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State of Minnesota
In Supreme Court

Riverview Muir Doran, LLC,

Respondent,

vs.

JADT Development Group, LLC, et al.,

Respondents,

First Choice Bank,

Respondent,

Darg, Bolgrean, Menk, Inc., et al.,

Defendants,

and

First Choice Bank,

Respondent,

vs.

JADT Development Group, LLC, et al.,

Respondents,

Riverview Muir Doran, LLC,

Respondent,

Darg, Bolgrean, Menk, Inc.,

Defendant,

KKE Architects, Inc.,

Appellant,

and

KKE Architects, Inc.,

Appellant,

vs.

JADT Development Company, LLC,

Respondent,

First Choice Bank, et al.,

Respondents,

Darg, Bolgrean, Menk, Inc., et al.,

Defendants.

JOINT BRIEF OF AMICI CURIAE AMERICAN INSTITUTE OF ARCHITECTS MINNESOTA, AMERICAN COUNCIL OF ENGINEERING COMPANIES OF MINNESOTA, AND MINNESOTA SOCIETY OF PROFESSIONAL SURVEYORS

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INTEREST OF AMERICAN INSTITUTE OF ARCHITECTS MINNESOTA (AIA), AMERICAN COUNCIL OF ENGINEERING COMPANIES OF MINNESOTA (ACEC), AND MINNESOTA SOCIETY OF PROFESSIONAL SURVEYORS (MSPS) [1]

All three associations submitting this brief have a common interest because they all represent member design professionals who are entitled to mechanic lien rights by virtue of their providing services for the improvement to real property. The associations urge this Court to reverse the court of appeals because the rule of law it has articulated is practically unworkable, injects uncertainty into the statutory scheme regarding what a design professional needs to do to protect its interest, and is inconsistent with the statute's remedial purpose.

AIA Minnesota is a non-profit association that advocates on behalf of architects in Minnesota. AIA Minnesota was formed in 1892, and is a state component of the national American Institute of Architects (AIA). Based in Washington, D.C., the national AIA has been the leading professional membership association for licensed architects since 1857. AIA Minnesota has over 2,300 members located in three local chapters: Minneapolis, St. Paul, and northern Minnesota. AIA Minnesota's mission is to serve as a resource and advocate on behalf of its architect members, to advance the values of its members, and to improve the quality of the built environment in Minnesota.

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[1] Pursuant to Minn.R.Civ.App.P. 129.01, the undersigned counsel certify that counsel for no party authored this brief in whole or in part and that no one made a monetary contribution to the preparation or submission of this brief other than the three amici curiae and their counsel.

ACEC/MN is the leading business practice and policy advocate for consulting engineering firms in Minnesota. Formed in 1949, ACEC/MN´s 150 member firms represent over 4,500 employees and provide services to all segments of society, including federal, state and local governments, private industry and the general public. ACEC/MN is a member of the American Council of Engineering Companies (ACEC), the largest national organization of engineers engaged in the practice of consulting engineering. ACEC is located in Washington, DC, with over 5,500 member firms located throughout the country.

The MSPS was established in 1953. It has nearly 600 members state-wide, comprised of registered land surveyors, technicians and surveyors-in-training, and affiliates who provide equipment and products to surveyors. The purpose of the organization is to elevate the standards of the surveying profession in the State of Minnesota; to establish basic minimum guidelines for surveys; to assist in promoting legislation, educational programs and public relations to improve the profession of the land surveyor; to work in cooperation with local, county and state governments in its field of endeavor; to uphold a rigid code of ethics; and strive to improve relations with its clients and the protection of the public by doing its work with precision and integrity. MSPS is an affiliate of the American Congress on Surveying and Mapping (ACSM). The ACSM in turn represents the interests of over 5,000 affiliate members working in the fields of surveying, geology and other spatial data compilation.

SUMMARY OF ARGUMENT

I. The court of appeals erred because it held that, for a design professional to maintain its lien priority:

1. the mortgagee must have actual knowledge of the design professional's lienable work; *and*

2. unpaid fees must be owing to the design professional when the mortgage is recorded; *and*

3. the mortgagee must know that the fees were owing at the time of recording.

The court of appeals was correct on the first point but incorrect on points 2 and 3. Minn. Stat. § 514.05 states that the lien is superior where the mortgagee has knowledge of the lien itself. It does not state that the mortgagee must also have knowledge of how much is or is not currently owing on the lien at the time of recording of the mortgage.

II. The court of appeals also erred in holding that the mortgagees in this case were bona fide encumbrancers, entitled to priority of their mortgages notwithstanding that a prior lien existed against the real property. Even if this Court were to hold that the amount owing to a lien claimant at a certain point in time is relevant to priority, a mortgagee has the burden to establish its bona fide encumbrancer status by showing that it could not have reasonably known that amounts were currently owing on the lien. Here, the mortgagees did not meet their burden of showing they made any reasonable effort to determine the amount owed, and there is no finding by the trial court to that effect.

For the reasons stated in either I or II above, this Court should reverse the decision of the court of appeals and reinstate the trial court's judgment.

ARGUMENT

The court of appeals' decision creates a confusing and unworkable rule of law. Its holding would mean that a design professional with an existing mechanics lien may maintain the lien's priority only if it does not allow itself to be paid up to date on its work, even if the lien claimant intends to provide, and does provide, future services on the same project. The decision further means that the lien claimant would need to give continual notice to the world that its work is unpaid for so as to avoid a result like this case where a mortgagee claims senior status on the grounds that the lien claimant did not affirmatively advise the mortgagee that amounts were outstanding. It is unreasonable and impracticable, if not impossible, for a lien claimant to provide effective, continuous notice to all potential encumbrancers as the court of appeals would require.

I. Section 514.05 Provides Simply that a Mechanics Lien Maintains Its Priority Where the Subsequent Mortgagee Has Actual Knowledge of the Lien at the Time It Records Its Mortgage.

Respondents do not dispute that appellant KKE has a mechanics lien by virtue of its providing professional design services. Architects, engineers, land surveyors and other design professionals are entitled to a lien upon real property for their services. *Kirkwold Construction Co. v. M.G.A. Construction, Inc.*, 513 N.W.2d 241, 243 (Minn. 1994); *Korsunsky Krank Erickson, Inc. v. Walsh*, 370 N.W. 2d 29, 32 (1985).

Respondents do not dispute that the priority date for the lien is January 17, 2003, because design professionals' liens attach upon the first date of work, even if there is no visible improvement because the owner abandons the project. *Lamoreaux v. Andersch*, 128 Minn. 261, 263-68, 150 N.W. 908, 909-911 (1915).

And the respondents do not dispute that the lien was in existence and effective when the mortgagees recorded their mortgages on March 23, 2005. Respondents contend only that, as against the mortgagees, the lien is subordinate. But that argument, like the court of appeals decision, cannot withstand the plain meaning of the lien statute or practical considerations.

A. Section 514.05 Addresses only the Mortgagee's Knowledge of the Existence of the Lien, not Knowledge of the Current Balance Which is Secured by the Lien.

1. This Court should apply the statute as written to require only notice to the mortgagee of the existence of the lien.

The statutory language is sufficient, by itself, to determine the case. The first sentence of section 514.05 creates the lien and indicates that it is "preferred to any mortgage" not of record when the work begins. The second sentence provides a limited exception for a "bona fide . . . mortgagee . . . without actual or record notice . . . " The sentence does not say notice of what, but the case law is clear that notice means notice of the existence of the lien. *Kirkwold*, 513 N.W.2d at 245 (mortgagee's interest subordinate where it "has notice of lienable work performed" by design professional). So, if the mortgagee has notice of the existence of the lien, then its mortgage does not get priority. Here, the mortgagee undisputably knew about KKE's lien because it knew that KKE had done lienable work affecting the real property.

The court of appeals simply reads new language into the statute, requiring not only notice of the existence of the lien, but also notice of current payment status as to the amounts currently secured by the lien. The statutory language is not there. Chapter 514,

along with numerous statutory amendments and 150 years of case law, is sufficiently complex without a court's adding more language to it. Moreover, the addition of this new requirement undermines the purpose of the lien statute. This Court has held that the mechanics lien statute is remedial in nature and should be liberally construed so as to protect the rights of those who perform work to improve real property. *Armco Steel Corp. v. Chi. & N.W. Ry. Co.*, 276 Minn. 133, 137-138, 149 N.W.2d 23, 26 (1967).

Amici design professional associations are not asking this Court to break new ground. For clarity and simplicity, and to reaffirm its ruling in *Kirkwold*, the Court should hold that section 514.05 does not require a lien holder to show that a mortgagee has knowledge of the payment status of an existing lien. Such a holding would benefit legal practitioners because it would not insert a hidden loophole or condition into the clear statutory language. It also would provide a fair and workable standard for both lenders and design professionals.

2. Mortgagees may readily protect their rights in instances where design professionals provide services.

At or before closing, lenders typically make reasonable inquiry as to whether anyone has performed design services pertinent to the real property being mortgaged. (Indeed, in most instances the financing pertains to the anticipated improvements so that a lender is already aware that the services have been or will be provided.) If the intended mortgagee learns through inquiry or otherwise that work has been done, then the mortgagee knows that the mechanics lien will be prior to its mortgage. Mortgagees

routinely encounter prior liens of design professionals and have no difficulty structuring the financing to protect their own interests.

If the loan is to pay for construction, a mortgagee typically requires proof that its loan disbursements are being used to pay the lien claimants for their current work. This proof is in the form of sworn partial lien waivers and receipts required with each payment request. In this way, the mortgagee assures itself that their disbursements have resulted in improvements to the property and a resultant increase in the value of its collateral secured by the mortgage.

If the loan is for operating or other non-construction costs, the mortgagee will require the owner to account timely for expenses and to covenant not to impair the mortgagee's collateral by failing to pay for improvements to the property, which increases the amount of the unpaid and prior lien. Failure to abide by these requirements is a condition of default allowing the mortgagee to cease further disbursements and to foreclose on the real property. By controlling the purse strings on an ongoing basis, the mortgagee assures itself that the amount of any mechanics lien will not be excessive.

The mortgagee also has the option of requesting a lien subordination from the design professional as a condition to financing the property owner, who often is the design professional's client. This can be a mutually beneficial arrangement where the design professional agrees to the mortgage's priority in return for some assurance of a continuing source of financing for its future work.

None of these strategies is burdensome or uncommon. Sound lending practice is to know where the money is going and to prevent the borrower from impairing the

collateral by ordering work and not paying for it. Banks and other lenders already have these practices in place. In contrast, design professionals often do not have access to information regarding potential lenders or mortgagees until well after the transaction is closed and the mortgage is recorded. So placing the burden on design professionals to act affirmatively and continuously to protect their priority is unreasonable and unworkable.

B. A Mechanics Lien Remains in Force Until the Design Professional Completes Its Work, Regardless of the Amount of the Unpaid Balance.

The court of appeals' holding is tantamount to a holding that a lien ceases to exist when the lien claimant is paid to date. That is the only logical explanation for the court's rationale. Certainly, prior to disbursement, the mortgagees knew that KKE had a lien by virtue of all the work it had done. So, the mortgagees had actual notice of KKE's lien, as "notice" is contemplated by section 514.05, such that the mortgagees' interests remained subordinate. The only way that the court of appeals could conclude that the mortgagees suddenly did *not* have notice of KKE's lien was to conclude that the KKE lien *ceased to exist* the moment that the mortgagees believed the invoice balance was reduced to zero. This "zero balance dissolves the lien" conclusion is legally wrong and extremely unworkable in the real world.

1. A mechanics lien maintains its priority for work done on a continuous project.

Holding that a lien loses its priority when an account is paid current is to treat all future work as a new construction project with a new first date of work. This Court has consistently held that the interruption and resetting of a lien priority date is not allowed where the work is part of a continuous improvement. *Rochester's Suburban Lumber Co.*

v. Slocumb, 282 Minn. 124, 129-29, 163 N.W.2d 303, 307 (1968). *Barrett v. Hampe*, 237 Minn. 80, 82, 53 N.W.2d 803, 805 (1952). The court of appeals correctly applied this principle in *Witcher Construction Co. v. The Estes II, Ltd. Partnership*, 465 N.W. 404 (Minn.App. 1991), *review denied* (Minn. March 15, 1991). In *Witcher*, the lender financed two phases of the construction project. The lender argued that, because its mortgage was placed of record before commencement of stage two of the project, its mortgage was senior to all lienable work performed in stage two. Relying on *Rochester's Suburban Lumber, Barrett,* and other authority from this Court, the court of appeals held that the priority date could not be re-set where the lienholders continued to perform work continuously as part of single purpose project. *Witcher*, 465 N.W.2d at 407.

It is the continuity and unitary nature of the improvement, not its periodic payment status, which determines the priority date. The mortgagees in this case understood that KKE was to continue its services under the same project because KKE's pay requests to the lenders expressly stated that, while KKE had completed 100% of its conceptual design and city approval work, it had completed only 48.31% of its design development and construction documents work and only 4% of its bidding/negotiation work. (KKE's Addendum ADD-25.) By failing to recognize the incomplete nature of KKE's work (to be performed in a single improvement project) the court of appeals effectively set a new first date of work (priority date) as though KKE was commencing a new project immediately after the mortgage was recorded on March 23, 2005.

2. The court of appeals' re-establishment of first date of work/priority date creates an unworkable standard.

Lien claimants often are paid up to date on invoices. That is the desirable course of events for everyone. To hold that a lien ceases to exist, even temporarily, seriously jeopardizes the claimant's priority status. The lien claimant always would have to claim an outstanding balance so that its lien would not dissolve and re-establish itself with a later priority date. But this strategy of the perpetual unpaid balance leads to absurd results. Is the court of appeals suggesting that, had KKE maintained a $1 unpaid balance, of which the lenders were aware, it would have preserved its lien priority for all its future work, exceeding $300,000? If not, what is the amount of the unpaid balance which preserves priority, or is a $1 balance sufficient to secure priority for all future advances?

Other questions arise if the knowledge of the unpaid balance is the life or death question for lien priority. For example, what documentation must a design professional submit to a potential mortgagee to satisfy its new obligation to provide notice of an unpaid bill for services rendered? What if the project owner disputes the fees for design services rendered and contradicts the information provided by the design professional, notifying the potential mortgagee that the design professional is not owed any money? And will the project owner and mortgagee make full progress payment at closing intending to assert, offensively, that the lien claimant has lost its priority because it was paid in full when the mortgage was recorded? If so, should the lien claimant refuse to accept full payment for fear of losing its lien?

The "unpaid balance" standard is absurd because the test for priority as against a mortgagee is not whether the mortgagee knows there is an unpaid balance. The test is whether the mortgagee knows work has already begun and will continue under the same contract or improvement. A partial payment or zero balance does not end the project and terminate the lien. Only the conclusion of services and full and final payment for those services terminates the lien, because any future services would have to be under a new project with a new priority date. *Superior Construction Services, Inc. v. Belton*, 749 N.W.2d 388 (MinnApp. 2008) (mortgagee entitled to priority over lien claimant where prior project was abandoned and lien claim was based on work after commencement of new project); *Langford Tool & Drill Co. v. Phenix Biocomposites, LLC*, 668 N.W.2d 438, 444 (Minn. App. 2003) (same) (following *Kirkwold*, 513 N.W.2d at 244). So, if a lender reasonably understands that the claimant is paid to date and that its services are completed for the whole project, then the lender may conclude there is no lien – and the lender may prevail on its argument under section 514.05 that it is a bona fide mortgagee "without actual or record notice."

II. If Knowledge of an Unpaid Balance for Lienable Work Is the Test, Then the Mortgagees Did Not Prove Their *Bona Fide* Mortgagee Status Because They Did Not Show, and the Trial Court Did Not Find, That the Mortgagees Did Not Know and Should Not Have Known About the Unpaid Balance.

The question of burden of proof is critical in this case. The court of appeals erred by implicitly holding that it was the lien claimant's burden to show the absence of the mortgagee's *bona fide* status rather than the mortgagee's burden. The court of appeals (wrongly, we assert) relied on this Court's language in *Kirkwold* which recited the trial

court's finding (in *Kirkwold*) that the mortgagees "knew or should have known" that the lien claimants were not paid in full. *Id.,* 513 NW2d at 242. In this case, the trial apparently was not asked to consider and did not make a finding on the question of whether the mortgagees "should have known" that KKE was not paid in full. That the trial court did not make such a finding is fatal to the mortgagee's position that it is a *bona fide* encumbrancer.

Section 514.05, subd, 1, states that a prior mechanics lien is subordinate only to a "bona fide ... mortgagee ... without actual or record notice...." If the legislature had intended that only record or actual notice was sufficient, it would not have included the term "bona fide." The term bona fide must have meaning because the legislature is presumed to have intended that all its words have meaning. Minn. Stat. § 645.16 (2008). This Court has unequivocally held that one claiming bona fide purchaser status in a real estate transaction has the affirmative burden of proving: payment of a valuable consideration; *good faith;* and absence of notice, actual or constructive, of the outstanding rights of others. *Goette v. Howe*, 232 Minn. 168, 173-74, 44 N.W.2d 734, 738 (1950). *See also Holt v. R.C.A. Photophone, Inc.*, 196 Minn. 527, 265 N.W. 313, 314-15 (1936) (person seeking to establish bona fide purchaser or encumbancer status upon sale of personal property has burden of proof to show good faith and lack of prior notice). So the mortgagees here had to show some minimal effort on their part to determine the outstanding rights of KKE. They did not do so and the trial court correctly omitted any finding that the mortgagees had made an inquiry. More importantly, the trial

court omitted any finding that the mortgagees *reasonably* believed that KKE was paid in full.

Most troubling about the court of appeals decision is the suggestion that the Recording Act, Minn. Stat. § 507.34, and the mechanics lien priority statute, Minn. Stat. § 514.05, should *not* be read in conjunction with each other. The statutes indeed are related: they both pertain to priority interests in real property; they both embody the centuries-old doctrine of race-notice; and they both expressly require a showing of good faith. (Section 514.05 uses the term "bona fide;" section 507.34 uses the term "good faith." The terms are synonymous. *See, e.g. State v. Hoyt*, 304 N.W.2d 884, 891 (Minn. 1981) ("A bona fide belief, i.e. a good faith claim of right ...."); *Goette v. Howe*, 232 Minn. 168, 44 N.W.2d 734, 738 (1950) (person must act in good faith to attain status as bona fide purchaser)).

In addressing priority as between mortgages and mechanics liens, this Court explained the relationship between the two statutes:

> To determine the issue of priority, we begin with the controlling statutes. Minn.Stat. § 507. 34 (1994) establishes mortgage priority from the date of recording with the county recorder or the registrar of titles. Minn.Stat. § 514.01 (1994) grants a mechanics lien to anyone who contributes to the improvement of real estate by performing labor or furnishing skill, material or machinery. A mechanics lien attaches, takes effect, and is preferred to any mortgage not then of record from the time the first item of material or labor is furnished upon the premises for the beginning of the improvement, unless the lienholder had actual notice thereof. Minn. Stat. § 514. 05, subd. 1 (1994). * * *.

Home Lumber Co. v. Kopfmann Homes, Inc., 535 N.W.2d 302, 304 (Minn. 1995). Where this Court refers to sections 507.34 and 514.05 in the same breath as "controlling

statutes" on the priority issue, the synonyms "good faith" and "bona fide" in the respective sections should receive consistent treatment.

A bona fide purchaser under section 507.34 has the burden to prove it acted in good faith and without actual *or constructive* notice of a prior unrecorded interest. *Goette*, 44 N.W.2d at 738. The same burden should exist under the related section 514.05. To the extent the law is not clear, this Court should clarify it.

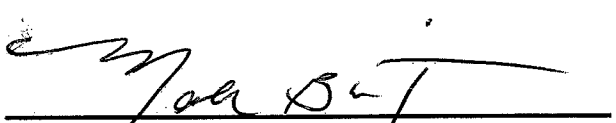
CONCLUSION

This Court should reverse the court of appeals and rule that a mortgagee with actual notice that a design professional has performed lienable and unfinished work takes subject to the lien claimant's rights. This ruling will maintain a fair and workable rule in the construction industry for both lenders and design professionals.

This Court also should clarify that a bona fide purchaser, mortgagee, or encumbrancer, pursuant to either and both sections 507.34 and 514.05, bears the burden of proof to show that it acted in good faith in order to gain priority over an unrecorded interest.

Respectfully submitted,

Dated: January 21, 2009



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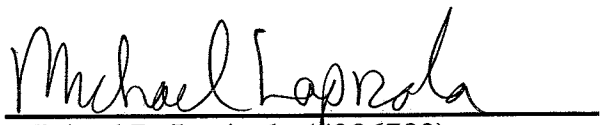

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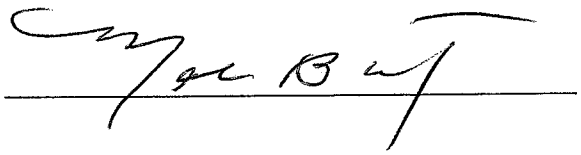
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