consent or over their express objections. Although appeals courts have largely disallowed such forced vesting in the context of bankruptcy proceedings, state law could still create a forced vesting mechanism to combat zombie mortgages. State legislatures, heavily influenced by financial incentives, have enacted statutes that deal with the treatment of abandoned properties. Law and economics presents a lens through which states may examine the desirability of adding forced vesting provisions to their statutes to incentivize lenders and borrowers to reach agreements before a distressed property becomes a zombie. By statutorily allocating to borrowers the right to transfer title to a lender under certain circumstances, states can encourage borrowers and lenders to negotiate mutually beneficial mortgage reductions. This mechanism would be effective regardless of whether a mortgage is recourse or nonrecourse. The tax effects of a borrower's decision to exercise forced vesting rights would provide the largest financial motivation for both parties to negotiate for a mutually beneficial economic outcome. For state legislatures that are concerned with adverse economic effects on their communities and seek an economically efficient solution, this approach may very well provide a strong justification for the creation of a statutory right of forced vesting.

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[233] *See id.* (indicating that damages would be imposed under a liability rule only when a party already violated the entitlement, or right, being protected by the rule).