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The Open-End Encumbrance

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THE OPEN-END ENCUMBRANCE

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Although in recent years a great deal has been written and said about open-end mortgages or deed of trust,[1] the concept of an encumbrance given for a sum of money advanced at the time of the execution thereof, or to be advanced in the future, or both, is not new. Attorneys and lenders are perhaps less familiar with the rights of the parties where a future advance encumbrance is used than in the normal mortgage relationship, because the open-end encumbrance is in less frequent use. Those rights, however, appear to be well established in Colorado, as well as in other parts of the country; the mystery appears to be one of unfamiliarity more than anything else.

Since 1812, when the case of *Shirras v. Caig*, 7 Cranch. 34, 3 L.Ed. 260, was decided, the validity of such encumbrances has been generally upheld.[2] Various decisions have resulted in confusion because of peculiar wording in the instrument involved in the litigation; a few have followed the English theory that the mortgagee, as legal title holder, has the right to retain title as security. Occasionally jurisdictions have based their decisions on local statutes,[3] but even though the purpose is not so stated, it is

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[1] For further discussion of this problem see Hiester, *The Open End Mortgage*, 28 DICTA 204 (1951); Ashley, *Mortgages to Secure Future Advances*, 31 N.C.L. REV. 504 (1953); Smith, *Open End Mortgages*, 2 PORTLAND U. L. REV. 19 (1952); LIFE, July 27, 1953, p. 61 (a pictorial illustration); 29 N.Y.U. L. REV. 733 (1953).

[2] Jones v. N. Y. Guaranty Co., 101 U. S. 622; In re Rosenbatt, 299 Fed. 771; Eggleston v. Birmingham Trust, 277 Fed. 1015; In re Corbett, 248 Fed. 988; Thomas v. Blair, 208 Ala. 48, 93 S. 704; Hendon v. Morris, 110 Ala. 106, 20 S. 27; Patterson v. Ogles, 152 Ark. 395, 238 S. W. 598; Vogan v. Caminetti, 65 Calif. 438, 4 P. 435; Am. Sav. Bank v. Kemp, 21 Calif. App. 571, 132 P. 617; DuBois v. Denver First Ntl. Bank, 43 Colo. 400, 96 P. 169 (1908); Hubbard v. Savage, 8 Conn. 215; Carrington v. Cit. Bank, 144 Ga. 52, 85 S. E. 1027; Weiser L. & T. Co. v. Comberford, 238 P. 515; Freutel v. Schmits, 299 Ill. 320, 132 N. E. 534; Good v. Woodruff, 208 Ill. App. 147; Bowen v. Ratcliff, 140 Ind. 393, 30 N. E. 860; Corn Belt Trust v. May, 197 Iowa 54, 196 N. W. 735; Allen v. Fuget, 42 Kan. 672, 22 P. 725; Ky. Lum. Co. v. Ky. T. Sav. Bank, 184 Ky. 244; Merchants' Bank v. Hervey Plow, 14 S. 139; West. Nat. Bank v. Jenkins, 131 Md. 239, 101 A. 667; Taft v. Stoddard, 142 Mass. 545, 8 N. E. 586; Cit. Sav. Bank v. Kock, 117 Mich. 225, 75 N. W. 458; Madigan v. Mead, 31 Minn. 94, 16 N. W. 539; Foster v. Reynolds, 38 Mo. 553; Raymond Nat. Bank v. Rabke, 72 Mont. 527, 235 P. 327; Wagner v. Breed, 29 Neb. 720, 46 N. W. 286; Reed v. Rochford, 62 N. J. Eq. 186, 50 A. 70; Ackerman v. Hunsicker, 85 N. Y. 43; Merchants' State Bank v. Tufts, 14 N. D. 238; Berry-Beall Co. v. Francis, 104 Okla. 81, 230 P. 496; Nicklin v. Betts Sp. Co., 11 Ore. 406, 230 P. 496; Moats v. Thompson, 283 Pa. 313, 129 A. 105; *Ex parte* Am. Fertilizer Co., 122 S. C. 171; Vacuum Oil Co. v. Liberty Ref. Co., 265 S. W. 749; Segman v. Darrow, 31 Vt. 122; Eltopia Fin. Co. v. Colby, 126 Wash. 554, 219 P. 24.

[3] New Hampshire has a statute (REV. ST. c. 131, §3) prohibiting optional future advances, and has held mortgages providing for such advances are invalid. Staniels v. Whitcher, 72 N. H. 451, 57 A. 678.

generally held that encumbrances for optional, additional advances are valid,[4] even as against creditors and subsequent purchasers, and even though the amount be unlimited,[5] and that such an advancement creates a lien prior to any intervening lien of which the original mortgagee had no actual notice.

As is commonly the case, the rule of law is more readily stated than applied. To arrive at a practical application of the general rule of law, terminology must be defined; the rights of other persons—the trustee, the intervening lien owner—must be considered; the lender is entitled to advice from his attorney which will prevent litigation and which will, at the same time, answer practical, competitve problems in a business-like manner.

The open-end encumbrance is becoming more and more common, not only in the financing of construction,[6] but also in the indemnifying of prospective endorsements, guarantees, and accommodations of commercial paper,[7] as well as in the financing of improvement and maintenance repairs and construction of residential property. Through the device of the open-end encumbrance, the mortgagee has the advantage of extending additional credit as the value of the security increases, and of maintaining an additional outlet for available funds without the necessity of the expenses incident to additional loans.[8] The mortgagor has the obvious advantage of obtaining additional funds at low interest rates and under long-term amortization schedules. In addition, the mortgagor avoids problems resulting from frequent title examinations, refinancing, or the alternative of second or third mortgages.[9] By means of the open-end encumbrance, additional moneys may be advanced by the mortgagee, to be secured by the original encum-

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[4] Dubois v. First Natl. Bank, 43 Colo. 400, 96 P. 169 (1908); Dummer v. Smedley, 110 Mich. 466, 68 N. W. 260; Reeves v. Evans, 34 A. 477 (N. J. Eq.). See also: Ferguson v. Mueller, 115 Colo. 139, 169 P. (2d) 610 (1946); and 1 Jones on Mortgages (8th Ed. Sec. 461).

[5] United States v. Hoos, 3 Cranch 73; Thomas v. Blair, 208 Ala. 48; Hamilton v. Rhodes, 72 Ark. 625; Tapia v. Demartini, 77 Calif. 383, 19 P. 641; Davis v. Carlisle, 5 Ind. Terr. 83; Union State Bank v. Chapman, 124 Kan. 315; Bunker v. Barron, 93 Mo. 87; Cit. Sav. Bank v. Rock, 117 Mich. 225; Candler v. Cromwell, 101 Miss. 161, 57 S. 554; Rice Bros. v. Davis, 99 Mo. App. 636, 74 S. W. 431; Wagner v. Breed, 29 Neb. 720, 46 N. W. 286; Chartz v. Cardelli, (Nev.) 270 P. 761; First Nat. Bank v. Byard, 26 N. J. Eq. 255; Cooan v. Bosque Bonita Land Co., (N. M.) 42 P. 77; Robinson v. Williams, 22 N. Y. 380; Paschal v. Bohannan, 59 Okla. 139, 158 P. 365; Moats v. Thompson, 283 Pa. 313, 129 A. 105; *Ex Parte* Am. Fertilizer Co., 122 S. C. 171; Klein v. Glass, 53 Tex. 37; Lamoille County Sav. Bank v. Belden, 90 Vt. 535; Alexandria Sav. Inst. v. Thomas, (Va.) 29 Gratt 483; Carey v. Herrick, 146 Wash. 283, 263 P. 190.

[6] New Baltimore Loan & Savings Ass'n v. Tracey, 142 Md. 211, 120 A. 441 (1923); Tripp v. Babcock, 195 Mass. 1, 80 N. E. 593 (1907).

[7] Robinson v. Williams, 22 N. Y. 380 (1860).

[8] An informative series of articles discussing the advantages and procedures involved in open-end mortgages was published intermittently in House & Home, July, 1952-Dec., 1953.

[9] 65 HARV. LAW REV. 478 (1952).

brance, as the need arises, as the parties agree, or in accordance with original commitments.

These encumbrances have generally been classified as either *optional* or *obligatory*. An *obligatory* open-end encumbrance is one under which the mortgagee has agreed in advance to loan the additional funds or one under which the mortgagee can elect to make an advancement or an expenditure upon the security property without the consent or approval of the mortgagor. In the latter group will fall such advancements as the payment of taxes, maintenance of the security to prevent waste, and the like. In the former group will be the customary construction loan, under the terms of which the mortgagee agrees, at the time of the original instrument, to advance the sums of money, within the limits specified in said instrument, as the construction progresses.

There is little or no doubt concerning the priority of the lien resulting from each advancement under an *obligatory* open-end encumbrance. It is, almost without question, held that such lien relates back to the lien of the original encumbrance, even though other liens have intervened and the mortgagor has knowledge of such intervening lien.[10]

A large portion of the texts and legal publication articles on the subject have concerned themselves with the priority of the lien of these *obligatory* open-end encumbrances and have paid little or no attention to the priority of liens for advancements made under *optional* open-end encumbrances. The most acute problems, however, exist in the use of *optional* open-end encumbrances.

If an encumbrance on its face purports to secure not only the sum originally advanced but also additional amounts, with or without limit, as may be agreed upon by both parties from time to time in the future, does such an encumbrance or an advance made thereunder create a valid lien? What is the priority of such lien—or liens? What is the effect of such an instrument on third parties claiming subsequent liens? Is the original mortgagee protected? Can the intervening lienor protect his rights? Upon whom is placed the obligation—the original mortgagee or the intervening lienor—to give notice of additional money advancements? What are the duties of the trustee upon release of the encumbrance, or upon foreclosure?

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[10] New Orleans Bank Assn. v. LeBreton, 120 U. S. 765; Schiffer v. Feagin, 51 Ala. 335; Keese v. Boardsley, 190 Calif. 465, 213 P. 500; Weissman v. Volimo, 84 Conn. 326, 80 A. 81; Good v. Woodruff, 208 Ill. App. 147; Belle Plaine Bank v. May, 197 Iowa 54, 196 N. W. 735; Nelson v. Royce, (Ky.) 7 J. J. Marsh 401, 23 Am. Dec. 411; Wilson v. Russell, 13 Md. 494; Gerrity v. Wareham Bank, 202 Mass. 156; Erickson v. Ireland, 134 Minn. 156; Sumers v. Roos, 42 Miss. 749; Creigh v. Jones, 103 Neb. 706; Farnum v. Burnett, 21 N. J. Eq. 87; Hyman v. Hauff, 138 N. Y. 48; Land Title Co. v. Shoemaker, 257 Pa. 213; Smith v. Smith, 33 S. C. 210; Colquhoun v. Atkinson, 20 Va. 550; McCarty v. Chalfant, 14 W. Va. 531; Wis. Planing Mill Co. v. Schuda, 72 Wis. 277; *In re* O'Byrne, L. R. 15 Ir. 373; Pierce v. Canada Co., 25 Ont. 671.

Such an encumbrance, where moneys beyond, or in addition to, the amount of the original indebtedness (less amortization payments) may be secured, if and when such moneys are advanced, is an *optional* open-end encumbrance.[11] The amount of the advancements may be limited by the original instrument or no limit whatsoever may be expressed.[12] Advancements may be evidenced by additional notes or other instruments, or appropriate wording in the original note may include such advancements.[13] The advancements may result in a total indebtedness far in excess of that stated in the original note, or such advancements may be limited by agreement, or otherwise, to the original indebtedness.[14]

If the mortgagee has bound himself in advance by agreement to lend future sums, or if the mortgagee can elect to make an advancement or an expenditure upon the security property without the consent or the approval of the mortgagor, it is *not* an *optional* advance . . . but is an *obligatory* advance. The *optional* open-end encumbrance is most commonly in use in residential financing because of its adaptability to the needs of the homeowner who makes conscientious efforts to maintain and increase the value of his property.[15]

Although some question may be raised as to the negotiability of the promissory note which permits additional advances under the original instrument, there can be no question that such a note would be at least transferable.

Three Colorado cases seem to express the prevailing law as to the validity of the open-end encumbrance and as to the priority of the lien of the additional advance.

In *Ferguson v. Mueller,* 115 Colo. 139, 169 P. (2d) 610 (1946), the Court said:

> No question is made concerning the validity of the mortgage to cover future advances and it is now well settled that the mortgage need not state on its face that such was its purpose.

In the early Colorado case of *Joralmon v. McFee,* 31 Colo. 26,

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[11] 138 A. L. R. 579.

[12] 81 A. L. R. 631.

[13] The following wording in the original note appears to be sufficient:

> For value received, we promise to pay to the order of..... the sum of $....., and such additional sums as may be advanced hereunder, at the option of the holders hereof, to the makers or their successors in title.

[14] Connecticut has held that mortgages for unlimited future advances are invalid as to creditors. Pettibone v. Griswold, 4 Conn. 158; Welch v. Chaffee, 73 Conn. 318.

[15] Where advances are to be made only to a certain amount or within a certain period, loans in excess of the amount or after expiration of the period are not entitled to priority. When the advances are an obligation on the mortgages, the mortgage takes effect immediately upon its execution. Atkinson v. Foote, 44 Cal. App. 149; Kohn v. Southern Ohio Loan and Trust Co., 101 Ohio 34; In re Moroney's Appeal, 24 Pa. St. 372.

71 P. 419 (1903), the Court upheld the validity of open-end encumbrances, and in *DuBois v. First National Bank*, 43 Colo. 400, 96 P. 169 (1908), the Court had before it the question of the priority of an advance made under an open-end encumbrance over an intervening good faith purchaser. The Court adopted the theory of the law advanced by the mortgagee, which was stated as follows:

> The position of the bank is that until she (the intervening good faith purchaser) gave to it actual notice of the acquisition of her interest in the property, it might continue to make advances to the mortgagor even after the maturity of the mortgage notes, since the mortgage did not restrict the time within which the advances were to be made, which would be protected by the mortgage as to the entire property.

and found that all the advances which the bank made to DuBois were made before defendant gave notice of her rights, and were, therefore, prior to such rights.

It would seem, therefore, that, in Colorado, *optional* advances made under an open-end encumbrance are within the lien of the original encumbrance if, at the time of such advance, the mortgagee had no *actual* notice of the intervention of other liens or claimants.

The *DuBois* case, never having been overruled, remains as the present law on the priority of the lien of advances made under *optional* open-end encumbrances. The lien of such advance relates back to the time of the original encumbrance, unless intervening lienors or claimants have given notice to the mortgagee of their intervening rights.[16]

The recording acts are meant to give reasonable notice to subsequent creditors and purchasers concerning the credits which have been or may be advanced and the purpose of or security for the contract. The Mississippi case of *Witczinski v. Everman* [17] is representative of opinions which state that even though no upper limit is stated in the mortgage, the fact of recordation itself puts subsequent parties on inquiry as to the state of dealings between the parties. Although there is some authority for the premise that the recording of a subsequent encumbrance puts the original

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[16] Davis v. Carlisle, 142 Fed. 196; Reidy v. Collins, 26 P. (2d) 712; Boswell v. Goodwin, 31 Conn. 74; Frye v. Bank of Illinois, 11 Ill. 367; Brinkmeyer v. Browneller, 55 Ind. 487; Nelson v. Boyce, (Ky.) 7 J. J. Marsh 401; Gray v. McClellan, 214 Mass. 92; Finlayson v. Crooks, 47 Minn. 74; Chartz v. Cardelli, (Nev.) 271 P. 761; Peaslee v. Evans, (N. H.) 133 A. 448; Micele v. Falduti, (N. J.) 137 A. 92; Catskill Nat. Bank v. Saxe, 24 N. Y. S. (2d) 82; U. S. Nat. Bank v. Embody, (Ore.) 25 P. (2d) 149; Nat. Bank v. Gunhouse, 17 S. C. 489; McDaniels v. Colvin, 16 Vt. 4; Alexandria Sav. Inst. v. Thomas, 29 Gratt (70 Va.) 483; Cisco Banking Co. v. Keystone Pipe Co., (Tex.) 277 S. W. 1060; Eltopia Fin. Co. v. Colby, 126 Wash. 554; Hall v. Williamson Grocery Co., 69 W. Va. 671.

[17] 51 Miss. 841 (1876).

mortgagee on notice of the rights of such intervening lienor, it is generally held that recording the junior lien does not constitute notice to the mortgagee who advanced the sums under the mortgage.[18] The intervening lien must be recorded to have any claim, but the recording act does not work upwards to prior-recorded liens.

A majority of the jurisdictions, as well as England, Canada, and Ireland, have held that where the advance is optional the intervening liens are not superior thereto unless the advance is made with *actual* notice or knowledge of the intervening encumbrance. Constructive notice is not sufficient, in most jurisdictions, to prevent the lien of the additional advance from relating back to the priority of the original encumbrance.[19]

Under date of April 28, 1954, the Public Trustee of the City and County of Denver has issued a statement of policy with reference to the releasing and foreclosing of open-end deeds of trust.

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[18] Witczinski v. Everman, 51 Miss. 841 (1876); Elmendorf-Anthony Co. v. Dunn, 10 Wash. (2d) 29, 116 P. (2d) 253 (1941). 4 POMEROY, EQUITY JURISPRUDENCE, §1199 (5th Ed., 1941):

> When a mortgage to secure future advances reasonably states the purposes for which it is given, its record is a constructive notice to subsequent purchasers and encumbrancers; they are thereby put upon an inquiry to ascertain what advances or liabilities have been made or incurred. The record of a subsequent mortgage or conveyance, or the docketing of a subsequent judgment, is not a constructive notice of its existence to such prior mortgagee. The prior mortgage, therefore, duly recorded, has a preference over subsequent recorded mortgages or conveyances, or subsequent docketed judgments, not only for advanced previously made, but also for advances made after their recording or docketing without notice thereof.

[19] The majority doctrine discussed above is further clarified and enlarged upon by Leonard A. Jones, *The Law of Chattel Mortgages and Conditional Sales*, (6th Ed., 1933), as follows:

> Generally the amount intended to be advanced need not be stated, provided it can be otherwise ascertained by the description. But even where limitation is necessary in order to constitute a continuing security, which will not be affected by subsequent conveyances, a recorded mortgage for an unlimited sum is notice to a subsequent encumbrancer as to all sums advanced upon the mortgage before the subsequent lien attaches. Moreover, the record of the subsequent mortgage is no notice to such prior mortgagee, that any subsequent lien has attached. A subsequent mortgagee can limit the credit that may be safely given under the mortgage for future advances only by giving the holder of it express notice of his lien, and a notice also that he must make no future advances on the credit of that mortgage. The mortgage will then stand as security for the real equitable claims of the mortgagee, whether they existed at the date of the mortgage or arose afterward, but prior to the receipt of such notice. If such mortgagee is not under any obligation to make advances, and after notice of a subsequent mortgage does make further advances, to the extent of such advances the subsequent mortgagee has the right of precedence. But if such mortgagee is under obligation to make the advances, he is entitled to the security, whatever may be the encumbrances subsequently made upon the property, and whether he has notice of them or not.

Because the Public Trustee, by statute, is obligated to determine that the entire indebtedness has been paid in full and because the priority of the lien of advancements made under open-end encumbrances is dependent upon the knowledge and notice of the parties,[20] the Public Trustee does not feel that he should be placed in a position of determining the rights acquired under an improperly worded open-end encumbrance. Accordingly, the Public Trustee of the City and County of Denver has stated that he will release any open-end deed of trust without requiring bond only if the deed of trust shows on its face a method by which the public Trustee can determine with certainty, at the time the release is requested, that the person, association, or corporation signing the request is the holder of all obligations secured by the deed of trust, including the original loan at the time of execution, and all subsequent loans or advances, if any; or if the deed of trust contains on its face authorization to the Public Trustee to release the deed of trust upon receipt of the original note, duly cancelled, without inquiry concerning subsequent loans or advances.

The Public Trustee has suggested certain forms of deeds of trust which may be used as open-end encumbrances. Of these, the following provision appears to be the simplest:

> This deed of trust secures not only the indebtedness evidenced by the promissory note above described, but also any additional indebtedness that may hereafter be incurred by the debtor, his or their heirs, executors, administrators, successors or assigns, to the beneficiary; provided, however, if the debtor, his heirs, executors, administrators or assigns shall hereafter exhibit said above described note, duly cancelled, to the public trustee with a written request for the release of this deed of trust containing a statement that the entire indebtedness secured hereby has been fully paid, the public trustee may release this deed of trust without further showing as to the additional indebtedness and without liability for so doing.

The Public Trustee also has specifically approved the following language:

> And whereas, said note provides for additional advances at the option of the said Mortgagee, it is specifically agreed that said advances shall be a part of the principal indebtedness, that all of the covenants and agreements evidencing such advances shall be a part hereof, and that this deed of trust shall secure, in addition to

[20] The Public Trustee of Denver has prepared a complete statement of policy, as well as approved provisions to be used in open-end deeds of trust, all of which are available on request.

> the original indebtedness, any additional advances made by said Mortgagee to the makers or their successors in title. The public trustee may, upon the production of said note, duly cancelled, release this deed of trust without further showing as to said additional advances and without liability for so doing; such release shall also constitute a release of the lien for any such advancements.

Although the above provisions have been approved by the Denver Public Trustee, it is recommended that the specific provisions to be included in the encumbrance of any lender, if varying in substance from said provisions, be submitted to the Public Trustee for his prior approval. Other forms have also been approved, any one of which may more adequately meet the needs of the particular lender.

It is further suggested that, at the time of the release of an open-end encumbrance, the request for release state as follows: "Please execute this release; the indebtedness, together with all additional advances, if any, secured by the above-mentioned deed of trust, having been fully paid."

If the above-quoted phrases, or others approved by the Public Trustee, are incorporated in open-end deeds of trust, no question will be raised by the Public Trustee upon the release of said instrument. The Public Trustee has requested that all additional advances be endorsed upon the original promissory note, or be evidenced by additional agreements or notes. Such additional notes, if any, must, of course, be surrendered to the Public Trustee at the time of the release of the encumbrance.

Whether or not the abstract is to be recertified by the mortgagee at the time of making an additional advance is a matter of business policy to be determined by the mortgagee. It is felt that, as a practical matter, better practice would be for the mortgagee to take whatever steps may be necessary to determine the existence of intervening lienors or title holders. In the event that such intervening lien appears, the mortgagee can well insist that the holder of such intervening lien execute a consent and subrogation agreement before the additional advancement is made.[21] In this manner, no question can be raised concerning the priority of the lien of the additional advance. In the event, however, that the additional advance is made without knowledge of such lien or without the subrogation agreement I have referred to, it is recommended that the open-end encumbrances be foreclosed through the courts rather than the Public Trustee, so that the rights of all parties in the proceeds of the sale can be determined in advance, in one proceeding.

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[21] Where the intervening lien is expressly made subject to the mortgage for future advances, it would seem to follow that the advances constitute a prior lien, as was held in dicta of *Menzies v. Lightfoot*, L.R. 11 Eq. (England) 459.

It has been suggested that legislation be adopted to clarify the Colorado law concerning open-end encumbrances. In the opinion of the writer, such legislation is, at the present time, not necessary. The distinction between *obligatory* and *optional* open-end encumbrances has been made certain by court decision. The rights of the mortgagee under an *optional* open-end encumbrance are well settled, and an intervening lienor can easily protect his rights by ascertaining the total amount advanced under the prior encumbrance and by giving immediate actual notice to the mortgagee of his interest. It seems, therefore, that any statute would only complicate an already well-established rule of law and would afford no additional protection to any of the parties.

ANNUAL MEETING OF THE NATIONAL COUNCIL OF JUVENILE COURT JUDGES

June 30-July 3, 1954, Colorado Springs, Colorado, Broadmoor Hotel

Honorable Phillip G. Gilliam, President, Presiding

Speakers will include Governor Dan Thornton, Judge William McKesson of the Los Angeles Juvenile Court, and the Honorable Mortimer Stone, Chief Justice of the Colorado Supreme Court.

Some of the topics to be discussed are:

1. The control of obscene literature and horror comics, now being studied by the U. S. Senate Committee on Juvenile Delinquency.
2. Standards for specialized Courts dealing with children.
3. Newspaper publicity given to juveniles before the Court.
4. Young men entering the armed services with juvenile court records.
5. Interstate Compact relating to runaway children.
6. Punishment of parents who contribute to the delinquency of children.
7. The rights of children.
8. A review of the important judical decisions during the past year.

Entertainment will include cocktail parties and scenic trips.

Further information regarding arrangements may be obtained from Judge Charles J. Simon, El Paso County Court, Colorado Springs, Colo.