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Construction Mortgage Financing in Ohio

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CONSTRUCTION MORTGAGE FINANCING IN OHIO

by Malcolm B. Ramey and Robert A. Jefferies, Jr.***

I. Introduction

SINCE JULY OF 1967, two seemingly isolated events have prompted institutional lenders in Ohio to reassess their construction loan lending procedures. The first event to occur was the Ohio Supreme Court's decision in *Wayne Bldg. & Loan Co. v. Yarborough.*[1] The *Yarborough* opinion is lengthy and complex. It has important ramifications upon a mortgagee's lien priority vis-a-vis intervening liens[2] acquired by mechanics men (workmen and materialmen), vendees and other mortgagees. The second event to take place was the passage by the Ohio legislature of a new open-end mortgage statute.[3] This statute drastically alters the law governing the priority between optional disbursements made under a statutory open-end mortgage and intervening liens acquired by workmen and other lienholders.

This article consists of a review and analysis of the *Yarborough* decision and the open-end mortgage statute and an assessment of their probable impact upon current construction loan lending procedures. In addition, the authors offer various observations regarding the form in which disbursing agreements and construction mortgage deeds should be drafted.[4] The structure

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1 11 Ohio St. 2d 195, 228 N.E. 2d 841 (1967). *Yarborough* is discussed in Note, *Mortgages—Lien And Priority—Mortgages And Mechanic's Liens,* 19 *W. Res. L. Rev.* 423 (1968); Comment, *Construction Mortgages In Ohio,* 29 *Ohio St. L. J.* 917 (1968).

2 The phrase "intervening lien" as used in this article means any lien (e.g. mechanic's lien, judgment lien, mortgage lien) which attaches to mortgaged property after the recording of the mortgage but before any disbursements are made thereunder.

3 Ohio Rev. Code, § 5301.232. Hereafter all citations to the Ohio Revised Code will contain a section number only.

4 All observations set forth in this article are made, of course, for the purpose of informing a mortgagee of the most reliable method of acquiring a first and best lien against any property with respect to which it makes a construction loan.

of the article may be briefly described as follows: First, attention will be given to the three methods by which a mortgagee can preserve the priority of its mortgage lien over liens of mechanics men which attach to the mortgaged premises after the recording of the mortgage but before any disbursements are made thereunder. Special consideration will be given to the manner in which the *Yarborough* decision affects each method.

Second, the writers will discuss the manner in which open-end mortgages relate to: (1) non-statutory construction mortgages and (2) mechanics' and other types of liens which attach to the mortgaged premises after the recording of an open-end mortgage but before any optional disbursements are made thereunder. In this connection, the use of open-end mortgages to secure construction loans will be considered.

Third, the advisability of drafting an open-end mortgage which incorporates the provisions of § 1311.14 of the Mechanic's Lien Statute will be examined.

Fourth, the authors will discuss a proposed method by which a mortgagee can reasonably assure that its mortgage lien will take priority over any vendees' liens which exist on the date of the recording of the mortgage.

II. Maintaining Mortgage Priority—Mechanics' Liens

A. General Discussion

Three methods exist by which a mortgagee may maintain the priority of its construction mortgage over mechanics' liens which attach to the premises after the recording of the mortgage but before any disbursements are made thereunder. These three methods of preservation consist of disbursing the mortgage proceeds: (1) in accordance with Divisions (A) through (G) of § 1311.14 (hereafter usually referred to as a § 1311.14 disbursement); (2) in accordance with the provisions of § 1311.04-.05 as incorporated in § 1311.15 by judicial decree (hereafter generally referred to as a statutory affidavit disbursement); and (3) in accordance with the obligatory terms of a non-statutory construction mortgage[5] (hereafter usually referred to as an obligatory mortgage disbursement).

[5] The phrases "non-statutory construction mortgage" and "obligatory mortgage," as used in this article, mean a mortgage (whether open-end or otherwise): (1) which requires the mortgagee to disburse to the mortgagor a certain and definite sum in a particular manner; and (2) which does not comply with the provisions of § 1311.14.

The effective date of a § 1311.14 mortgage, a statutory affidavit mortgage, and an obligatory mortgage is the date the mortgage is duly recorded in the proper county recorder's office. By contrast, the effective date of a mechanic's lien is the date on which the first labor is performed or the first material is delivered to the mortgaged premises, irrespective of when the particular labor or material which gives rise to the lien is performed or delivered and irrespective of when the lien is perfected in accordance with the provisions of the mechanic's lien statute.[6]

B. Section 1311.14 Disbursements

Before the enactment of the predecessor[7] to what is now § 1311.14, all mechanics' liens were given priority over a construction mortgage recorded after the commencement of construction, regardless of whether the labor or material which gave rise to the lien was furnished before or after the recording of the mortgage.[8] Insofar as institutional lenders were concerned, this was an unduly harsh requirement.[9] Accordingly, in 1915, the Ohio legislature added a new section to the mechanic's lien statute. This new section (§ 1311.14) provided, in essence, that the lien of a mortgage given in whole or in part to improve real estate or to pay off prior encumbrances thereon would take priority over all mechanics' liens filed for record after the mortgage was filed for record, to the extent that the proceeds of the mortgage were distributed in accordance with the terms of that section.

A careful examination of the language of § 1311.14 reveals that the section fails to state whether it applies to construction mortgages recorded before construction commences as well as to construction mortgages recorded after the commencement of construction. For many years it was thought that § 1311.14 applied only to those construction mortgages which were recorded after the commencement of construction.[10] However, the comparative-

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[6] § 1311.13. See *Fryman v. McGhee,* 108 Ohio App. 501, 163 N.E. 2d 63 (1958).

[7] *Ohio General Code,* § 8321-1. Many cases cited in this article involved disputes which arose while the Ohio General Code was still in effect (i.e. prior to October 1, 1953). In discussing such cases, this article, as a matter of convenience, replaces all references to sections of the General Code with references to their counterpart sections in the Revised Code.

[8] *Rider v. Crobaugh,* 100 Ohio St. 88, 125 N.E. 130 (1919).

[9] See discussion in *Demann, The Ohio Mechanic's Lien Law,* § 10.4 (2d ed. 1953); 36 *Ohio Jurisprudence 2d, Mechanics' Liens* § 116 (1959).

[10] *In re Taylor,* 20 F.2d 8, 9 (6th Cir. 1927); *Rider v. Crobaugh,* 100 Ohio St. 88, 98-100, 125 N.E. 130, 133-34 (1919).

ly recent case of *Falls Lumber Co. v. Heman,*[11] when coupled with the *Yarborough* decision, establishes that the benefits of § 1311.14 can be reaped by a mortgagee which records its § 1311.14 construction mortgage before the commencement of construction on the mortgaged premises, provided it (the mortgagee) complies in every respect with the disbursing requirements of that section.

Now that Ohio courts have established that a mortgagee may utilize a § 1311.14 mortgage even though the mortgage is recorded before construction commences on the mortgaged premises, each mortgagee must decide whether it should use § 1311.14.

It is submitted that a mortgagee's use of § 1311.14 is inadvisable for several reasons: First, the oft-repeated statement that a § 1311.14 distribution of mortgage proceeds will absolutely insure the priority of the mortgage lien is likely to lull any mortgagee into a false sense of security. This is, of course, dangerous.

Second, the method of distribution required by divisions (A) through (G) of § 1311.14 is complex and confusing.[12] Because of the complexity of the divisions and the confusion which they generate, errors in the required methods of distribution are inevitable. Of course, such errors destroy the priority of the mortgagee's lien when they result in the mortgage funds being distributed other than in accordance with § 1311.14.

Assuming that a mortgagee is not lulled into a false sense of security, and assuming that it can safely thread its way through the complexity and confusion generated by § 1311.14, there are still other factors which militate against the use of that section. To begin with, the procedure involved in making the required distribution thereunder is expensive, burdensome, and difficult to follow. In addition, the distributions which a mortgagee is permitted to make under this statute are very limited and therefore commercially unrealistic. A mortgagee must, prior to the completion of construction, limit its distributions to: (1) payments to remove prior encumbrances; (2) distributions to meet labor payrolls (contractor or any subcontractor) certified by the owner to be necessary; and (3) distributions made directly to material-

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[11] 114 Ohio App. 262, 181 N.E. 2d 713 (1961). Also see *Holgate State Bank v. Gauggel,* 6 Ohio St. 2d 256, 217 N.E. 2d 867 (1966).

[12] A quick glance at the voluminous annotations to § 1311.14 confirms the confusion which that section has generated. Also see Magrish, *Disbursement of Ohio Mortgage Construction Loans,* 12 *U. Cin. L. Rev.* 1, 16 (1938). *Compare,* Note, *supra* note 1 at 434, which states: "Subjecting the mortgagee to section 1311.14 would be no hardship . . . ."

men and laborers.[13] As is evident, distributions may not be made to any contractors or subcontractors before the completion of construction except for the specific purpose of enabling such persons to meet their labor payrolls. Furthermore, mortgage proceeds may not be used for other expenses commonly associated with construction, such as land acquisition costs, and engineering fees, surveying and loan charges, interest, and legal fees.

Another negative factor is that any mortgagee which accepts the distribution duties imposed by § 1311.14 becomes responsible for all losses which result from its failure to comply with that section. *Falls Lumber Co. v. Heman*[14] vividly illustrates the liability with which a mortgagee may be saddled if it seeks to comply with § 1311.14. In that case Heman, in order to finance the construction of a home, executed a construction mortgage, which he delivered along with his promissory note to the North Akron Savings & Loan Association. The mortgage was duly recorded. Thereafter, construction was commenced upon the house. After the mortgagee had disbursed all of the mortgage funds and after Heman had paid for his home, the Falls Lumber Co. asserted that it held a perfected mechanic's lien against the mortgaged premises, which mechanic's lien remained unsatisfied. Accordingly, it brought an action to marshall liens and sell Heman's home. On appeal the Summit County Court of Appeals ruled that Heman's mortgage fell within the ambit of § 1311.14, since it was a construction mortgage which contained the provisions required by that section. Accordingly, the Court held that the failure of the mortgagee to strictly comply with the provisions of § 1311.04,[15] which provided for the securing of various affidavits, notices, and waivers, was the direct and proximate cause of Heman's loss and that, therefore, it was liable in tort for the loss sustained by Heman.[16]

Finally, assuming a mortgagee complies in every respect with the disbursing provisions of § 1311.14, it must nevertheless

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[13] An excellent discussion of § 1311.14 distributions appears in Magrish, *supra* note 12, at 10-23.

[14] 114 Ohio App. 262, 181 N.E. 2d 713 (1961). For a discussion of *Falls Lumber Co.* see Note, *Bank Held Liable To Construction Mortgagor For Mechanic's Liens Resulting From Negligent Disbursement of Construction Loan,* 24 *Ohio St. L. J.* 679 (1963).

[15] The disbursement procedures of §§ 1311.04-.05 have been judicially incorporated into § 1311.14. See text accompanying notes 22-31.

[16] It is interesting to note that under the *Falls Lumber Co.* tort rationale a construction mortgagee may be held liable to a construction mortgagor for damages in excess of the loan agreement.

bear the legal burden of establishing by the preponderance of the evidence its compliance with those complex provisions before its mortgage lien will be accorded priority over mechanics' liens which are perfected after the recording of the mortgage but before disbursements are made thereunder.[17]

When the cumulative effect of each of the above discussed factors is assessed, it becomes manifest that a mortgagee which desires to protect the priority of its mortgage lien should, if at all possible, avoid disbursing under § 1311.14.

C. Avoiding Application of § 1311.14

The Common Pleas opinion[18] in the *Falls Lumber* case intimates that whenever § 1311.14 language appears in a mortgage deed the mortgagee may avoid liability for failure to disburse in accordance with the terms of that section by informing the mortgagor that it (the mortgagee) does not intend to comply therewith or with the disbursement procedure of §§ 1311.04-.05. In spite of the intimations in the *Falls Lumber* Common Pleas opinion, no mortgagee holding a mortgage containing § 1311.14 language should be so naive as to believe that it may inform the mortgagor that it (the mortgagee) does not intend to comply with § 1311.14 and that it will thereby ipso facto relieve itself from the application of that section.

Obviously, the first positive step which should be taken by a mortgagee desiring to avoid the application of § 1311.14 is to eliminate from its standard mortgage deed all references to § 1311.14 and, in particular, to eliminate the statutory covenant required by that section. In this respect, all references to § 1311.14 should be deleted even though the mortgage deed expressly provides that the mortgagee may, but is not required to, comply with that section. In a situation involving a mortgagee's discretionary compliance with § 1311.14, the Ohio Supreme Court might hold, as it did in *Kuhn v. The Southern Ohio Loan & Trust Company,* that:

> ". . . an inference of fact arises that the mortgagee [under a § 1311.14 mortgage] obligated itself for the purposes and the amounts stipulated [in the mortgage even though it was

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[17] *Wayne Bldg. & Loan Co. v. Yarborough,* 11 Ohio St. 2d 195, 209-10, 228 N.E. 2d 841, 851-52 (1967).

[18] *Falls Lumber Co. v. Heman,* 88 Ohio L. Abs. 337, 345, 183 N.E. 2d 265, 270 (C.P. 1960).

not *required* to disburse under § 1311.14 but was merely given the option to do so]." [19]

A mortgagee which desires to be doubly sure that it is not saddled with the work load of § 1311.14 should consider the advisability of inserting in its mortgage deed language which expressly provides: (1) that the mortgage is not a construction mortgage within the meaning of § 1311.14; (2) that the mortgagee shall not and will not be responsible for assuring any contractor, subcontractor, laborer or materialmen that he will be paid for furnishing services or material with respect to any work performed on or material delivered to the mortgaged premises; and (3) that the mortgagor is and shall be solely responsible for assuring payment to the aforementioned persons of all amounts due them.

It has been stated that application of § 1311.14:

> ". . . 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 mechanic's liens when the construction mortgagor has employed private legal counsel for that purpose." [20]

Since the quoted statement concerned a mortgage which contained standard § 1311.14 language,[21] it is submitted that the thoughts contained therein are not applicable to the avoidance of § 1311.14 duties where the mortgage deed contains the three provisions set forth in the preceding paragraph of this article. Nevertheless, the insertion of the following statement in a mortgagee's disbursing agreement or in its mortgage deed might prove helpful and certainly could do no harm:

> "Mortgagee urges Mortgagor to consult his attorney prior to the time loan funds are disbursed for advice and direction with respect to protecting the premises from mechanics' and other types of liens."

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[19] 101 Ohio St. 34, 38, 126 N.E. 820, 822 (1922).

[20] Note, *supra* note 14, at 684.

[21] The mortgage in question was the mortgage executed by Heman and delivered to the North Akron Savings & Loan Association. See *Falls Lumber Co. v. Heman,* 114 Ohio App. 262, 181 N.E. 2d 713 (1961) and text accompanying notes 14-15. The mortgage empowered the mortgagee in its discretion to comply with § 1311.14. The court found that the mortgagee accepted the duties of § 1311.14 when it informed Heman that "It would take care of things" and "You let us handle and pay out this money and everything will be all right." See Note, *supra* note 14, at 684, note 31 referring to Brief for Appellee.

So far this article has: (1) demonstrated that until § 1311.14 is amended to reflect reasonable mortgage loan procedures, a mortgagee should not seek to maintain the priority of its mortgage by disbursing mortgage proceeds in accordance with divisions (A) through (G) of that section and; (2) described ways by which a mortgagee can probably avoid the application of § 1311.14 with its attendant costs and dangers. Attention is now directed to another method by which a mortgagee may insure the priority of its mortgage over intervening lienors.

D. Statutory Affidavit Disbursements

A second method of preserving the priority of a construction mortgage consists of disbursing the mortgage proceeds in accordance with the statutory affidavit procedure. Under the statutory affidavit procedure, if a mortgagee establishes that the mortgage proceeds were "actually used in such improvement [of real estate] in the manner contemplated in §§ 1311.02 and 1311.03" [22] and "disbursed pursuant to statutory affidavits, certificates and notices (§§ 1311.04, 1311.05) . . .",[23] then its mortgage lien will take priority pursuant to § 1311.14 over all mechanics' liens which are perfected after the recording of the mortgage even though the mortgage proceeds were not distributed in accordance with § 1311.14(A) through (G) and even though the mortgage was non-obligatory.

The theory that a mortgagee may secure priority pursuant to § 1311.14 even though it fails to distribute the mortgage proceeds in accordance with divisions (A) through (G) of that section was first voiced by James L. Magrish in his excellent article "Disbursement of Ohio Construction Mortgage Loans," which appeared in a 1938 issue of the University of Cincinnati Law Review.[24] Magrish hypothecized that the requirements of § 1311.14 are satisfied whenever distributions of mortgage proceeds are such that:

> ". . . the proceeds . . . [are] actually used in such improvement [of real estate] in the manner contemplated in Sections . . . [1311.02] and . . . [1311.03] . . ." [25]

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[22] § 1311.14.

[23] *Wayne Bldg. & Loan Co. v. Yarborough*, 11 Ohio St. 2d 195, 210, 228 N.E. 2d 841, 852 (1967).

[24] Magrish, *supra* note 12.

[25] Magrish, *supra* note 12, at 17-18, quoting 8321-1 (now § 1311.14).

In this regard, Magrish pointed out that distributions "in the manner contemplated in Sections . . . [1311.02] and . . . [1311.03]" meant distributions in accordance with §§ 1311.04-.05, which distributions insure the payment of persons furnishing labor, machinery, materials or fuel to the premises as much as to distributions under divisions (A) through G of § 1311.14.[26]

Two years after the publication of Magrish's perceptive article the Court of Appeals for Hamilton County decided *Knollman Lumber Co. v. Hillenbrand.*[27] In *Knollman,* the owner executed a construction mortgage which he delivered to The Liberal Savings & Loan Company as security for the payment of his $6,000.00 promissory note. The mortgage was executed and recorded after construction had commenced on the mortgaged premises. It contained the following recitals:

> "This mortgage is given to improve the premises herein described. The mortgagors hereby consent and agree with the mortgagee that the fund secured by this mortgage may be paid out by the mortgagee as provided in Section . . . [1311.14] . . . ."
>
> "The grantee is authorized and empowered to do all things provided to be done by a mortgagee under Section . . . [1311.14] . . . ." [28]

As construction progressed, disbursements were made by the mortgagee. Each disbursement was made only after the mortgagee had inspected the construction and only in the proportion that the completed construction bore to the total project. In addition, the disbursements were made in accordance with the requirements set out in §§ 1311.04 and 1311.05.

The trial court denied the priority of the mortgage lien over various mechanics' liens which had been perfected after the recording of the mortgage. Its holding was predicated on the mortgagee's failure to disburse in strict compliance with divisions (A) through (G) of § 1311.14.

The Court of Appeals reversed. It adopted Magrish's theory in its entirety and held that § 1311.14 extends to disbursements made under the system of affidavits, certificates, and notices of §§ 1311.04 and 1311.05 the same priority over mechanic's liens as

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[26] Magrish, *supra* note 12, at 19-20.

[27] 64 Ohio App. 549, 29 N.E. 2d 61 (1940).

[28] *Id.* at 551, 29 N.E. 2d at 62.

disbursements made under the procedure set out in divisions (A) through (G) of § 1311.14. The Supreme Court thereafter overruled a motion to certify.

Language contained in the *Yarborough* decision appears to conclusively demonstrate that the Ohio Supreme Court has now sanctioned and adopted Magrish's theory as set forth by the Court of Appeals in *Knollman Lumber Co. v. Hillenbrand.* In this regard, the court stated:

> "Although the Wayne mortgage satisfied the formal requirements of Section 1311.14, *Revised Code,* distribution of the mortgage fund was apparently not made by the means set forth in divisions (A) to (G), inclusive, of such section, . . . Nor did Wayne establish that the mortgage proceeds were 'actually used in such improvement in the manner contemplated in Sections 1311.02 and 1311.03' (Section 1311.14, *Revised Code*) . . . , and disbursed pursuant to statutory affidavits, certificates and notices (Section 1311.04, 1311.05) so averring. See *Knollman Lumber Co. v. Hillenbrand* (1940) 64 Ohio App. 549, 29 N.E. 2d 61, motion to certify overruled, October 23, 1940; Magrish, Disbursement of Ohio Construction Mortgage Loans, 12 Cincinnati L. Rev. 1, 17-23 (1938)." [29]

The negative implication to be drawn from the Court's language as above quoted is that a mortgagee which makes all disbursements in accordance with the statutory affidavits, certificates and notices required by §§ 1311.04-.05 will be accorded priority under § 1311.14 over mechanics' liens which are perfected after the recording of the mortgage.[30]

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[29] *Wayne Bldg. & Loan Co. v. Yarborough,* 11 Ohio St. 2d 195, 209-10, 228 N.E. 2d 841, 851-52 (1967).

[30] The loosely drafted Yarborough opinion intimates that a construction mortgagee who has not disbursed in accordance with § 1311.14 or §§ 1311.04-.05 will nevertheless be accorded priority over intervening lienors, provided the loan proceeds advanced by the mortgagee have in fact been used in the construction of the premises. For example, the court's opinion states: "Therefore, it is held that where non-obligatory advances are made after the commencement of construction and . . . are not shown to have been actually used in the construction for which liens are claimed . . . , under a mortgage contemplating future advances which was recorded prior to such commencement of construction, the lien of such advances is held subsequent in priority to the mechanic's liens arising from such construction." 11 Ohio St. 2d at 219, 228 N.E. 2d at 857 (1967). Also see Headnote 5 in the *Yarborough* syllabus and 11 Ohio St. 2d at 218, 228 N.E. 2d at 856-57.

The court's language concerning the priority of loan advances actually used in the construction of the premises must be read in the context of the entire opinion. When the court's language is so read, it becomes clear that merely because the mortgage proceeds are used in the construction of the

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All objections set forth in this article to a mortgagee's use of divisions (A) through (G) of § 1311.14 also apply to the use by a mortgagee of the statutory affidavits, certificates, and notices under §§ 1311.04-.05 as incorporated in § 1311.14 by judicial decree. In addition, mortgagees should remember that they may not safely employ §§ 1311.04-.05 when the owner-mortgagor is in whole or in part his own contractor, since the restriction of lien claimants to the amount that may be owing by the owner-mortgagor on his contract with the original contractor does not apply where the amount claimed is owed by the owner-mortgagor, acting as his own contractor, to an unpaid lien claimant.[31]

Because of the objections discussed above, it is suggested that a mortgagee should not seek to maintain the priority of its mortgage lien through the use of statutory affidavits, certificates, and notices, and that a mortgagee should take those steps

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premises is not in itself enough to guarantee the construction mortgagee that it will be accorded priority over intervening lienors. In support of this assertion, the reader is referred to the text accompanying footnote 29 and to the Yarborough opinion itself (11 Ohio St. 2d at 219, 228 N.E. 2d at 857) which states:

> "This court is not disposed to change the traditional Ohio rule in the case of construction mortgagees who make non-obligatory advances after the commencement of construction without compliance with Section 1311.15, Revised Code, or without *statutory proof* [i.e. affidavits, etc. under 1311.04-.05] that the funds are actually used in the contemplated improvement." [Emphasis added]

One court has already mistakenly read *Yarborough* to hold that a mortgagee is entitled to priority over intervening lienors if the proceeds advanced by it are, without more, actually used in construction of the premises. In this regard, see *Kingsberry Mortgage Co. v. Maddox,* 13 Ohio Miscellaneous 98 (C.P. 1968) which states at 102-103:

> ". . . There are some cases [e.g. *Yarborough*] which hold that so long as the money from the construction loan was used in the construction of the house, it was sufficient to give the loan company that priority. This certainly, however, is not [in the Court's opinion] in conformity with the statute. It is not in conformity with the avowed purpose of the mechanic's lien law, and the construction loan law, which was an attempt to give equal priority to all people furnishing material or doing labor on the building, as where the loan companies are permitted to make distribution to any one who does work on the building, would mean that persons that furnish the material for the basement, the subfloor, and did that type of work on the building, would be paid in full, wherein if there is a deficiency, the person that put on the roof, the finishing carpenter, and plumbing work, would get nothing, even though the law says specifically that their claim is equal priority to the first person doing the labor. This was one of the findings of the Supreme Court in the cases of *Wayne Building & Loan Co. v. Yarborough,* . . ."

[31] Magrish, *supra* note 12, at 9.

outlined in part II-C of this article to insure that it does not assume the statutory duties of a mortgagee under § 1311.14.

E. Obligatory Disbursements

As the *Yarborough* case demonstrates, a mortgagee can best assure the priority of its mortgage lien by using an obligatory, non-statutory construction mortgage. In *Yarborough* the Ohio Supreme Court "spelled out" for the first time the law which hereafter will govern the priority between non-statutory, obligatory construction mortgages and intervening mechanics' liens. Before discussing the effect of *Yarborough* on construction mortgages, this article will first review the history of such mortgages.

Nearly every article dealing with mortgages to secure future advances, of which the construction mortgage is the most prominent example, discusses the early and leading case of *Spader v. Lawler*.[32] This article is no exception.

The essential facts of *Spader* were these:

1. In 1832, Bonsal mortgaged certain property to Lawler. The mortgage, which was duly recorded, contained a typical defeasance clause. In addition, the mortgage provided that it was to secure:

> ". . . any other sum, or sums of money, which the said Bonsal may be owing, or indebted in, to the said Lawler, his heirs and assigns." [33]

The opinion does not indicate whether the mortgage given by Bonsal was a construction mortgage.

2. In 1836 and again in 1838 Bonsal mortgaged the property to complainants.

3. In 1841 Lawler, as mortgagee under the 1832 mortgage, advanced $1,008.00 to Bonsal.

An action was brought to foreclose a mortgage on Bonsal's property which had been given and recorded prior to the mortgages held by Lawler and the complainants. The case was eventually appealed to the Ohio Supreme Court. That court held that the lien of a mortgage for future advances (Lawler's mortgage),

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[32] 17 Ohio 371 (1848). Discussions of *Spader* appear in Magrish, *supra* note 12; Note, *The Open-End Mortgage in Ohio*, 25 *U. Cin. L. Rev.* 82 (1956); Note, *Mortgages—Future Advances—Obligatory and Non-Obligatory Advances in Ohio*, 1 *U. Cin. L. Rev.* 348 (1927).

[33] 17 Ohio 371, 372 (1848).

to the extent of such advances ($1,008.00), did not take priority over the lien of a second mortgage (complainant's mortgage) filed for record prior to the making of the advances.

The Court, in capsuling its rationale, drew no distinction between instances when a mortgagee is obligated to make future advances and instances when it is not so obligated. It merely stated:

> ". . . a mortgage [is] a mere legal instrument . . . [it] has no vitality or existence until it is placed upon record as notice to all the world . . . it should advise the public of the only really material thing for them to know—what is the amount that it actually secures. What would be the legal nature of a mortgage placed upon record to secure all advances hereafter to be advanced? It would not be a mortgage, because it would have nothing to secure . . . . A mortgage is a security for the payment of money. If there was no money due there could be nothing to secure, and consequently no mortgage." [34]

For over seventy years following the decision in *Spader v. Lawler,* no significant case was decided involving priority between a mortgage to secure future advances (e.g. a construction mortgage) and intervening liens. Then, in 1919, the Ohio Supreme Court decided *Rider v. Crobaugh.*[35] In essence, *Rider* was a 20th Century counterpart of *Spader,* its only significant distinguishing characteristic being that the intervening lienors were mechanics' lienors instead of mortgagees as was the case with *Spader.*[36]

In *Rider,* the Ohio Supreme Court held that the lien of a construction mortgage recorded before the commencement of construction was prior in right to mechanics' liens which stemmed from the construction. In *Rider,* as in *Spader*: (1) the mortgage the priority of which priority was questioned contained no covenant requiring or empowering the mortgagee to perform any or all acts which a mortgagee might perform under the mechanic's lien statute as then in effect; and (2) the Court failed to differentiate the distinguishing legal effects, if any, between obligatory and non-obligatory mortgages.

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[34] *Id.* at 379.

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

[36] Of course, *Rider* involved a construction mortgage whereas *Spader* apparently did not. However, this is not legally significant, since both cases involved mortgages for future advances.

In the 1920 case of *Kuhn v. The Southern Ohio Loan & Trust Co.*,[37] the Ohio Supreme Court, for the first time, discussed the differing legal consequences which, with respect to lien priorities, attach to obligatory and non-obligatory construction mortgages. In *Kuhn* the Court first pointed out that the mortgagee had obligated itself in accordance with what is now the provisions of § 1311.14 to make certain future disbursements.[38] The Court then held that due to the obligatory nature of the mortgage (i.e. the mortgagee was required to disburse under § 1311.14), the mortgagee was entitled to priority for the full amount of its future disbursements over a subsequent mortgage recorded after the former one though prior to the making of disbursements thereunder. Nearly half of the Court's opinion was devoted to distinguishing the oft-cited *Spader* case in which the Court, as pointed out earlier, had failed to differentiate between obligatory and non-obligatory mortgages. The Court stated:

> "Certain it is, the actual decision in . . . [*Spader v. Lawler*] was made with reference to future advances, neither the amount nor the purpose of which was specified in the instrument. Moreover, there was not involved in that case the question of future advances which the mortgagee was under obligation to make."
>
> "In the instant case, the situation is radically different. The record of the earlier [1311.14] mortgage [given to The Southern Ohio Loan & Trust Co.] was notice to the world that the mortgagee therein had obligated itself to loan the mortgagor a certain sum upon the faith of the title as it then was. Upon what principle, then, of equity or public policy, can it be said that such mortgagee must again search the records before making each advance to mortgagor? The search would be a vain thing, since the advance or further loan would remain obligatory, whatever the state of the title disclosed." [39]

In 1967, the Ohio Supreme Court decided *Yarborough* and thereby formally resolved the theretofore unanswered question of whether the doctrine of obligatory advances as set forth in *Kuhn* applies to give priority to a non-§ 1311.14 obligatory construction mortgage when mechanics' liens attach to the mortgaged premises after the recording of the mortgage but prior to the time when disbursements are made thereunder.

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[37] 101 Ohio St. 34, 126 N.E. 820 (1920).

[38] *Id.* at 38, 126 N.E. at 822.

[39] *Id.* at 37, 126 N.E. at 821.

The following were the relevant facts of *Yarborough*:

1. Yarborough (the builder) purchased certain land from the Sauter Development Company, a land developer. In exchange for the delivery of the deed, Yarborough gave to Sauter $1,000.00 in cash, his promissory note for $4,600.00, and a purchase money mortgage on the land to secure the note.

2. Since Yarborough had entered into an agreement with a third party to construct a home upon the land and to convey the land to the third party upon completion of construction, he attempted to secure a construction loan from The Wayne Building & Loan Company. He was successful in obtaining the loan and in exchange therefor, he and his wife executed and delivered to Wayne their promissory note for $22,000.00, and as security therefor, mortgaged the land to Wayne. The mortgage contained the provisions set out in § 1311.14.

3. Wayne duly recorded its construction mortgage.

4. Work commenced on the home which Yarborough had contracted to build.

5. Sauter duly recorded its purchase money mortgage.

6. Wayne made its first disbursement under the construction mortgage.

After Wayne had made disbursements to Yarborough totaling $18,500.00 and after Yarborough had breached various conditions of the construction mortgage, Wayne instituted a foreclosure proceeding and thereupon sale of the mortgaged premises was ordered.

The Court of Appeals for Summit County ranked the liens held by Wayne, Sauter and various mechanics men in the following order:

1. Wayne's mortgage lien.

2. The mechanics' liens.

3. Sauter's mortgage lien.

Various parties involved in the foreclosure proceeding then filed with the Ohio Supreme Court motions to certify the record. These motions were granted.

The Supreme Court first pointed out that:

1. The Wayne construction mortgage satisfied the formal requirements of § 1311.14 and thus had the method of distribu-

tion set out in divisions (A) through (G) of that section been followed, Wayne's mortgage would have been accorded priority over the mechanics' liens which attached to the premises after the recording of the mortgage but before the disbursements were made thereunder.

2. The priority of Wayne's mortgage lien vis-a-vis intervening mechanics' liens could also have been preserved under § 1311.14 had Wayne complied with the statutory affidavit disbursement procedures set out in §§ 1311.04-.05.

3. Wayne's distribution of the construction mortgage proceeds complied with neither divisions (A) through (G) of § 1311.14 or §§ 1311.04-.05.[40]

The Court then pointed out that since Wayne's construction mortgage was recorded before the attachment of the mechanics' liens, its failure to comply with either method of distribution sanctioned by § 1311.14 did not preclude its mortgage lien from acquiring priority over the intervening mechanics' liens provided it was obligated under the construction mortgage to make the advancements in question.[41]

Though the applicability of the doctrine of obligatory advancements where the attaching of mechanics' liens intervenes between the recording of the mortgage intended to secure the advances and the actual making of the advances involved a question of first impression,[42] the Court experienced no difficulty in extending the scope of *Kuhn* to protect a mortgagee's priority over intervening mechanics' liens as well as intervening mortgage liens. The Court simply stated:

> "This Court can see no reason for distinguishing between the intervening mechanics' lienors and the [intervening] mortgagee in *Kuhn* . . . ." [43]

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[40] 11 Ohio St. 2d 195, 209-10, 228 N.E. 2d 841, 851-52 (1967).

[41] In effect the Court treated Yarborough's mortgage to Wayne as if it were a construction mortgage containing none of the language required by § 1311.14.

[42] See *Connecticut Gen. Life Ins. Co. v. Birzer Bldg. Co.*, 101 N.E. 2d 408 (C.P. 1950) wherein a Common Pleas Court applied the obligatory advances requirement in a dispute involving a mortgagee and intervening mechanic's lienors. Also see *Second National Bank of Warren v. Boyle*, 155 Ohio St. 482, 99 N.E. 2d 474 (1951) where the obligatory advances requirement was applied by the Supreme Court in a dispute involving a mortgagee and an intervening judgment lienor.

[43] *Wayne Bldg. & Loan Co. v. Yarborough*, 11 Ohio St. 2d 195, 217, 228 N.E. 2d 841, 856 (1967).

The Court next pointed out that an obligatory mortgage is one which requires the mortgagee to advance a certain and definite sum to the mortgagor in a particular manner.[44] The Court held that Wayne's mortgage was not obligatory, since Wayne remained free at all times to discontinue advancing sums to Yarborough whenever it felt that construction was not progressing in a manner satisfactory to it.[45] Therefore, the Court, relying on the well-established case law, held that the lien of Wayne's mortgage would date only from the time each optional disbursement was made by it. Thus, Wayne's entire mortgage lien was made

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[44] *Id.* at 196, 220 and 221, 228 N.E. 2d at 844 and 858. See also *Id.* at 216, 228 N.E. 2d at 855, where the court intimates that a mortgage which requires the mortgagee to advance a certain and definite amount in a particular manner will not be obligatory unless the advancements are made "for a certain purpose." It seems that the "certain purpose" language may be safely disregarded by mortgagees, since the court failed to use this language in other portions of its opinion where it defines an obligatory mortgage (e.g. *Id.* at 196, 220 and 221, 228 N.E. 2d 844 and 858). Moreover, no logical legal reason exists as to why advances otherwise required under a mortgage for future advances (e.g. a construction mortgage) should be considered to be non-obligatory merely because the advances are not made for a certain purpose.

The "certain purpose" language can probably be attributed to the loose manner in which some portions of the *Yarborough* opinion are drafted. In this regard, see note 30.

[45] In holding that Wayne's mortgage was not obligatory, the court relied heavily on various findings made by the Court of Appeals. *Id.* at 221, 228 N.E. 2d at 858. In addition, the court noted that the § 1311.14 language in the mortgage deed imposed ". . . no obligation on the part of . . . [Wayne] to disburse any certain amount of money under the mortgage in any particular manner." *Id.* at 220, 228 N.E. 2d at 858.

It has been theorized that Wayne, contrary to the Supreme Court's finding, was indeed under an obligation to disburse to Yarborough the full amount set forth on the face of the mortgage. See Note, *supra* note 1 at 430-31:

> ". . . it is difficult to understand how the court found no obligation on the part of the mortgagee to make future advances.
>
> "Whatever the reasons behind the mortgagee's unilateral action to reduce the amount of the loan, it does not necessarily follow that the mortgagee could, under its agreement, do so. The fact that Yarborough did not bring an action for a breach of the agreement does not mean that he did not have such a cause of action against the mortgagee.
>
> "The better way to view the construction mortgage agreement would be as a series of payments each upon a condition precedent. The obligation arose with the original note and mortgage, and continued as long as construction proceeded properly. If Yarborough had said that a certain portion of the house was completed and that he therefore needed funds, could the mortgagee have refused? As long as the event, progress on the building, arose, there was an obligation to disburse a portion of the funds."

The foregoing theory possesses considerable merit. However, since it has now been categorically rejected by the Supreme Court, secured lenders must seek other theoretical foundations upon which to base their assertions concerning the priority of construction mortgages.

subsequent to the intervening mechanics' liens, for Wayne had made each of its optional disbursements after the commencement of construction (i.e. after the date when the mechanics' liens had attached to the mortgaged premises). In addition, the Court also held that Wayne's mortgage lien was subsequent to Sauter's lien, since Sauter had recorded its purchase money mortgage before Wayne had made the first of its optional disbursements.[46]

F. Drafting the Obligatory Mortgage

Because of the many factors which militate against the use of a § 1311.14 disbursement procedure and the statutory affidavit disbursement procedure, and because of the implied sanction given by *Yarborough* to the use of non-statutory obligatory construction mortgages, it appears that a prospective mortgagee can best protect the priority of its lien by executing an obligatory, non-statutory construction mortgage. Of course, the principal problem in drafting an obligatory construction mortgage lies in insuring that the mortgage is "obligatory" (i.e. that it obligates the mortgagee to advance a certain and definite sum to the mortgagor in a particular manner).

Neither the *Yarborough* opinion nor that in the recent construction loan case of *Akron Savings & Loan Co. v. Ronson*[46a] renders any appreciable assistance to a mortgagee which is vitally interested in ascertaining the type and number of conditions which it can, without destroying the obligatory nature of its mortgage, impose as a prerequisite to its obligation to disburse.[47] Nevertheless, it appears that if the conditions inserted in a mortgage deed are commercially reasonable when applied to the construction and banking industries, such conditions, assuming they otherwise require the mortgagee to disburse a certain and definite amount in a particular manner, will not be held by Ohio courts to destroy the obligatory nature of the mortgage.[48]

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[46] Of course, the mechanic's liens were accorded priority over Sauter's mortgage lien since work had already begun on the mortgaged premises when Sauter recorded its mortgage. *Id.* at 207, 228 N.E. 2d at 850.

[46a] 15 Ohio St. 2d 6, 238 N.E. 2d 760 (1968).

[47] See note 44 and the text accompanying said note.

[48] See Ison, *Open-End Mortgages and Wayne B & L vs. Yarborough,* The Ohio Record for November, *1967,* 50 (1967). Therein Mr. Ison states (p. 54):

> "The [Yarborough] requirement of advancing 'a certain and definite sum in a particular manner,' in the language of the Court, may or may

(Continued on next page)

The problem of pinpointing the prerequisites of an obligatory mortgage may have been rendered nugatory by § 5301.232(E)(4). Subsection (E)(4), which is a portion of the extensively amended open-end mortgage statute, became effective on November 24, 1967. It provides:

> "A holder of a mortgage is 'obligated' to make an advance if said holder or the person to whom the repayment of such advance is owed has a contractual commitment to do so, even though the making of such advance may be conditioned upon the occurrence or existence, or the failure to occur or exist, of any event or fact, which event or fact must occur or exist or fail to occur or exist within three (3) years following the time the mortgage is delivered to the recorder for record; provided, that such three (3) year limitation does not apply to any mortgage given to secure, in whole or in part, loan advances made to pay the cost of any construction, alteration, repair, improvement, enhancement, or embellishment of any part of the mortgaged premises;"

If a construction mortgage can, as this article submits, be drafted so as to constitute an open-end mortgage, then Subsection (E)(4) is of immense significance, since it permits a mortgagee, without destroying the obligatory nature of its mortgage, to condition its mortgage disbursements on the existence or non-existence of "any event or fact"; and at the same time it permits the mortgagee to enjoy certain advantages which the open-end statute extends to holders of obligatory mortgages vis-a-vis intervening lienors. If a construction mortgage cannot be

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(Continued from preceding page)

not permit the traditional excuses for non-performance to be operative and still have the mortgagee 'obligated' to make advances. To allow the mortgagee 'to advance a certain sum, under particular conditions,' for the purpose of construction *does seem to allow* the mortgagee to require that certain conditions precedent be met prior to disbursement." (Emphasis added)

However, compare *Kingsberry Mortgage Co. v. Maddox,* 13 Ohio Misc. 98 (C.P. 1968) which states (p. 103):

> "The court in . . . [*Yarborough*] stated that the building and loan [association] would obtain priority if . . . [it] was required unequivocally to advance all of the money agreed to in the loan . . . ." (Emphasis added)

The *Kingsberry* decision distorts *Yarborough. Yarborough* did not hold that a mortgage is obligatory only when it "unequivocally" requires the mortgagee to advance the face amount of the mortgage. On the contrary, Yarborough held that a mortgage is obligatory whenever it requires the mortgagee to advance the face amount of the mortgage (i.e. "a certain and definite sum") in a particular manner and under "certain conditions," provided, of course, the conditions are not in themselves arbitrary or subject to the unfettered discretionary control of the mortgagee.

drafted so as to constitute an open-end mortgage, subsection (E) (4) will nevertheless be of assistance to the mortgagee which has conditioned disbursements upon the occurrence or non-occurrence of various events or facts, since it can support its assertion regarding the obligatory nature of its mortgage by referring, by way of analogy, to (E) (4).

Ohio courts have not yet definitively decided whether an obligatory construction mortgage which does not mention the mortgagee's obligation to make disbursements will acquire priority over mechanics' liens which attach to the mortgaged premises after the recording of the mortgage but before any disbursements are made thereunder. At times, the *Yarborough* opinion leads one to conclude that had Wayne obligated itself to disburse to Yarborough a certain and definite amount in a particular manner, Wayne's mortgage lien would have been accorded priority over the intervening mechanics' liens and Sauter's mortgage lien even though the mortgage deed did not declare Wayne's obligation to disburse. However, this conclusion is tempered by the following language of the *Yarborough* decision:

> "Although the *better practice* would seem to be for the mortgage papers filed for public record to contain or refer to the obligation to advance, for such would furnish notice to the respective mechanic or materialmen that there is a prior lien in the amount specified, it is not necessary to decide that question for the present." [Emphasis added][49]

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[49] 11 Ohio St. 2d 195, 220, 228 N.E. 2d 841, 858 (1967).

In *Yarborough,* the Court states that two rationale underlie its holding that an obligatory mortgage (unlike a non-obligatory mortgage) must be accorded priority over mechanic's liens which attach to the premises after the recording of the mortgage but before disbursements made thereunder. First, the Court in effect states that under an obligatory mortgage the mortgagee cannot, without violating its agreement to disburse, avoid making, as it can under a non-obligatory mortgage, the required disbursements (11 Ohio St. 2d at 215-16, 228 N.E. 2d at 855). Second, the Court states that non-obligatory mortgages do not furnish to intervening lienors notice of the outstanding mortgage (*Id.* at 216, 228 N.E. 2d at 855), the implication being that an obligatory mortgage furnishes the requisite notice to intervening lienors.

Of course, the Court is correct as to its first rationale—a mortgagee under an obligatory mortgage cannot lawfully avoid making the required disbursements. However, the Court is incorrect as to the implication which stems from its second rationale—an obligatory construction mortgage ordinarily furnishes no notice to an intervening lienor of the mortgagee's obligation to disburse just as a non-obligatory mortgage furnishes no notice concerning the absence of a disbursal obligation on the mortgagee's part. Perhaps this inapplicability of the second rationale to the world of realty explains the Court's curious and cryptic comment concerning "the better practice" since if "the better practice" was followed by mortgagees the Court's second rationale would be given vitality.

In *Akron Savings & Loan Co. v. Ronson*[49a] the mortgagor had executed and delivered to the mortgagee a construction mortgage which did not on its face obligate the mortgagee to disburse under definite conditions to the mortgagor the face amount of the mortgage. In ruling that various materialmen who had delivered materials to the mortgaged premises were entitled to priority over the mortgagee which had recorded its mortgage before construction commenced but disbursed its loan proceeds after such commencement, the Ohio Supreme Court stated:

> "As this court has concluded that the mortgage in the instant case [and all written agreements between mortgagor and mortgagee] did not contemplate definite and certain advances [i.e. was not 'obligatory'], it is not necessary to consider whether the oral [non-obligatory disbursement] agreement [between mortgagor and mortgagee] would [assuming it was 'obligatory'] constitute sufficient notice to subsequent encumbrances." [49b]

After making its remarks concerning the oral disbursing "agreement," the Court immediately reaffirmed its views as set forth in *Yarborough* concerning the "better practice."

In view of the Ohio Supreme Court's intimation—in both the *Yarborough* and *Ronson* decisions—of what it considers to be the "better practice," a mortgagee which desires to insure the priority of its mortgage lien has no real choice but to heed the Court's "advice" and to begin placing in its mortgage deeds the conditions governing its obligation to disburse or, in the alternative, including a reference to such obligation and attendant conditions.

III. Open-End Mortgages

A. General Discussion

As stated in an earlier portion of this article, it appears that a non-statutory, obligatory construction mortgage can and should be drafted as an open-end mortgage.[50] Accordingly, at this point,

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[49a] 15 Ohio St. 2d 6, 238 N.E. 2d 760 (1968).

[49b] 15 Ohio St. 2d 6, 13, 238 N.E. 2d 760, 765 (1968).

[50] Compare, Note, *Ohio Lien Priority Rules Affecting Mortgages, Mechanic's Liens, and Fixture Security Interest,* 18 *W. Res. L. Rev.* 1284, 1289 (1967) which states:

> ". . . there seems to be no substantial reason for imposing the open-end mortgage formalities upon the improvement [§ 1311.14] mortgage."

Unless the context indicates otherwise, the phrase 'open-end mortgage' as used in this article means an open-end mortgage which meets all of the requirements set out in § 5301.232.

it seems desirable briefly to set forth the rules which govern the creation of an open-end mortgage and which regulate the priorities of disbursements made thereunder insofar as such disbursements relate to mechanics' and other types of liens.

Before the adoption of the original Ohio open-end mortgage statute, a mortgagee acting pursuant to the future-advances clause of a mortgage could make additional loans to the mortgagor, which loans would be secured by the original mortgage. No particular form of mortgage deed was required.

In 1965 the Ohio legislature enacted an open-end mortgage statute. This statute, as subsequently amended in 1967, provides that a mortgage "[W]hether or not it secures any other debt or obligation . . . may secure unpaid balances of loan advances made [by the holder of the mortgage] after the mortgage is delivered to the recorder for record . . . ." [51] In addition, the statute also provides that a mortgage will constitute an open-end mortgage within the meaning of the statute only if it:

1. Indicates in substance or effect that it secures future advances, if any, made by the mortgagee to the mortgagor.

2. States the maximum amount of unpaid loan indebtedness, exclusive of any interest thereon, which may be outstanding thereunder at any time.

3. Contains at the beginning thereof the words "OPEN-END MORTGAGE." [52]

The statute also provides that all obligatory future advances made under an open-end mortgage take priority over all intervening liens which attach to the premises after the mortgage is recorded.[53] In this respect, the statute merely codifies the existing Ohio case law.

B. Deviation from Ohio Case Law

The principal thrust of the open-end mortgage statute lies in its alteration of the existing Ohio case law governing optional future advances. Such alteration results in according more favorable treatment to a mortgagee under a statutory open-end mortgage than is accorded his non-statutory counterpart.[54] To be

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[51] § 5301.232(A).

[52] *Ibid.*

[53] § 5301.232(B).

[54] The phrase "non-statutory counterpart" refers to any mortgagee holding a mortgage which does not meet the requirements of § 5301.232(A).

more specific, under the Ohio case law, if a mortgagee makes an optional advancement after a lien (mechanic's or otherwise) has attached to the premises, then the intervening lien takes priority over the optional advancement. Under the open-end mortgage statute, a mortgagee which makes an optional advancement to the mortgagor takes priority with respect to such advancement over all intervening liens which attached to the premises *before* the date of the advancement, provided the mortgagee has not received from the lienor written notice of the lien.[55] Of course, if a mortgagee, prior to its optional advancement, receives the requisite written notice of lien or if it has received written notice of work or labor performed or to be performed or machinery, material or fuel furnished or to be furnished, for construction on the mortgaged premises, then its mortgage lien for the unpaid balance of the optional advancements will be subordinated to the lien or the lien acquired by reason of the work or labor performed or to be performed or the machinery, material, or fuel furnished or to be furnished as specified in the written notice.[56]

C. Drafting the Open-End Mortgage

When the liberal treatment accorded optional disbursements under an open-end mortgage is coupled with the knowledge that such a mortgage does not affect the favorable treatment extended by the *Yarborough* decision to obligatory non-§ 1311.14 mortgages, it becomes obvious that a construction mortgage should be drafted, if possible, as an open-end mortgage. A question as yet unresolved either by statute or judicial fiat is whether a construction mortgage may be drafted in the form of an open-end mortgage. As indicated earlier, it seems that the question can and should be answered in the affirmative.

An open-end mortgage is defined by implication in § 5301.232 (A) to include every mortgage which secures ". . . unpaid balances of loan advances made after the mortgage is delivered to the recorder for record . . . ." provided the form of the mortgage complies with the various requirements set out in Subsection (A) of that section.[57] It is manifest that the typical construction mortgage secures "unpaid balances of loan advances" made by the mortgagee for the purpose of enabling the mortgagor to construct

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[55] § 5301.232(B).

[56] *Ibid.*

[57] See text accompanying note 52.

improvements on the mortgaged premises. Thus, it is submitted that a construction mortgage which is drafted to comply with § 5301.232(A) should entitle the mortgagee to be accorded all the benefits which are derived from the use of the statutory open-end mortgage form.

Though the open-end mortgage statute clearly states that an optional disbursement made under a recorded open-end mortgage takes priority over intervening liens if the mortgagee has not, prior to the time of the disbursement, received written notice of the lien, it is not difficult to imagine an Ohio court refusing to so read the statute. Ohio courts have traditionally construed the Mechanic's Lien Statute in a liberal manner so as to extend, whenever possible, maximum protection to laborers and materialmen.[58] Therefore, it is not difficult to imagine an Ohio court ruling that the legislature did not intend for one isolated section of the open-end mortgage statute (§ 5301.232(B)) to negate all of the priority rights granted to mechanics men by Chapter 1311.[59] In the alternative, if the court feels that it cannot legitimately disregard the clear wording of the open-end mortgage statute

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[58] Section 1311.24 states:

> "Sections 1311.01 to 1311.24, inclusive, of the Revised Code, are to be construed liberally to secure the beneficial results, intents, and purposes thereof; and a substantial compliance with said section is sufficient for the validity of the liens under said sections, provided for and to give jurisdiction to the court to enforce the same."

[59] See *Vernon v. Harper,* 79 Ohio St. 181, 187, 86 N.E. 882-883 (1908), stating:

> "The policy of the state with respect to the claims of laborers and materialmen to be compensated for their work and material out of the structure to which their work and material have combined is indicated by the statute as to liens and has been clearly defined in a number of decisions in this and other courts. The statute should be liberally construed in order to carry out the purpose of the general assembly in its enactment, the legislation being highly remedial in character."

Also see Note, *supra* note 50, at 1298, declaring:

> "It [is] . . . noted that the improvement [1311.14] mortgage might be a type of future-advances mortgage not controlled by the open-end mortgage statute."

Cf. Constitution of Ohio, Art. II, Section 33, which states:

> "Laws may be passed to secure to mechanics, artisans, laborers, sub-contractors and materialmen, their just dues by direct lien upon the property, upon which they have bestowed labor as for which they have furnished material. No other provision of the Constitution [and a fortiori the Revised Code?] shall impair or limit this power."

But see *Western and Southern Indem. Co. v. Chicago Title & Trust Co.,* 128 Ohio St. 422, 191 N.E. 462 (1934) stating (Headnote 1):

> "Where two sections of the . . . Code contain inconsistent provisions relating to the same subject matter, the later enactment must prevail and the earlier is repealed by implication."

with respect to the priorities between optional disbursements and intervening mechanics' liens, it can eliminate the priority accorded optional disbursements when written notice is not given by the lienor by holding that whenever a mortgagee makes an optional disbursement and knows either actually or constructively that liens have attached to the premises, such knowledge on the part of the mortgagee negates the written notice requirement. In this manner, the court could in many instances provide for the priority of intervening liens even though the required written notice was not given.

If Ohio courts adopt either of the stances discussed in the preceding paragraph, then the priority between optional disbursements and intervening mechanic's liens will be governed by the present case law, which provides that optional disbursements made under a construction mortgage take priority over liens only if and to the extent that the disbursements are made before the liens attach.

Because of the possibility that Ohio courts may eventually hold that the written notice provisions of the open-end mortgage statute are inapplicable with respect to intervening mechanics' liens, a mortgagee should refuse, if possible, to make optional disbursements unless it is assured of the mortgagor's solvency or the general contractor's integrity or, in the alternative, unless it secures the necessary waiver of lien forms from the holders of all liens which have attached to the mortgaged premises prior to the date of the contemplated optional disbursement.

In spite of the judicial "roadblocks" which future Ohio courts may toss into the path of the open-end mortgage statute, no harm can result to a mortgagee from the insertion of the necessary open-end language into its present mortgage deed, assuming, of course, that optional disbursements are restricted in the manner suggested in the preceding paragraph. On the other hand, if future Ohio courts interpret the open-end mortgage statute to mean exactly what it "says" then mortgagees which have drafted their mortgage deeds in open-end form will be able to operate with greater flexibility than those of their counterparts who have not availed themselves of the statutory form.

IV. Combining Open-End and § 1311.14 Mortgages

A. The Thesis

It has been suggested that a mortgage which secures a construction loan should not only be drafted as an open-end mortgage but ". . . should also incorporate the provisions of § 1311.14 in a permissive, and not mandatory, way." [60] In this regard, it has been asserted: (1) that the open-end portion of the mortgage will protect the mortgagee's priority for all disbursements made by it until it receives (after the mortgage has been breached) a written notice that a lien has attached to the mortgaged property; and (2) that the § 1311.14 portion of the mortgage will thereafter protect the mortgagee's priority for all further disbursements made by it, provided, of course, the disbursements are made in accordance with divisions (A) through (G) of that section.[61]

B. The Thesis Examined

Obviously, the above suggestion will be both intriguing and inviting to holders of mortgages which secure construction loans. Moreover, the suggestion possesses considerable merit. Nevertheless, a mortgagee should exercise caution in combining open-end provisions and § 1311.14 provisions in its mortgage deed until the now undefined relationship between § 5301.232 (open-end mortgages) and § 1311.14 is defined either by statute or judicial decree. The relationship between § 5301.232 and § 1311.14 may be judicially defined in a manner which totally or partially destroys the priority of the mortgage lien over intervening mechanics' liens in those instances when a mortgagee combines both open-end provisions and § 1311.14 provisions in its mortgage deed.

Attention is directed to those portions of § 1311.14 providing that a mortgage lien takes priority over all intervening mechanics' liens which are perfected after the § 1311.14 mortgage deed is "filed for record." In this respect, it is possible and perhaps even probable that Ohio courts will ascertain the record date of a mortgage combining both open-end provisions and § 1311.14

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[60] Ison, *supra* note 48, at 54. *Cf.* Comment *supra* note 1, at 940.

[61] "In other words, I am stating that I think it is possible, in the bad situation where a default occurs, for a mortgagee to have priority with respect to all loan disbursements, partially because of the open-end mortgage sections and partially because of Section 1311.14, if literal compliance with Section 1311.14 is had after condition is broken." *Ibid.*

provisions in a manner which, as pointed out earlier, will result in the court's negating the priority of the mortgage lien.

An Ohio court might adopt one of two approaches in ascertaining the record date of the § 1311.14 portion of an open-end mortgage. Either approach, if blindly followed, could result in a judicial decree destroying the priority of the mortgage lien.

The first approach in ascertaining the record date of the § 1311.14 portion of an open-end mortgage consists of surrendering to the subtleties of logic. Such surrender might result in a court reasoning that even though the § 1311.14 portion of the recorded mortgage deed did not become effective until after default by the mortgagor and the mortgagee's receipt of the requisite written notice of lien, nevertheless, the record date of the § 1311.14 portion of the mortgage obviously must be and is the date on which the mortgage deed was recorded. Or a court might adopt a slightly more sophisticated method of reasoning and still reach an identical conclusion. For example, the court might state:

> "After the mortgagor has defaulted under the open-end portion of the mortgage deed and after the requisite written notice of lien has been delivered to the mortgagee, the § 1311.14 portion of the mortgage automatically becomes operative. When the § 1311.14 portion becomes operative, it necessarily supersedes and replaces the open-end portion of the mortgage. Since the § 1311.14 portion of the mortgage replaces and supersedes the open-end portion, it obviously follows that the record date of the § 1311.14 portion relates back to the record date of the open-end portion i.e. the date on which the mortgage deed containing both portions was duly recorded."

Once a court has convinced itself that the § 1311.14 portion, upon becoming operative, relates back to the date the mortgage deed was recorded, it should experience no difficulty in taking the next "logical" step, which might consist of reasoning as follows:

> "Since upon becoming operative, the § 1311.14 portion of the mortgage replaces the open-end portion as of the record date of the mortgage deed, the open-end portion *must be disregarded* in determining priorities under § 1311.14. Therefore, all disbursements made by the mortgagee prior to the default by the mortgagor and the mortgagee's receipt of the requisite written notice of lien *will not take priority* over the mechanic's liens which attached to the premises and which were perfected after the record date of the mortgage except to the extent that such disbursements were made in accordance with divisions (A) through (G) of § 1311.14."

A second approach in ascertaining the record date of the § 1311.14 portion of an open-end mortgage consists of judicially creating a fictitious record date in such a manner that the judicially created record date reflects "the true state of affairs between the mortgagee and the mortgagor." A court which chooses the second approach might reason that the § 1311.14 portion of the mortgage does not become operative until the mortgagor has defaulted under the open-end portion of the mortgage and the mortgagee has received the requisite written notice of lien. Since the § 1311.14 portion does not become operative until the mortgagee has received (after default) the written notice of lien, the court might then reason that the record date for the purpose of applying § 1311.14 should be considered to be the date on which the § 1311.14 portion of the mortgage became operative.

Of course, the critical danger which stems from treating the operative date of the § 1311.14 portion as the record date lies in the possibility that some court might then hold that all mechanics' liens which were perfected prior to the record date take priority under § 1311.14 over all disbursements made thereafter.

In summary, it is recommended that a discretionary § 1311.14 provision should not be inserted in an open-end mortgage, since Ohio courts might indiscriminately apply the "logic" set forth above and as a result thereof judicially destroy, either in whole or in part, the priority of the mortgage lien. In this regard, it should be remembered: (1) that in cases involving mechanics men and mortgages, when two plausible yet mutually exclusive alternatives present themselves, Ohio courts tend to adopt the alternative which accords priority to the mechanic's lienor over the mortgage lienor; and (2) that a mortgagee which adopts the combined form of mortgage must bear the burden of establishing to the satisfaction of the judiciary that it should enjoy the best of both worlds (§ 5301.232 and § 1311.14) even if as a result thereof the priority of intervening mechanics' liens must suffer. Until the questions posed herein have been resolved, it is recommended that mortgagees use the obligatory non-§ 1311.14 mortgage (borrowing from § 5301.232 for whatever help it can give) combined with acceleration of the mortgage obligations in the event of a breach thereof.

V. Vendees' Liens

A. The Problem

A prospective mortgagee under a construction mortgage can ill afford to limit its concern to insuring that its mortgage lien will acquire priority over mechanics' liens which attach to the mortgaged premises by reason of the contemplated construction. On the contrary, the mortgagee should also take any action necessary to insure that its mortgage lien acquires priority over any vendee's liens which might exist.

The *Yarborough* decision created new law with respect to vendee's liens. In that case, Yarborough (the builder) and Donald and Gloria Lantz (the purchasers) executed a contract which obligated Yarborough to build a home on a certain piece of land and then to convey the land to the Lantzes. In return, the Lantzes gave Yarborough their promissory note in the amount of $8,000.00 in partial payment of the agreed-upon purchase price of $30,000.00. Thereafter, on October 11, 1963, the Lantzes paid $4,000.00 in cash to Yarborough.

After the execution of the contract to purchase and the $4,000.00 cash payment, Sauter Development Company, the owner of the land on which the Lantzes' home was to be constructed, deeded the land to Yarborough, who thereupon mortgaged it to Sauter as security for a portion of the purchase price. When Sauter executed and delivered the deed to Yarborough and when Yarborough executed and delivered the mortgage to Sauter, Sauter knew of the Lantzes' contract to purchase the land. Sauter did not immediately record its deed.

Yarborough and his wife then executed and delivered to Wayne Building and Loan Co. their mortgage deed and promissory note in the amount of $22,000.00. In exchange, Wayne agreed to supply $22,000.00 to be used in the construction of the Lantzes' home. At this time, Wayne knew of the Lantzes' contract to purchase.

Wayne then recorded its mortgage and thereafter Sauter recorded its mortgage.

After the recording of the mortgages, the Lantzes made an additional $4,000.00 cash payment to Yarborough. When both of the $4,000.00 cash payments were made by Donald and Gloria Lantz, neither knew that Yarborough had mortgaged the property to Wayne and Sauter.

Before the completion of the Lantzes' home, Wayne filed an action for foreclosure and the marshalling of liens against the Yarboroughs and numerous other parties who claimed liens against the mortgaged property. Both the trial court and the Court of Appeals refused to give the Lantzes priority for the $8,000.00 paid by them to Yarborough.

The Supreme Court first considered the issue of the existence of the Lantzes' vendee's lien. It pointed out that a ". . . vendee under an executory contract for the sale and purchase of real property has an equitable lien . . . in the land in the amount paid on the purchase price." [62] It also pointed out that ". . . there is no legal distinction between the case where the vendor contracts to sell land to which he already has title, and the case . . . , where the vendor [e.g. Yarborough] did not have title to the land at the time of the contract, but either represented that he had title or represented that he could and would obtain it, *and he subsequently did obtain it.*" [63]

Having established the existence of Lantzes' vendee's lien, the Court then proceeded to determine the lien's priority. The Court first pointed out that the Lantzes' vendee's lien was equitable in nature and thus was subject to being cut off by the rights of a bona fide purchaser such as a mortgagee.[64] The Court next pointed out that neither Wayne or Sauter could qualify as a bona fide purchaser if either had knowledge of the Lantzes' equity in the land when it accepted and recorded its mortgage.[65]

The Court of Appeals had felt that mere knowledge on the part of Wayne and Sauter of the Lantzes' contract to purchase was not legally sufficient knowledge of the Lantzes' equity in the mortgaged property to warrant denying priority to the mortgage liens. (Apparently, the Court of Appeals would have required actual knowledge by the mortgagees of the cash payments made by the Lantzes to Yarborough.)[66] Accordingly, the Court of Appeals held that the Lantzes possessed no vendee's lien which could take priority over the respective mortgage liens held by Wayne and Sauter. (In other words the Lantzes' vendee's lien had been cut off by bona fide purchasers—Wayne and Sauter.)

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[62] 11 Ohio St. 2d 195, 199, 228 N.E. 2d 841, 845 (1967).

[63] *Id.* at 200, 228 N.E. 2d at 846.

[64] *Ibid.*

[65] *Id.* at 200-01, 228 N.E. 2d at 846-47.

[66] *Id.* at 201, 228 N.E. 2d at 846-47.

The Ohio Supreme Court emphatically disagreed with the Court of Appeals regarding the requisite "knowledge" which a mortgagee must possess before a court is justified in according priority to the vendee's lien over the mortgage lien. The Court stated:

> ". . . it would certainly seem, on reason alone, that a . . . [mortgagee] loaning money on property for the purpose of construction of a house thereon, and *being informed that there is an outstanding contract for the sale of such property* upon completion, would be on inquiry as to the extent of any already existing interest of a purchaser under such contract, and would take a mortgage on the property subject to the equities of the purchaser." [67]

Accordingly, the court held that:

> ". . . notice to Wayne [and Sauter] of an outstanding contract to purchase the subject premises was sufficient notice of the equities of the Lantzes under such contract." [68]

Having defined the quantum of knowledge necessary to disqualify Wayne and Sauter as bona fide purchasers and having ruled that Wayne and Sauter possessed such knowledge, the court then turned its attention to the second factor necessary to insure the priority of the Lantzes' vendee's lien—their lack of actual knowledge of the mortgages. The court pointed out that:

> "Where the vendee continues to pay out purchase money under his contract to purchase real estate without *actual* notice of a recorded mortgage, which is held by a mortgagee who took with notice of the vendee's rights under his contract, the vendee . . . [is], in Ohio, . . . entitled to priority against such mortgagee, for the amount he has actually paid before such actual notice." [69]

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[67] *Id.* at 202-03, 228 N.E. 2d at 847.

[68] *Id.* at 203, 228 N.E. 2d at 848. In effect, the court stated the knowledge held by Wayne and Sauter precluded them from assuming the role of a bona fide purchaser.

One author has observed that the *Yarborough* court might have accorded priority to the Lantzes vendee's lien vis-a-vis Wayne's mortgage lien even if Wayne had possessed no knowledge of the Lantzes contract to purchase. See Note, *supra* note 1 at 426-427. In view of the Court's obvious desire to protect the Lantzes, this observation appears valid.

[69] *Id.* at 203-04, 228 N.E. 2d at 848.

It is submitted that a vendee's "actual notice" of a recorded mortgage should not, in all instances, constitute the triggering event which thereafter results in denying priority to all further payments made by the vendee. The facts of *Yarborough* can be adapted to illustrate this point. Assume, for example, that the Lantzes actually knew Wayne had recorded its non-

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The Court, relying upon findings made by the Court of Appeals, held that the Lantzes had made both of their $4,000.00 payments before they learned of the mortgages held by Wayne and Sauter and thus were entitled to priority over said mortgages.

B. The Solution

From the *Yarborough* decision, it may be inferred that a properly executed and recorded mortgage will take priority over a vendee's equitable lien if the mortgagee has no knowledge that a vendee and the mortgagor have executed a contract pursuant to which the vendee is obligated to purchase the realty in question. In addition, the priority of the mortgage will be preserved if the vendee waives his equitable lien insofar as the mortgagee is concerned. (In this situation, it is immaterial that the mortgagee knows of the vendee's executory contract to purchase.)

In view of the foregoing, the disbursing agreement used by a mortgagee should require the mortgagor to inform the mortgagee if he has entered into a contract with a vendee pursuant to which the mortgagor is obligated to convey the realty to the vendee. If the mortgagor has entered into such a contract, the disbursing agreement should require him to set forth: (1) the name of the vendee; (2) the address of the vendee; and (3) the amount of the purchase price paid to him by the vendee. Upon receiving the name and address of any vendee, the mortgagee should immediately inform the vendee that it intends to make a secured loan to the vendor-mortgagor and at such time, the mortgagee should request the vendee to waive the priority of his equitable lien insofar as the mortgagee is concerned.

If the vendee executes a waiver of lien, and if the waiver is supported by consideration, then the mortgage securing the construction loan will take priority over the vendee's equitable lien. If the vendee will not execute a waiver of lien, then the mortgagee should take such action as it deems appropriate under the

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obligatory mortgage and that thereafter they nevertheless made various payments to Yarborough. In this instance, all payments thereafter made by the Lantzes should be accorded priority over all optional advancements made by Wayne to the extent that such further payments were made by the Lantzes without actual knowledge on their part that optional advancements had been made by Wayne. In essence, the *Yarborough* language concerning the effect of a vendee's lack of actual knowledge should hereafter be applied by courts only to obligatory mortgages.

circumstances (such as reducing the amount of the proposed loan by the amount of the outstanding vendee's lien).[70]

If the mortgagor states in the disbursing agreement that he has not entered into any contract pursuant to which he is obligated to convey to any person all or any portion of the realty, then the mortgage lien will take priority over any vendee's equitable liens which in fact exist when the obligatory or § 1311.14 mortgage deed is recorded, provided that at the date of the recording of the mortgage, the mortgagee has no actual knowledge of any facts or circumstances which, if pursued or investigated, would lead a reasonable man to discover the existence of the vendee's equitable lien.

VI. Summary and Conclusion

Three methods exist by which a mortgagee may preserve the priority of its mortgage lien over liens of mechanics men which attach to the mortgaged premises after the recording of the mortgage but before any disbursements are made thereunder. The three methods consist of: (1) disbursing mortgage proceeds in accordance with divisions (A) through (G) of § 1311.14; (2) disbursing mortgage proceeds in accordance with §§ 1311.04-.05 as incorporated in § 1311.14 by judicial degree; and (3) disbursing mortgage proceeds in accordance with the obligatory terms of a properly recorded non-statutory construction mortgage.

A mortgagee should avoid disbursing in accordance with § 1311.14 or §§ 1311.04-.05 as incorporated in § 1311.14 by judicial decree, since these methods of disbursing are complicated and expensive and will jeopardize the priority of the mortgage lien.

Disbursement of mortgage proceeds in accordance with the obligatory terms of a non-statutory construction mortgage filed prior to the date of commencement of construction affords the best method (from both a legal and cost standpoint) of insuring the priority of a mortgage lien.

The non-statutory obligatory construction mortgage may be

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[70] If the vendee refuses to execute a waiver of lien immediately after the construction mortgage is recorded, the mortgagee should inform the vendee first by phone and then registered letter of the recording of the mortgage. (The constructive notice afforded by proper recording will not suffice.) If the vendee is not so informed, then all payments thereafter made by him to the vendor will be accorded priority over the mortgage to the extent the payments were made by him at a time when he had no actual notice of the recorded mortgage.

drafted as an open-end mortgage, with the result that a mortgagee may avail itself of the special benefits extended by that statute to mortgagees over intervening lienors.

Until the undefined relationship between the open-end mortgage statute and § 1311.14 is clarified, mortgagees should resist the temptation to combine open-end provisions and § 1311.14 provisions in a single mortgage deed.

Through the careful drafting of its disbursing agreement, a mortgagee may assure the priority of its mortgage lien over any vendees' liens which may exist.

The *Yarborough* decision and the new open-end mortgage statute are the principal sources of authority which a mortgagee must comprehend in order to draft a construction mortgage whose priority will withstand the assaults of intervening lienors. Hopefully, this article has exposed some of the ramifications of and relationships between these two important legal phenomena which will increasingly command the attention of institutional lenders in the months and years ahead.