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Priority of Liens Between Construction Mortgagee and Mechanic's Lienors; Wayne Building & Loan of Wooster v. Yarborough

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RECENT CASES

MECHANICS' LIENS—MORTGAGES—Priority of Liens Between Construction Mortgagee and Mechanic's Lienors.

Wayne Building & Loan of Wooster v. Yarborough, 11 Ohio St. 2d 195, 228 NE2d 841. (Ohio, 1967)

Yarborough, a builder, contracted to sell D.L. a lot and construct a house thereon. After purchasing the lot from the subdivision developer, he applied to Wayne Building and Loan Company for a mortgage loan of $22,000 to enable him to construct the house. After approving the plans for the house, Wayne granted the loan, and Yarborough executed a promissory note and mortgage deed on October 31, 1963. The mortgage was recorded on the following day. Construction of the house began on November 21, 1963, and Wayne made disbursements of $18,500 toward the amount of Yarborough's loan. However, these disbursements were not in fact used by Yarborough to pay his construction costs, but rather were used to pay unrelated debts previously incurred. (Yarborough was subsequently discharged in bankruptcy.) In June, 1964, Wayne brought suit to foreclose its mortgage (for breach of conditions), and foreclosure and sale were ordered. The Court of Appeals affirmed the trial court's Judgment giving Wayne's mortgage lien priority over the liens of the materialmen and the vendee. On appeal, the Supreme Court of Ohio reversed, subordinating Wayne's lien to the vendee's and the mechanics' liens.

Ohio follows the generally accepted rule that where there is a mortgage securing future advances such advances create liens only as they are actually made, unless the mortgagee is obligated to make the advances. In the latter case the mortgagee's lien will date from the time of its recording.[1] In addition to this nonstatutory method by which a mortgagee can obtain lien priority, there is a statutory method by which he can do so, namely the

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[1] 37 O. Jur.2d *Mortgages* § 62 (1959); 36 Am. Jur. *Mortgages,* § 232 (1941); 59 C.J.S. *Mortgages,* § 230 (1949); 4 *American Law of Property,* § 16.101 (1952); 10 *Thompson on Real Property,* § 5221 (1957); For a detailed analysis of the rule, see Annot., 80 A.L.R.2d 179 (1961).

This is qualified in Ohio by § 1311.14 Ohio Rev. Code (1965), which subordinates all such advances to mechanics' liens, regardless of when the latter become operative, if the mortgage does not comply with the terms of the statute and is recorded after any construction has begun. This section is further discussed below.

procedure provided by § 1311.14 of Ohio Rev. Code. This statute is not new, having been enacted in 1915. However, in 1919 the Ohio Supreme Court held, in the case of *Rider v. Crobaugh,*[2] that the act was intended to apply "only to mortgages which were given and filed for the purpose of improving real estate after the actual commencement of operations." [3] In deciding *Rider,* the court was answering a contention that the passage of what is now § 1311.14 impliedly repealed what is now § 5301.23, which gives mortgagees a lien from the date of filing, with the asserted result that all mortgage liens would be subordinated to mechanics' liens unless the statutory procedure were followed. The *Rider* holding should therefore be limited to the proposition that a construction mortgage executed and recorded before the commencement of construction is not *required* to follow the statutory scheme. However, there is nothing in the *Rider* decision to *prohibit* the use of the statutory procedure in this situation. Because, however, of the interpretation commonly given the above-quoted language in *Rider* and the cumbersome procedure provided by the statute, the statutory-form construction mortgage has in practice been used only for mortgages which finance construction that has already begun.[4]

After the decision in *Rider v. Crobaugh,* construction loans generally took the form of non-statutory mortgages given to secure future advances. In 1920 the priority of the lien of such a mortgage was recognized by the Ohio Supreme Court in *Kuhn v. The Southern Ohio Loan and Trust Co.*[5] In *Kuhn,* the pertinent clause of the mortgage agreement read as follows:

> "This mortgage is given to improve the premises described herein, to pay off prior encumbrances 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 of the General Code of Ohio (now § 1311.14 Ohio Rev. Code)." [6]

The court, although recognizing that the above clause "does not disclose an obligation in terms on the part of the mortgagee to advance to the mortgagor the amount specified in the instru-

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[2] 100 Ohio St. 88, 125 N.E. 130 (1919).

[3] 100 Ohio St. at 98.

[4] See 3 McDermott, *Ohio Real Property Law and Practice,* §§ 21-15A and 21-16D (3rd ed. 1966).

[5] 101 Ohio St. 34, 126 N.E. 820 (1920).

[6] 101 Ohio St. at 34 (1920).

ment," [7] nonetheless held: "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." [8]

The significance of the *Kuhn* decision soon became apparent. By using a clause similar to the one quoted above, a mortgagee could obtain the lien priority accorded a mortgagee obligated to make future advances, even though the clause failed to so obligate the mortgagee. The reference in the agreement to the construction mortgage statute (now § 1311.14) was not interpreted as binding the mortgagee to the statutory disbursement procedure.[9] This is understandable in view of the *Rider* decision (rendered only eight months earlier than *Kuhn*) that the statute was not intended to apply to such a mortgage. Furthermore, the Ohio courts in practice ignored the statement in *Kuhn* that the inference of an obligation to disburse arose only in the absence of other evidence.[10]

This was the state of the law in this area when the principal case came before the court. In *Wayne,* the Ohio Supreme Court had to interpret a mortgage agreement containing a clause substantially identical to that quoted earlier from the agreement in *Kuhn.*[11] After considering this clause the Court of Appeals concluded, "The promissory note and mortgage deed alone imply the obligation on the part of the mortgagee to advance monies in the amount indicated to the mortgagor, and there is no requirement

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[7] 101 Ohio St. at 34.

[8] 101 Ohio St. at 34.

[9] *In re Taylor,* 20 F.2d 8 (1927). Also see Maguish, *Disbursement of Ohio Construction Mortgage Loans,* 12 Cinc. L. Rev. 1 (1938). But see *Connecticut General Life Insurance Co. v. Birzer Building Co.,* 60 O.L.A. 477 (Ohio 1950). This is not the case when the mortgage is recorded after commencement of construction. In that regard, see: *In re Braker,* 127 F.2d 652 (1942); *First Savings and Loan v. Ward,* 22 O.L.A. 184 (Ohio 1936).

[10] See *McDermott, supra* note 5, at § 21-15A. Since the dispute in the *Kuhn* case was between two mortgagees, the applicability of the decision to a dispute between a mortgagee and mechanics' lienors was apparently not considered.

[11] The *Wayne* clause reads as follows:

"Said grantors further say that this mortgage is given to pay for improvements or prior liens, or both, on said premises and hereby covenant and agree with the grantee, its successors and assigns, that said grantee, its successors and assigns, as mortgagee herein, is authorized and empowered to do all things provided to be done by § 1311.14 of the Ohio Rev. Code and by all sections of the Ohio mechanics' lien laws, so called, and amendments thereto." 228 N.E.2d at 851.

that such monies be used in the construction of a building on the premises." [12]

The Ohio Supreme Court did not agree that the note and mortgage implied such an obligation. The high court indicated that if the reference in the mortgage agreement to § 1311.14 was intended to make that statute the standard by which the mortgagee's performance was to be judged, then *Wayne* could not prevail, since the procedures for disbursement set forth in the act admittedly were not followed, and the requirement that the proceeds of the loan actually be used in the contemplated construction was not satisfied. This conclusion seems inescapable.[13]

The court then discussed the holding of *Kuhn* that there is an "implication of fact" that the mortgagee under a mortgage agreement such as the one involved here is obligated to make advances. The court recalled the statement in *Kuhn* that such an inference arises only "in the absence of other evidence," and after examining the record of the principal case decided that there was in actuality no such obligation on Wayne's part; hence Wayne's mortgage lien could not be deemed superior to the liens of the materialmen, since construction began before any disbursements were made.

The effect of this decision has been to eliminate the anomaly which had embarrassed the law in this field since the decision in *Kuhn* in 1920. Prior to the present decision, "the mortgagee has . . . obtained priority because of a fiction that it had a loan agreement, a fiction that by curious irony would not exist if there were no mechanics' lien statute. Thus in *Kuhn* one mortgagee gained priority over another by referring to a statute that was intended to benefit only artisans and materialmen." [14]

The question still remains as to what effect *Wayne* will have on Ohio mortgage lending practice. There are presently three ways for a mortgage lender to obtain priority for his lien: He

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[12] 228 N.E.2d at 854.

[13] This part of the decision brings the mortgagee whose mortgage is executed and recorded prior to the start of construction into the same class as those whose mortgages date from after the start of construction, where the former mortgagee relies on the use of § 1311.14. Presumably such a mortgagee would be within the scope of *In re Braken* and *First Savings and Loan v. Ward, supra* note 10.

This should also eliminate any question as to whether § 1311.14 may be used in the situation where the mortgage is executed before construction begins. As was previously indicated, this was doubtful after the decision in *Rider v. Crobaugh, supra* note 2.

[14] Brief of Appellant, Falls Lumber Company, p. 9.

may use a mortgage loan agreement which calls for obligatory future advances; he may use the statutory construction mortgage provided for in § 1311.14 of Ohio Rev. Code; or he may use the open-end mortgage recently made possible by § 5301.232. Where the mortgage loan is to be made before the start of construction, the attorney choosing between the statutory and non-statutory mortgage forms for this agreement will generally prefer a non-statutory mortgage loan agreement. He will thereby avoid the cumbersome disbursement procedure of § 1311.14(A)-(G) and obtain protection identical to that given by that section. It is still too early to predict with confidence what the effect of the new open-end mortgage statute (§ 5301.232) will be, as the act has only been operative since November, 1967, and there have been no decisions construing it to date. However, since use of the statute appears to offer the lender no potential advantage over the non-statutory mortgage loan agreement, it seems likely that the latter will continue to be the predominant method of financing new construction in Ohio.

In conclusion, it is submitted that the *Wayne* decision—by eliminating the unjustified priority which the liens of mortgage lenders had previously enjoyed—will assure better protection for materialmen, and will do so without depriving mortgage lenders of an opportunity to obtain the security to which they are entitled.

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