

STATE OF MINNESOTA
IN SUPREME COURT
Case No. A07-1832

The Business Bank,
Petitioner,

vs.

Kevin C. Hanson, et al.,
Respondents,

Option One Mortgage Corporation,
Respondent,

The United States of America,
Defendant.

PETITIONER THE BUSINESS BANK'S REPLY BRIEF

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The Bank respectfully submits this Reply Brief in response to Option One's Brief. After reviewing the parties' submissions, this Court should conclude that the Court of Appeals' decision should be reversed.

I. Option One Ignores Its Own Failure To Conduct A Proper Title Search And Asks This Court To Remedy Its Negligence.

A significant fact that Option One glosses over, and would have this Court disregard, is that Option One is the negligent party in this case, not the Bank. Option One admittedly made an error in its title search and missed the Bank's properly recorded Mortgage when Option One subsequently recorded its mortgage. In its effort to avoid the application of the Minnesota Recording Act, which places Option One's mortgage in a position junior to the Bank's Mortgage, Option One seeks a ruling from this Court interpreting Minn. Stat. § 287.03 to completely invalidate the Bank's Mortgage when it was properly recorded with payment of the correct tax. Option One is asking this Court to uphold the Court of Appeals' decision and issue a ruling that would change the use and purpose of Chapter 287 for the sole purpose of correcting Option One's mistake.

Under well established Minnesota law, even though Option One did not have actual notice of the Bank's Mortgage, it had constructive notice of the Bank's properly recorded Mortgage. *Chaney v. Minneapolis Community Dev. Agency*, 641 N.W.2d 328, 332 (Minn. Ct. App. 2002), *rev. denied* (May 28, 2002). Had Option One conducted an adequate title search, Option One would have discovered the Bank's fifteen-page Mortgage, which stated information that complies with Chapter 287. The Mortgage stated in capital letters on its first page that it was a Mortgage "TO SECURE PERSONAL GUARANTY OF VARIOUS NOTES AND OBLIGATIONS." (PET 001.)

The Mortgage also indicated on its first page, again in capital letters, the total amount of debt secured by the Mortgage: “NOTWITHSTANDING ANYTHING TO THE CONTRARY HEREIN, THE MAXIMUM INDEBTEDNESS SECURED BY THIS MORTGAGE IS \$200,000.” (*Id*) Thus, the Mortgage employed the very language contemplated by section 287.05, subd. 1a(a), which specifically authorizes and contemplates mortgages that secure only a portion of a debt, because only the secured amount of debt, in this case \$200,000, is taxed.

Had Option One conducted a proper title search, it would also have discovered, on the second page of the Mortgage, the recitals and references to “Notes,” a “Yap Note,” and a “Guaranty,” which were partly secured by the Mortgage. (PET 002.) Other provisions in the Mortgage specifically and repeatedly referenced several “Notes,” a “Yap Note,” and a “Guaranty” (PET 003), placing Option One and the entire world on notice of Hanson’s indebtedness. Option One was fully charged with notice of not only the \$200,000 secured by the Mortgage but also additional indebtedness not secured by the Mortgage—indebtedness that is irrelevant to the payment of the mortgage tax or a subsequent lien holder’s lien position.

Even if the Mortgage *had* specified the total \$512,000 in secured and unsecured debt Hanson had guaranteed to the Bank, since Option One negligently failed to discover the Mortgage, Option One still would have taken a mortgage on the Hansons’ property that was subject to the Bank’s \$200,000 Mortgage. The irony here is that Option One self-righteously contends the Bank must “suffer the consequences” for failing to disclose information in the Mortgage, even though Option One was unaware of the Mortgage

when Option One recorded its own mortgage. Option One is making a technical argument that the Bank failed to disclose information that it contends is required by section 287.03, without any evidence that the inclusion of such language would have made any difference at all in Option One's decision to issue a mortgage to the Hansons. Option One's position that it was entitled to notice of the full \$512,000 indebtedness is entirely theoretical, because Option One's negligent title search would not have discovered the Bank's Mortgage regardless of how the Mortgage had been written.

II. The Bank Complied With All Provisions Of Chapter 287, Including Minn. Stat. § 287.03, By Specifying The Amount Of Debt Secured By Its Mortgage.

Option One argues that, because the Mortgage does not state the full amount of Hanson's guaranty of debt to the Bank—\$512,000—then the Mortgage is completely invalid under the plain language of section 287.03. (Option One's Br. at 9, 11-12.) Option One contends that, until the full \$512,000 is repaid, the \$200,000 lien is not satisfied, the Mortgage actually secures \$512,000, and the Bank therefore paid the wrong tax on its Mortgage. (*Id.* at 4, 10, 13.) Option One's arguments are without merit.

To confirm the Bank's position, the Mortgage fully complies with Chapter 287, including section 287.03. Minn. Stat. § 287.03 provides, "No instrument . . . relating to real estate shall be valid as security for any debt, unless the fact that it is intended and the initial known amount of the debt are expressed in it," and Minn. Stat. § 287.01, subd. 3, defines "debt" as "the principal amount of an obligation to pay money that is secured in whole or in part by a mortgage of an interest in real property." (PET 053, 055.) The Mortgage specified that it was security for a debt, and the Mortgage specified that the debt was \$200,000. (PET 001-002.) The "debt" the Hansons owed the Bank for

purposes of Chapter 287 was \$200,000 because that was the amount secured by the Mortgage and for which mortgage tax was to be calculated and paid. Under Chapter 287, the amount of debt secured by the Mortgage is significant only for purposes of paying the correct tax.

Option One's argument that the amount secured by the Mortgage is \$512,000 (Option One's Br. at 13) is not consistent with the purpose and effect of a mortgage. A mortgage is a lien against property, which is pledged as security for the payment of a debt expressed in a note. *Krahmer v. Koch*, 216 Minn. 421, 422-423, 13 N.W.2d 370, 370-371 (1944). The amount of debt secured by a mortgage is that amount expressed on the mortgage instrument even if a note indicates that the debt is greater than the amount secured by the mortgage. *Kingsley v. Anderson*, 103 Minn. 510, 511, 115 N.W. 642, 643 (1908). A mortgage can secure more than one note and can secure a lien in an amount that is less than the debt that is owed. *Winne v. Lahart*, 155 Minn. 307, 309, 193 N.W. 587, 588 (1923). "[T]he note and mortgage are separate and distinct instruments, so different in their nature and purpose that the negotiable character of the note does not affect the character of the mortgage" *Id.* If the mortgagor defaults on the note, the mortgagee may initiate foreclosure by advertisement, or foreclosure proceedings seeking a judicial decree and approval of sale of the mortgaged property, as a means for the mortgagee to enforce its lien on the mortgaged property. *Norwest Bank Hastings, N.A. v. Franzmeier*, 355 N.W.2d 431, 433 (Minn. 1984). The holder of the mortgage may bid for the purchase of the property at the sheriff sale in the amount of the secured mortgage debt. Minn. Stat. §§ 580.05, 581.11 (2008).

Thus, the information that needs to be stated in a mortgage is the amount of debt that is secured by the mortgage so as to provide notice to subsequent purchasers or mortgagees of the lien amount and to provide the amount of the lien that may be foreclosed in the event of a default under the mortgage.

The Bank's Mortgage was one of several instruments that secured all or part of the loans the Bank issued to NAPD. (PET 019.) NAPD's owners, Kevin Hanson and Travis Carter, each signed unconditional guaranties of NAPD's indebtedness. (PET 017.) Mr. Hanson and his wife executed the Mortgage, which was a third-party mortgage, on their home with a lien amount of \$200,000, and Mr. Carter and his wife executed a similar third-party mortgage on their home with a lien amount of \$200,000. (PET 019; Bank's Appendix RA 45.) In 2006, Mr. Carter settled with the Bank by paying a portion of the outstanding indebtedness, and the Bank satisfied the Carters' mortgage on their home. (PET 035; Bank's Appendix RA 49.) The Hansons did not pay the Bank, so the Bank proceeded with foreclosure of its \$200,000 Mortgage lien.

Accordingly, \$200,000 is the sole amount secured by the Bank's Mortgage, \$200,000 is the sole amount relevant to the Mortgage, and \$200,000 is precisely the amount specified in the Mortgage. In the event the Bank is allowed to proceed with the foreclosure of its Mortgage, the maximum amount of mortgage debt that the Bank could bid at the foreclosure sale would be \$200,000, plus interest, costs, and fees, and the Hansons or Option One could redeem from the foreclosure by paying only \$200,000 (plus interest, costs, and fees)—not \$512,000. The amount of Hanson's guaranty of debt owed to the Bank is therefore irrelevant to the \$200,000 secured debt on the Hansons'

property. While the Mortgage stated that the Mortgage shall remain in full force and effect until the principal balance of Hanson's indebtedness is paid in full, only \$200,000 of the \$512,000 was secured by the Mortgage and superior to Option One's mortgage. Nothing in Chapter 287, or any other provision of Minnesota law, prohibits mortgages written in this manner.

Option One criticizes the District Court's and Court of Appeals' rulings that the Bank paid the correct tax on the Mortgage by suggesting that the Mortgage actually secured \$512,000 in total debt. (Option One's Br. at 13 n.3.) But Option One failed to raise the issue of whether the Bank had paid the correct tax as an issue for this appeal. *See* Minn. R. Civ. App. P. 117, subd. 4 (stating that a party may seek conditional review in a response to a petition for review). The question of whether the Bank paid the correct tax is therefore not before this Court.

Moreover, Option One ignores the actual language of the Mortgage, which specifies on its first and second pages that it secures only \$200,000 in debt, and both the District Court and the Court of Appeals correctly found that the Bank had paid the correct tax on the \$200,000 the Bank claimed as a mortgage lien. Section 287.05, subd. 1a(a), specifically permits the payment of tax only on a portion of a debt that secures a mortgage, and section 287.05 does not reference or require specifying the amount required to satisfy a mortgage. The Bank complied with section 287.05, subd. 1a(a), which contemplates and authorizes the very type of language the Bank employed in drafting its Mortgage, specifically, mortgages that secure only part of a debt.

Contrary to Option One's assertions that the "plain language" of section 287.03 must be applied (*Id* at 15), it does not make sense to interpret this provision of the statute in a vacuum. Considering the language of section 287.03 in the context of the surrounding provisions of the Mortgage Registry Tax statutes, and the provisions of the Mortgage, the District Court correctly rejected Option One's argument, and this Court should do so as well

III. Chapter 287 Is A Revenue Statute Intended To Ensure The Payment Of The Correct Tax And Not A Statute That Governs Mortgage Lending, Underwriting, Or Priority.

Option One argues, and the Court of Appeals found, that Option One was entitled to notice of the total \$512,000 debt the Hansons owed the Bank. (Option One's Br. at 11; PET 051.) But Chapter 287 is purely a collection of revenue statutes, not statutes that govern mortgage lending, underwriting, or priority. The Recording Act governs the priority of properly recorded mortgages, and it is well established that subsequent purchasers are charged with notice of all liens of record. The underwriting decision to make a loan and take a mortgage is not governed by Chapter 287. Chapter 287 seeks to ensure only the correct payment of mortgage and deed taxes. Chapter 287 does not require the full disclosure of a mortgagor's indebtedness, and subsequent mortgagees are charged with constructive notice of all properly recorded instruments.

Option One flippantly argues that the District Court's opinion is "unintelligible" and, "what the District Court meant is anybody's guess." (Option One's Br. at 10.) But the District Court clearly articulated the purpose of Chapter 287 as "a tax statute. It's not necessarily a statute for the benefit of [Option One.] It's a revenue raising statute so the

County gets paid.” (Hansons’ Appendix at A91.) The District Court also held that the Mortgage was limited to \$200,000: “[T]he debt that’s secured is the \$200,000 because . . . that’s the amount [the Bank] stated in the instrument.” (*Id.* at A93.) Option One conceded below that the Mortgage was limited to enforcement of \$200,000 in the event of a foreclosure. (*Id.* at A97.) Option One cannot seriously contend that it did not understand the District Court’s reasoning or ruling.

Option One argues that *Engenmoen* supports its position (Option One’s Br. at 17.) But in that case, Lutroe provided his bank a deed as security for indebtedness. 153 Minn. 409, 410, 190 N.W. 894, 895. The bank recorded the deed, which was in fact an equitable mortgage. *Id.* Engenmoen subsequently secured a judgment against Lutroe and attempted to execute on the judgment. *Id.* Engenmoen then sought to void the bank’s deed and assert her judgment lien as prior to the deed, because the bank had failed to pay the mortgage registry tax. *Id.*

This Court emphasized that the amount of the tax to be paid was the based on the amount of the debt secured by the instrument. *Id.* This Court reasoned that, although the full amount of the tax was not paid, and the document did not state that it was intended as security for a debt, Chapter 287’s predecessor was “a revenue measure purely, and the only purpose of its prohibitive provisions is to compel the payment of the prescribed tax.” *Id.* at 412, 190 N.W. at 895-96. The Court observed that Engenmoen had the burden of proving she had no notice of the bank’s deed, which, because the tax had not been paid, “was not entitled to be recorded, and must stand as if unrecorded.” *Id.* at 414, 190 N.W.

at 896. But the Court found that Engenmoen had notice of Lutroe's deed to the bank, and therefore her lien was subordinate to the bank's equitable mortgage. *Id.*

Contrary to what Option One argues, *Engenmoen* did not stand for the proposition that a subsequent mortgagee or lien holder could take priority away from a superior lien holder simply on the basis that the superior lien holder had not complied with the mortgage registry tax statute. The bank in *Engenmoen* had failed to pay the tax, but this Court still found its prior recorded deed superior to Engenmoen's judgment, as Engenmoen had failed to prove she had no notice of the deed when she secured her judgment lien. Unlike the deed in *Engenmoen*, which provided no notice that it secured a debt or the amount of the debt, the Bank's Mortgage in this case provided full notice that it was intended to secure a debt and that the debt secured was \$200,000. Further, the Bank in this case paid the correct tax on the amount of debt secured by its Mortgage. Unlike the deed in *Engenmoen*, the Bank properly recorded its Mortgage and paid the correct tax on the Mortgage.

Option One also misstates the holding in *Staples*. (Option One's Br. at 18.) There, the Staples had given East St. Paul State Bank a deed on their home in exchange for debt "due or to become due." 122 Minn. 419, 420, 142 N.W. 721, 721. East St. Paul State Bank sought to reform the deed as a mortgage because it had not previously identified that the deed was intended as security for a debt, and the bank had failed to pay any mortgage tax: the deed did not specify the amount of the debt but instead stated it was only for "\$1." *Id.* at 421, 142 N.W. at 721-22. The bank subsequently paid the tax, and the trial court found that the bank had not attempted to evade the payment of the tax

but was merely ignorant of the statute *Id.* The Court emphasized that the purpose of the statute was to enforce the payment of taxes: “The state wants all the tax on money loaned upon real estate security” *Id.* at 423, 142 N.W. at 722.

Contrary to what Option One argues, *Engenmoen* and *Staples* stand for the proposition that mortgages for which no tax has been paid, i.e., equitable mortgages, are not enforceable or recordable until the tax has been paid, and that the Mortgage Registry Tax statutes are not intended to invalidate mortgages when there is no attempt to avoid the payment of the tax. Both cases hold that Chapter 287 is a revenue measure purely and not intended to invalidate mortgages that do not comply with Chapter 287. Neither case addresses a subsequent mortgagee’s notice of the full amount of debt secured by a properly recorded mortgage. Unlike in those cases, where the deed did not at all state that it was a security for a debt, or specify any amount of debt, in this case the Bank’s Mortgage stated precisely that it was security for a debt and that the debt secured was \$200,000. Further, the Bank paid the correct tax on its Mortgage. Thus, the Bank’s Mortgage was properly recorded, the correct tax was paid, and Option One had more than adequate notice of the Bank’s Mortgage.

IV. As Evidenced By Option One’s Arguments, The Court Of Appeals’ Decision Will Invite Needless Litigation And Creates A Harsh And Unintended Result.

The Bank and Amicus strongly disagree with Option One’s position that the Court of Appeals’ decision was narrowly based on the facts and that there is no evidence other mortgages would be affected by the Court of Appeals’ ruling. (Option One’s Br. at 14.) It is precisely Option One’s arguments in this action that show the consequences of an

erroneous interpretation of Chapter 287: admittedly junior mortgage holders may seek to invalidate superior liens through the use of the Mortgage Registry Tax statutes. It is not surprising that the Bank did not introduce into the record evidence that other mortgages might be written similarly to the Bank's Mortgage, because the Bank merely sought to foreclose its prior recorded and superior lien. Further, Minnesota's real estate bar has submitted an amicus brief in support of the Bank's position, which shows the state-wide impact the Court of Appeals' decision could have.

The Court of Appeals' ruling could affect other mortgages written similarly to the Bank's Mortgage, and for which proper title searches had been conducted, even when subsequent lien holders had full notice of the amount of superior liens. Junior lien holders in those instances might seek to employ Option One's tactics to invalidate properly recorded senior mortgages even though they had discovered the senior mortgage lien through a proper title search

Option One further argues that the Legislature intended a "harsh" and "unreasonable" result in drafting section 287.03. (Option One's Br. at 15.) Option One's arguments that all mortgages written like the Bank's should be invalidated, and that the Legislature intended a harsh and unreasonable result, are unsupported by the statutory language, inequitable, contrary to the canons of construction, and should be rejected.

V. While Reformation Is Not An Issue Before The Court, The Bank Would Be Entitled To Reform Its Mortgage And Maintain Its First-Lien Priority.

Option One criticizes the Court of Appeals' lack of "authority or analysis" and asks this Court, "in the interest of judicial efficiency," to rule that a reformed mortgage is not effective notice until it is reformed. (Option One's Br. at 19 n. 5.) But the issue of

reformation is another issue Option One failed to raise in a cross petition for review with this Court. *See* Minn. R. Civ. App. P. 117, subd. 4 (stating that a party may seek conditional review in a response to a petition for review) To the contrary, Option One stated, in its response to the Bank's Petition for Review, "all Business Bank would have to do to have its mortgage comply with § 287 03 is to simply state the initial amount of the four notes totaled \$512,000." (Option One's Response in Opp. to the Bank's Pet. for Rev. at 2 n. 1.) Further, the parties never briefed or argued below whether the Bank's Mortgage need be reformed or whether such reformation would affect the Mortgage's first-lien position.

Even if the Court considers the issue of reformation, nothing precludes the Bank from seeking reformation of its Mortgage in the District Court to state the total amount of secured and unsecured debt and to establish the senior priority of its Mortgage over Option One's mortgage. If the Bank were to seek to reform its Mortgage, the Bank would be entitled to reform its Mortgage and maintain its first-lien position over Option One's mortgage to the extent of the Bank's \$200,000 lien.

CONCLUSION

Option One made a clear error in failing to discover the Bank's Mortgage before deciding whether to issue a loan to, and take a mortgage from, the Hansons. Option One's recourse is against its title company, and not the Bank. In fact, Option One has a simple and clear remedy against its title company. Option One was charged with notice of the Bank's \$200,000 Mortgage of record and had the duty to inquire about additional indebtedness. Under the District Court's ruling, Option One is only behind a \$200,000

Mortgage. Option One is now attempting to cure its negligence and invalidate the Bank's Mortgage by use of the Mortgage Registry Tax statutes. Option One, through its glib arguments, is the party seeking to have its cake and eat it too.

Option One's arguments are precisely why this Court should reverse the Court of Appeals' decision: countless junior mortgagees may dream up reasons to invalidate properly recorded and superior mortgages through the use of creative but misguided interpretations of the revenue statutes. Because the Bank's Mortgage complied with Chapter 287, this Court should reverse the Court of Appeals and affirm the District Court's decision that the Bank's Mortgage is valid, prior, and superior to Option One's mortgage.

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