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Between Mechanics' Lienors
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NORMAN T. SMITH AND CHARLES M. COBBE*

Laborers, suppliers, subcontractors, or contractors who have contributed materials or labor to a construction project and have not been paid for those contributions commonly file mechanics' liens against the property on which the construction has taken place. At the same time, however, the identical difficulties that have prevented payment to the laborers, suppliers, and others usually induce the lender, which has extended a construction loan to the owner of the premises, to foreclose on its mortgage. The proceeds of sale are generally not enough to satisfy both the mechanics' liens and the debt secured by the mortgage, whether or not the project is ultimately completed before it is sold. Thus, it must be determined in each case which of these two types of claims will be given priority.

The Ohio Supreme Court's decision in Wayne Building & Loan Co. v. Yarborough1 and the subsequently enacted Open-End Mortgage Act2 have answered many of the questions that arise in this situation; however, they have also left a number of important issues unresolved. Among these are the continuing role of earlier statutes enacted with reference to mechanics' liens; the nature of the requirements that a mortgagee must meet in order to ensure that its mortgage will retain priority over mechanics' liens; and the priorities that should govern when a mortgagee, despite some default by its borrower, continues its disbursements in order to preserve and, perhaps, complete the improvements on the mortgaged property. This article will deal with these issues, primarily with regard to Ohio law. It will also consider the preliminary question of what rationale best supports the system of priorities that has evolved in Ohio, and it will offer some conclusions regarding a matter closely related to the operation of this system of priorities: the doctrine of negligent disbursement of construction loan proceeds by lenders.

I. OHIO'S SYSTEM OF PRIORITIES

An early Ohio statute provided that a mortgage, once recorded, conferred priority on the mortgagee over subsequent lienors.3 How-

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1. 11 Ohio St. 2d 195, 228 N.E.2d 841 (1967).
ever, when the General Assembly later created a statutory mechanics' lien, it also established that the effective date of a mechanics' lien for purposes of priority over other encumbrances was not the date the lien was filed, but the date on which construction began on the premises involved. This was true even if the person asserting a lien did not contribute labor or materials until after the construction had begun.

This relation back of mechanics' liens did not affect a lender that had recorded its mortgage and disbursed all loan proceeds before construction had commenced. However, the courts hesitated to protect a lender that had recorded its mortgage before work had begun but had disbursed the applicable loan fund only in stages corresponding to stages in the completion of construction; although the lender was compelled to follow this practice in order to ensure that the value of its security increased along with the amounts it had paid out, the courts were reluctant to find that the mortgagee's priority could attach at a time when it had advanced far less than the total amount of loan proceeds available. This problem was partially resolved by Kuhn v. Southern Ohio Loan & Trust Co., in which the court held that a mortgagee's priority dated from the filing of its mortgage, even when the loan proceeds were advanced in stages, if the mortgagee had obligated itself to pay out the full amount of the loan proceeds. The court in Kuhn found that the mortgagee should not be subordinated to a subsequent encumbrance when it was powerless to withhold its advances after such an encumbrance arose. This protection for mortgagees obligated to make future advances has now been established in Ohio by the Open-End Mortgage Act.

In addition to the doctrine of obligatory advances, there are other statutory provisions that provide at least some degree of protection for lenders. One such provision states that the owner of premises that

6. See Jefferies, Yarborough Scrutinized: An Analysis of the Theoretical Foundations of the Future Advance Mortgage, 30 Ohio St. L.J. 458, 464-65 (1969). Spader v. Lawler, 17 Ohio 371 (1848) has often been cited as an example of the court's reluctance to grant priority as to advances made subsequent to the recording of a second mortgage.
7. 101 Ohio St. 34, 126 N.E. 820 (1920). The decision in Kuhn is consistent with the view held by the courts of most other states in which the system of priorities has not been altered by legislation. See Comment, Mortgages to Secure Future Advances: Problems of Priority and the Doctrine of Economic Necessity, 46 Miss. L.J. 433, 437-38 (1975).
8. A related question concerns the priority available to a mortgagee whose advances are not obligatory. The jurisdictions have differed as to the type of notice which an intervening encumbrancer must give the mortgagee in order to cut off the protection that the mortgagee has obtained by recording its mortgage before the commencement of construction. See Note, The Open-End Mortgage in Ohio, 25 Cin. L. Rev. 82, 88 (1956); Jones, Mortgages Securing Future Advances, 8 Tex. L. Rev. 371, 374-77 (1930). Ohio Rev. Code Ann. § 5301.232 (Page 1970) now provides that the intervening encumbrancer must provide actual notice of his lien to the mortgagee in order to cut off the mortgagee's priority.
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are being improved is not liable for more than the amount owed to his principal contractor, as long as the owner obtains statements of amounts due and accordingly pays those amounts. By extension, since no lien against the property may arise if these requirements have been met, a mortgagee cannot be subordinated to a claim made by a subcontractor, laborer, or supplier who has not been paid. However, these provisions apply only when a single principal contractor is involved. When a developer has undertaken to improve premises that he owns and does not engage a single principal contractor, his liability and that of his mortgagee can no longer be limited to the amount due to one individual. Hence, in the numerous cases involving real estate developers, the system of priorities between mortgagees and mechanics' lienors remains extremely important.

A further possible source of protection for mortgagees is contained in Ohio Revised Code § 1311.14. This provision confers on the mortgagee the authority to take certain measures to ensure that payments from loan proceeds reach the subcontractors, laborers, and others entitled to them. More importantly, § 1311.14 states that a mortgagee, by referring to this authority to regulate payments in its mortgage and following a complex order of disbursements of mortgage funds, obtains priority over any mechanics' liens filed after the lender records its mortgage. Section 1311.14 is designed to protect the potential mortgagee that might be willing to initiate a loan after construction has commenced, but that might be deterred from doing so by the prospect that all mechanics' liens attaching to the project will attain priority over its mortgage.

It is not entirely clear whether § 1311.14 also applies to a mortgage recorded before the commencement of construction; however, the better view is that a mortgagee that has complied with the requirements of § 1311.14 may invoke the protection of that provision regardless of the time when it records its instrument. In Wayne Building

10. Id. § 1311.05 (Page 1962).
11. Id. § 1311.04 (Page 1962).
12. See Magrish, Disbursement of Ohio Construction Mortgage Loans, 12 Cin. L. Rev. 1, 7-10 (1938).
13. See id.
15. The application of § 1311.14 is more fully discussed in Comment, Construction Mortgages in Ohio, 29 Ohio St. L.J. 917, 926-40 (1968); Magrish, supra note 12, at 11-23 (discussing Gen. Code § 8321-1).
17. A number of authorities suggest that § 1311.14 applies only to mortgagees that make loans and record their mortgages after construction has begun. In Rider v. Crobaugh, 100 Ohio St. 88, 99, 125 N.E. 130, 133 (1919), and Ulmer v. Pottage Constr. & Fin. Co., 26 Ohio N.P. (n.s.) 257, 260-81 (C.F. Summit County 1928), the courts reasoned that Ohio General Code § 8321-1 (current version at Ohio Rev. Code Ann. § 1311.14 (Page 1962)) had been enacted
& Loan Co. v. Yarborough\textsuperscript{18} the court implicitly accepted this view, in that it carefully considered the terms of § 1311.14 as well as the doctrine of obligatory advances before it decided that the mortgagee that had recorded its mortgage before the commencement of construction was not entitled to full priority. The purpose and effect of § 1311.14 are to ensure that the proceeds of a mortgage loan are applied to the improvement of the mortgaged premises and that subcontractors and others are paid for their labor and materials.\textsuperscript{19} If a major objective of the courts is to protect subcontractors and others who have invested labor and materials in a construction project,\textsuperscript{20} this objective is equally well achieved by compliance with § 1311.14. The mortgagee that invokes this section and meets its requirements should therefore be protected.

A question likely to occur more often is whether a mortgagee that has mentioned § 1311.14 in its mortgage instrument is required to comply with that section in order to retain priority. The courts have generally agreed that there is no such requirement, and that a mortgagee that has mentioned § 1311.14 nevertheless remains free to invoke the obligatory advance doctrine.\textsuperscript{21} However, this holds true only where the language of the mortgage merely authorizes the mortgagee to disburse proceeds in accordance with § 1311.14. Where the mortgage clearly requires the mortgagee to disburse the loan funds in accordance with that section, as by stating that the loan proceeds "shall be disbursed" in compliance with § 1311.14, the lender may not depart from the provisions of that section, even if the subsequent disbursements might otherwise be protected by the doctrine of obligatory advances.\textsuperscript{22}

\textsuperscript{18} See section II infra.
\textsuperscript{19} See section II infra.
\textsuperscript{20} See section II infra.
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Although a lender incurs few risks by referring to § 1311.14 in its mortgage document, reference to this section is of little value as a practical matter. Most mortgagees that refer to the section undoubtedly do so with the expectation of relying principally on the doctrine of obligatory advances; they intend to fall back on § 1311.14 only in the event that some later occurrence should render remaining advances optional, thus depriving them of the protection of the obligatory advance doctrine. However, even under these circumstances, compliance with § 1311.14 is cumbersome, and it is unlikely that, if its provisions are followed, laborers and suppliers will long continue to contribute their services in view of the delays which § 1311.14 imposes on payments to them. More importantly, a lender that seeks to comply with this section must begin by discharging any mechanics’ liens that have already attached to the premises. Payments for this purpose are extremely undesirable to a lender, for the reasons suggested by the following example: A mortgagee agrees to lend forty thousand dollars to a developer to finance improvements expected to cost that amount. After the mortgagee has disbursed twenty thousand dollars in reliance on the doctrine of obligatory disbursements, it becomes apparent that, although the value of the premises has been increased to the extent of twenty thousand dollars, certain subcontractors and others have not been paid because, by reason of the developer’s inefficiency or dishonesty, the funds disbursed have not been sufficient to pay for all the improvements actually made. In order to retain its priority under § 1311.14 the lender must now discharge the mechanics’ liens that inevitably have resulted from the developer’s shortage of funds. Let it be supposed that the amount of


23. The authors of one article have concluded that this might not be acceptable to the courts, reasoning that § 1311.14 would be construed to provide no protection unless all disbursements, including those made earlier in reliance on the obligatory advance doctrine, had been made in accordance with that section. Ramey & Jeffries, Construction Mortgage Financing in Ohio, 3 Akron L. Rev. 1, 26-28 (1969). However, the courts would probably not take such a rigid view. The first step in complying with the section is to satisfy all existing encumbrances or to set aside funds for that purpose. Ohio Rev. Code Ann. § 1311.14(A) (Page 1962). If this is done, those subcontractors and others who have participated in the project during its early stages and then filed mechanics’ liens cannot be prejudiced by the lender’s original failure to comply with § 1311.14. Of course, those laborers and suppliers who have failed to file mechanics’ liens may remain unpaid, as the mortgagee’s obligation to compensate them is subordinate to other obligations imposed by the section. See note 24 infra. However, one suspects that most laborers and others generally protect themselves by filing mechanics’ liens.

24. See Magrish, supra note 12, at 10-23. As pointed out in In re Williams, 252 F. 924, 929 (N.D. Ohio 1918), the mortgagee’s obligation to pay amounts due to laborers and suppliers at the time the loan is made is subordinate to its obligation to withhold sufficient funds to complete the improvements. See Ohio Rev. Code Ann. § 1311.14(B), (D) (Page 1962). As the Williams court also points out, the mortgagee is likely to experience difficulty in retaining suppliers and laborers if the mortgage funds are insufficient for both of the obligations just mentioned. Id.

such liens is four thousand dollars. The mortgagee’s next obligation is to set aside sufficient funds to complete the project—here twenty thousand dollars—and to use these funds in completing the improvements.\textsuperscript{26} If it does so, it will upon completion of the project have paid out forty-four thousand dollars to complete improvements worth forty thousand dollars. Moreover, the repeated reference in § 1311.14 to the terms of the mortgage would probably indicate to a court that the mortgagee’s interest in the property extends only to the amount stated on the mortgage.\textsuperscript{27} Thus, the mortgage is unsecured as to four thousand dollars of its investment. Although the mortgagee has, in principle, discharged all liens that attached before it began to rely on § 1311.14, and although that section protects it against any mechanics’ liens filed after it has begun to rely on § 1311.14, the statute offers no protection against judgment liens and, perhaps, other encumbrances that may attach after disbursements have begun in accordance with the statute. The mortgagee could avoid this problem by obtaining a new mortgage at the time it begins to rely on § 1311.14; this mortgage could state an amount sufficient to discharge prior encumbrances and complete the improvements. However, in order to retain its priority the mortgagee would still be required to discharge all prior encumbrances, including any judgment liens, although such liens might have no relation to any improvement in the property.\textsuperscript{28}

Since these latter two statutory measures for the protection of mortgagees are of limited usefulness, most lenders are well advised to rely instead on the doctrine of obligatory disbursement to protect their priority.

\textbf{II. THE RATIONALE FOR THE DOCTRINE OF OBLIGATORY DISBURSEMENT}

The rationale originally advanced for the greater protection accorded mortgagees that had made their advances pursuant to an obligation was that a mortgage ordinarily could not come into existence until a debt had first been created. Therefore, no mortgage could be found to exist, and no priority assured a mortgagee, until advances

\textsuperscript{26} Id. § 1311.14(B), (C).

\textsuperscript{27} \textit{Ohio Rev. Code Ann.} § 5301.232 (Page 1970), which codifies the obligatory advance doctrine, requires the mortgagee to state the total amount which may be secured by the mortgage.

\textsuperscript{28} To be sure, the latter difficulty is also faced by mortgagees that extend loans in connection with projects already in progress but in which they have had no prior interest. However, \textit{Ohio Rev. Code Ann.} § 1311.14 (Page 1962) provides a period, at the outset of the transaction, during which the prospective mortgagee may withdraw from the project if it discovers unacceptable encumbrances. This period is of little use to a mortgagee that is already involved in a project and seeks only to use § 1311.14 to salvage what it can from a troubled construction project.
had been made pursuant to the mortgage agreement. However, it was deemed consistent with this reasoning to hold that a mortgage came into existence immediately upon the execution of the instrument and of the agreement to repay if the mortgagee bound itself to make advances in the future. The reason for this view was that the mortgagee's unequivocal promise to make future advances was, from the mortgagor's standpoint, an adequate assurance that the proceeds of the loan would be made available; thus the mortgagor immediately received the equivalent of full disbursement of the loan proceeds. Because there was both a present benefit to the mortgagor and a promise to repay it, the debt, the mortgage, and the mortgagee's priority came into existence at the outset.

The critics of this highly conceptual view have argued that any mortgage should be held to arise immediately upon the initial disbursement. Even when advances are optional, most construction loans include an immediate disbursement by the lender to permit construction to begin. This disbursement constitutes sufficient consideration to sustain a mortgage and its underlying indebtedness. Hence, there is no doctrinal reason why priority cannot relate back to the time of execution of the mortgage.

A more pragmatic rationale for the obligatory advance doctrine is based on the operation of the recording system. It is argued that a recorded mortgage that refers to an obligation of the lender to advance the full amount stated therein provides adequate notice to prospective encumbrancers of the extent of the lender's ultimate claim on the premises. In contrast, when a mortgagee agrees to make advances only at its option, it is impossible for subsequent encumbrancers to know what portion of the value of the mortgaged premises will be claimed by the mortgagee in the event of default.

However, this reasoning is circular. It could as well be postulated that a mortgagee is entitled to priority as to the full amount shown on the face of the mortgage, or whatever lesser amount is in fact advanced, regardless of any distinction between obligatory and optional advances. An encumbrancer would then assume that he would be subordinated to the extent of the face amount of the prior mortgage, and

32. Id.
33. See Wayne Bldg. & Loan Co. v. Yarborough, 11 Ohio St. 2d 195, 216-17, 228 N.E. 2d 841, 855-56 (1967).
34. Id. See also Kuhn v. Southern Ohio Loan & Trust Co., 101 Ohio St. 34, 36-37, 126 N.E. 820, 821 (1920).
he would not be prejudiced upon finding that the mortgagee's priority did not extend to this full amount.\(^{35}\)

An additional difficulty with basing the rules of priority on the operation of the recording system is that it is often not clear from recorded instruments whether advances in particular cases are obligatory. The Ohio Supreme Court has twice declined to decide whether mortgagees are required to refer in their recorded instruments to their obligations to make future advances,\(^{36}\) and the Open-End Mortgage Act\(^{37}\) does not resolve this question. Even if a mortgagee makes such a reference in its mortgage, it is permitted to impose certain types of conditions on its obligations;\(^{38}\) and it would be of questionable wisdom to require a subsequent encumbrancer to decide whether to perform work or extend credit on the basis of its conclusion whether the conditions in a prior mortgage were so extensive as to vitiate the mortgagee's obligation to make advances.

A different rationale is that the doctrine of obligatory advances protects the owner against restrictions on the alienability of his property.\(^{39}\) It is argued that the lender's obligation to make all stated future advances compensates the mortgagor for the possibility that the future-advance mortgagee may abrogate the security of a subsequent owner or encumbrancer by making additional advances following a sale or second mortgage. This possibility must necessarily make the property less marketable. However, the weakness of this argument is that a later purchaser or mortgagee is easily able to avert the danger of subsequent advances by obtaining a release or cancellation of that encumbrance or a covenant that no further advances will be made by the mortgagee.\(^{40}\) Such a covenant should be easily obtained since the borrower will in most cases have no immediate need of financing by a new lender if the first mortgagee is willing to remain involved in the transaction and advance the entire amount stated in the loan agreement.

The best rationale for the doctrine of obligatory advances is that it protects potential mechanics' lienors against arbitrary conduct by construction loan mortgagees. While purchasers and mortgagees are

\(^{35}\) See G. Osborne, supra note 31, § 116.

\(^{36}\) Akron Sav. & Loan Co. v. Ronson Homes, Inc., 15 Ohio St. 2d 6, 13, 238 N.E.2d 760, 765 (1968); Wayne Bldg. & Loan Co. v. Yarborough, 11 Ohio St. 2d 195, 220, 228 N.E.2d 841, 858 (1967).


\(^{38}\) Id. § 5301.232(E)(4) (Page 1970).

\(^{39}\) See G. Osborne, supra note 31, § 117a. See also Blackburn, Mortgages to Secure Future Advances, 21 Mo. L. Rev. 209, 211-12 (1956).

\(^{40}\) See Comment, Mechanics' Liens: The "Stop Notice" Comes to Washington, 49 Wash. L. Rev. 685, 693 (1974). Ohio's Open-End Mortgage Act, Ohio Rev. Code Ann. § 5301.232(C) (Page 1970), permits a mortgagor to limit its indebtedness under a future-advance mortgage by filing a notice to that effect. However, this provision does not apply to mortgages securing construction loans.
able to protect themselves against subsequent advances, many contractors, laborers, and suppliers are less aware of releases, subordination agreements, and other devices that might be used for their protection. Hence, they require greater protection against the danger that a mortgagee may, long after the execution of the mortgage, lend additional amounts that are not used to increase the value of the property which mechanics' lienors may reach. The effect of this abuse is that the mortgagee thereby increases its share of the proceeds of sale of the property at the expense of mechanics' lienors.

The courts have shown strong hostility to this conduct on the part of mortgagees in cases not involving mechanics' liens. It has been held that a mortgage that purported to secure all debts, present or future, did not secure a loan extended two years after the mortgage for a purpose other than the purchase or improvement of the mortgaged property. More generally, the courts have held that a mortgage securing one debt does not secure a later obligation if the two obligations are not of the same character.

In the context of construction loans, the doctrine of obligatory advances provides a rough method for restricting the types of indebtedness to which particular mortgages may apply. A mortgagee is necessarily reluctant to incur an obligation to pay out money in the distant future for purposes other than construction because the mortgagor's reliability may by then have deteriorated; yet, if the mortgagee retains only the option of making such advances, an intervening mechanics' lienor is not threatened with loss of his priority. Furthermore, the doctrine of obligatory advances relieves the courts of making the sometimes difficult determination of whether a given advance is so closely related in purpose to prior advances that it may share the priority of these advances.

The courts' distinction between obligatory and optional advances also performs a secondary function. It provides a degree of protection for subcontractors, suppliers, and laborers against mortgagees that may unjustifiably cease making advances before construction is complete and before the entire stated amount of the mortgage proceeds has been disbursed. Although instances of this are probably not common, it is possible to imagine a case in which a lender discovers that the ultimate value of the premises being improved will be less than anticipated and, therefore, insufficient to enable the developer to repay its loan. The lender would be inclined to respond to this

41. Second Nat'l Bank v. Boyle, 155 Ohio St. 482, 99 N.E.2d 474 (1951). Spader v. Lawler, 17 Ohio 371 (1848), although often cited as an outright rejection of future-advance mortgages, is closely similar to Boyle. In Spader, the mortgagee asserted that his interest secured a loan made several years after the original loan had been paid in full.

situation by cutting off its advances and relying on its position as mortgagee to enable it to recover the amounts so far disbursed. The danger from such conduct is that, at any time during construction, there are likely to be subcontractors and others who have supplied labor and materials but have not yet been compensated. Since they have expected to be paid from the next advance made by the mortgagee, they may not have filed mechanics' liens. Although they are, of course, able to file liens when it becomes apparent that they will not be paid, the value of real estate during construction is often insufficient to compensate both the mortgagee and the mechanics' lienors. The doctrine of obligatory advances can therefore serve to force mortgage lenders to incur part of the risk that the improvement of the mortgaged premises may prove to be a poor investment.

One writer has suggested that the doctrine of obligatory advances is, at best, a primitive means for protecting any parties involved in construction because mortgagees know that their agreement to lend money will not be specifically enforced and that damages for breach of their agreement are likely to be only nominal. However, an aggrieved mortgagor would be entitled to recover damages for refusal to lend money as agreed in those cases in which the interest rate had risen because of market conditions and not merely because the mortgagor's reliability had deteriorated. In addition, it is easy to envision a large construction project that can be supported only by a group of lenders; if one of these lenders should withdraw its support for reasons not directly related to the mortgagor's performance, such as a dispute among the lenders or exhaustion of the resources of one of the lenders, the mortgagor may encounter serious difficulty in locating new sources of funds. During the time needed to arrange for new financing, the mortgagor might be confronted with lost rental income, deterioration of the partially completed premises, and worsened relations with laborers, subcontractors, suppliers, and prospective tenants or purchasers of the mortgaged premises. To a lesser extent these same problems would arise even in the case of a smaller project involving a single lender. At the same time, mortgagees are further deterred from arbitrarily cutting off disbursements by the probable repercussions of such conduct on their reputations among potential customers.

43. The case of such subcontractors, laborers, and others is different from those who have already filed mechanics' liens, in that the previous filing of mechanics' liens and the mortgagor's failure to discharge them justifies the lender in cutting off further advances. Discharge of all liens is undoubtedly one of the conditions that a mortgagee may impose on its obligation to continue disbursement of the loan proceeds. See Ohio Rev. Code Ann. § 5301.232(E)(4) (Page 1970).

44. 2 G. Gilmore, Security Interests in Personal Property § 35.4 (1965).

45. See Skipworth, Should Construction Lenders Lose Out on Voluntary Advances if a Loan Turns Sour?, 5 REAL ESTATE L.J. 221, 228 (1977).
The conclusion that the function of the doctrine of obligatory advances is primarily to protect actual or potential mechanics’ lienors\textsuperscript{46} will be helpful in considering two other problems relating to future advances: the necessary content of the mortgage document, and the priority to be accorded the mortgagee that continues to make disbursements despite a breach of the conditions of the loan agreement.

III. NEGLECTFUL DISBURSEMENT OF LOAN PROCEEDS

The issue of negligent disbursement arises when disbursed proceeds of a mortgage loan do not reach the subcontractors and others who are entitled to payment. In this situation mortgagors and unpaid subcontractors may argue that the mortgagee was under a duty to ensure that the proceeds of its loan would be paid to them rather than diverted by an inefficient or dishonest contractor. However, the majority rule is that a mortgagee is not liable to subcontractors and others under this theory unless the mortgagee has actively contributed to the failure to pay subcontractors, has represented to the subcontractors and others that they would be paid, or has acted with actual knowledge that the proceeds of its loan were not reaching those entitled to be paid. These propositions provide a way to reconcile the two Ohio cases decided on this issue.\textsuperscript{47} They are also helpful in determining what conditions a mortgagee may impose on its obligations, as well as the extent of the priority available to a mortgagee that continues its disbursements after breach of these conditions.

A clear case for holding a mortgagee subject to mechanics’ liens or liable to a mortgagor occurs when the mortgagee itself diverts mortgage loan proceeds toward other uses than those contemplated in the loan agreement. A number of courts have held lenders liable to their mortgagors in such situations; the net effect of these cases on mortgagees is the same as that of granting priority to the claim of mechanics’ lienors to the proceeds of sale of the mortgaged premises. In a Minnesota case a mortgagee was held liable to its borrower after the mortgagee had applied the proceeds of its loan to offset debts owed to it by the borrower’s contractor but unrelated to the project being financed.\textsuperscript{48} Similarly, a mortgagee that has agreed to finance

\textsuperscript{46} It is also interesting to note that the obligatory advance doctrine is enforced not by the mortgagors but by the mechanics’ lienors who may be able to use the doctrine to alter the priorities in their own favor. See Akron Sav. & Loan Co. v. Ronson Homes, Inc., 15 Ohio St. 2d 6, 238 N.E.2d 760 (1968), in which the mortgagee’s failure to make one disbursement until three months after the requisite voucher and warranty were presented influenced the court in concluding that the mortgagee’s advances were not obligatory and, therefore, not entitled to priority over the lien of a supplier.


construction projects owned by several different developers may be held liable to a mortgagor if it disbursers funds from that mortgagor's account for work on projects that he does not own. In imposing liability on a mortgagee in one such case, the court pointed out that the mortgagee was in the best position to prevent misapplication of the loan funds, as it could have required proof that the construction on the mortgaged property had progressed and that the funds advanced were used to meet costs of the construction; without taking such measures, the mortgagee could not reasonably have relied on the mortgaged property as security for the amounts that it had disbursed.

Although there is little direct authority on the question, it would also be proper to hold a mortgagee liable when it had continued to disburse the proceeds of its loan with actual knowledge that these amounts were being misappropriated by a contractor. In such a case the mortgagee would be in the best position to prevent further misappropriation of the funds, and should bear the cost of its failure to do so.

Another line of decisions has imposed liability on mortgagees that have, either expressly or by their conduct, undertaken duties beyond the fundamental duty to refrain from knowingly misapplying loan proceeds. Thus, where a construction contract provided that the mortgagee would inspect the premises before disbursement of the instalments of loan proceeds, the court held the mortgagee liable for the amounts of mechanics' liens for the charges unpaid by the defalcating contractor. Although the mortgagee had made the required inspections, it disbursed two-thirds of the loan proceeds before the project was more than one-third complete. In another case the mortgagee had assumed full control of the disbursement process, insisting on paying the loan proceeds directly to the suppliers and subcontractors rather than to the mortgagor; this led the court to conclude that the mortgagee was under the same duty to pay the suppliers and subcontractors as the mortgagor would have been, and, therefore, that it lost its priority over the mechanics' lienor who was not fully paid.

49. See Fikes v. First Fed. Sav. & Loan Ass'n, 533 P.2d 251 (Alas. 1975). The plaintiff in this case was not a mortgagor but a vendee possessing an equitable interest in the property. The vendee's position was similar to that of a mortgagor, in that it sought to avoid paying the full contract price for property that had not benefited from the application of the entire amount of mortgage funds.


52. Speights v. Arkansas Sav. & Loan Ass'n, 239 Ark. 587, 393 S.W.2d 228 (1966). It should be noted that in this case an officer of the mortgagee was engaged in fraudulent conduct.

53. Fulmer Bldg. Supplies, Inc. v. Martin, 251 S.C. 353, 162 S.E.2d 541 (1968). Other circumstances in this case, although not expressly taken into account by the court, probably
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Nevertheless, there are many situations in which the mortgagor’s words and conduct will not cause its interest to be subordinated. In asserting their priority over mortgagees, mechanics’ lienors have maintained that, in bidding on a project, they have relied on the availability of mortgage loan proceeds; hence, they argue, the mortgagee is estopped from refusing to pay the amounts due to these lienors. This argument is not well founded. Subcontractors, suppliers, and laborers are not generally among those entitled to assert an estoppel against the mortgagee if the reliance was due to statements by contractors or mortgagors regarding the availability of loan proceeds; a mortgagee cannot be estopped by the statements of a third person unless that third person is the mortgagee’s agent. Alternatively, a mechanic’s lienor asserting his own priority may argue that he has relied on the statement of the maximum amount of loan proceeds that is contained in the recorded mortgage document. In this situation the lienor has arguably relied not upon an assertion by a person unrelated to the mortgagee, but upon a statement by the mortgagee itself. The weakness of this argument is that a party generally may not assert an estoppel unless he is in privity with the person who made the statement.

The courts of a number of jurisdictions have refused to hold the mortgagee liable in other contexts where the mortgagee has neither diverted the loan funds to an account unrelated to the mortgaged premises nor made direct representations to the claimant. In one contributed to its conclusion; in particular, the mortgagee disbursed part of the contested amounts to accounts that it knew were not related to the mortgage in question.

54. In Miller v. Mountain View Sav. & Loan Ass’n, 238 Cal. App. 2d 644, 48 Cal. Rptr. 278 (Dist. Ct. App. 1965), involving an asserted equitable lien on the proceeds of sale of the mortgaged property, the court sustained this argument.


56. Lubric Oil Co. v. Drawe, 26 Ohio App. 478, 160 N.E. 93 (Cuyahoga County 1927).


58. Morgan v. Spangler, 14 Ohio St. 102 (1862).

59. Although this proposition is supported by the authorities subsequently discussed in the text, the courts are not unanimous in so limiting the liability of mortgagees. In Southern Life Ins. Co. v. Pollard Appliance Co., 247 Miss. 211, 150 So. 2d 416 (1963), the court found that the mortgagee had violated its duty to potential mechanics’ lienors in that its loan officer, who inspected the mortgaged premises, did not obtain affidavits or other evidence of payment to
such decision a mortgagee had paid the loan proceeds directly to the owner without undertaking to satisfy any unpaid charges; the mortgagee's lien was held not subject to the loss of its priority over mechanics' liens.\(^{60}\) Another court has concluded that a mortgagee does not become the trustee of suppliers and subcontractors merely because it retains possession of the funds to be disbursed.\(^{61}\) A third has stated that a mortgagee's duty to suppliers and subcontractors is negated by the absence of any contractual relation between the mortgagee and these claimants.\(^{62}\) It has also been determined that the mortgagee will not be held liable for the malfeasance of a contractor unless that contractor is the agent of the mortgagee. However, no court has ever held that a contractor is the agent of a mortgage lender.\(^{63}\)

The preceding discussion makes it possible to harmonize the two major Ohio decisions on the issue of improper disbursement. In _Falls Lumber Co. v. Heman\(^ {64}\)_ a mortgagee had undertaken to disburse loan proceeds directly to the principal contractor, expressly assuring the mortgagors that it would protect them from any claims in excess of the agreed price of their house. In making its disbursements, however, the mortgagee failed to obtain the waivers that would have protected the borrowers under the Ohio statute.\(^{65}\) The court held that in making such assurances the mortgagee had assumed the duties of an agent of the borrowers and was consequently liable to them for disbursing funds without obtaining the necessary waivers.

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\(^{61}\) General Mortgage Corp. v. Campbell, 258 Iowa 143, 138 N.W.2d 416 (1965).


\(^{63}\) _Cf. Connor v. Great Western Sav. & Loan Ass'n_, 69 Cal. 2d 850, 73 Cal. Rptr. 369, 447 P.2d 609 (1968) (lender not liable as a joint venturer with a contractor, despite the lender's extensive involvement in planning a housing development). _But cf. Speights v. Arkansas Sav. & Loan Ass'n_, 239 Ark. 587, 393 S.W.2d 228 (1965) (mortgagee liable for fraudulent conduct of its employee).

\(^{64}\) 114 Ohio App. 262, 181 N.E.2d 713 (Summit County 1961).

\(^{65}\) OHIO REV. CODE ANN. § 1311.04 (Page 1962).
In a more recent case, *Gardner Plumbing, Inc. v. Cottrill*, the court held that a mortgagee was not liable to its borrowers merely because it had disbursed funds without obtaining the waivers that would have protected the borrowers. The court reasoned that under the terms of the statute the mortgagee was not required to obtain such waivers; it also determined that the evidence at trial had not demonstrated a fiduciary relationship between the lender and the mortgagors. The majority opinion in *Cottrill* contains no reference to the decision in *Falls Lumber*. This indicates that the earlier decision has not been overruled, and that the Ohio Supreme Court has adhered to the rule that mortgagees are liable only when they have engaged in a narrow range of conduct.

Compelling reasons of policy support the rule followed in *Cottrill*. While the equities in foreclosure cases generally favor the mechanic's lienor, who has increased the value of the security of a prior mortgagee, and so created a potential windfall, these equities are not present in cases of construction loans and should not be invoked to bolster the position that a mortgagee owes the mechanics' lienor a broad duty of diligence. A mortgagee that extends a construction loan necessarily contributes heavily to the mortgaged project and relies on the new improvements to provide adequate security. A second reason for restricting the liability of mortgagees is that subcontractors are commonly in as good a position as mortgagees to prevent losses that may be caused by inefficient or dishonest contractors. Even small subcontractors and suppliers are often able to judge the solvency and reliability of individual contractors through informal exchanges of information. Moreover, subcontractors and suppliers occasionally assume part of the risk of default by the con-

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66. 44 Ohio St.2d 111, 338 N.E.2d 757 (1975).

67. Again, the waivers were those specified in Ohio Rev. Code Ann. § 1311.04 (Page 1962).

68. The lender's statements regarding periodic inspection of the premises were held to have been merely a disclosure of measures designed for the lender's own protection and not an offer to take special steps to protect the borrowers. The fact that the lender made disbursements to the borrowers rather than to the contractor undoubtedly reinforced the court's conclusion that the lender had undertaken no special duties.


tractor by colluding with contractors or mortgagors in executing false vouchers of payment.\textsuperscript{72} Even where the work that the vouchers represent has been completed, this practice seriously impedes the construction lender that seeks to detect and prevent cost overruns as early as possible. A final consideration of policy is that subcontractors and suppliers customarily rely, not on any commitment of a mortgage lender to ensure payment of all those involved in a construction project, but instead on the general credit of the contractor with whom they are in direct privity.\textsuperscript{73} For all these reasons the courts should, and generally do, hesitate to impose extensive liability on mortgagees merely because these represent an easily accessible "deep pocket."

IV. THE CONTENTS OF THE MORTGAGE AND LOAN AGREEMENT

The preceding discussion has set forth a rationale for the doctrine of obligatory advances and, with reference to the issue of negligent disbursement, has suggested how the risks attendant on any construction project should be allocated between the mortgagee and the potential mechanics' lienors. With this discussion in mind, the requirements that a mortgagee must meet in order to ensure that its future advances are obligatory and therefore entitled to priority will now be considered.

A. Including Future Obligations in the Mortgage Document

An initial question is whether the language which makes future advances obligatory must be included in the recorded mortgage document. In \textit{Wayne Building & Loan Co. v. Yarborough}\textsuperscript{74} the court suggested that the "better practice"\textsuperscript{75} would be for mortgagees to refer in their mortgages to their obligations to make future advances. The basis for this statement appears to be the court's fear that mechanics' lienors will be unexpectedly deprived of priority, after they have already contributed to a construction project, by a subsequent determination that the mortgagee's advances were obligatory. It would be foolish for a mortgagee to ignore such a clear warning by the court; however, if a mortgagee that has somehow omitted this reference in the recorded instrument is forced to defend its priority against intervening lienors, the priority of its mortgage is supported by the weight of authority and by the fact that, in practice, potential

\textsuperscript{72} Lefcoe & Schaffer, \textit{supra} note 55, at 447.
\textsuperscript{73} First Nat'l Bank v. Carlyle House, Inc., 102 N.J. Super. 300, 246 A.2d 22 (Ch. 1968).
\textsuperscript{74} 11 Ohio St. 2d 195, 228 N.E.2d 841 (1967).
\textsuperscript{75} \textit{Id.} at 220, 228 N.E.2d at 858.
mechanics' lienors are rarely influenced by the contents of recorded mortgages.

Despite the above cited dictum in *Yarborough*, the Ohio courts have never held that mortgagees must refer in their mortgages to their obligations to make future advances. In *Akron Savings & Loan Co. v. Ronson Homes, Inc.* the Ohio Supreme Court, although repeating the warning of *Yarborough*, declined to hold even that an oral commitment to advance loan funds is necessarily ineffective to secure priority. Instead of holding outright that the oral agreement was without effect because intervening lienors could learn of it only with great difficulty, the court carefully examined all the evidence, including the alleged oral agreement, before determining that the future advances were not obligatory. The plain implication is that mortgagees will not be deprived of priority merely because reference to their obligations is omitted from their recorded documents.

Nothing in the recent codification of the doctrine of obligatory advances changes this conclusion. Although the statute sets forth in some detail the types of information which must be included in the recorded documents, it contains no requirement that the mortgagee include a statement of its obligation to advance loan proceeds. In view of the uncertainty created as to this question in *Yarborough*, it may be inferred that had the legislature deemed such statements to be necessary, it would expressly have provided for them.

The majority view is that mortgagees need not refer in recorded documents to their obligations to make future advances. This is based on the operation of most states' recording systems. A mortgagee generally is not permitted to adduce parol evidence of the terms of a mortgage if the rights of third persons would thereby be prejudiced, and mechanics' lienors are arguably within this class of "third persons." However, it is also true that a recorded mortgage constitutes notice of those facts that would be revealed by an investigation based on information contained in the mortgage. There can be little question that the statements in the mortgage of the maximum amount of the loan proceeds and of the fact that it secures future advances, together with the knowledge by potential mechanics' lienors that the mortgagor intends to erect a building, are sufficient to put the potential lienor on inquiry notice of whether the mortgagee is obligated to make the advances in question.

This reasoning has led the courts of numerous states to hold directly that a mortgagee's priority is not destroyed by its failure to

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76. 15 Ohio St. 2d 6, 238 N.E.2d 760 (1968).
79. 59 C.J.S. Mortgages § 262 (1949).
mention in its recorded documents its obligation to make future advances. 80 Several courts have concluded that a potential encumbrancer who knows the total amount to be secured by a mortgage normally assumes that the earlier mortgagee will have priority to the full extent of that amount; hence, such an encumbrancer is not prejudiced by his discovery that the future advances are in fact obligatory and, therefore, the mortgagee retains full priority. 81 It is consistent with this reasoning to hold, as one court has done, that a party challenging a mortgagee bears the burden of pleading that the mortgagee's disbursements are optional. If this assertion is not included in the pleadings, and if the mortgage document does not show on its face that the mortgagee's disbursements are optional, it is appropriate to hold that the disbursements are obligatory and that the mortgagee is entitled to full priority. 82

It may be an unstated premise in these decisions that suppliers, subcontractors, and others, even if they find no mention of the mortgagee's obligation in the recorded document, do not rely on the possibility that they may obtain priority over a mortgagee if the latter's advances are not obligatory. Instead, such lienors benefit from any obligation on a mortgagee to advance the full stated amount of loan proceeds, whether or not this obligation is mentioned in a recorded document. Rather than arguing that they have been led to assume that their liens have priority over the mortgage, mechanics' lienors are likely to assert that they have relied on the mortgagee to disburse the full amount stated in the recorded mortgage. 83 These two arguments are not consistent, and the courts have evidently determined that mechanics' lienors will not be permitted to stand on both sides of the issue.

B. Terms and Conditions of the Obligation in the Agreement

Although a mortgagee need not fear loss of priority merely because it has failed to mention its obligation in a recorded document, it nevertheless faces the danger that the language in the agreement on which it relies to confer priority will not be found sufficiently binding to create the necessary obligation. 84 It is not enough that the

83. See notes 54-58 supra and accompanying text.
84. It has been asserted that most agreements governing residential construction loans in Ohio do not contain language sufficiently binding to confer priority on mortgage lenders. Lucas, Construction Mortgage v. Mechanic's Lien—The Struggle for Priority, BAR BRIEFS, Sept. 20, 1968, at 7 (publication of Columbus, Ohio Bar Association).
mortgagee be merely "authorized" to make future advances in a certain manner; the words "obligated" or "required," or their equivalent, must appear in the statement of the mortgagee's commitment in order for the mortgage or loan agreement to confer priority. The loan agreement or mortgage must state the amount which the mortgagee is obligated to disburse, and it must specify the manner in which disbursement is to take place. The last named requirement does not refer to escrow accounts, assignments of funds, or other administrative details; however, the loan agreement or mortgage must indicate, when this is the case, that the funds will be advanced as various stages of construction are reached and must specify any conditions that the mortgagee has imposed on its obligation to extend future advances. A statement that a mortgage is given "to pay for improvements" is not sufficient. Also insufficient are provisions that the lender will disburse funds only on the mortgagor's written order and presentment of vouchers, or that the lender will conduct inspections and surveys.

Reference to the procedure for disbursement set forth in Ohio Revised Code § 1311.14 does not confer priority unless the mortgagee carefully follows this procedure. It is true that in Kuhn v. Southern Ohio Loan & Trust Co. the court held that a reference to this statute was sufficient indication of the parties' intent that the future advances be obligatory. However, Kuhn has been so narrowly distinguished that it is now of little value as authority on this question.

Ohio's Open-End Mortgage Act permits mortgagees to impose conditions on their obligations to make future advances without losing priority as to these advances. However, this provision should not be taken to mean that any condition conceived by mortgagees is necessarily acceptable, since some conditions would obviously vitiate the mortgagee's purported obligation to disburse loan proceeds. Because the statute gives no help in determining what conditions are acceptable, it is necessary to consult the case law on this question.

The most common condition imposed by mortgagees is that dis-
bursement of loan proceeds is to take place only in increments corresponding to stages in the completion of construction. The reason for this is that lenders seek to ensure that the value of their security remains commensurate with the amounts they have paid out. If a loan agreement or mortgage states that the lender is in all other respects obligated to disburse the loan proceeds, a provision for disbursement in stages does not by itself defeat the lender's priority.\textsuperscript{93} However, if the stages at which disbursements are to be made are not set forth with sufficient definiteness, there is substantial danger that the advances will be found optional;\textsuperscript{94} courts will not infer from business custom or the exigencies of mortgage loan transactions that the lender is bound to continue its advances so that the amount disbursed always approximates the value of the mortgaged premises. The advances will be deemed optional and the mortgagee will no longer be entitled to full priority if a mortgage provides merely that funds shall be advanced at times and in amounts to be determined by the mortgagee,\textsuperscript{95} or if it appears that a mortgagee retains discretion as to whether or not to make advances even after the corresponding stages of construction have been reached.\textsuperscript{96}

Decisions in other jurisdictions have allowed mortgagees substantial discretion over the times when disbursements are to be made, provided only that mortgagees are not permitted to retain all loan funds until construction is complete.\textsuperscript{97} However, mortgagees in Ohio should not rely on these cases. The weight of authority, as indicated above, is that more exact provisions must govern the times when

\textsuperscript{93} Geer v. Tuggle, 22 Ohio N.P. (n.s.) 129, 29 Ohio Dec. 552 (C.P. Clark County 1919). There is ample support for this conclusion from other jurisdictions. See, e.g., House v. Long, 244 Ark. 778, 426 S.W.2d 814 (1968); Whelan v. Exchange Trust Co., 214 Mass. 121, 100 N.E. 1095 (1913).

\textsuperscript{94} See Home Sav. & Loan Ass'n v. Sullivan, 140 Okla. 300, 284 P. 30 (1929). An example of the stages applicable to residential construction at which a lender becomes obligated under its loan agreement to disburse successive installments of the mortgage proceeds is given in Lefcoe & Schaffer, supra note 55, at 439 n.1:

1. foundation is laid and all rough lumber has been delivered to the site;
2. structure is roughed in and roofing is in place;
3. interior plastering and exterior finishing are complete;
4. cabinetry, flooring and interior painting have been commenced;
5. improvements are fully complete and certificates have been obtained from the necessary authorities.

\textsuperscript{95} National Bank v. Equity Investors, 81 Wash. 2d 886, 506 P.2d 20 (1973). This decision has been superseded by Wash. Rev. Code § 60.04.220 (Supp. 1975); however, it remains relevant to those states, such as Ohio, that have not enacted similar statutory provisions.

\textsuperscript{96} Kingsberry Mortgage Co. v. Maddox, 13 Ohio Misc 98, 233 N.E.2d 887 (C.P. Clermont County 1968).

\textsuperscript{97} E.g., Thompson v. Smith, 420 P.2d 526 (Okla. 1966). The court in this decision distinguished Home Sav. & Loan Ass'n v. Sullivan, 140 Okla. 300, 284 P. 30 (1929), supra note 94, on the ground that the mortgagee in the earlier case could have withheld all disbursements until construction was complete. However poorly this distinction comports with the realities of construction lending, it is consistent with the opinion in E.K. Wood Lumber Co. v. Mulhol-land, 118 Cal. App. 472, 5 P.2d 669 (Dist. Ct. App. 1931).
disbursements are to be made. Moreover, the burden on lenders to specify the stages of construction is slight in comparison to the increased protection that specific statements provide for suppliers, laborers, and subcontractors, who are thereby relieved of the need to rely for long periods on the credit of the contractor.

In addition to making disbursements conditional on the completion of various stages of construction, mortgagees commonly attempt to impose conditions relating to the quality of their borrowers' or the contractors' performance. Examples of such conditions are: a requirement of an appraisal satisfactory to the mortgagee before the first disbursements may be made; requirements that the borrower's architect be satisfactory to the lender, and that the architect supply satisfactory progress reports before each disbursement; and a provision that disbursements may be withheld unless the lender finds that construction has been done in a workmanlike manner.\(^8\) It is easy to imagine other conditions that a mortgagee might seek to impose: a requirement that the borrower maintain bonds, comply with government regulations, and pay any debts that might result in mechanics' liens; reservation by the lender of the power to stop disbursements if cost overruns appear prohibitive; and a requirement that materials used in construction will be of the quality called for by plans and specifications.

Although one court has found certain of the above named conditions to be unacceptable,\(^9\) it is submitted that conditions of this kind do not vitiate a lender's obligation, provided that the loan agreement does not state simply that the times and amounts of disbursements are left to the lender's discretion. This conclusion is in accord with the law of contracts, under which conditions destroy the obligations of the parties to an agreement only if one party's performance becomes dependent entirely on its own desire to perform.\(^10\) The satisfaction of a lender with the quality of materials or workmanship or with other aspects of a construction project is a permissible condition because a finder of fact can determine whether or not the lender was in truth satisfied.\(^11\) In determining whether a mortgagee's conditions have been met, the finder of fact is permitted to consider whether a reasonable person in the mortgagee's position would have been satisfied with the performance.\(^12\) It may also apply other objective tests

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\(^8\) These conditions were present in National Bank v. Equity Investors, 81 Wash. 2d 886, 506 P.2d 20 (1973). The court held that they destroyed the obligatory nature of the loan.

\(^9\) Id. It may be that these conditions would not have been fatal to the lender's priority if they had not been coupled with a provision that disbursements would be made in amounts and at times to be determined by the mortgagee; however, the express enumeration of these conditions indicates that they may, by themselves, cause difficulty for lenders.


\(^11\) See id. §§ 644-45.

when performance is mechanical and subject to measurable standards, as is often true of construction work. As a result, a mortgagor can enforce its lender's commitment to make future advances, and the courts should have no difficulty in finding that future advances are obligatory and, therefore, protected against competing liens, despite the presence of these conditions.

A different problem is posed by conditions that, unlike those discussed above, are not within the control of the mortgagor or its contractors. An example is a provision that the mortgagee may cease to make disbursements if it should appear during construction that the soil or other subterranean conditions are unsuitable for the type of construction in progress. Such a condition is objectionable not because it threatens to make the mortgagee's obligations illusory, but rather because the possibility of unsatisfactory subterranean conditions is not the kind of risk that should be imposed on suppliers, laborers, and subcontractors. As the discussion of negligent disbursement of loan funds has shown, the majority of courts have concluded that suppliers, subcontractors, and others in their position must bear the risk of the dishonesty or inefficiency of mortgagors and principal contractors. The reasons for this are that suppliers and subcontractors are capable of helping to avoid these problems, and that they are expected to rely on the ability and integrity of mortgagors and contractors more heavily than they rely on mortgagees. These considerations do not apply to conditions based on subterranean problems. It is true that mortgagors may be expected to determine whether subterranean conditions are adequate for any planned construction and that subcontractors and others could obtain this information from mortgagors; however, mortgagees, which are often large institutional lenders, are more capable of demanding and utilizing technical information and are in a much stronger position to prevent a construction project from proceeding without assurance that subterranean conditions are suitable.

Similar reasoning applies to conditions that are entirely aleatory, such as a provision that disbursements will stop, with the mortgagee retaining priority as to proceeds, if the site of construction is condemned by government authority. While it is appropriate to shift to subcontractors and suppliers the risk that construction will be halted for reasons that can be prevented or avoided by them, subcontractors and suppliers are virtually unable to anticipate in any given instance that condemnation or some similar event will occur, and clearly do not rely on contractors and mortgagors to prevent these occurrences. For these reasons, suppliers, subcontractors, and other

103. See Corbin, supra note 100, § 646.
104. See section III supra.
potential mechanics' lienors should not be required to bear the risks associated with conditions not fully within the control of mortgagors or contractors.

V. PRIORITY AS TO DISBURSEMENTS MADE AFTER CONDITIONS HAVE BEEN BROKEN

When a mortgagor defaults on its obligations, the mortgagee may wish to continue to disburse funds since it is often justifiably apprehensive that it cannot obtain a satisfactory price at a foreclosure sale unless it makes additional expenditures to complete the project.\textsuperscript{105} It is not practical for the mortgagee to foreclose on the premises and purchase them at foreclosure sale before such time. During the long pendency of the foreclosure action, the mortgagee could incur substantial loss from deterioration of the premises and wasted rental value. Alternatively, the mortgagee after commencing a foreclosure action might ask the court to appoint a receiver. The receiver could, upon application to the court, obtain the authority to borrow funds (usually from the mortgagee) and issue receiver's certificates as security therefor. The receiver's certificates would enjoy priority superior to even the first mortgage. However, this course of action carries with it substantial disadvantages, including the expense of the receivership and the mortgagee's lack of control over the receiver, since the receiver is accountable only to the court. Additionally, there is the danger that a particular appointment will be considered suspect if the trustee is determined to be too closely associated with the mortgagee. Unfortunately, objections to such appointments often do not arise until, by hindsight, a third party can see how additional funds might have been generated by following a different course of action.

At the same time, it is unwise for a mortgagee simply to continue to make the expenditures needed to complete a mortgaged project without first commencing a foreclosure action. In all likelihood the mortgagee has attempted to protect its original priority by imposing conditions on its obligation to make future advances.\textsuperscript{106} Often, it is the breach of precisely these conditions which constitutes the borrower's default. Many courts have held that a failure to perform any of these conditions releases the mortgagee from its obligation to continue its disbursements, and that any disbursements made subsequent to default are optional and, therefore, not protected by the mortgagee's original priority.\textsuperscript{107} There are no reported Ohio deci-

\textsuperscript{105} See Kratovil & Werner, Mortgages for Construction and the Lien Priorities Problem—The "Unobligatory" Advance, 41 Tenn. L. Rev. 311, 313-16 (1974).

\textsuperscript{106} See id.

\textsuperscript{107} E.g., Yost-Linn Lumber Co. v. Williams, 121 Cal. App. 571, 9 P.2d 324 (Dist. Ct. App. 1932); Elmendorf-Anthony Co. v. Dunn, 10 Wash. 2d 29, 116 P.2d 253 (1941).
sions resolving this dilemma. When the issue does arise, the Ohio courts should view the majority rule with skepticism and should take into account both the significant economic reasons and the doctrinal justifications for granting priority to mortgagees that make funds available for completion of troubled construction projects.

Several decisions grounded on the rule that disbursements made after a breach of conditions are not protected by the mortgagee's original priority could better have been decided on the basis of other doctrines. In a California case a party purchased a deed of trust, thereby assuming the position of mortgagee, after the contested mechanic's lien had attached. Under the general rules of priority, the court could have held that party's interest subordinate to the mechanic's lien. Moreover, the purchaser of the trust deed had affirmatively undertaken to ensure that all mechanics' liens existing at the time it acquired its interest would be discharged, but had failed to do so. Thus, the case is distinguishable on its facts from ordinary cases involving disbursements following default.

Other cases, although also ostensibly decided on the grounds of the majority rule on disbursements after default, similarly contain special facts that detract from their value as authority for this rule. In a Delaware case a mortgagee's agent fraudulently ordered payments to a contractor; this decision could easily have been based instead on the doctrine of negligent disbursement. Another decision involved a contest between a construction mortgagee and a purchase-money mortgagee who had subordinated his interest to the extent of only a stated portion of the total construction loan proceeds. Disbursements beyond this amount were held not protected under the disbursement-after-default rule. However, the limited extent of the

108. In Connecticut Gen. Life Ins. Co. v. Birzer Bldg. Co., 61 Ohio L. Abs. 477, 101 N.E.2d 408 (C.P. Hamilton County 1950), the court determined that the mortgagee had bound itself to disburse loan proceeds in accordance with OHIO REV. CODE ANN. § 1311.14 (Page 1962), and that, in failing to disburse in this manner, the mortgagee lost its priority. However, Birzer does not control the problem at hand, since the consequences of departure from the statutory scheme are clearly established by the statute itself and not by any judicial reasoning concerning a mortgagor's failure to meet conditions.

109. Community Lumber Co. v. California Publ. Co., 215 Cal. 274, 10 P.2d 60 (1932). In this case, the owner of property had executed a deed of trust to a construction contractor, who then sold the trust deed to a third party after mechanics' liens had already attached. In Community Lumber, as under Ohio law, all mechanics' liens attached as of the time construction commenced. See E.K. Wood Lumber Co. v. Mulholland, 118 Cal. App. 475, 5 P.2d 669 (1931). Although the shelter doctrine might appear to protect the purchaser of the deed of trust in this case, since the deed of trust had originally been executed before the commencement of construction, the court found that the contractor, to whom the deed of trust had first been granted, was the agent of the owner of the premises. Hence, the purchaser could not argue that it had acquired its interest from a prior party that had obtained the deed of trust before construction had commenced.


subordination agreement would by itself have allowed the court to protect the purchase-money mortgagee.

In contrast to the above cases, a decision which illustrates the proper—and limited—application of the doctrine of obligatory advances is *Swaye v. Murphy*,112 where the mortgage agreement provided that the final disbursement would be made only after a certificate of occupancy had been issued. Because the mortgagee had made the final disbursement before this condition had been met, the court held that the mortgagee was not entitled to priority as to that disbursement. The doctrine of negligent disbursement was not applicable in favor of the mechanics' lienors because the mortgagee had never represented to them that it would undertake special measures for their protection; nevertheless, it was desirable to impose some sanction to ensure that the mortgagee adhered to its own stated schedule of disbursements. By failing to observe this schedule, the mortgagee eliminated a major source of control over cost overruns on the construction and increased the likelihood that the loan proceeds would be diverted to pay costs unrelated to the construction project. For these reasons it was appropriate to invoke the rule denying priority as to advances made while conditions in the mortgage agreement remain unfulfilled.

The considerations that support the decision in *Swaye v. Murphy* are not applicable to the more common cases in which a lender continues to make disbursements despite a default in one of the conditions in the loan agreement. In *Swaye* the mortgagee itself was responsible for the default since it removed all incentive for the contractor to comply with the lender's conditions by prematurely disbursing an installment of the loan proceeds. In contrast, the source of default in an ordinary case lies entirely with the mortgagor or his contractor; thus it is of little use to deprive the mortgagee of its priority as a sanction for permitting cost overruns or other difficulties. Moreover, a mortgagee that assumes control of a project following a default thereby takes the most effective possible measure to prevent further difficulties and becomes able to ensure that the remaining funds will be properly applied. In addition, once a mortgagee has assumed control, a court is free to reimpose the standards that the mortgagee itself created in establishing conditions for disbursement. Thus a court can, as in *Swaye*, deny priority as to any advances made before the corresponding stages in construction have been reached; and it can impose the same sanction as to all advances made following the mortgagor's default should the mortgagee arbitrarily interrupt its new series of disbursements. Similarly, a court can easily determine from the original loan agreement and the specifications for construction the purposes for which the loan proceeds were intended to be

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112. 126 Conn. 497, 12 A.2d 547 (1940).
paid out, and can deny the mortgagee's priority as to any amounts which have been expended to enhance the value of the mortgagee's priority beyond that which was originally envisioned.

Although the majority rule at least appears to deny the mortgagee's priority in these situations, there is strong support in some decisions for a rule more favorable to lenders. This support is evident in decisions involving a mortgagee's priority for amounts advanced following default to pay taxes and expenses of maintenance; in decisions applying the doctrine of negligent disbursement; and in a number of other decisions bearing on the general question of disbursements following default.

There is little question that a mortgagee, upon the mortgagor's default, is entitled to pay insurance premiums, taxes, and costs of maintenance in order to protect its security, and to include these amounts in the debt secured by its mortgage. As a result, the mortgagee may recover these expenditures from the proceeds of sale upon foreclosure, and its claim to these amounts is superior to the claim of the mortgagor to proceeds of the sale exceeding the face amount of the mortgage. Moreover, as against intervening encumbrancers, the mortgagee is entitled to the same priority in recovering these expenditures as in recovering the amounts of disbursements made before any intervening encumbrance arose. In contests between mortgagees and other encumbrancers the courts have ignored the doctrine of obligatory advances and stated merely that the mortgagee's equitable right to protect its security prevails over the rights of other encumbrancers, although these other rights may have accrued before the mortgagee has made its contested payments.

As several writers have argued, the rule applied to expenditures for taxes, maintenance, and repairs should be extended to cases where mortgagees have made expenditures needed to complete mortgaged improvements. It can further be argued that such expenditures by the mortgagee generally do not diminish the value of mechanics' liens which have attached to the property but, instead, that the in-

113. In Ohio this rule has been codified as Ohio Rev. Code Ann. § 5301.233 (Page 1970). Although it is often not appropriate to reason by analogy from statutory provisions, this provision is declaratory of previous case law and, therefore, has some application to the issue of disbursements following default.


116. E.g., Mayo v. City Nat'l Bank & Trust Co., 103 N.J. Super. 227, 247 A.2d 33 (Ch. 1968). In this case, the mortgagee had disbursed part of the loan proceeds to discharge mechanics' liens on the mortgaged property. The court held that, in so doing, the mortgagee had violated no duty to an assignee of the mortgagor who asserted a claim to part of the mortgage loan proceeds as payment for work completed under a contract with the mortgagor.

creased value of the premises as completed more than compensates the mechanics' lienors for the increases in the amounts secured by construction mortgages.

It is true that if the expenditures by a mortgagee following default prove to be a poor investment and the value of the property is not enhanced to the extent of increases in the mortgagee's claim, the mechanics' lienors suffer. Courts have applied the rule denying priority as to disbursements made following default in part to ensure that mortgagees do not cast the risks of these investments onto mechanics' lienors. However, it is possible to protect these persons against such risks without depending on such an inflexible rule. In cases involving expenditures for taxes, maintenance, and operation, courts have permitted lenders to include in the amounts secured by their mortgages, expenditures used to preserve and increase the value of the mortgaged premises. In so doing, the mortgagee is required to exercise good faith, and it may not add to its claim the costs of improvements that it has made in a merely speculative attempt to increase the value of the mortgaged premises beyond the value that these premises were understood to have when the mortgage was executed.\textsuperscript{118} It also may not make improvements that are "merely ornamental."\textsuperscript{119} A reading of the cases on this point suggests that the courts' primary concern is to ensure that whatever expenditures are made by the mortgagee, beyond essential payments for taxes, maintenance, and operation, are conservative investments, unlikely to increase the mortgagee's lien without increasing the value of the property by an equal amount. To this end the courts are willing to determine in each case whether expenditures by the mortgagee were proper. They should be no less willing to do so in cases concerning the relative priorities of mortgagees and mechanics' lienors. In evaluating mortgagees' decisions on a case-by-case basis they would, as suggested earlier, be considerably aided by the terms of applicable loan agreements and building specifications. There would be little danger of allowing a mortgagee to pay for more elaborate improvements than those originally projected, while shifting to other lienors the risks that such expenditures may not lead to a commensurate increase in the value of the mortgaged premises.

A rule giving priority to mortgagees for reasonable expenditures made after default would be consistent not only with the decisions outlined above, allowing priority for amounts paid for taxes and maintenance, but also with the majority of decisions on negligent disbursement of loan proceeds.\textsuperscript{120} As already indicated, the majority

\textsuperscript{119} Bowen v. Boughner, 189 Ky. 107, 113, 224 S.W. 653, 656 (1920) (dictum).
\textsuperscript{120} See section III supra.
of those decisions place on the mortgagee only the risk of those losses which it has promised to prevent or which it has directly caused by its own misconduct. Where losses are occasioned by dishonest or inefficient contractors or mortgagors, most courts have declined to subordinate the claims of mortgagees. Cases involving asserted negligent disbursement are similar in at least one major respect to cases in which mortgagees seek to continue making advancements following default: in both situations, the issues revolve around the failure of certain loan proceeds to reach their intended recipients. It would be inconsistent for courts to limit the liability of mortgagees, as they have done in cases of alleged negligent disbursement, while expanding mortgagees' liability where no negligence is asserted but where mortgagees have made additional expenditures to protect and improve the premises that stand as security not only for mortgagees, but also for holders of mechanics' liens.

Several courts have held directly that a mortgagee retains its priority as to all advances made in order to complete the mortgaged project after default. For example, one court has held that where, at the time of execution of the mortgage and loan agreement, the intent of the parties is clearly to confer priority on the mortgagee as to all disbursements used to complete the improvements, this priority will not be defeated by the combined operation of the filing of mechanics' liens and the breach of one or more of the conditions contained in the mortgage.\(^{121}\) Another court has held that a mortgagee retains its priority unless its advances are, by the express terms of the mortgage, "purely and plainly optional";\(^2\) the failure to meet conditions in the mortgage does not, according to this court, have the same effect as would such express language. An additional rationale put forth by


\(^2\) Hyman v. Hauff, 138 N.Y. 48, 54, 33 N.E. 735, 737 (1893). Under the reasoning of this case, the following language should be sufficient to confer priority as to all disbursements following default, while giving the mortgagee discretion to cease disbursements if justified:

> Upon failure by the mortgagor to comply with any of the conditions set forth in this mortgage, the mortgagee shall be relieved of all obligations imposed upon it by this mortgagee. However, in the event of such failure by the mortgagor, the mortgagee shall retain the power to make further payments for the purpose of protecting and completing the improvements on the mortgaged premises. Such payments shall be secured by this mortgage, and the priority of the mortgagee's lien as to such payments shall be the same as the priority of its lien as to those payments made by it in accordance with this mortgage before any failure by the mortgagor to comply with the conditions set forth in this mortgage.

This language obviously does not bind the mortgagee to make future advances; however, it clearly expresses the intent of the parties as to the ultimate issue of priority, and leaves little possibility that the mortgagee may arbitrarily cease disbursement absent a breach of its conditions.
some courts in protecting the mortgagee's priority is that mechanics' lienors are not parties to a loan agreement or mortgage, and are not intended to benefit from the provisions of these documents. Hence, they do not have standing to complain of any waiver of conditions by the mortgagee.\(^{123}\)

A final reason for protecting the mortgagee, although not present in all cases, is that mechanics' lienors have sometimes been parties to the mortgagor's representations that the conditions for disbursement have been met; as a result, they are estopped to assert that the mortgagee's conditions have been broken.\(^{124}\) This occurs when subcontractors or suppliers execute vouchers falsely stating that certain work has been completed in order that the contractor or mortgagor may obtain funds to pay costs already incurred at a much earlier stage of construction.

To all the foregoing arguments in favor of protecting the priority of a mortgagee as to advances made even after default has occurred, the objection most likely to be raised is the hardship that may fall on mechanics' lienors as a result of protecting mortgagees. When heavy cost overruns and a default by a contractor have occurred, leaving certain subcontractors and others unpaid, it may appear inequitable to permit the mortgagee to assume control of the construction, provide for full payment of all who have contributed to the project following default, and then recover all or nearly all its investment while the proceeds of sale of the premises are insufficient to compensate those who contributed to the early stages of construction. However, the priorities established by the Open-End Mortgage Act lead to an equivalent result where a mortgagee, fearing the loss of its priority, simply halts disbursement, forecloses on its mortgage, and causes the premises to be sold, in all probability for an amount too small to provide for full payment to mechanics' lienors. There is no reason why the priority of these lienors should be improved merely because the mortgagee has chosen instead to complete the construction, thereby saving itself, and ultimately the local economy, the costs of deterioration and lost rental value. Rather than denying priority outright to mortgagees in such cases, the courts should engage in the practical task of ensuring that mortgagees do not, at the risk of mechanics' lienors, either arbitrarily cease disbursements or embark on improvements not envisioned in the original loan agreement and mortgage.

\(^{123}\) See Landers-Morrison-Christenson Co. v. Ambassador Holding Co., 171 Minn. 445, 214 N.W. 503 (1927); Hyman v. Hauff, 138 N.Y. 48, 33 N.E. 735 (1893). The Ambassador decision involved other elements in addition to the mechanics' lienors' lack of standing; however, the court clearly relied on this as one of the grounds for its decision.

VI. SUMMARY AND CONCLUSIONS

Mortgagees that have agreed to disburse the proceeds of loans in the course of construction on mortgaged premises are likely to find that § 1311.14 and related statutory provisions are not only cumbersome in application, but also inadequate to protect them against intervening encumbrances. Therefore, they often invoke the protection that the Open-End Mortgage Act\(^\text{125}\) confers on mortgagees that are under an obligation to disburse the proceeds of their loans. In order to obtain this protection mortgagees must make it clear either in their mortgages or in their loan agreements that they are subject to an obligation to disburse the loan proceeds.\(^\text{126}\) However, this obligation need not be stated in the mortgagee's recorded instruments. Furthermore, mortgagees may impose conditions on their obligations, but these conditions may not pertain to matters not within the control of the mortgagors or their contractors.

In general, when losses in construction are caused by dishonest or inefficient mortgagors or contractors, these losses should not be imposed on mortgagees. Where it is alleged that mortgagees have negligently disbursed loan proceeds they should lose priority to the mechanics' lienors only where the mortgagees themselves have misallocated the proceeds of their loans or have expressly or impliedly undertaken a special duty to their mortgagors or to potential mechanics' lienors. Where mechanics' lienors assert that mortgagees have waived their priority by continuing to make disbursements despite the default in the conditions imposed in loan agreements, mortgagees should be subordinated to other claimants only in the uncommon cases where the mortgagees' conduct has aggravated the danger that contractors or mortgagors will not fulfill their obligations to potential mechanics' lienors. Where mortgagees in these cases have not contributed to the difficulties of construction projects and have continued disbursements as the most effective way to restrict losses to all parties involved, they should not be penalized by subordination of their interests to those of other parties.


\(^{126}\) The mortgage must also be recorded prior to the commencement of construction. See text accompanying notes 3-5 supra.