

RETHINKING FUTURE ADVANCE MORTGAGES: A BRIEF FOR THE *RESTATEMENT* APPROACH

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I. INTRODUCTION: THE PROBLEM OF FUTURE ADVANCE PRIORITY

In many land financing transactions it is commercially advantageous to enter into a present mortgage even though a significant portion of the loan funds is not to be advanced to the mortgagor until some future date.¹ The most common examples are construction loans and other loans to improve real property, in which most or all of the funds are advanced in installments as work progresses

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1. See, e.g., GRANT S. NELSON & DALE A. WHITMAN, *REAL ESTATE FINANCE LAW* § 12.7 (3d ed. 1993); Ryan P. Dyches, Comment, *Priority Disputes In Future Advance Mortgages: Picking the Winner in Arizona*, 1985 ARIZ. ST. L.J. 537, 537-38; Benjamin E. Griffith & Crane D. Kipp, Comment, *Mortgages to Secure Future Advances: Problems of Priority and the Doctrine of Economic Necessity*, 46 MISS. L.J. 433, 435-36 (1975); James B. Hughes, Jr., *Future Advance Mortgages: Preserving the Benefits and Burdens of the Bargain*, 29 WAKE FOREST L. REV. 1008, 1101 (1994); Robert Kratovil & Raymond J. Werner, *Mortgages for Construction and the Lien Priorities Problem—The "Unobligatory" Advance*, 41 TENN. L. REV. 311, 311 (1974); Harry E. Meek, *Mortgage Provisions Extending the Lien to Future Advances and Antecedent Indebtedness*, 26 ARK. L. REV. 423, 424-25 (1973); Larry Skipworth, *Should Construction Lenders Lose Out on Voluntary Advances If a Loan Turns Sour?*, 5 REAL EST. L.J. 221, 222 (1977); Norman T. Smith & Charles M. Cobbe, *Questions of Priority Between Mechanics' Lienors and Construction Loan Mortgagees*, 38 OHIO ST. L.J. 3, 8-9 (1977); Edmund T. Urban, *Future Advances Lending in North Carolina*, 13 WAKE FOREST L. REV. 297, 298 (1977); Leland E. Rolfs, Note, *Consumer Law—Limitations on the Validity of Future Advance Clauses in Mortgage Contracts*, 23 KAN. L. REV. 745, 746-47 (1975).

and the property increases in value.² Another illustration is the "home equity" loan, usually a junior mortgage in which the parties contemplate a series of future advances to fund a variety of the mortgagor's personal financing needs. The use of this device has become especially popular because the Tax Reform Act of 1986 and subsequent legislation permit the deduction of consumer interest only when a loan is secured by the borrower's home.³ As a result, there is a significant incentive for homeowners to place liens on their homes to secure loans for the acquisition of automobiles and other personal property that otherwise would not have to be secured by home mortgages.⁴ Other important transactions involving future advances include mortgages to secure commercial lines of credit established with banks and other institutional lenders,⁵ "open-end" mortgages,⁶ mortgages to secure letters of credit, guarantees, or accommodations of commercial paper to be issued by the mortgagor, and mortgages issued to secure a corporate bond issue or a series of issues.⁷

The advantages of such arrangements, under which the mortgagor takes none or only a portion of the loan at the outset but

2. See NELSON & WHITMAN, *supra* note 1, § 12.1; George Lefcoe & Mark Schaffer, *Construction Lending and the Equitable Lien*, 40 S. CAL. L. REV. 439, 439 n.1 (1967).

3. See I.R.C. § 163(h)(3) (1988); Julia P. Forrester, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of Home Equity Financing*, 69 TUL. L. REV. (forthcoming Dec. 1994).

4.

It is unclear whether the home equity deduction encourages homeowners to borrow when they otherwise would not, but it is certain that homeowners are using the home equity loan vehicle for borrowing that might be unsecured or secured by collateral other than a home. . . . Homeowners have attempted to take full advantage of the tax deduction by converting outstanding debt to home equity debt and by using the home equity loan vehicle for additional borrowing where possible.

Forrester, *supra* note 3.

5. See, e.g., ILL. REV. STAT. ch. 17, para. 6405 (1991) (facilitating the use of mortgages to secure revolving lines of consumer credit); *Peterson Bank v. Langendorf*, 483 N.E.2d 279, 282 (Ill. App. Ct. 1985) (discussing consideration for a commercial line of credit mortgage); *McDaniels v. Colvin*, 16 Vt. 300, 304-05 (1844) (holding that a mortgage deed can provide for future accruing amounts); RESTATEMENT (THIRD) OF PROPERTY—SECURITY (MORTGAGES) § 2.1 cmt. a, illus. 4 (Tentative Draft No. 1, 1991).

6. See Comment, *The Open-End Mortgage—Future Advances: A Survey*, 5 DEPAUL L. REV. 76 (1955); Note, *Refinements in Additional Advance Financing: The "Open End" Mortgage*, 38 MINN. L. REV. 507 (1954); *infra* text accompanying notes 34-36.

7. See, e.g., *In re Sunflower State Ref. Co.*, 183 F. 834 (D. Kan. 1911) (concerning issue of bonds under a mortgage as collateral security by a bankrupt corporation); *Appeal of Reed*, 16 A. 100 (Pa. 1888) (allowing issue of bonds); RESTATEMENT (THIRD) OF PROPERTY—SECURITY (MORTGAGES) § 2.1 cmt. a (Tentative Draft No. 1, 1991).

receives the balance in the future, are substantial. The mortgagor saves interest on the unadvanced portion until it is needed and avoids the need to invest this portion at an interest rate that at least equals the rate being paid to the lender. Moreover, both parties avoid the expense and paperwork inherent in refinancing the initial loan or in executing a series of junior mortgages to secure each advance. Finally, in the construction loan context, before committing large sums of money to the project, the mortgagee has the advantage of assurance that loan funds are being used for construction purposes and not being diverted for impermissible uses, that construction is progressing satisfactorily, and that the growth in value represented by the construction is reasonably adequate to secure the additional advances.

Despite the usefulness of mortgages to secure future advances, problems related to the priority of such advances have long proved perplexing to courts,⁸ legislatures,⁹ and commentators.¹⁰

8. See, e.g., *National Bank v. Equity Investors*, 506 P.2d 20, 29 (Wash. 1973), in which the court recognized the ambiguity inherent in the application of the traditional common law rule, discussed *infra* note 27 and accompanying text, distinguishing between optional and obligatory advances: "[I]n a given case there may be difficulty in ascertaining from the circumstances and the language of the mortgage and loan papers covering the whole agreement whether the advances are to be regarded as optional or mandatory"

9. The Missouri General Assembly has taken the matter more seriously than most legislatures but has found the drafting of a properly functioning statute challenging. Missouri's statute, enacted in 1981, was amended in 1984, 1991, and 1994. See MO. REV. STAT. § 443.055 note (Vernon 1994).

10. See sources cited *supra* note 1. Most adverse comment centers on the uncertainties of the distinction between optional and obligatory advances, discussed *infra* note 27 and accompanying text. The following comments are representative:

An additional difficulty with basing the rules of priority on the operation of the recording system is that it is often not clear from recorded instruments whether advances in particular cases are obligatory. The Ohio Supreme Court has twice declined to decide whether mortgagees are required to refer in their recorded instruments to their obligations to make future advances

Smith & Cobbe, *supra* note 1, at 10;

That the ritualistic obligatory-optional advances rule, with its "deep pocket" protection of local tradesmen and suppliers against financial institutions . . . can stifle development is obvious The obligatory-optional test operates uniformly and poorly to discourage many necessary construction projects. Moreover, the test gives rise to much litigation, yielding inconsistent and often surprising results in light of the language of the statutes.

Kratovil & Werner, *supra* note 1, at 321;

The rationales offered to support the existing priority rule are not valid. Basing priority upon economic compulsion, so that the lender has priority on all prudent advances, would increase the lender's incentive to complete the project without eliminating any necessary protection for the other participants in the construction process.

The traditional common law approach to these problems, which distinguishes between obligatory and optional advances, has proved inadequate and should be discarded. We will describe this approach and analyze its deficiencies. In its place, we will propose an alternative approach that is embodied in a tentative draft of the *Restatement (Third) of Property—Security (Mortgages)*,¹¹ which accords all future advances the priority of the original mortgage, but under which the mortgagor may give the mortgagee a notice terminating the effect of the mortgage's future advances clause. We believe the *Restatement* solution will work fairly and efficiently for all parties and will facilitate the flow of mortgage funds for worthwhile purposes.

II. WHY ARE FUTURE ADVANCES PROBLEMATIC?

Future advance mortgages are clearly valid between the mortgagor and the mortgagee; so long as the agreement is clear as to what debts are secured by the mortgage, a court should have no reservations about enforcing it.¹² Major problems arise, however,

Skipworth, *supra* note 1, at 241.

Professor Gilmore freely admitted that the law of future advance priority was a morass of confusion, but he argued that confusion has its advantages: "There is . . . much to be said for having no rule at all, or only a make-believe rule, and for letting the judges decide: judges are not necessarily wiser than other people, but they are paid to decide things." GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 35.4, at 930 (1965). We are not convinced.

11. RESTATEMENT (THIRD) OF PROPERTY—SECURITY (MORTGAGES) §§ 2.1–2.3 (Tentative Draft No. 1, 1991). Subsections 2.3(a) and 2.3(b), the core of the present proposal, contain the following text:

(a) If a mortgage secures future advances, all such advances have the priority of the original mortgage. Whether or not a mortgage secures future advances, if the parties have agreed that the mortgage secures interest, costs of collection or foreclosure, or attorneys' fees, these items have the priority of the original mortgage.

(b) Except as provided in subsection (c), the mortgagee must comply with a request made at any time by the mortgagor

(1) to refrain from making further advances and thereby to terminate the operation of the mortgage as to further advances; or

(2) to subordinate the priority of the mortgage, as against intervening interests, with respect to further advances.

The mortgagee's duty to comply with such a request exists even if the request violates a contractual obligation of the mortgagor to draw further advances, but the mortgagor may be liable in damages for breach of such an obligation. The mortgagee must provide the mortgagor with a certificate in recordable form stating that such a request has been honored. If the mortgagor requests a subordination with respect to further advances, the mortgagee may elect to treat the request as one to refrain from making further advances.

12. Cases enforcing parties' agreements that a mortgage will secure additional ad-

when a third party enters the picture, typically as a junior mortgagee, and perhaps less frequently as a subordinated mechanic's lienor, lessee, or other interest holder. If such parties acquire their interests voluntarily, they are naturally concerned with the balance on the debt secured by the mortgage to which they will be subordinate. For example, a grantee who buys mortgaged property and takes subject to (or assumes) an existing mortgage routinely obtains from the mortgagee a "payoff letter," "estoppel statement," or other document in which the mortgagee states the current balance outstanding on the mortgage debt.¹³ The price the grantee will pay for the real estate is then adjusted to reflect that balance.¹⁴

Much the same process is employed by lenders that take junior mortgages on real estate. Such lenders typically establish as a matter of policy certain "target" aggregate loan-to-value ratios that they will not exceed.¹⁵ A junior mortgagee can compute such

vances include *Industrial Supply Corp. v. Bricker*, 306 So. 2d 133 (Fla. Dist. Ct. App. 1975); *Potwin State Bank v. J.B. Houston & Son Lumber Co.*, 327 P.2d 1091 (Kan. 1958); *House of Carpets, Inc. v. Mortgage Inv. Co.*, 514 P.2d 611 (N.M. 1973). See RESTATEMENT (THIRD) OF PROPERTY—SECURITY (MORTGAGES) § 2.1 (Tentative Draft No. 1, 1991), providing that any agreement between mortgagor and mortgagee stating that the mortgage will secure future advances will be enforced as between those two parties. It is not necessary that the agreement appear in the mortgage itself; a side agreement suffices.

13. Several jurisdictions have statutes mandating that senior mortgagees provide information on the outstanding balance of their loans to interested parties. See CAL. CIV. CODE § 2943 (West 1993); CONN. GEN. STAT. ANN. §§ 49-8a, -10a (West 1994); IOWA CODE ANN. § 535B.11 (West Supp. 1994); MASS. GEN. LAWS ANN. ch. 183, § 55 (West 1991); N.Y. REAL PROP. LAW § 274a (McKinney 1989 & Supp. 1994); PA. STAT. ANN. tit. 7, § 6610 (Supp. 1994-1995); R.I. GEN. LAWS § 19-25.2-26 (1989); UTAH CODE ANN. § 57-15-8 (1994). See also RESTATEMENT (THIRD) OF PROPERTY—SECURITY (MORTGAGES) § 1.6 (Tentative Draft No. 1, 1991), providing that mortgagees have a common law duty to provide such information. This section of the Tentative Draft has not yet been adopted by the American Law Institute. Controversy developed around the reporters' recommendations as to the scope of the information to be disclosed. *Discussion of RESTATEMENT (THIRD) OF PROPERTY—SECURITY (MORTGAGES)*, 1991 A.L.I. PROC. 591-602.

14. Adjustment is usually necessary because at the time the contract of sale is executed, the parties do not know precisely what the balance of the mortgage loan will be on the date of settlement. Assume, for example, that the contract of sale provides for a full price of \$100,000, with the buyer to take subject to an existing mortgage having a balance of approximately \$70,000. If this were the precise balance, the buyer would be required to pay \$30,000 cash at the settlement. Suppose that shortly before the settlement date, however, the buyer obtains a statement from the mortgagee showing that the actual balance as of the settlement date (including accrued interest) will be \$70,300. The cash required of the buyer at settlement will be decreased to \$29,700 to reflect the fact that the mortgage debt balance was higher than the parties had estimated.

15. In some cases, a governmental regulator may dictate this policy. See, e.g., Real

a ratio only with knowledge of the balance owing on the first mortgage. Thus, before making the junior loan, the lender obtains from the first mortgagee a statement like that described above. If the statement discloses that the first mortgage has a higher balance than the second mortgagee expected, the second mortgage loan will be made for a lower amount, to compensate.¹⁶

While other takers of subordinate interests in real estate may not be as conscientious as grantees and junior lenders in determining the precise balance of the senior debt, they are nonetheless mindful of that balance in at least general terms. For example, a contractor hired to construct improvements on real estate for an owner will recognize that if the owner does not pay the contract price when due, the contractor may need to file a mechanic's lien to aid in its collection. Such a lien will have much greater practical value to the contractor if the prior mortgage liens are for only a modest percentage of the value of the real estate. The greater the mortgage balance in relation to the property's value, the less efficacious the mechanic's lien is likely to be. Contractors may well take this risk-assessment into account in bargaining for other concessions from the owner.

All of the calculations and adjustments described above work smoothly and effectively when the balance on the senior mortgage can be definitely determined. Information about the balance, when combined with appraisal or other information about the value of the real estate, allows junior mortgagees and grantees to evaluate their own interests and risks fairly precisely. These assessments are not perfect, of course. Appraisals are only approximations and are sometimes seriously inaccurate.¹⁷ Property values can fluctuate

Estate Lending Standards, 57 Fed. Reg. 62,890 (1992) (codified in scattered sections of 12 C.F.R.) (establishing maximum real estate loan-to-value ratios for federally supervised lending institutions); Scott A. Lindquist, *Real Estate Lending Regulations: The New Ball Game*, PROB. & PROP., May-June 1993, at 11 (discussing the above-cited regulation).

16. For example, assume that the junior lender will not accept an aggregate loan-to-value ratio in excess of 90%. If the mortgagor applies for a loan of \$20,000 and represents that the first mortgage has a balance of \$70,000, and if the real estate is appraised at \$100,000, the junior lender may approve the loan. However, if the payoff statement discloses that the actual balance on the first loan is \$70,300, the junior lender may reduce its loan to \$19,700 to preserve the 90% aggregate loan-to-value ratio.

17. Inadequate and sometimes fraudulent appraisals have been blamed for much of the difficulty experienced by savings and loan associations during the 1980s. See GENERAL ACCOUNTING OFFICE, *THRIFT FAILURES: COSTLY FAILURES RESULTED FROM REGULATORY VIOLATIONS AND UNSAFE PRACTICES* 33-34 (1989). In Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), 12 U.S.C.

over time. The amount owing on the senior mortgage can increase if interest payments are not made and interest is consequently added to the principal, or if the mortgagee makes advances to pay taxes, insurance, or other sums for the protection of the property and is not reimbursed by the mortgagor.¹⁸

However, these factors are usually relatively modest in impact and are unlikely to get out of hand without the knowledge, and to some extent the control, of the holder of the junior interest. A junior mortgagee can, for example, request that the senior mortgagee notify it of any default in payment. Statutes in some jurisdictions require the senior lender to honor such a request,¹⁹ and in others the senior lender may well voluntarily honor such a request because of its hope that the junior will cure the default.²⁰ The junior mortgagee can also require that tax and insurance payments be made through an escrow account held by the junior if the senior lender is not already maintaining such an account; this system provides an early warning if the mortgagor fails to make the required payments. The junior lender can also minimize the risk of waste or deterioration of the real estate by appropriate covenants in its mortgage²¹ and by regular inspections.

Of course, even these problems do not arise when the junior interest holder is a grantee rather than a subordinate lienholder. The reason is obvious: after the real estate is sold to a grantee, if

§§ 3331-3352 (Supp. IV 1992), Congress required that all states create a system for certification of appraisers who provide appraisal reports on federally related financial transactions. The effectiveness of the appraisal procedures of the Federal Housing Administration has also been questioned. See GENERAL ACCOUNTING OFFICE, WEAKNESSES IN HUD'S SINGLE FAMILY APPRAISAL PROGRAM (1987).

18. See, e.g., *Van Dusseldorp v. State Bank*, 395 N.W.2d 868, 871 (Iowa 1986) (involving advances to pay property taxes); *First Vt. Bank & Trust Co. v. Kalomiris*, 418 A.2d 43 (Vt. 1980) (involving advances to pay prior mortgage); RESTATEMENT (THIRD) OF PROPERTY—SECURITY (MORTGAGES) § 2.1 (Tentative Draft No. 1, 1991) (involving expenditures for protection of the security).

19. ARIZ. REV. STAT. ANN. § 33-809 (1990) (requiring notice of foreclosure sale to parties to a deed of trust upon properly recorded request for notice); CAL. CIV. CODE § 2924b(b) (West 1993) (requiring that notice of default be filed in office of recorder); MO. ANN. STAT. § 443.325 (Vernon 1986) (requiring notice of foreclosure sale upon properly recorded request for notice); UTAH CODE ANN. § 57-1-26 (1994) (requiring notice of default or sale upon properly recorded request).

20. See, e.g., *Illinois State Bank v. Yates*, 678 S.W.2d 819 (Mo. Ct. App. 1984).

21. See *Krone v. Goff*, 127 Cal. Rptr. 390, 391 n.1 (Ct. App. 1975); RESTATEMENT (THIRD) OF PROPERTY—SECURITY (MORTGAGES) § 4.6(a)(4) (Tentative Draft No. 3, 1994) (providing that mortgage covenants can expand the usual definition of waste to give the mortgagee additional protection); NELSON & WHITMAN, *supra* note 1, § 4.11.

a default in interest payments, a failure to pay taxes or insurance premiums, or waste occurs, it is the grantee who is responsible for the default. The grantee can hardly complain about the increase in the mortgage balance that results. Hence, the primary parties with legitimate concerns about such unexpected enlargements of the senior mortgage balance are junior lienholders, and they are generally satisfied with the risk-reduction measures mentioned above.

However, when the senior mortgage also provides for future advances, the risk to junior lienors is significantly increased. A large advance by the senior lender, if it has the priority of the original first mortgage, can so jeopardize the junior's position in relation to the land's value that the security becomes virtually worthless. From the viewpoint of prospective junior lenders, this risk must be managed carefully because the results can be devastating. Two techniques are available for coping with the risk. The first is to insist, as a condition of making (or subordinating to) the loan, that the senior mortgagee limit²² or completely waive the power to make further advances with the priority of the original lien; the second is for the junior lender to refrain from lending altogether if the senior lender has the power to add further advances to its lien.

The first of these methods is widely used by well-advised junior mortgagees that subordinate their interests to construction loan mortgages. Such mortgagees are often vendors that sell land to developers. Such a vendor can condition its subordination on the construction lender's restricting its advances in ways that will safeguard the vendor's junior lien. For example, the vendor's subordination agreement may impose a maximum amount and a maximum interest rate on the construction loan, may specify the nature of the improvements to be constructed, and (perhaps most

22. See *United States v. South Atl. Prod. Credit Ass'n*, 606 So. 2d 691, 695 (Fla. Dist. Ct. App. 1992) (involving subordination to a first mortgage "in an amount not to exceed \$85,000"); *Life Sav. & Loan Ass'n v. Bryant*, 467 N.E.2d 277, 282 (Ill. App. Ct. 1984) (involving subordination to a first mortgage not exceeding a stated amount and interest rate, and only for 45 days); *National Bank v. Moeller*, 434 N.W.2d 887, 888 (Iowa 1989) (permitting subordination only on condition that subordinating mortgagee be provided additional collateral by mortgagor); *Riggs Nat'l Bank v. Wines*, 474 A.2d 1360, 1361 (Md. Ct. Spec. App.) (involving subordination to a mortgage "from a recognized lending institution, the proceeds of which are to be applied to the erection of improvements"), *cert. denied*, 481 A.2d 802 (Md. 1984); *Blanton v. FDIC*, 706 P.2d 1111, 1112-13 (Wyo. 1985) (involving subordination to loan not exceeding \$200,000 to be used for certain specific purposes).

importantly) may require that all advances made under the senior loan actually be spent on "hard" construction costs that will directly enhance the value of the real estate.²³ These protections are not foolproof, but a carefully crafted agreement can give the junior vendor significant protection.

If the junior and senior loans are arranged as part of the same transaction, or the junior loan is arranged first (as is often the case with the purchase-money mortgages described above), there may be ample opportunity for negotiation of the sorts of protection just described. However, if a senior loan permitting future advances is already in place when the owner of real estate approaches a prospective junior lender to apply for a new loan, the junior lender has no opportunity to negotiate with the senior lender about the terms of its future advances clause, for the clause is already in place. Hence, unless that clause strictly limits the nature and extent of possible advances, the junior lender is likely

23. See *Roskamp Manley Assocs. v. Davin Dev. & Inv. Corp.*, 229 Cal. Rptr. 186, 187 (Ct. App. 1986) (requiring that all advances be used only "to pay for material and labor directly incorporated" into improvements of the property); *Stockwell v. Lindeman*, 40 Cal. Rptr. 555, 557-58 (Ct. App. 1964) (requiring that the construction loan not exceed \$80,000 and that the annual interest rate not exceed 7.5%); *Peninsula Fed. Sav. & Loan Ass'n v. DKH Properties*, 616 So. 2d 1070, 1074 (Fla. Dist. Ct. App.) (requiring that all advances be used for hard costs "as they relate to the rehabilitation of the property"), *review denied*, 626 So. 2d 204 (Fla. 1993). Some courts have been willing to imply conditions to protect subordinating purchase-money mortgagees who did not negotiate adequate protection. See *Woodworth v. Redwood Empire Sav. & Loan Ass'n*, 99 Cal. Rptr. 373, 383-84 (Ct. App. 1971) (interpreting an automatic subordination clause as restricting the use of loan funds to construction and property improvements); *Middlebrook-Anderson Co. v. Southwest Sav. & Loan Ass'n*, 96 Cal. Rptr. 338, 347 (Ct. App. 1971) (implying the condition that loan proceeds be used only for construction purposes); *Peoples Bank & Trust Co. v. L & T Developers, Inc.*, 434 So. 2d 699, 705 (Miss.) (holding in part that construction lender had breached his duty to landowner to exercise reasonable diligence to see that funds loaned were in fact used for construction project on the subject property), *corrected by*, 437 So. 2d 7 (Miss. 1983); *Cambridge Acceptance Corp. v. Hockstein*, 246 A.2d 138, 141 (N.J. Super. Ct. App. Div.) (implying condition that construction lender would "make and administer the loan in the conventional manner of a construction lender"), *certification denied*, 248 A.2d 434 (N.J. 1968). For decisions refusing to imply conditions, see *In re Nash*, 60 B.R. 27, 31 (Bankr. 9th Cir. 1986) (applying Arizona law); *Home Sav. Ass'n, F.A. v. State Bank*, 763 F. Supp. 292, 298 (N.D. Ill. 1991) (declining to impose a condition of "cautious loan administration"); *Connecticut Bank & Trust Co. v. Carriage Lane Assocs.*, 595 A.2d 334, 338 (Conn. 1991) (refusing to imply conditions when parties had negotiated the matter and failed to include express conditions); *Rockhill v. United States*, 418 A.2d 197, 200 (Md. 1980) (declining to imply a conditional or limited subordination agreement); *Tuscarora, Inc. v. BVA Credit Corp.*, 241 S.E.2d 778, 782 (Va. 1978) (rejecting the reasoning of courts approving the "principle of implied conditional subordination").

to refuse to make the loan. To take a junior position behind an unlimited future advances provision in a senior mortgage is, as indicated above, potentially disastrous.

From an economic viewpoint, the mortgagor may thus be placed in an awkward and inefficient position. Suppose the value of the real estate substantially exceeds the current balance owing on the first mortgage, and the mortgagor would like to seek additional financing and might approach the mortgagee for a further advance. Whether the mortgagee has any obligation to respond favorably depends on the terms of the original loan transaction. If those terms obligate the mortgagee to lend more money (and if any conditions to that obligation are met), the mortgagor will get the necessary funds. However, the terms of the loan may include no such obligation; they may provide merely that *if* the mortgagee lends additional money, its repayment will be secured by the mortgage. Alternatively, the loan contract may make the mortgagee's obligation to make further advances contingent on conditions (such as the borrower's minimum net worth or the condition of the real estate) that the borrower cannot meet.

In such a case, the borrower's next recourse may be to approach a different lender and seek a loan secured by a second mortgage on the real estate. But if prospective junior lenders realize that the senior lender has the capacity to make additional advances and to secure them with its senior priority, they will almost certainly reject the borrower's loan application, as discussed earlier. The risk that the security of the junior loan will become valueless by virtue of such advances is simply unacceptable to them. Hence the borrower is faced with a dilemma. She has substantial equity of value in the land, but cannot borrow on it from anyone—not from a junior lender, for the reasons just discussed, and not from the senior lender who, for whatever reasons,²⁴ is disinclined to lend more, and who has no duty to do so.²⁵

24. There are many possible reasons. The senior lender may simply be out of lendable funds. It may have had a bad payment experience with the borrower and concluded that she is a poor risk. It may have tightened its lending policies under pressure from federal or state regulators. It may have decided, for reasons of geographic diversification, to refrain from lending more funds in the area where the borrower's land is located.

25. The borrower has one additional course of action, but it is often unattractive: to refinance the first mortgage and pay it off. In some cases, that is impossible; the first mortgage loan may be "locked in" and nonprepayable. See Dale A. Whitman, *Mortgage Prepayment Clauses: An Economic and Legal Analysis*, 40 UCLA L. REV. 851, 863

Can the borrower solve this problem by contracting with the junior lender not to borrow additional funds from the senior? This approach is only superficially attractive; the borrower may make such a promise, but may also breach it by drawing additional funds on the senior loan. If the borrower does so, the junior lender's sole remedy is likely a suit for damages against the borrower, which is apt to be of little value. What the junior lender needs is not the borrower's promise to refrain from borrowing, but the senior lender's promise to refrain from lending. The junior lender typically has no leverage to exact such an agreement from the senior, however.

This inability to obtain junior financing is disadvantageous to society at large as well as to the individual borrower. Free transferability is fundamental to the economic basis of private ownership of land.²⁶ Transferability and its corollary, mortgageability, permit land to be pledged to secure funds for development and other economic activity, thus shifting borrowers' wealth, held in the form of equity in land, to more productive uses. Owners' inability to borrow additional funds despite possessing substantial equity in land impedes the construction of improvements on the land and the commencement of other business ventures and in the long run diminishes the net wealth of the community. Such a result is unacceptable to society at large. One might argue that the

(1993). Alternatively, prepayment of the first mortgage may be permissible only with the payment of an accompanying fee so high as to make the transaction infeasible. *Id.* at 876-77. Lock-ins and prepayment fees are little-used today in single-family residence mortgages, since the standard forms published by the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC), and widely used by nearly all home mortgage lenders, provide for free prepayment at any time. See FNMA/FHLMC Multistate Fixed Rate Note—Single Family, reprinted in GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE TRANSFER, FINANCE AND DEVELOPMENT app. at 1308 (4th ed. 1992) ("I have the right to make payments of principal at any time before they are due. . . . I may make a full prepayment or partial prepayments without paying any prepayment charge."). However, lock-ins and prepayment charges are still common in mortgages on commercial and income properties. See generally Whitman, *supra*. Such fees and lock-in clauses are generally enforceable. RESTATEMENT (THIRD) OF PROPERTY—SECURITY (MORTGAGES) § 6.2 (Tentative Draft No. 3, 1994). Finally, refinancing means giving up the benefits of the existing interest rate of the first mortgage, perhaps in a market in which current rates are much higher. The higher debt service cost may again make the transaction wholly unattractive.

26. See, e.g., RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 13 (1973) ("The third criterion of an efficient system of property rights is *transferability*. If a property right cannot be transferred, there is no way of shifting a resource from a less productive to a more productive use through voluntary exchange.")

borrower has created this dilemma by signing a loan agreement permitting the first mortgagee to secure additional advances with the mortgage but not requiring it to make them. That may well be so, but this explanation provides no remedy for the fundamental economic inefficiency that results.

III. THE COMMON LAW RESPONSE

The traditional common law approach to the foregoing problems, as this Article will show, has proved inadequate and should be discarded. We will describe this approach and analyze its deficiencies, and will propose, in its place, an alternative approach that we believe will work fairly and efficiently for all parties and will facilitate the flow of mortgage funds for worthwhile purposes.

A. *The Optional/Obligatory Advance Doctrine*

The common law answer to this problem of inefficiency has been what is commonly termed the optional/obligatory advance doctrine. Originating in the English House of Lords in 1861,²⁷ the

27. *Hopkinson v. Rolt*, 11 Eng. Rep. 829, 833 (1861). Cases following *Hopkinson* in the United States include *In re Kirk*, 133 B.R. 914, 916 (Bankr. S.D. Ohio 1991) (applying Ohio law); *In re Johnson*, 124 B.R. 648 (Bankr. E.D. Pa. 1991) (applying Pennsylvania law); *La Cholla Group, Inc. v. Timm*, 844 P.2d 657 (Ariz. Ct. App. 1992); *National Lumber Co. v. Advance Dev. Corp.*, 732 S.W.2d 840 (Ark. 1987); *Kimmel v. Batty*, 451 P.2d 751 (Colo. 1969); *Idaho First Nat'l Bank v. Wells*, 596 P.2d 429 (Idaho 1979); *Freese Leasing, Inc. v. Union Trust & Sav. Bank*, 253 N.W.2d 921 (Iowa 1977) (overruled by 1984 Iowa Acts ch. 1272, § 1 (codified at IOWA CODE ANN. § 654.12A (West 1995))); *Potwin State Bank v. J.B. Houston & Son Lumber Co.*, 327 P.2d 1091 (Kan. 1958) (providing for priority of all future advances, whether obligatory or not) (overruled by 1971 Kan. Sess. Laws ch. 190, § 1 (codified at KAN. STAT. ANN. § 58-2336 (1993))); *Earnshaw v. First Fed. Sav. & Loan Ass'n*, 249 A.2d 675 (N.H. 1969); *Goldome Realty Credit Corp. v. Harwick*, 564 A.2d 463 (N.J. Super. Ct. Ch. Div. 1989); *House of Carpets, Inc. v. Mortgage Inv. Co.*, 514 P.2d 611 (N.M. 1973); *Briarwood Towers 85th Co. v. Guterman*, 523 N.Y.S.2d 98 (App. Div. 1988); *Schalmo Builders, Inc. v. Malz*, 629 N.E.2d 52 (Ohio Ct. App. 1993); *Thompson v. Smith*, 420 P.2d 526 (Okla. 1966); *Central Pa. Sav. Ass'n v. Carpenters of Pa., Inc.*, 463 A.2d 414 (Pa. 1983); *Kemp v. Thurmond*, 521 S.W.2d 806 (Tenn. 1975); *Bank of Ephraim v. Davis*, 559 P.2d 538 (Utah 1977); *Western Mortgage Loan Corp. v. Cottonwood Constr. Co.*, 424 P.2d 437 (Utah 1967); *National Bank v. Equity Investors*, 506 P.2d 20 (Wash. 1973) (overruled by 1991 Wash. Laws ch. 281, § 23 (codified at WASH. REV. CODE ANN. § 60.04.226 (West Supp. 1990))); *Colonial Bank v. Marine Bank, N.A.*, 448 N.W.2d 659 (Wis. 1989); *Poulos Inv., Inc. v. Mountainwest Sav. & Loan Ass'n*, 680 P.2d 1073 (Wyo. 1984); W.M. Moldoff, Annotation, *Priority Between Mechanics' Liens and Advances Made Under Previously Executed Mortgage*, 80 A.L.R. 2D 179 (1961).

The optional/obligatory advance distinction has occasionally been modified by statute with respect to the priority of construction (mechanic's) liens. See, e.g., S.C. CODE

doctrine holds that if a mortgagee is contractually obligated to make advances, they will be senior to any intervening lien. On the other hand, if future advances are optional with the mortgagee (that is, the mortgagor has no contractual right to demand advances), and if the mortgagee has notice of an intervening lien at the time advances are made, they lose priority to the intervening lien.

While this doctrine has the incidental effect of occasionally promoting the priority of junior lienors, that is plainly not its purpose. Indeed, junior lienors hardly need protection or promotion, for when they make their loans they already have notice from the wording of the prior recorded mortgage that future advances may be given.²⁸ Rather, the doctrine's objective is to assist the borrower in obtaining further secured financing, as outlined above. In theory, if the mortgagor is unable to convince the first mortgagee to make additional advances and has no legal right to demand them, the borrower can approach a second mortgagee, explain the situation, and borrow the funds. The junior lender will, it is presumed, be entirely willing to lend; the optional advance rule sup-

ANN. § 29-3-50 (Law. Co-op. 1991 & Supp. 1993) (providing that such liens will gain priority over subsequent future advances under a prior mortgage, even if the advances are obligatory, provided that the lien is filed of record and the prior mortgage holder is served with notice of the lien), *construed in* *Glover v. Lewis*, 382 S.E.2d 242 (S.C. Ct. App. 1989).

28. If the future advance agreement is not in the mortgage and is not otherwise recorded, it seems clear enough that a junior lienor who gives value, who records, and who has no notice of the agreement will take free of it under any reasonable construction of the recording acts. *See* RESTATEMENT (THIRD) OF PROPERTY—SECURITY (MORTGAGES) § 2.1(c) (Tentative Draft No. 1, 1991):

As against a person acquiring an interest in the mortgaged property subsequent to the mortgage, future advances will be secured only if an agreement [to secure future advances] exists and (1) the mortgage states that future advances are secured; or (2) the person has other notice of the parties' agreement concerning future advances at the time the interest is acquired; or (3) the mortgage states a monetary amount to be secured.

See also *Commercial Bank v. Rockovits*, 499 N.E.2d 765, 767-68 (Ind. Ct. App. 1986) (finding valid security in an "open-ended mortgage" expressly referenced in agreement); *Leche v. Ponca City Prod. Credit Ass'n*, 478 P.2d 347, 351 (Okla. 1970) (holding claims for future advances by prior mortgagee, offered with actual knowledge of subsequent obligations, inferior to claims of subsequent mortgagee that lacked notice of potential future advances); NELSON & WHITMAN, *supra* note 1, § 12.7. The third option mentioned, that the mortgage state a maximum amount to be secured, would seem to sufficiently protect junior lienors even if they do not have specific notice that future advances may be the means of bringing the mortgage balance up to that maximum. Some cases, however, give the junior lienor protection against an undisclosed future advances clause even when the balance is below the maximum level stated. *See* *Sadd v. Heim*, 124 A.2d 522, 525 (Conn. 1956); *Tyler v. Butcher*, 734 P.2d 1382, 1386 (Or. Ct. App. 1987).

posedly assures the junior that its security position will not be impaired by any subsequent advances by the senior lender.

This scenario, however, is pure theory, and it is extremely doubtful that it plays out so nicely in practice. To be sure, junior lenders may understand that they will have priority if the senior lender lacks any duty to make further advances. But whether any such advances will be optional or obligatory can, as discussed below, be a very close question indeed. If the senior lender's duty to make further disbursements depends on the satisfaction of various conditions, as is often the case, judging whether advances will be optional or obligatory can involve subtle issues of both fact and law. Junior lenders, we suggest, are rarely so eager to advance their money that they are willing to assume the risk of loss of priority if they are wrong in making such judgments. Rather, they are likely to reject a junior loan application in any case in which the "optionality" of advances on the prior mortgage is even slightly uncertain.

In our view, the optional/obligatory distinction rarely accomplishes its purpose—to ensure that a borrower with substantial equity can obtain additional financing. Unfortunately, what the doctrine does do is frustrate and confuse the legitimate needs and expectations of senior lenders and borrowers alike. To demonstrate how this happens, we first present a brief taxonomy of future advance loans. There are four common categories of such loans,²⁹ and the optional/obligatory advance doctrine affects each somewhat differently.

Construction loans comprise the first category. Virtually all new construction (and much rehabilitation) of improvements on real estate is financed with loans that contemplate future advances.³⁰ In construction lending the parties usually enter into an or-

29. The four types of future advance loans discussed in the text do not exhaust the possibilities. Future advances can be useful in many other business contexts. For example, a corporate mortgage bond indenture may encumber the corporation's real estate to secure not only an initial bond issue, but additional bonds to be issued in the future. As another example, a long-term mortgage lender on a newly constructed office building may disburse a portion of the loan upon completion of the project, but may reserve a "holdback" until the building achieves a particular level of occupancy or a particular "debt service coverage ratio" (that is, until the project's net cash flow is, for example, 1.2 times the debt service on the loan), at which time the remainder of the loan will be funded. See Charles L. Edwards, *Commercial Mortgage Loan Commitments: A Borrower's Perspective*, PROB. & PROP., July-Aug. 1994, at 28.

30. See Kratovil & Werner, *supra* note 1, at 311.

inary note and mortgage, but supplement them with a "construction loan agreement" spelling out the conditions under which advances to (or on behalf of) the borrower will be made.³¹ In theory, the advances on a construction loan are obligatory; the lender is committed to making them in order to complete the planned improvements. In practice, they are often optional, for reasons discussed below.

Line of credit loans, the second category, have fluctuating balances. The borrower may draw down funds, repay them, and draw them down again, within some upper dollar limit. Lines of credit are often used by business borrowers whose financial needs vary over time. In recent years they have also become popular with consumers, often in the guise of "home equity" loans, which may be secured by first or junior mortgages.³² As with construction loans, in principle the lender is obligated to permit the drawing of funds up to the agreed ceiling, making the advances obligatory. However, the applicable loan documents may impose conditions on the lender's duty, and if those conditions are not met the lender can cut off further draws on the loan.³³

Dragnet clauses are not really separate loan agreements at all. Instead, a dragnet clause is often included (typically in innocuous small print) in a mortgage loan for some entirely ordinary purpose, such as a home or business purchase. In its simplest form, the dragnet clause states that if the borrower ever becomes liable to the lender on any *other* loan, this mortgage will also secure it.³⁴ In most cases the lender has made no commitment to make any such other loan, and probably no such loan is anticipated. The purpose of the dragnet clause is to provide a sort of contingent cross-collateralization; if any other loan is made in the future, the presently mortgaged real estate will serve as additional collateral

31. See NELSON & WHITMAN, *supra* note 1, § 12.1.

32. See Forrester, *supra* note 3; GENERAL ACCOUNTING OFFICE, TAX POLICY: MANY FACTORS CONTRIBUTED TO THE GROWTH IN HOME EQUITY FINANCING IN THE 1980S 5-6 (1993).

33. See *infra* text accompanying notes 68-70.

34. See RESTATEMENT (THIRD) OF PROPERTY—SECURITY (MORTGAGES) § 2.4(c) (Tentative Draft No. 1, 1991); NELSON & WHITMAN, *supra* note 1, § 12.8; Rolfs, *supra* note 1, at 745. See *Union Bank v. Wendland*, 54 Cal. App. 3d 393, 398 (1976), for a typical dragnet clause: "This mortgage is given to secure the payment of a promissory note [described in detail], and also the payment of any additional sums and interest thereon now or hereafter due or owing from mortgagor to mortgagee."

for it. Advances secured under a dragnet clause are thus virtually always optional rather than obligatory.

Open-end mortgage clauses are the fourth category of future advance mortgages. In substance, they provide that the mortgagee may, at its option, make additional advances to the mortgagor in the future, and that such advances, if any, will be secured by the mortgage.³⁵ A clause may specify a maximum limit on the amount of the future advances, or it may limit them to the original principal balance of the loan, thus permitting a borrower who has paid down the loan balance to borrow enough to return the loan to its original amount.³⁶ An open-end mortgage clause is, in a sense, a narrow dragnet clause; it permits the mortgage to secure future advances only if they are designated as being related to the original mortgage, while a dragnet clause typically purports

35. Until recently, open-end clauses were commonly included in residential mortgage forms. See, e.g., Nonuniform Covenant 21 of the District of Columbia FNMA/FHLMC Single Family Deed of Trust, reprinted in D. BARLOW BURKE, LAW OF FEDERAL MORTGAGE DOCUMENTS app. A at 434 (1989), which provides as follows:

Future Advances. Upon request of Borrower, Lender, at Lender's option prior to the release of this Deed of Trust, may make Future Advances to Borrower. Such Future Advances, with interest thereon, shall be secured by this Deed of Trust when evidenced by promissory notes stating that said notes are secured hereby.

This clause was enforced according to its terms in *In re Hawkins*, 156 B.R. 745 (Bankr. D. Vt. 1993). The FNMA/FHLMC Multifamily Mortgage forms formerly contained identical open-end language. See the FNMA/FHLMC Texas Multifamily Deed of Trust form reproduced in NELSON & WHITMAN, *supra* note 1, § 14.16, cl. 33. However, in the past several years the use of such clauses in both of the FNMA/FHLMC mortgage forms mentioned above has been discontinued. Telephone Interview with John Mansfield, Vice President and Deputy General Counsel, Federal National Mortgage Association (Sept. 9, 1994).

36. Nonuniform Covenant 33 of the Texas FNMA/FHLMC Multifamily Deed of Trust form, reprinted in NELSON & WHITMAN, *supra* note 1, § 14.16, cl. 33, added the following language to that quoted in the previous footnote: "At no time shall the principal amount of the indebtedness secured by this Instrument, not including sums advanced in accordance herewith to protect the security of this Instrument, exceed the original amount of the Note (US\$___) plus the additional sum of US\$___." In at least some jurisdictions a statement of maximum amount such as this is necessary to comply with statutes. See, e.g., MD. CODE ANN., REAL PROP. § 7-102 (1988) (requiring future advance mortgages to state a maximum amount).

to secure any and all types of future loans.³⁷ By its terms, an open-end clause contemplates optional, not obligatory, advances.

Dragnet clauses and open-end clauses encounter no significant problems with the optional/obligatory advance doctrine. Lenders that employ these clauses have no particular expectation that advances secured by them will have the priority of the original mortgage, since the advances are so obviously optional. A lender that makes an advance under an open-end clause realizes that it must first conduct a title examination, and that any junior lien disclosed by that examination will have priority over the advance it proposes to make. In other words, the open-end clause gives the lender security, but not priority. With a dragnet clause, the lender's expectations are even more attenuated; when the subsequent loan is made, the lender may not even be aware of the existence of the prior mortgage containing the dragnet clause. This is particularly likely if the subsequent loan is made by a different loan officer in a different branch of the lending institution. In most cases, an officer approving a subsequent loan places little reliance on a dragnet clause. It is only when the subsequent loan is defaulted on, and the collateral given as security for it proves to be inadequate, that the lender focuses on the dragnet clause as a sort of *deus ex machina* to aid in collection. The lender does not view the

37. This is not to say that dragnet clauses actually are enforced so broadly. On the contrary, courts often limit them to the securing of future loans of the same type or character as the original mortgage loan. *See, e.g.,* Lundgren v. National Bank, 742 P.2d 227, 236 (Alaska 1987), *superseded by* 756 P.2d 270 (Alaska 1987); Security Bank v. First Nat'l Bank, 565 S.W.2d 623, 627-28 (Ark. 1978); Akamine & Sons, Ltd. v. American Sec. Bank, 440 P.2d 262, 268 (Haw. 1968); Decorah State Bank v. Zidlicky, 426 N.W.2d 388, 390 (Iowa 1988); Mark Twain Kansas City Bank v. Cates, 810 P.2d 1154, 1162 (Kan. 1991); Dalton v. First Nat'l Bank, 712 S.W.2d 954, 958-59 (Ky. Ct. App. 1986); Canal Nat'l Bank v. Becker, 431 A.2d 71, 75 (Me. 1981); Airline Commerce Bank v. Commercial Credit Corp., 531 S.W.2d 171, 175 (Tex. Civ. App. 1975); First Sec. Bank v. Shiew, 609 P.2d 952, 957 (Utah 1980). *Contra* First Nat'l Bank v. Rozelle, 493 F.2d 1196, 1201-02 (10th Cir. 1974); *In re Stone*, 49 B.R. 25, 27 (Bankr. N.D. Tex. 1985); Thorp Sales Corp. v. Dolese Bros., 453 F. Supp. 196, 200 (W.D. Okla. 1978); *In re Dorsey Elec. Supply Co.*, 344 F. Supp. 1171, 1175 (E.D. Ark. 1972); Wong v. Beneficial Sav. & Loan Ass'n, 128 Cal. Rptr. 338, 345 (Ct. App. 1976); Fleming v. First Am. Bank & Trust Co., 319 S.E.2d 119, 120 (Ga. Ct. App. 1984); Financial Acceptance Corp. v. Garvey, 380 N.E.2d 1332, 1335 (Mass. App. Ct. 1978); Rogers v. First Tenn. Bank Nat'l Ass'n, 738 S.W.2d 635, 636-37 (Tenn. Ct. App. 1987); Murdock Acceptance Corp. v. Jones, 362 S.W.2d 266, 270 (Tenn. Ct. App. 1961); *cf.* Union Nat'l Bank v. First State Bank & Trust Co., 697 S.W.2d 940, 942 (Ark. Ct. App. 1985) (enforcing the mortgage to secure an unrelated debt when the terms of the mortgage expressly provided that it would cover such debt).

dragnet clause as a tool for achieving priority over intervening liens.

B. *Construction Loans and Optional Advances*

It is with construction loan advances that the optional/obligatory advance doctrine does its greatest mischief. In this context the lender's expectations are entirely different from those with respect to open-end and dragnet clauses, for the lender fully expects and intends all advances to have the priority of the original mortgage. Indeed, preservation of this priority is essential from the viewpoint of construction lenders. The principal reason is that in every construction project it is possible that unpaid contractors, laborers, and materials suppliers will file statutory liens (typically termed mechanic's liens or construction liens) on the real estate. In most jurisdictions the original mortgage, if properly recorded, will have priority over such liens. But if some construction advances are denied that priority, they may end up in subordinate position to construction liens. In a project on which those liens represent a substantial dollar amount, any construction advances that fail to get the priority of the original construction mortgage may be so far subordinate as to be essentially unsecured and uncollectible. This problem is especially acute in the many jurisdictions that treat all individual mechanic's liens as taking their priority from the time of commencement of the construction project rather than from the time each individual lienor begins furnishing labor or materials.³⁸ Thus, lenders regard the preservation of priority for all construction advances as critically important.

Under the traditional optional/obligatory advance doctrine, we have already seen that preservation of priority requires that the lender make no optional advances while having knowledge of intervening liens. Although superficially this seems to be a simple

38. See *Dixie Heating & Cooling Co. v. Bank of Gadsden*, 437 So. 2d 576, 577 (Ala. Civ. App. 1983); *M.D. Marinich, Inc. v. Michigan Nat'l Bank*, 484 N.W.2d 738, 741 (Mich. Ct. App. 1992), *appeal denied*, 497 N.W.2d 184 (Mich. 1993); *Schalmo Builders, Inc. v. Malz*, 629 N.E.2d 52, 53 (Ohio Ct. App. 1993) (construing OHIO REV. CODE ANN. § 1311.13(A)(1) (Baldwin Supp. 1993)); *Republic Bank & Trust Co. v. Bohnar Minerals, Inc.*, 661 P.2d 521, 523 (Okla. 1983); ROBERT KRATOVIL, *MODERN MORTGAGE LAW AND PRACTICE* § 214 (1972). Under this view, it is immaterial whether the particular lienor's work was done before or after the mortgage was recorded. *Barker's, Inc. v. BDJ Dev. Co.*, 308 N.W.2d 78, 80 (Iowa 1981).

test, in the construction lending context it is fraught with difficulties, as illustrated below.

1. *Discretionary Advances.* Construction loan agreements often give lenders fairly wide discretion in determining whether to make advances. For example, a lender's obligation may be made dependent on satisfactory inspections by its architects, satisfactory proof of the costs of labor and materials used, and satisfactory evidence that the project is within a preestablished budget. If too much discretion is reserved, a court may determine that the lender in fact had no contractual obligation to make further advances, and hence that all of its advances should lose priority to intervening liens.³⁹ Some range of discretion is needed, for no construction lender wants to be forced to continue making advances if the borrower is acting in bad faith, performing sloppy or inadequate construction, or diverting loan funds from the project to other uses. Yet the caselaw makes it extremely difficult to judge how much discretion the lender may retain without jeopardizing its priority.

This dilemma is illustrated by comparing two cases with similar facts. In *National Bank v. Equity Investors*,⁴⁰ a construction loan agreement provided that funds were

“to be advanced at such times and in such amounts as the Lender shall determine.” It provided, too, that “No advance shall be due unless, in the judgment of the Lender” all work for which the advance had been made had been done in a good and workmanlike manner, and unless the construction be approved by the architect.⁴¹

The Washington Supreme Court concluded that this language

left so wide an area of discretion in the bank as to render the amounts to be advanced and the intervals of their advancing optional rather than compulsory as a matter of law. Had the borrowers sought a decree to overcome these reservations and to

39. Perhaps the most obviously “optional” advances are those made under a construction loan agreement that fails to make any clear statement about the circumstances under which advances will be made. See *First Nat'l Bank & Trust Co. v. Worthley*, 714 P.2d 1044, 1046-47 (Okla. Ct. App. 1985). But it is doubtful that many modern loan agreements are this sloppily drafted.

40. 506 P.2d 20 (Wash. 1973).

41. *Id.* at 28.

compel the advances, or to override the bank's discretionary power to advance or withhold the loan funds, they would have met with nearly insuperable obstacles at law. So broad and yet so specific were the bank's discretionary powers under the contract as to the times and amounts of the advances, a court could not properly override such discretion without abrogating the contract.⁴²

Quite a different attitude is reflected in the Arkansas Supreme Court's opinion in *Dempsey v. McGowan*.⁴³ The construction loan agreement in this case was similar to that in *Equity Investors*; it provided that the lender would make advances "upon authorization of the borrower and his furnishing current lien releases, and approval of the lender."⁴⁴

The court recognized that this language seemed to give the lender considerable discretion, but it nonetheless concluded that the advances made under the agreement were "obligatory" and retained their priority as against intervening liens:

A literal requirement that a lender can have absolutely no discretion or any conditions relating to future advances in a mortgage would defeat the purpose of the loan and probably bring an end to construction money loans. From the language in the present mortgage, it is apparent that the mortgagee was unequivocally obligated to advance the balance of the funds for construction purposes even though some restraints and conditions were included in the agreement.⁴⁵

To reconcile these two cases takes a fine eye indeed. It is plausible to conclude that the Arkansas court was simply more sympathetic than its Washington counterpart to the need of construction lenders for reasonable discretion in making advances. In all events, cases of this sort place the drafters of construction loan agreements in a difficult posture; the line between enough discretion to protect the lender and so much discretion that priority will be lost is exceedingly difficult to draw.

Courts' uneasiness with the optional/obligatory distinction sometimes drives them to make statements that are nonsensical. In

42. *Id.* at 29.

43. 722 S.W.2d 848 (Ark. 1987).

44. *Id.* at 850.

45. *Id.*

Southern Trust Mortgage Co. v. K & B Door Co.,⁴⁶ a construction loan agreement, in a bald-faced attempt to let the lender have its cake and eat it too, provided that “[f]unds advanced in the reasonable exercise of [the lender’s] judgment that the same are needed to complete the improvements or to protect its security are to be deemed *obligatory advances* hereunder”⁴⁷ This is nothing more than a statement that even optional advances are to be considered obligatory. Amazingly, the Nevada Supreme Court was happy to cooperate in this absurdity:

There is nothing in the loan agreement or other documents created by the parties, nor in the parties’ conduct, nor in the nature of the parties’ legal relations that even remotely suggests anything but a clear duty on the part of STM to advance monies under the agreed-upon “obligation to do so.” This conclusion is cemented by the parties’ unambiguous written agreement that “all funds” are “to be deemed obligatory advances.”⁴⁸

The opinion does not give enough information about the other terms of the agreement to permit us to form a judgment about whether the advances in question were actually optional. But it is clear that the “to be deemed obligatory” clause does not “cement” anything. A pig does not become a cow merely because parties “deem” it to be a cow. In effect, the court permitted the lender to rewrite the law of future advances in complete disregard of the fundamental purpose of the optional/obligatory advance doctrine. Drafters in other jurisdictions might be tempted to employ the same technique, but they have no assurance that other courts will be similarly receptive.

2. *The Lender’s Failure to Use Its Protective Conditions.* Construction loan agreements frequently contain conditions designed to protect the lender that are not at all vague or discretionary. Rather, they spell out objective facts that condition the lender’s obligation to make advances.⁴⁹ For example, in *J.I.*

46. 763 P.2d 353 (Nev. 1988).

47. *Id.* at 354.

48. *Id.* at 354-55.

49. *See, e.g.,* Briarwood Towers 85th Co. v. Guterman, 523 N.Y.S.2d 98, 101 (App. Div. 1988); Schalmo Builders, Inc. v. Malz, 629 N.E.2d 52, 55 (Ohio Ct. App. 1993) (failing to make clear whether the conditions in the case were actually satisfied); *see also* Conshohocken Fed. Sav. & Loan Ass’n v. Period & Country Homes, Inc., 430 A.2d 1173, 1179 (Pa. Super. Ct. 1981) (finding that a schedule of progress payments submitted by

Kislak Mortgage Corp. v. William Matthews Builder, Inc.,⁵⁰ a construction loan agreement provided as follows:

None of the said respective installments or any part thereof, not theretofore paid over shall be required to be made by Lender unless and until Borrower shall procure and deliver to Lender original receipts or such other evidence as shall be satisfactory to Lender, showing that any installment received theretofore under this Agreement has been disbursed fully and properly to materialmen, laborers, subcontractors, and to any other person, firm or corporation providing or furnishing materials or labor or both, in connection with the construction of said improvements on the above mentioned premises.⁵¹

A clause of this sort is quite objective and perfectly reasonable as a means of assuring the lender that the borrower is not diverting construction funds while leaving bills unpaid. The existence of such conditions does not undermine the obligatory nature of the advances, provided, of course, that the conditions are met when the advances in question are made.⁵²

The lender in *Kislak*, however, did not enforce the condition; it made advances without first demanding to see receipts showing that the bills had been paid.⁵³ This may have been a reasonable decision by the officer administering the construction loan. Perhaps the borrower had a track record of reliability and trustworthiness such that it seemed unnecessary to demand the receipts. But the lender's decision to forgo this protection turned out to be fatal, for the court held that since there was no obligation to make advances without submission of the receipts, all of the advances were optional and hence lost their priority when construction liens were filed.⁵⁴ The point is clear: the lender must actually *use* the protective conditions it has given itself in the construction loan agreement. If it waives or disregards them, it risks loss of priority.

the developer to the construction lender was merely an estimate, and that compliance with the schedule was not a condition to the making of advances).

50. 287 A.2d 686 (Del. Super. Ct. 1972), *aff'd*, 303 A.2d 648 (Del. 1973).

51. *Id.* at 688-89.

52. *See, e.g.*, Colonial Mortgage Serv. Co. v. Southard, 384 N.E.2d 250, 253 n.2 (Ohio 1978) ("The fact that the agreement contained conditions precedent to payments of a given advance does not affect the obligatory nature of those advances."); *see also* cases cited *supra* note 49.

53. *Kislak*, 287 A.2d at 689.

54. *Id.*

3. *Advances Made After Default.* Virtually without exception, construction loan agreements give the lender the power to discontinue the making of advances (and ultimately to foreclose the mortgage) if the borrower defaults. There are many possible forms of default. The borrower might, for example, build structures that fail to comply with the plans and specifications incorporated into the agreement. The borrower might fail to make a required payment of interest. The project might fall behind schedule, so that it cannot be completed within the term of the loan. The construction loan agreement may make the filing of mechanic's liens against the project a condition of default.⁵⁵

But the sort of default that is most likely to occur is an "out of balance" construction loan account. When a construction loan is made, the entire loan amount is usually transferred by the lender to a construction loan account, earmarked for the project in question, and held by the lender. This is only a paper transfer; the lender still has control of the funds.⁵⁶ The loan agreement typically provides that before each advance is made, the funds remaining in the account must be sufficient to complete the project. Often the inspecting architect must certify this fact prior to the making of each advance.⁵⁷ If this certification cannot be made, the loan is said to be out of balance. This means that factors such as price increases in labor or materials, construction delays, defaults by subcontractors, or unexpected conditions on the site have made it impossible to complete the project with the remaining funds. In the most extreme form of this sort of default, the construction

55. *First Nat'l Bank & Trust Co. v. Worthley*, 714 P.2d 1044, 1046 (Okla. Ct. App. 1985) ("The question that must be answered is whether the bank was in fact obliged to advance the full \$325,000.00 despite receiving reports that supplies and mechanics were not being paid.").

56. Pennsylvania courts, in a remarkable exercise of judicial legerdemain, have held that a lender's transfer of loan funds into the construction loan account somehow makes all advances obligatory, even if some of those advances are subject to conditions and the conditions are not met. *Central Pa. Sav. Ass'n v. Carpenters of Pa.*, 444 A.2d 755 (Pa. Super. Ct. 1982), *aff'd*, 463 A.2d 414 (Pa. 1983). No other jurisdiction seems to have followed this peculiar theory.

57. See GEORGE LEFCOE, *REAL ESTATE TRANSACTIONS* 1030-34 (1993); NELSON & WHITMAN, *supra* note 1, § 12.1; Colin C. Livingston, *Current Business Approaches—Commercial Construction Lending*, ABA SECTION ON REAL PROPERTY, PROBATE AND TRUST LAW, *REAL ESTATE FINANCING—TODAY & TOMORROW* 54 (1978); Noel W. Nellis, *A Construction Loan Agreement*, *PRAC. REAL EST. L.*, July 1985, at 65, 68.

loan account has been exhausted but the project is not yet complete.

What is a construction lender to do in such a case? One course of action is to cease making advances, foreclose the construction mortgage, take over the project,⁵⁸ complete it, and place it on the market.⁵⁹ While this course is open to the lender, it is usually unattractive. The lender is usually a financial institution with little expertise in hands-on real estate development. Construction is a risky business at best,⁶⁰ and if the lender steps into the developer's shoes, it inherits a partially completed project with little detailed knowledge of the problems the developer has encountered thus far. Few lenders wish to place themselves in such a position except as a last resort. It is usually much more sensible to allow the borrower to continue construction, waive the default, continue to fund the loan, and if necessary, even increase the amount of the loan somewhat in order to get the project finished.

The difficulty with the latter course of action, however, is that since the lender has no duty to allow the borrower to continue, all of the further advances become optional. One writer has argued that although advances made in this context are admittedly optional in a legal sense, they are obligatory in a business sense, for continuing to fund the loan is the only rational decision the lender can make.⁶¹ However, there is no case authority for the proposition that this sort of "obligation" serves to preserve the construction lender's priority.

4. *What Constitutes Notice?* The optional/obligatory advance doctrine causes a loss in priority only to intervening liens of which the future advances lender has notice at the time of the advance. In a minority of states, constructive notice is the test. Since the intervening lien is usually recorded, in these states the prior

58. This assumes that no third-party bidder will outbid the construction lender at the foreclosure sale. This assumption is usually realistic, for partially completed projects are notoriously unattractive investments to foreclosure bidders. The construction lender nearly always ends up taking title.

59. Conceivably the project can be sold by the lender in its partially completed form, but such a sale is likely only at a very large loss, since few buyers are apt to be interested in assuming the risks of completing somebody else's botched project.

60. See, e.g., Henry S. Kesler, *Construction Lending Risks and Returns*, MORTGAGE BANKING, Jan. 1989, at 62; Henry S. Kesler, *Construction Loans: Lenders Beware*, MORTGAGE BANKING, July 1987, at 38.

61. Skipworth, *supra* note 1, at 221.

mortgagee may safely make optional advances only if it obtains a title examination before each advance.⁶² Under the majority approach, only actual knowledge counts against the prior mortgagee,⁶³ and therefore regular title examinations during the administration of the construction loan are presumably unnecessary.

However, it is by no means obvious what constitutes actual knowledge in the common situation in which the intervening lien is a mechanic's or materialman's lien. There is authority that the future advances lender loses priority when making an optional advance if visible work has been done by the lienor,⁶⁴ if the lender knows that suppliers or subcontractors have not been paid on time,⁶⁵ or if it knows that there are unpaid claims and that "[mortgagor] is unable to pay such claims or that the claimant

62. *Lincoln Fed. Sav. & Loan Ass'n v. Platt Homes, Inc.*, 449 A.2d 553, 555-58 (N.J. Super. Ct. Ch. Div. 1982); *Briarwood Towers 85th Co. v. Guterman*, 523 N.Y.S.2d 98, 100-01 (App. Div. 1988) (requiring "actual or constructive notice"); *Tyler v. Butcher*, 734 P.2d 1382, 1385-86 (Or. Ct. App. 1987); *People's Sav. Bank v. Champlin Lumber Co.*, 258 A.2d 82 (R.I. 1969).

63. See *Mobley v. Brundidge Banking Co.*, 347 So. 2d 1347, 1349-50 (Ala. 1977); *Union Nat'l Bank v. First State Bank & Trust*, 697 S.W.2d 940, 942 (Ark. Ct. App. 1985); *Idaho First Nat'l Bank v. Wells*, 596 P.2d 429, 433-34 (Idaho 1979); *Axel Newman Heating & Plumbing Co. v. Sauers*, 47 N.W.2d 769, 772 (Minn. 1951); *North v. J.W. McClintock, Inc.*, 44 So. 2d 412, 414 (Miss. 1950); *Housing Mortgage Corp. v. Allied Constr., Inc.*, 97 A.2d 802, 805-06 (Pa. 1953); *Central Pa. Sav. Ass'n v. Carpenters of Pa.*, 444 A.2d 755, 758 (Pa. Super. Ct. 1982), *aff'd*, 463 A.2d 414 (Pa. 1983); *Lake v. Shumate*, 20 S.C. 23, 25 (1882) (reversed in 1934 by former S.C. CODE ANN. § 8712-2 (Law. Co-op. 1942) (recodified at S.C. CODE ANN. §29-3-50 (Law. Co-op. 1991) (giving full priority to all future advances irrespective of notice)), *applied in* *McMillen Feed Mills, Inc. v. Mayer*, 220 S.E.2d 221, 225-27 (S.C. 1975); *Bank of Ephraim v. Davis*, 559 P.2d 538, 540-41 (Utah 1977); *Colonial Bank v. Marine Bank, N.A.*, 448 N.W.2d 659, 661 (Wis. 1989); *First Interstate Bank v. Heritage Bank & Trust*, 480 N.W.2d 555, 558 (Wis. Ct. App. 1992).

Several states have enacted statutes requiring written notice to the future advances lender in order to deprive it of its priority. These statutes effectively eliminate the confusion discussed in the text. See ME. REV. STAT. ANN. tit. 33, § 505(5)(B) (West Supp. 1994); NEB. REV. STAT. § 76-238.01(1)(b) (1990); OHIO REV. CODE ANN. § 5301.232(B) (Baldwin Supp. 1993), *construed in* *Schalmo Builders, Inc. v. Malz*, 629 N.E.2d 52 (Ohio Ct. App. 1993); R.I. GEN. LAWS § 34-25-10(b) (1984); VT. STAT. ANN. tit. 8, § 1207 (1984); W. VA. CODE § 38-1-14(e) (Supp. 1994). See also the following repealed statutes, which provide additional drafting illustrations. ALASKA STAT. § 06.30.560(2) (1988), *repealed by* 1993 Alaska Sess. Laws ch. 26, § 102; N.D. CENT. CODE § 6-03-05.1 (1987), *repealed by* 1991 N.D. Laws ch. 84, § 1.

64. *R.B. Thompson, Jr. Lumber Co. v. Windsor Dev. Corp.*, 374 N.W.2d 493, 497 (Minn. Ct. App. 1985).

65. *First Nat'l Bank v. Worthley*, 714 P.2d 1044, 1047 (Okla. Ct. App. 1985).

intends to 'file a lien.'"⁶⁶ In many states there is no clear decision as to what sort of information about potential mechanic's liens results in the denial of the construction lender's priority.

In this ocean of ambiguity a construction lender can find no island of refuge. Both aspects of the common law optional/obligatory distinction are unclear: what makes an advance optional, and what sort of notice of intervening mechanic's liens destroys the priority of such an advance? Careful drafting of construction loan agreements may clarify the first aspect a bit, but the law is fundamentally flawed and frustrates reasonable business planning.

C. *Line of Credit Loans and Optional Advances*

While lenders have long disliked the optional/obligatory test in the context of construction loans, the 1980s witnessed great growth of a new type of loan with which the test was equally incompatible: the "home equity" loan, typically a second mortgage to secure a fluctuating line of credit on the borrower's residence.⁶⁷ Credit line mortgages have been used for decades in business lending, but their widespread use in loans to consumers is much more recent. Some of these arrangements contemplate advances over which the lender has sufficient discretion that the advances might well be regarded as optional. Of course, the lenders have no wish to suffer the inefficiency and delay that would result if it were necessary for them to examine the record title before every disbursement.

Credit line mortgages often contain conditions; if the borrower fails to meet these conditions, the lender may discontinue advances. Such conditions may include, for example, a default under a senior mortgage,⁶⁸ a material deterioration in the borrower's financial condition, an unacceptable reduction in the value of the real estate,⁶⁹ and failure to maintain the improvements on the real estate in a manner acceptable to the lender.⁷⁰ Like the con-

66. *Grider v. Mutual Fed. Sav. & Loan Ass'n*, 565 S.W.2d 647, 649 (Ky. Ct. App. 1978).

67. See Forrester, *supra* note 3.

68. A provision of this sort is known as a cross-default clause. See, e.g., *Taylor v. Brennan*, 621 S.W.2d 592, 593 (Tex. 1981).

69. See, e.g., *Russell Corp. v. BancBoston Fin. Co.*, 434 S.E.2d 716, 717 (Ga. Ct. App. 1993) (conditioning continuation of advances on appraisal of real estate).

70. The home equity deed of trust in effect on the home of one of the authors provides that the trustor agrees

struction loan clauses discussed above, these conditions may raise optional advance issues in two distinct ways: they may be considered so subjective as to make all advances inherently discretionary, and even if the standards they set are clear, lenders will often continue making advances even when those standards are not met. Additionally, virtually all line of credit loans impose ceilings on the total outstanding balance, and a lender who voluntarily permits draws in excess of such a ceiling, even for good business reasons, will doubtless be held to have made an optional advance.⁷¹ As far as we can tell, there are yet no reported cases raising these issues, but their advent is simply a matter of time.

IV. STATUTORY ATTEMPTS TO SOLVE THE FUTURE ADVANCES PROBLEM

From the viewpoint of mortgagees, the optional/obligatory advance doctrine is a serious and costly problem. Not surprisingly, lenders have lobbied energetically and fairly effectively for statutory change in a number of jurisdictions. Many changes occurred during the 1980s. One form of change, adopted by several states, is found in the Uniform Land Security Interest Act (ULSIA), promulgated in 1985 by the National Conference of Commissioners on Uniform State Laws. Its intent is to eliminate the mortgagor's default as a basis for deeming advances "optional." To accomplish this, the Act redefines "obligatory" to mean to be "pursuant to commitment, . . . whether or not a default . . . has relieved or

[t]o properly care for and keep the Property in good condition and repair;
Not to remove, demolish or materially alter any building or any improvement on the Property; nor to change or alter (i) the terms and/or conditions of any existing lease with respect to all or part of the Property; nor (ii) the present character or use of the Property;

To complete or restore promptly, and in good and workmanlike fashion, any building or improvement which may be in process, constructed, damaged or destroyed on the Property and to pay in full all costs and expenses incurred in connection with such completion or restoration;

To comply with all laws, ordinances, regulations, covenants, conditions or restrictions affecting the Property

First Interstate Bank of Utah, *Advanceline Deed of Trust with Assignment of Rents* (Dec. 1989). It is easy to imagine violations of these covenants that would in theory permit the lender to discontinue further advances, but that in fact the lender would consider trivial and would disregard. Any advance made thereafter would technically be optional.

71. See *Russell Corp.*, 434 S.E.2d at 718 ("[T]he bank did not have an unconditional obligation to fund overadvances up to \$4,000,000, once it had received the appraisals.").

may relieve [the mortgagee] from its obligation."⁷² ULSIA further states that an advance is considered "pursuant to commitment . . . whether or not . . . [an] event not within [the mortgagee's] control has relieved or may relieve it from its obligation."⁷³

This language solves most of the problems of construction lenders and line of credit lenders discussed above. It ensures that advances will have priority even if the borrower has failed to meet the conditions imposed by the loan agreement or has defaulted and is therefore no longer entitled to any advances. It may also (although the point is debatable) preserve the lender's priority when the lender fails to enforce or utilize the protections it has reserved in the loan agreement.⁷⁴ The only problem of construction lenders discussed above that ULSIA does not adequately address is the situation in which the mortgagee has reserved too much discretion, or has too much control of the relevant conditions, so that its advance cannot be regarded as "pursuant to commitment."⁷⁵

But while ULSIA provides great comfort to future advances lenders, it does so at a high cost, for it loses sight of the original purpose of the optional/obligatory doctrine: to protect the mortgagor's right to use his unencumbered equity in the real estate as security for additional borrowing. Assume, under a statute contain-

72. UNIF. LAND SECURITY INTEREST ACT § 111(19) (1985). The language was drawn from U.C.C. § 9-105(1)(k) (1990). State statutes following it with respect to future advance mortgages include ILL. ANN. STAT. ch. 735, para. 5/15-1302 (Smith-Hurd 1992); R.I. GEN. LAWS § 34-25-10(b) (1984).

73. The quoted phrases are drawn from U.C.C. § 9-105(1)(k). Article 9 of the U.C.C. implements a system for determining future advance priorities similar to that of ULSIA, with certain modifications to accommodate the Federal Tax Lien Act of 1966, Pub. L. No. 89-719, 80 Stat. 1125 (codified as amended in scattered sections of 26 U.S.C.). See U.C.C. §§ 9-301(4), -307(3), -312(7) (1990).

74. Whether the quoted language will have that effect depends on the meaning of the phrase an "event not within [the mortgagee's] control." UNIF. LAND SECURITY INTEREST ACT § 111(19) (1985). Consider the facts of *J.I. Kislak Mortgage Corp. v. William Matthews Builder, Inc.*, 287 A.2d 686, 687 (Del. Super. Ct. 1972), *aff'd*, 303 A.2d 648 (Del. 1973). In that case, the construction lender failed to insist that the borrower submit paid invoices of suppliers and subcontractors before honoring each draw, as the loan agreement provided. The lender was therefore technically not required to make the advances, but did so anyway. Was the "event" that excused the lender's duty to make advances the borrower's failure to submit the invoices (arguably an event "not within [the mortgagee's] control," as ULSIA puts it) or the lender's failure to demand the invoices (obviously an event "within the lender's control")? ULSIA can be read either way on this point.

75. See *National Bank v. Equity Investors*, 506 P.2d 20, 29 (Wash. 1973).

ing the features described above, that Mortgagee-1 makes a line of credit mortgage loan to Mortgagor for business purposes. Mortgagee-1 promises to fund the loan up to a maximum of \$100,000, but only on certain conditions, one of which is that Mortgagor maintain a specific credit rating. After Mortgagor borrows \$50,000 under this loan, Mortgagor's credit rating falls below the specified level and Mortgagee-1 refuses to make further advances. The value of the real estate is still well above \$100,000, so Mortgagor approaches Mortgagee-2 and attempts to arrange a junior mortgage loan. Mortgagee-2 is willing and is plainly able to give Mortgagee-1 actual notice that a second loan is about to be made. However, Mortgagee-2 realizes that Mortgagee-1 might in the future relax its position and make further advances to Mortgagor. If Mortgagee-1 did so, those advances would quite plainly be "pursuant to commitment" as defined in ULSIA, despite the fact that because the credit condition would be unsatisfied, Mortgagee-1 could not be compelled to make them. Hence, these advances would have priority over Mortgagee-2's lien. Since Mortgagee-2 cannot be sure that such advances will not be made by Mortgagee-1, Mortgagee-2 will consider the real estate inadequate security and will refuse to make the second mortgage loan. Thus Mortgagor is in precisely the awkward and inefficient position that the optional/obligatory doctrine was designed to avoid: she has substantial unencumbered equity in the realty but cannot get a loan from any source on its security.

Viewed in this light, ULSIA is puzzling. It provides protection for lenders, but at the expense of borrowers, who are left unable to borrow against their equity. The baby is thrown out with the bathwater. It would have been simpler, and no less harmful to borrowers, for ULSIA to repeal the optional/obligatory advance distinction altogether and give priority to all future advances. Indeed, a number of recent state statutes do precisely this, at least in some situations, rather than following ULSIA.⁷⁶

76. See HAW. REV. STAT. § 506-1(b) (1993); KAN. STAT. ANN. § 58-2336 (1983); KY. REV. STAT. ANN. § 289.441(4) (Baldwin 1987); MD. CODE ANN., REAL PROP. § 7-102(b) (1988); N.H. REV. STAT. ANN. § 479:3 (1992); N.J. STAT. ANN. § 46:9-8.2 (West Supp. 1994); N.M. STAT. ANN. § 48-7-9 (Michie 1978); N.Y. REAL PROP. LAW § 281(2) (McKinney 1989); S.C. CODE ANN. § 29-3-50(A) (Law. Co-op. Supp. 1993); S.D. CODIFIED LAWS ANN. § 44-8-26 (1983); WASH. REV. CODE ANN. § 60.04.226 (West Supp. 1995).

Quite a different approach to the future advances problem is represented by recent statutes in a number of jurisdictions redefining "notice" to make it clear that only actual written notice delivered to the mortgagee will place its priority at risk.⁷⁷ These statutes place the onus on the prospective intervening lienor to take affirmative steps to ensure that the senior mortgagee is aware of its position. This is a marginally worthwhile but essentially trivial modification of the traditional optional/obligatory advance doctrine. It eliminates the uncertainty about what sort of notice will result in loss of priority of an advance, but it does nothing to resolve the fundamental problem discussed above. It is doubtful that these statutes facilitate the making of any junior mortgage loans that would not be made otherwise, since even a junior lender that gives actual written notice to the senior mortgagee will still be subordinate to the senior's advances if they are considered obligatory.

A. *The Statutory Cutoff Notice*

About a dozen recent statutes attempt to deal with the problem of unavailability of junior financing to the borrower in a much more ingenious and effective way. Under these statutes, all future advances, whether obligatory or optional, take the priority of the original mortgage and are senior to any intervening liens. However, in order to help the borrower obtain junior mortgage loans, the statutes adopt the concept of a "cutoff notice": a notice issued by the borrower to the future advances lender that freezes advances at their current level.⁷⁸ The notice, in effect, empowers borrowers

77. See statutes cited *supra* note 63. Most of these statutes permit the delivery of notice by a junior lienor to act as a subordination only of optional advances, thus following the common law approach, but several of them appear to subordinate all advances to an intervening lienor who gives notice. See ALASKA STAT. § 06.30.560(2) (1988), *repealed by* 1993 Alaska Sess. Law ch. 26, § 102; ME. REV. STAT. ANN. tit. 33, § 505(5)(B) (West Supp. 1994); VT. STAT. ANN. tit. 8, § 1207 (1984). In effect, the latter statutes are operationally similar to the cutoff notice statutes discussed *infra* text accompanying note 78, except that the notice is given by the junior lienor rather than the mortgagor.

78. FLA. STAT. ANN. § 697.04(1)(b) (West Supp. 1995); ME. REV. STAT. ANN. tit. 33, § 505(5)(A); MO. ANN. STAT. § 443.055(6) (Vernon Supp. 1994); MONT. CODE ANN. § 71-1-206(3) (1993); NEB. REV. STAT. § 76-238.01(1)(a) (1990); NEV. REV. STAT. ANN. § 106.380(1) (Michie 1994); N.C. GEN. STAT. § 45-72 (1991); OHIO REV. CODE ANN. § 5301.232(C) (Baldwin 1993); OR. REV. STAT. § 86.155(3) (1988); R.I. GEN. LAWS § 34-25-11 (Michie 1984); TENN. CODE ANN. §§ 47-28-105 to -110 (1988); VA. CODE ANN. § 55-58.2 (Michie Supp. 1994). The earliest of these statutes was Montana's. See MONT. CODE ANN. § 71-1-206(3) note (1993). For an additional drafting illustration, see ALASKA STAT. § 06.30.560 (1988), *repealed by* 1993 Alaska Sess. Laws ch. 26, § 102.

to write future advances clauses out of mortgages, but only prospectively. A borrower who has this power to freeze advances has no need of the optional/obligatory distinction. If the borrower needs additional financing, cannot get it on satisfactory terms from the existing mortgagee, and wishes to pursue borrowing opportunities with other lenders, she need merely issue a cutoff notice. The mortgagee is thus informed that no further advances will be secured by the mortgage; the future advance provisions of the loan are terminated. Other lenders may then safely take junior mortgages on the property, knowing that no further advances on the senior debt will occur to exhaust the borrower's equity.⁷⁹

The cutoff notice is a brilliantly simple solution to the dilemma of the borrower who has signed a mortgage with a future advances clause and who now needs additional financing. While technically it is the borrower who must issue the cutoff notice, it will ordinarily be the prospective junior lender that requires the borrower to issue it, for no knowledgeable junior lender will make a loan without it. With a cutoff procedure in effect, there is no need for the law to subordinate optional advances, for once a cutoff notice is given, there will not be any further advances by the senior lender, optional or otherwise. Hence, the cutoff notice statutes simply repeal the optional/obligatory advance doctrine and

The Maine statute was amended in 1993 to apply, effective January 1, 1994, to mortgages taken by all types of lenders; the previous version, ME. REV. STAT. ANN. tit. 9-B, § 436 (West 1980 Supp. 1994), applied only to mortgage loans made by financial institutions. The previous version remains in effect with respect to mortgages recorded before January 1, 1994.

The Missouri statute applies only if the security interest "contain[s] a provision expressly stating that the instrument is to be governed by this section." MO. ANN. STAT. § 443.055(1)(10); see *Bank of Urbana v. Wright*, 880 S.W.2d 921 (Mo. Ct. App. 1994) (applying this language and determining that previous common law principles governed a future advance mortgage that did not contain such an election). The Rhode Island statute likewise applies only if the title of the mortgage includes a direct reference to the code section. R.I. GEN. LAWS § 34-25-13.

Four of the statutes (those in Alaska, Nebraska, North Carolina, and Virginia) permit a cutoff notice to operate only against optional advances. This limitation seriously restricts these statutes' usefulness, since the application of the optional/obligatory distinction remains uncertain.

79. Under these statutes the junior lien is still subject to accrual of interest on the senior loan, to the senior's costs of enforcement and foreclosure, and to any advances the senior lender might make to protect the security. But these are risks that every junior lienholder must assume, whether the prior mortgage generally secures future advances or not. See *supra* text accompanying note 18.

provide that all advances made before the lender's receipt of a cutoff notice have the priority of the original mortgage.⁸⁰

A junior lender will doubtless prefer the protection of the cutoff notice to that given by the traditional optional/obligatory advance doctrine. The effect of the cutoff notice is clear and absolute; the junior lender knows that the balance on the senior lien cannot be enlarged by any further advances. By contrast, under the traditional doctrine, the junior lender must worry about the vagaries of the courts' views as to which advances are deemed optional and which ones obligatory—a nasty thicket indeed.

Many of the cutoff notice statutes provide for the recording of some form of certificate executed by the senior lender, showing that it has received the cutoff notice.⁸¹ This is a highly convenient feature from the viewpoint of a borrower who has decided to seek a junior loan but has not yet identified the lender that will make it. With the certificate on record, the borrower can approach various lenders and immediately establish that the future advances clause in the original senior mortgage presents no risk to them.

There is a minor variation in the effect of the statutory cutoff notice provisions. Some of them render unsecured any advances made after receipt of the notice; the mortgage's future advances clause is made entirely ineffective as to such advances.⁸² Others, however, merely subordinate the priority of further advances to intervening liens.⁸³ There seems to be no sound reason to restrict the borrower to one of these results rather than the other; either will have the desired effect of making junior financing readily

80. See, e.g., MO. ANN. STAT. § 443.055(5):

As to any third party who may acquire or claim any rights in or a lien upon the encumbered real property, the priority of the lien of a security instrument securing future advances or future obligations shall date from the time the security instrument is recorded, whether or not any third party has actual notice of any such advances or obligations and whether or not such advances or obligations are optional or obligatory with the lender.

81. MO. ANN. STAT. § 443.055(6) (1994); NEV. REV. STAT. ANN. § 106.380(2) (Michie 1994); N.C. GEN. STAT. § 45-72(a) (1991); OR. REV. STAT. § 86.155(4) (1988); R.I. GEN. LAWS § 34-25-11 (1984).

82. FLA. STAT. ANN. § 697.04(1)(b) (West Supp. 1995); MO. ANN. STAT. § 443.055(6)(1); NEV. REV. STAT. ANN. § 106.400 (Michie 1994); N.C. GEN. STAT. § 45-72(b); OHIO REV. CODE ANN. § 5301.232(C) (Baldwin 1993); OR. REV. STAT. § 86.155(3); R.I. GEN. LAWS § 34-25-11.

83. ALASKA STAT. § 06.30.560(2) (1988), *repealed by* 1993 Alaska Sess. Laws ch. 26, § 102; MONT. CODE ANN. § 71-1-206(3) (1993); NEB. REV. STAT. § 76-238.01(1)(b) (1990); TENN. CODE ANN. § 47-28-108(b) (1988); VA. CODE ANN. § 55-58.2(7) (Michie Supp. 1994).

available. However, if the future advances lender had a duty to make further advances upon the borrower's request, it should certainly be excused from that duty by a cutoff notice that subordinates the further advances;⁸⁴ otherwise, a lender that expected to have first priority for its advances would have only third (or worse) priority instead, surely an unconscionable result.

B. *Cases in Which a Cutoff Is Impermissible*

As some of the statutes recognize, there are certain situations in which a borrower should not be permitted to issue a cutoff notice because doing so could unfairly harm the future advances lender's legitimate interests. Two distinct forms of unfairness to the lender are conceivable: impairment of the value of the real estate as security, and impairment of the lender's ability to perform obligations it has undertaken to third parties. Each of these issues requires some discussion.

In some cases, if the lender cannot make any further advances, it may not get the real estate value for which it bargained as collateral. The best illustration is a construction loan. Obviously a half-finished building may not be worth half as much as a finished building. A lender that forecloses on a partially completed project may have to spend far more money than remains in the construction loan account to complete and market it. In such a case the lender usually has to employ a general contractor to complete the work that another party started, using that party's plans and specifications and often hiring the same subcontractors. The cost of completion will have these added and somewhat unusual risks built into it.

Hence a lender that has made a construction loan and receives a valid cutoff notice from the borrower partway through the construction process (perhaps because the borrower has found a lower-interest source of funds with which to complete the project) can be placed in a very awkward position. If the project is never actually completed (a fact now beyond the original construction lender's control), the lender's security may be seriously inadequate to cover the outstanding debt. Several of the cutoff notice statutes, recognizing this problem, exempt construction loans from the cutoff notice procedure.⁸⁵ This is a sound idea, for construction loan

84. Oddly, none of the cutoff notice statutes seem to deal with this issue.

85. FLA. STAT. ANN. § 697.04(b) (West Supp. 1995); MO. ANN. STAT.

borrowers have little legitimate need for cutoff notices. The purpose of the notice, after all, is to permit borrowers to use their equity to obtain junior financing. Construction loan borrowers, however, typically have little or no equity until construction is complete; because of the risks outlined above, during most of the construction process their loans are often "under water" or nearly so. And while construction loan borrowers might occasionally appreciate the opportunity to "reshop" their loans for lower interest rates partway through the construction, there is certainly no important public policy to be served by giving them cutoff notice rights to help them do so.⁸⁶

The second context in which a cutoff notice may operate unfairly against a lender arises when the lender has duties to third parties and the mortgage secures the borrower's obligation to reimburse the lender's performance of those duties. Suppose, for example, the borrower is a real estate developer who wishes to obtain a ground lease of certain land. The developer's credit, however, is not strong enough to satisfy the prospective ground lessor. The lender therefore convinces a bank to issue an irrevocable standby letter of credit to the lessor, in effect guaranteeing the developer's performance under the lease.⁸⁷ The bank, in turn, requires the developer to execute a reimbursement agreement promising to repay any sums that the bank is compelled to pay out under the letter of credit. Finally, the bank demands that the developer provide collateral to secure the reimbursement agreement, and the developer gives the bank a mortgage on certain other land for this purpose.

Initially the bank has paid nothing, and there is no obligation on the developer to reimburse any particular sum. If the developer subsequently defaults on the ground lease and the lessor demands payment by the bank under the letter of credit, an obligation will arise on the developer to reimburse that sum. In substance, the draw on the letter of credit is a future advance. Suppose, however,

§ 443.055(9)(d) (Vernon Supp. 1994); OHIO REV. CODE ANN. § 5301.232(C) (Baldwin 1993); TENN. CODE ANN. § 47-28-109(3) (1988).

86. Even if no cutoff notice is available to construction loan borrowers, they still have the opportunity to refinance the entire loan partway through construction. Such refinancings are probably quite rare.

87. We say "in effect" because technically a letter of credit is not a guaranty, but rather a direct and primary obligation of the issuing bank. See 1 JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 19-1, at 4 (3d ed. 1988).

that the developer, knowing that a default on the ground lease is imminent, has the power to issue a cutoff notice to the bank. Since the letter of credit is irrevocable, the bank must pay under it, but the cutoff notice will deprive the bank of the collateral it reserved to secure the reimbursement to which it is entitled.

Under these circumstances, it is intolerable to permit the issuance of a cutoff notice. The bank cannot escape its duty to "advance" the funds, and therefore it cannot in good conscience be denied its security for their repayment. Several of the cutoff notice statutes recognize this imperative.⁸⁸

C. *The Cutoff Notice as a Breach by the Borrower*

The duties of borrowers and lenders with respect to future advances depend on the nature of the loan commitment or agreement and can conveniently be arranged into three categories. In the first and simplest, the traditional "optional" advance, neither party has a duty to lend or borrow; the lender merely says, "If you later request a further advance, and if we decide to make that advance to you, its repayment will be secured by the original mortgage." In the second and third categories, the commitment or agreement may be either unilateral or bilateral.⁸⁹ If it is unilateral, the lender says, in substance, "We promise to honor your request for a further advance, if any, and the original mortgage will secure its repayment." A bilateral loan agreement, on the other

88. The Missouri statute, in which this problem is more fully developed than in any of the other statutes, provides that

the notice of termination shall be ineffective:

(a) To the extent of the liability of the lender obligated under an irrevocable letter of credit and to the extent the security instrument secures the repayment of obligations to the lender arising therefrom; or

(b) To the extent of the liability of the guarantor to a person guaranteed and to the extent the guarantee is secured by the security instrument, and was given in a business or agricultural loan transaction; or

(c) To the extent that a security instrument secures the liability of a third party in a business or agricultural loan transaction

MO. ANN. STAT. § 433.055(9)(1)(a)-(c) (Vernon Supp. 1994).

89. It is a sad fact of business life that both lenders and borrowers are unduly casual in clarifying whether they intend loan agreements to be unilateral or bilateral, and that the resulting vagueness sometimes gives rise to disagreement and litigation. *See, e.g.,* *Lowe v. Massachusetts Mut. Life Ins. Co.*, 127 Cal. Rptr. 23, 26-27 (Ct. App. 1976); *Financial Fed. Sav. & Loan Ass'n v. Burleigh House, Inc.*, 305 So. 2d 59, 62 (Fla. Dist. Ct. App. 1974), *cert. dismissed*, 336 So. 2d 1145 (Fla. 1976), *cert. denied*, 429 U.S. 1042 (1977).

hand, also imposes a duty on the borrower to draw down the funds; the lender says, "We promise to lend, and you promise to borrow, the advance in question, and the original mortgage will secure its repayment."⁹⁰

It is this third sort of agreement on which we now wish to focus. Suppose the borrower has a contractual duty to borrow the funds, but nonetheless issues a cutoff notice that amounts, in effect, to an anticipatory breach of that obligation. Should the cutoff notice be effective? None of the statutes seem to address this issue, but the simple and obvious answer is that the right to issue a cutoff notice is nonwaivable. Damages are the lender's only remedy; the courts have consistently refused to award specific performance of loan commitments to lenders.⁹¹ Thus, the borrower who issues a notice under these circumstances can refuse to borrow additional funds, but may be liable in damages for the breach of contract. A borrower may be ill-advised to take such a step, but the notice will work.

From an economic viewpoint, this result is entirely warranted by the concept of the "efficient breach." In the present context, it is entirely possible that the borrower can find other financing with interest cost low enough that the borrower's savings will more than cover the original lender's damages in full. If this is the case, economic efficiency is served, since the borrower is plainly better off and the original lender no worse off as a result of the breach. The law should facilitate such breaches, and permitting the issuance of a cutoff notice does precisely that.⁹²

V. THE CASE FOR JUDICIAL ADOPTION OF A CUTOFF NOTICE SYSTEM

On the whole, the cutoff notice statutes provide an intelligent and highly functional solution to the problem of priority of future

90. See NELSON & WHITMAN, *supra* note 1, § 12.3 nn. 25-27.

91. See, e.g., *City Centre One Assocs. v. Teachers Ins. & Annuity Ass'n of Am.*, 656 F. Supp. 658 (D. Utah 1987); Roger D. Groot, *Specific Performance of Contracts to Provide Permanent Financing*, 60 CORNELL L. REV. 718, 727-36 (1975).

92. See WERNER Z. HIRSCH, *LAW AND ECONOMICS: AN INTRODUCTORY ANALYSIS* 142 (2d ed. 1988); James P. Fenton, Note, *Liquidated Damages as Prima Facie Evidence*, 51 IND. L.J. 189, 190-92 (1975) ("Where contracts have become unproductive, breach of contract should be encouraged by awarding only compensation, because compensation properly reallocates resources.").

advances. However, only twelve states have such statutes.⁹³ In many other jurisdictions, the problems of the common law optional/obligatory advance doctrine discussed earlier in this Article continue to plague lenders and borrowers alike. Thus the question arises: is it appropriate for a court to adopt the cutoff notice concept as a matter of court-made law, with no statute to support the decision? At first blush this may seem a radical idea, but we believe it is a step greatly to be encouraged and entirely within the scope of judicial authority in all states except those in which a specific statute stands in the way.⁹⁴

As reporters for the *Restatement (Second) of Property—Security (Mortgages)*, we have drafted, and the American Law Institute has tentatively approved, a *Restatement* section that would implement this step.⁹⁵ We offer here a brief for such judicial action.

A. A Historical Rationale

We begin with the obvious premise that the traditional optional/obligatory advance doctrine is itself court-made law. In *Hopkinson v. Rolt*,⁹⁶ the 1861 English case in which the doctrine may have originated,⁹⁷ the House of Lords made no reference to any statute in support of its decision, for no relevant statute existed. Since the doctrine was created by a court, can a court not replace

93. See statutes cited *supra* note 78.

94. In a few states, the common law optional/obligatory doctrine is enshrined in statute, at least in limited situations, and could not be overthrown without legislative amendment. See, e.g., NEB. REV. STAT. § 76-238.01 (1994) (providing that optional advances lose priority to intervening lien or encumbrance, including valid mechanic's lien, if intervening lienor gives mortgagee written notice); OHIO REV. CODE ANN. § 5301.232(B) (Baldwin Supp. 1993) (same); TENN. CODE ANN. § 47-28-103(c) (Supp. 1994) (providing that optional advances lose priority if mortgagee has "actual notice" of intervening lien); W. VA. CODE § 38-1-14(e) (Supp. 1994) (providing that optional advances lose priority if intervening lienor gives mortgagee written notice). For additional illustrative statutory language, see N.D. CENT. CODE § 6-03-05.1 (1987), *repealed by* 1991 N.D. Laws ch. 84, § 1.

95. See RESTATEMENT (THIRD) OF PROPERTY—SECURITY (MORTGAGES) § 2.3 (Tentative Draft No. 1, 1991).

96. 11 Eng. Rep. 829 (1861).

97. Whether *Hopkinson* marked the inception of the doctrine is uncertain. The opinion in that case contains an extensive debate among the judges about the significance of *Gordon v. Graham*, 22 Eng. Rep. 502 (1716), which appears to have awarded priority for future advances to a first mortgagee on the ground that the second mortgagee had actual notice of the existence of the future advances clause in the first mortgage. The report of the *Gordon* case is brief, the facts are not fully developed, and it is difficult to determine the precise holding. For our purposes the debate is unimportant.

it with a more functional doctrine? We think the answer is affirmative.

Indeed, the concurring opinion of Lord Cranworth in *Hopkinson v. Rolt* comes very close to foreshadowing just this development:

[S]uppose that the second mortgage should be made on the express contract of the mortgagor, communicated to the first mortgagee, that he would not thenceforth borrow any more money from the first mortgagee. In such a case the rule giving precedence to the first mortgagee for future advances could not be acted on. . . . And whenever the dealings of the parties have been such as to satisfy the Court that they intended to postpone the future advances of the first mortgagee to those under the second mortgage, effect will be given to that intention.⁹⁸

The sort of contract Lord Cranworth described comes remarkably close to being a cutoff notice. Cranworth's comment (which seems to have been given as an aside, and hardly as a main point of his opinion) is subject to some criticism. He appears to have assumed that the mortgagor's promise not to borrow additional funds on the first mortgage will bind the first mortgagee if communicated to it, but that is by no means obvious under ordinary principles of contract law. Suppose *B* promises *C* that *B* will engage in no further transactions with *A*, and *A* has knowledge of the promise. Nevertheless, *B* later approaches *A* and proposes a further transaction. *A* may know that doing so will result in a breach of *B*'s contract with *C*, or *A* may assume that the *B-C* contract is now terminated or that *C* has waived any objection to the new *A-B* transaction. Whatever *A* thinks, assume that *A* indeed consummates the new transaction with *B*. It hardly seems open to doubt that the new *A-B* transaction is legally valid and enforceable. *A* might worry about being charged with the tort of intentional interference with the *B-C* contract, but even if the tort were proved it would have no effect on the enforceability of the *A-B* transaction.

Cranworth's last sentence quoted above is not quite to the point. He wrote that if the "parties" intend to subordinate additional advances under the first mortgage to a second mortgage, the courts will give effect to that intent. That is doubtless true; the intent would comprise a subordination agreement. But this prin-

98. *Hopkinson*, 11 Eng. Rep. at 841-42.

ciple does not fit the postulated facts. The mortgagor and the second mortgagee may provide copious evidence that *they* intend that any subsequent advances on the first mortgage should be subordinated, but this is a far cry from evidence that the *first mortgagee* intends to subordinate. Absent such concurrence by the first mortgagee, further advances under the first mortgage will retain their priority no matter what the intent of the mortgagor and the second mortgagee might be. An argument could be made that if the mortgagor and the second mortgagee enter into an agreement by which the mortgagor covenants to refrain from taking any more advances, and if these parties then notify the first mortgagee of their agreement, the first mortgagee may be estopped from making any such advances and claiming priority for them. Such a notice would inform the first mortgagee of the reliance the second mortgagee was placing on the absence of any further advances. But whether a court would find estoppel on these facts is uncertain.

These are not technical quibbles. No intelligent second mortgagee will make a loan to the mortgagor unless it can be absolutely sure that the balance on the first mortgage will not be inflated by additional advances. Lord Cranworth's hypothetical facts, as they stand, do not satisfy this condition. It is easy to modify them so that they do, however. Imagine that Cranworth had added the following bracketed words to his first sentence quoted above: "[S]uppose that the second mortgage should be made on the express contract of the mortgagor, communicated to [and agreed to by] the first mortgagee, that he would not thenceforth borrow any more money from the first mortgagee." This additional phrase makes the hypothetical do the work Cranworth asked of it. If the first mortgagee agrees that no further advances will be made on the security of the mortgage, the second mortgagee will become the third-party beneficiary of that promise and will be able to enforce it. In substance, the first mortgagee's agreement is tantamount to a subordination to the second mortgage with respect to any further advances on the first loan. A Florida District Court of Appeal recently reached precisely this conclusion in a case in which the first mortgagee had specifically agreed to make no more advances.⁹⁹

99. *NCNB Nat'l Bank v. Barnett Bank*, 560 So. 2d 360, 360 (Fla. Dist. Ct. App. 1990).

The difficulty is that the general law of contracts provides no mechanism by which the mortgagor or the junior mortgagee can compel the first mortgagee to join in their agreement that no additional funds will be drawn on the first loan. That is the missing element in Lord Cranworth's logic, and it is precisely the element that the cutoff notice statutes supply; under these statutes, a first mortgagee that receives a cutoff notice has no choice. Unless the first mortgagee is exempted from the notice because of the sorts of special conditions discussed above, it is bound by the notice whether it likes it or not.

If the statutes can supply this element of compulsory concurrence by the first mortgagee, court-made caselaw can do so equally well. Except in the limited situations in which fairness requires that the mortgagee be exempt from cutoff notices, it is perfectly proper and highly desirable for the courts to hold cutoff notices binding on senior mortgagees whether they expressly agree to be bound or not. A court might rest this conclusion on the estoppel argument discussed above, but it is critically important that the conclusion *not* rest on a detailed finding of some particular degree of actual reliance by a subordinate lienor. To be effective in practical terms, the notice must be binding *per se*, and the courts must clearly announce it as being so. No junior lender will be willing to take the risk of litigating whether its actual reliance was sufficient, so if the rule binding the senior lender to the notice is not absolute, junior lenders will not lend and the whole purpose of the cutoff notice concept advocated here will be defeated.

There is ample precedent in other real estate and mortgage law contexts to support the judicial adoption of a notice requirement despite the absence of any statutory mandate. Indeed, one of the elements of the common law optional/obligatory doctrine (a doctrine that we propose to abandon) is notice to the senior lender of the existence of intervening liens.¹⁰⁰ In addition, state courts frequently impose notice requirements in the context of mortgage acceleration.¹⁰¹ The Texas Supreme Court, for example,

100. See *supra* text accompanying notes 27-28.

101. See, e.g., *Smith ex rel. Coe v. Piluso*, 719 P.2d 33, 34 (Or. Ct. App. 1986); *Ogden v. Gibraltar Sav. Ass'n*, 640 S.W.2d 232, 233-34 (Tex. 1982); cf. *Shumway v. Horizon Credit Corp.*, 801 S.W.2d 890, 894-95 (Tex. 1991) (holding that note provision allowing mortgagee to accelerate "without prior notice or demand" was effective to waive the mortgagor's right to presentment and notice of acceleration, but not to waive notice of intent to accelerate).

recently announced the judicial doctrine that "[n]otice of intent to accelerate is necessary in order to provide the debtor an opportunity to cure his default prior to harsh consequences of acceleration and foreclosure."¹⁰²

Another illustration is found in the law of installment land contracts, in which courts over the past several decades have formulated the rule, without statutory authorization, that a vendor who has actual knowledge of a mortgage on the vendee's interest may not declare a forfeiture of an installment contract without giving the vendee's mortgagee both notification of intent to forfeit and an opportunity to protect itself.¹⁰³ Some courts have taken the position that even when the vendor lacks actual knowledge of the vendee's mortgage, recording by the latter constitutes constructive notice to the vendor of the mortgage's existence.¹⁰⁴ Finally, judicially imposed notice requirements are significant for mortgage lenders under the law of subrogation. Most courts hold, for example, that a lender who loans money to pay off a senior mortgage will be denied subrogation and priority with respect to an intervening lien if the lender has actual knowledge of that lien when it makes the loan.¹⁰⁵

102. *Ogden*, 640 S.W.2d at 234.

103. *See, e.g.*, *Credit Fin., Inc. v. Bateman*, 660 P.2d 869, 871 (Ariz. Ct. App. 1983); *Lockhart Co. v. B.F.K. Ltd.*, 691 P.2d 1248, 1250 (Idaho Ct. App. 1984); *Stannard v. Marboe*, 198 N.W. 127, 127 (Minn. 1924); *Fincher v. Miles Homes, Inc.*, 549 S.W.2d 848, 857 (Mo. 1977) (en banc); *Yu v. Paperchase Partnership*, 845 P.2d 158, 166 (N.M. 1992); *Kendrick v. Davis*, 452 P.2d 222, 227 (Wash. 1969) (en banc).

104. *See, e.g.*, *Stannard*, 198 N.W. at 127; *Recent Developments, Mortgages—Notice—Vendor and Purchaser—Vendor Not Charged with Constructive Notice of Subsequent Mortgage of Contract Purchaser's Equity—Mortgagee Required to Notify Vendor to Protect Security Interest—Kendrick v. Davis*, 75 Wash. Dec. 2d 470, 452 P.2d 222 (1969), 45 WASH. L. REV. 645 (1970) (discussing the overruling of *Norlin v. Montgomery*, 367 P.2d 621 (Wash. 1961), which held that recording constitutes constructive notice).

105. *See, e.g.*, *United States v. Baran*, 996 F.2d 25, 28 (2d Cir. 1993) (applying New York law); *Han v. United States*, 944 F.2d 526, 529-30 (9th Cir. 1991) (applying California law); *In re Hubbard*, 89 B.R. 920, 923 (Bankr. N.D. Ala. 1988); *Herberman v. Bergstrom*, 816 P.2d 244, 247 (Ariz. Ct. App. 1991); *Commonwealth Bldg. & Loan Ass'n v. Martin*, 49 S.W.2d 1046, 1047-48 (Ark. 1932); *Smith v. State Sav. & Loan Ass'n*, 223 Cal. Rptr. 298, 301 (Ct. App. 1985); *Rusher v. Bunker*, 782 P.2d 170, 174 (Or. Ct. App. 1989); *Pee Dee State Bank v. Prosser*, 367 S.E.2d 708, 713 (S.C. 1988); *see also* RESTATEMENT (THIRD) OF PROPERTY—SECURITY (MORTGAGES) § 7.6 (Tentative Draft No. 4, 1995) (taking the view that lack of notice of the intervening lien is not critical to the payor's right of subrogation).

As these examples show, there is no great novelty in a court's imposing a notice requirement in the interest of fairness even when no statute so dictates.

B. *Elements of a Judicial Doctrine*

The beginning point for a judicial doctrine of future advances incorporating the cutoff notice concept is the premise that all future advances, irrespective of their optional or obligatory nature, take the priority of the original mortgage. No distinctions among types of advances are needed, since the mortgagor's opportunity to obtain additional financing will be protected by the right to issue a cutoff notice.

The mortgagor's notice can take the form of either a request to refrain from making further advances (thereby effectively terminating the future advances clause in the mortgage) or a request to subordinate all future advances to any and all intervening interests. The *Restatement Tentative Draft* recognizes either form of notice as effective.¹⁰⁶ From the mortgagor's viewpoint, either suffices to make the real estate attractive to a prospective junior lender. Some mortgagors may prefer subordination to elimination of future advances, since it is conceivable that a mortgagor who issues a cutoff notice may wish to return to the lender at some future time, borrow additional funds, and have repayment secured with a third or fourth priority on the real estate. However, this possibility is usually remote, and in any event it presents the lender with a different sort of loan arrangement than it originally agreed to. Hence, the lender should have the right to treat a "subordinating" cutoff notice as a "terminating" notice if the lender wishes, thereby eliminating any risk that the lender might be called on subsequently to make advances with a junior priority.¹⁰⁷

A cutoff notice does not eliminate the mortgage security for whatever balance is owing on the debt at the time the notice is issued; by its nature, the notice operates only prospectively. More-

106. RESTATEMENT (THIRD) OF PROPERTY—SECURITY (MORTGAGES) § 2.3(b) (Tentative Draft No. 1, 1991). Most of the statutory cutoff notice procedures assume that the notice will terminate the future advances clause, but a few indicate that it will merely subordinate future advances. *See supra* text accompanying note 82–83.

107. RESTATEMENT (THIRD) OF PROPERTY—SECURITY (MORTGAGES) § 2.3(b) (Tentative Draft No. 1, 1991) ("If the mortgagor requests a subordination with respect to further advances, the mortgagee may elect to treat the request as one to refrain from making further advances.").

over, interest that accrues on that balance will continue to be secured notwithstanding the cutoff notice. But beyond these elementary principles, what exceptions should courts recognize to the mortgagor's power to issue a cutoff notice?

First, no lender should be compelled to recognize a cutoff of future advances if doing so would unreasonably jeopardize the security for advances already made. The *Restatement* Tentative Draft adopts this standard.¹⁰⁸ The most obvious illustration, discussed earlier in this Article, is a construction loan on a partially completed project.¹⁰⁹ A cutoff notice might well leave the mortgagee with inadequate security and no control over the completion of the work, which may indeed never occur. The lender could, of course, require the borrower to covenant to complete the project, and even to do so entirely with funds from the original loan, but it is unlikely that a court would enforce such a covenant with any remedy other than damages. In many cases, a remedy of damages would be uncollectible against the project's developer. Hence the courts should refuse to recognize cutoff notices that present these risks to construction lenders. Some of the statutes simply exempt construction loans from cutoff notices,¹¹⁰ but this approach seems overbroad; in many cases the borrower may be able to establish beyond serious doubt that firm arrangements have been made to complete the project with other funding. A more sensible approach is to ask, on a case-by-case basis, whether cutting off the construction loan will in fact unreasonably jeopardize the original lender's security.

In addition, a cutoff notice should not operate against advances made by a lender to protect its security. Such advances include those made to pay delinquent taxes, casualty insurance premiums, condominium or homeowners association assessments, ground rents, and other similar charges. In addition, advances may be made to repair waste to the improvements or to protect the property from physical damage from the elements. In general, these

108. RESTATEMENT (THIRD) OF PROPERTY—SECURITY (MORTGAGES) § 2.3(c)(1) (Tentative Draft No. 1, 1991).

109. See *supra* text accompanying note 85. A home improvement loan or other loan given to finance modifications of a building can raise the same issue. See TENN. CODE ANN. § 47-28-109(3) (1988) (involving home improvement loans).

110. See FLA. STAT. ANN. § 697.04(1)(b) (West Supp. 1994); MO. ANN. STAT. § 443.055(3)(2) (Vernon Supp. 1994); OHIO REV. CODE ANN. § 5301.23.2(C) (Baldwin 1993); TENN. CODE ANN. § 47-28-109(3).

advances for protection fall into two classes: those necessary to protect the value of the real estate and those necessary to prevent the assertion of prior liens. Widely accepted common law principles permit a mortgagee to add the amounts of such advances to the lien of the mortgage, whether the mortgage itself contains a future advances clause or not.¹¹¹ The borrower's issuance of a cutoff notice should not deprive the mortgagee of its security for these protective advances.

Similarly, mortgage documents routinely permit lenders to include the costs of collection of the loan in the amount secured by the real estate. These costs may include attorney's fees, court costs, advertising expenses, and the like. They might be regarded as future advances, but in all events should be exempt from the operation of a cutoff notice in order to give the lender the benefit of its bargain.

A second general exception to the borrower's cutoff notice power must be recognized. Mortgages often secure the mortgagor's obligation to reimburse the mortgagee's performance of a duty to a third party. A common example, discussed earlier in this Article,¹¹² is a letter of credit issued by a bank to a third party on behalf of a real estate developer; the developer's duty to reimburse the bank if it is called on to pay the letter of credit is secured by a mortgage on real estate. Since the bank cannot escape the duty to pay the letter of credit, it would plainly be unjust to permit a cutoff notice to deprive the bank of the security for its reimbursement. Numerous other examples involving guaranties, surety bonds, endorsements of instruments, and other undertakings to third parties can be envisioned. In any case in which a lender's advances will benefit a party other than the mortgagor, and a lender has a contractual duty to provide that benefit, the lender must be free to disregard the cutoff notice. The *Restatement Tentative Draft* so provides.¹¹³

The mechanics of cutoff notices warrant some consideration. The statutes vary widely; some require that notices be delivered by registered or certified mail,¹¹⁴ but most refer merely to "filing"

111. See RESTATEMENT (THIRD) OF PROPERTY—SECURITY (MORTGAGES) § 2.2 (Tentative Draft No. 1, 1991).

112. See *supra* text accompanying notes 87–88.

113. RESTATEMENT (THIRD) OF PROPERTY—SECURITY (MORTGAGES) § 2.3(c)(2) (Tentative Draft No. 1, 1991).

114. FLA. STAT. ANN. § 697.04(1)(b) (West Supp. 1995) (certified mail); ME. REV.

with or "delivery" to the mortgagee.¹¹⁵ Large institutional lenders may argue that more specificity is needed in defining the mode of delivery, since otherwise the borrower may tender the notice to an employee who has nothing to do with the loan in question, perhaps works in a different location from that where the loan is administered, and will not pass the notice along to the relevant administrator. This problem is not unique to cutoff notices, however; all sorts of legal notices to lenders are subject to being mishandled in this way, and lenders must be responsible for training their employees to deal with notices correctly. Even an oral cutoff notice should be effective, at least in principle, although a well-advised lender would doubtless insist that the oral statement be confirmed in writing, and a court should uphold that insistence.

Borrowers, on the other hand, need from the cutoff notice process a document executed by the lender, showing that it has received and accepted the cutoff notice, and further showing the balance owing on the loan at the time it was "locked in" by the notice. Without this evidence, a borrower may face serious difficulties in convincing a prospective junior lender that the notice is in effect. Moreover, efficiency requires that the lender's certificate be in recordable form, for recording it will afford constructive notice to all subsequent lenders by a single stroke. Most cutoff notice statutes provide for some sort of recordation. Some require recordation by the mortgagee of a certificate or statement,¹¹⁶ others provide for recordation of the cutoff notice itself by the mortgagor (and require no certificate by the mortgagee at all),¹¹⁷

STAT. ANN. tit. 33, § 505(5)(A) (West Supp. 1994) (registered mail); OR. REV. STAT. § 86.155(3) (1988) (certified mail); R.I. GEN. LAWS § 34-25-11 (1984) (registered or certified mail).

115. MO. ANN. STAT. § 443.055(6) (Vernon Supp. 1994) ("filing"); MONT. CODE ANN. § 71-1-206(3) (1993) ("delivery"); NEB. REV. STAT. § 76-238.01(1)(a) (1990) ("filing"); NEV. REV. STAT. ANN. § 106.380(1) (Michie 1994) ("delivery"); OHIO REV. CODE ANN. § 5301.232(c) (Baldwin 1986) ("delivery"); TENN. CODE ANN. § 47-28-105(b)(1)(A) (1988) ("service"); ALASKA STAT. § 06.30.560(1) (1988) (repealed 1993) ("filing"), *repealed* by 1993 Alaska Sess. Laws ch. 26, § 102.

116. MO. ANN. STAT. § 443.055(6); NEV. REV. STAT. ANN. § 106.380(2); *see also* N.C. GEN. STAT. § 45-72 (1991) (providing that the mortgagee's certificate is "entitled" to registration but not stating who is to record it).

117. FLA. STAT. ANN. § 697.04(1)(b) (West Supp. 1995); ME. REV. STAT. ANN. tit. 33, § 505(5)(A) (West Supp. 1994); MONT. CODE ANN. § 71-1-206(3); NEB. REV. STAT. § 76-238.01(1)(a); OHIO REV. CODE ANN. § 5301.232(c); TENN. CODE ANN. § 47-28-105(b)(1)(B); ALASKA STAT. § 06.30.560(1) (1988), *repealed* by 1993 Alaska Sess. Laws ch. 26, § 102.

and some permit recordation by the mortgagor only if the mortgagee fails in its duty to record a certificate.¹¹⁸

The most sensible approach, and the one we recommend for purposes of a judicially created cutoff notice procedure, is to require the lender to provide a certificate showing that the cutoff notice has been received.¹¹⁹ Merely recording the cutoff notice itself does not show receipt, and a subsequent lender that sees a recorded cutoff notice has no way of knowing whether it was actually delivered to the senior lender. Future advances lenders are not held to constructive notice of such recordings, for to do so would impose an intolerable burden on them to examine the title before every advance.¹²⁰ Thus a two-step process is needed, under which the mortgagor issues the cutoff and the lender is obligated to respond with the recordable certificate. There is no need for the lender to record the certificate; the borrower can do so if she wishes.

Some of the statutes require that the lender's certificate state the "capped" balance of the loan.¹²¹ This is unnecessary, however, since lenders have a general legal duty, affirmed by statute in many states, to provide loan balance information at the borrower's request at any reasonable time.¹²² It is doubtful that a junior lender would wish to rely on the statement of the balance appearing in a senior lender's recorded cutoff certificate if any appreciable time had elapsed since that certificate was recorded; the junior lender would simply request (or have the borrower request) a current statement instead.

VI. CONCLUSION

The notion of a judicially created cutoff notice system is not as radical as it may first appear. Courts in real estate matters frequently adopt notice systems that do not originate in any stat-

118. MO. ANN. STAT. § 443.055(6); NEV. REV. STAT. ANN. § 106.380(3); OR. REV. STAT. § 86.155(5) (1989).

119. RESTATEMENT (THIRD) OF PROPERTY—SECURITY (MORTGAGES) § 2.3(b) (Tentative Draft No. 1, 1991).

120. See *Giorgi v. Pioneer Title Ins. Co.*, 454 P.2d 104, 106 (Nev. 1969).

121. See MO. ANN. STAT. § 443.055(2); NEV. REV. STAT. ANN. § 106.380; N.C. GEN. STAT. § 45-72 (1991); OR. REV. STAT. ANN. § 86.155(4)(a) (1988); R.I. GEN. LAWS § 34-25-4 (Supp. 1994).

122. See RESTATEMENT (THIRD) OF PROPERTY—SECURITY (MORTGAGES) § 1.6 (Tentative Draft No. 1, 1991) and cases and statutes cited therein.

ute.¹²³ Indeed, one of the elements of the common law optional/obligatory doctrine itself is notice to the senior lender of the existence of intervening liens. While that doctrine has functioned poorly, it illustrates the courts' creativity in fashioning a system that relies on notice but that has no statute to bolster it. The alternative system we have advocated here is hardly more drastic, but it has the ability to work far more smoothly and effectively, and to generate far less peripheral litigation. We believe it is worthy of adoption by the courts¹²⁴ in jurisdictions in which the legislatures have not already acted.

123. For example, subrogation of a third mortgagee that pays off a first mortgage.

124. The cutoff notice system was approved in dictum, with a citation to the *Restatement*, in *Shutze v. Credithrift of Am., Inc.*, 607 So. 2d 55, 63 & n.13 (Miss. 1992); Mississippi has no statute on the subject.