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Future Advances Under The Ulta And The Uslta: The Construction Lender Receives A New Status

FUTURE ADVANCES UNDER THE ULTA AND THE USLTA: THE CONSTRUCTION LENDER RECEIVES A NEW STATUS

The prevalence of future advance clauses[1] in construction mortgages[2] and the dearth of well-defined laws concerning the security and priority status of such advances[3] have combined to produce much uncertainty among real property lienholders as to the priority of their claims in foreclosure proceedings.[4] The law of future advances has evolved primarily in case law,[5] and thus disparity exists from state to state.[6] Even when specific guidelines have been enunciated by the courts,[7] the interpretation and application of those guidelines have not been uniform.[8] Perceiving a need for statutory reform, several states have passed legislation concerning future advances.[9] Nevertheless, the current lack of uniform authority, either statutory or nonstatutory, presents continuing priority problems, particularly for the construction lender.[10]

Two proposed uniform statutes, the Uniform Land Transactions Act (ULTA)[11] and the Uniform Simplification of Land Transfers Act

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[1] The typical future advance clause provides that the debt which the mortgage secures represents in whole or in part advances to be made or obligations to be incurred by the lender subsequent to the time when the security agreement is executed. *See* 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 35.1, at 916 (1965) [hereinafter cited as GILMORE]; G. OSBORNE, HANDBOOK ON THE LAW OF MORTGAGES § 113, at 178 (2d ed. 1970) [hereinafter cited as OSBORNE].

[2] *See* 2 GILMORE, *supra* note 1, § 35.3, at 922; OSBORNE, *supra* note 1, § 113, at 178-79.

[3] *See* 2 GILMORE, *supra* note 1, § 35.4, at 930; *see also* notes 6 and 9 *infra*.

[4] Kratovil & Werner, *Mortgages for Construction and the Lien Priorities Problem—The "Unobligatory" Advance*, 41 TENN. L. REV. 311 (1974) [hereinafter cited as Kratovil & Werner]; Skipworth, *Should Construction Lenders Lose Out on Voluntary Advances If a Loan Turns Sour?* 5 REAL ESTATE L.J. 221 (1977) [hereinafter cited as Skipworth].

[5] 2 GILMORE, *supra* note 1, § 35.4, at 930; Kratovil & Werner, *supra* note 4, at 320.

[6] *See generally* Annot., 80 A.L.R.2d 179 (1961).

[7] *See* text accompanying notes 24-35 *infra*.

[8] *See* note 6 *supra*.

[9] *See, e.g.*, FLA. STAT. ANN. § 697.04 (West 1969); MD. CODE ANN. [REAL PROP.] § 7-102 (1974); N.C. GEN. STAT. §§ 45-67 to -74. (1976 Repl. Vol). Some statutes, however, simply perpetuate certain concepts as developed in case law. *See, e.g.*, N.C. GEN. STAT. § 45-70(a) and § 45-70(b)(1976 Repl. Vol.).

[10] *See* note 4 *supra*.

[11] The Uniform Land Transactions Act [hereinafter cited as ULTA] was approved by the National Conference of Commissioners on Uniform State Laws in Au-

(USLTA),[12] which have been approved and recommended for enactment in the states by the National Conference of Commissioners on Uniform State Laws, deal with the security and priority status of real property future advances.[13] Arguably, the peculiarly local character often attributed to realty in the United States[14] represents a formidable barrier to any widespread enactment of the complete texts of both acts or of any uniform act concerning real estate law.[15] The recognized need for uniformity in the area of mortgage foreclosures,[16] however,

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gust, 1975. Article 1 of the Act contains definitions and general provisions applicable to both sales and secured transactions; Article 2 concerns leases and sales of real estate; and Article 3 deals with secured transactions. The structure of the three articles follows Uniform Commercial Code (U.C.C.) Articles 1, 2, and 9. *See generally* ULTA, Prefatory Note, at vii-x.

Pursuant to recommendation made by its Special Committee on the Uniform Land Transactions Act, the Section of Real Property, Probate and Trust Law of the American Bar Association recommended that the A.B.A. disapprove the ULTA in its present form. While the section reaffirmed its concern for the principle of uniformity, it concluded that "in the field of real property uniformity can best be achieved by concentrating in the first instance upon specific areas of general interest, such as mortgage foreclosures, with which only one portion of the current act is concerned." A.B.A. SECTION OF REAL PROP., PROB. & TR. L., 5 PROB. & PROP. 8 (Special Issue 1976) [hereinafter cited as PROB. & PROP.]. The House of Delegates of the A.B.A. has not yet considered the ULTA.

[12] The Uniform Simplification of Land Transfers Act [hereinafter cited as USLTA] was approved by the National Conference of Commissioners on Uniform State Laws in August, 1976. Article 1 of the Act contains definitions and general provisions applicable throughout the act; Article 2 concerns conveyancing and recording; Article 3 deals with priorities, marketable record title, and extinguishment of claims; Article 4 provides for the recording of statutory liens and pending judicial proceedings; Article 5 concerns construction liens (mechanics' and materialmen's liens); Article 6 governs the maintenance of public land records; and Article 7 contains transitional and repealer provisions. *See generally* USLTA Prefatory Note, at 3-4.

The Section of Real Property, Probate and Trust Law of the A.B.A. has not yet stated its position on the USLTA, and the ABA House of Delegates has not yet considered the Act.

[13] ULTA §§ 1-201(5), 3-205(c)-(f), 3-301(b); USLTA §§ 1-201(14), 3-202(a)(8), 3-209, 5-209(b),(c).

[14] The reasons commonly given for the contention that real property, unlike personalty, possesses a "unique" character are that realty is permanent, immovable and durable, and has deep-rooted local significance.

[15] *See* note 14 *supra*. Whether or not it is valid to assume that because land is "unique" uniformity cannot be achieved among the states in the area of modern real estate law, the mere fact that the assumption is often made creates an obstacle to adoption of a uniform act concerning land transactions. Bruce, *Mortgage Law Reform Under the Uniform Land Transactions Act*, 64 GEO. L. REV. 1245, 1246 (1976).

[16] ULTA art. 3, Introductory Comment, at 9. *See* 5 PROB. & PROP., *supra* note 11, at 8; H.R. 10688, 93d Cong., 1st Sess. § 402 (1973). In § 402, which concerns a proposal to establish a uniform foreclosure system for mortgages insured, guaranteed or owned

should prompt state legislatures to give careful consideration to the specific sections in each proposed act that deal with real estate financing.[17] The provisions relating to the security and priority of future advances thus deserve scrutiny to determine the changes that the two statutory schemes would make in the existing law, individually as well as collectively,[18] and the objectives the drafters sought to

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by federal agencies, Congress found that "the availability of a uniform, less expensive and more expeditious foreclosure procedure" is required to ameliorate high costs and risks imposed on homeowners, to facilitate the sale and resale in nationwide secondary mortgage markets of secured real estate loans and to reduce unnecessary litigation in the courts. *Id.*

[17] Article 3 of the ULTA is devoted exclusively to consensual security interests in real estate. Part 1 defines the scope of the article and contains definitions applicable throughout the article; Part 2 concerns the validity of security agreements and the rights of parties thereto; Part 3 defines priorities between conflicting security interests in the same collateral; Part 4 deals with finance charges and usury; and Part 5 concerns default and foreclosure. Article 3 expressly excludes from its scope non-consensual security interests in real estate, including mechanics' liens. ULTA § 3-104.

Article 3 of the USLTA addresses priority questions, and Article 5 of the Act deals comprehensively with the subject of mechanics' liens.

[18] As individual statutes, the ULTA and the USLTA do not deal comprehensively with the subject of future advances. While there is some overlap between the acts concerning future advances in general, and those made under construction security agreements, *see* note 22 *infra*, in particular, each statute contains gaps that appear to be filled only by provisions in the other. For example, the ULTA expressly allows that obligations secured by a security agreement may include future advances, that such advances need not be made "pursuant to commitment," *see* text accompanying notes 44-45 *infra*, and that advances may not exceed a maximum amount stated in the agreement. ULTA § 3-205(c). Furthermore, under the ULTA, advances made under a construction security agreement "to enable completion of the contemplated improvement" are deemed secured by the security agreement even though the agreement does not provide for advances and even if they cause the total of future advances to exceed the stated maximum amount. ULTA § 3-205(e)(2). The USLTA, however, contains no provision concerning the basic security status of future advances. Rather, that security status which is explicitly set forth in the ULTA must be inferred from USLTA provisions concerning priority of future advances. *See* USLTA §§ 3-209, 5-209.

At the same time, the USLTA specifically addresses the crucial question of priority of advances made by a construction lender as against mechanics' liens, *see* USLTA § 5-209(c)(1), while the ULTA does not. Moreover, since ULTA § 3-104(3) expressly provides that Article 3 of that Act does not apply to mechanics' liens, the priority status accorded advances made by a lender under ULTA § 3-301(b) clearly does not protect advances from intervening mechanics' lien claims. Rather, the mechanics' lien statute operative in a particular state continues to determine the priority status of the mechanics' lienor. In Virginia, for instance, the mechanics' lienor receives complete priority with respect to the building, even over a mortgagee who recorded prior to the date of attachment of the mechanics' lien. VA. CODE § 43-21 (1976 Repl. Vol.). The ULTA unlike the USLTA, effects no change in the operation of the Virginia statute. For a general discussion of the varied rules of mechanics' liens applied in the different

achieve by these changes.[19] Since future advances are a common and significant feature in construction mortgages,[20] particular attention should be paid the special rules[21] provided for advances made under construction security agreements[22] and the policy decisions underlying those rules.[23]

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states, see OSBORNE, *supra* note 1, at §§ 215, 216.

Both the ULTA and the USLTA resulted from a single drafting project concerning land transactions initially undertaken by the National Conference of Commissioners on Uniform State Laws in 1968. In 1974, the first draft of the ULTA, which contained an article comparable to Article 5 of the USLTA concerning mechanics' liens, was presented to the Conference at its annual meeting. Considerable controversy, however, particularly concerning the article on mechanics' lien, led to a decision to divide the project into three component acts: the ULTA, the USLTA and a Uniform Condominiums Act. Thus, the proposed article on mechanics' liens was not included in the final version of the ULTA as approved and recommended by the Conference in 1975. *See* Letter of John M. McCabe, Legislative Director, National Conference of Commissioners on Uniform State Laws, June 16, 1977, on file in WASH. & LEE L. REV. office, Lexington, Va., 24450 [hereinafter cited as McCabe Letter].

Since the mechanics' lienor may well be a lender's most formidable competitor for priority status with respect to future advances, *see* Kratovil & Werner, *supra* note 4, at 311-13; Kuklin, *The Uniform Land Transactions Act: Article 3*, 11 A.B.A. REAL PROP., PROB. & TR. J. 12, 19 (1976), the priority provisions of the ULTA do not provide a uniform scheme for the determination of the priority status of advances in foreclosure proceedings. The Conference, however, is encouraging the states to consider the ULTA in conjunction with the USLTA. *See* McCabe Letter, *supra* at 2. The Uniform Condominiums Act, the final component of the total drafting project, was considered for approval by the Conference at its most recent annual meeting in August, 1977. *Id.*

[19] Basic goals of both the ULTA and the USLTA include the simplification, clarification, and modernization of the law governing real estate transactions and promotion of the interstate flow of funds for such transactions. *See generally* ULTA § 1-102; USLTA § 1-102. More specifically, the provisions that give special priority to advances made by construction lenders are designed to encourage new construction and the completion of construction despite cost overruns, and to prevent the abandonment of buildings. *See* USLTA § 3-209, Comment.

[20] *See* note 2 *supra.*

[21] ULTA §§ 3-205(e)(2), 3-301(b)(4); USLTA §§ 3-204(4), 5-209(c)(1).

[22] A "security agreement" is defined by ULTA § 3-106(6) as "a writing that creates or provides for a security interest in real estate." The USLTA, however, does not define that term. A "security interest" is defined by ULTA § 3-103(7) as "an interest in real estate which secures payment or performance of an obligation." ULTA § 3-102(a) further indicates that Article 3 of the ULTA applies only to consensual security interests. Section 1-201(25) of the USLTA defines a "security interest" as "a consensual interest in real estate which secures payment or performance of an obligation."

Both acts define a "construction security interest" as "a security interest that secures an obligation which the debtor incurred for the purpose of making an improvement of the real estate in which the security interest is given, if the instrument recorded to perfect the interest states that it is a construction security interest." ULTA § 3-103(2); USLTA § 1-201(1).

[23] *See, e.g.*, USLTA § 3-209, Comment; USLTA § 5-209, Comment 2.

Case law generally recognizes the secured status of future advances made under mortgage loans,[24] and in some jurisdictions specific legislation provides that advances may be so secured.[25] Traditionally, the future advance arrangement may take one of several forms. In one type of arrangement, the mortgage instrument makes no mention of future advances. Parol evidence, however, reveals that only a portion of the stated face amount is given to the mortgagor at the outset, with advances to be made at later intervals.[26] The mortgagee is obligated to make the advances up to the stated sum; thus, such an arrangement has been characterized as involving "obligatory" future advances.[27] Another form of mortgage instrument securing "obligatory" future advances is that in which the mortgagee contractually binds himself under the security agreement to make advances pursuant to a schedule. This form is most often used by construction lenders, who generally tie the schedule of advances to successive stages of completion of the building or improvement involved.[28] A third type of mortgage instrument expressly provides for future advances, but allows the mortgagee discretion in determining whether he will in fact make the advances. This type of arrangement has been characterized as involving "optional" future advances.[29]

The characterization of a mortgage as securing "obligatory" or "optional" advances has primary significance under existing law in

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[24] *E.g.*, National Bank v. Whitney, 103 U.S. 99, 102-03 (1880); Tapia v. DeMartini, 77 Cal. 383, 19 P. 641 (1888); Larson Cement Stone Co. v. Redlim Realty Co., 179 Neb. 134, 137 N.W.2d 241 (1965).

[25] *See, e.g.*, FLA. STAT. ANN. § 697.04 (West 1969); MD. CODE ANN. [REAL PROP.] § 7-102 (1974); N.C. GEN. STAT. §§ 45-67 to -74 (1976 Repl. Vol.).

[26] *See, e.g.*, Tapia v. DeMartini, 77 Cal. 383, 19 P. 641 (1888); Whelan v. Exchange Trust Co., 214 Mass. 121, 100 N.E. 1095 (1913). In *Tapia*, the court noted that the express limitation of liability to a definite amount is sufficient to protect subsequent encumbrances. *But see* Matz v. Arick, 76 Conn. 388, 56 A. 630 (1904)(failure to state that mortgage secures future advances was constructively fraudulent against subsequent encumbrances except for amount of initial advance).

[27] Whelan v. Exchange Trust Co., 214 Mass. 121, 122, 100 N.E. 1095, 1096 (1913). *See also* Coke Lumber & Mfg. Co. v. First Nat'l Bank, 529 S.W.2d 612 (Tex. Ct. App. 1975).

[28] *E.g.*, Landers-Morrison-Christenson Co. v. Ambassador Holding Co., 171 Minn. 445, 214 N.W. 503 (1927); Larson Cement Stone Co. v. Redlim Realty Co., 179 Neb. 134, 137 N.W.2d 241 (1965). *See also* Kemp v. Thurmond, 521 S.W.2d 806 (Tenn. 1975). Courts often hold that advances made ahead of schedule are optional, however, despite the fact that the lender would eventually be obligated to make them. *See* cases cited in note 39, and text accompanying notes 38-41 *infra*.

[29] *See, e.g.*, W.P. Fuller & Co. v. McClure, 48 Cal. App. 185, 191 P. 1027 (1920); Blaustein v. Aiello, 231 Md. 375, 190 A.2d 639 (1963).

determining the priority of lien claims in foreclosure proceedings.[30] Under traditional priority rules, where provisions in a mortgage obligate the mortgagee to make future advances, the advances receive priority from the time of recordation of the mortgage over all intervening encumbrances. This priority is accorded obligatory advances even if the mortgagee has actual knowledge of the intervening lien at the time he makes them.[31] Such advances thus always relate back to the date of recordation.[32] If the mortgagee retains the option of determining whether advances will be made, however, the mortgagee does not receive priority with respect to those advances made after he has acquired knowledge of a subsequent encumbrance.[33] The majority of courts require that the mortgagee have actual knowledge[34] of the subsequent encumbrance before his rights are defeated, although some courts hold that constructive notice suffices.[35]

Determination of the priority status of future advances in accordance with whether the lender was obligated to advance funds or whether he did so at his option presents special problems for the construction lender. The cases often express the test for determining if an advance was "obligatory" as involving an inquiry into whether the lender could have been compelled by a court to advance the funds pursuant to his contractual agreement.[36] Thus, where refusal by the lender to make certain advances would have subjected him to liability for breach of contract, courts hold that such advances are obligatory.[37] The construction lender, however, generally includes provisions in the construction loan agreement which either require that certain conditions be satisfied pursuant to a schedule before the

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[30] Some states, however, have legislatively abolished the obligatory-optional distinction with respect to determining priority of advances. *See, e.g.*, FLA. STAT. ANN. § 697.04 (West 1969); MD. CODE ANN. [REAL PROP.] § 7-102 (1974).

[31] *See* cases cited in note 27 *supra.*

[32] *Id.*

[33] *See* cases cited in note 30 *supra.*

[34] *E.g.*, Woodruff v. National City Bank, 272 F.2d 696 (7th Cir. 1959); Tapia v. DeMartini, 77 Cal. 383, 19 P. 641 (1888).

[35] *E.g.*, McMasters v. Campbell, 41 Mich. 513, 2 N.W. 836 (1879); Swift Lumber & Fuel Co. v. Elwanger, 127 Neb. 740, 256 N.W. 875 (1934).

[36] *See, e.g.*, Landers-Morrison-Christenson Co. v. Ambassador Holding Co., 171 Minn. 445, 214 N.W. 503 (1927); National Bank v. Equity Investors, 81 Wash. 2d 886, 506 P.2d 20 (1973).

[37] *But see* Hyman v. Hauff, 138 N.Y. 48, 33 N.E. 735 (1893)(where loss of profits or fruits of contract would follow discontinuation of advances such that advances are not "purely and plainly optional," advances are "obligatory" even though lender is absolved under contract provision from making them because of owner's default in making payments).

lender is obligated to make an advance or relieve the lender of his obligation to advance funds upon the occurrence of certain events of default.[38] Since these provisions protect the lender from incurring contractual liability if the conditions are not met, or if default occurs, courts generally hold that advances made in such a situation are thereby rendered optional.[39] Characterizing such advances as optional operates to deny the advances priority status.[40] This test based on contractual liability has been criticized as ignoring economic realities which compel the lender either to make advances out of schedule or to continue making advances after default by the borrower, even if he is not legally obligated to do so.[41]

The common law distinction between obligatory and optional advances remains significant under certain provisions of the ULTA and the USLTA.[42] Both acts abandon the use of the terms "obligatory" and "optional," however, and instead distinguish between whether or not advances are made "pursuant to commitment."[43] The same definition is set forth in the general provisions of each statute:

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[38] P. ROHAN, REAL ESTATE FINANCING § 3.05(4)(1973).

[39] J.I. Kislak Mtge. Corp. v. William Matthews Builder, Inc., 287 A.2d 686 (Del. Super. 1972); New York & Suburban Fed. Sav. & Loan Ass'n v. Fi-Pen Realty Co., 133 N.Y.S.2d 33 (Sup. Ct. 1954); National Bank v. Equity Investors, 81 Wash. 2d 886, 506 P.2d 20 (1973); *Contra,* Hyman v. Hauff, 138 N.Y. 48, 33 N.E. 735 (1893) (advances are not "purely and plainly optional" where loss of profits or fruits of contract would follow discontinuation of advances).

[40] *See* text accompanying notes 33-35 *supra.*

[41] It may be economically desirable for the lender who has already invested capital in a construction project to protect his investment by continuing to advance funds that are not required according to the loan payout schedule. An unfinished building often deteriorates in value over time because the building is exposed to vandalism and to the elements. Furthermore, the building produces no revenue because it cannot be sold or rented. The lender's foreclosure rights are thus jeopardized when delay is occasioned by the necessary adjudication of priority rights of lienors prior to a judicial sale. Yet, should the lender choose to continue advancing funds in order to enable completion of the building and enhancement of the ultimate value of the security, he loses priority as to those continued advances under prevailing law because he was not contractually obligated to make them. *See* Kratovil & Werner, *supra* note 4, at 316-19; Skipworth, *supra* note 4, at 223.

Some courts have sought to accommodate the economic pressures facing the construction lender by holding that certain advances made by a lender not contractually bound to make them are nonetheless "obligatory." *See, e.g.,* United States v. Seaboard Nat'l Bank, 206 F.2d 62 (4th Cir. 1953)(expenditures for taxes and insurance premiums obligatory); Hyman v. Hauff, 138 N.Y. 48, 33 N.E. 735 (1893)(advances to prevent loss of profits or fruits of contract obligatory).

[42] *See* ULTA § 3-301(b)(1),(2); USLTA § 3-209(1),(2); *see also* text accompanying notes 53-57 *infra.*

[43] ULTA § 1-201(15); USLTA § 1-201(14).

"An advance is made 'pursuant to commitment' if the obligor has bound himself to make it, whether or not a default or other event not within his control has relieved or may relieve him from his contractual obligation."[44] This definition apparently refers to contractual commitments. Significantly, however, it also provides that the lender may continue to make advances without jeopardizing their secured status if events beyond his control relieve him of his contractual duty to make them.[45]

In accordance with existing case law,[46] ULTA section 3-205(c) explicitly provides that "[o]bligations secured by a security agreement may include future advances or other future obligations, whether or not the obligation was incurred pursuant to commitment."[47] Section 3-205(c) further provides, however, that "except as to advances made . . . [for the reasonable protection of the security interest in the real estate or under a construction security agreement],[48] the maximum amount of the obligation secured may not exceed the maximum amount stated in the agreement."[49] While the USLTA contains no provision comparable to ULTA section 3-205(c), this same security status of future advances may be inferred from the USLTA priority provisions concerning advances set forth in section 3-209(1) and (2).[50] Clearly, advances must first be secured before they can receive priority. Under USLTA section 3-209(1) and (2), priority is given to advances made pursuant to commitment as well as to advances not made pursuant to commitment.[51] Moreover, priority is limited under those subsections to the extent of advances "which do not exceed the maximum amount stated in the record."[52]

The general priority rules of ULTA section 3-301(b) and USLTA section 3-209 incorporate traditional priority notions,[53] but substitute the distinction between advances made pursuant to commitment and those not made pursuant to commitment for the obligatory-optional

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[44] *Id.*

[45] The same provision concerning when advances are made "pursuant to commitment" is contained in U.C.C. § 9-105(k), and is applicable with respect to the future advance provisions of Article 9 of the U.C.C. *See also* OHIO REV. CODE ANN. § 5301.23.2(E)(4) (Page 1970 Repl. Vol.).

[46] *See* note 24 *supra.*

[47] ULTA § 3-205(c).

[48] *See* text accompanying notes 70-71 *infra. See also* note 67 *infra.*

[49] ULTA § 3-205(c).

[50] *See also* USLTA § 5-209(c)(1).

[51] USLTA § 3-209(1),(2).

[52] *Id.*

[53] *See* text accompanying notes 30-35 *supra.*

distinction.[54] All secured advances made pursuant to commitment have priority over intervening interests from the date the security interest was recorded insofar as they do not exceed the maximum stated in the record.[55] Advances not made pursuant to commitment receive priority over intervening interests as of the recording date to the extent of advances made before the secured party had knowledge of the intervening interest and not exceeding the stated maximum.[56] Under both acts, a person has "knowledge" of a fact only when he has actual knowledge of it.[57] Constructive notice through recordation of an intervening interest therefore would not suffice under either statute.

Both the ULTA and the USLTA use the term "security interest" to refer to consensual interests in real estate.[58] Furthermore, the references to priority of advances over intervening interests in the general priority rules of ULTA section 3-301(b) and USLTA section 3-209 do not come into play when an intervening interest is a non-consensual mechanics' lien.[59] Article 3 of the ULTA expressly excludes the mechanics' lien from the scope of its provisions.[60] Thus, adoption of that statute would not affect the continued applicability of a state's mechanics' lien statute in the resolution of priority conflicts between mechanics' liens and future advances.[61]

The USLTA, however, devotes an entire article to the codification of mechanics' lien law.[62] Accordingly, USLTA section 3-209 provides

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[54] *See* text accompanying notes 42-45 *supra.*

[55] ULTA § 3-301(b)(1); USLTA § 3-209(1).

[56] ULTA § 3-301(b)(2); USLTA § 3-209(2).

[57] ULTA § 1-202(b); USLTA § 1-202(b).

[58] *See* note 22 *supra.*

[59] The priority rules of the ULTA apply exclusively to consensual security interests. Section 3-104(3) of the Act clearly states that Article 3 does not apply to any non-consensual lien. The USLTA, however, does not contain such a sweeping exclusionary provision. Instead, USLTA § 4-101(a) brings within the ambit of that Act's priority provisions any lien "created or recognized by this Act or by any other law . . ." Section 3-209 excludes only the mechanics' lien from its scope, subjecting its provisions to those of § 5-209, a section specifically concerning the priority of mechanics' liens. *See* text accompanying notes 62-66 *infra.*

[60] ULTA § 3-104(3). An article which did concern the priority of advances made by a construction lender as against mechanics' liens was contained in early drafts of the ULTA, but was not adopted as part of the final version of the Act. *See* note 18 *supra.*

[61] *See* note 18 *supra.*

[62] USLTA Article 5 deals comprehensively with the subject of mechanics' liens. The Article is entitled "Construction Liens" because, according to the drafters, the title "Mechanics' Liens" improperly implies that laborers are the primary beneficiaries of mechanics' lien laws. USLTA Art. 5, Introductory Comment. Despite the fact that

that section 5-209 of that Act controls the priority of future advances when an intervening claim is a mechanics' lien.[63] Section 5-209(b) states the general rule that a mechanics' lien has priority over all subsequent advances made with knowledge that the lien has attached,[64] whether or not the advance was made pursuant to a commitment in a mortgage recorded before the lien attached.[65] This provision gives the intervening mechanics' lienor greater priority over subsequent advances than is given the intervening secured party under USLTA section 3-209(1) and (2).[66]

A significant feature of both the ULTA and the USLTA is the inclusion in each statute of special provisions that apply exclusively to advances made under a construction security agreement.[67] These

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the term "mechanics' lien" may be technically incorrect, that term has been in use for well over one hundred years, *see generally* OSBORNE, *supra* note 1, at § 214, and the term "construction lien" is likely to cause more confusion because the mortgage given a construction lender may properly be referred to as a lien. To avoid such confusion, this writer uses the term "mechanics' lien" throughout this article when referring to provisions of Article 5 of the USLTA.

[63] USLTA § 3-209.

[64] USLTA § 5-207 states when a mechanics' lien attaches for priority purposes under Article 5.

[65] USLTA § 5-209(b).

[66] *See also* ULTA § 3-301(b). Under ULTA § 3-301(b)(1) and USLTA § 3-209(1), all advances made by a lender pursuant to commitment, *see* text accompanying notes 43-44 *supra*, receive priority over intervening consensual security interests, even if the lender had knowledge of the intervening interest at the time he made the advances. Under USLTA § 5-209(b), however, those advances made by the lender with knowledge of an intervening mechanics' lien do not receive priority over the mechanics' lien. This greater protection of the mechanics' lienor reflects a policy determination that such claimants deserve favored treatment.

[67] *See* notes 2, 21 and 22, and text accompanying notes 20-23 *supra*. The ULTA and the USLTA also accord the same special treatment to future advances made "for the reasonable protection of the security interest in the real estate." *See* ULTA §§ 3-205(e)(1), 3-301(b)(3); USLTA §§ 3-209(3); 5-209(c)(2). Such advances include payments "for real property taxes, hazard insurance premiums, or maintenance charges imposed under a condominium declaration or other covenant." *Id.* It is not uncommon for a mortgagee to make such expenditures to protect his interest in the real estate even if he is not legally or contractually obligated to do so. For this reason, some courts have held that these advances enjoy priority from the date the mortgage was first recorded. United States v. Seaboard Citizens Nat'l Bank, 206 F.2d 62 (4th Cir. 1953); Harper v. Ely, 70 Ill. 581 (1873). *But see* Heller v. Gate City Bldg. & Loan Ass'n, 75 N.M. 596, 598-99, 408 P.2d 753, 755-56 (1965)(advances for taxes, insurance premiums and repairs, which were "wholly discretionary" with the mortgagee, were denied priority against a purchase money mortgage claim which had been subordinated to the construction loan only with respect to obligatory advances). The drafters of the ULTA and USLTA apparently have adopted the view that all mortgagees are "obligated" to make

provisions are intended to accommodate the economic pressures faced by construction lenders[68] in an effort to encourage lenders to advance funds in every case where to do so would enable completion of a construction project.[69] Thus, ULTA section 3-205(e) expressly provides that such advances:

> are secured by the security agreement even though the security agreement does not provide for future advances or obligations or the advances cause the total of future advances or obligations to exceed the maximum amount stated in the security agreement.[70]

Advances made by the construction lender are thereby specifically exempted from the face amount limitation imposed by ULTA section 3-205(c) on other lenders.[71]

Under the USLTA, this same security status of advances made by construction lenders may be inferred from that statute's priority provisions concerning future advances made under construction security agreements.[72] Both USLTA section 3-209(4) and USLTA section 5-209(c)(1) address the priority of advances made by construction lenders,[73] providing that such advances have priority "whether or not [they] exceed the secured maximum amount stated in the instrument."[74] Advances exceeding the face amount must necessarily be secured to receive a priority status.

ULTA section 3-301(b)(4) and USLTA section 3-209(4) specifically concern the priority of future advances made under a construction security agreement "to enable completion of the agreed improvement of the real estate."[75] Both provisions state that a recorded security interest takes priority:

> as of the date of its recording as to advances or obligation thereafter made or incurred under the security agreement
> . . . .

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such advances. *See* Blackburn, *Mortgages to Secure Future Advances*, 21 Mo. L. Rev. 209, 221 (1956).

[68] *See* note 41 *supra*.

[69] *See* USLTA § 3-209, Comment; USLTA § 5-209, Comment 2.

[70] ULTA § 3-205(e).

[71] *Id.*

[72] *See* ULTA § 3-209(4); USLTA § 5-209(c)(1). *See also* text accompanying notes 49-51 *supra*.

[73] ULTA § 3-209(4); USLTA § 5-209(c)(1).

[74] *Id.*

[75] ULTA § 3-301(b)(4); USLTA § 3-209(4).

> . . . if made under a construction security interest to enable completion of the agreed improvement of the real estate, whether or not the advances or obligations exceed the secured maximum amount stated in the instrument or the secured creditor had knowledge of the intervening interest.[76]

Thus, under the ULTA and the USLTA, a construction lender receives priority over intervening security interests from the time the mortgage was recorded for all advances made "to enable completion" of the construction, regardless of whether they were made pursuant to commitment.[77]

The Comment to USLTA section 3-209 states that "[m]ajor policy reasons" support according this special priority to advances made by the construction lender "to enable completion" of construction.[78] The listed policy reasons include the encouragement of construction starts, the completion of construction projects despite cost over-runs, and the prevention of building abandonment.[79] Nevertheless, ULTA section 3-301(b)(4) and USLTA section 3-209(4) may go beyond protecting advances made by the construction lender and in fact used to complete the project. Since the provision requires only that the advances be made under a construction security agreement to *enable* completion of construction, advances arguably receive priority even if they are diverted from construction by the borrower. This allowance of priority to diverted funds clearly does not forward the policy goals set forth in the Comment to USLTA section 3-209.

In contrast to ULTA section 3-301(b)(4) and USLTA section 3-209(4), USLTA section 5-209(c)(1) denies the construction lender priority with respect to diverted funds when an intervening encum-

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[76] *Id.*

[77] *See* text accompanying notes 30-35 *supra.*

[78] USLTA § 3-209, Comment.

[79] *Id.*

[80] According priority to funds advanced "to enable completion" of the improvement but diverted by the borrower appears inevitable under the USLTA. The special provision concerning the priority of advances when an intervening interest is a mechanics' lien accords the construction lender priority only for advances made "in payment of the price" of the improvement, not for all funds advanced "to enable completion" of the improvement. USLTA § 5-209(c)(1). Comment 2 to § 5-209 specifically indicates that the language of USLTA § 5-209(c)(1) is intended to protect the mechanics' lien claimant against possible diversion of funds by the borrower. *See* text accompanying notes 81-87 *infra.* Arguably, if the drafters of the USLTA intended to give consensual lien claimants similar protection against diversion, they would have used the "in payment of the price" language rather than the "to enable completion" language in § 3-209(4).

brance is a mechanics' lien. The provision states that advances made under a construction security agreement have priority over a mechanics' lien only if the security agreement was recorded before the lien attached and if the subsequent advance was made "in payment of the price of the agreed improvements."[81] The requirement that the construction security agreement be recorded prior to the attachment of the lien accords with basic recording principles. The further requirement that the advances be made "in payment of the price" of an improvement, rather than "to enable completion" of an improvement, gives the mechanics' lien claimant significant protection against possible diversion of funds.[82] The priority of advances di-

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Under the Federal Tax Lien Act of 1966, cash advances made after tax lien filing but pursuant to a written real property construction or improvement financing agreement entered into before tax lien filing are accorded priority as against the intervening tax lien. I.R.C. § 6323(c)(1)(A)(ii). The Act further provides that the agreement must be to make cash disbursements "to finance" the construction or improvement (or a contract to construct or improve), but does not specifically address the question of diversion of funds by the borrower. I.R.C. § 6323(c)(3)(A)(i),(ii). However, since the underlying policy rationale for the special priority given such advances is that they generally enhance the value of the property for the purposes of the tax lien, the legislative intent appears to be that the disbursement must in fact finance the construction or improvement. *See* S. REP. No. 1708, 89th Cong., 2d Sess. 2, *reprinted in* [1966] U.S. CODE CONG. & AD. NEWS 3722, 3723.

[81] *Id.*

[82] *See* text accompanying note 79 *supra*. USLTA § 5-209(c)(1) places a distinct burden on construction lenders to advance funds with reasonable diligence and to insure that the funds are actually used in the construction project. Since the construction lender must accept this burden in every case to prevent the diversion of funds and thereby maintain his priority over mechanics' lien claimants, he would assume no greater burden if he were denied priority over intervening consensual security interests under USLTA § 3-209(4) when diversion eoes occur. *See also* ULTA § 3-301(b)(4).

Allowance of priority to diverted funds presents particular problems under existing law for the seller of land who takes a purchase money mortgage from his buyer. A construction lender normally requires the purchase money mortgagee to enter into an agreement by which he subordinates his otherwise paramount interest to that of the construction lender. *See, e.g.*, Kennedy v. Betts, 33 Md. App. 258, 364 A.2d 74, (Ct. Spec. App. 1976); Cambridge Acceptance Corp. v. Hockstein, 102 N.J. Super. 435, 246 A.2d 138 (1968)(per curiam). Should the purchase money mortgagee execute an unqualified and unconditional subordination agreement, all advances made by the construction lender receive priority over the purchase money claim. Forest Inc. v. Guaranty Mtge. Co., 534 S.W.2d 853, 856 (Ct. App. Tenn. 1975). In the more common situation, when the purchase money mortgagee agrees to subordinate on condition that advances be made according to a schedule determined by various stages of completion, his claim retains its priority with respect to advances made in excess of those stipulated in the schedule. Housing Mtge. Corp. v. Allied Constr. Inc., 374 Pa. 312, 97 A.2d 802 (1953); 1 L. JONES, A TREATISE ON THE LAW OF MORTGAGES OF REAL PROPERTY § 742, at 1104 (8th ed. 1928). *See generally* Bell, *Negotiating the Purchase-Money Mortgage,* 7 REAL EST. REV. 51, 52-54 (1977).

verted by the borrower to some purpose other than payment of a prime contractor or a lien claimant on the job is governed by section 5-209(b). Under that subsection, diverted advances are subordinated to the mechanics' lien if they were made with knowledge that the lien had attached.[83]

USLTA section 5-209(c)(1) strikes a balance between the competing interests of the construction lender and the mechanics' lienor. On the one hand, funds advanced by the construction lender and in fact used to complete construction enhance the value of the security. The services and materials supplied by the mechanics' lienor also add value to the security, but "more often than not it is to the interests

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In applying the traditional rules of priority, the majority of courts hold that the purchase money mortgagee must assume the risk that the borrower will divert advanced funds that are given priority under the subordination agreement. Only if the lender had agreed to monitor the application of the funds advanced, or engaged in collusion with the borrower in the diversion of funds, does the purchase money mortgagee retain priority with respect to any diverted funds. Kennedy v. Betts, 33 Md. App. 258, 364 A.2d 74, (Ct. Spec. App. 1976); Forest Inc. v. Guaranty Mtge. Co., 534 S.W.2d 853 (Ct. App. Tenn. 1975); 4 AMERICAN LAW OF PROPERTY § 16.10D, at 218 (A.J. Casner ed. 1952). *Cf.* Cambridge Acceptance Corp. v. Hockstein, 102 N.J. Super. 435, 438, 246 A.2d 138, 141 (1968)(per curiam). In *Hockstein,* the court held that a lender's total indifference to whether advanced funds were applied to the construction was evidence that the designated "construction loan" was essentially a camouflage for a loan on the general credit of the borrower and the security of the land. Since the subordination agreement extended only to genuine construction loans, the court denied priority to diverted advances. The court nevertheless noted that "under general principles of mortgage subordination law . . ., a construction lender taking the benefit of a subordination is not a guarantor to the subordinator or liable to him for mere negligence in seeing to the appropriation of the moneys to the construction . . ." *Id. Contra,* First Nat'l Bank v. Virden, 208 Miss. 679, 682, 45 So. 2d 268, 270-71 (1950) (construction lender should advance funds with "reasonable diligence" so that holders of statutory liens will not be unjustly defeated in their claims; lender has priority only to the extent that its funds actually went into construction).

The purchase money mortgagee may avoid the harsh rules of the prevailing law only by providing in the subordination agreement that his claim is not subordinated to any advances that are not applied to the construction project. Even though he is compelled to subordinate so that the mortgagor may obtain funds for construction, the onus remains upon him to limit narrowly the terms of the subordination agreement.

Since the ULTA and the USLTA do not specifically address the priority status of purchase money claims, the preferred status given the purchase money mortgagee under existing law, *see generally* OSBORNE, *supra* note 1, at § 213, is not altered under either statute. Nor are interpretations of the terms of a subordination agreement governed by any specific statutory provisions. Thus, the courts remain free to continue to interpret agreements that are not narrowly drawn to allow for subordination of the purchase money interest to funds advanced according to schedule but subsequently diverted by the borrower.

[83] USLTA § 5-209(b).

of [mechanics' lienors] as a class to have the construction lender supply funds to the project."[84] Thus, funds advanced by the lender and applied to the construction project receive priority even if the lender had knowledge that a mechanics' lien had attached.[85] On the other hand, funds advanced by the construction lender but diverted by the borrower do not enhance the value of the security. The claim for the value-adding services and materials of the mechanics' lienor consequently prevails over the diverted advances if the advances were made with knowledge that the mechanics' lien had attached.[86]

The provisions dealing with future advances in the ULTA and USLTA represent a long overdue attempt to codify an area of real estate law that is of significant concern to the construction industry and to construction lenders. The present law of future advances is basically decisional and varies from state to state.[87] Questions of priority of lien claimants cannot readily be determined, and this uncertainty may impede real estate development, particularly in unfavorable economic periods.[88] Uniform legislation in the area is therefore desirable, and the ULTA and USLTA provisions accordingly deserve careful study by state legislatures. The states must recognize, however, that the ULTA and USLTA as individual statutes do not provide comprehensive coverage of the law of future advances.[89] Furthermore, while both statutes recognize the importance of encouraging construction and the completion of construction projects, the special priorities accorded construction lenders[90] do not take into account the problem of diversion of advanced funds when an intervening interest is not a mechanics' lien claim.[91] Integration as well as revision of the provisions and concepts of each statute is therefore necessary to achieve the desired uniformity in this area of the law.

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[84] USLTA § 5-209, Comment 2.
[85] USLTA § 5-209(c)(1).
[86] USLTA § 5-209(b).
[87] *See* notes 5-6 *supra.*
[88] Kratovil & Werner, *supra* note 4, at 321-22.
[89] *See* note 18 *supra.*
[90] *See* text accompanying notes 74-85 *supra.*
[91] *Id.*