

CONSTRUCTION MORTGAGES IN OHIO

I. INTRODUCTION

A construction mortgage may be described as the security for a loan whose proceeds are to be used in the improvement of real estate. Section 1311.14, Ohio Revised Code, formulates the requirements and codifies the effects of a construction mortgage.¹ The essence of this section is that, in the event the requisites of the section are met, the lien of a mortgage given to improve real estate, or to pay off prior encumbrances thereon, and which is actually used for such purposes, shall be prior to all mechanic's liens and similar liens that are filed for record after the improvement mortgage is filed.

In addition, the mortgage must empower the mortgagee to perform all activities which are enumerated under this section of the Code. The activities authorized by this statute include the right of the mortgagee to pay out on the owner's order such sums as the owner certifies to be necessary to meet and pay labor payrolls, and to pay on the owner's order the accounts of materialmen and laborers who have filed notice of debt as required by this statute. Furthermore, in the event that notice of amounts due are filed with the mortgagee, and the owner refuses to issue an order to pay these amounts, the mortgagee may retain the whole amount claimed until the proper amount of such claim has been established.

A review of Ohio authorities reveals, however, that the mortgagee, although authorized to make disbursements in this manner, is not required to do so. At the time the loan is transacted the mortgagee may pay over the entire amount loaned to the borrower, and, if in fact the money is used in the construction project for which it was made available, the mortgagee will retain his priority over intervening lienholders. The statute provides for a blanket priority and the priority is applicable to improvements of any nature. The court in *Knollman Lumber Co. v. Hillenbrand*² observed that the construction mortgage statute clearly affords priority to construction mortgages to the extent that the proceeds are actually used in the improvement of the real estate regardless of the form which the improvement takes. The court placed a great deal of emphasis on the fact that the statute does not limit the priority to specific improvements.

An initial perusal of the statute by an individual unsophis-

¹ OHIO REV. CODE ANN. § 1311.14 (Page 1962).

² 64 Ohio App. 549, 29 N.E.2d 61 (1940).

ticated in the area of liens might result in his determination that this statute was simply reiterating the common law doctrine that a lien filed previous to another lien maintains priority over the subsequently filed lien. An exploration of section 1311.13 of the Ohio Revised Code and an examination of authorities construing this section reveal, however, that this assumption would be erroneous. The priority scheme with respect to mechanic's liens is established by section 1311.13:

- B) Such liens shall be preferred to all other titles, liens, or encumbrances which may attach to or upon such construction, excavation, machinery, or improvement, or to or upon the land upon which they are situated, which shall either be given or recorded subsequent to the commencement of said construction, excavation, or improvement.

This section of the code reveals that once construction has been initiated under the original contract, all mechanics liens for labor performed and materials furnished, under the original contract or subcontracts executed in pursuance of the original contract, are deemed to have attached as of the date construction commenced.³ It is therefore apparent that a mechanic's lien would have priority over another mortgage, if construction had been started by any individual before the filing of the mortgage, even though the mortgage was filed before the holder of the mechanic's lien had supplied any labor or materials.

In the case of *Rider v. Crobaugh*⁴ the court refused to grant priority to an individual who had filed his mortgage after construction had begun, but previous to the date when the lien holders with whom he was competing had begun work or furnished materials. The court in referring to section 8321, paragraph 12, Ohio General Code (the predecessor of section 1311.14 of the Ohio Revised Code) recognized that the statute did not differentiate between the mechanic's lienors who had performed their work at various times during the construction. It maintained that the statute was unambiguous in granting priority to the several liens obtained by several

³ A lien is created at the time construction commences, and the filing of the affidavit required by OHIO REV. CODE ANN. § 1311.06 (Page Supp. 1967) is simply the means by which the lien is perfected. It is stated in DEMANN, OHIO MECHANIC'S LIEN LAW § 10.1 (2d ed. 1959):

The lien exists prior to the filing of the affidavit and the filing of the affidavit for lien simply prevents the lien from being barred by the statutory limitation.

⁴ 100 Ohio St. 88, 125 N.E. 130 (1919).

persons upon the same job in respect to any lien or encumbrance recorded subsequent to the commencement of construction and that the priority attached irrespective of whether or not the particular work in question was performed previous to the filing of the mortgage.

The effect of section 1311.14 is to grant priority to the individual who makes a construction mortgage loan, conforming with this section, in respect to certain mechanic's lienholders. A construction lender who is conscientious in meeting the requisites of this section is afforded priority over mechanic's lienors whose liens are filed for record after his lien is filed.⁵ Thus, although a mechanic's lien is generally effective from the date any construction on a particular job is initiated, it does not become effective against a section 1311.14 mortgage lender until after this particular mechanic's lienor has done his part of the work and has filed a mechanic's lien in respect thereto.

II. OBLIGATORY AND NON-OBLIGATORY LOANS DISTINGUISHED

A comprehensive examination of Ohio construction mortgage law cannot be accomplished without a discussion of the distinction which is recognized between mortgages securing loans that are obligatory and those that secure loans that are considered non-obligatory. A loan is obligatory to the extent that the lender has assumed a contractual obligation to pay over a sum certain to the borrower. A loan loses its obligatory nature, however, if the lender has discretion as to whether or not the money will be advanced or if the amount to be advanced is left to his determination.

A mortgage which secures an obligatory loan is a lien on the property for the full amount of the loan and is effective as of the time the mortgage is filed.

In *Kuhn v. Southern Ohio Loan & Trust Co.*⁶ the court discussed the difference between obligatory and non-obligatory future advances. Faced with the problem of determining priorities between a construction loan mortgagee and an intervening mortgagee, the court ruled that the construction mortgagee was obligated to make the advancements and because of that fact granted him priority. They rested their holding on the ground that when a mortgagee

⁵ DEMANN, OHIO MECHANIC'S LIEN LAW § 10.5 (2d ed. 1959). A similar analysis of the operation of § 1311.14 was made in the case of First Federal Sav. & Loan Ass'n. v. Robbins, 23 Ohio Op. 110, 36 N.E.2d 991 (Ct. App. 1939).

⁶ 101 Ohio St. 34, 126 N.E. 820 (1920).

has bound himself to make advancements for a clearly defined purpose, he immediately acquires the status of a bona fide purchaser to the extent of the entire amount of his contractual liability, and his position is identical to the position he would have attained if the entire consideration had passed on the execution and delivery of the mortgage. The lender who has executed a mortgage obligating himself to make certain definite advances can be distinguished from the individual who has made actual advances only by the almost insignificant factor, that instead of having made the advances, he has made a binding contractual promise to advance the sum at a later date.

Conversely, a mortgage given as security for a non-obligatory loan does not become effective until an actual advance is made and is then effective only to the extent of payments actually advanced. Under the Ohio approach, a loan securing optional advances is placed subsequent in priority to a second mortgage securing present advances which is filed, to the extent of advances not yet actually made at the time of the filing of the second mortgage. This result is predicated on the function of a mortgage as recognized under Ohio law. A mortgage has validity only to the extent that it secures a valid debt, and there is no debt until money is advanced or until a binding contract to advance money is executed. The function of a mortgage was commented upon by the court in the case of *Spader v. Lawler*,⁷ where it was observed that a mortgage placed upon record to secure all monies hereinafter advanced would undoubtedly have no legal effect. The court reasoned that since a mortgage is a security for the payment of money, if no valid debt was due, there could be nothing to secure and consequently no mortgage.

The second reason for Ohio's treatment of non-obligatory advances is also based on Ohio's concept of the function of a mortgage, that it should furnish notice to subsequent encumbrancers of the debt which it secures.⁸ The purpose of requiring a public filing of a mortgage is to provide other individuals with knowledge of the extent to which the property is held as collateral so as to assist them in determining whether they should make a certain loan. A mortgage securing advances which may or may not be made does little to inform a subsequent mortgagee of the amount of the debt which it secures. When a mortgage is filed which secures an indeterminate sum, the prospective lender's position is not much improved as com-

⁷ 17 Ohio 371 (1848).

⁸ *Id.* at 379.

pared to when he had no knowledge concerning the presence or absence of a mortgage on the property.

More recently, in the case of *Second National Bank v. Boyle*,⁹ the theory for subordinating mortgages securing non-obligatory future advances was explained in the following language:

Obviously, where there is no obligation to make future advances, a mortgage, purporting to secure such future advances, cannot secure such advances until the advances have been made. Until then, so far as such advances are concerned, there is nothing for the mortgage to secure. . . .¹⁰

There are two basic differences between obligatory and non-obligatory advances to be made in the future. These differences are of such a nature that it is logical to make a distinction in respect to when the mortgage securing the advances is effective. The first difference is that a subsequent mortgagee is given constructive notice that the initial mortgagee is obligated to make a certain advance as opposed to having an option to make an advance if he considers it advantageous. Secondly, even if the obligatory mortgagee was aware of the encumbrance intervening between the taking of the mortgage and the advance, he could not escape his contractual obligation to make the advance and an avoidance of this obligation would result in his breaching his contract.¹¹

It should be observed at this juncture that Ohio's determination that the filing of a subsequent mortgage is sufficient to afford priority to this mortgage over a mortgage securing non-obligatory advances has not been universally accepted. On the contrary, the majority of jurisdictions have adopted the theory that it is necessary for the intervening claimant to give actual notice of his mortgage to the mortgagee who has filed a mortgage securing non-obligatory future advances, in order to elevate his subsequently-filed mortgage to a position of priority over later non-obligatory advances.¹² The rationale which supports the majority rule is that subsequently recorded instruments afford no notice to the recorders of previously recorded instruments, while on the other hand, previously filed instruments do give notice to subsequent recorders. It would be unfair and cumbersome to require a mortgagee, who had given record notice, to

⁹ 155 Ohio St. 482, 99 N.E.2d 474 (1951).

¹⁰ *Id.* at 486, 99 N.E.2d at 476.

¹¹ Note, *Obligatory and Non-Obligatory Advances in Ohio*, 1 U. CIN. L. REV. 348, 350 (1927).

¹² Annot., 138 A.L.R. 566, 579 (1942).

check for subsequent encumbrances each time he advances funds. Thus, the intervening encumbrancer can obtain priority by giving notice to the holder of the previously recorded mortgage, which is not burdensome and moreover follows the general pattern of notice established by the recording statute.¹³

The difference between the Ohio rule and the viewpoint adopted in the majority of jurisdictions is primarily predicated on the categorical determination of who should bear the burden of checking the mortgage records. Ohio and the other jurisdictions which operate under the same theory assert that it is illogical to demand that an intervening mortgagee give notice to the mortgagee whose mortgage is for non-obligatory future advances due to the fact that the non-obligatory mortgage does not secure a valid debt. In *Ladue v. Detroit & M. R.R.*,¹⁴ the court stated that the majority rule

rests upon the erroneous idea that the recording of a mortgage adds something to its validity as between the parties, and that, even as between them, an instrument may be made a mortgage by recording it, which would not have had that operation without the record.¹⁵

On the other hand, the jurisdictions which have promulgated the majority rule assert that the subsequent filing of a mortgage should not be considered sufficient to constitute notice to the non-obligatory mortgagee. Those jurisdictions assert that the recording of an intervening lien gives notice to subsequent claimants only and does not give notice to prior mortgagees of record.¹⁶ Additionally, the proponents of the majority rule reason that a claimant filing subsequent to the future advance mortgage has notice of the possibility of these advances.¹⁷

¹³ *Tapia v. Demartini*, 77 Cal. 383, 19 P. 641 (1888); *Oaks v. Weingartner*, 105 Cal. App. 2d 598, 234 P.2d 194 (1951); *Ackerman v. Hunsicker*, 85 N.Y. 43 (1881).

¹⁴ 13 Mich. 380 (1865).

¹⁵ *Id.* at 400.

¹⁶ *Note, The Open-End Mortgage in Ohio*, 25 U. CIN. L. REV. 82, 88 (1956).

¹⁷ Legal Bull., September, 1953, p. 78 *et seq.*, published by the United States Savings and Loan League, Chicago, Ill. (This article presents a complete survey of the law in forty-eight of the fifty states (Alaska and Hawaii being omitted); Illinois, Michigan, Ohio and Pennsylvania are listed as following the minority or "Michigan" rule under which intervening lienors take priority over subsequent advances made under a non-obligatory loan).

III. THE EFFECT OF OHIO'S OPEN END LEGISLATION

It is pertinent that the application of the minority approach has been diminished to a large degree by a recent Ohio statutory enactment. This statute is commonly designated as the "open-end mortgage statute."¹⁸ Basically this provision adopts the above-mentioned majority rule under circumstances where the requirements of the statute are met. In effect, this statute states that a mortgage may secure unpaid balances of loans made after the mortgage is recorded, if it contains the words "open-end mortgage" at the beginning of the instrument, and the maximum amount of unpaid loan indebtedness. In addition, the mortgage must also state that the parties intend that the mortgage shall secure the above-mentioned amount. However, the statute continues by providing that if an amount is advanced after the mortgagee receives written notice of a lien or encumbrance on the mortgaged premises, which is subordinate to his mortgage, and he is not obligated to make the advancement at that time, the lien of the mortgage for the unpaid balance of the advance so made shall be subordinate to such lien or encumbrance. The lien of a mortgage for the unpaid balance of the advance is also subordinate to a valid mechanic's lien to the extent that the mortgagee received notice that the work was performed or to be performed or machinery, material, or fuel was furnished or to be furnished, in respect to any advance the mortgagee was not obligated to make at the time he receives such notice.

The impact of this statute is that all advances made under a non-obligatory loan effectively attach at the time of the filing of the mortgage which secures them. The priority of the mortgage securing these advances is subject only to subordination in situations where the advance was made after actual notice of a subordinate or mechanic's lien was received.

IV. THE YARBOROUGH CASE

The present state of Ohio law in the area of construction mortgages is governed to a large degree by the Ohio Supreme Court's recent decision in the case of *Wayne Building & Loan Co. v. Yarrowborough*.¹⁹ The dominant influence this case will exert on the construction mortgage field in Ohio necessitates a detailed consideration of the legal questions which were present in that case and of the

¹⁸ OHIO REV. CODE ANN. § 5301.232 (Page Supp. 1967).

¹⁹ 11 Ohio St. 2d 195, 228 N.E.2d 841 (1967). See also *Wayne Bldg. & Loan Co. v. Yarrowborough*, 11 Ohio St. 2d 224, 228 N.E.2d 860 (1967). This case was a com-

manner in which they were resolved by Ohio's highest court. A familiarity with the facts of *Yarborough* is instrumental in gaining a thorough understanding of the court's decision.

On August 28, 1963, Mr. Yarborough, a builder, executed an agreement with a Mr. and Mrs. Lantz whereby the Lantzes were to purchase certain real estate in Cuyahoga Falls, Ohio, upon Mr. Yarborough's completion of construction of a house upon that real estate. A cognovit note for 18,000 dollars was given to Yarborough by the Lantzes on August 28, but the only cash paid out to Yarborough by the Lantzes was in two four thousand dollar payments, the first on October 11, 1963, and the second on March 10, 1964. On October 16, 1963, Yarborough notified Sauter Development Company of the contract of sale with the Lantzes. Sauter deeded the above-mentioned real estate to Yarborough on this date. Yarborough paid one thousand dollars cash and executed a note for four thousand six hundred dollars, Sauter retaining a mortgage as security for the note.

Also on October 16, Yarborough applied to the Wayne Building and Loan Company for a 22,000 dollar construction loan on the lot and proposed house. Wayne received a mortgage as security and it was informed of the prior sale of the residential property and approved the plans for the house. On November 1, Wayne recorded its mortgage.

On November 21, construction was commenced on the residence, with Sauter filing its mortgage on December 11. Later that same day it filed the warranty deed for the lot which it had sold to Yarborough. Immediately subsequent to the filing of the deed, Wayne filed its mortgage, probably with the realization that when it initially filed on November 1, Yarborough was not the owner of record. Apparently due to Yarborough's financial difficulties, the house was not completed. The basic problem which the court en-

panion case to the first mentioned case of the same name, and the court's reasoning was almost identical. The facts were substantially the same as those present in the first *Yarborough* case with the exceptions that Eaton & Co. were the developers, and there was no individual involved who possessed a vendee's equitable lien. Additionally, Wayne's mortgage was filed before Eaton's, and both were filed prior to the commencement of the construction on the residence. However, since Wayne had made no actual disbursements before Eaton's mortgage was filed, they were positioned lower in priority. Furthermore, since Wayne's disbursements were not obligatory and did not follow the procedure required by OHIO REV. CODE ANN. § 1311.14 (Page 1962), or were not shown to have actually been used in the construction, they were subordinated to the mechanic's liens. *Akron Sav. & L. Co. v. Ronson Home, Inc.*, 15 Ohio St. 2d 6, 238 N.E.2d 760 (1968) reaffirmed the court's holding in *Yarborough*.

countered was determining the relative priority of the liens on the property which were possessed by the Lantzes, various materialmen, Sauter, and Wayne. Both the Court of Common Pleas and the Court of Appeals of Summit County found the following priorities among these claimants: (1) Wayne's construction mortgage lien; (2) mechanic's liens; (3) Sauter's mortgage lien. Reversing the decision of the lower courts, the Ohio Supreme Court first considered the Lantzes' equitable vendee's lien. They stated a generally recognized rule that a vendee's equitable lien arises as security to the vendee to the extent of the amount he pays out. Additionally, although Wayne alleged to have had no knowledge of the Lantzes' lien, knowledge was imputed to it since it knew that the lot was sold. The court held that it was incumbent upon them to investigate the interest which was held by the purchaser of the real estate. Priority was afforded to both of the Lantzes' four thousand dollar payments over Wayne and Sauter, although the Lantzes' second payment on March 10, 1964, was subsequent to the filing of both Wayne and Sauter's liens. The court held that the filing of these mortgages did not constitute notice to the Lantzes, and only actual notice on the part of the Lantzes concerning Wayne's and Sauter's mortgages would bestow priority to these mortgages.

In upholding the preference which section 1311.13 of the Ohio Revised Code grants to mechanic's liens, the court allowed priority to the four thousand dollar payment of the Lantzes made previous to the commencement of construction, but placed the mechanic's lien holders ahead of the Lantzes in respect to the second four thousand dollar payment which was made subsequent to the start of construction.²⁰

Sauter's lien was placed subordinate to the mechanic's lien as it was filed after construction was initiated. Furthermore, Sauter was

²⁰ Chief Justice Taft, concurring, was reluctant to accept the majority's ruling that the Lantzes should be afforded priority over the mechanic lienholders, to the extent of payments by the Lantzes previous to the commencement of construction. His caution was predicated on the fact that the mechanic lienholders did not have notice of the Lantzes' lien and there is no precedent for subordinating a mechanic lienholder in this situation. In addition, he was apprehensive of establishing this priority under this fact situation. His viewpoint was based on the observation that enough money was realized from the sale of the real estate and partially completed residence to pay both the Lantzes and the mechanic lienholders the entire amounts owed to them. As a result, neither side had presented significant arguments as to whether they should be afforded priority. The question of priority between these two claimants was not really in issue as both parties clearly would be paid in full no matter how the priority scheme between them was resolved. *Wayne Bldg. & Loan Co. v. Yarborough*, 11 Ohio St. 2d 195, 222, 228 N.E.2d 841, 859 (1967).

positioned above Wayne on the rationale that, although Wayne's mortgage was filed sooner, Wayne did not make the disbursements until after December 11. Therefore, Wayne's recorded mortgage did not secure a lien until advances were actually made. Conversely, Sauter had given value before his mortgage was filed, that is, when he forwarded the deed to the property, so his lien was given priority.

Wayne argued that its mortgage was a construction mortgage and that according to section 1311.14 of the Ohio Revised Code, it should be allowed priority over mechanic's liens filed for record after the construction mortgage was filed for record. The court said, however, that the advances which Wayne made were not obligatory. It explained that Wayne was not required by its mortgage loan to make payments of specific amounts to certain people at definite times, but rather was to pay out up to a maximum of 22,000 dollars in the manner and at times it felt was proper. The court continued by stating that where payments are not obligatory and, absent the establishment of compliance with the disbursement requirements as designated by section 1311.14 of the Ohio Revised Code, or proof that the advances made were actually used in the construction for which the liens were given, mortgages contemplating future advances are subsequent in priority to mechanic's liens arising from the construction.

The result reached by the court in *Yarborough* can be explained on the grounds that it is a judicial solution to a problem created by a certain practice which has gained popularity in the construction industry. A contractor presents his plans for the construction of a house to a lending institution and negotiates a construction loan which is secured by a mortgage on the proposed building and the property which is to be the site of the building. After receiving the money, instead of applying it to the construction for which the advance was made, he utilizes the money to meet past obligations which are due from other transactions in which he was a participant. If the contractor continues to be financially successful, he completes the construction when other obligations owing to him are met. The difficulty arises, however, in situations where the contractor has over-extended himself and is not capable of completing the construction for which the loan was given. A sale of the uncompleted structure is necessary, and the proceeds of this sale are not sufficient both to compensate the laborers and materialmen and repay the loan to the construction lender. The decision in *Yarborough* is directly responsive to the question of who should be given preference in these circumstances, with the court indicating that it is incumbent upon the

construction lender to insure that the loan proceeds are applied to the construction.

This burden is placed on the mortgage lender because he is in control of the money and his close scrutiny of its disbursement will result in completion of the construction. If the construction is completed, the problem of lien priority will be nonexistent. This conviction of the court is well illustrated by the following excerpt from its opinion:

If his estimate of the value of the improvement is accurate, and he sees to it that the money advanced is actually used in the construction of the improvement, the mechanics and the materialmen will be paid; there will be no valid mechanics' liens; the value of the security will be enhanced; and the mortgagee can get back the money he advanced upon foreclosure and sale of the security, if that is necessary, *without the necessity of being held prior to mechanics' lienors*. Since the mortgagee has the option of advancing or not advancing, and he may by due diligence insure that the money advanced inures to the benefit of his security before he advances, it is only just that he should bear the burden of any loss which he could have prevented, in contrast to a mechanic's lienor who has enhanced the value of the mortgagee's security by his labor or goods and who exercises the diligence which the law requires from him and pursues his only remedy by following the statutory procedure to obtain his lien.²¹

Even if one is convinced that the holding in *Yarborough* brings about an equitable result, it must be recognized that the court engaged in an unnecessary disregard of precedent.

A review of the decision reveals that the requirements for meeting the test of "obligatory" have been significantly magnified. In *Kuhn v. Southern Ohio Loan & Trust Co.*,²² the court ruled that the loan in question was obligatory. Their decision was grounded on the inclusion of the following statutory covenant quoted from the loan agreement:

"This mortgage is given to improve the premises described herein, to pay off prior incumbrances thereon and the mortgagor hereby consents and agrees with the mortgagee that the funds secured by this mortgage may be paid out by the mortgagee as provided in Section 8321-1 [now section 1311.14 Ohio Revised Code] of the General Code Ohio."²³

²¹ *Id.* at 218, 228 N.E.2d at 857.

²² 101 Ohio St. 34, 126 N.E. 820 (1920).

²³ *Id.* at 34, 126 N.E. at 820.

The court reasoned as follows:

In the present case the record does not disclose an obligation in terms on the part of the mortgagee to advance to the mortgagor the amount specified in the instrument. However, the purpose of the loan as stated in the mortgage itself was "to improve the premises described [and] to pay off prior incumbrances thereon," and it is expressly agreed between the parties that "the funds secured by this mortgage may be paid out by the mortgagee as provided in Section 8321-1 of the General Code of Ohio," this is to say, to mechanics and materialmen. Under these stipulations, and in the absence of other evidence, an inference of fact arises that the mortgagee obligated itself for the purposes and in the amount stipulated.²⁴

Clearly, the inclusion of the statutory covenant, which was held sufficient to constitute an obligation in *Kuhn*, is no longer an adequate safeguard that may be employed to insure that the loan will be considered obligatory. Now the requirement is the presence of an existing obligation at the time the mortgage is executed to pay certain sums upon certain conditions. While not expressly overruling *Kuhn*, the decision in *Yarborough* indicated the existence of "other evidence" which was sufficient to outweigh the "inference of fact" arising from the inclusion in the mortgage of the statutory covenant. As there will always be "other evidence" which can be used to counterbalance the "inference of fact," it is evident that the requirements of an obligatory loan have actually been significantly increased.

Even though the construction loan in *Yarborough* arose before construction commenced, the court displayed no reluctance in applying section 1311.14. The application of the statute under these circumstances is in direct conflict with the unanimous position of a continuous line of cases. These cases have held that this statute does not apply to loans executed previous to the commencement of construction. As recently as 1961, it was held that this statute's scope was limited to the extent that it protected only lenders who make construction loans after construction on the property had commenced. In *A. G. Sharp Lumber Co. v. Manus Homes, Inc.*²⁵ the court was confronted with the problem of whether this statutory provision was applicable to a construction loan and the mortgage securing it when the loan was made previous to the beginning of construction. The court ruled in no uncertain terms that section 1311.14 was not concerned with the priority of a mortgage filed for

²⁴ *Id.* at 38, 126 N.E. at 821-822.

²⁵ 90 Ohio L. Abs. 421, 189 N.E.2d 447 (Ct. App. 1961).

record before construction has started and consequently has no bearing on this type of mortgage.

This court's interpretation of the statute appears correct upon considering the purpose for which this legislation was adopted. The court in *Rider v. Crobaugh*²⁶ explained the impetus behind the passage of section 1311.14 by examining the priority status of construction mortgages prior to its enactment. In 1913 the Ohio legislature adopted a statute which provided that the liens obtained by various individuals on the same job should be preferred to a mortgage recorded subsequent to the commencement of the construction. Therefore a construction mortgage lender who made a loan subsequent to when the first work was done would be junior to all mechanic lienors who ultimately provided labor or materials for the job. Naturally construction lenders were reluctant to make a loan when confronted with this highly unfavorable priority scheme and as a result, if a contractor's financial resources were inadequate to meet the needs of the construction project, the building operations were stopped entirely. Two years later, in order to combat this problem the legislature passed section 8321-1 General Code (now section 1311.14 of the Ohio Revised Code). It is therefore apparent that the legislative motivation behind the enactment of section 1311.14 was the desire to encourage mortgage lenders to make loans of this nature in order that construction could be completed. As a result, all parties having an interest in the property would receive a larger share of that to which they were entitled.

The view adopted in *A. G. Sharp Lumber Co.* is also buttressed by the fact that the statute serves no function in respect to construction loan mortgages filed previous to the commencement of construction. Even previous to the adoption of this statutory provision, a construction mortgage filed before any construction had begun was afforded priority to subsequently filed mechanic's liens.

In refusing to afford priority to Wayne's mortgage, which was found to be non-obligatory, the court adopted an approach that is unique when contrasted to the rationale utilized in analogous cases. The *Yarborough* court's reasons for favoring constructive notice apparently do not derive from analysis of the proper functioning of the recording system. While the court first holds the Wayne mortgage is properly recorded, it then states that the question is whether

²⁶ 100 Ohio St. 88, 125 N.E. 130 (1919).

such prior recordation entitles the Wayne mortgage to priority.²⁷ This is the same question posed by *Ladue*²⁸ and, to some extent, *Spader*.²⁹ Instead of discussing the effect of recordation, the *Yarborough* decision discussed the result of giving effect to recordation. The court, primarily concerned with reaching an equitable result, reasons that no loss would have resulted to either of the parties if the funds had been disbursed in accordance with section 1311.14 or had been actually used in the construction. If such procedure was followed, the construction mortgagee would not need to be prior to the intervening mechanic's lienors to preserve his security, because the mechanics and materialmen would have been paid from the loan proceeds.³⁰

When the court discusses notice, it has already arrived at a solution to the problem of what effect to give to the construction mortgagee's prior recordation. Two reasons are given for retaining Ohio's rule charging the holder of a mortgage contemplating future advances with constructive notice of intervening encumbrances. First, the constructive notice given by the reasonably apparent commencement of construction a relatively objective test, similar to record notice, when compared with the subjective determination of the mortgagee's actual knowledge. Second, if the mortgagee is under a duty of diligence to see that the loan proceeds are disbursed in accordance with section 1311.14 or actually used in construction, knowledge of the commencement of construction is imperative to the discharge of such duty.³¹

If the court had adopted the majority rule requiring actual notice, the mortgagee, who has no actual notice of the intervening mechanic's lien, could make discretionary advances to the mortgagor. This would result in mechanic's lienors bearing the entire loss if the fund were not used in the construction or disbursed in accordance with section 1311.14. The court argued that the mechanic's lienors, who followed their only remedy by perfecting their liens under section 1311.13, should be accorded priority. But the construction mortgagee could have avoided this result by contracting to make

²⁷ *Wayne Bldg. & Loan Co. v. Yarborough*, 11 Ohio St. 2d 195, 213, 228 N.E.2d 841, 854 (1967).

²⁸ *Ladue v. Detroit and Milwaukee R. R. Co.*, 13 Mich. 380 (1965).

²⁹ *Spader v. Lawler*, 17 Ohio 371 (1848).

³⁰ *Wayne Bldg. & Loan Co. v. Yarborough*, 11 Ohio St. 2d 195, 218, 228 N.E.2d 841, 857 (1967).

³¹ *Id.* at 219-220, 228 N.E.2d at 858.

obligatory advances or by disbursing the loan proceeds in accordance with section 1311.14. Both alternatives available to the construction mortgagee would have given him adequate security for his loan.³² Therefore, it is evident that the majority and minority rationales consider notice in different contexts.³³ The *Yarborough* decision predicates its discussion of notice upon the availability to the lien claimants of alternative methods of protecting their security. This reasoning led the court to the equitable selection of a construction mortgagee as a better lien claimant to bear the loss. The court's resolution appears to coerce the construction mortgagee, whose mortgage secures optional advances, to disburse the loan proceeds in accordance with section 1311.14 or to see that they are actually used in the construction. The construction mortgagee can avoid this duty by entering into a contractual agreement with the mortgagor obligating himself to advance definite sums under certain conditions.³⁴ The court's construction of section 1311.14 appears to be in conflict with the ruling in *Rider v. Crobaugh*³⁵ that a construction mortgage filed before construction began does not obligate the mortgagee to disburse advances in accordance with section 1311.14. The construction mortgage considered in *Rider* did not contain the statutory covenant.³⁶ It is possible to argue that the inclusion of the covenant in the mortgage is a contractual assumption³⁷ of the duty to disburse in accordance with section 1311.14. However, several Ohio lower court decisions, without extensive discussion, have held a construction mortgage including the statutory covenant superior to a subsequent mechanic's lien on the authority of *Rider*.³⁸

The court could have disposed of the construction mortgagee's claim for priority without going into a discussion of the detrimental effect which the granting of such priority would have on mechanic's lien holders. By simply utilizing its past decisions, which espoused

³² *Id.* at 218, 228 N.E.2d at 857.

³³ *Tapia v. Demartini*, 77 Cal. 383, 19 P. 641 (1888); see Note, *The Open-End Mortgage in Ohio*, 25 U. CIN. L. REV. 82, 83 (1956).

³⁴ *Wayne Bldg. & Loan Co. v. Yarborough*, 11 Ohio St. 2d 195, 200, 228 N.E.2d 841, 858 (1967).

³⁵ 100 Ohio St. 88, 125 N.E. 130 (1919).

³⁶ *Id.* at 89, 125 N.E. at 131. The statutory covenant which is referred to is the same covenant which was the basis on which the advance was held obligatory in *Kuhn v. Southern Ohio Loan & Trust Co.*, 101 Ohio St. 34, 126 N.E. 820 (1920).

³⁷ *In re Williams*, 252 F. 924, 930 (N.D. Ohio 1918).

³⁸ *Commerce-Guardian Bank v. Catawba Cliffs Beach Club*, 54 Ohio App. 437, 7 N.E.2d 830 (1936); *Becker v. Wilson*, 30 Ohio App. 340, 165 N.E. 108 (1929). See also *In re Taylor*, 20 F.2d 8 (6th Cir. 1927).

a doctrine that prior recordation of a mortgage securing non-obligatory advances was not effective against subsequent mortgages, the court could have avoided the creation of a theory of priority which depends on a consideration of the various manners in which the competing mortgagees could have secured their loans. The facts in *Yarborough* could have been considered as consisting of two problems: The first problem is the effect to be given to the prior recordation of a mortgage securing non-obligatory advances. The theory that the mortgage secures a debt of *Spader* and *Boyle* when applied to the facts of *Yarborough* results in the attaching of the mechanic's liens before the lien of the construction mortgage. The second problem is the relative priority of the lien claimants in a situation where the construction mortgagee claims he has qualified under section 1311.14. The court could have ruled that section 1311.14 would not apply because the construction mortgage was not effectively filed for record previous to the filing of the mechanic's lien. This decision could have been predicated on the court's construction of section 1311.14 as designating that construction mortgages contemplating optional future advances do not take effect as a valid lien on the premises until such advances are made on the faith of the mortgage.

This approach seems preferable to the one adopted. By emphasizing the importance of obtaining an equitable distribution of the loss occasioned by the mortgagor's default, the court failed adequately to integrate precedent in its *ratio decidendi*. The decision, which seems just and equitable, could have been derived more explicitly from the rationale of *Spader*, *Kuhn* and *Boyle*. The court, however, chose to discuss alternative methods available to the construction mortgagee to secure his loan. Logically the availability of these alternatives or the purpose for which the loan proceeds are used should not be determinative of the effect which should be given to recordation. However, under the present law these considerations are determinative of the question of priorities between mechanic's lienors and the subsequently recorded construction mortgage under section 1311.14 in Ohio.

V. THE PRACTICAL RAMIFICATIONS OF THE YARBOROUGH DECISION

Although legal academicians are doubtlessly amused by the exercise of pointing out the logical fallacies in the court's opinion, this activity has limited value. The remainder of this article will consider some questions concerning construction mortgages which have not yet been litigated, followed by a consideration of the safe-

guards which should be utilized by construction lenders in the future.

The court's holding in *Yarborough* assures a mortgagee of top priority if his advances are actually used in the improvement of the property.³⁹ A problem of great practical consideration which remains unanswered, however, is whether a narrow or broad connotation will be applied to the clause "used in the improvement." In light of the court's ruling that section 1311.14 encompasses construction loans executed previous to the commencement of construction, it is evident that the proceeds of the loan will be used to meet expenditures whose characteristics are of such a nature that it is questionable whether or not they are "used in the improvement." Architects' fees, which necessarily arise from the planning and formulating of blueprints of the proposed building, and surveyors' fees, which are charged for the determination of the property boundaries, are two examples of these questionable expenditures. Both of these items, although not strictly part of the construction itself, are necessary prerequisites to the initiation of construction. A determining factor in the future judicial interpretations of the scope of the clause "used in the improvement" will be a consideration of the purpose for which the statute was enacted. As previously discussed,⁴⁰ courts have generally accepted the proposition that the intent of the legislature was to provide a mechanism which would stimulate lenders to make loans in situations where the construction could not be completed unless additional working capital was obtained. The courts' holdings have generally reflected the preferential treatment which the legislature designated for this type of lender. Any prophecy concerning whether the courts will develop a favorable attitude towards construction loans made previous to the beginning of construction would be purely conjectural. It appears logical, however, that if these loans are to be encouraged, the interpretation of the clause "used in the improvement" will be broad enough to encompass architects' fees, surveyors' fees and other similar expenses. The mortgage lender realizes that a survey of the land and the utilization of an architect are required to construct a building. He is therefore cognizant of the fact that some of the money which he loans will be used for that purpose. If the lender is not given priority in respect to these expenditures, the likelihood of his making a loan is lessened.

³⁹ *Wayne Bldg. & Loan Co. v. Yarborough*, 11 Ohio St. 2d 195, 219, 228 N.E.2d 841, 857 (1967).

⁴⁰ See notes 30-31, *supra* and accompanying text.

From a practical standpoint, it also seems consistent with the theory of priorities to treat these expenses as though they were "used in the improvement." The value of the property is enhanced by these expenditures and therefore the mechanic's lienholder is not damaged by the granting of priority in respect to these expenses. This situation can be contrasted to the circumstance where a mortgagee gives money to the borrower and obtains a priority to the extent of the amount paid, and the borrower does not utilize the money for the construction. The impetus behind the demand that the money be "used in the improvement" is to avoid placing the mechanic's lienholder in an inferior position by granting priority to a mortgagee when in fact the money he advanced did not increase the value of the construction property.⁴¹

A question of similar import is whether priority will be granted to the lender for the discount or service fee which he charges for making the loan. In conjunction with the above discussion, it does not seem improbable that a lender would be reluctant to make a loan if he is denied priority as to his profits on the transaction. One might argue, therefore, that in order to motivate lenders to make these loans, courts ought to extend the priority to the percentage of the loan which the mortgage lender retains as the cost for making the loan. But unlike architect's and surveyors' fees, the problem of the lender's profits is not a question of first impression. The court in *Burrer v. Keystone Construction & Loan Co.*,⁴² when considering whether priority should be granted to the lender on the percentage of the loan which he designated profit, remarked that they found no statutory authority for the payment of the lender's costs out of the funds made available under a section 8321-1 General Code (the predecessor of section 1311.14 Ohio Revised Code) loan. The pertinent statutory provision reads as follows:

Such mortgage is a lien on the premises therein described from the time it is filed for record for the full amount that is ultimately and actually paid out under said mortgage, regardless of the time when the money secured thereby is advanced.⁴³

Similarly in *Simpson v. Lewis*⁴⁴ the lender deducted five percent from the mortgage loan, retaining such amount as a service charge.

⁴¹ *Wayne Bldg. & Loan Co. v. Yarrowborough*, 11 Ohio St. 2d 195, 218, 228 N.E.2d 841, 857-58 (1967).

⁴² 19 Ohio L. Abs. 393 (Ct. App. 1935).

⁴³ OHIO REV. CODE ANN. § 1311.14 (Page 1962).

⁴⁴ 23 Ohio L. Rep. 297 (C. P. 1925).

The court refused to grant priority due to the fact that the five percent was not "actually paid out under such mortgage." The rationale for the position that the lender should not be granted priority is basically statutory. The fact that the money actually never leaves the hands of the lender is fatal.

This problem could conceivably be avoided by careful manipulation of the loan funds. The mortgagee could pay the amount of the service charge out of the mortgage fund to the borrower. Subsequently, the borrower could pay an identical amount back to the lender. But courts will probably recognize that this is only a meaningless exchange of the funds, and it is dubious that they will consider this as satisfying the requirement of "paying out" the funds. Furthermore, courts may hold the money was not "used in the improvement" of the property, even though it is clear that the obtaining of a loan is in furtherance of the construction.

The transactions in *Yarborough* arose in 1963, and thus prior to the adoption of any open-end mortgage legislation in Ohio. Clearly, the open-end mortgage can be utilized to effect a transformation in the scheme of priorities which existed previous to the adoption of the open-end mortgage statute.⁴⁵ Before the enactment of this statute, a mortgagee making non-obligatory advances occupied a perilous position. Regardless of when his mortgage was filed, it was not a lien on the premises until an advance was made and even then it was only a lien to the extent of the payments actually made. Thus if construction was commenced before the mortgagee made any advances, all the individuals entitled to mechanic's liens on the premises would be senior to the mortgage lender as their liens are deemed to have attached at the time construction was initiated. Furthermore, even if he had made advances before the beginning of construction, any advances made subsequent to this date would be subsequent in priority to the mechanic's liens. Under the new open-end mortgage act, the priority scale is different. If the formal requisites of the open-end mortgage are met, a mortgage for non-obligatory future advances becomes a lien on the premises as of the date the mortgage is recorded. A subsequent mortgagee or a mechanic's lienholder can gain priority only by serving actual notice of their liens on the non-obligatory mortgagee. A mortgage lien is subordinate to these liens only to the extent that he is not obligated to make advances at the time he receives such notice. The major effect of this statute is to postpone the time at which a lien becomes effective against a non-

⁴⁵ OHIO REV. CODE ANN. § 5301.232 (Page Supp. 1967).

obligatory mortgagee who has met the requirements of the open-end mortgage statute. Under this system, instead of the mechanic's liens attaching as of the date construction commences, they do not attach until the non-obligatory mortgagee gets actual notice of their existence. Likewise, other subordinate liens are not effective as of the date they are filed; rather, they acquire priority only to the extent that non-obligatory advances are made by the mortgagee after he receives actual notice of these liens.

However, the significance of this statute in respect to the construction mortgage should not be over-emphasized. Practical considerations lead one to doubt the sagacity of lending under a non-obligatory open-end mortgage. Although the mortgage will be afforded priority to the extent of advances made prior to the receipt of actual notice of subsequent liens, when construction is involved notices of work and labor to be performed and materials to be furnished will be forthcoming in the near future.

VI. ALTERNATIVE METHODS BY WHICH PRIORITY CAN BE ACCOMPLISHED

There are several procedures which a prospective construction mortgage lender should employ to insure that his mortgage will maintain superiority.

A. *The Equitable Vendee Lien Problem*

The first caveat is that Yarborough decided that an individual possessing an equitable vendee's lien will be granted priority over a construction mortgagee who knows that the borrower has entered into a contract for the sale of the real estate. The priority extends to all payments made by the vendee prior to the time when he obtains actual notice of the construction lender's mortgage. This priority problem can be alleviated by including a clause in the construction mortgage to the effect that the borrower states he has not entered into a contract for the sale of the real estate and he will not negotiate such a contract without notifying the construction lender. Additionally, this clause should require that the notice of the prospective contract of sale will contain the name and address of the future purchaser. This clause will insure that the lender will not be presumed to have had knowledge of the contract for the sale of the real estate. Furthermore, since the borrower is bound to notify the lender before the execution of any contract for the sale of the real

estate, an opportunity will be afforded to the lender to give actual notice of his mortgage to the prospective purchaser. It should be noted, however, that in a great many cases a construction lender will not find it desirable to obtain a statement from the borrower that the borrower has not sold the property. On the contrary, many lenders require that the borrower have a buyer before they will negotiate the loan. This is due to their belief that only when the borrower has sold the real estate are they adequately assured the loan will be repaid. This belief is predicated on the fact that a certain number of contractors and builders build a large number of houses and then encounter difficulty in selling them. Their creditors become impatient and the houses are sold at foreclosure sales. This action results in the houses bringing an extremely low price, and consequently, the lender as well as other creditors receive only partial recompense. There is an alternative solution to the problem of vendee's liens when the lender prefers to lend only if the borrower has sold the real estate. The lender should inform the borrower that he will make loans only if the borrower has included in his contract to sell the real estate a clause stating that the purchaser is cognizant of the fact that a construction loan will be necessary for completion of the residence, and that he agrees that his equitable vendee's lien shall be subordinated to the mortgage which secures the construction loan.

In order to obtain priority over mechanic's lienholders, it appears there are three alternatives available to the construction lender: (1) clearly emphasize in the loan agreement that the advances are obligatory, or (2) establish that the advances were actually used in the construction for which the liens are claimed, or (3) demonstrate that the advances were disbursed in conformity with the provisions of section 1311.14.

B. *Obligatory Advances*

The obligatory nature of a loan can be emphatically established by the utilization in the loan agreement of words which indicate the assumption of a binding contractual obligation to make definite payments of sums certain at specific times. Careful draftsmanship should be practiced to insure that the instrument does not contain language which could be interpreted as granting discretion to the lender concerning the amounts to be advanced. The incorporation of a disbursement schedule into the loan agreement would be a wise precautionary measure. This schedule should state the amounts that

will be advanced at various structural stages as the construction progresses.⁴⁶

A thorough discussion of obligatory advances necessitates the recognition of a distinction that is not clear from the opinion as expressed in the *Yarborough* decision; a distinction which if overlooked would prove fatal to the construction mortgage lender. A lender who makes his construction loan advances obligatory secures a position equivalent to the mortgagee whose advances are actually used in construction or who disburses in accordance with section 1311.14 only under circumstances where the mortgage securing the construction loan is filed previous to the commencement of construction. Due to the fact that all mechanic's liens attach at the time construction begins, except with respect to mortgagees who qualify under section 1311.14, even a mortgagee whose advances are obligatory is subordinate to these liens if he does not satisfy the requirements of section 1311.14. It is therefore clear that the three alternatives as set forth in *Yarborough* are only equivalent alternatives under the *Yarborough* fact pattern, *i.e.*, when the mortgage is recorded preceding the commencement of construction.

C. *Advances Actually Used in the Improvement*

The priority afforded to the mortgagee for advances made which were actually used in the construction should not be relied on to any large degree. Although this priority may be advantageous when the question of priority is examined in retrospect, there is in reality no way of policing the activities of the borrower to insure that the advances are employed in the furtherance of the designated construction. There is no method by which one can prevent the borrower from using the money for other purposes if it is paid directly to him. Therefore, although this priority should be argued in litigation there is no systematized procedure that can be integrated into a comprehensive planning pattern which can assure the lender in advance that the amounts paid will be used in the construction and the accompanying priority received.

D. *Disbursements Pursuant to Section 1311.14*

The third alternative which can be employed to obtain priority is for the lender to make disbursements in conformity with section 1311.14. As previously mentioned, this section authorizes a lender to withhold payments from the mortgage loan, which are sufficient to

⁴⁶ See *Akron Sav. & L. Co. v. Ronson Homes, Inc.*, 15 Ohio St. 2d 6, 13, 238 N.E.2d 706 (1968).

cover any notices, which the lender receives, of labor or materials furnished or to be furnished. Under this alternative, the lender has a relatively simple task of informing the borrower that certain amounts will not be advanced until the borrower has ordered that these laborers and materialmen be paid. Requirements of this disbursement section can be met without difficulty, but it is obvious that the lender's maintenance of records of laborers and materialmen becomes a job of major importance.⁴⁷

Irrespective of the mortgage lender's diligence in meeting the requirements of the above alternatives, it is important to note that if his mortgage is filed after the construction commences, it will only be superior to those laborers and materialmen who have not participated in the construction as of that date. For this reason, the lender should take measures to insure that these individuals situated above him in the priority hierarchy are satisfied. This goal could be achieved by making provisions in the loan agreement to pay off these prior encumbrances, or more simply by the lender retaining amounts sufficient to cover these liens from the mortgage fund. As an additional alternative the lender could negotiate with these mechanic's lienors and reach an agreement with them that their liens would be subordinate to his. Although these prior lienors would be reluctant to relinquish their priority, the lender occupies a strong bargaining position if his loan is necessary to complete the construction.

VII. CONCLUSION

The *Yarborough* decision has already exerted a considerable influence on the construction lending industry and promises to continue as a dominant concern to construction lenders in the future. Although *Yarborough* does not present a crystal clear answer to several of the problems, and will necessarily be subject to buffering by subsequent cases, certain principles do emerge from the decision.

⁴⁷ It is significant to note that the standard practice in the construction lending industry is to include a loan disbursement agreement in the mortgage instrument. The court in *Yarborough*, in the course of examining the obligatory or non-obligatory nature of Wayne's advances, appeared to attach considerable weight to the absence of any such schedule in the transaction that was under scrutiny.

It was specifically found by the Court of Appeals that there was no agreement between the Yarboroughs and Wayne that was not contained in the mortgage, note, assignment of funds, or agreement with respect to mechanics liens, and perhaps the loan application. While these reveal that the purpose of the advances was to construct a house, they reveal no obligation on the part of Wayne to advance a certain sum, under particular conditions, for this purpose.

¹¹ Ohio St. 2d at 221, 228 N.E.2d at 858.

Initially, it is evident, at least at this time, that section 1311.14 of the Ohio Revised Code is applicable to construction mortgage loans filed prior to the commencement of construction in addition to situations where some work has been performed before the construction mortgage was filed. Irrespective of the presence of an abundance of cases reaching a contrary result and even though the legislature did not appear to intend to include within the scope of the statute lenders who filed their mortgages before the start of construction, *Yarborough* expressly ruled that these lenders are encompassed by the statute.

The *Yarborough* decision also establishes that a prospective construction lender has three methods by which he can preserve priority for his mortgage. He may make his advances obligatory, police the money paid out to make sure that it is actually used in the construction or make the advances in conformance with the disbursement requirements of section 1311.14. As demonstrated earlier, these three alternatives are not equally effective and their individual utility will vary with various circumstances. The chameleon-like definition of "obligatory," the difficulty of producing evidence sufficient to establish that the amounts were actually used in construction, and unforeseeable disbursement errors perpetuate uncertainty in this area. Therefore, it seems safe to predict that the intelligent lender will adopt a construction mortgage procedure that will encompass as many characteristics of all three alternatives as is possible.

The Ohio open-end mortgage statute, which was not effective at the time the *Yarborough* case arose, should also be considered by a lender who engages in the business of making construction loans. Under this statute, a person who makes a non-obligatory loan is afforded priority over all subsequently filed mortgages unless the subsequent mortgagee has notified him of the mortgage before the time he actually makes the advance. However, the utility of this statute appears limited, due to the fact that most lenders will not want to be placed in a position where they are subject to subordination in the event another mortgagee follows the relatively simple procedure of serving notice upon them.

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