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CONSTRUCTION LOAN ADVANCES AND THE SUBORDINATED PURCHASE MONEY MORTGAGEE: AN APPRAISAL, A SUGGESTED APPROACH, AND THE ULTA PERSPECTIVE

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INTRODUCTION

The Subordinated Purchase Money Mortgage Scenario

THE financing and development of land involves a delicate symbiosis of numerous parties that "own" an interest in the property and that have a stake in the successful completion of the development project. Among such parties are the original land owner, the developer, the construction lender, the permanent lender and the subcontractors; such parties perhaps hold title to the land or a mortgage, encumbrance or lien upon it. A coordinated effort among this group is required to achieve a successful development enterprise, with each party looking to the others for the completion of certain tasks.

Often, however, conflicts arise between the various interests as to relative rights of "ownership" in the land. Such disputes most frequently arise in the context of foreclosure, when a project has encountered difficulty. In the absence of an express understanding between the parties as to their respective rights and remedies, there is a need for the law to interpose a resolution. Courts can most effectively resolve such disputes by taking into account doctrines of lien law and foreclosure, the legitimate expectations of the parties, as well as some general policy concerns.

In some cases, however, these doctrines are not adequately considered and an unsatisfactory result is reached. One example in land financing law in which courts have inadequately resolved the conflict because of their failure to give effect to such considerations involves the dispute for priority between a construction lender who has made advances that were not used to improve the realty and a purchase money mortgagee who agreed to take a subordinate lien in order to give the construction lender a first position.

While there are numerous variations to the subordinated purchase money mortgage transaction, a general scenario is essential to an

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understanding of the problem. A developer seeking to purchase raw land for development purposes[1] may be unwilling to pay cash for the property[2] and unable to borrow funds for that purpose from conventional lenders due to legal prohibitions and lender investment policies.[3] Faced with this situation, developers have often used a purchase money mortgage arrangement. In such a transaction, the buyer gives the seller a note for all, or substantially all, of the purchase price secured by a first mortgage on the property in exchange for the seller's deed.[4] The value of the raw land represents the seller's security and the developer now has fee title to the property, which he can mortgage to a construction lender in return for funds to build the project. However, conventional construction lenders usually require a first lien on the mortgaged premises due to legal requirements[5] and investment criteria.[6] This obstacle to the subordinated purchase money transaction is overcome by the purchase money mortgagee agreeing to assume a second lien position behind the construction mortgage.[7] Al-

1. The developer might be planning to sell the project to third party users, such as homeowners. *See* Middlebrook-Anderson Co. v. Southwest Sav. & Loan Ass'n, 18 Cal. App. 3d 1023, 96 Cal. Rptr. 338 (1971). Alternatively, the property may be a rental project owned by the developer, or by a purchaser from the developer, and used by third parties, such as a shopping center or an office building. *See* Dugan v. First Nat'l Bank, 227 Kan. 201, 606 P.2d 1009 (1980).

2. *See* Barry v. General Mtge. & Loan Corp., 254 Mass. 282, 284, 150 N.E. 293, 293 (1926).

3. J. Krasnowiecki, Materials on Real Estate Financing and Development (2d ed. 1981)(unpublished materials available at the University of Pennsylvania Law School) (citing, *inter alia*, Pa. Stat. Ann. tit.7, § 310(a)(ii)(Purdon 1976), which limits the funds state-chartered institutions can lend for development of land).

4. At various points in this Article, the "developer" is referred to as "buyer," "purchase money mortgagor," or "borrower"; the "seller" is referred to as the "purchase money mortgagee"; the "construction lender" is referred to as the "lender."

5. Institutional lenders are often restricted by statute to receiving only first mortgages or are severely limited in the amount of junior liens which they may hold. 4C P. Rohan, Real Estate Financing § 9.03, at 9-8 (1981); *e.g.*, 12 U.S.C. § 1464 (c)(1)(B) (1976); N.J. Stat. Ann. § 17:9A-65(A)(3) (West Supp. 1981-1982).

6. 4C P. Rohan, *supra* note 5, § 9.03, at 9-8.

7. There are various ways in which the purchase money mortgagee can assume a position subordinate to the contruction mortgage: (1) The purchase money mortgage is recorded first and, pursuant to an agreement to subordinate contained therein (or in the agreement of sale), a subordination instrument making the lien junior to the construction mortgage is executed by the seller, *e.g.*, Handy v. Gordon, 65 Cal. 2d 578, 422 P.2d 329, 55 Cal. Rptr. 769 (1967); Kennedy v. Betts, 33 Md. App. 258, 364 A.2d 74 (1976); (2) pursuant to language in the recorded purchase money mortgage, it becomes subordinate to a subsequently recorded construction mortgage without any further action, *e.g.*, Gluskin v. Atlantic Sav. & Loan Ass'n, 32 Cal. App. 3d 307, 108 Cal. Rptr. 318 (1973); First Conn. Small Bus. Inv. Co. v. Arba, Inc., 170 Conn. 168, 365 A.2d 100 (1976); Guardian Fed. Sav. & Loan Ass'n v. Suskind, 265 A.2d 295 (D.C. 1970); Central Trust Co. v. Sheahen, 66 A.D.2d 1015, 411 N.Y.S.2d 741 (1978); (3) the purchase money mortgage is recorded first, and the purchase money mortgagee executes a subordination instrument although there is apparently

though the subordination is required by the lender, the agreement providing for subordination is usually between only the purchase money mortgagee and the developer.[8]

Construction loan documents and lender practice typically provide that the funds will not be disbursed in a lump sum. Rather, the funds are advanced from time to time as construction progresses, upon the lender's ascertainment, by the use of standard monitoring procedures such as vouchers and on-site inspections, that the work for which the funds are requested has actually been performed.[9] In this way, the lender can feel secure that the value of the property will increase with the amount outstanding on the loan so that in the event of foreclosure, the lender will be able to realize its debt from the property.[10] This situation also has ramifications for the purchase money mortgagee who has subordinated his lien to the construction mortgage. If advances are made under the construction mortgage only when an equivalent amount of work has already been performed on the project, the position of the purchase money mortgagee is theoretically protected on foreclosure. Protection is available because there is arguably sufficient value in the property represented by these new improvements to satisfy the outstanding balance of the lender's first

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no agreement to do so in the agreement of sale or purchase money mortgage, *see* Brooklyn Trust Co. v. Fairfield Gardens, Inc., 260 N.Y. 16, 182 N.E. 231 (1932); (4) the purchase money mortgagee agrees to become subordinate by waiting to record his mortgage until after the construction mortgage has been recorded. *E.g.*, Middlebrook-Anderson Co. v. Southwestern Sav. & Loan Ass'n, 18 Cal. App. 3d 1023, 96 Cal. Rptr. 338 (1971); Turner v. Lytton Sav. & Loan Ass'n, 242 Cal. App. 2d 457, 51 Cal. Rptr. 552 (1966); *see infra* note 67.

8. *See infra* note 142 and accompanying text.

9. Fikes v. First Fed. Sav. & Loan Ass'n, 533 P.2d 251, 261 (Alaska 1975)(stating that a prudent lender requires vouchers and inspections before disbursements); Middlebrook-Anderson Co. v. Southwest Sav. & Loan Ass'n, 18 Cal. App. 3d 1023, 1037, 96 Cal. Rptr. 338, 346-47 (1971)(lender can corroborate expenditures with on-site inspections and documents); Housing Mtge. Corp. v. Allied Constr., Inc., 374 Pa. 312, 315, 97 A.2d 802, 803 (1953)(describing a construction loan agreement providing a schedule of payments based on work completed to the lender's satisfaction); Forest Inc. v. Guaranty Mtge. Co., 534 S.W.2d 853, 855 (Tenn. Ct. App. 1975) (discussing a custom providing for funding by periodic disbursements after inspection); *see* 4A P. Rohan, *supra* note 5, § 3.09[1][f][i], at 3-395 to -399; Kratovil & Werner, *Mortgages for Construction and the Lien Priorities Problem—the "Unobligatory" Advance*, 41 Tenn. L. Rev. 311, 311 (1974); Lefcoe & Schaffer, *Construction Lending and the Equitable Lien*, 40 S. Cal. L. Rev. 439, 439 n.1 (1967); Note, *Subordination of Purchase-Money Security*, 52 Calif. L. Rev. 157, 157 n.5 (1964).

10. Iowa Loan & Trust Co. v. Plewe, 202 Iowa 79, 79, 209 N.W. 399, 400 (1926); Brooklyn Trust Co. v. Fairfield Gardens, Inc., 260 N.Y. 16, 24-25, 182 N.E. 231, 234 (1932); *see* 4 American Law of Property § 16.70 (A. Casner ed. 1952); 2 G. Gilmore, Security Interests in Personal Property § 35.3, at 922-23 (1965). The developer is benefitted by gradual disbursement as interest is usually payable only on sums actually advanced, thus limiting the developer's expenses. *Id.*

mortgage and sufficient value in the property represented by the raw land to satisfy the subordinated purchase money mortgage.[11]

If, on the other hand, funds disbursed by the lender were diverted by the borrower and not used in the project, perhaps due to the construction lender's failure to follow standard monitoring procedures or circumvention of the safeguards,[12] there will be a gap between the total value of the land and the sum due on outstanding mortgages. Should the lender receive priority for diverted advances, then the cushion provided by the raw land's value will be necessary to satisfy the first mortgage, leaving no value with which to pay the subordinated purchase money mortgage.[13] Thus, the purchase money mortgagee has, in effect, surrendered his title in the land for little or no return. As a result, challenges to the construction lender's first priority are made by the purchase money mortgagee who seeks restoration, in whole or in part, of his first lien status by denying priority for advances that were not employed in the project.[14]

The Scope of the Problem

The difficult construction lender-subordinated purchase money mortgagee cases to resolve are those in which there is no express

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11. For example, assume a 100x purchase money mortgage is subordinated to a construction loan with a face amount of 500x, and 100x is advanced thereunder to pay for construction work performed on the project. If default and foreclosure then occur and the property is sold at foreclosure sale for 200x (representing the raw land value and the 100x of work) then both the first and second liens can be satisfied. Note, however, the assumption implicit in this example that the property will bring 200x on foreclosure sale. This assumption is subject to question because (1) foreclosure sales tend to bring less than the "true" value of the property, because a troubled project is for sale; (2) 100x of work in an uncompleted building will not likely sell for 100x because the purchaser bears the risk of completing the project; (3) it is of some doubt that the raw land is worth 100x on the open market, given that the figure reflects a bonus to the seller for his agreement to take paper, and the risks incumbent therein, rather than cash for his land. *See generally* Annot., 5 A.L.R.4th 794 (1981).

12. *See infra* notes 196-98 and accompanying text.

13. Thus, continuing with the above example, *supra* note 11, if 100x worth of work was not put into the project despite 100x having been advanced, and foreclosure takes place, the property will only bring 100x on sale (representing the raw land's value). This 100x, barring a rearrangement of priorities, will be used to satisfy the construction mortgage, leaving no funds to pay the purchase money mortgage.

14. A situation analogous to that of the subordinated purchase money mortgage occurs when a ground lessor subordinates his fee interest to the lien of a construction loan, which the ground lessee has obtained to develop the property. Cambridge Acceptance Corp. v. Hockstein, 102 N.J. Super. 435, 436-37, 246 A.2d 138, 139 (App. Div. 1968), *aff'g* Cambridge Acceptance Corp. v. American Nat'l Motor Inns, Inc., 96 N.J. Super. 183, 232 A.2d 692 (1967). A lender frequently requests such subordination, as a condition of the loan, in order to give him increased security. ABA Committee on Leases, *Ground Leases and Their Planning*, 4 Real Prop. Prob. & Tr. J. 437, 440-44 (1969). Challenges have arisen to the subordination of the

agreement between the parties as to priority for diverted advances. In such cases, however, two major considerations should serve as guideposts in determining the relative rights of the lender and purchase money mortgagee. First, it seems clear that although there is no express agreement, the subordinated purchase money mortgagee has a legitimate expectation that the lender will follow reasonable lender behavior in monitoring disbursements. As will be developed, this expectation is based on the generally accepted connotation of the term "construction loan" as a loan the proceeds of which are used to improve real property and which the construction lender administers by means of commonly accepted monitoring procedures designed to ensure that the proceeds are used for property development.[15] When a purchase money mortgagee forgoes a superior position and subordinates to a "construction loan," and the lender, while not a direct participant in such agreement, knowingly accepts the benefits of such subordination, this expectation of reasonable lender behavior, though not articulated, must be given effect as an integral part of the parties' understanding.[16]

As a second major consideration, it seems clear that an equitable balance must be achieved between those risks of the development venture which the subordinated purchase money mortgagee, as a participant, must justifiably bear, and those with which he cannot legitimately be burdened. On one hand, the subordinated purchase money mortgagee should absorb losses arising from occurrences, such as a poor location, over which he had some degree of control and, consequently, some ability to prevent. On the other hand, it seems inappropriate to require the subordinated purchase money mortgagee to bear the risk of lender misconduct with respect to disbursements since only the lender has the means to prevent the loss. As will be discussed, these equitable concerns cannot be ignored in an action for foreclosure.[17]

Based on these and other considerations, this Article suggests a rule of decision that denies priority to a construction mortgage over a subordinated purchase money mortgage for construction lender advances that were not applied by the borrower toward improvements if, when the disbursements were made, the lender failed to follow reasonable lender practice to ascertain and ensure that the funds were being employed in the project. Such a standard will give effect to the purchase money mortgagee's legitimate expectation that the lender

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lessor's interest and foreclosure thereof upon default under the construction mortgage. *See* cases cited *infra* note 23.

15. *See supra* note 9 and accompanying text.

16. *See infra* pt. III(A)(2).

17. *See infra* pt. III(A)(1).

will behave in a professional, responsible manner, using necessary skill under the circumstances, and, at the same time, will not transform the lender into a guarantor.

Unfortunately, the solutions offered by courts to resolve disputes between a construction mortgagee and a subordinated purchase money mortgagee most often ignore these concerns. The construction lender is usually granted priority for diverted advances unless there is an express agreement requiring the lender to monitor funds.[18] Some courts attempt to assist the subordinated purchase money mortgagee but rely on doctrines that have been borrowed from other areas of the law and are thus ill-suited to resolve the special problems of the construction lender-subordinated purchase money mortgagee conflict.[19]

This Article criticizes the commonly accepted doctrine that grants the construction lender priority for diverted advances in the absence of a contrary express agreement and demonstrates its faulty theoretical and precedential underpinnings. The strengths and weaknesses of doctrines applied by some courts to provide relief for the subordinated purchase money mortgagee are evaluated,[20] and it is concluded that none of the currently favored doctrines provide an adequate framework to deal with the special problems of the construction lender-subordinated purchase money mortgagee dispute. An alternate approach, based on the legitimate expectations of the purchase money mortgagee, equitable principles, and policy concerns, and calling for the denial of lender priority for diverted advances when the lender failed to follow reasonable lender behavior in making disbursements, is suggested. Finally, the effect of the Uniform Land Transactions Act, with its abolition of the voluntary/obligatory rule for construction mortgages and its general provisions supporting lender responsibility for advances, is considered.[21]

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18. *See infra* pt. I.

19. *See infra* pt. II.

20. This Article considers the voluntary/obligatory rule, conditional subordination, lack of consideration, and tort and contract concepts.

21. The relationship between the construction lender and a mechanic's lien are outside of the scope of this Article, though reference is made thereto for the purposes of analogy. *See infra* notes 169, 214 and accompanying text. This Article does not extensively consider those cases that refuse to enforce an executory agreement to execute a subordination instrument. Some courts have refused to enforce such agreements unless the terms of the construction mortgage were set forth with specificity. *E.g.*, Handy v. Gordon, 65 Cal. 2d 578, 422 P.2d 329, 55 Cal. Rptr. 769 (1967); Lawrence v. Shutt, 269 Cal. App. 2d 749, 75 Cal. Rptr. 533 (1969). *Contra* Rivers v. Rice, 233 Ga. 819, 213 S.E.2d 678 (1975); *see* North Shore Realty Corp. v. Gallaher, 114 So. 2d 634 (Fla. App. 1959); Annot., 26 A.L.R.3d 855 (1969).

I. The "General Rule" — No Duty on the Lender Unless Expressly Provided

Courts have declared, and routinely followed, a so-called "general rule"[22] to dispense with the claim of a subordinated purchase money mortgagee who seeks to deny priority to a construction lender for advances that were not used for construction of improvements. This rule flatly states that the construction lender is entitled to priority for such diverted advances unless there is an express agreement requiring the lender to monitor funds, or there was fraud or collusion between the lender and the borrower.[23] This section analyzes the rationales offered by these courts for this rule, and then demonstrates that the three cases often cited for this "general rule" lack adequate legal basis to warrant consideration as persuasive authority.

A. *The Inherent Ambiguities*

Despite differences among various purchase money mortgagees, each subordinated purchase money mortgage arrangement usually involves two essential, ambiguous features. It is these two factors that

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22. *E.g.*, Grenada Ready-Mix Concrete, Inc. v. Watkins, 453 F. Supp. 1298, 1313 (N.D. Miss. 1978); Kennedy v. Betts, 33 Md. App. 258, 260, 364 A.2d 74, 77 (1976).

23. Gill v. Mission Sav. & Loan Ass'n, 236 Cal. App. 2d 753, 757, 46 Cal. Rptr. 456, 458-59 (1965); Drobnick v. Western Fed. Sav. & Loan Ass'n, 479 P.2d 393, 397 (Colo. Ct. App. 1970); First Conn. Small Bus. Inv. Co. v. Arba, Inc., 170 Conn. 168, 176-77, 365 A.2d 100, 104 (1976); Roberts v. Harkins, 292 So. 2d 603, 605-06 (Fla. Dist. Ct. App.), *cert. denied*, 302 So. 2d 417 (Fla. 1974); Iowa Loan & Trust Co. v. Plewe, 202 Iowa 79, 81, 209 N.W. 399, 400 (1926)(per curiam); Rockhill v. United States, 288 Md. 237, 245-46, 418 A.2d 197, 201 (1980); Hyatt v. Maryland Fed. Sav. & Loan Ass'n, 42 Md. App. 623, 629, 402 A.2d 118, 122 (1979); Kennedy v. Betts, 33 Md. App. 258, 262, 364 A.2d 74, 77 (1976); Barry v. General Mtge. & Loan Corp., 254 Mass. 282, 288-89, 150 N.E. 293, 295 (1926); Tripp v. Babcock, 195 Mass. 1, 7, 80 N.E. 593, 594 (1907); Brooklyn Trust Co. v. Fairfield Gardens, Inc., 260 N.Y. 16, 25, 182 N.E. 231, 234 (1932); Woodside Sav. & Loan Ass'n v. Minisink Homes, Inc., 51 A.D.2d 593, 594, 378 N.Y.S.2d 779, 780, *appeal dismissed*, 39 N.Y.2d 822, 351 N.E.2d 433, 385 N.Y.S.2d 766 (1976); Forest Inc. v. Guaranty Mtge. Co., 534 S.W.2d 853, 857 (Tenn. Ct. App. 1975); Fandel, Inc. v. First of Denver Mtge. Investors, 522 S.W.2d 721, 724 (Tex. Civ. App. 1975) (per curiam); Tuscarora, Inc. v. B.V.A. Credit Corp., 218 Va. 849, 858-59, 241 S.E.2d 778, 783 (1978); *cf.* Grenada Ready-Mix Concrete, Inc. v. Watkins, 453 F. Supp. 1298, 1313 (N.D. Miss. 1978) (involving subordinated ground lessor); Matthews v. Hinton, 234 Cal. App. 2d 736, 739, 44 Cal. Rptr. 692, 696-97 (1965) (same); Cambridge Acceptance Corp. v. Hockstein, 102 N.J. Super. 435, 438, 246 A.2d 138, 140 (App. Div. 1968) (per curiam) (same). See York Mtge. Corp. v. Clotar Constr. Corp., 254 N.Y. 128, 172 N.E. 265 (1930), discussed below, *infra* note 129, for a case apparently involving a "collusion" situation. *See also* National Bank v. Equity Investors, 81 Wash. 2d 886, 898, 506 P.2d 20, 41 (1973); 4 American Law of Property, *supra* note 10, § 16.106D, at 218; 1 G. Glenn, Mortgages § 50.3, at 327 (1943); 9 G. Thompson, Real Property § 4747, at 395 (1958).

make the construction lender-subordinated purchase money mortgagee dispute so difficult and that have apparently misled the "general rule" courts.

First, there is the contradictory nature of the subordinated purchase money mortgagee. On one hand, the purchase money mortgagee appears to be the victim of the acts of others. He depends on the developer to successfully build and market the project and to scrupulously use the construction funds solely for construction purposes.[24] If the developer fails to do so, the purchase money mortgagee's interest in the land may be eroded. The purchase money mortgagee's fate will also be determined by the behavior of the construction lender when making the advances. If the lender fails to supervise construction progress before disbursements are made, the purchase money mortgagee's position may be in jeopardy. On the other hand, the purchase money mortgagee freely chose to subordinate his lien and thus expose himself to economic loss in order to make a profit on the sale of his land. The cases are rare in which the purchase money mortgagee alleges that he was defrauded or coerced into subordination or was unaware that he was signing a subordination document.[25] There is a compelling economic motivation for entering into the subordination transaction. The successful development of the land will bring the seller a profit on his property, either through payment of a release price to the purchase money mortgagee each time a unit of a subdivision is sold[26] or by the construction of a rental project generating sufficient income out of previously unproductive land to pay the amounts due on the seller's note and mortgage.[27] Without a senior construction loan, the development would likely never have taken place. Thus, the purchase money mortgagee benefits from the subordination transaction. It is this ambiguous status of the purchase money mortgagee as both victim and quasi-joint venturer that makes the issue so difficult.[28]

When confronted with a construction mortgage-subordinated purchase money mortgage dispute, some courts have alluded to the idea

24. *See* Miller v. Citizens Sav. & Loan Ass'n, 248 Cal. App. 2d 555, 561, 56 Cal. Rptr. 844, 850-51 (1967).

25. *Cf.* Dreckshage v. Community Fed. Sav. & Loan Ass'n, 555 S.W.2d 314 (Mo. 1977) (vendor sought to cancel subordination agreement on the basis of fraud); New York Business Dev. Corp. v. Gilbert's Hotel, Inc., 28 A.D.2d 597, 279 N.Y.S.2d 767 (1967) (same), *motion dismissed*, 20 N.Y.2d 750, 229 N.E.2d 709, 283 N.Y.S.2d 115 (1967). There is, of course, lack of clarity as to the extent of the subordination.

26. *See, e.g.*, Magna Dev. Co. v. Reed, 228 Cal. App. 2d 230, 235 n.3, 39 Cal. Rptr. 284, 288 n.3 (1964).

27. *See* Grenada Ready-Mix Concrete, Inc. v. Watkins, 453 F. Supp. 1298 (N.D. Miss. 1978); National Bank v. Equity Investors, 81 Wash. 2d 886, 506 P.2d 20 (1973).

28. *See* Gluskin v. Atlantic Sav. & Loan Ass'n, 32 Cal. App. 3d 307, 315-16, 108 Cal. Rptr. 318, 324 (1973).

that the purchase money mortgagee is taking an entrepreneurial risk when entering a subordinated sale transaction, and therefore should suffer any loss which is incurred.[29] There is some validity to such an argument in the sense that the seller is participating in a venture with the developer, relying on the latter's activities to produce a profit. Therefore, the argument continues, because the seller chose to deal with the developer in such a manner, the seller should bear the loss if the developer misspends the construction funds.[30]

This argument is not sufficient, however, to bar relief for the subordinated purchase money mortgagee. Such a proposition may explain the seller's economic motivation in entering into the transaction. It does not, however, change the purchase money mortgagee's expectation of reasonable behavior by the construction lender with respect to advances, nor does it indicate that the purchase money mortgagee has consented to the erasing of his equity in the property by the construction lender.[31]

The second central ambiguity involved in the construction mortgagee-subordinated purchase money mortgagee dispute centers on the expectations of the subordinated purchase money mortgagee. It seems clear that the purchase money mortgagee has an "expectation" that the construction lender will advance the funds in a responsible manner in order to achieve an increase in the value of the realty commensurate with the increase in the construction debt. This expectation, however, is rarely embodied in an "express promise" by the lender.[32]

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29. *E.g.*, Rockhill v. United States, 288 Md. 237, 245-46, 418 A.2d 197, 198 (1980)(owner assumes risks of project by subordinating); Kennedy v. Betts, 33 Md. App. 258, 260, 364 A.2d 74, 77 (1976)("the diversion of funds on the part of the mortgagor is a risk run by" the purchase money mortgagee); *cf.* Grenada Ready-Mix Concrete, Inc. v. Watkins, 453 F. Supp. 1298, 1313 (N.D. Miss. 1978)(involving a subordinated ground lessor).

30. See *supra* text accompanying notes 26-28, discussing the subordinated purchase money mortgagee's pecuniary interest. Interestingly, the courts which most completely discuss the entrepreneurial involvement of the subordinated purchase money mortgage also grant relief to such parties. Miller v. Citizens Sav. & Loan Ass'n, 248 Cal. App. 2d 655, 662, 56 Cal. Rptr. 844, 850-51 (1967). Indeed, sometimes the subordinating party's economic advantage is not sufficiently explored. *See* Ban-Co Investment Co. v. Loveless, 22 Wash. App. 122, 127, 587 P.2d 567, 570-71 (1978)(citing a treatise that focuses on subordination from only the developer's point of view).

31. *See* Middlebrook-Anderson Co. v. Southwest Sav. & Loan Ass'n, 18 Cal. App. 3d 1023, 96 Cal. Rptr. 338 (1971); Miller v. Citizens Sav. & Loan Ass'n, 248 Cal. App. 2d 655, 56 Cal. Rptr. 844 (1967). Lender negligence in disbursements is a risk that the purchase money mortgagee should not be required to bear. *See infra* text accompanying note 176.

32. Gill v. Mission Sav. & Loan Ass'n, 233 Cal. App. 2d 753, 755, 46 Cal. Rptr. 456, 458 (1965); Iowa Loan & Trust Co. v. Plewe, 202 Iowa 79, 80, 209 N.W. 399, 400 (1926)(per curiam); Brooklyn Trust Co. v. Fairfield Gardens, Inc., 260 N.Y. 16, 24-25, 182 N.E. 231, 234 (1932); Cambridge Acceptance Corp. v. Hockstein, 102 N.J. Super. 435, 437-38, 246 A.2d 138, 139-40 (App. Div. 1968) (per curiam).

Yet, it is hard to imagine that the lender, which is accepting the benefit of the subordination, is unaware of this expectation. The lender itself has such an expectation, as evidenced by its own practices and documents.[33] Still, this gap between "expectations" and "express promises" has been used to rationalize denying relief to the subordinated purchase money mortgagee.[34] Such an approach does violence to accepted notions of contract interpretation.[35]

As a related matter, some courts try to justify the doctrine of no lender responsibility with respect to advances by asserting that the purchase money mortgagee was free to refuse to subordinate his lien if he found the subordination terms unacceptable.[36] This merely seems to be a variation of the position that a duty will be recognized only if it is express.[37] Such wooden reasoning fails to take into account the legitimate expectations of the subordinated purchase money mortgagee.[38] A statement that the court "cannot make a more equitable agreement for one who has voluntarily contracted to his detriment"[39] does little more than assume the result.

B. *The Case Law*

Tripp v. Babcock,[40] *Brooklyn Trust Co. v. Fairfield Gardens, Inc.*[41] and *Iowa Loan & Trust Co. v. Plewe*[42] are three cases which are often

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Despite recognition of this expectation, these courts do not grant relief to the purchase money mortgagee. *See* Drobnick v. Western Fed. Sav. & Loan Ass'n, 479 P.2d 393, 396-97 (Colo. Ct. App. 1970).

33. *See supra* note 9 and accompanying text.

34. *See* cases cited *supra* note 32.

35. *See infra* text accompanying notes 125-29, 152.

36. *E.g.*, Rockhill v. United States, 288 Md. 237, 252, 418 A.2d 197, 204 (1980); Tuscarora, Inc. v. B.V.A. Credit Corp., 218 Va. 849, 857-58, 241 S.E.2d 778, 783 (1978); *cf.* Woodside Sav. & Loan Ass'n v. Minisink Homes, Inc. 51 A.D.2d 593, 594, 378 N.Y.S.2d 779, 780, (expressing concern about "overreaching" by a lender requiring subordination, which opens the possibility of an unequal bargaining position argument), *appeal dismissed*, 39 N.Y.2d 822, 351 N.E.2d 433, 385 N.Y.S.2d 766 (1976).

37. *See* cases cited *supra* note 32.

38. *See supra* text accompanying notes 32-35. The rigidity of some courts is illustrated by the following statement: "The [purchase money mortgagee's] claim could not be supported without affirming that a first mortgagee who learns that part of the purchase money is secured by a second mortgage must at his peril see that all his future advances are applied to increasing the value of the property. None of the authorities cited by the plaintiff go to this length; and we are not willing to take such a [position]." Tripp v. Babcock, 195 Mass. 1, 7, 80 N.E. 593, 594 (1907).

39. Tuscarora, Inc. v. B.V.A. Credit Corp., 218 Va. 849, 857, 241 S.E.2d 778, 783 (1978).

40. 195 Mass. 1, 80 N.E. 593 (1907).

41. 260 N.Y. 16, 182 N.E. 231 (1932).

42. 202 Iowa 79, 209 N.W. 399 (1926).

cited to support the "general rule" of no lender liability.[43] An examination of the three cases, however, reveals that they are of little precedential value in the situations to which they have been applied. Moreover, they reflect a level of responsibility that is inappropriate and unrealistic for the construction lender-subordinated purchase money mortgagee dispute.

1. *Tripp v. Babcock*

In *Tripp*, the construction lender claimed priority over a junior purchase money mortgagee[44] for a sum that was not "related to the land."[45] The court first addressed the issue in terms of the purchase money mortgagee's "assumption" that the lender had a "duty . . . to see to it that what he advanced . . . went . . . to pay for the expenses of improving the property by erecting a building thereon," and held this assumption to be incorrect.[46] Presumably, this is the part of *Tripp* that is said to represent the "general rule." The court in *Tripp* continued, however, and stated what appears to be the actual ration-

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43. *Brooklyn Trust* has been cited in First Conn. Small Bus. Inv. Co. v. Arba, Inc., 170 Conn. 168, 177, 365 A.2d 100, 104 (1976); Rockhill v. United States, 288 Md. 237, 247, 418 A.2d 197, 201 (1980); Cambridge Acceptance Corp. v. Hockstein, 102 N.J. Super. 435, 438, 246 A.2d 138, 140 (App. Div. 1968); Forest Inc. v. Guaranty Mtge. Co., 534 S.W.2d 853, 857 (Tenn. Ct. App. 1975); National Bank v. Equity Investors, 81 Wash. 2d 886, 920, 506 P.2d 20, 41 (1973); 4 American Law of Property, *supra* note 9, § 16.106D, at 218 n.18; 1 G. Glenn, *supra* note 23, § 50.3, at 327 n.7. *Iowa Loan* has been cited in Grenada Ready-Mix Concrete, Inc. v. Watkins, 453 F. Supp. 1298, 1313 (N.D. Miss. 1978); Rockhill v. United States, 288 Md. 237, 247, 418 A.2d 197, 201 (1980); Hyatt v. Maryland Fed. Sav. & Loan Ass'n, 42 Md. App. 623, 629, 402 A.2d 118, 122 (1979); Kennedy v. Betts, 33 Md. App. 258, 261, 364 A.2d 74, 77 (1976); Cambridge Acceptance Corp. v. Hockstein, 102 N.J. Super. 435, 438-39, 246 A.2d 138, 140 (App. Div. 1968); Forest Inc. v. Guaranty Mtge. Co., 534 S.W.2d 853, 857 (Tenn. Ct. App. 1975); 4 American Law of Property, *supra* note 10, § 16.106D, at 218 n.18. *Tripp* has been cited in Barry v. General Mtge. & Loan Corp., 254 Mass. 282, 288, 150 N.E. 293, 295 (1926); Brooklyn Trust Co. v. Fairfield Gardens, Inc., 260 N.Y. 16, 25, 182 N.E. 231, 234 (1932); 59 C.J.S. *Mortgages* § 230, at 298 n.75 (1949).

44. The facts of *Tripp*, set forth in a brief opinion, are quite unclear. The plaintiff's mortgage is referred to in the last part of the first paragraph of the opinion as securing a "part of the purchase [price]." 195 Mass. at 7, 80 N.E. at 594. Thus, plaintiff could be the original owner who sold the property and received a purchase money mortgage for part of the price in return; or he could be a "third party" purchase money mortgagee who did not originally own the property but supplied funds to the buyer to enable the purchase of the property. 4 American Law of Property, *supra* note 10, § 16.106E, at 220; *see* Brooklyn Trust Co. v. Fairfield Gardens, Inc., 260 N.Y. 16, 182 N.E. 231 (1932); *infra* notes 149, 174, 185.

45. Again, the *Tripp* opinion is unclear as to what this item represents. Moreover, there is an intimation in the first paragraph of the opinion that this sum had been advanced to the borrower before the construction mortgage was given, and the mortgage served to secure this antecedent debt. 195 Mass. at 7, 80 N.E. at 594.

46. *Id.*

ale behind its denial of relief to the purchase money mortgagee—the fact that there was an express agreement that the sum "not related to construction" would be secured by the construction mortgage.[47]

While the opinion of the court is not clear as to whether the purchase money mortgagee had notice of this agreement before agreeing to take a subordinate position, if in fact he did have notice, then the result in *Tripp* seems appropriate.[48] Where a purchase money mortgagee, before subordinating, has notice that non-construction items will be secured by the senior lien, then he can have no legitimate expectation that only construction disbursements will be given priority. In such a case, the express understanding as to non-construction advances should control. *Tripp* can only reasonably be read as stating this limited proposition. Therefore, viewing this case as support for the "general rule" is inappropriate. The difficult cases in this area are not those in which there is an express agreement that advances not going into construction will have priority, as in *Tripp*, nor are they those in which the parties have expressly agreed that the construction lender will not have priority for diverted advances.[49] Rather, problems arise, and there is a need to fashion a workable solution, where the parties have been silent on the question of priority for advances which are not used to improve the realty, and where the netherworld of "expectations," as opposed to "express promises," is encountered.[50]

2. *Brooklyn Trust Co. v. Fairfield Gardens, Inc.*

Brooklyn Trust,[51] another so-called "general rule" case, involved a purchase money mortgagee which executed an instrument subordinating its lien to a specifically described construction mortgage, that

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47. The court further stated: "But besides this the master has found that [the lender's] mortgage was taken with the express agreement that this item should be secured by it . . . ." *Id.*

48. Among other issues, the opinion simply is not clear as to (1) the background of the transaction and how and why the purchase money mortgagee agreed to take a second position, (2) whether the agreement to include non-construction items was oral or written and (3) whether the purchase money mortgagee was deemed to have record or inquiry notice. For another case purporting to state the general rule but which seems to rely on the fact that the purchase money mortgagee knew before subordinating that certain non-construction items would be secured by the construction mortgage, see Barry v. General Mtge. & Loan Corp., 254 Mass. 282, 285, 150 N.E. 293, 294 (1926). Again, the problem is not with express agreements but with unarticulated expectations.

49. *See generally* Albert & Kernahan, Inc. v. Franklin Arms, Inc., 104 N.J. Eq. 446, 447-48, 146 A. 213, 214 (1929)(dealing with a construction lender and a non-purchase money second mortgage); Equitable Sav. & Loan Ass'n v. Hewitt, 67 Or. 280, 281, 135 P. 864, 864 (1913)(dealing with a construction lender who had agreed to monitor advances to a contractor and a mortgagor).

50. *See supra* text accompanying notes 32-35.

51. 260 N.Y. 16, 182 N.E. 231 (1932).

incorporated by reference a certain construction loan agreement.[52] On foreclosure of the construction mortgage, the purchase money mortgagee contested the priority of the construction mortgage.[53] The objection of the purchase money mortgagee differed from that in the typical case because it was not asserted that the advanced sums were not used for improvements on the property. Rather, the purchase money mortgagee claimed that the construction loan agreement had provided for the construction of an apartment complex with two garages. He further claimed that he had been shown the construction mortgage before executing the subordination agreement and had relied on its provisions as to the character of the building. Therefore, when an apartment building was constructed without such garages, the purchase money mortgagee was injured, since the improvement as built did not provide sufficient revenue to support the mortgages. Thus, the purchase money mortgagee asserted that the construction lender owed it a duty to guarantee, or at least to exercise reasonable care to see that the monies advanced were used to erect a two-garage building. The New York Court of Appeals, however, rejected this claim, finding no such duty on the lender in the absence of an express agreement.[54]

The use of *Brooklyn Trust* as precedent for the so-called "general rule" is highly suspect for two reasons. First, the New York courts have consistently applied the "voluntary/obligatory" doctrine when evaluating the priority of advances under a mortgage to secure future advances, including a construction loan, against a subsequent encumbrance.[55] As will be discussed below, courts in New York and some other jurisdictions have used the voluntary/obligatory distinction to restore priority to the subordinated purchase money mortgagee by deeming advances by the lender that were not used in the project as "voluntary" and thus not entitled to priority.[56] Indeed, the *Brooklyn*

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52. Though the document was titled "Subordination Agreement" and the construction lender was designated as the "party of the second part," the construction lender did not execute the document; it became enforceable against the lender, however, when the funds were disbursed. *Id.* at 20-21, 182 N.E. at 233. Although the existence of the purchase money mortgage was apparently a matter of record notice, the case does not indicate whether the lender was actually aware of it.

53. The original mortgagee under the construction mortgage (Prudence) assigned its interest to plaintiff (Brooklyn Trust), though the case does not indicate the date of such assignment. It appears from the court's discussion that Prudence made all the advances, and so the assignment must have come thereafter. *Id.* at 23-24, 182 N.E. at 234. One can only speculate whether plaintiff's status as assignee of the construction mortgage, uninvolved in any alleged construction lending "wrongdoing," militated in favor of finding that the construction mortgage was to retain priority. *See* Comptroller of New York v. Gards Realty Corp., 68 A.D.2d 186, 416 N.Y.S.2d 821 (1979).

54. 260 N.Y. at 24-25, 182 N.E. at 234.

55. *See* cases cited *infra* note 76.

56. *See infra* pt. II(A).

Trust opinion includes a discussion of the voluntary/obligatory standard and reaches the conclusion that the advances were not "voluntary" on the facts.[57] Therefore, reliance on *Brooklyn Trust* as support for the notion that a construction lender is secured for all advances, whether or not linked to construction performed on the job, misconstrues the case and ignores its built-in safety valve, in the guise of the voluntary/obligatory doctrine, to the "general rule." Despite this, many subsequent decisions turn on this mistaken reliance.[58]

Second, *Brooklyn Trust* did not describe the typical subordinated purchase money mortgage disaster since the facts did not involve diverted advances, but rather advances used to build an improvement that differed, albeit slightly, from the one originally contemplated.[59] It is important to note that the structure was not completed as originally planned because local zoning regulations did not permit garage construction without a modification or variance, and apparently, this legal obstacle could not be overcome.[60] The court found that the lender was unaware of the problem until substantial work had been done on the project and that advances after such knowledge were appropriate to finish the building and protect the investment.[61]

It seems clear that in a situation such as *Brooklyn Trust* the lender has not violated any legitimate expectation of the purchase money mortgagee with respect to the construction lender's behavior. Unlike a situation where the lender carelessly fails to ascertain whether the funds it advances are being employed in the project, *Brooklyn Trust* is not an instance where the act of, or the failure to act by, the lender

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57. 260 N.Y. at 24, 182 N.E. at 234; *see infra* note 205 and accompanying text.

58. *See, e.g.*, First Conn. Small Bus. Inv. Co. v. Arba, Inc., 170 Conn. 168, 172, 365 A.2d 100, 102 (1976); Rockhill v. United States, 288 Md. 237, 239, 418 A.2d 197, 198 (1980); Cambridge Acceptance Corp. v. Hockstein, 102 N.J. Super. 435, 439, 246 A.2d 138, 141 (App. Div. 1968); Forest Inc. v. Guaranty Mtge. Co., 534 S.W.2d 853, 856 (Tenn. Ct. App. 1975). Perhaps the failure of the Connecticut and Maryland courts to recognize that *Brooklyn Trust's* indication of no lender duty is actually tempered is due to the statutory rejection of the voluntary/obligatory rule by those jurisdictions. *See infra* note 76. Though the voluntary/obligatory doctrine may no longer be available, these courts apparently ignored *Brooklyn Trust's* equivocal nature and flatly adopted the "general rule." See National Bank v. Equity Investors, 88 Wash. 2d 886, 888, 506 P.2d 20, 21 (1973), which applied the voluntary/obligatory rule to a mechanic's lien but did not raise the issue with respect to the subordinated purchase money mortgage, though on the facts there was an express warning that the funds could be used for non-construction purposes, thus providing a basis for giving the lender priority. *See supra* text accompanying note 49. Washington, by statute, subsequently repealed the voluntary/obligatory rule. *See infra* note 76.

59. 260 N.Y. at 23-24, 182 N.E. at 234.

60. *Id.*

61. *Id.* at 24, 182 N.E. at 234. Indeed this approach has been argued to be the appropriate result in cases where advances, although technically "voluntary," serve to better protect all interested parties. *See infra* notes 205-07 and accompanying text.

injures the purchase money mortgagee and where only the lender could have prevented the loss. Rather, it is a case of an external force causing a loss to both the lender and the purchase money mortgagee, disappointing the desires of both as to the value of the project. Furthermore, in this situation both the lender and the purchase money mortgagee could have prevented the catastrophe by prior analysis of the zoning regulation. To hold the lender responsible in this instance would transform it into a guarantor. Moreover, after disaster occurred, the lender took the prudent course necessary to salvage the situation and followed reasonable construction lender practice with respect to advances.

3. *Iowa Loan & Trust Co. v. Plewe*

The Supreme Court of Iowa issued three opinions in the *Iowa Loan* dispute, the last of which is designated as superseding the two earlier opinions.[62] It is this last opinion which sets forth, and is cited for, the "general rule" that the lender maintains priority for diverted advances. In *Iowa Loan*, the seller agreed to convey a lot to a buyer in return for a purchase money mortgage. It was agreed that the buyer would obtain a construction loan mortgage for the purpose of building a house on the lot and that the purchase money mortgage would be recorded after the construction loan mortgage. Such action was subsequently taken. Upon default by the buyer, and foreclosure by the construction lender, the purchase money mortgagee contested the priority of the lender for advances to the borrower that were not used for construction, but were used to repay the lender for amounts due under prior loans made to the borrower by the lender's commercial loan department.[63]

Reversing its holding in the second opinion, the Supreme Court of Iowa, in a third opinion, granted the construction lender priority for all advances and flatly stated that the lender had neither a duty to control any disposition of funds it made, nor to ensure that the proceeds of the loan were applied to enhance the value of the property by the construction of improvements. This result is troubling on several levels. First, the court did not set forth any reasons for its decision; instead it posed the syllogism that these sums were found to be "advanced under the mortgage," the lender was entitled to a senior lien for funds "advanced by it under the mortgage," and thus, it had priority for these advances.[64] The court also stated that the lender was not chargeable as a "trustee,"[65] but this determination is a red

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62. 202 Iowa 79, 209 N.W. 399 (1926), *superseding* 205 N.W. 358 (1925) *and* 202 N.W. 539 (1925).
63. *Id.* at 83, 209 N.W. at 400.
64. *Id.* at 80, 209 N.W. at 400.
65. *Id.*

herring because all that should be required is reasonable construction lender safeguards, not a trustee's extensive fiduciary duty.[66] The court cited no prior cases, nor did it discuss any meaningful policy considerations. After reading the court's declaration of the rule of no duty, one is left with the unanswered question, "why?"

The result in *Iowa Loan* is also troubling because the behavior of the construction lender was highly questionable. This factor seems to place the case within the exception to the "general rule" denying priority because of fraud or collusion between the lender and the borrower. In its second and subsequently superseded opinion, the court appropriately found that the lender, knowing that the seller had surrendered its position for the specific purpose of obtaining funds to build improvements, could not under any principle of law or equity in good faith obtain a first lien for funds previously advanced for a commercial loan.[67] A similar factual background was presented in *Cambridge Acceptance Corp. v. Hockstein.*[68] In that case the court, although purporting to adopt the "general rule," found that a construction lender could not, under "plain principles of equity," retain priority when none of the funds went into construction and the construction mortgage vehicle was used merely to "mask what is essentially a loan on the general credit and reliability of the borrower."[69] *Iowa Loan* and *Cambridge Acceptance* involve not merely negligent lender acts, but rather devious behavior, and should be dealt with appropriately even by "general rule" courts.

It is, therefore, unfortunate to rely on *Iowa Loan* as influential precedent for the proposition that a construction lender owes no duty to a subordinated purchase money mortgagee with respect to advances. Notwithstanding the difficulties in the opinion, however, *Iowa Loan* is frequently cited for the "general rule" without a clear evaluation or rethinking of the underlying issues.[70]

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66. Even the second opinion of the court, which denied the construction lender a first priority for the advances in question, rejected the "trustee" duty as inappropriate. 205 N.W. at 358.

67. *Id.* at 359. The finding that the construction lender knew of (1) the seller's outstanding loan before giving its mortgage and (2) the fact that the seller agreed to take a subordinate purchase money mortgage, seems important in establishing liability. *See infra* note 180. Once that issue is resolved, it should be noted that Middlebrook-Anderson Co. v. Southwestern Sav. & Loan Ass'n, 18 Cal. App. 3d 1023, 1029-32, 96 Cal. Rptr. 338, 341-42 (1971), rejects any distinction between relief granted to a purchase money mortgagee who originally had a first lien but became subordinated pursuant to a subordination instrument, and relief granted to a purchase money mortgagee who took a subordinate position by agreeing to record after the construction mortgage. *See supra* note 7.

68. 102 N.J. Super. 435, 246 A.2d 138 (App. Div. 1968).

69. *Id.* at 440, 246 A.2d at 141.

70. *See* cases cited *supra* note 43. One is reminded of Leach's statement with respect to the development of class gift rules in the Rule Against Perpetuities area:

II. The Responses to the "General Rule"

Despite the prevalence of the doctrine that the construction lender retains its priority over the subordinated purchase money mortgagee for diverted advances,[71] some courts in various jurisdictions have provided relief for the subordinated purchase money mortgagee.[72] It is interesting that even though these courts are dealing with similar issues and factual patterns, they have used varying theories and doctrines to grant relief.[73] Moreover, their theories are often developed without reference to solutions offered by courts in other jurisdictions[74] or even by those within their own jurisdictions.[75]

The efforts of these courts often seem to be an example of a result in search of a theory. Many borrow doctrines developed to deal with other issues in the law and attempt to apply them to the construction lender-subordinated purchase money mortgagee dispute. As will be discussed below, however, these borrowed doctrines do not adequately fit the subordinated purchase money mortgagee situation. While they may at times achieve appropriate results, they do not present a theoretical basis that sufficiently demonstrates a true understanding of the subordinated purchase money mortgagee-construction lender dispute and that can be used as a method of analysis in future cases.

Rather than relying on a mere acceptance of the "general rule" and attempts to create exceptions to it by the application of scattered doctrines, the courts should employ a new method of decision for the construction mortgage-subordinated purchase money mortgage conflict. A critical analysis of the opinions granting relief to subordinated purchase money mortgagees demonstrates the need for the alternate approach suggested by this Article.

A. *The Voluntary/Obligatory Rule*

1. The Doctrine and its Weaknesses

Faced with the general rule of no duty on the construction lender to monitor advances, some courts have sought to provide relief to subor-

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"The subsequent history of the rule of *Leake v. Robinson* in England can be described in two words: *stare decisis*. The cases have all been examined with care in the hope that some rationalization of the rule might be found. No further explanation has appeared . . . ." Leach, *The Rule Against Perpetuities and Gifts to Classes*, 51 Harv. L. Rev. 1329, 1345 (1938).

71. *See supra* pt. I.

72. Some courts specifically express a concern for the fate of the subordinated purchase money mortgagee. *See* Handy v. Gordon, 65 Cal. 2d 578, 422 P.2d 329, 55 Cal. Rptr. 769 (1967); *see, e.g.*, cases cited *supra* note 31.

73. *See* Rockhill v. United States, 288 Md. 237, 241-42, 418 A.2d 197, 199 (1980).

74. But see Ban-Co Inv. Co. v. Loveless, 22 Wash. App. 122, 134-35, 587 P.2d 567, 574-75 (1978), which adopts the approach of the California courts.

75. *See infra* note 113.

dinated purchase money mortgagees by applying the long-standing voluntary/obligatory advance rule. As a matter of general mortgage law, it is almost universally held that "obligatory" advances under a mortgage to secure future advances after notice of the attachment of a junior encumbrance will have priority over the junior encumbrance under a relation-back theory. However, any "voluntary" or "optional" advances after notice of the attachment of a junior encumbrance will not have priority over the junior encumbrance.[76] This rule applies to different types of senior mortgages to secure future advances and to many varieties of junior encumbrances.[77] Thus, the use of this standard in the construction lender-subordinated purchase money mortgagee dispute is simply a matter of courts' labelling the interests and dropping them into the appropriate boxes provided by the universal voluntary/obligatory advance rule.[78] A number of

76. National Bank v. Blankenship, 177 F. Supp. 667, 675-76 (E.D. Ark. 1959) (general open-end deed of trust versus second and third deeds of trust), *aff'd sub nom.* National Bank v. General Mills, Inc., 283 F.2d 574 (8th Cir. 1960); City Nat'l Bank v. First Nat'l Bank, 285 Ala. 340, 344, 232 So. 2d 342, 345 (1970) (general open-end mortgage versus second mortgage); Ashdown Hardware Co. v. Hughes, 232 Ark. 541, 546, 267 S.W.2d 294, 298 (1954) (construction mortgage versus mechanic's lien); Reidy v. Collins, 134 Cal. App. 713, 716, 26 P.2d 712, 716 (1933) (per curiam) (general open-end mortgage versus attaching judgment creditor); Kimmel v. Batty, 451 P.2d 751, 753, 168 Colo. 431, 435-36 (1969) (general open-end deed of trust versus attaching judgment creditor); Biersdorff v. Brumfield, 93 Idaho 569, 572, 468 P.2d 301, 304 (1970) (general open-end mortgage versus attaching judgment creditor); Axel Newman Heating & Plumbing Co. v. Sauers, 234 Minn. 140, 145, 47 N.W.2d 769, 772 (1951) (construction mortgage versus attorney's lien); Micele v. Falduti, 101 N.J. Eq. 103, 104-05, 137 A. 92, 93 (Ch. 1927) (contruction mortgage versus second mortgage); Hyman v. Hauff, 138 N.Y. 48, 54-55, 33 N.E. 735, 737 (1893) (construction mortgage versus junior mortgages given to mechanics and materialmen); First Fed. Sav. & Loan Ass'n v. Green-Acres Bldg. Corp., 38 Misc. 2d 149, 150, 236 N.Y.S.2d 1009, 1010 (County Ct. 1963) (construction mortgage versus second mortgage); Akron Sav. & Loan Co. v. Ronson Homes, Inc., 15 Ohio St. 2d 6, 9-10, 238 N.E.2d 760, 762-63 (1968) (construction mortgage versus mechanic's lien); Garey v. Rufus Lillard Co., 196 Okla. 421, 426, 165 P.2d 344, 349 (1945) (general open-end mortgage versus second mortgage). See 4 American Law of Property, *supra* note 10, § 16.75, at 140 n.1; 3 G. Glenn, *supra* note 23, § 402, at 1611-12 nn. 2 & 3; and Annot., 80 A.L.R.2d 191-203 (1961), which cite cases in numerous jurisdictions regarding the competing claims of mortgages and mechanics' liens. At least five jurisdictions have rejected the voluntary/obligatory distinction by statute and grant priority to all future advances. Conn. Gen. Stat. Ann. § 49-3 (West Supp. 1981); Fla. Stat. Ann. § 697.04(3) (West 1969), *discussed in* Silver Waters Corp. v. Murphy, 177 So. 2d 897 (Fla. Dist. Ct. App. 1965); Md. Real Prop. Code Ann. § 7-102(b) (1974); S.C. Code Ann. § 29-3-50 (1976), *discussed in* McMillen Feed Mills Inc. v. Mayer, 265 S.C. 500, 510-14, 220 S.E.2d 221, 225-27 (1975); Wash. Rev. Code Ann. § 60.04.220 (Supp. 1981).

77. *See* cases cited *supra* note 76.

78. The court in Turner v. Lytton Sav. & Loan Ass'n, 242 Cal. App. 2d 457, 51 Cal. Rptr. 552 (1966), indicated that it is merely a matter of applying the general voluntary/obligatory rule to the case before the court: "While the cases relied upon

courts have done just that.[79] There is, however, no theoretical basis for the voluntary/obligatory rule that makes it an appropriate means by which to solve construction lender-subordinated purchase money mortgagee priority problems. Furthermore, while at times it may have been an effective tool to assist subordinated purchase money mortgagees, it has often proved to be too crude a vehicle for the task.

There are two major shortcomings to the voluntary/obligatory theory in the subordinated purchase money mortgage-construction mortgage context. The first relates to situations in which the lender should be found responsible for monitoring advances. The second concerns the standard of behavior required once lender responsibility has been determined.

With respect to situations in which lender responsibility is found, it should be emphasized that the voluntary/obligatory rule, by definition, is applied automatically. The threshold question is only whether the situation involves a senior mortgage to secure future advances and a junior encumbrance; if so, the voluntary/obligatory distinction, and its reordering of priorities, is mechanically applied. As a result, the issue of whether responsibility will be placed upon the construction lender and relief given is decided regardless of the legitimate expectations of the parties or the special interrelationship of the subordinated purchase money mortgagee and the construction lender. Responsibility thus revolves around technical operation of the doctrine.

The application of the voluntary/obligatory rule to a case in which the purchase money mortgagee, as part of the subordination transaction, has been given shares in the development corporation, named an officer thereof and taken an active role in the business, illustrates the inadequacy of the voluntary/obligatory rule with respect to the first

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by plaintiffs involve the priorty [sic] of liens as between deeds of trust or mortgages and mechanics' lien claims, the principle of those cases should be equally applicable to the lien priority as between a first deed of trust and a second deed of trust." *Id.* at 458, 51 Cal. Rptr. at 553.

79. *E.g.*, Turner v. Lytton Sav. & Loan Ass'n, 242 Cal. App. 2d 457, 51 Cal. Rptr. 552 (1966); Althouse v. Provident Mut. Bldg.-Loan Ass'n, 59 Cal. App. 31, 209 P. 1018 (1922); Housing Mtge. Corp. v. Allied Constr. Inc., 374 Pa. 312, 97 A.2d 802 (1953); *see* Security Trust Co. v. Graney, 89 Misc. 2d 290, 293, 391 N.Y.S.2d 46, 48 (Sup. Ct. 1977); *cf.* Heller v. Gate City Bldg. & Loan Ass'n, 75 N.M. 596, 408 P.2d 753 (1965) (involving a purchase money mortgage subordinated to a remodeling, rather than a development, loan); Brooklyn Trust Co. v. Fairfield Gardens, Inc., 260 N.Y. 16, 182 N.E. 231 (1932) (applying the voluntary/obligatory advance rule to a construction mortgage-subordinated purchase money mortgage situation but finding no relief for the latter on the facts); Roslyn Sav. Bank v. Merz, 13 A.D.2d 550, 213 N.Y.S.2d 218 (1961) (dealing with a contract vendee's lien subordinated to construction mortgage), *aff'd*, 11 N.Y.2d 832, 182 N.E.2d 117, 227 N.Y.S.2d 445 (1962). *But see* Kingsberry Mtge. Co. v. Maddox, 13 Ohio Misc. 98, 233 N.E.2d 887 (Ct. C.P. 1968) (using a statutory voluntary/obligatory rule to give priority to a subsequent mechanic's lien, but apparently not applying the doctrine to a subordinated purchase money mortgage).

issue discussed above—situations in which lender responsibility is found. Assume in this case that "voluntary" advances are made by the lender and such funds are diverted by the original developer. It is difficult in this case to imagine a legitimate expectation on the part of the purchase money mortgagee that the lender will monitor advances to the borrower for the benefit of the purchase money mortgagee, given his participation in the borrower's business. However, application of the voluntary/obligatory rule would result in the lender losing priority for these so-called "voluntary" advances.[80]

Furthermore, the voluntary/obligatory rule presents an inadequate form of analysis with respect to the second issue discussed above—the standard required once lender responsibility is found. When lender responsibility is found and the voluntary/obligatory rule is invoked, there follows no examination of the particular transaction before the court nor of the conduct of the parties against an acceptable standard. Instead, the standard of decision of the rule rests upon classifying an advance as "voluntary" or "obligatory." The answer to that linguistic puzzle determines whether or not the advance in question has priority. The courts most commonly define "obligatory" as something that is contractually compelled.[81]

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80. *Cf.* Woodworth v. Redwood Empire Sav. & Loan Ass'n, 22 Cal. App. 3d 347, 99 Cal. Rptr. 373 (1971) (decided not on voluntary/obligatory doctrine but on conditional subordination theory). Also consider the following: (1) In Roslyn Sav. Bank v. Merz, 13 A.D.2d 550, 213 N.Y.S.2d 218 (1961), *aff'd*, 11 N.Y.2d 832, 182 N.E.2d 117, 227 N.Y.S.2d 445 (1962), the court merely declared that advances not in accordance with the schedule were "voluntary" and had no priority, without any discussion whatsoever of the background of the advances, *id.* at 551, 213 N.Y.S.2d at 220; (2) if a mortgage states that funding is required only if the borrower is not in default, advances made after the borrower makes a technical default under the mortgage (for example, by mailing tax receipts to the lender two weeks after the required date) might be held, under strict application of the voluntary/obligatory doctrine, to be voluntary and denied priority.

81. *E.g.*, Peaslee v. Evans, 82 N.H. 313, 315, 133 A. 448, 449-50 (1926); Landers-Morrison-Christenson Co. v. Ambassador Holding Co., 171 Minn. 445, 449, 214 N.W. 503, 505 (1927); Housing Mtge. Corp. v. Allied Constr., Inc., 374 Pa. 312, 321, 97 A.2d 802, 806 (1953); Elmendorf-Anthony Co. v. Dunn, 10 Wash. 2d 29, 39, 116 P.2d 253, 258 (1941). Thus, any advance made where the borrower fails to perform or meet conditions of the loan agreement is viewed as voluntary by most courts. Skipworth, *Should Construction Lenders Lose Out on Voluntary Advances If a Loan Turns Sour?*, 5 Real Est. L.J. 221, 223 n.5 (1977); *see* G. Osborne, G. Nelson & D. Whitman, Real Estate Finance Law § 12.7, at 764 (1979). A few courts, however, have a less restrictive definition of "obligatory" and allow the construction lender to waive a condition set on the borrower without rendering the advance voluntary. *E.g.*, Hyman v. Hauff, 138 N.Y. 48, 54-56, 33 N.E. 735, 737 (1893); Colonial Mtge. Serv. Co. v. Southard, 56 Ohio St. 2d 347, 349, 384 N.E.2d 250, 252 (1978) (discussing Ohio code § 5301.232(E)(4) (1978)). Another issue under the voluntary/obligatory doctrine is whether the notice to the junior lender must be actual or constructive. *See* 4 American Law of Property, *supra* note 10, § 16.74; Annot., 138 A.L.R. 566, 566-67 (1942). This issue is not of great importance in the subordinated

It is submitted that this is a fruitless examination and bears no relationship to the underlying dynamic of the construction mortgage-subordinated purchase money mortgage conflict nor to an acceptable concept of responsibility. Rather than relying on a definitional analysis, the courts should concern themselves with whether the construction lender behaved reasonably with respect to advances.[82] Consider, for example, a case in which a construction lender advances funds to the borrower before they are due under the terms of the loan agreement in order to allow the borrower to make purchases of material before a price rise. On foreclosure after subsequent default, the lender would lose priority for these "voluntary" advances under concepts of contractual compulsion despite the reasonable nature of such advances.

The voluntary/obligatory distinction reaches almost absurd proportions when it is applied to a construction mortgage that simply provides for advances to be made by the lender, at times and in amounts within its discretion, for work already completed.[83] Assume that a lender made advances under such a construction mortgage, all of which were put into the job. Then after a default by the borrower in payment of such mortgage, the construction lender foreclosed. Applying the technical voluntary/obligatory rule, all of the advances would apparently be deemed voluntary because there was no contractual compulsion to make the advances. Thus, the lender would lose priority not only when he complied with reasonable construction standards for advances, but also despite the fact that every penny of the advanced money ended up in the job.

2. The Theoretical Gap

A construction mortgage is one example of a mortgage to secure future advances. There now appears to be agreement regarding the

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purchase money mortgage situation because usually the construction lender will see the purchase money mortgage of record and then call for the subordination. There may be a question of notice, however, in the order of recording subordination. *See infra* note 180. 2 G. Gilmore, *supra* note 10, § 35.4, at 926-27, questions the underlying logic of the voluntary/obligatory distinction for a contract to lend money.

82. Despite Gilmore's criticism of the logic of the voluntary/obligatory rule, he finds that it has merit in that it allows for wide judicial discretion in an area where decisions are close and flexibility is needed. 2 G. Gilmore, *supra* note 10, § 35.4, at 929-30. Gilmore is correct in stating that rigid rules in this area are not helpful. The voluntary/obligatory rule as presently constituted, however, does not tell the parties what standard their behavior will be measured against and what criteria will be applied. The approach suggested by this Article adds a framework to this judicial discretion by setting forth a standard of conduct, that of the reasonable construction lender.

83. J. Krasnowiecki, *supra* note 3, at 13-14 (citing Demharter v. First Fed. Sav. & Loan Ass'n, 412 Pa. 142, 152, 194 A.2d 214, 219 (1963) and Clardy v. Barco Constr. Co., 205 Pa. Super. 218, 221 n.1, 208 A.2d 793, 794 n.1 (1965)).

validity of mortgages to secure future advances.[84] It has been asserted that this acceptance was a function of the need for mortgages to secure future advances in the expanding economy of young America.[85] It seems insufficient, however, to decide the question of the validity and scope of mortgages to secure future advances as an abstract matter because these issues become most critical in the context of competing claims for priority between the mortgagee to secure future advances and an intervening encumbrancer. The courts, when faced with such disputes, have developed the voluntary/obligatory rule to determine the parties' rights.

Because of the importance of the voluntary/obligatory distinction, its theoretical basis must be understood. It has been asserted that the law of mortgages does not require the distinction.[86] Unfortunately, virtually no explanation has been offered by the courts for employing the voluntary/obligatory rule to decide general senior lender-junior lender disputes.[87] Suggestions have been made of policy concerns that might have motivated the adoption of the doctrine;[88] however,

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84. 2 G. Gilmore, *supra* note 10, § 35.3, at 921. The view is expressed that there is but one transfer of an interest in the property by the mortgagor when the transaction is originally entered into, and that this transfer is intended from the beginning to stand as consideration for the entire performance by the mortgagee. 4 American Law of Property, *supra* note 10, § 16.72. *But see* Ter-Hoven v. Kerns, 2 Pa. 96 (1846); G. Osborne, G. Nelson & D. Whitman, *supra* note 81, § 12.7, at 760.

85. 1 G. Glenn, Fraudulent Conveyances and Preferences § 372 (rev. ed. 1940), *cited in* 2 G. Gilmore, *supra* note 10, § 35.3. " 'The rapid development of our own country that featured the nineteenth century, required the use of this type of mortgage, and forced American courts to give it place in the scheme of things. So today the mortgage for future advances is institutional with us . . . .' " *Id.* at 922 (quoting G. Glenn, *supra*, § 372); *see* 4 American Law of Property, *supra* note 10, § 16.70 (discussing the advantages of such a mortgage).

86. G. Osborne, G. Nelson & D. Whitman, *supra* note 81, § 12.7, at 761; *see* 2 G. Gilmore, *supra* note 10, § 35.4, at 929.

87. The court in Hyman v. Hauff, 138 N.Y. 48, 33 N.E. 735 (1893), seemed to be an unwilling captive of the voluntary/obligatory theory. Apparently, the court felt obligated to apply the doctrine because of stare decisis, *see supra* note 70, and it did so "[w]ithout attempting to discuss the equity of the [rule]." 138 N.Y. at 54, 33 N.E. at 737. The court did, however, adopt a flexible definition of "obligatory," thus weakening the grip of the rule.

88. Some commentators contend that courts were concerned with the shackling of the borrower's equity in his property by leaving him with a first mortgage under which he could not compel advances but which would deter other potential mortgagees from making loans. *E.g.*, G. Osborne, G. Nelson & D. Whitman, *supra* note 81, § 12.7; 2 M. Tiffany, Real Property § 637 (2d ed. 1939). If the purpose of the rule is to protect the mortgagor's equity in the property, one wonders how well this is served in situations where the first lender's response to the vagaries of the voluntary/obligatory doctrine is to prohibit the placing of second mortgages on the property. *See generally* 4A P. Rohan, *supra* note 5, § 3A.03[1][a]. Another commentator apparently indicates an interest in the position of subsequent encumbrancers. 3 G. Glenn, *supra* note 23, § 401, at 1611 ("impairs an intervening security"); *see* Heintze v. Bentley, 34 N.J. Eq. 562, 566-67 (1881) ("to the disadvantage of the second encum-

none are entirely satisfactory. Moreover, cases applying the broad voluntary/obligatory rule to the specific subordinated purchase money mortgage situation do not offer any policy explanations nor any other theoretical bases for the use of that broad rule in connection with that particular variety of junior mortgages. One court merely announced that the voluntary/obligatory rule is employed with respect to other junior encumbrances and that there was no reason why it should not apply to the purchase money mortgage as well.[89] Another stated that the voluntary/obligatory "law is definitely established" and cited prior cases in the jurisdiction adopting that rule with respect to other encumbrances.[90] A review of the cited cases reveals little in terms of explanation.[91]

There is thus no clear rationale for applying the voluntary/obligatory rule in the construction mortgage-subordinated purchase money mortgage situation. As a result, there seems to be room for flexibility in approaching these disputes in the future. Even accepting the commercial need for the mortgage to secure future advances,[92] there is no reason to assume that there are no boundaries within which a mortgage to secure future advances must operate. Moreover, there is no real barrier to creating a device that is tailored to take account of all competing interests in the property. A flexible doctrine which focuses on the underlying interrelationships of the parties, rather than the voluntary/obligatory distinction, is necessary.

3. Some Illustrative Cases

Reference to some purchase money mortgage cases decided on the basis of the voluntary/obligatory rule illustrates its inadequacy. To the extent that it is possible to generalize, the problem cases involve

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brance"). Yet another has suggested why the rule is sensible for the various situations to which it has been applied. Skipworth, *supra* note 81, at 229-34. As pointed out in pt. II(A)(1) of this Article, however, the rule is too crude a vehicle to govern efficiently the construction mortgage-subordinated purchase money mortgage dispute.

89. Turner v. Lytton Sav. & Loan Ass'n, 242 Cal. App. 2d 457, 51 Cal. Rptr. 552 (1966); *see supra* note 78. It is not clear, however, why the court did not cite Althouse v. Provident Mut. Bldg-Loan Ass'n, 59 Cal. App. 31, 209 P. 1018 (1922), which dealt with a construction mortgage-subordinated purchase mortgage conflict and the voluntary/obligatory theory.

90. Housing Mtge. Corp. v. Allied Constr. Inc., 374 Pa. 312, 320-21, 97 A.2d 802, 805-06 (1953).

91. *See id.* at 321, 97 A.2d at 806.

92. *See supra* note 85. Undoubtedly, there will be debate whether such changes can be made by the courts or whether the legislatures should act. The questionable origins of the voluntary/obligatory rule in the subordinated purchase money mortgage context support an appeal for judicial action; "reliance" by lenders on the voluntary/obligatory rule, as well as the need for a comprehensive approach to the issue, militate in favor of a legislative approach.

situations in which certain advances, which would be granted priority if evaluated by a standard of reasonable construction lender behavior, are deemed to be "voluntary" by the courts and so denied priority.[93] In *Turner v. Lytton Savings and Loan Association*,[94] the seller of a parcel of property received a purchase money deed of trust and, by agreement, recorded behind a $39,000 construction deed of trust. The agreement provided for advances in accordance with the progress of the work and reserved to the lender the right to declare a default if the work did not progress in a satisfactory manner. The construction lender declared such a default, but it later withdrew the declaration and resumed making advances. The full amount of the loan was advanced but the building was not completed. The trial court specifically found that all construction loan funds had been applied toward the construction of the agreed upon improvements on the property.[95] The subordinated purchase money mortgagee asserted priority for advances made after the declaration of default, however, claiming that after such default the lender was not bound to make further disbursements and that these payments were therefore voluntary.

Turner exemplifies the first problem inherent in the voluntary/obligatory doctrine—the automatic application of the rule and its ensuing rearrangement of priorities once a senior mortgage to secure future advances and a junior encumbrance have been found.[96] It seems clear that a court applying the "contractually compelled" test for obligatory advances would find that such advances were voluntary, and priority would be lost.[97] Such a result, however, would not be desirable. This is a case where no lender responsibility should be found in the first place, though the inflexible voluntary/obligatory rule would do so. Unlike the case in which the construction lender makes "voluntary" payments by issuing funds without respect to progress and the disbursements are diverted from the job, the loss in

93. On the other hand, it seems that there are fewer situations when priority should not be granted for an "obligatory" advance. Assume, for example, a construction loan agreement providing for payments on set dates, regardless of progress. A purchase money mortgagee agreeing to subordinate to such terms should be bound thereby, even though such a "construction loan" most likely does not encompass normal construction lender behavior. *See supra* notes 47-50 and accompanying text (discussing *Tripp v. Babcock*). If, however, a seller received a purchase money mortgage which required no further subordination document and provided for subordination to any future construction loan to develop the property, *see supra* note 7, then it seems that the advances pursuant to the above-posited construction loan agreement should not be protected although "obligatory," because of deviation from reasonable construction lender behavior. Note, however, that some courts may not enforce such a vague subordination agreement. *See supra* note 21.

94. 242 Cal. App. 2d 457, 51 Cal. Rptr. 552 (1966).

95. Id. at 458, 51 Cal. Rptr. at 552-53.

96. *See supra* text accompanying note 80.

97. *See supra* note 81. Under the New York and Ohio approaches discussed there, the advance may be deemed to be non-voluntary.

Turner was not occasioned by any negligent act of the construction lender with respect to the subordinated purchase money mortgagee. Rather, both the construction lender and purchase money mortgagee in *Turner* made an error with respect to estimating the amount of funds needed to complete the job. This resulted in an unfinished project where $39,000 of work would be unlikely to bring that amount on the foreclosure market.[98] In such a situation, the construction lender does not have exclusive control in the matter or the sole means to prevent the loss. As a result, it is harder to discern a legitimate expectation on the part of the subordinated purchase money mortgagee that the construction lender's activity would be subject to a responsibility toward the subordinated purchase money mortgagee. Instead, the case involves an entrepreneurial risk as to the viability of the project, and the subordinated purchase money mortgagee should be responsible himself for his own evaluation and undertaking. In this situation, there is no reason to shift the loss from the purchase money mortgagee to the lender and thus force the latter to serve as a safety net.

Therefore, in a case such as *Turner*, a loss of priority to the lender should not result.[99] Whether or not the payments are deemed to be "voluntary" bears no relation to how the loss occurred and the dynamic involved. Unfortunately, however, traditional voluntary/obligatory analysis misses this point.

Housing Mortgage Corp. v. Allied Construction, Inc.[100] also illustrates the rough-hewn nature of the voluntary/obligatory approach. In that case, a purchase money mortgagee subordinated to a construction mortgage that provided, in an incorporated construction loan agreement, a schedule of advances based upon the completion of various parts of the job. As events transpired, however, advances were made before the various stages of work had been completed.

The court, in an opinion that flirted with a reliance or implied agreement theory which would bind the construction lender directly,[101] ultimately resorted to the voluntary/obligatory theory and

98. *See supra* text accompanying notes 11 & 12.

99. In *Turner* the court held that the advances, though voluntary, would be deemed prior under a California statute, currently codified at Cal. Civ. Code § 1188-1 (West 1968), which gave priority for non-obligatory advances in payment of costs of the work for improvement of the property. This California statute addresses the problem raised by the voluntary/obligatory rule discussed below. *Infra* note 107.

100. 374 Pa. 312, 97 A.2d 802 (1953).

101. The court seemed to make much of the fact that the purchase money mortgagee had seen the construction loan agreement before subordinating and that there was a "perfect understanding" among all three parties as to the adherence to the schedule. *Id.* at 317-19, 97 A.2d at 804-05. Despite the subsequent strict application of the voluntary/obligatory rule, one can only speculate if the court would have decided differently had there been no such "understanding." There is nothing about the voluntary/obligatory doctrine that requires such a "perfect understanding"; it operates as part of mortgage and lien law.

stated that any advance not made in accordance with the schedule was voluntary and therefore not awarded priority. *Housing Mortgage* demonstrates the second major objection to the voluntary/obligatory approach—establishing the standard to which a lender will be held once responsibility is found.[102] The difficulty with the opinion is that it does not explain how and why these "voluntary" advances were made. Nowhere does the court describe the lender's disbursement activities and analyze their propriety in light of a standard of acceptable lender behavior. It seems true that in some cases payments should be classified as "voluntary" and denied priority because the failure to follow a progress payment schedule corresponds to improper construction lender behavior.[103] In other situations, however, certain deviations from the schedule may be permitted or even required under a concept of responsible lender behavior. For example, the court in *Housing Mortgage* rejected the auditor's finding that various stages of the work were substantially completed before advances were made, and stated that even if there had been substantial completion, advances would be given priority only if actual completion of each stage had been accomplished.[104] This statement seems unsupportable; it illustrates the rigidity of the voluntary/obligatory approach and its failure to focus on the fundamental dynamic of the construction lender-subordinated purchase money mortgagee dispute. First, this view ignores the commercial need for flexibility in the construction business[105] and overlooks the case law requiring the acceptance of substantial completion in the construction area.[106] Second, if the construction lender is made responsible for advances on the basis of an expectation that it will take reasonable steps to achieve the construction of the project, then this lender should be given the latitude to take reasonable action and should be allowed to adjust its activity to the particular circumstances.[107] Instead, there is a sense of strict liability permeating the voluntary/obligatory approach in that once the rule is applied and a "voluntary" advance found, liability will always result.

4. The Worthwhile Lessons

Despite objections to the automatic application of the voluntary/obligatory rule in the subordinated purchase money mortgage context

102. *See supra* text accompanying notes 81-82.

103. *See* Forest Inc. v. Guaranty Mtge. Co., 534 S.W.2d 853, 856 (Tenn. Ct. App. 1975); Kratovil & Werner, *supra* note 9, at 314-16.

104. 374 Pa. at 321-22, 97 A.2d at 806.

105. *See* Kratovil & Werner, *supra* note 9, at 316-19.

106. *See, e.g.*, Jacobs & Youngs, Inc. v. Kent, 230 N.Y. 239, 129 N.E. 889 (1921); Bernhardt v. McGuire & Pritchard, 607 S.W.2d 8 (Tex. Civ. App. 1980).

107. One aspect of the rigidity of the voluntary/obligatory rule has been criticized. Under standard voluntary/obligatory analysis, advances by the lender after default where the lender has the option to cease funding will be denied priority even though,

and the standard of lender behavior thereunder, there are two positive attributes of the doctrine. First, despite its failure to reach the heart of the subordinated purchase money mortgagee-construction lender dispute, the doctrine, in some cases, offers an alternative to the "general rule" of no duty on the construction lender to monitor advances.[108] Therefore, critics of the rule should be aware that its abolition would deny a potent weapon to the subordinated purchase money mortgagee when proper lender behavior has not been followed.[109]

There is a second benefit to be gained from adapting aspects of the voluntary/obligatory rule and applying them to purchase money mortgage situations. Because the rule is a function of the law of foreclosure and lien priority and so is applied automatically, it does away with the need to have an express agreement between the construction lender and the subordinated purchase money mortgagee in order to give protection to the latter. Thus, lender responsibility is an initial assumption, and the lender carries the burden of focusing the attention of the parties on the problem so that they can expressly deal with the issue if they so choose. The rule proposed by this Article adopts this aspect of the voluntary/obligatory rule and has as its starting point a standard of reasonable lender behavior. Only by express and meaningful waiver can this duty be removed.[110]

B. *Conditional Subordination*

1. The Shape of the Doctrine

Some courts have adopted a conditional subordination approach as another response to the "general rule" of no construction lender duty to monitor advances.[111] When examined in light of the two inquiries

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as an economic matter for all parties, it may be preferable for the lender to complete the project. *See infra* text accompanying notes 204-07.

108. It may well be that purchase money mortgagees have consciously relied on the voluntary/obligatory theory when subordinating, rather than just benefitting from a court's application of the rule as part of a salvage effort after things have gone wrong.

109. *See infra* text accompanying notes 209-15.

110. *See infra* pt. III.

111. *E.g.*, Middlebrook-Anderson Co. v. Southwest Sav. & Loan Ass'n, 18 Cal. App. 3d 1023, 96 Cal. Rptr. 338 (1971); Miller v. Citizens Sav. & Loan Ass'n, 248 Cal. App. 2d 555, 56 Cal. Rptr. 844 (1967); Collins v. Home Sav. & Loan Ass'n, 205 Cal. App. 2d 86, 22 Cal. Rptr. 817 (1962); *see* Cambridge Acceptance Corp. v. American Nat'l Motor Inns, Inc., 96 N.J. Super. 183, 205, 232 A.2d 692, 704 (Ch. 1967), *aff'd sub nom.* Cambridge Acceptance Corp. v. Hockstein, 102 N.J. Super. 435, 246 A.2d 138 (App. Div. 1968) (apparently rejecting the lower court's reasoning on the conditional subordination issue). *Contra* Roberts v. Harkins, 292 So. 2d 603 (Fla. Dist. Ct. App. 1974) (refusing to apply conditional subordination theory because lender was not a party to the agreement and because subordination agreement

raised earlier, situations in which the construction lender will be found responsible and the standard of lender behavior to be required once responsibility is established,[112] the conditional subordination theory emerges as unsatisfying for two reasons. First, it fails to address unarticulated expectations and, second, it requires the lender, once responsibility is found, to act as an insurer and not merely in a reasonable manner. Moreover, the courts adopting the theory rely on certain significant assumptions. Once these assumptions are questioned, the conditional subordination theory does little more than restate the accepted doctrine that a construction lender will be bound to monitor advances if it has expressly agreed to do so.

The leading case advancing the conditional subordination view is *Middlebrook-Anderson Co. v. Southwest Savings and Loan Association.*[113] In *Middlebrook-Anderson*, a land seller receiving a purchase money mortgage agreed with the developer to record second in order to allow the construction lender to obtain priority.[114] The purchase money mortgagee alleged that the agreement was based on representations by the developer that the funds received from the lender would be used exclusively for the construction of improvements on the property.[115] Some $300,000 of the advanced funds did not end up in the job. Upon foreclosure, the subordinated purchase money mortgagee challenged the lender's priority as to the diverted funds.[116] The trial court granted a motion to dismiss the action.[117] The court of appeal, however, held that the subordinated purchase money mortgagee had indeed stated a cause of action.[118]

Because the basis of the decision is not entirely clear, the opinion of the court of appeal requires close scrutiny. The better reading of the court's reasoning is as follows. An oral agreement was alleged between the purchase money mortgagee and the borrower providing that as a condition of the subordination, the funds would be used only to

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was "clear and unambiguous" on its face), *cert. denied*, 302 So. 2d 417 (Fla. 1974); *see* Gluskin v. Atlantic Sav. & Loan Ass'n, 32 Cal. App. 3d 307, 315, 108 Cal. Rptr. 318, 323 (1973).

112. *See supra* text accompanying notes 78-82.

113. 18 Cal. App. 3d 1023, 96 Cal. Rptr. 338 (1971). It is curious that the court developed the conditional subordination theory to provide relief for the subordinated purchase money mortgage even though Turner v. Lytton Sav. & Loan Ass'n, 242 Cal. App. 2d 457, 51 Cal. Rptr. 552 (1966), had already been decided by a California court and relief could probably have been provided through the voluntary/obligatory doctrine. Oddly enough, however, *Turner* has not been cited by any subsequent California or other state court. For a discussion of the *Turner* decision, see *supra* text accompanying notes 94-99.

114. *Id.* at 1027, 96 Cal. Rptr. at 339.

115. *Id.* at 1028, 96 Cal. Rptr. at 341.

116. *Id.* at 1027, 96 Cal. Rptr. at 340.

117. *Id.*

118. *Id.* at 1029, 96 Cal. Rptr. at 341.

improve the property. The lender, though not a party to that agreement, was a third party beneficiary of the promise to subordinate. Because a portion of the funds was not applied to construction, the condition was not met, and, as a matter of contract law, the failure to meet the condition excused the subordinated purchase money mortgagee's performance with respect to the $300,000. The construction lender, as a third party beneficiary of that promise, could not enforce the promise to take a subordinate position because all defenses available against the promisee were available against the third party beneficiary.[119]

2. Situations and Standard of Lender Responsibility

It is initially necessary to analyze situations in which the conditional subordination theory will impose lender responsibility. It must be emphasized in this regard that *Middlebrook-Anderson* was decided by the court in a review of a granted motion to dismiss, and consequently, the court dealt with allegations of an *express* oral agreement that the subordination was only for advances that went into the project.[120] Therefore, the conditional subordination theory of *Middlebrook-Anderson* can be read to require an *express* condition between the developer and purchase money mortgagee before relief will be granted and priority denied to the lender. Such an express condition was alleged by the purchase money mortgagee in its complaint in *Middlebrook-Anderson*,[121] and it was on the assumption of such an express condition that the court of appeal found a cause of action through the conditional subordination theory. In the absence of such a condition, the conditional subordination doctrine would seemingly be of no use to the subordinated purchase money mortgagee.[122]

Thus explained, the limitations of the conditional subordination doctrine as a remedy for the subordinated purchase money mortgagee emerge. The difficult cases of construction lender-purchase money mortgagee dispute involve situations in which there is no express agreement as to the use of the funds. Instead, courts are faced with the purchase money mortgagee's unarticulated expectation that the funds will be administered in a conventional manner and the lender's unspoken acceptance of such an expectation. The conditional subordination doctrine in *Middlebrook-Anderson*, with its assumption of an

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119. *Id.* at 1033, 96 Cal. Rptr. at 344; *see* Restatement (Second) of Contracts § 309 (1981); Note, *Purchase Money Subordination Agreements in California: An Analysis of Conditional Subordination*, 45 S. Cal. L. Rev. 1109, 1113-16 (1972) [hereinafter cited as *Agreements in California*].

120. 18 Cal. App. 3d at 1033, 96 Cal. Rptr. at 344.

121. *Id.* at 1029, 96 Cal. Rptr. at 341.

122. *See* Gluskin v. Atlantic Sav. & Loan Ass'n, 32 Cal. App. 3d 307, 314, 108 Cal. Rptr. 318, 323 (1973).

express condition, fails to address these situations.[123] Only if courts are willing to imply a condition in the agreement to subordinate will the conditional subordination theory become more than a variation on the accepted doctrine that a lender is bound to monitor funds if there is an express agreement to do so.[124]

However, most courts have been unwilling to imply such a condition. It appears that close construction of language that provides for subordination to a "construction loan"[125] or to a loan "for the sole purpose of establishing improvements"[126] or other similar language[127] requires the conclusion that, as a simple maxim of contract interpretation,[128] the purchase money mortgagee intended to be subordinated only to what is commonly understood to be a construction loan—a loan in which the proceeds are used for the sole purpose of erecting improvements on real estate. Yet, every court that adopts the "general rule," imposing no duty on the lender to monitor advances, rejects such an argument sub silentio, and few cases recognize the possibility of implying a condition from such subordination language.[129]

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123. This factor of unarticulated expectations is not addressed by *Agreements in California*, *supra* note 119, at 1113-16, 1127 in its discussion of *Middlebrook Anderson*.

124. *See* cases cited *supra* note 23. Presumably, a purchase money mortgagee sophisticated enough to require an express condition from the developer could have requested such a promise from the lender and either received such a promise or a clear refusal of an obligation to monitor funds. The purchase money mortgagee would then be able to choose whether or not to subordinate.

125. Kennedy v. Betts, 33 Md. App. 258, 261, 364 A.2d 74, 76 (1976).

126. Fandel, Inc. v. First of Denver Mtge. Investors, 522 S.W.2d 721, 724 (Tex. Civ. App. 1975) (emphasis deleted).

127. G. Credit Co. v. Mid-West Land Dev., Inc., 207 Kan. 325, 326, 485 P.2d 205, 206 (1971) ("to any mortgage . . . for purposes of financing the improvements to be placed upon said property"); Cambridge Acceptance Corp. v. American Nat'l Motor Inns, Inc., 96 N.J. Super. 183, 189, 232 A.2d 692, 695 (Ch. 1967)("construction loan," "construction monies"), *aff'd sub nom.* Cambridge Acceptance Corp. v. Hockstein, 102 N.J. Super. 435, 246 A.2d 138 (App. Div. 1968); York Mtge. Corp. v. Clotar Constr. Corp., 254 N.Y. 128, 134, 172 N.E. 265, 267 (1930)(" 'building loan bond and mortgage' "); National Mtge. Corp. v. American Title Ins. Co., 261 S.E.2d 844, 845 (N.C. 1980)(" 'for the purpose of erecting certain improvements' "); *see* Forest Inc. v. Guaranty Mtge. Co., 534 S.W.2d 853 (Tenn. Ct. App. 1975).

128. Subordination agreements are usually strictly construed by the courts. *E.g.*, First Funding Corp. v. Birge, 220 Va. 326, 257 S.E.2d 861 (1979); Campanella v. Rainier Nat'l Bank, 26 Wash. App. 418, 612 P.2d 460 (1980).

129. See National Mtge. Corp. v. American Title Ins. Co., 299 N.C. 369, 375-76, 261 S.E.2d 844, 848 (1980), which involved a ground lessor who subordinated his interest to a loan " 'for the purpose of erecting certain improvements' " on the property. *Id.* at 371, 261 S.E.2d at 845. None of the advanced funds ended up in the property, and in a prior suit the subordination agreement had been voided. In this action by the lender against the title insurer, the court indicated that the above quoted language was a condition of subordination, and the subsequent misappropriation of *all* advances caused the nullification of the subordination agreement. There is some question, given the procedural posture of the case, whether these statements are dicta. Moreover, the question of what the result would have been if just a portion,

Therefore, the reach of *Middlebrook-Anderson* is limited. Unlike the voluntary/obligatory theory, conditional subordination does not begin with the assumption of lender responsibility; rather, it appears to require unequivocal purchase money mortgagee action by means of an express condition to ensure protection. Moreover, if an express condition is not involved, it seems more straightforward to control the lender's activities by placing a duty with respect to advances directly on the lender based on the interrelationship of the parties, rather than involving the developer by implying a condition between the developer and the purchase money mortgagee and then linking it to the lender by third party beneficiary theory. Nevertheless, in cases where an express condition does indeed exist, the conditional subordination

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rather than all, of the proceeds had been misappropriated remains open. Collins v. Home Sav. & Loan Ass'n, 205 Cal. App. 2d 86, 96, 22 Cal. Rptr. 817, 824-25 (1962), can be read as supporting implication of a condition that funds are to be used only for construction purposes. *See Agreements in California*, *supra* note 119, at 1118 n.35. While there is language that could be so viewed, however, the court's decision seemed to involve an incorporation, into a subsequent subordination agreement, of subordination language in a previous instrument which expressly limited use of funds. 205 Cal. App. 2d at 88, 92-93, 22 Cal. Rptr. at 819, 825. In Miller v. Citizens Sav. & Loan Ass'n, 248 Cal. App. 2d 555, 561, 56 Cal. Rptr. 844, 851 (1967), there is support for the position that a condition on the use of the funds should be implied in all subordination agreements. This could be deemed dictum, however, because the subordination language in the case was quite explicit in its restrictions on the use of funds. *Id.* at 558, 56 Cal. Rptr. at 847. *Miller* was adhered to in Ban-Co Inv. Co. v. Loveless, 22 Wash. App. 122, 134-35, 587 P.2d 567, 574-75 (1978). In Fandel, Inc. v. First of Denver Mtge. Investors, 522 S.W.2d 721, 724-25 (Tex. Civ. App. 1975), the sellers agreed that the language of their purchase money deed of trust requiring subordination to financing "for the sole purpose of establishing improvements" was incorporated by reference into a subsequent subordination agreement which contained no such express language. The court rejected this argument; one wonders, however, why the lender was not on notice of this provision by virtue of the recording of the purchase money deed of trust. This decision could be read to imply that if such language had been incorporated into the subordination agreement, it would have given protection to the purchase money mortgagee. In G. Credit Co. v. Mid-West Land Dev., Inc., 207 Kan. 325, 329-30, 485 P.2d 205, 208-09 (1971), the court affirmed a lower court's holding that expenses incidental and preliminary to construction were included within the scope of "for the purposes of financing the improvements" language in the subordination document. Apparently, the court viewed such language as implying some sort of a duty to monitor funds. In York Mtge. Corp. v. Clotar Constr. Corp., 254 N.Y. 128, 172 N.E. 265 (1930), the court found that when (1) the original amount of the loan was far from enough to erect improvements, (2) "not a dollar" was advanced to construction and (3) the only advances made were to pay off old liens and bonuses, the purchase money mortgagee did not intend to subordinate to such sums pursuant to language subordinating to a lien of a "building loan bond and mortgage." Still, this case seems to address a fraudulent or collusive situation, such as Cambridge Acceptance Corp. v. Hockstein, 102 N.J. Super. 435, 246 A.2d 138 (App. Div. 1968), discussed above, *supra* text accompanying notes 68-69, rather than a case of merely careless construction lender behavior.

approach prevents the promises of a buyer to a seller from being rendered meaningless.[130]

The response of the conditional subordination doctrine is also inadequate with respect to the second line of inquiry—the standard of lender behavior that is required once lender responsibility is found. Because the theory focuses on funding being used for improvements as a condition to the construction lender's priority, one must merely show that this condition has not been met with respect to certain advances and priority for such funds would be totally defeated. The *Middlebrook-Anderson* court does not give any weight to the reason behind the breach of the condition and consequently does not address the reasonableness of the construction lender's behavior with respect to the advances. As a result, the lender becomes a guarantor.[131] While this may be acceptable if a lender expressly agrees to such a role, it seems to be an inappropriate standard in cases where there is no express agreement to that effect.[132] Finding lender responsibility without inquiry into the cause of the loss and the behavior of the lender may lead to significant injustice.

3. Additional Concerns—Notice, Parol Evidence and the Condition

The extent to which courts will use the conditional subordination theory in conjuntion with third-party beneficiary theory to control a lender's behavior where the factors of notice to the lender and the nature of the condition are varied is a matter of speculation. With respect to notice, it is not clear whether the lender would be bound by an oral condition attached to a subordination agreement, or agreement to record second, if the lender had no knowledge of the condition. The court in *Middlebrook-Anderson* did not address whether the lender had actual notice of the condition or was under a duty to inquire if there were any conditions.[133] If the lender is without actual or record notice, or a duty to inquire, the reaction of a court could

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130. An approach which is conceptually related to conditional subordination is the use of the constructive trust device. Courts have held a foreclosing lender to be a constructive trustee in favor of a land seller where the lender knew of an agreement between the buyer and the seller restricting the buyer's activity on the property. *E.g.*, Dunson v. Stockton, Whatley, Davin & Co., 346 So. 2d 603 (Fla. Dist. Ct. App. 1977); Lawrence v. Cameron Sav. & Loan Ass'n, 395 S.W.2d 452 (Mo. 1965). Like conditional subordination, however, these cases require an express agreement between the developer and the seller, and specifically note that the lender had knowledge of such agreement.

131. If a court applying the conditional subordination theory did wish to move away from this guarantor status of the lender and focus on the underlying problems, it might be able to do so by the use of standard contract defenses to the performance of conditions, such as impossibility or impracticability.

132. *See infra* pt. III(B).

133. 18 Cal. App. 3d at 1029, 96 Cal. Rptr. at 341.

well be that the construction lender should be protected as a bona fide purchaser and should not be held to the condition.[134]

A related concern involves the applicability of the parol evidence rule to an oral condition, limiting subordination to funds used in construction, allegedly imposed upon the developer by the purchase money mortgagee. The *Middlebrook-Anderson* court did not address this issue, most likely because the subordination was achieved not by a written agreement but by an oral understanding that the purchase money mortgagee would wait and record after the lender and so allow the lender to have a prior lien.[135] In contrast, when faced with subordination achieved not by order of recording but by a written agreement, one court refused to allow such oral representations to vary the terms of what it found to be an "unambiguous" agreement.[136]

Furthermore, the nature of the condition may have some importance. Assume that, as a condition to subordination, the construction lender must be a federally chartered institution. Would the failure of the condition be used to deny a non-federally chartered lender priority upon foreclosure? Although, in this example, technical application of the conditional subordination theory might lead to loss of priority, such a result would miss the spirit underlying the use of the conditional subordination doctrine in *Middlebrook-Anderson*. While the *Middlebrook-Anderson* decision is framed in terms of conditional subordination, the opinion also recognizes that the heart of the matter is lender misbehavior in disbursement activities, which disappoints the seller's legitimate expectations and carelessly harms him. This recognition becomes evident when the opinion suddenly veers away from conditional subordination analysis and briefly frames the issue in terms of the existence of an implied duty to fairly apply funds, existing directly between the construction lender and the subordinated purchase money mortgagee.[137] This is the preferable form of analysis for

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134. *See* Roberts v. Harkins, 292 So. 2d 603 (Fla. Dist. Ct. App.), *cert. denied*, 302 So. 2d 417 (Fla. 1974); Dreckshage v. Community Fed. Sav. & Loan Ass'n, 555 S.W.2d 314, 322-23 (Mo. 1977); Comptroller of New York v. Gards Realty Corp., 68 A.D.2d 186, 416 N.Y.S.2d 821 (2d Dept. 1979); Miller, Starr and Regalia, *Subordination Agreements in California*, 13 U.C.L.A. L. Rev. 1298, 1310-11 (1966) [hereinafter cited as Miller].

135. *See supra* note 67.

136. Roberts v. Harkins, 292 So. 2d 603, 605-06 (Fla. Dist. Ct. App.), *cert. denied*, 302 So. 2d 417 (Fla. 1974). *But see* Collins v. Home Sav. & Loan Ass'n, 205 Cal. App. 2d, 86, 22 Cal. Rptr. 817 (1962).

137. "In the superior position of a financial institution constantly engaged in professional construction lending, [the lender] had no reason to believe [its] trust deed conferred any lien to which the fee was subordinate other than to the extent of money spent for construction purposes. Its loan under the circumstances cannot be viewed other than as subject to the fair application of the construction funds." 18 Cal. App. 3d at 1037, 96 Cal. Rptr. at 347. *Middlebrook-Anderson* has been cited as having been decided on this "implied obligation" theory. *E.g.*, Grenada Ready-Mix

courts dealing with such situations. While, in some cases, conditional subordination achieves appropriate results, its analytical framework prevents it from directly confronting the construction lender-subordinated purchase money mortgagee conflict.

C. *Lack of Consideration*

Another theory providing relief for a subordinated purchase money mortgagee is illustrated in a recent case[138] involving a ground lessor who subordinated her fee to a construction mortgage. Because none of the funds advanced under the construction mortgage were used to improve the property, the court found that there was "no consideration" for the subordination and that the lender, therefore, could not foreclose against the fee. The obvious questions flowing from this case are, what if one dollar had found its way into the project? Ten dollars? One thousand dollars? While the lack of consideration approach presents an opportunity for tantalizing numerical hypotheticals and does provide a safety valve to the "general rule" of lender priority for diverted advances,[139] the key inquiry should not focus on what percentage of the advanced funds did or did not find their way into the job, but how and why they were advanced. The lack of consideration approach fails as an analytical framework because it does not focus, at least on its face, on a lender's conduct. If the term "no consideration" is merely a shibboleth used by courts to reach a result based on other concerns, for example the reasonableness of lender's behavior, then perhaps it is acceptable. Still, because it is a doctrine not designed to address the construction lender-subordinated purchase money mortgagee dispute, the doctrine is cumbersome and

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Concrete, Inc. v. Watkins, 453 F. Supp. 1298, 1313 (N.D. Miss. 1978); Woodworth v. Redwood Empire Sav. & Loan Ass'n, 22 Cal. App. 3d 347, 363, 99 Cal. Rptr. 373, 384 (1971); Rockhill v. United States, 288 Md. 237, 243-44, 418 A.2d 197, 200 (1980). As discussed above, *supra* text accompanying note 119, the *Middlebrook-Anderson* court apparently relied on conditional subordination theory, rather than an implied duty.

138. Dugan v. First Nat'l Bank, 227 Kan. 201, 606 P.2d 1009 (1980); *accord* Levitz v. Capitol Sav. & Loan Co., 267 Mich. 92, 96-97, 255 N.W. 166, 168 (1934); *cf.* Rivers v. Rice, 233 Ga. 819, 821-22, 213 S.E.2d 678, 680-81 (1975) (finding sufficient consideration on the facts, but leaving open the possibility of a claim in the absence of such adequate consideration).

139. The following cases reject the "no consideration approach": Cambridge Acceptance Corp. v. American Nat'l Motor Inns, Inc., 96 N.J. Super. 183, 199-200, 232 A.2d 692, 701 (Ch. 1967), *aff'd sub nom.* Cambridge Acceptance Corp. v. Hockstein, 102 N.J. Super. 435, 246 A.2d 138 (App. Div. 1968); Pozar v. Kirby, 259 A.D. 455, 460-61, 19 N.Y.S.2d 634, 639 (1940); Fandel, Inc. v. First of Denver Mtge. Investors, 522 S.W.2d 721, 725 (Tex. Civ. App. 1975). Some statutes provide that consideration is not required for an enforceable subordination agreement. *E.g.*, N.Y. Gen. Oblig. Law § 5-1103 (McKinney 1980); *see* ULTA § 1-310(a).

contains certain technical traps which may yield an unacceptable result.[140]

D. *Direct Duty on Construction Lender*

A few courts have held that the construction lender owes the subordinated purchase money mortgagee a direct, independent duty to monitor advances. Furthermore, these courts have found this responsibility to arise specifically out of the relationship between the construction lender and purchase money mortgagee. While the lines of demarcation are often unclear, the theoretical underpinnings of these cases lie in tort concepts and contract theories. The difficult task is to initially find the requisite lender responsibility, either as a tort duty or a contract obligation. Ultimately, because the construction lender-subordinated purchase money mortgagee conflict exists in a twilight zone between the two doctrines, neither contract nor tort alone provides a satisfactory solution. The cases, therefore, need to be examined to determine their theoretical bases as well as their positive contributions to the search for a solution to the construction lender-subordinated purchase money mortgagee dispute.

1. Contract Theory

Under classic contract analysis, the doctrine of privity makes it difficult to find the lender directly obligated to the subordinated purchase money mortgagee with respect to disbursement of construction funds.[141] In the typical case, privity of contract is found to be lacking because the subordination agreement is executed only by the developer and the purchase money mortgagee, not the construction lender.[142] A case can be posited, however, for transcending these

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140. For example, if 90% of the funds are used in construction and 10% are used by the buyer for other purposes, due to lender's negligence, there may indeed be adequate consideration to enforce the agreement but, at the same time, grounds for a loss of priority due to the lender's failure to follow reasonable behavior.

141. *E.g.*, Gill v. Mission Sav. & Loan Ass'n, 236 Cal. App. 2d 753, 46 Cal. Rptr. 456 (1965); Matthews v. Hinton, 234 Cal. App. 2d 736, 44 Cal. Rptr. 692 (1965); Roberts v. Harkins, 292 So. 2d 603 (Fla. Dist. Ct. App.), *cert. denied*, 302 So. 2d 417 (Fla. 1974); *see* Miller, *supra* note 134, at 1308.

142. *E.g.*, Collins v. Home Sav. & Loan Ass'n, 205 Cal. App. 2d 86, 90, 22 Cal. Rptr. 817, 821 (1962); Rockhill v. United States, 288 Md. 237, 242, 418 A.2d 197, 198 (1980); Hyatt v. Maryland Fed. Sav. & Loan Ass'n, 42 Md. App. 623, 625, 402 A.2d 118, 120 (1979); Dreckshage v. Community Fed. Sav. & Loan Ass'n, 555 S.W.2d 314, 322-23 (Mo. 1977); *accord* Roberts v. Harkins, 292 So. 2d 603, 604 (Fla. Dist. Ct. App.), *cert. denied*, 302 So. 2d 417 (Fla. 1974); Brooklyn Trust Co. v. Fairfield Gardens, Inc., 260 N.Y. 16, 182 N.E. 231 (1932); *see supra* notes 51-54 and accompanying text (discussing *Brooklyn Trust*). *But see* Dugan v. First Nat'l Bank, 227 Kan. 201, 202-03, 606 P.2d 1009, 1012 (1980). In many cases it is not clear who signed. *E.g.*, Rivers v. Rice, 233 Ga. 819, 819-20, 213 S.E.2d 678, 679 (1975);

traditional boundaries in light of the special interrelationships involved in a development venture, and it can be argued that an "implied agreement" exists between the lender and purchase money mortgagee with respect to advances.[143]

A development venture involves numerous parties, all of whom are necessary to the successful completion of the project. Each has a discrete task to complete, knows that the others will be performing their own specific roles, and relies on their efforts so that the larger goal can be reached. Thus, when a seller agrees to subordinate to a construction loan in order to provide a necessary first lien for the lender and a lender knowingly accepts the benefit of the subordination, it seems clear that the parties intend a subordination to what is commonly understood to be a construction loan—that is, a mortgage made to provide funds for the sole purpose of improving real property, under which mortgage advances are made pursuant to commonly accepted construction lender practices so as to safeguard the use of the funds.[144] In this situation, the parties are aware of each other's existence and realize that they are entering into a symbiotic transaction in which each has a unique function to fulfill. Each party understands the expectations of the others, and these unarticulated expectations must be given effect.[145] To do otherwise would be to recognize an unreasonable manner of dealing.

It could be asserted, therefore, that when the various sub-relationships and agreements are blended and the transaction is taken as a whole, a fabric of promises and expectations emerge.[146] Despite this line of argument, the privity gap still yawns before the courts.

Moreover, since the implied agreement theory does not require application of a legal framework not specifically designed to address

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Cambridge Acceptance Corp. v. American Nat'l Motor Inns, Inc., 96 N.J. Super. 183, 189, 232 A.2d 692, 695 (Ch. 1967), *aff'd sub nom.* Cambridge Acceptance Corp. v. Hockstein, 102 N.J. Super. 435, 246 A.2d 138 (App. Div. 1968); Forest Inc. v. Guaranty Mtge. Co., 534 S.W.2d 853, 856 (Tenn. Ct. App. 1975); Fandel, Inc. v. First of Denver Mtge. Investors, 522 S.W.2d 721, 723 (Tex. Civ. App. 1975).

143. Privity does not create difficulties under the voluntary/obligatory doctrine since it is a function of the recording system, not contract. Moreover, the advantage of the conditional subordination approach is that it avoids the need for privity between the lender and the purchase money mortgagee by making the former the third party beneficiary of the agreement between the latter and the developer. If a lender promises the developer to monitor funds, then it could be argued that the purchase money mortgagee is a third party beneficiary, eliminating the privity problem. It is virtually inconceivable that the lender would make such a promise, however, as such activity is for its own benefit, not the developer's.

144. *See* Housing Mtge. Corp. v. Allied Constr., Inc., 374 Pa. 312, 317-18, 97 A.2d 802, 804 (1953).

145. A different situation may exist if the lender did not know of the existence of the purchase money mortgage. *See infra* note 180.

146. *See* Housing Mtge. Corp. v. Allied Constr., Inc., 374 Pa. 312, 319-20, 97 A.2d 802, 805 (1953).

the conflict, incongruous results based on technical application of a borrowed doctrine can be avoided. Additionally, because the theory focuses on the interrelationship of the parties, it has the requisite flexibility to deal with variations on the basic construction lender-subordinated purchase money mortgagee scenario and to determine whether lender responsibility is appropriate.[147]

A handful of cases appear to have placed an obligation on the construction lender to monitor advances based on an "implied agreement" theory rooted essentially in contract. In *Glencoe State Bank v. Cole*,[148] a purchase money mortgagee agreed to relinquish its first lien to a construction mortgagee by recording second. The lender recorded first and made advances, but only thirty percent of the funds so advanced were put into the project.[149] The court recognized that there was no express agreement between the subordinated purchase money mortgagee and the construction lender, but held that the lender had "impliedly placed itself under obligation in equity and good conscience to so apply all the proceeds of the loan to the costs of the building construction."[150] The court found such an obligation based on the fact that the construction lender knew that there was a purchase money mortgage and had informed the purchase money mortgagee that it would make a building loan if the purchase money mortgagee took a second position. Consequently, "equity and good conscience" mandated lender responsibility, and holding the lender to be under an obligation "was only fair and promotive of common justice."[151] The court seemed to be applying a contract model, referring to the "understanding" of the parties and stating that the construction lender had "impliedly agreed" to monitor funds.[152]

With respect to the issue of the standard of behavior to be used to judge the lender once responsibility is found, the *Glencoe* court held the construction lender to an absolute standard. The court spoke of an obligation to put all of the proceeds in the project, found that only thirty percent of the proceeds were so used, and thus awarded the construction lender priority for only the thirty percent.[153] The weak-

147. Consider Woodside v. Redwood Empire Sav. & Loan Ass'n, 22 Cal. App. 3d 347, 99 Cal. Rptr. 373 (1971), which is discussed above. *Supra* text accompanying note 80. In such a situation, it seems that there would be no legitimate expectation of lender responsibility with respect to the purchase money mortgagee.

148. 265 Ill. App. 158 (1932).

149. The purchase money mortgagee in *Glencoe* was a third-party purchase money mortgagee. *Id.* at 161; *see supra* note 44. This means that another party has been added to this symbiotic transaction.

150. 265 Ill. App. at 170.

151. *Id.*

152. The court varied from such contract based language, however, and stated that "equity imposed a duty on the mortgagee." *Id.*

153. *Id.* at 170, 172-73.

nesses of the *Glencoe* opinion lie, first, in its failure to recognize that the legitimate expectation of a purchase money mortgagee is not of a guarantee by the lender but of reasonable construction lender behavior with respect to advances, and second, in the consequent lack of examination by the court as to whether the funds were diverted due to failure to adhere to reasonable lender behavior.[154]

Only a few other cases have alluded to the existence of a contractual duty owed directly to the subordinated purchase money mortgagee by the construction lender.[155] None face the issue as squarely as *Glencoe*, nor do they rely on that court's reasoning as the foundation of their opinions. In *Housing Mortgage Corp. v. Allied Construction, Inc.*, there is some discussion of a "perfect understanding," apparently never made express, between the subordinated purchase money mortgagee, the construction lender and the developer, that the funds would be advanced as work was completed, pursuant to a schedule in the construction loan agreement between the developer and the construction lender.[156] In *Housing Mortgage*, however, it appeared that the purchase money mortgagee had seen the specific construction loan agreement, with its advance schedule, before agreeing to subordinate. Thus, despite broad language hinting at such a result,[157] the case did not involve implication of a duty merely from knowledge that a "construction loan" was being made.

Other courts have specifically rejected the implied agreement theory. In *Forest Inc. v. Guaranty Mortgage Co.*, the court held that a local custom that construction lenders were to advance funds only upon the completion of work was neither so imperative nor compulsory as to be binding in law, and that the construction lender owed no duty to the subordinated purchase money mortgagee to follow the custom.[158] If the court based its decision on a belief that the practices of Knoxville lenders differ from those of lenders elsewhere, the deci-

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154. Instead, the court only stated that "the record is silent as to what became of the remainder of the loan except that it went to [the borrower] and was presumably used by him for other purposes." *Id.* at 170.

155. *See supra* note 137 and accompanying text. *But see* Cambridge Acceptance Corp. v. Hockstein, 102 N.J. Super. 435, 438, 246 A.2d 138, 140 (App. Div. 1968) (rejecting the implied contract theory), *aff'g* Cambridge Acceptance Corp. v. American Nat'l Motor Inns, Inc., 96 N.J. Super. 183, 203, 232 A.2d 692, 703 (Ch. 1967).

156. 374 Pa. 312, 318-19, 97 A.2d 802, 805 (1953); *see supra* text accompanying notes 100-07.

157. "When [the purchase money mortgagee] agreed that [the construction lender] should have the right to place construction loans on the property, the liens of which by proper stipulation should be made prior to the lien of his purchase money mortgage, he obviously meant by the term 'construction loans' what is ordinarily understood thereby, namely, loans to be advanced as the building operations progressed." *Id.* at 317-18, 97 A.2d at 804.

158. 534 S.W.2d 853, 856 (Tenn. Dist. Ct. App. 1976).

sion might be sensible. If this was not the basis of the decision, however, it is hard to understand how such a local custom fails to fall within a definition of reasonable construction lender behavior and the concept of the legitimate expectation of the purchase money mortgagee.[159]

2. Tort Theory

A second approach which has been discussed by some courts in the effort to find a duty that the construction lender owes directly to the subordinated purchase money mortgagee revolves around a negligence theory based in tort. The difficulty with this approach has been with respect to the threshold issue of establishing any duty whatsoever on the lender. However, this negligence-based approach, because it holds the lender to reasonable lender behavior, has much to offer with respect to the question of the standard by which the lender will be judged once responsibility is found.

The negligence theory has been specifically rejected by a number of courts. In *Gill v. Mission Savings and Loan Association*,[160] the court refused to impose a duty on a construction lender to manage advances so as not to injure the subordinated purchase money mortgagee, finding that in the absence of privity there were no circumstances motivating imposition of a duty on the basis of public policy. After quoting the California test of imposition of tort duty in the absence of privity,[161] the court held that no moral blame attached to the lender's conduct and that the law need not intervene since the harmed party could protect itself in the future. Leaving aside subsequent California decisions which have found construction lender liability under this test on arguably less lender wrongdoing,[162] the court excused a great deal in saying that no moral blame attaches to the lender. It is difficult to comprehend how a construction lender, knowing that someone has relinquished a preferred position to it and fully aware that this party is looking to the property for security, can be permitted to act without reasonable care with respect to the security and not be the subject of moral blame. With respect to the issue of future prevention of harm, the court's rationale fails to consider the question of which party is better equipped to recognize and raise the diverted advances issue.[163]

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159. *See infra* text accompanying notes 220-223.

160. 236 Cal. App. 2d 753, 46 Cal. Rptr. 456 (1965).

161. *Id.* at 754, 46 Cal. Rptr. at 459 (quoting Biakanja v. Irving, 49 Cal. 2d 647, 650, 320 P.2d 16, 19 (1958)).

162. *E.g.*, Connor v. Great W. Sav. & Loan Ass'n, 69 Cal. 2d 850, 73 Cal. Rptr. 369 (1968).

163. *See infra* text accompanying notes 189-93.

There seems to be a great deal of ambivalence by other courts with respect to the adoption of a negligence standard. Although purporting to reject this approach, some cases make statements which can only be understood as approving of a standard of reasonable care.[164] In *Cambridge Acceptance Corp. v. Hockstein*,[165] the court specifically declared that the lender was not liable for "mere negligence" but then stated that equitable principles required advances to be made "in the conventional manner . . . rather than mask what is essentially a loan on the general credit . . . as a construction loan."[166] The words "conventional manner" can be analogized to the "reasonable man" of negligence theory, and *Cambridge Acceptance* has indeed been viewed by one court as requiring a duty of reasonable care on the lender with respect to disbursements.[167] Despite its broad language, however, *Cambridge Acceptance* might stand for no more than the statement of the "general rule" that lender priority will be lost if there is collusion with the developer in diverting the funds.[168]

While some courts have rejected placing a tort-based duty upon the construction lender because of an insufficient theoretical foundation, other courts have imposed a negligence-type obligation to follow a reasonable lender standard without clearly indicating the source of this duty.[169] Thus, lenders are criticized for making advances "carelessly and wrongfully,"[170] and for not "administering the loan in its typical[ly] prudent manner" of requiring "documented evidence" and "inspections" to ascertain if the funds were being used in the project by the borrower.[171] Though this leap of faith may be troubling for

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164. *E.g.*, Grenada Ready-Mix Concrete, Inc. v. Watkins, 453 F. Supp. 1298, 1314 (N.D. Miss. 1978)(rejecting a duty on lender but then stating that Mississippi supports "priority of mortgagees who exercise ordinary care in the disbursement of their funds"); Dugan v. First Nat'l Bank, 227 Kan. 201, 202-08, 606 P.2d 1009, 1015-16 (1980) (holding lending institution to standard of reasonable care).

165. 102 N.J. Super. 435, 246 A.2d 138 (App. Div. 1968).

166. *Id.* at 440, 246 A.2d 141.

167. Fikes v. First Fed. Sav. & Loan Ass'n, 533 P.2d 251 (Alaska 1975). That case dealt with a contract vendee, rather than a subordinated purchase money mortgagee, and does not clearly indicate whether the lender's responsibility arises from contract, tort or other theory.

168. *See supra* text accompanying notes 23, 68-69.

169. *E.g.*, Fikes v. First Fed. Sav. & Loan Ass'n, 533 P.2d 251 (Alaska 1975). See Equitable Sav. & Loan Ass'n v. Hewitt, 67 Or. 280, 135 P. 864 (1913); First Nat'l Bank v. Virden, 45 So. 2d 268, 270-71 (Miss. 1950); Houston Lumber Co. v. Skaggs, 613 P.2d 416 (N.M. 1980), which deal with mechanics' claims but apply a negligence standard. Rockhill v. United States, 288 Md. 237, 418 A.2d 197 (1980), and Grenada Ready-Mix Concrete, Inc. v. Watkins, 453 F. Supp. 1298 (N.D. Miss. 1978), attempt to distinguish the mechanics' liens of *Virden* from purchase money mortgages and ground lease reversions.

170. Equitable Sav. & Loan Ass'n v. Hewitt, 67 Or. 280, 283, 135 P. 864, 865 (1913).

171. Fikes v. First Fed. Sav. & Loan Ass'n, 533 P.2d 251, 261 (Alaska 1975).

some courts, a negligence-based, reasonable lender standard is an appropriate test of a lender's behavior.[172]

The difficulty with a strict tort approach, however, lies in the fact that the framework of tort doctrine might lead to some results which would be inappropriate in the construction lender-subordinated purchase money mortgagee conflict. For example, an application of a tort damage doctrine might permit claims by the purchase money mortgagee for damages that exceed the total amount of advances which were negligently made. Such an award would seem inappropriate and excessive in what is essentially a dispute over lien priorities in real property.

III. A Suggested Approach

A. *Source of the Lender's Responsibility*

The foregoing examination of the "general rule" and the efforts of some courts to ameliorate its effect has highlighted the theoretical and practical problems of these various positions. It is submitted that courts should adopt an alternate approach. Under this suggested rule of decision, a construction mortgage would be denied priority over a subordinated purchase money mortgage for advances by the construction lender which were not used by the borrower in the project if, at the time of the making of such advances, the lender failed to follow reasonable construction lender behavior to ascertain and ensure that the advances were being used by the borrower to improve the property.[173] The application of this standard is mandated by the equitable principles of mortgage and foreclosure law, the legitimate expectations of the purchase money mortgagee, and other significant policy concerns.[174]

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172. *See infra* pt. III(B).

173. Once such a duty is found, it will have to be determined what expenses paid by the developer will or will not be considered to be sufficiently related to the development so as to be protected. *See* G. Credit Co. v. Midwest Land Dev., Inc., 207 Kan. 325, 485 P.2d 205 (1971) (incidental and preliminary expenses insufficiently related); York Mtge. Corp. v. Clotar Constr. Corp., 254 N.Y. 128, 172 N.E. 265 (1930)(liens and bonuses insufficiently related). In the absence of contrary language, the court should include only those expenses which are normally paid out of construction loan funds.

174. It may be asked whether the responsibility of the lender should apply not only to a subordinated purchase money mortgagee but also to a third party who also places a second mortgage, unrelated to a purchase transaction, on the property after the construction mortgage has been recorded. While a complete response to this question involves issues outside the scope of this Article, the brief answer is that lender responsibility should not be imposed with respect to non-purchase money junior mortgages. First, there has been a recognition by the courts that a purchase money mortgage is something more than a loan, in that it is linked to an exchange of ownership of the property. *E.g.*, Mandelino v. Fribourg, 23 N.Y.2d 145, 242 N.E.2d

1. Principles of Equity

The struggle of some courts to characterize the lender's responsibility as lying in contract or tort has numerous theoretical problems and, ultimately, such a line of inquiry seems unproductive. The alternate approach to lender responsibility, suggested by this Article, is grounded in the law of foreclosure. Foreclosure is a function of the law of equity and is subject to the courts' application of broad equitable concepts in determining the parties' relative priorities and rights in order to achieve fairness and justice.[175] While such doctrines are

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823, 295 N.Y.S.2d 654 (1968); DHNH Realty Corp. v. Marino P. Jeantet Residence for Seniors, Inc., 105 Misc. 2d 690, 693, 432 N.Y.S.2d 829, 831 (Sup. Ct. 1980); *see* N.J. Stat. Ann. § 17:9A-70 (West 1963). Thus, it seems to be recognized that a purchase money mortgagee has a greater bundle of rights than an ordinary mortgagee. Moreover, the case of the purchase money mortgagee should be distinguished from other subsequent mortgagees because the latter cannot be said to have the same legitimate expectation of responsible construction lender care that the subordinated purchase money mortgagee has. A subsequent mortgagee is not a party to the original transaction and does not forego any priority for the benefit of the construction lender. Rather, the subsequent encumbrancer is an outsider to the transaction who would be receiving the benefit of a duty on the lender to monitor by the unilateral action of placing a mortgage on the realty. Contrast this with a third party mortgagee who formed an integral part of the transaction from the beginning and who relinquished rights in exchange for the lender's duty to monitor the disbursement of funds. *See supra* note 149.

175. Major Capital Corp. v. 4487 Third Ave. Corp., 15 Misc. 2d 1052, 182 N.Y.S.2d 848 (Sup. Ct. 1959), is noteworthy in this regard because it applies principles of equity and fairness at foreclosure to a priority dispute between two mortgagees. The foreclosing second mortgagee claimed priority over a third mortgagee, who had subordinated its prior mortgage to that of the foreclosing mortgagee, for payments by it on account of the first mortgage, taxes and insurance premiums. The court evaluated such payments by means of an inquiry into whether they were "equitable and fair." *Id.* at 1055, 182 N.Y.S.2d at 853. The court also stated "[i]t should not be forgotten that a foreclosure action is an equitable one. The court should 'direct its officer to act in accordance with fairness and equity'." *Id.*, 182 N.Y.S.2d at 852-53 (quoting Lane v. Chantilly Corp., 251 N.Y. 435, 437, 167 N.E. 578, 579 (1929)). Security Nat'l Bank v. Village Mall at Hillcrest, Inc., 85 Misc. 2d 771, 382 N.Y.S.2d 882 (Sup. Ct. 1976), is similarly interesting as it deals with a conflict between a foreclosing construction lender having a first lien and condominium contract vendees seeking to deny the construction lender's priority. The court noted that foreclosures invoked equity jurisdiction, and "bases for equitable relief, *viz.*, bad faith, injustice, unfairness, unconscionable conduct" must be considered. *Id.* at 789, 382 N.Y.S.2d at 895; *accord* Harbel Oil Co. v. Superior Ct., 86 Ariz. 303, 306, 345 P.2d 427, 431 (1959) ("[T]he foreclosure of a mortgage is an equitable proceeding, and in this case the court of equity has the obligation to weigh and consider such defenses as laches, estoppel, fraud, lack of equity . . . ."); Cummins v. Bank of Am., 17 Cal. 2d 846, 112 P.2d 593 (1941) (similar language); Hartford Fed. Savs. & Loan Ass'n v. Lenczyk, 153 Conn. 457, 463, 217 A.2d 694, 697 (1966) ("Foreclosure is peculiarly an equitable action, and the court may entertain such questions as are necessary to be determined in order that complete justice may be done."); State *ex rel.* Brigance v. Smith, 345 Mo. 793, 796, 135 S.W.2d 355, 359 (1940)(similar language); Murphy v. Fox, 278 P.2d 820, 825-26 (Okla. 1955)(same);

quite amorphous, it is difficult to understand how a court in applying such principles could ignore the fact that an irresponsible act by the lender with regard to advances will destroy the subordinated purchase money mortgagee's position and that the latter is unable to prevent this loss. This is to be contrasted with other risks of the project where the purchase money mortgagee is in a position to prevent the loss and thus should not be allowed to look to the lender for rescue if such problems occur.[176]

The issue, therefore, should be viewed as essentially a question of the efficacy of a specific type of mortgage to secure future advances, and the amount secured thereunder, in conflict with other encumbrances on the property. In other areas of mortgage law, obligations have been established on mortgagees as prerequisites to the priority of their liens; similarly, conditions can be placed on the construction lender's priority. Consider, for example, a lender who provides funds to enable a mortgagor to purchase realty and, as a consequence, is granted a priority over a prior mortgagee possessing a lien that purports to include property subsequently acquired by the mortgagor. The subsequent lender is not awarded this priority as a matter of course. Instead, a number of conditions are attached to the receipt of such extraordinary treatment.[177] Another illustration involves the duty that the courts impose on a senior mortgagee who takes possession of the security to make an accounting to junior mortgagees for funds that it collects.[178] This approach recognizes that many parties look to the land as security and that the first mortgagee, although possessing a senior lien, cannot act irresponsibly with respect to these parties. It also lends support to a recognition of the construction

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First Nat'l Bank v. Haymond, 89 Utah 151, 156, 57 P.2d 1401, 1405 (1936)(same); *see* Glencoe State Bank v. Cole, 265 Ill. App. 158, 170 (1932); Iowa Loan & Trust Co. v. Plewe, 205 N.W. 358, 361 (Iowa 1925), *superseded by* 202 Iowa 79, 209 N.W. 399 (1926).

176. *See supra* notes 60-61 and accompanying text. Other examples of losses that the purchase money mortgagee and the construction lender are capable of preventing are those wherein (1) the estimate of the amount of funds necessary to complete the project is too low and the project is not completed, *see supra* text accompanying note 98, (2) the project is poorly conceived or located and yields insufficient income or sales to pay the sums due on the debt, and (3) the developer simply is unable to carry out the project. *See, e.g.*, Dreckshage v. Community Fed. Savs. & Loan Ass'n, 555 S.W.2d 314 (Mo. 1977).

177. For example, it must be proven that there was an agreement that the money was to be loaned only for this purpose. 4 American Law of Property, *supra* note 10, § 16.101E, at 220; 2 G. Glenn, *supra* note 23, § 349, at 1448; G. Osborne, G. Nelson & D. Whitman, *supra* note 81, § 9.1, at 574.

178. 4 American Law of Property, *supra* note 10, § 16.98, at 186 n.1; 3 R. Powell, Real Property ¶ 454 n.17, at 691 (P. Rohan ed. 1979); *see infra* text accompanying note 235. Admittedly, a mortgagee taking possession is an extraordinary event, and a position, with its attendant responsibilities, that a mortgagee voluntarily assumes.

lender's responsibility to protect the interest of the subordinated purchase money mortgagee.

Reliance on the law of mortgages and lien priority, as opposed to contract and tort, serves to transcend the claims of lack of privity between the lender and purchase money mortgagee.[179] At the same time, however, the lender's notice of the subordinated purchase money mortgage becomes significant. In most cases, notice seems likely.[180] When the lender has no notice of the subordinated purchase money mortgagee, however, it may not be appropriate to hold the lender responsible to the subordinated purchase money mortgagee for diverted advances because the lender was not aware that its behavior could harm another, nor did it knowingly accept the benefit of the subordination transaction.[181]

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179. *See supra* text accompanying notes 141-46.

180. In most cases it seems likely that at the time the construction lender receives its construction mortgage it will have actual notice of the fact that there will be a subordinated purchase money mortgage from discussions with the developer and the purchase money mortgagee. Moreover, in many other cases it will be clear that the lender has notice of the existence of a subordinated purchase money mortgagee from the record because, in cases where a previously recorded purchase money mortgage is being made subordinate, the prior mortgage and subordination document will be shown on record. *See supra* note 7. However, in situations where the purchase money mortgagee agrees to take a junior position by simply waiting to record until the construction mortgage has been recorded, *see supra* note 7, there may be no record notice. It is possible, though, that a court could find the construction lender had inquiry notice if it holds that the lender was fixed with a duty, arising if the records indicate that the developer had not yet obtained title or because of other circumstances, to inquire as to how transfer of, and payment for, the property would be made. Even without such inquiry notice, a lender could subsequently gain notice of such a subordinated purchase money mortgage if it receives an updated title report before making advances; such report is likely to be required in most transactions. Moreover, it is possible that the lender could be found to have record notice of a purchase money mortgage recorded after the construction mortgage, though under the voluntary/obligatory rule this is a minority view. *See* 2 G. Gilmore, *supra* note 10, § 35.4, at 927; *supra* note 81. In any case, even if the lender is found to have acquired notice after receiving its construction mortgage, there is some question as to whether an obligation with respect to advances should be required because, although the lender may have been aware that another party would be harmed by its actions, it did not knowingly accept the benefit of subordination. *See supra* note 174; *infra* text accompanying note 181.

181. Courts may be troubled, however, if an order of recording subordination and an assertion of lack of notice are used to subvert the standard of behavior suggested herein. In such a case, the court may be willing to take a broad view of inquiry notice. *See supra* note 180. Alternatively, it may look to the conditional subordination theory and imply a condition between the purchase money mortgagee and developer based on legitimate expectations, *see supra* text accompanying notes 122-29, and try to enforce it against the lender despite possible objections that the lender as a bona fide purchaser should not be bound. *See supra* note 134 and accompanying text.

2. Legitimate Expectations

The recognition of a lender's responsibility to use reasonable construction lender practices to monitor advances is mandated not only as a function of a court's application of equitable principles to resolve an unforeseen dispute, but also by the legitimate, though unarticulated, expectation of the purchase money mortgagee that the lender will follow such standards to oversee the use of the funds. This expectation arises for two reasons. First, a "construction loan" is generally accepted as a loan the proceeds of which are used to develop real property and during the term of which the construction lender, as a matter of course, will follow a procedure of monitoring advances to achieve a rise in the value of the realty serving as security corresponding to the increase of the outstanding debt.[182] A claim that the subordination document is "silent" as to the imposition of a responsibility on the lender, because it contains no express provision, is spurious; once the parties understand that a "construction loan" is involved, there is in actuality no "silence" as to the existence of lender responsibility because of the type of behavior associated with the term "construction loan."

Furthermore, the purchase money mortgagee has forgone a superior position to enable the construction lender to obtain a prior lien and, therefore, can legitimately expect that the lender, in accepting such a benefit, will follow reasonable behavior so as not to erode the newly adopted subordinate position.[183] Otherwise, it would be difficult to understand the decision to subordinate by the seller and the acceptance of the benefit of subordination by the lender. Moreover, it cannot be seriously contended that the lender is unaware of this legitimate expectation of the purchase money mortgagee.[184] These recognized legitimate expectations must be given effect.[185]

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182. *See* Restatement (Second) of Contracts § 20(2) (1981); *supra* notes 125-29, 144, 155-57 and accompanying text.

183. Where the subordinated purchase money mortgagee can prevent the loss, there should be no legitimate expectation of lender responsibility. *See supra* text accompanying note 176.

184. *See supra* note 10 and accompanying text. Indeed, in most cases, the lender itself has indicated an expectation of reasonable lender behavior by adopting internal controls over disbursements. *See supra* note 9 and accompanying text.

185. In other areas of mortgage law, special rules of priorities are developed in order to account for just expectations. Consider the justification offered for the special priorities granted to purchase money mortgagees. *See* 4 American Law of Property, *supra* note 10, § 16.106E, at 225 ("The other answer justifies the doctrine on the equity and justice of protecting one who has parted with his property on the faith of having a security interest in it until the money for which he was exchanging it is received . . . ."); *supra* note 177 and accompanying text (lender financing acquisition of land). For a discussion of the importance of giving effect to legitimate expectations in modern property law, see Javins v. First Nat'l Realty Corp., 428 F.2d 1071 (D.C. Cir.), *cert. denied*, 400 U.S. 925 (1970).

3. Additional Policy Concerns

Denial of priority for diverted advances when the lender has not used reasonable care is supported by various policy considerations. First, recognition of a responsibility on the lender for advances with respect to the purchase money mortgagee is unlikely to increase the lender's activity or to impose any additional expense on the lender in its day-to-day activities.[186] The construction lender should use, as a matter of course, reasonable care to monitor the advances for its own protection, which, in the case of an institutional lender, redounds to its depositors, shareholders and other investors.[187] Because part of the lender's return presumably includes a portion for its expenses, the developer has already paid the expense of such policing activities.[188]

Second, an initial imposition of duty gives the construction lender an opportunity to specifically raise the issue of responsibility with respect to advances during negotiations and attempt to reach an express agreement absolving the lender of such responsibility. If the subordinated purchase money mortgagee, having been made aware of the issue, expressly chooses to release the construction lender, then such action should normally be binding on the subordinated purchase money mortgagee.[189] The placing of the burden to alter the status quo on the lender, rather than on the purchase money mortgagee, is desirable since it is likely that construction lenders, as specialists, would be aware of the issue and more likely to raise it. On the other hand, while some purchase money mortgagees have the requisite level of sophistication to focus on the problem, the amount of litigation in the area illustrates that many have failed to articulate their expectation of reasonable lender behavior to obtain a sufficiently clear express

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186. Of course, there is an additional potential liability for failure to follow such standards. Moreover, title insurance will likely be of no assistance to the lender because it will not protect against acts of the insured. *See* National Mtge. Corp. v. American Title Ins. Co., 299 N.C. 369, 373, 261 S.E.2d 844, 847-48 (1980).

187. Middlebrook-Anderson Co. v. Southwest Sav. & Loan Ass'n, 18 Cal. App. 3d 1023, 1037, 96 Cal. Rptr. 338, 346-47 (1971); 4 American Law of Property, *supra* note 10, § 16.106D, at 218; Note, *Subordination of Purchase-Money Security*, 52 Cal. L. Rev. 157, 157-58 n.5 (1964); *see* authorities cited *supra* note 9.

188. It has also been suggested that lenders are good "risk spreaders" and thus it is appropriate to place a duty on them as such. Middlebrook-Anderson Co. v. Southwest Sav. & Loan Ass'n, 18 Cal. App. 3d 1023, 1037, 96 Cal. Rptr. 338, 346-47 (1971). While lenders may indeed be good "risk spreaders," the weight of such a factor in fixing liability is a debatable point.

189. Such waiver would have to be clear. *See* National Bank v. Equity Investors, 81 Wash. 2d 886, 908-09, 506 P.2d 20, 34 (1973) (example of language clearly indicating to a subordinating purchase money mortgagee that the lender will not be responsible for diverted advances); *supra* note 49 and accompanying text. Some courts may attempt to police lender "overreaching" in obtaining waivers. *See* Woodside Savs. & Loan Ass'n v. Minisink Homes, Inc., 51 A.D.2d 593, 594, 378 N.Y.S.2d 779, 780 (1976).

agreement.[190] As a result of the suggested approach of this Article, the parties will be more likely to confront the issue expressly, and the socially desirable outcome of having the parties control their actions through an articulated, express agreement, rather than being subjected to a solution imposed by the law, will be achieved. Moreover, an additional policy concern may be given effect if articulated agreements reduce the amount of litigation centering on conflicts between construction lenders and subordinated purchase money mortgagees.

Reference to various mechanic's lien statutes offers support for shifting the burden to raise the issue of diverted advances to the lender. The position of such statutes is that a mechanic is entitled to obtain a lien on the realty for work performed or materials provided. While this right or the lien itself may be waived in numerous jurisdictions,[191] waiver by the mechanic is only permitted if such waiver is clear and unambiguous.[192] Thus, the party seeking the waiver must clearly raise the issue. The result of this requirement is a reduction of the possibility that the mechanic will unknowingly lose his lien on the property.[193] Similarly, the expectation of a purchase money mortgagee that his security will not be devalued by a construction mortgage should not be rendered meaningless without clear agreement thereto by the purchase money mortgagee.

Finally, it has been asserted that a duty should not be imposed upon the construction lender since it would introduce "uncertainty" because of the possibility that the construction mortgage could be reduced to second priority.[194] This concern, however, is unrealistic. First, despite the alleged "certainty" of the "general rule," there is always the "uncertainty" that a particular court might adopt one of the theories that provide relief for the seller. Lenders' positions may well be more secure if they are forced to confront the issue and attempt to negotiate it away, rather than relying on what is, at best, an ambiguous doctrine. It is at least possible that substitution of a reasonable lender standard for the present ambiguities in the law may increase lender confidence.[195] Substitution of the standard suggested

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190. *But see* Gill v. Mission Sav. & Loan Ass'n, 236 Cal. App. 2d 753, 46 Cal. Rptr. 456 (1965).

191. G. Osborne, G. Nelson & D. Whitman, *supra* note 81, § 12.4, at 740-41.

192. *See* Benner-Williams, Inc. v. Romine, 200 Kan. 483, 485, 437 P.2d 312, 314 (1968); Maryland Brick Co. v. Spilman, 76 Md. 337, 344-45, 25 A. 297, 299 (1892); Skidmore v. Eby, 57 N.M. 669, 671, 262 P.2d 370, 374 (1953); N.Y. Lien Law § 34 (McKinney Supp. 1980-1981).

193. But see Uniform Simplification of Land Transfers Act (USLTA) § 5-214 & comment (1978), which state that, while a waiver must be knowing, ambiguities will be construed against the mechanic.

194. *E.g.*, Rockhill v. United States, 288 Md. 237, 252, 418 A.2d 197, 204 (1980).

195. The familiar negligence type of rule proposed herein is more attractive than the technicalities and vagaries of the voluntary/obligatory rule and the unpredictability of a "no consideration" approach.

herein for the uncertainty of some of the other doctrines used by the courts to provide relief to subordinated purchase money mortgagees may result in a reduction of construction lenders' hesitation to allow subordinate purchase money mortgages on property on which they are making construction loans; this hesitation may result in a failure to improve land because of the lack of funds to make the initial land purchase.

Moreover, if the standard of behavior proposed herein yields "uncertainty," then it can be argued that much of the law of torts is similarly uncertain, since both articulate a general standard of behavior to be applied to specific situations as they arise. Yet, one can hardly think of "uncertainty" serving as the basis for the abolition of the law of torts.

B. *Standard of Behavior*

Once the responsibility of the construction lender is established, the standard against which its activity will be tested requires further elaboration. The lender should be required to take only reasonable construction lender precautions with respect to monitoring advances. The lender should not be held to a strict liability or guarantor standard which would require all funds to be used in the project regardless of the circumstances under which they were diverted. The proposed standard is flexible, requiring consideration of the particular events causing the loss and measuring it against reasonable behavior generally followed in the industry. Thus, for example, if a construction lender advances funds without requiring any written funding requests and on-site inspections, it would appear that he has failed to adopt reasonable lender behavior.[196] If, however, the lender has taken reasonable precautions and set up appropriate safeguards, but a fraud was perpetrated on the lender with respect to the work actually being done that such reasonable safeguards could not reveal, then no loss of priority would be required.[197] A more difficult case would be posed if a lender lessened to some extent its usual monitoring procedures on a particular project because it had dealt with the borrower previously and had found him to be extremely reliable in his application of funds. Depending on the type of procedures followed by the lender in such a case, the method by which the funds were misappropriated,

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196. *See* Fikes v. First Fed. Sav. & Loan Ass'n, 533 P.2d 251, 261 (Alaska 1975). *But see* Forest Inc. v. Guaranty Mtge. Co., 534 S.W.2d 853, 856 (Tenn. Dist. Ct. App. 1975).

197. *Cf.* J.I. Kislak Mtge. Corp. v. William Matthews Builder, Inc., 287 A.2d 686 (Del. Super. 1972), *aff'd*, 303 A.2d 648 (Del. 1973) (dealing with a mechanic's claim rather than a subordinated purchase money mortgagee). Because the fraud was perpetrated by an employee of the lender, there may be a basis for finding the lender itself responsible in a case such as *Kislak*.

and other factors, such lender behavior might indeed be deemed acceptable.[198]

There are several reasons for adopting a reasonable care as opposed to a strict liability standard. First, because the dispute should be viewed as one involving the application of equitable principles in a foreclosure context, the ambiguous nature of the subordinated purchase money mortgagee cannot be ignored.[199] While it seems appropriate to make the construction lender responsible for negligent behavior so as to protect the precarious position of the subordinated purchase money mortgagee, the fact that the subordinated purchase money mortgagee is a knowing participant in an entrepreneurial venture requires that the purchase money mortgagee share the risks and losses from unexpected and extraordinary events. The reasonable behavior standard seems a fair balance to strike. Reference to the purchase money mortgagee's legitimate expectation yields further support for a reasonable lender standard. The purchase money mortgagee has a right to expect that the lender, when accepting the benefit of subordination, will carry on its unique role in this symbiotic transaction in a professional, responsible manner. While the subordinated purchase money mortgagee can expect that the lender not act carelessly in its endeavors, however, there is no basis for an expectation that the lender alone is underwriting the success of the project and that it alone should bear a loss not due to its negligence.

IV. The Uniform Land Transactions Act Perspective

The Uniform Land Transactions Act (ULTA), dealing with transfers and mortgaging of real estate, has an impact on the issue of the responsibility of a construction lender to monitor advances.[200] First, the Act abolishes the voluntary/obligatory rule in the construction mortgage context without expressly requiring reasonable lending be-

198. Other factors which might have an impact on the level of safeguards in order to meet a reasonableness test may include, *inter alia*, the amount of the loan, the complexity of the project, and actual building exigencies.

199. *See supra* text accompanying notes 24-28.

200. The Uniform Land Transactions Act was approved by the National Conference of Commissioners on Uniform State Laws in 1975, and a number of amendments were approved by the National Conference in 1977. *See generally* Bruce, *An Overview of the Uniform Land Transactions Act and the Uniform Simplification of Land Transfers Act*, 10 Stetson L. Rev. 1 (1980); Bruce, *Mortgage Law Reform Under the Uniform Land Transactions Act*, 64 Geo. L.J. 1245 (1976); Kratovil, *The Uniform Land Transactions Act: A First Look*, 49 St. John's L. Rev. 460 (1975); Kuklin, *The Uniform Land Transactions Act: Article 3*, 11 Real Prop., Prob. & Tr. J. 12 (1976); *Summary of the Uniform Land Transactions Act*, 13 Real Prop., Prob & Tr. J. 672 (1978). The ULTA provides a new vocabulary, with the mortgagor being the "debtor," the mortgagee being the "secured creditor," and the mortgage being a "security interest." ULTA §§ 3-103(3), (5), (7) (1978).

havior. Thus, under the ULTA, this theory is no longer available to courts to provide relief for subordinated purchase money mortgagees. At the same time, however, various sections of the more general provisions of the ULTA lend support to the imposition of a standard of reasonable lender behavior with respect to advances.

A. *Mortgage Priority Provisions*

Under the ULTA, a holder of any type of mortgage to secure future advances will receive priority over intervening security interests to the extent of subsequent advances made pursuant to a "commitment" not exceeding the maximum amount stated in the record.[201] If advances are not made pursuant to a "commitment," the lender will have priority dated as of the initial recording date of the security interest only for advances made before the lender had actual knowledge of the intervening interest.[202] The "commitment" requirement represents a limited departure from the classic voluntary/obligatory doctrine and its generally accepted test of contract compulsion. A lender under the ULTA can continue to advance funds notwithstanding a default by the borrower and even though the loan documents provide that the borrower not be in default as a condition to each advance.[203] The effect of this provision is to prevent the safeguards established by the lender from being asserted against it. The ULTA, however, retains aspects of the traditional rule. The ULTA requirement that the lender be "bound" to make an advance in order for it to be found to have been made "pursuant to a commitment" does resemble the voluntary/obligatory rule and its test of contract compulsion.

However, the ULTA provides for a special method of obtaining priority for construction security interests. Section 3-301(b)(4) provides that any advance made under a construction mortgage "to enable completion of the agreed improvement" will have priority, even if the advances exceed the stated maximum amount of the

201. ULTA § 3-301(b)(1) (1978); *see* G. Osborne, G. Nelson, & D. Whitman, *supra* note 81, § 12.7, at 756; Note, *Future Advances Under the ULTA and USLTA: The Construction Lender Receives a New Status*, 34 Wash. & Lee L. Rev. 1027, 1035 (1977) [hereinafter cited as *Future Advances*].

202. ULTA § 3-301(b)(2) (1978). See *id.* § 1-202(b) for a definition of "knowledge."

203. *Id.* § 1-201(14) (defines "commitment"). See *supra* note 81 and accompanying text for the classic definition of "obligatory." The ULTA's definition resembles the New York and Ohio courts' definition of "obligatory" and "voluntary." *See id.* Further, the ULTA's use of the term "commitment" may be confusing since the lending trade uses the term to refer to a written promise by a lender to make a loan in the future upon execution of loan documents and the borrower's fulfillment of certain conditions. *See generally* G. Osborne, G. Nelson & D. Whitman, *supra* note 81, § 12.3.

loan.[204] This provision of the Act does not include either the classic voluntary/obligatory distinction or the modified "commitment" rule of section 3-301(b)(1) as a check on the lender's activity.

In many respects, the rule of section 3-301(b)(4) is preferable to the voluntary/obligatory doctrine as a rule to govern the priority of construction loan advances. No longer will lenders face a loss of position for post-default advances that are used to finish the job. In most cases, allowing the lender to complete the project is economically sound and will benefit all junior encumbrancers on the theory that each dollar actually used in finishing the improvement will increase the total value of the property by more than a dollar.[205] There are, however, some difficulties with this approach. If the job is actually completed by these advances, it seems that a subordinated purchase money mortgagee will be benefitted. On the other hand, if the lender advances an additional 60x which is put into the project but the improvement is not completed, then the 60x of additional funds in an uncompleted building may only bring 50x at foreclosure.[206] The result would be that the purchase money mortgagee stands behind an additional 10x of prior lien, which may be satisfied out of the value of the land.[207] As a corollary to the approach advocated by this Article with respect to diverted advances, it seems that the actions of a lender in making such post-default disbursements should be scrutinized under a standard of reasonable lender behavior, rather than flatly awarding the construction lender priority for them.[208]

Moreover, the "to enable completion" formulation of section 3-301(b)(4) has been read, and criticized, as permitting a construction lender to obtain priority even though funds were diverted and not

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204. ULTA § 3-301(b)(4) (1978).

205. *See* Althouse v. Provident Mut. Bldg.-Loan Ass'n, 59 Cal. App. 31, 209 P. 1018 (1922); USLTA § 3-209 comment, § 5-209 comment 2 (1978); Kratovil & Werner, *supra* note 9; Skipworth, *supra* note 81; *cf.* Turner v. Lytton Sav. & Loan Ass'n, 242 Cal. App. 2d 457, 51 Cal. Rptr. 552 (1966) (advances made after declaration of default awarded priority because of compliance with California statute); Brooklyn Trust Co. v. Fairfield Gardens, Inc., 260 N.Y. 16, 182 N.E. 231 (1932) (applying the looser New York concept of "voluntary" to reach the conclusion that advances to complete the building, though they deviated from the original plans, were protected because they served to protect the security and benefitted all lien holders). See Cal. Civ. Code § 1188-1 (West 1968), discussed above, *supra* note 99, for a statutory approach to this problem.

206. Under the language of ULTA § 3-301(b)(4) (1978), there is no indication that such advances would not be given priority.

207. *See* Security Trust Co. v. Graney, 89 Misc. 2d 290, 391 N.Y.S.2d 46 (Sup. Ct. 1977); Skipworth, *supra* note 81, at 241; *supra* notes 11 & 13.

208. Relevant factors would include, among others, the reason for incompletion and a consideration of whether the lender was sufficiently secured before making the additional advances.

actually used in the project.[209] The language of the statute does not, on its face, place any duty to monitor funds on the lender.[210] It could be argued, however, that comment 4 to section 3-301, which states that "a lender is entitled to absolute priority as to expenditures reasonably made to protect his collateral,"[211] contemplates priority for advances made under reasonable lender guidelines. Still, the language is weak, and it may well be that the "reasonable" language is only descriptive of the type of protected advances, rather than the manner in which they are made. The ULTA does indicate that advances of the type made in *Iowa Loan & Trust Co. v. Plewe*,[212] where the construction mortgage was merely a facade for a commercial loan, would not be deemed a "construction security interest" because the "purpose" of the loan was not to improve the mortgaged realty.[213]

There has also been criticism of the disparity between the granting of priority under ULTA and what appears to be an awarding, under the USLTA, of priority to a construction loan over mechanics' liens only for advances actually used in the project.[214] There is no specific explanation for this divergent treatment, and no justification for it is given.

The ULTA rejects the voluntary/obligatory theory with respect to construction mortgages because this approach yielded solutions, based on technical application of rules, that were often unrelated to the realities of the construction industry. Furthermore, the ULTA is designed to present a system of priority that gives effect to the special dynamic of construction projects and that purports to offer sensible solutions to construction difficulties. Given these two factors, such a priority system should only legitimize sensible construction lender behavior. Allowing priority for diverted funds without inquiry into the nature of the lender's activity clashes with the Act's goal of presenting a rational and fair system of construction lending.[215] Section

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209. G. Osborne, G. Nelson, & D. Whitman, *supra* note 81, § 12.7, at 771; *see Future Advances*, *supra* note 201, at 1038-40.

210. *But see infra* text accompanying note 212-13.

211. ULTA § 3-301 comment 4 (1978)

212. 202 Iowa 79, 209 N.W. 399 (1926); *accord* Cambridge Acceptance Corp. v. Hockstein, 102 N.J. Super. 435, 246 A.2d 138 (App. Div. 1968); York Mtge. Corp. v. Clotar Constr. Corp., 254 N.Y. 128, 172 N.E. 265 (1930).

213. ULTA § 3-103(2) (1978).

214. USLTA § 5-209(c)(1) (1978), *discussed in* G. Osborne, G. Nelson & D. Whitman, *supra* note 81, § 12.7, at 771, *and Future Advances*, *supra* note 201, at 1040. The language awarding priority to advances "made in payment of the price of agreed improvements" is somewhat unclear as to the existence of a duty. In any case, the strict liability approach of the USLTA, rather than a duty of reasonable care, is an unfair and unrealistic burden on the lender. For a statute similar in some respects to USLTA § 5-201(c)(1) (1978), see Cal. Civ. Code § 1188-1 (West 1968) (limiting advances to the loan maximum, unlike the USLTA).

215. *See* ULTA § 1-102 (1978).

3-301 leaves the subordinated purchase money mortgagee in a most vulnerable position[216] by abolishing the voluntary/obligatory rule, which served as an imprecise tool for courts to protect subordinated purchase money mortgagees, and by not including, at the same time, an express duty to monitor funds.

B. *Effect of Other ULTA Provisions*

While it would be preferable to have a reasonable lender standard with respect to advances clearly set forth in section 3-301 of the ULTA, a basis for the arguments suggested earlier as to the existence of lender responsibility with respect to advances[217] is supplied by some of the Act's more general provisions. The Act supports the need to recognize a subordinated purchase money mortgagee's legitimate expectations, the use of equitable principles to achieve fairness, and the policy behind lender responsibility.

1. Support for Legitimate Expectations

The ULTA provides that the parties to a transaction may by agreement vary, with some exceptions, the effect of the provisions of the Act.[218] Thus, the subordination transaction, effected either by a subordination agreement or agreement to record second, can be viewed as altering by agreement the section 3-301 priority system by requiring the denial of priority for diverted advances where the lender failed to exercise reasonable care. Such an agreement to alter section 3-301 priorities can be found in the legitimate expectation of a purchase money mortgagee subordinating to a "construction loan," and in the lender's recognition of such expectation, that reasonable lending practices will be followed with respect to advances.[219]

Various provisions of the ULTA mandate giving effect to such legitimate expectations based on commonly recognized views of the nature of a "construction loan." First, the Act's view of an "agreement" to subordinate includes recognition of not only the language used, but also "other circumstances."[220] Specifically, because they form part of the parties' expectations, usages in the real estate business are to be included as part of the agreement.[221] These usages help in

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216. This may indeed have occurred in those jurisdictions adopting the "general rule" of no lender responsibility to monitor advances but rejecting the voluntary/obligatory rule and its safety valve. See *supra* text accompanying notes 23, 55, and 76 for Connecticut, Florida and Maryland experiences.

217. *See supra* pt. III.

218. ULTA § 1-103 (1978).

219. *See supra* text accompanying pt. III(A)(2).

220. ULTA § 1-201(2) (1978).

221. ULTA §§ 1-201(2), -201 comment 2, -303(b) (1978); *see id.* § 1-308. Parol evidence rule problems alluded to in Roberts v. Harkins, 292 So. 2d 603 (Fla. Dist.

discerning what the parties expected their language to mean and form the framework of common understanding.[222] Thus, if a pattern of general lender monitoring of disbursements is shown, it should be considered as part of the subordination agreement.[223]

Moreover, in other areas the ULTA shows that even broader reasonable expectations, not necessarily found in usage, are to be given effect.[224] This should extend as well to a purchase money mortgagee's expectation that when the lender accepts the benefit of subordination, the lender will act reasonably so as not to erode the purchase money mortgagee's new, vulnerable position.[225]

2. Additional Foundations for Lender Responsibility

The ULTA provides that the principles of law and equity supplement the Act.[226] The equitable principles of the law of priority and foreclosure which militate in favor of denying priority for diverted advances in a subordinated purchase money mortgage transaction in which the construction lender has not used reasonable care should, therefore, still apply.[227]

Additionally, the Act's requirement of good faith in real estate transactions with respect to the performance and enforcement of all agreements and duties[228] may compel the denial of priority to a lender over a subordinated purchase money mortgagee for failure to use reasonable care. Although the concept of good faith is rather amorphous in the ULTA, reference can be made to section 1-203 of the Uniform Commercial Code, which is noted in the ULTA comment as the source of the ULTA good faith standard.[229] The notion of good

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Ct. App.), *cert. denied*, 302 So. 2d 417 (Fla. 1974), are countered by ULTA § 1-306 (1978), which specifically excepts usage. The result of Forest Inc. v. Guaranty Mtge. Co., 534 S.W.2d 853 (Tenn. Ct. App. 1975), is apparently rejected by ULTA § 1-303 comment 4.

222. ULTA § 1-303 comment 4 (1978).

223. *See* ULTA § 1-303(b) (1978). The claim of lack of privity between the lender and purchase money mortgagee should be rejected. *See supra* text accompanying notes 179-81.

224. ULTA § 2-309 comment 1 (1978) (dealing with warranties of quality in the sales of residences).

225. *See supra* text accompanying notes 183-84.

226. ULTA § 1-104 (1978).

227. *See supra* text accompanying notes 175-78. ULTA § 1-104 (1978) states that these principles apply unless displaced by a particular provision of the Act. Because a subordination transaction involves a variation by agreement of the ULTA § 3-301 priority system, *see supra* text accompanying note 218, it does not seem that § 3-301 applies in a manner that displaces those equitable principles.

228. ULTA § 1-301 (1978).

229. *Id.* § 1-301 comment. Good faith under U.C.C. § 1-203 requires honesty in fact. U.C.C. § 1-201(19) (1977).

faith is further developed in the U.C.C., and the standard for a merchant under Article 2 includes "the observance of reasonable commercial standards of fair dealing in the trade."[230] This aspect of good faith appears to be reflected in the comment to the ULTA section 1-301, which states that good faith is "implemented by Section 1-205 on course of dealing and usage."[231] Arguably, under this standard, fair dealing by a construction lender would include the observance of standard lender practices with respect to advances.[232]

Moreover, a court might rely on section 1-311 of the Act and refuse to enforce a subordination agreement that does not include a responsibility with respect to advances as an "unconscionable" contract. In light of the unarticulated expectation of the purchase money mortgagee and the lender's understanding of that expectation, the failure of a subordination agreement to include a duty to monitor disbursements may be a case in which "the contract terms would be fair as between the parties in usual circumstances, but are unconscionable because one party has relied on the ignorance or lack of understanding of the other in securing the contract."[233]

Finally, the ULTA represents an attempt to modernize the law of real estate transactions.[234] Sophisticated real estate transactions involve many levels of "ownership," and all of these interests must be accommodated by the law. One section of the Act, reflecting an understanding of the special interrelationships and matrix of interests involved in land financing, requires a mortgagee in possession of property to manage it as would a "prudent man."[235] This is presumably for the protection of all persons "owning" an interest in the property.[236] There is a similar need for reasonable behavior with respect to construction loan advances in order to recognize and protect the legitimate interests of the subordinated purchase money mortgagee.

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230. U.C.C. § 2-103(1)(b) (1977). An institutional lender appears to meet the "merchant" test of the Code. U.C.C. § 2-104(1) (1977).

231. ULTA § 1-301 (1978). Additionally, though U.C.C. § 2-103 is not specifically mentioned by the comment to ULTA § 1-301, that section's standard of good faith should be considered as applicable to the ULTA because it is noted in the comment to U.C.C. § 1-203 and it forms part of an overall U.C.C. good faith concept. The reference to § 1-205 in the comment to ULTA § 1-301 should presumably be to § 1-303.

232. *See* Swift v. J.I. Case Co., 266 So. 2d 379, 382 (Fla. Dist. Ct. App. 1972).

233. ULTA § 1-311 comment 4 (1978).

234. *See id.* § 1-102(1).

235. *Id.* § 3-504(c) (1978).

236. *Id.* Unfortunately, the Act does not specify whether this duty is owed to the mortgagor only, or to others as well. Section 3-504(c) does talk of responsibility to "other persons" with respect to acts of a manager. By implication such language could apply to all of § 3-504(c), and would presumably include junior mortgages. *See supra* text accompanying note 178.

CONCLUSION

It has been demonstrated that the so-called "general rule" of construction lender priority for diverted advances need not be considered binding on courts. Moreover, it has been shown that there are severe theoretical and practical problems with the doctrines currently used by some courts to provide relief for the subordinated purchase money mortgagee. There is, however, a firm doctrinal and policy basis for adopting the approach suggested by this Article, which approach will fairly balance the competing interests of the parties by focusing on the dynamic of the construction lender-subordinated purchase money mortgagee dispute.