

NO. A08-1560

State of Minnesota
In Supreme Court

Citizens State Bank,

Appellant,

vs.

Raven Trading Partners, LLC,

Raven Trading Partners, Inc. and Raven Trading, Inc.,

Respondents.

**BRIEF OF MINNESOTA LAND TITLE ASSOCIATION,
AS AMICUS CURIAE**

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STATEMENT OF INTEREST:

The Minnesota Land Title Association (“MLTA”) submits this brief as amicus curiae requesting reversal of the decision of the Minnesota Court of Appeals.¹ MLTA’s interest in this action is public in nature. MLTA was formed in 1908 as a professional organization interested in securing the integrity of land titles through Minnesota. With over 130 members throughout the state, MLTA is Minnesota’s largest land title association. MLTA members provide abstracts of title, real estate closing services, title insurance, and related services to the real estate and lending industries, on behalf of the public. MLTA’s membership includes title insurance agents, title insurance underwriters, abstractors, settlement agents and real estate attorneys. MLTA members have firsthand knowledge of the public consequences of the restrictive application of equitable subrogation by the Court of Appeals versus the broader application of equitable subrogation set forth in the Restatement of Property and in other jurisdictions. MLTA offers insight into the public benefits of the Restatement position of preventing unjustified windfalls and unjust enrichment.

SUMMARY OF DISCUSSION:

The Minnesota Supreme Court has long favored the doctrine of equitable subrogation and has applied it liberally. Equitable subrogation exists alongside the recording act and provides equitable relief when a strict application of the recording act

¹ In accordance with Minn. R. Civ. App. P. 129.03, the Minnesota Land Title Association hereby certifies that its counsel authored this brief and that no person or entity, other than the Minnesota Land Title Association, has made a monetary contribution to the preparation or submission of this brief.

would be unjust and inequitable. The Court of Appeals misapplied Minnesota law and adopted a stricter application of equitable subrogation than the Minnesota Supreme Court intended. The Court of Appeals should be reversed in this case, and a 2005 Court of Appeals case should be overruled, so that the application of the doctrine of equitable subrogation is consistent with established Minnesota Supreme Court precedent. The Court should also adopt the Restatement position on equitable subrogation, a growing trend and the fairest approach to equitable subrogation.

DISCUSSION:

The legal priority of competing lien holders is generally governed by the Minnesota Recording Act, Minnesota Statutes section 507.34 (the "Recording Act"). A conveyance of an interest in real property recorded in good faith, for valuable consideration, and without notice of a prior encumbrance has priority over subsequently recorded conveyances. *See id.* However, equity exists alongside the Recording Act and the doctrine of equitable subrogation has long been applied in Minnesota to avoid the harsh and inequitable results of a strict legal application of the Recording Act.

I. History of Equitable Subrogation

The doctrine of equitable subrogation has been widely recognized throughout American jurisprudence. *See Richards v. Security Pacific Nat. Bank*, 849 P.2d 606, 608 (Utah 1993). Courts began to adopt the doctrine of equitable subrogation in the late 1800s. *See Bank of America, N.A. v. Prestance Corporation*, 160 Wash.2d 560, 573, 160 P.3d 17, 24 (Wash. 2007). Equitable subrogation is a purely equitable doctrine borrowed from civil law and was first applied only to sureties. *See Martin v. Hickenlooper*, 90

Utah 150, 59 P.2d 1139, 1140 (Utah 1936). Early courts were divided in their application of equitable subrogation, with many courts requiring the party asserting the doctrine to have no knowledge of intervening interests. *See Bank of America, N.A.*, 160 Wash.2d at 573, 160 P.2d at 24 (citing *Martin*, 59 P.2d at 1142-44). The doctrine developed and was liberalized as a “natural consequence of a call for the application of justice and equity to particular situations.” *Martin*, 59 P.2d at 1140. Equitable subrogation became recognized as a “wholesome and highly meritorious doctrine” highly favored in equity. *See id.*

Some early courts applying equitable subrogation required the party asserting the doctrine to have no knowledge of intervening interests. *See Bank of America, N.A.*, 160 Wash.2d at 573, 160 P.3d at 24. This requirement of no knowledge was carried over from an early mistrust of the doctrine of equitable subordination and was borrowed by courts applying subrogation as a restitution remedy. *See id.* In early cases, some courts would not allow a lender with actual or constructive knowledge of an intervening lien to assert equitable subrogation. *See id.*, 160 Wash.2d at 574, 160 P.2d at 25. However, most courts gradually departed from this strict application. *See id.* Many courts were quick to allow equitable subrogation for a party with constructive knowledge of an intervening lien, while courts have been reluctant to allow equitable subrogation for a party with actual knowledge of an intervening lien. *See id.*

Lately, a growing number of courts do not look at the knowledge of the party asking for equitable subrogation, and instead concentrate on the party’s expectations and whether the intervening lien holder is materially prejudiced by the application of

equitable subrogation. *See generally* Grant S. Nelson & Dale A. Whitman, *Adopting Restatement Mortgage Subrogation Principles: Saving Billions of Dollars for Refinancing Homeowners*, 2006 BYU L.REV. 305. The general trend is toward a more liberal approach to the application of equitable subrogation. *See Bank of America, N.A.*, 160 Wash.2d at 576, 160 P.3d at 26.

II. Three Approaches to Equitable Subrogation

There are three prevailing approaches to the application of equitable subrogation.

A. The “Restatement Approach”

The growing trend and a better reasoned approach to equitable subrogation is in the Restatement (Third) of Property: Mortgages, section 7.6 (1997) (the “Restatement”).

The Restatement states as follows:

§ 7.6 Subrogation

(a) One who fully performs an obligation of another, secured by a mortgage, becomes by subrogation the owner of the obligation and the mortgage to the extent necessary to prevent unjust enrichment. Even though the performance would otherwise discharge the obligation and the mortgage, they are preserved and the mortgage retains its priority in the hands of the subrogee.

(b) By way of illustration, subrogation is appropriate to prevent unjust enrichment if the person seeking subrogation performs the obligation:

- (1) in order to protect his or her interest;
- (2) under a legal duty to do so;
- (3) on account of misrepresentation, mistake, duress, undue influence, deceit, or other similar imposition; or
- (4) upon a request from the obligor or the obligor's successor to do so, if the person performing was promised repayment and reasonably expected to receive a security interest in the real estate with the priority of the mortgage being discharged, and if subrogation will

not materially prejudice the holders of intervening interests in the real estate.

Under this approach (“the Restatement Approach”), a lender who refinances an existing lien on the property, will be subrogated to that lien position if (1) the new lender reasonably expected to receive that lien priority position and (2) the intervening lien holder will not be materially prejudiced by the application of equitable subrogation. In other words, the knowledge relating to an intervening lien of the party asserting equitable subrogation is irrelevant. The prevailing consideration for courts adopting the Restatement position is justice, equity, and placing the parties into the lien position for which they bargained.

Examples of court decisions in the following jurisdictions have substantively approved of the Restatement Approach to equitable subrogation: Arizona, the District of Columbia, Georgia, Indiana², Iowa, Massachusetts, Missouri, Nevada, Texas, New Jersey, and Washington. See Grant S. Nelson & Dale A. Whitman, *Adopting Restatement Mortgage Subrogation Principles: Saving Billions of Dollars for Refinancing Homeowners*, 2006 BYU L.REV. 305, 314, ft. 39; see also *Bank of America v. Prestance*, 160 P.3d 17 (Wash. 2007).

B. The “Majority Approach”

The approach followed by many jurisdictions allows equitable subrogation to be asserted by parties with constructive knowledge of an intervening lien, but bars equitable

² The court in *Ripley v. Piehl*, 700 N.W.2d 540 (Minn. Ct. App. 2005) cited Indiana as being representative of the majority approach. See *Ripley* at 545. However, subsequent

subrogation to a party with actual knowledge of an intervening lien. *See Bank of America, N.A.*, 160 Wash.2d at 569, 160 P.2d at 22. Examples of court decisions in the following jurisdictions have followed the “majority approach”: California, Idaho, Illinois, Arkansas, Louisiana, Mississippi, Maine, New York, Oregon, South Carolina, Vermont, and Wisconsin. *See* Grant S. Nelson & Dale A. Whitman, *Adopting Restatement Mortgage Subrogation Principles: Saving Billions of Dollars for Refinancing Homeowners*, 2006 BYU L.REV. 305, 314, ft. 40; Restatement (Third) of Property: Mortgages, § 7.6 (1997), Reporter’s Notes, comment e. Additionally, a number of federal courts have interpreted state laws in Alabama, Texas, New York, California, and the District of Columbia in accordance with the majority approach. *See id.* Finally, as will be discussed in detail below, the Minnesota Supreme Court has substantively ascribed to the majority approach.

C. The “Minority Approach”

A minority of courts still take a narrow and strict approach to the application of equitable subrogation. These courts deny equitable subrogation to any party with constructive or actual knowledge of an intervening lien. Examples of court decisions in the following jurisdictions apply the minority approach: Connecticut, North Carolina, Ohio, Virginia, and Michigan. *See* Grant S. Nelson & Dale A. Whitman, *Adopting Restatement Mortgage Subrogation Principles: Saving Billions of Dollars for Refinancing Homeowners*, 2006 BYU L.REV. 305, 314, ft. 41. The Minnesota Court of

to the decision in *Ripley*, the Indiana Supreme Court substantively adopted the Restatement Position. *See Bank of New York v. Nally*, 820 N.E.2d 644 (Ind. 2005).

Appeals held that Minnesota ascribes to the minority approach, with the additional burden that sophisticated parties are held to a higher standard for determining whether they acted under justifiable or excusable mistake of fact. *See Ripley v. Piehl*, 700 N.W.2d 540 (Minn. Ct. App. 2005). MLTA submits that the Court of Appeals erred in its interpretation of Minnesota Supreme Court precedent.

III. The Minnesota Approach to Equitable Subrogation

Minnesota adopted the concept of equitable subrogation, at least insofar as to sureties, as early as 1886 in *Connor v. How*, 35 Minn. 518, 29 N.W. 314 (1886). By 1892, the Supreme Court applied the doctrine of equitable subrogation beyond instances of sureties, and acknowledged that the doctrine was “steadily growing and expanding in importance, and becoming more general in its application to various subjects and classes of persons.” *Emmert v. Thompson*, 49 Minn. 386, 391, 52 N.W. 31 (1892). Equitable subrogation has been favorably applied to lenders refinancing an existing lien in Minnesota since *Emmert* in 1892. Since the earliest days of equitable subrogation, the Minnesota Supreme Court has viewed the doctrine with favor and has taken a liberal approach to the application of equitable subrogation.

A. *Emmert v. Thompson*, 49 Minn. 386, 52 N.W.31 (1892)

The Minnesota Supreme Court applied the doctrine of equitable subrogation to a loan refinancing transaction in 1892. The *Emmert* Court applied equitable subrogation to a party with constructive knowledge of an intervening lien. *Emmert*, 49 Minn. at 391, 52 N.W.2d at 31. The *Emmert* Court noted that equitable subrogation was “... a mode which equity adopts to compel the ultimate payment of a debt by one who in justice and

good conscience ought to pay it, and is not dependent upon contract, privity, or strict suretyship.” See *Emmert*, 49 Minn. at 391, 52 N.W.2d at 31-32. In *Emmert*, a lender refinanced an existing first mortgage on two separate tracts of real property and also paid delinquent property taxes. See *Emmert*, 49 Minn. at 390, 52 N.W.2d at 31. The lender believed that after the existing mortgages and delinquent taxes had been paid by its loan proceeds, the lender would hold a first mortgage on the property. See *id.* The lender was not aware of any encumbrances on the property. See *id.* However, there was a fully perfected intervening mortgage of record against the property at the time of the refinancing transaction. See *Emmert*, 49 Minn. at 391, 52 N.W.2d at 31. Due to the refinancing transaction and the discharge of the previous first mortgage, the intervening mortgage was elevated to first lien position. See *id.*

The refinancing lender in *Emmert* failed to check the county property records to discover the intervening mortgage, the *Emmert* Court nevertheless characterized the refinancing lender as acting under a “justifiable or excusable mistake of fact.” See *Emmert*, 49 Minn. at 391, 52 N.W.2d at 32. The “justifiable or excusable mistake of fact” standard permeates subsequent Minnesota Supreme Court decisions on equitable subrogation. It is clear from a plain reading of *Emmert* that the Minnesota Supreme Court intended that a “justifiable or excusable mistake of fact” includes situations where the lender *mistakenly believes* no intervening mortgages exist. The error by the refinancing lender grew out of an error in its agent’s abstracting books. Both the lender and its agent failed to check the county’s title records before entering into the refinancing transaction. See *id.*, 49 Minn. at 393, 52 N.W.2d at 32. The refinancing lender in

Emmert had constructive notice of the intervening mortgage and could have found the intervening mortgage if it had checked the title to the property prior to closing on the refinancing transaction. Nevertheless, the *Emmert* Court found that the refinancing lender's action or inaction constituted a justifiable or excusable mistake of fact warranting the application of equitable subrogation.

The *Emmert* Court recognized the early mistrust of equitable subrogation in other jurisdictions, but ultimately applied a liberal approach. The *Emmert* Court illuminates the approach Minnesota took toward equitable subrogation:

There are a very respectable number of cases, several having been cited, in which relief has been refused under circumstances precisely like those now before us, where one who has loaned and used his money in good faith, and for the express purpose of relieving a debtor from a pressing obligation, and his real property from a specific lien for the amount of the same, under a genuine but excusable misapprehension as to the rank and position of security taken by him on the same property, has been treated and characterized as a volunteer, a stranger, and an officious intermeddler, and denied the rights of an equitable assignee. But of late years, with the development of the principles on which the doctrine is founded, the courts have been taking a broader and more commendable view of the situation of such a party, and at this time very little is left of the views expressed in the earlier cases. The better opinion now is that one who loans his money upon real estate security for the express purpose of taking up and discharging liens or incumbrances on the same property has thus paid the debt at the instance, request, and solicitation of the debtor, expecting and believing, in good faith, that his security will, of record, be substituted, in fact, in place of that which he discharges, is neither a volunteer, stranger, nor intermeddler, nor is the debt, lien, or incumbrance regarded as extinguished, if justice requires that it should be kept alive for the benefit of the person advancing the money, who thereby becomes the creditor.

Emmert v. Thompson, 49 Minn. at 391-92, 52 N.W. at 32.

The equitable subrogation standard set forth in *Emmert* is similar to the Restatement Position. The *Emmert* Court held that a "justifiable or excusable mistake of

fact” means a good faith expectation and belief by the refinancing lender that its security will be substituted in the priority position of the lien discharged. *See id.* The *Emmert* Court rejected the intervening mortgagee’s argument to deny the refinancing lender equitable subrogation because it was “culpably negligent” for failing to check the title records and failing to discover the existence of the properly recorded intervening mortgage. *See Emmert*, 49 Minn. at 393, 52 N.W. at 32. Instead, the *Emmert* Court stated, “It is a common thing for courts of equity to relieve parties who have by mistake discharged mortgages upon the record, and to fully protect them from the consequences of their acts, when such relief will not result prejudicially to third or innocent persons.” *See id.* (citing *Gerdine v. Menage*, 41 Minn. 417, 43 N. W. Rep. 91).

It is important to note that the mistake made in *Emmert* was by a professional. The *Emmert* Court does not focus on the experience of the lender or its agent, but states that the mistake was made by the lender’s agent who kept its own abstracting books. *See Emmert*, 49 Minn. at 393. It is logical that any person who keeps abstracting books for real property would be a sophisticated.

The *Emmert* Court intended that mistakes by refinancing lenders which do not prejudice an intervening lien holder (such as failure to check the title), should not prevent the favorable application of equitable subrogation. In fact, no Minnesota Supreme Court case since *Emmert* has denied the application of equitable subrogation on that basis.

B. Minnesota Supreme Court Cases Applying a Liberal Approach to Equitable Subrogation

In *Heisler v. C. Aultman & Co.*, 56 Minn. 454, 57 N.W. 1053 (1894), the Minnesota Supreme Court reinforced the notion that a lender may be equitably subrogated to a mortgage the lender paid off despite having constructive knowledge of an intervening lien. In *Heisler*, the intervening lien was a judgment lien properly docketed in the county in which the real property was situated. *See Heisler*, 56 Minn. at 456. The lender seeking equitable subrogation in *Heisler* failed to examine the judgment records in the clerk of court's office. *See Heisler*, 56 Minn. at 457. The Court did not cite a reason for the lender's failure to check the judgment records. Nevertheless, the *Heisler* Court characterized the failure to check the judgment records as a "mistake of fact." *See Heisler*, 56 Minn. at 459. The *Heisler* Court focused on the equities of the case and the fact that the intervening lien holder would not be prejudiced by the application of equitable subrogation, instead of focusing on the failure to check the judgment records. *See Heisler*, 56 Minn. at 459-60.

In *Gerdine v. Menage*, 41 Minn. 417, 43 N.W. 91 (1889), the Court granted equitable subrogation to a party who paid off a mortgage on real property under the belief that he successfully foreclosed his mortgage on the property and that he was the owner of the property. *See Gerdine*, 41 Minn. at 419. However, the party seeking equitable subrogation conceded the notice of sale in his mortgage foreclosure was defective. *See id.* Despite the negligence by the party asserting equitable subrogation, the Court granted equitable subrogation and held it would be equitable to interfere and place the parties back into the *status quo*. *See id.* at 421.

In *Elliot v. Tainter*, 88 Minn. 377, 93 N.W. 124 (1903), due to an abstracting error by a professional abstracting company, the title search failed to reveal an intervening mortgage to the lender. Similar to today's typical refinancing transactions, the lender relied on an outside title company for searching the title. Despite the clear negligence by a professional title company acting for the lender, the court granted equitable subrogation. The *Elliot* Court stated:

The equitable doctrine of subrogation is well established, and is not now open to question in this court. Where a person having an interest in real property has paid money to satisfy a mortgage or lien to protect his interest, he is entitled, when justice requires, to be substituted in place of a prior incumbrancer, and treated as an equitable assignee of the lien, notwithstanding it has been canceled; the true principle being that, where money is so paid, it shall operate in the nature of an assignment of the canceled lien, to continue it in force to subserve the ends of justice. This doctrine is applied when such lien has been discharged under a mistake of the real situation, to save the party who has made the payment from loss if such payment and discharge would otherwise give the owner of the land an unconscionable and inequitable advantage over the person who had paid the same. (citing *Emmert v. Thompson*, 49 Minn. 386, 52 N. W. 31, 32 Am. St. Rep. 566; *Heisler v. C. Aultman & Co.*, 56 Minn. 354, 57 N. W. 1053, 45 Am. St. Rep. 486; *Mortgage Co. v. Tracy*, 58 Minn. 201, 59 N. W. 1001.)

Elliot v. Tainter, 88 Minn. at 378-79.

In *Hirleman v. Nickels*, 193 Minn. 51, 258 N.W. 13 (1934) the Court granted equitable subrogation despite a properly recorded and perfected intervening mortgage at the time of the refinancing transaction. The refinancing mortgage in *Hirleman* contained a covenant that specifically identified the intervening mortgage, although the lender claimed it did not know about the intervening mortgage. See *Hirleman*, 193 Minn. at 53. The Court granted equitable subrogation to the lender, despite the intervening mortgage being identified in the refinancing mortgage. The *Hirleman* Court also gave a definition

for “mistake” in equitable subrogation analysis, stating that “a mistake is ‘that result of ignorance of law or of fact, which has misled a person to commit that, which, if he had not been in error, he would not have done’” (citing *Bruse v. Nelson*, 35 Iowa 157, 160).

In *Sucker v. Cranmer*, 127 Minn. 124, 149 N.W. 16 (1914), a purchaser at a sheriff’s sale paid taxes on the property during the redemption period but failed to record the affidavit required for reimbursement of the expense in a redemption from the foreclosure. The Court granted equitable subrogation to the sheriff’s certificate holder who had paid taxes and found that the holder of the sheriff’s certificate could be subrogated to the lien rights represented by the taxes paid. The *Sucker* Court noted that the property owners had no good reason to complain of the application of equitable subrogation and “[u]nder this situation it would be a gross injustice to permit defendants to profit several hundred dollars from plaintiff’s mistake or inadvertence.” *Sucker v. Cranmer*, 127 Minn. at 128.

Through this long line of cases of favorable to equitable subrogation, Minnesota recognized and embraced the common law doctrine of equitable subrogation. See *Commercial Union Ins. Co. v. Minnesota School Bd. Ass’n*, 600 N.W.2d 475 (Minn. Ct. App. 1999). The standard developed by the Minnesota Supreme Court is that equitable subrogation will be applied where: a) the payment of a prior lien was made “under a justifiable or excusable mistake of fact” and b) “where ... no injury to innocent parties will result.” *Heisler v. C. Aultman & Co.*, 56 Minn. 454, 57 N.W. at 1053-54. Minnesota Supreme Court cases cited generally do not hold that “justifiable or excusable mistake of fact” creates a standard under which negligence bars equitable subrogation. Negligence

was committed by the party seeking equitable subrogation in nearly every case in which the Court granted equitable subrogation. Under existing Minnesota Supreme Court authority, equitable subrogation should be applied when a “lien has been discharged under a mistake of the real situation.” See *Elliot v. Tainter*, 93 N.W. 124, 124-25 (Minn. 1903), *Heisler v. C. Aultman & Co.*, 56 Minn. 454, 57 N.W. 1053 (1894). “Justifiable” or “excusable,” in the context of the cited authorities, can be understood as an “honest and good faith” mistake of the real situation and not a negligence standard. The purpose of equitable subrogation is to “save” a party which mistakenly pays off a lien from loss if the payment would otherwise provide an unconscionable and inequitable advantage. *Elliot*, 93 N.W. at 125 (citations omitted).

C. *Carl H. Peterson Co. v. Zero Estates*, 261 N.W.2d 346 (Minn. 1977)

Since the earliest cases in the late 1800s, the Minnesota Supreme Court continued to apply equitable subrogation liberally and where justice requires. According to Judge Crippen in his concurring opinion, equitable subrogation was granted in every reported case until 1977 when this Court decided the mechanics lien case *Carl H. Peterson Co. v. Zero Estates*, 261 N.W.2d 346 (Minn. 1977). Equitable subrogation was denied under the unusual facts of that case, but the Court did not intend to deviate from its historical liberal application of the doctrine of equitable subrogation.

In *Peterson*, the bank loaned money to the property owners to purchase land and received a mortgage in return. Over two years later, the property owners began construction of a horse barn. Nine months after construction began the bank and the property owner entered into a second loan secured by a second mortgage. At the time of

the second mortgage, the bank was fully aware of the construction of the horse barn. Because of the bank's position as a sophisticated lender, the Court found the bank knew that the commencement of construction created inchoate mechanic's liens on the property. Armed with actual knowledge of inchoate mechanic's liens perfected at the time of first visible improvement, the Small Business Administration, as an insurer of the bank's second mortgage, instructed that the bank used part of the proceeds of the second mortgage to pay off the first mortgage and to pay property taxes. The horse barn subsequently collapsed and numerous mechanic's lien claimant's commenced enforcement of their mechanic's liens.

The *Peterson* Court denied the bank equitable subrogation because the bank was fully aware of the real situation when the bank took its second mortgage and did not act under a mistake. *See id.* at 348. The *Peterson* Court distinguished between the unsophisticated lender in *Heisler* and the sophisticated lender in *Peterson*, but the Court did not establish a rule that prevents sophisticated lenders from seeking equitable subrogation. The *Peterson* Court simply used the bank's status as a sophisticated lender to conclude that the bank knew the commencement of construction created mechanic's liens and therefore, the bank knew the situation as it really existed. The *Peterson* Court denied equitable subrogation because there was no mistake of fact, justifiable or otherwise. More importantly, the *Peterson* Court made a specific finding that, under the unique facts and circumstances of that case, the rights of the mechanic's lien claimants would be "substantially impaired" if not lost. *See id.*

D. *Universal Title Ins. Co. v. United States*, 942 F.2d 1311 (8th Cir. 1991)

Clarity regarding the liberal approach to equitable subrogation in Minnesota was obfuscated when a federal court interpreting Minnesota law had to reconcile *Peterson* with prior Minnesota case law in *Universal Title Ins. Co. v. United States*, 942 F.2d 1311 (8th Cir. 1991). In *Universal Title*, a lender failed to identify intervening federal tax liens when conducting a refinancing transaction.³ The government argued that the lender's title insurer should be denied equitable subrogation because the title insurer failed to discover the federal tax liens during the title examination for the refinancing transaction. After reviewing Minnesota law, and citing *Peterson*, the Eighth Circuit concluded that "Minnesota courts impose stricter standards on professionals than lay persons in assessing whether mistakes are 'excusable' for purposes of the doctrine of legal subrogation, especially when the professional relationship arises out of a commercial transaction involving consideration." See *Universal Title*, 942 F.2d at 1317.

The *Universal Title* Court misinterpreted *Peterson* to draw this conclusion. The *Peterson* Court used the bank's sophisticated party status to determine whether the bank acted under a mistake of fact, not whether the mistake was justifiable or excusable. The *Peterson* Court concluded that the bank, as a sophisticated party, knew the commencement of the construction created inchoate mechanic's liens as of the first

³ In *Universal Title*, the lender's title insurer commenced litigation in its own name to enforce its insured's equitable subrogation rights against the federal government. The *Universal Title* Court used this fact as an additional basis to deny relief and held that an insurer, without knowledge of the insured's collateral rights, is not entitled to be subrogated to the rights of the insured against a third person who did not cause the compensable loss. See *Universal Title* at 1318. The more common practice is for a lender to bring an equitable subrogation claim in its own name.

visible improvement, and therefore, loaned the money knowing the true facts. There was no mistake in *Peterson* for the Court to evaluate as justifiable or excusable. The Minnesota Supreme Court has never held that sophisticated parties are held to a stricter standard regarding whether their mistakes are justifiable or excusable. This rule, subsequently cited and relied upon by the Minnesota Court of Appeals, has never been adopted by the Minnesota Supreme Court and runs contrary to the cases in which the Minnesota Supreme Court liberally applied the doctrine after the lender had made a mistake.

E. *Ripley v. Piehl*, 700 N.W.2d 540 (Minn. Ct. App. 2005)

The Eighth Circuit's misinterpretation of *Peterson* was compounded by the Minnesota Court of Appeals in *Ripley v. Piehl*, 700 N.W.2d 540 (Minn. Ct. App. 2005). In *Ripley*, the lender refinanced an existing first mortgage on the property and believed it obtained a first mortgage in return. The refinancing lender did not have actual knowledge of the intervening mortgage. However, because the intervening mortgage was of record, the refinancing lender had constructive knowledge of the intervening mortgage. Despite the numerous Supreme Court cases allowing equitable subrogation when there was constructive knowledge of the intervening lien by the party asserting equitable subrogation, the *Ripley* Court denied application of equitable subrogation. The *Ripley* Court repeated the *Universal Title* misinterpretation of *Peterson* and held that professional lenders are held to a stricter standard when determining whether a mistake of fact was justifiable or excusable. *See Ripley*, 700 N.W.2d at 545-46. However, the *Peterson* Court merely used the lender's sophistication to show that the lender did not act

under a mistake of the true situation and the Court did not need to analyze whether a “mistake” was “justifiable or excusable” because no “mistake” existed.

The Court of Appeals in *Ripley* further misconstrued the Supreme Court’s approach to equitable subrogation by asserting that the Supreme Court had adopted the “minority approach” to equitable subrogation that “actual and constructive notice of an existing lien bars equitable subrogation.” *Ripley* at 545. This statement is incorrect. The Minnesota Supreme Court has not adopted an approach to equitable subrogation in which constructive notice of an existing lien bars equitable subrogation. In fact, the Minnesota Supreme Court has favorably applied equitable subrogation to numerous cases where the party asserting equitable subrogation had constructive knowledge of an existing lien. *See generally Emmert*, 49 Minn. 386, 52 N.W.31, *Heisler*, 56 Minn. 454, 57 N.W. 1053, *Elliot*, 88 Minn. 377, 93 N.W.124, and *Hirleman*, 193 Minn. 51, 258 N.W. 13. If this Court ultimately does not adopt the Restatement Position on equitable subrogation; at a minimum, the Court should at the least reaffirm its own precedent and clarify that Minnesota holds the “majority view” that actual knowledge of an existing lien may bar the application of equitable subrogation, but that constructive knowledge of an existing lien will not bar the application of equitable subrogation.

F. The Court of Appeals Decision

The Court of Appeals in this case relied on the incorrect holding in *Ripley* and set forth a strict and narrow approach to equitable subrogation. The Court of Appeals in this case went further than in *Ripley* and made the standard stricter by holding that negligence *after* the closing on the refinancing mortgage bars the application of equitable

subrogation. The intervening mortgage in this case did not exist at the time of the refinancing mortgage closing and the lender could not have actual or constructive knowledge of the intervening mortgage. Nevertheless, the Court of Appeals held that a recording delay *after* closing barred the application of equitable subrogation. The Court of Appeals admitted that no prejudice would result to the intervening mortgage holder by applying equitable subrogation.

The Court of Appeals, through *Ripley* and this case, has adopted a strict and narrow application of equitable subrogation wherein constructive knowledge of an intervening lien or *any* mistake or negligence on the part of a sophisticated lender bars the application of equitable subrogation. Taking its cue from *Universal Title and Ripley*, the holding in the Court of Appeals in this case completes the process of turning the longstanding liberal application of equitable subrogation by the Minnesota Supreme Court on its head. The approach articulated by *Ripley* and by the Court of Appeals in this case would place Minnesota amongst the states with the strictest application to equitable subrogation, which was never intended by the Minnesota Supreme Court. However, there is no persuasive or compelling reason to take such a narrow interpretation of equitable subrogation and the strict interpretation is prone to mischief and unjust enrichment.

It is impossible to reconcile the strict approach to equitable subrogation set forth in *Ripley* and by the Court of Appeals in this case, with the liberal approach set forth in numerous prior opinions by the Minnesota Supreme Court. The strict approach set forth in *Ripley* and by the Court of Appeals in this case would render the doctrine of equitable

subrogation practically useless, particularly for professional lenders, because it would be an extremely rare case where a party seeking equitable subrogation did not have constructive notice of an intervening lien and acted free of negligence. The Minnesota Supreme Court did not intend for such a strict application of the doctrine and there is no persuasive or compelling reason to do so now.

III. The Restatement Approach to Equitable Subrogation is the Preferred Approach

The Court of Appeals in this case and the *Ripley* Court based its holding on misinterpretation of precedent. The Court of Appeals has adopted a strict application for equitable subrogation without any discussion of whether such an application is preferable to the more liberal approaches. The Court of Appeals has not discussed whether a strict application of equitable subrogation benefits public policy. The Court of Appeals has not articulated a reason, other than *stare decisis*, for adopting a strict application of equitable subrogation. MLTA asserts that upon careful consideration of the three primary approaches to equitable subrogation, the Restatement Approach is the fairest and the most just because it places the parties in the lien positions for which they bargained and expected, prevents unjustified windfalls, and prejudices nobody. Departure from the broad approach to equitable subrogation and adoption of a strict approach to equitable subrogation that awards unexpected and unjustified windfalls to undeserving parties at other parties' expenses and should require a compelling reason. MLTA argues that no compelling reason exists.

The only conceivable argument for the strict approach set forth by the Court of Appeals is summary certainty of lien priorities under the Recording Act. However, if the Minnesota Supreme Court valued summary certainty of lien priority, there would be no reason for the doctrine of equitable subrogation, let alone its valued status by the Supreme Court. Clearly the Minnesota Supreme Court found that equity and justice trumped the strict application of the Recording Act in cases such as *Emmert*, *Heisler*, *Gerdine*, *Elliot*, and *Hirleman*.

The Restatement Approach goes beyond the majority approach and focuses on whether the party asserting equitable subrogation intended to receive the same priority position as the lien it discharged and requires that intervening lien holders are not materially prejudiced. The comments to the Restatement explain the primary difference in approach by the Restatement and courts that focus on the knowledge of the payor in a typical refinancing transaction.

Many judicial opinions dealing with a mortgagee who pays a preexisting mortgage focus on whether the payor had notice of the intervening interest at the time of the payment. Most of the cases disqualify the payor who has actual knowledge of the intervening interest, although they do not consider constructive notice from the public records to impair the payor's right of subrogation. Under this Restatement, however, subrogation can be granted even if the payor had actual knowledge of the intervening interest; the payor's notice, actual or constructive, is not necessarily relevant. The question in such cases is whether the payor reasonably expected to get security with a priority equal to the mortgage being paid. Ordinarily lenders who provide refinancing desire and expect precisely that, even if they are aware of an intervening lien. See Illustration 26. A refinancing mortgagee should be found to lack such an expectation only where there is affirmative proof that the mortgagee intended to subordinate its mortgage to the intervening interest.

See Restatement (Third) of Property: Mortgages, § 7.6, comment e.

At first blush, it may seem allowing equitable subrogation to a party with actual knowledge of an intervening lien is not equitable. However, the party asserting equitable subrogation still needs to prove that, despite the actual knowledge, it intended to get the security interest with a priority equal to the mortgage being paid. This approach better reaches the primary purpose of equitable subrogation, which is to preserve the status quo and the parties' expectations about their security interests.

Besides equity, justice, and fairness, another public benefit for the Restatement Approach to equitable subrogation is that it will reduce costs associated with refinancing transactions. Adoption of the Restatement position could afford substantial financial benefits to the consumer. A recent law review article argues that a liberal approach to equitable subrogation can save consumers a significant amount of money by reducing title insurance premiums in refinancing transactions. *See Grant S. Nelson & Dale A. Whitman, Adopting Restatement Mortgage Subrogation Principles: Saving Billions of Dollars for Refinancing Homeowners*, 2006 BYU L.REV. 305, 359. The reason set forth by the authors is that a sizeable source of title insurance loss payouts, i.e. intervening liens on refinancing transactions, would be greatly reduced by a liberal application of equitable subrogation and should lead to significant reductions in premiums. *See id.* at 356-57.

Another public benefit to the Restatement Approach is that it provides a homeowner facing foreclosure more options and could help stem the threat of foreclosure. *See Bank of America v. Prestance*, 160 P.3d at 28. Under the Restatement Approach, there is an incentive for a party to advance sums to help a property owner

avoid foreclosure. *See id.* (citing *Klotz v. Klotz*, 440 N.W.2d 406, 410 (Iowa App. 1989)). The Restatement Approach to equitable subrogation would also provide more flexibility to property owners in a variety of workouts or restructuring arrangements between the property owners and the senior lenders. *See id.* (citing Restatement (third), § 7.3, comment a.).

CONCLUSION

The Minnesota Supreme Court has historically applied a liberal approach to the doctrine of equitable subrogation. The Court of Appeals in this case and in *Ripley v. Piehl*, 700 N.W.2d 540 (Minn. Ct. App. 2005) misapplied Minnesota Supreme Court precedent by adhering to the minority approach which bars the application of equitable subrogation if the party had constructive or actual knowledge of an intervening lien. The Court of Appeals has also misinterpreted Minnesota Supreme Court precedent by holding that sophisticated parties are held to a higher standard in determining whether mistake of fact was justifiable or excusable. Moreover, the Court of Appeals in this case incorrectly expanded its strict application of equitable subrogation by barring a party with no actual or constructive knowledge of an intervening lien, based solely on post-closing recording delay as negligence. The Court of Appeals' strict approach to equitable subrogation makes it virtually impossible for a party to successfully invoke the doctrine of equitable subrogation and this Court should restore its liberal application of equitable subrogation by reversing the Court of Appeals in this case and overruling *Ripley v. Piehl*. Finally, this Court should substantively adopt the Restatement Approach because it is the most fair and just approach to equitable subrogation, would afford substantial financial benefits

to consumers, and would provide more flexibility for homeowners in foreclosure to save their house.

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