BANK HELD LIABLE TO CONSTRUCTION MORTGAGOR FOR MECHANICS' LEINS RESULTING FROM NEGLIGENT DISBURSEMENT OF CONSTRUCTION LOAN

Falls Lumber Co. v. Heman
114 Ohio App. 262, 181 N.E.2d 713 (1961)

Heman executed an $11,000 construction mortgage to the North Akron Savings and Loan Association, hereafter called the Bank, to finance the construction of a house. The total cost of the house and lot was $17,500. The mortgage was recorded before the commencement of construction,[1] and contained provisions required of the type of mortgage contemplated by Ohio Revised Code section 1311.14.[2] The Bank required Heman to deposit $5,500 which was held in escrow with the $11,000 provided by the mortgage. An officer of the Bank orally assured Heman that the Bank "would take care of things" for him. After disbursement of all the funds and payment of the entire contract price, it was discovered that mechanics' liens had attached to Heman's property. The action in the instant case was brought to foreclose a mechanic's lien. All lien claimants were made parties. The Bank prayed for a judgment against Heman on the mortgage, and Heman cross-petitioned against the Bank for the sum he was compelled to pay for the construction of the house which exceeded $17,500.[3] The court of common pleas found the mortgage to be the first and best lien on the property. The court also found valid mechanics' liens totaling $5170.39. Since the full contract price of $17,500 had already been paid out, the mechanics' liens represented costs in excess of the contract price. The court held that the Bank was Heman's paid agent, and found that the Bank was liable in the amount of $5170.39. The court found that the Heman mortgage was within the purview of section 1311.14 because it was a construction mortgage containing the provisions required by the section.[4] The court further held that the failure of the

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[1] Brief for Appellee, pp. 7-8, in opposition to a motion to certify the record from the court of appeals. Falls Lumber Co. v. Heman, 114 Ohio App. 262, 181 N.E.2d 713 (1961).

[2] Mortgages contemplated by Ohio Rev. Code § 1311.14 must contain the correct name and address of the mortgagee, and a covenant between the mortgagor and mortgagee authorizing the mortgagee to do all things provided to be done by the mortgagee under the section. Falls Lumber Co. v. Herman, 88 Ohio L. Abs. 337, 342, 183 N.E.2d 265, 269 (C.P. 1960), *aff'd*, 114 Ohio App. 262, 181 N.E.2d 713 (1961); Rider v. Crobaugh, 100 Ohio St. 88, 97-99, 125 N.E. 130, 132-33 (1919); *In re* Williams, 252 F. 924, 929 (N.D. Ohio 1918).

[3] The discrepancy between the amount in the hands of the Bank, $16,500, and the total contract price, $17,500, is not explained. However, since there seems to be no question that the entire contract price was paid before the instant case arose, it is fair to say that Heman cross-petitioned for the sum he was compelled to pay in excess of the contract price.

[4] The Ohio mechanics' lien laws provide protection for the rights of mechanics

Bank to comply with section 1311.04[5] of the mechanics' lien laws was the proximate cause of Heman's loss.[6] The Bank appealed, but the court of appeals affirmed. A motion to certify the record was overruled by the Supreme Court of Ohio.

The instant case is the first Ohio decision holding a construction mortgagee liable to a construction mortgagor for costs in excess of the contract price. The nonfiduciary nature of the morgagee-mortgagor relationship explains the paucity of authority.[7] The collateral agency theory[8] appears to be the crux of the holding.[9] However, the opinion is misleading in several respects: (1) The court's consideration of the mechanics' lien laws was unnecessary in deciding the Bank's liability;[10] (2) and the opinion may sanction the unauthorized practice of law. The issue of unauthorized practice

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lienors, owners, and mortgagors. Ohio Rev. Code § 1311.14 was enacted specifically to protect the priority of mortgages recorded after commencement of construction. *Infra* note 18. The wording of the section reveals a conscious effort not to confuse the power given the mortgagee to protect his priority with an obligation to protect the owner. *Infra* note 19.

[5] Ohio Rev. Code § 1311.04 gives the owner immunity from being compelled to pay any greater amount than he contracted to pay the original contractor, provided he complies with its provisions. Magrish, "Disbursement of Ohio Construction Mortgage Loans," 12 U. Cinc. L. Rev. 1, 11 (1936).

[6] Falls Lumber Co. v. Heman, *supra* note 2, at 346, 183 N.E.2d at 270.

[7] Restatement (Second), Agency §§ 13, comment b; 14 (H) (1958).

[8] Iltis v. Gentilly, 234 Iowa 689, 13 N.W.2d 699 (1944). The construction mortgagee orally agreed to obtain receipted bills from subcontractors before disbursing the funds. All the disbursements were made on the written order of the owner which the owner signed after the bank assured him it was all right to do so. The mortgagee was held liable for the cost of mechanics' liens above the contract price when he disbursed the money without procuring the receipted bills. The Iowa court said that liability rested on a collateral agency which was distinct from and independent of the mortgage. A collateral agency was the basis of liability in the Ohio decision of Painter v. Twinsburg Banking Co., 84 Ohio App. 418, 87 N.E.2d 502 (1949). The mortgagee orally agreed to insure the mortgaged property. Under the written provisions of the mortgage, it was the mortgagor's duty to insure. When fire destroyed the mortgaged property, the court held that the mortgagee had become the agent of the mortgagor for the purpose of obtaining the insurance, and upon failing to do so, the mortgagee was responsible for the loss.

[9] The court in the instant case speaks of the duty of the Bank with reference to the money belonging to Heman (as distinguished from that loaned to Heman under the mortgage) as "much like that of a trustee engaged to hold and disburse funds of the trust estate." However, no distinction is made between the duty created by the collateral agency and that arising from disbursement of Heman's funds. The question arises whether either alone would support the holding in the instant case. It is interesting to note that the judgment against the Bank did not exceed Heman's deposit.

[10] Brief for Appellee, *supra* note 1, p. 7. Counsel on behalf of Heman states, "It really makes no difference as between the Bank and the Hemans whether or not this was the type of loan that was subject to the provisions of R.C. 1311.14." The appellee argued that the Bank's liability resulted from the disbursal of funds belonging to Heman and from a collateral agency.

of law is not mentioned in the opinion.[11] However, the court impliedly indorsed the agency, and held that the Bank should have protected Heman by exercising the powers of section 1311.04.[12]

The court determined that section 1311.14 of the mechanics' lien laws applied to the Heman mortgage. This holding is questionable. The term "construction mortgage" applies to any mortgage executed for construction purposes whether or not the mortgage is technically a construction mortgage under section 1311.14.[13] Section 1311.14 contemplates only those mortgages recorded after commencement of construction,[14] and only protects the priority of mortgages when they contain the provisions required by that section.[15] The Heman mortgage contained section 1311.14 provisions, but they were surplusage because the mortgage was recorded *before* the commencement of construction.[16] Furthermore, priority of a construction mortgage can be preserved under section 1311.14 only by disbursing funds according to its provisions. The court of common pleas found that the Bank did not disburse funds in accordance with section 1311.14, but still held that the Bank had the first and best lien on Heman's property.[17] These contradictory findings, coupled with the history[18] and wording[19] of section 1311.14, substantiate

[11] Counsel on behalf of the Bank, in defense of the Bank's inaction, argued that performance of the agency would have constituted the unauthorized practice of law. Brief for the Appellant, p. 14, in support of a motion to certify the record from the court of appeals, Falls Lumber Co. v. Heman, *supra* note 1.

[12] The court of appeals sustained the conclusion of the common pleas court that the Bank had agreed to protect Heman from claims which would increase the cost beyond the contract price. The court stated that the Bank "holds itself out to the community as skilled in conducting all phases of such transactions. This Bank surely knew the necessary procedure to preclude the establishment of mechanics' liens upon the house being constructed herein. Ohio Rev. Code § 1311.04 sets out in detail how money *is to be paid* out in cases such as we have herein, in order to prevent the obtaining of mechanic's liens by those supplying material or doing work on a construction project such as we have in this matter before us." Falls Lumber Co. v. Heman, *supra* note 1, at 264-265, 181 N.E.2d at 715. (Emphasis added.)

[13] 12 U. Cinc. L. Rev., *supra* note 5, at 1.

[14] *In re* Taylor, 20 F.2d 8, 9 (6th Cir. 1927); Rider v. Crobaugh, *supra* note 2, at 100, 125 N.E. at 134.

[15] Cases cited *supra* note 2; Fishman v. Helwig, 43 Ohio App. 530, 183 N.E. 883 (1932).

[16] *But see* Taylor, 16 F.2d 303 (D.C. Ohio 1926), *modified*, 20 F.2d 8 (6th Cir. 1927); See Rider v. Crobaugh, *supra* note 2, at 98-100, 125 N.E. at 133; 12 U. Cinc. L. Rev., *supra* note 5, at 6-7.

[17] Brief for Appellant, Appendix B. p. 2, *supra* note 11.

[18] Prior to 1913, the recording act, Ohio Gen. Code § 8542 (now Ohio Rev. Code § 5301.23) gave priority to all mortgages recorded before mechanics' liens. This was unfair to laborers and material men. In 1913 the mechanics' lien laws were amended giving priority to all mechanics' liens over any mortgage recorded after commencement of construction. 103 Ohio Laws 369, 376 (1913), amending Ohio Gen. Code § 8321 (now Ohio Rev. Code § 1311.13). This requirement was too harsh on lending institutions. In 1915, a new section of the mechanics' lien laws, the predecessor of present § 1311.14, was adopted empowering a construction mortgagee to obtain priority in spite of recording

the suggestion that the section is not applicable to the instant case.

The court held that the Bank's duty to Heman required it to comply with section 1311.04, and that failure to do so was negligent conduct. It is clear that the Bank did not specifically agree to protect Heman from loss by disbursing in accordance with section 1311.04. There are other methods by which this duty could have been discharged,[20] *e.g.*, the method suggested by *Iltis v. Gentilly*.[21] Section 1311.04 empowers a bank, as a mortgagee, to exercise its provisions.[22] However, a bank is entitled to exercise these powers only to protect the priority of its mortgage lien and not for the protection of the owner,[23] for had the Bank carried out the duties of the agency found by the court in the instant case, it would have been engaging in the unauthorized practice of law.[24]

The practice of law includes generally all advice to a client and all action taken for him by his attorney in matters connected with the law.[25]

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subsequent to commencement of construction. 106 Ohio Laws 522, 531 Ohio G. C. § 8321-1 (now Ohio Rev. Code § 1311.14). See Rider v. Crobaugh, *supra* note 2, at 98, 99, 125 N.E. at 133.

[19] Ohio Rev. Code § 1311.14 states:

> Sections 1311.01 to 1311.68, inclusive, of the Revised Code do not require the mortgagee to ascertain by affidavit or otherwise the respective claims of contractors, subcontractors, laborers or materialmen, or to determine priorities among lien claimants.
>
> The mortgagee is not responsible for a mistake of the owner in determining priorities, or for any failure of the payee properly to distribute funds paid on the written order of the owner.

While § 1311.14 seems to relieve the mortgagee from using the provisions of § 1311.04, it does not deny such use. 12 U. Cinc. L. Rev., *supra* note 5, at 18.

[20] Gosline, "The Ohio Mechanics' Lien Law," 1 Ohio St. L.J. 198, 205 (1935). The author suggests that the owner can be protected by obtaining waivers, causing the general contractor to post an indemnity bond, or deferring payment of part of the contract price until sixty days after the house is completed. In the instant case, the general contractor and the Bank had done business together for many years. It appears that the Bank had extensive control of the financial arrangements, for at the request of the Bank, the general contractor submitted a proposed schedule of payments to the Bank for approval. See Brief for Appellee, *supra* note 1.

[21] *Supra* note 8.

[22] When § 1311.14 was enacted to enable construction mortgagees to protect the priority of mortgages recorded after commencement of construction, *supra* note 18, § 1311.04 was also amended to empower mortgagees to use its provisions. 106 Ohio Laws 522 (1915). It has been suggested that it was the intention of the drafters that mortgages which failed to qualify for the protection of § 1311.14 because of failure to include the required provisions, *supra* note 2, could be protected by the exercise of § 1311.04 powers. *Infra* note 23. 12 U. Cinc. L. Rev., *supra* note 5, at 19.

[23] Where a mortgage is recorded after construction commences, exercising the provisions of § 1311.04 will protect the priority of the mortgage lien to the same extent that it protects the owner, and accrual of the benefit to the owner would be irrelevant.

[24] This conclusion is not supported by direct authority, but notes 25-29, *infra*, give it credence.

[25] *In re* Droker, 59 Wash. 2d 707, 719, 370 P.2d 242, 248 (1962); State Bar Ass'n

The legal nature of the service and not its complexity determines whether or not the performance of the service constitutes the practice of law.[26] Counsel employed by a corporation or an association may only furnish legal services which are beneficial in the prosecution of the corporation's approved business.[27] A corporation cannot render legal services to others.[28] The common pleas court in the instant case found that Heman had a right to rely upon the Bank to advise him when to give his order for disbursement of funds.[29] If the Bank had expressly undertaken to give such advice, it could not have been responsibly given without prior appraisal of Heman's contract with the contractor and the legal validity of the affidavits and certificates releasing all claims of materialmen and subcontractors.[30] The performance

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of Conn. v. Conn. Bank & Trust Co., 145 Conn. 222, 234-235, 140 A.2d 863, 870 (1958): "The practice of law . . . embraces giving legal advice on a large variety of subjects and the preparation of legal instruments covering an extensive field." See also Land Title Abstract & Trust Co. v. Dworken, 129 Ohio St. 23, 28, 193 N.E. 630, 652 (1934).

[26] State Bar Ass'n of Conn. v. Conn. Bank & Trust Co., 21 Conn. Supp. 42, 50, 144 A.2d 347, 351 (1958).

[27] Arkansas Bar Ass'n v. Union Nat'l Bank, 224 Ark. 48, 57, 273 S.W.2d 408, 413 (1954).

[28] State *ex rel.* Green v. Brown, 173 Ohio St. 114, 180 N.E.2d 157 (1962); Judd v. City Trust & Sav. Bank, 133 Ohio St. 81, 88, 12 N.E.2d 288, 293 (1937); Land Title Abstract & Trust Co. v. Dworken, *supra* note 25, at 30, 193 N.E. at 653; In re Battelle Memorial Institute, 84 Ohio L. Abs. 161, 168, 170 N.E.2d 774, 782 (1960). In State Bar Ass'n of Conn. v. Conn. Bank & Trust Co., *supra* note 25, at 234, 140 A.2d at 870, the Connecticut Supreme Court of Errors, after reviewing the qualities required of an attorney, stated: "Only a human being can conform to these exacting requirements. Artificial creations such as corporations or associations cannot meet these prerequisites . . . ."

[29] It must be remembered that the Bank at no time intended or apprehended the agency relationship. The court inferred the agency on the basis of the Bank's statement, *infra* note 31, the Bank's superior knowledge concerning construction loans and the mechanics' lien law, and its holding out to the community that it possessed such knowledge. The common pleas court remarked ". . . The Court takes the view that when the Defendant Bank called to acquire Heman's consent it impliedly represented to the Hemans that all things were done that reasonably should have been done to protect Heman's interest from mechanics' liens and the Hemans had the right to rely upon this premise, which they did. And if such were not done by the Defendant Bank, then the Bank owed the Hemans the duty of telling them so, otherwise as in this case, the oral consent by Heman authorizing payment meant nothing as protecting the Bank." Falls Lumber Co., v. Heman, 88 Ohio L. Abs. 337, 345, 183 N.E.2d 265, 270 (C.P. 1960).

[30] Drafting affidavits was generally held to be the practice of law in *In re* Small Home & Land Owners Federation, Civil No. 360395, C.P. Cuyahoga Cty, Ohio, Sept. 7, 1934. Drafting instruments which release legal rights for or without pay was held to be the practice of law in State Bar of Oklahoma v. Farmers & Merchants Bank of Arnett, Dist. Ct., Ellis Cty, Okla., 1936. Excerpts of both these opinions are found in Brand, Unauthorized Practice Decisions 268, 545 (1937). Since drafting affidavits or releases of legal rights is the practice of law, advice on the legal significance of these instruments is quite likely the practice of law.

of these services, being for Heman's benefit and not for the benefit of the Bank, very likely would have constituted the unauthorized practice of law.

The instant case is a warning to lending institutions to exercise caution when negotiating construction loans. Casual assurances made to prospective construction mortgagors may create collateral agencies which may amount to the unauthorized practice of law.[31] Written consent to pay out funds should always be obtained.[32] However, written consent alone may not prevent a court from implying a collateral agency where circumstances parallel those of the instant case.[33] Therefore, it is desirable that requests for written consent to pay contain notice of the mechanic's lien hazard, and that the written consent expressly acknowledge a bank's nonliability.[34] The collateral agency may be avoided most effectively by insisting that the construction mortgagor employ private legal counsel. The court will be hard-pressed to find a lending institution responsible for protecting a construction mortgagor from mechanics' liens when the construction mortgagor has employed private legal counsel for that purpose.

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[31] Brief for Appellee, *supra* note 1, p. 4. The Bank told Heman "It would take care of things" and "You let us handle and pay out this money and everything will be all right."

[32] This is particularly true if the mortgage is one contemplated by Ohio Rev. Code § 1311.14. See quote, *supra* note 19.

[33] *Supra* notes 8 & 29.

[34] *Supra* note 29. Note especially the court's reference to the Bank's duty to tell Heman that no steps had been taken to protect him from mechanics' liens.