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Negative Equity in Real Estate

by Alan C. Eidsness and Jaime Driggs

Ever since housing prices plummeted, family law attorneys have struggled to determine how to treat real property with negative equity. Does it go on the balance sheet as a negative number or does it get valued at zero? The Court of Appeals finally issued a decision addressing the issue that provides some direction but not a

comprehensive exposition on the subject and that is unpublished. *Middendorf v. Middendorf*, No. A12-1949 (Minn. Ct. App. Oct. 28, 2013).

Following trial, wife was awarded the homestead and husband was awarded another residence known as the 3030 Property, each subject to all encumbrances. There was no dispute that the 3030 Property had negative equity of \$25,253. The District Court listed the 3030 Property on the balance sheet in husband's column as having a zero value rather than crediting husband with the negative equity of \$25,253 and provided the following explanation: "Awarding [appellant] the 3030 [Property] with negative equity could result in [appellant] letting the property go into foreclosure, and still incurring the benefit from the property award. Moreover, if the housing market recovers, the property value of the 3030



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[Property] may increase thus resulting in an inequitable division of marital property."

Husband appealed and the Court of Appeals reversed the District Court. The Court of Appeals rejected the District Court's rationale as speculative and disagreed that a future increase in home values could render the division of property inequitable since wife also was awarded a piece of property that presumably would likewise increase in value. "The district court's zero valuation of the 3030 Property, when the parties were in agreement that the property had negative equity of \$25,253, overvalues the property by \$25,253 and was clearly erroneous on the record as a whole. Minnesota courts have cautioned against basing marital-property divisions and valuations on speculative future events."

Other than the above, the opinion does not include any analysis of the issue and provides little background information. For example, the opinion does not explain what arguments were made to the District Court on the negative equity issue and it does not recite the parties' respective arguments on appeal. Despite these limitations, the opinion is important because it is the first time the Court of Appeals has squarely addressed the negative equity issue and it represents a clear rejection of two arguments commonly made in support of using a zero value for a property with negative equity: (1) that it is not appropriate to credit a party for negative equity because he or she could walk away from the property and allow it to go into foreclosure; and (2) that housing

prices might increase and the party awarded the property does not actually realize a loss until the property is sold.

That the existence of the negative equity was undisputed made a difference on appeal because the Court of Appeals could not simply defer to the District Court's valuation as falling within a reasonable range of figures. That is what happened with respect to another property in dispute in the case, a commercial building with an outstanding loan balance of \$500,000. Husband argued that the value of the property was \$703,500, producing a positive equity of \$203,500, and wife argued that the value of the property was \$421,200, resulting in negative equity of \$78,800.

The District Court awarded the property to wife at a zero value on the balance sheet. Husband challenged this on appeal and the Court of Appeals affirmed because the zero value fell within the range of values put forward by the parties. "The district court's valuation of the 101 Commercial Property was not clearly erroneous on the record as a whole. A district court's valuation of marital property will be upheld if it 'lies within a reasonable range of figures.' Hertz, 304 Minn. at 145, 229 N.W.2d at 44. Here, factoring in the property's encumbrance, a value of zero lay within the range of values assigned to the 101 Commercial Property during trial."

Based on the *Middendorf* decision, in cases where there is no dispute regarding negative equity, parties advocating for a zero value will have to present arguments that are not based on

speculation about future events. For example, a property that is underwater may nonetheless provide a benefit to a party as an affordable place to live and, therefore, has some value.

However, in cases where the fact of negative equity is disputed because the parties disagree about the value of the property, District Courts will have wide discretion to value a property using a zero value so long as the zero value falls within a reasonable range after factoring in the encumbrances on the property. Thus, parties advocating for a zero value may be less inclined to agree to obtain a neutral appraisal of a property since it is now even more important to be able to dispute the fact of negative equity so that the zero value they are seeking falls within the range of values.

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