STATE OF MINNESOTA
IN COURT OF APPEALS
A13-0309

City of Minneapolis,
Plaintiff,

vs.

RW Farms, LLC, et al.,
Defendants,

and

Granite Re, Inc., intervening defendant,
Respondent,

and

Thomas Payne, third party plaintiff,
Appellant,

vs.

Russell W. Leistiko, et al.,
Third Party Defendants,

and

RW Farms, LLC, et al.,
Third Party Plaintiffs,

vs.

Flagship Bank Minnesota d/b/a Flagship Bank, et al.,
Third Party Defendants

Filed December 30, 2013
Affirmed in part and reversed in part
Peterson, Judge

Hennepin County District Court
File No. 27-CV-11-1410

Matthew Adam Helgemoe, Timothy James Peters, Peters Law Firm, P.L.C., Minneapolis, Minnesota (for appellant)

Daniel Rhodes Gregerson, Emeric James Dwyer, Gregerson, Rosow, Johnson & Nilan, Minneapolis, Minnesota (for respondent)

Considered and decided by Peterson, Presiding Judge; Halbrooks, Judge; and Ross, Judge.

U N P U B L I S H E D O P I N I O N

PETERSON, Judge

This appeal is from a summary judgment granted in an interpleader action initiated by the City of Minneapolis after it received competing claims for payments it owed under a contract with defendant RW Farms. Appellant Thomas Payne granted a loan to RW Farms and held a security interest in the proceeds of the contract with the city. Respondent Granite Re, Inc. issued a performance and payment bond to RW Farms securing the contract with the city and made payments under the bond. Appellant argues that the district court erred in determining that, under the doctrine of equitable subrogation, Granite Re's claim to the contract proceeds has priority over appellant's security interest. Appellant also argues that the district court erred in determining that respondent's attorney-fee award has priority over appellant's claim. We affirm in part and reverse in part.

FACTS

In March 2009, the City of Minneapolis entered into a contract with RW Farms, LLC, and Organic Technologies, Inc. (OTI), under which RW Farms and OTI agreed to compost and dispose of yard waste collected by the city. Appellant Thomas Payne loaned RW Farms $50,000 to fund seasonal start-up costs. RW Farms executed a promissory note for the loan on May 1, 2009, with a maturity date of December 31, 2009. The same day, Payne and RW Farms executed a security agreement securing "[a]ll present and future debts, even if this Agreement is not referenced, the debts are also secured by other collateral, or the future debt is unrelated to or of a different type than the current debt." The security agreement granted Payne a security interest in RW Farms' accounts receivable and other rights to payment. The security agreement also provided that Payne may collect enforcement costs, including reasonable attorney fees. Between July 2009 and January 2010, Payne advanced an additional $25,790 to RW Farms.

On May 1, 2010, respondent Granite Re, Inc. issued a payment-and-performance bond naming RW Farms as principal and Granite Re as surety for RW Farms' contract with the city. The bond obligated Granite Re to pay subcontractors and suppliers "for labor, materials, and equipment furnished for use in the performance of [RW Farms' contract with the city]." The same day, RW Farms and its principals, Ralph Leistiko and Wendy Leistiko, executed an agreement to indemnify Granite Re for any and all losses and costs, including attorney fees, incurred by Granite Re as a result of acting as surety.

In December 2010 and January 2011, the city withheld payments due to RW Farms for work performed under the contract in October and November 2010 because RW Farms owed approximately $61,000 to a subcontractor for services provided in late 2009 and early 2010.

On December 23, 2010, Payne filed a Uniform Commercial Code (UCC) financing statement with the Minnesota Secretary of State. On January 6, 2011, Payne sent the city notice that RW Farms had assigned to him its right to collect the amounts due to RW Farms under its contract with the city. The notice stated that Payne was foreclosing on his security interest in RW Farms' accounts receivable and demanded payment of amounts owed to RW Farms by the city. As of July 31, 2012, the payoff amount of the loan from Payne to RW Farms included $35,132.51 in principal and $9,426.68 in interest. Payne also sought collection costs and submitted a statement showing that he had incurred $39,990.65 in attorney fees as of August 2012.

On January 11, 2011, Granite Re received a claim against the bond from Hagen Trucking for unpaid work performed for RW Farms on the city contract in November 2010. Granite Re paid $13,804 to satisfy the claim. On January 13, 2011, Granite Re received a claim against the bond from Ries Farms and Excavating for unpaid work performed for RW Farms on the city contract between July and November 2010. Granite Re paid $61,612.64 to satisfy the claim. Granite Re also paid $3,469.28 to satisfy a claim against the bond by OTI.

The city withheld $114,658.12 that it owed to RW Farms under the contract and began this interpleader action to determine the rights of Payne, Granite Re, and other

claimants to the money. Payne and Granite Re asserted cross-claims and counterclaims against each other and the city regarding their rights of priority to the interpleader funds. The parties filed cross-motions for summary judgment, and the district court granted summary judgment for Granite Re under the doctrine of equitable subrogation. The parties and other claimants entered into a stipulation to dismiss the remaining claims. The district court issued an order accepting the stipulation, and judgment was entered. This appeal followed.

D E C I S I O N

I.

Summary judgment is appropriate when the record shows "that there is no genuine issue as to any material fact and that either party is entitled to a judgment as a matter of law." Minn. R. Civ. P. 56.03. We review the district court's grant of summary judgment de novo, to determine whether there are genuine issues of material fact and whether the district court erred in applying the law. *Mattson Ridge, LLC v. Clear Rock Title, LLP*, 824 N.W.2d 622, 627 (Minn. 2012). A party opposing summary judgment may not rest on "mere averments or denials . . . but must present specific facts showing that there is a genuine issue for trial." Minn. R. Civ. P. 56.05. "We view the evidence in the light most favorable to the party against whom summary judgment was granted." *STAR Ctrs., Inc. v. Faegre & Benson, L.L.P.*, 644 N.W.2d 72, 76–77 (Minn. 2002).

The Minnesota Supreme Court long ago considered whether a surety's equitable right of subrogation to contractor funds has priority over an assigned right to the same funds. *Barrett Bros. v. St. Louis County*, 165 Minn. 158, 206 N.W. 49 (1925). In *Barrett*

Bros., a contractor entered into two highway-construction contracts with St. Louis County. *Id.* at 159, 206 N.W. at 49. The contracts and a statutory surety bond took effect at the same time. *Id.* The contracts called for the contractor to be paid 85 percent of the amounts it had earned; the county retained the remaining 15 percent until the work was completed to its satisfaction. *Id.* Barrett Bros. Co., a wholesale grocer, furnished provisions to the contractor that were used on the two St. Louis County jobs and on other jobs. *Id.* at 160, 206 N.W. at 49. The contractor assigned to the grocer all of its earnings under the two St. Louis County contracts. *Id.* The grocer brought an action on the assignment against the county and the contractor, and the surety, laborers, and materialmen intervened. *Id.* at 159, 206 N.W. at 49. The grocer made no claim against the reserved 15 percent of earnings retained by the county, but argued that its assignment placed its claim to the contractor's remaining earnings "beyond attack by the surety." *Id.* at 160, 206 N.W.2d at 49. The district court granted judgment in favor of the surety, and the grocer appealed.

The supreme court rejected the grocer's argument that its assignment of 85 percent of the earnings had priority over the surety's equitable right of subrogation and explained:

> [T]here was no part of the prospective earnings, whether reserved or unreserved, which the contractor could assign to a mere stranger, such as plaintiff, having no independent equity, and thereby give to the assignee a right superior to that of the surety. . . .
>
> . . . Complying with the conditions of its bond, the surety has performed the obligation of the principal to pay laborers and materialmen. It is thereby subrogated to the

> rights of its principal to collect the entire balance due from the county, so far as required for its protection. Plaintiff's assignment can have no effect as against that right, because, as we have seen, it relates back to the date of the suretyship, and was merely matured by the surety's performance of the principal's obligation.

Id. at 161-62, 206 N.W. at 50.

Thus, under *Barrett Bros.*, a surety that provides a payment bond for a contractor has an equitable right of subrogation that, with respect to the contractor and those claiming under the contractor, attaches to the contractor's earnings under the contract at the moment the suretyship begins. Consequently, from that moment, the contractor's rights are subject to the surety's equitable right of subrogation and, therefore, the contractor cannot assign to a mere stranger with no independent equity any part of its earnings under the contract and give to the assignee a right that is superior to the right of the surety.

Payne concedes that *Barrett Bros.* appears to support Granite Re's position, but he argues that *Barrett Bros.* is neither controlling nor relevant because it is contrary to more recent precedents and because the facts in *Barrett Bros.* can be distinguished from the present case. But one of the Minnesota opinions that appellant cites, *Amer. Surety Co. of New York v. Bd. of Comm'rs of Waseca Cty.*, 77 Minn. 92, 79 N.W. 649 (1899), was decided 26 years before *Barrett Bros.* and, therefore, it is not a more recent precedent.

Furthermore, in *Waseca*, the dispute was between the surety and the municipality and involved whether the municipality, after learning from the surety that the contractor had not paid claims for labor and material, had a duty to protect the surety by withholding

payments due to the contractor. *Id.* at 95-96, 79 N.W. at 649. The opinion does not address the contractor's right to assign its earnings under the contract or the question of priority between conflicting claims to payments due from the municipality under the contract.

Similarly, in *Farmers State Bank of Madelia v. Burns*, 212 Minn. 445, 457, 4 N.W.2d 330, 331 (1942), the second opinion relied on by appellant, the court addressed a bank's claim that, under *Waseca*, the municipality had no authority to withhold contract payments that the contractor assigned to the bank and use the funds to enforce the contractor's duty to pay for labor and materials. Because the surety had not paid any claims under its bond, the *Burns* opinion did not discuss the surety's equitable right of subrogation. The opinion did, however, specifically discuss whether *Barrett Bros.* limited the rule in the *Waseca* case and determined that the two cases were distinguishable on their facts. *Id.* at 464, 4 N.W.2d at 335. This means that the supreme court did not consider *Waseca* and *Barrett Bros.* to be inconsistent.

The third case that appellant contends is contrary to *Barrett Bros.* is *First Nat'l Bank v. McHasco Elec., Inc.*, 273 Minn. 407, 141 N.W.2d 491 (1966). In *McHasco*, a contractor entered into contracts with three cities to install street-lighting facilities. *Id*. at 408, 141 N.W.2d at 492. Each contract required the contractor to pay all claims for labor and materials as a condition to receiving final payment and each authorized the city to withhold a percentage of progress payments due the contractor and to use the withheld funds to pay claims for labor and materials if the contractor failed to pay them. *Id.* The same surety provided performance bonds for the contractor on all three contracts, and,

when the bonds were executed, the contractor assigned to the surety all payments due under the contracts. *Id.* at 408-09, 141 N.W.2d at 492-93. But the assignment was effective only in the event of default in the performance of the contracts. *Id.* at 409, 141 N.W.2d at 493.

While the contracts were being performed, the contractor obtained two loans from a bank and, as security for the loans, made written assignments to the bank of all payments due or to become due on the contracts. *Id.* The contractor used most of the proceeds from the loans to pay labor and material claims that arose out of the three contracts. *Id.* The surety did not consent to the assignments and had no notice of the loans or the assignments. *Id.* The contractor completed the work called for in the contracts but went out of business without paying all claims for labor and material and without paying back the bank loans. *Id*. The surety paid the unpaid claims for labor and material. *Id*.

Each city withheld final payment of the amount due on its contract, and the surety and the bank each claimed a superior right to the withheld funds under principles of subrogation. *Id*. at 410, 141 N.W.2d at 493. The supreme court concluded that the surety had priority and explained:

> The bank, as assignee, takes no greater rights than the contractor would have had. By express contractual provisions, the municipalities reserved the right to withhold final payments until all claims were paid as well as the right to make good the contractor's default by direct payment of claims to labor and materialmen. These reserved rights are superior to the rights of the contractor or its assignee. Until such claims were paid, performance was incomplete and neither the contractor nor the assignee bank could compel

> final payment. The surety, in paying such claims, performed the contractor's obligation to the municipalities, thereby rendering the necessary performance requisite to compel final payment. *Upon payment, the surety is not subrogated to the rights of the contractor because the contractor, by its assignment, has divested itself of its right to the withheld funds, and it is the bank, and not the surety, who is in the position of the contractor. . . . Rather, in making payment, the surety acted under compulsion of the bond and thereby became subrogated to the rights of the laborers and materialmen and to the rights of the municipalities to withhold payment to insure completion of the contracts and to pay unpaid laborers and materialmen.*

Id. at 413, 141 N.W.2d at 495 (emphasis added).

Appellant contends that the emphasized language in this paragraph changes the principle stated in *Barrett Bros.* that a surety has an equitable right of subrogation that attaches to a contractor's earnings under the contract at the moment the suretyship begins. Appellant argues that, under *McHasco*, a surety that pays laborers or materialmen under a bond becomes subrogated only to the rights of the laborers and materialmen and to the rights of the municipality. Therefore, appellant concludes, when Granite Re paid RW Farms' subcontractors, Granite Re did not have an equitable right of subrogation that attached to RW Farms' earnings under the contract; instead, Granite Re was subrogated only to the subcontractors' rights to maintain actions against RW Farms for payment under their subcontracts and to the rights that the City of Minneapolis had under its contract with RW Farms. And, appellant contends further, because RW Farms completed its required performance under its contract with the city, and the city had no right under the contract to withhold payment when the subcontractors were not paid, Granite Re's subrogation rights do not include the right to withhold payment from RW Farms to make

payments due to the subcontractors. Consequently, appellant concludes that, under his assignment, he has priority over Granite Re to receive RW Farms' payment from the city.

We acknowledge that the emphasized language in *McHasco* that appellant has cited states a different equitable-subrogation principle than the supreme court stated in *Barrett Bros.*, but we are not persuaded that, in using the emphasized language, the supreme court intended to alter its holding in *Barrett Bros*. The contracts in both *Barrett Bros.* and *McHasco* included provisions that allowed the contracting governmental bodies to withhold a percentage of progress payments due the contractor until the contractor satisfactorily performed the contract. But the dispute in *Barrett Bros.* involved competing claims to the portion of the contract proceeds that the county could not withhold, while the dispute in *McHasco* involved competing claims to reserved funds that each city could withhold under the provisions of its contract.

Barrett Bros. specifically rejected the grocer's argument that a distinction should be made between contractor payments that are reserved and payments that are not reserved and explained that "the surety's equity of subrogation" became effective from the moment that the contracts and bonds became effective and acted as a qualification on the rights of the contracting parties. 165 Minn. at 161-62, 206 N.W. at 50 (emphasis in original).

The contracts in *McHasco* allowed the cities to reserve the contractor's payments to pay claims for labor and materials, and, by failing to pay for labor and materials, the contractor forfeited the right to receive the payments. Because the contractor had forfeited its right to receive payments, the supreme court had no reason to consider

whether the surety's subrogation rights included the right to receive the contractor's payments. Finally, *McHasco* cited *Barrett Bros.* for the principle that a surety's subrogation rights relate back to the date of the surety agreement. 273 Minn. at 416, 141 N.W.2d at 497. Because the supreme court had no reason to consider whether *McHasco* overruled *Barrett Bros.*, said nothing in *McHasco* that suggests that the court intended to overrule *Barrett Bros.*, and, in fact, cited *Barrett Bros.* in *McHasco*, we are not persuaded that *McHasco* changed the holding in *Barrett Bros.* that a contractor cannot assign to a mere stranger with no independent equity any part of its earnings under a contract and give to the assignee a right that is superior to the right of the surety on the contract.

Under *Barrett Bros.*, from the moment that Granite Re became the surety on RW Farms' contract with the City of Minneapolis, RW Farms could not assign to a mere stranger with no independent equity any part of its earnings under the contract and give to the assignee a right that is superior to Granite Re's right.

Payne does not claim that he had an independent equity that gave him a right to receive RW Farms' payments under its contract. But he does claim that this case is different from *Barrett Bros.* because RW Farms granted him a security interest in its contract payments on May 1, 2009, which was one year before Granite Re issued RW Farms a bond on May 1, 2010, and thereby became the surety on RW Farms' contract.

Payne, however, did not file a UCC financing statement with respect to his security interest until December 23, 2010.[1] With certain exceptions that do not apply

[1] Payne argues that because Granite Re did not claim in the district court that Payne's security interest was not perfected, it may not raise the claim for the first time on appeal.

here, the UCC requires that a financing statement must be filed to perfect a security interest. Minn. Stat. § 336.9-310(a) (2010). This means that Payne's security interest was perfected on December 23, 2010. But a surety claim arising under the doctrine of equitable subrogation is not a security interest under the UCC and is not required to be filed to be perfected. *In re J.V. Gleason Co.*, 452 F.2d 1219, 1222 (8th Cir. 1971). As the supreme court explained in *Barrett Bros.*,

> [t]he right of subrogation and its automatic equitable assignment relate to the date of the suretyship, as against the principal and those claiming under him. That equitable assignment to the surety of the principal's rights and remedies, when completed by the surety's performance of his principal's obligation, relates back to that earlier time when the surety first obligated himself as such.

165 Minn. at 161, 206 N.W. at 50 (quotations and citations omitted). This means that, upon paying RW Farms' subcontractors, Granite Re's interest related back to May 1, 2010, when it became the surety and, therefore, it has priority over Payne's security interest, which was perfected on December 23, 2010.

Payne argues that, if Granite Re has priority, its answer was fatally defective because Granite Re had made no payments when it filed its answer. But Minn. R. Civ. P. 24.01 states:

> Upon timely application anyone shall be permitted to intervene in an action when the applicant claims an interest relating to the property or transaction which is the subject of the action and the applicant is so situated that the disposition

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But an appellate court has an obligation to decide cases in a manner consistent with existing law when there is nothing "novel or questionable" about the relevant law. *State v. Hannuksela*, 456 N.W.2d 668, 673 n. 7 (Minn. 1990). There is nothing novel or questionable about the method of perfecting a security interest.

> of the action may as a practical matter impair or impede the applicant's ability to protect that interest, unless the applicant's interest is adequately represented by existing parties.

And the law recognizes two causes of action available to sureties before the payment of claims under the bond, quia timet and exoneration.

> Quia timet and exoneration contain common substantive elements. Specifically, the surety must establish that the debt is presently due (exoneration) or will come due (quia timet), that the principal is or will be liable for the debt, and, that absent equitable relief, the surety will be prejudiced because it will be forced to advance the money to the creditor.

Borey v. Nat'l Union Fire Ins. Co., 934 F.2d 30, 33 (2nd Cir. 1991). When Granite Re intervened, it had received claims against the bond.

II.

Finally, Payne argues that Granite Re's right of equitable subrogation does not give Granite Re priority to recover its attorney fees from RW Farms' earnings under its contract with the City of Minneapolis. The district court concluded:

> Granite Re is entitled to recover the full extent of its loss, including its attorney's fees . . . under the agreement between Granite Re, RW Farms, and the Leistikos, which states as follows: "That [RW Farms and/or the Leistikos] will . . . save [Granite Re] harmless from and against every claim, demand, liability, loss, cost, charge, counsel fee, payable on demand of [Granite Re], whether actually incurred or not (including fees of special counsel, whenever by [Granite Re] deemed necessary) expense, suit, order judgment and adjudication whatsoever, and any and all liability therefore, sustained or incurred by [Granite Re] by reason of having executed or procured the execution of said bonds or obligations . . . ."

The district court relied on *Hartford Acc. & Indem. Co. v. Dahl*, 202 Minn. 410, 278 N.W. 591 (1938), in which the supreme court stated:

> When a contract of surety is made, an obligation is implied on the part of the principal that he will indemnify the surety for any payment the latter may make under the contract. Payment merely fixes the amount of damages for which the principal is liable and relates back to the time the contract was entered into. [The principal] is responsible to [the surety] to the full extent of [the surety's] loss, provided the loss does not exceed the penalty of the bond. And within that limitation the indemnitee, as a necessary part of his damages may also recover against his indemnitor interest and his expenses, including costs which have been awarded against him in the trial court on his unsuccessful defense of a claim after due notice to the indemnitor.

Id. at 413, 278 N.W. at 593 (quotations and citations omitted).

But the attorney fees at issue in *Dahl* were fees incurred by the surety in defending the principal against claims covered by the surety's bond. Id. at 412, 278 N.W. at 592. The fees awarded to Granite Re were not incurred defending against the subcontractor's claims against RW Farms' bond; they were incurred seeking indemnification for the amounts that Granite Re paid to the subcontractors. *Dahl* does not support the attorney-fee award from payments due to RW Farms under its contract with the City of Minneapolis, and Granite Re has not cited, and we have not found, other authority that permits Granit Re to recover these fees under its right of equitable subrogation. Therefore, we reverse the attorney-fee award.

Affirmed in part, reversed in part.