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VIRGINIA MECHANICS' LIENS:  
A PRECARIOUS PRIORITY

By

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and

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INTRODUCTION

The Virginia mechanics' lien statutes prescribe a method whereby laborers and materialmen, incident to new construction or improvements to real estate, may perfect a lien upon the improved real estate to the extent of the value of their goods or services which contributed to the value of the realty. The statutes further provide a method of enforcement in the form of a chancery suit filed in the prescribed manner and within the prescribed time. Lastly, they accord to these liens a priority over all others, including antecedent deeds of trust, as to the value of the improvements, liens prior in time retaining priority as to the value of the property before the improvements were made.

The United States Government, nominally and through its numerous administrative agencies set up through the years to promote the public weal, has thrust itself into the position of the nation's most active creditor; as such it often finds it necessary to impose various liens to secure its bounty. Some of these liens arise by operation of federal law; resort is had to state law to perfect others. It is often surprising in the latter case that, having reaped the benefit of the local laws regarding the *establishment* of its lien, the United States takes occasion to repudiate other local laws regarding its relative *priority*.

The conflict between mechanics' liens and federal financing was recently brought into bold relief in the case of *W. T. Jones and Company v. Foodco Realty, Inc.*,<sup>1</sup> wherein the United States, undisclosed

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<sup>1</sup>318 F.2d 881 (4th Cir. 1963).

participant in a Virginia deed of trust loan, was accorded priority—unprecedented in Virginia—over several mechanics' lienors who under Virginia law had unquestioned priority. The result of this case and its counterparts should give pause to lending institutions, building contractors and suppliers who have become accustomed to rely upon the time-honored statutory priority of mechanics' liens.

#### THE VIRGINIA LAW

In Virginia, laborers and materialmen are accorded a statutory lien by section 43-3 of the Code of Virginia (1950), which provides in part as follows:

“All persons performing labor or furnishing materials, of the value of ten dollars or more, for the construction, removal, repair or improvement of any building or structure permanently annexed to the freehold... shall have a lien... upon such building or structure, and so much land therewith as shall be necessary for the convenient use and enjoyment thereof...”

It is further provided in section 43-4 that the lien may be perfected by the recordation, within sixty days from the time the work is completed or otherwise terminated, of a memorandum of lien setting out the particulars of the lien in detail. Enforcement of the lien may be effected in compliance with section 43-22, which requires the filing of a foreclosure suit in equity, in which the claimant must file an itemized and verified statement of account.

Upon compliance with the foregoing rather exacting statutes, the lienholder is vested with a lien prior in law to all others as to the improvements, and inferior to those before it as to the property as it existed before the improvements were made. Section 43-21 provides in part:

“No lien or encumbrance upon the land created before the work was commenced or materials furnished shall operate upon the building or structure erected thereon, or materials furnished for and used in the same, until the lien in favor of the person doing the work or furnishing the materials shall have been satisfied; nor shall any lien or encumbrance upon the land created after the work was commenced or materials furnished operate on the land, or such building or structure, until the lien in favor of the person doing the work or furnishing the materials shall have been satisfied...”

The priority set up by section 43-21 has been uniformly preserved

by the Virginia courts.<sup>2</sup> In *Rust v. Indiana Flooring Co.*,<sup>3</sup> it was held that the beneficiary under a prior recorded deed of trust is subordinated to the holders of subsequent mechanics' liens, where the deed of trust proceeds were applied to construction, even though the deed of trust obligee had made certain payments of the loan proceeds directly to the mechanics' lienors, and there could be no question of their notice of this encumbrance.

This established priority has been taken for granted in Virginia real estate transactions through the years, so much so that the obtaining of written mechanics' lien waivers is now a routine step in the closing of construction loan transactions where the deed of trust is put to record prior to the completion of construction.

#### EXPANSION OF FEDERAL FINANCING

We are told that there was a time when the federal government eschewed entry into the field of consumer credit, and did content itself with the management and safeguarding of matters then deemed to be of overriding national significance. However, the advent of the great depression and various subsequent crises forced or induced the central government to embark upon a program of financing which is now available in some form to most citizens, and which, in a very real and competitive sense, overhangs and profoundly affects the market.<sup>4</sup> The substantial increase in the scope and extent of real estate development which marks this era has been stimulated in no small measure by loan participation, either on a direct loan or a guaranty basis, by the federal government. The government's entry into the credit field, can, however, give rise to anomalous results by reason of the conflict between sovereign and private interests; such were the results obtained in *Foodco* case.

#### FACTS OF THE FOODCO CASE

Foodco Realty Inc., was the owner of certain real estate in Campbell County, Virginia, upon which it proposed to construct a large factory and warehouse to be operated by Foodco's parent corporation,

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<sup>2</sup>12 Mich. Jur., Mechanics' Liens § 39 (1950): "And there is no way that a person may lend money so that he will have priority over mechanics' liens, where the money is to be used for the construction of a building."

<sup>3</sup>151 Va. 845, 145 S.E. 321 (1928).

<sup>4</sup>Among the administrative agencies set up to provide such financing, the Federal Housing Administration, the Veterans' Administration, the Small Business Administration and the Farmers' Home Administration are probably the most active.

Famous Virginia Foods Company. The construction loan was made to Foodco by the Campbell County Bank, the bank participating, however, only to the extent of 10 per cent of the loan, and the Small Business Administration, an agency of the United States Government, for the remaining 90 per cent. There was no public record or notice of the federal participation. The note was made payable to the order of the bank alone, and the deed of trust was in a form usual in Virginia, naming two private individuals as trustees, and incorporating by reference the provisions of sections 55-59 and 55-60 of the Code of Virginia (1950). Shortly after the deed of trust was recorded, construction began and the same was completed within the following year. From time to time, in accordance with Virginia law, various laborers and materialmen perfected mechanics' liens against the real estate by recording the required memoranda of liens.<sup>5</sup> Subsequently a suit was brought in equity to subject the realty to these liens. There being no notice of federal involvement, the United States was not made a party to this suit. It intervened, however, and succeeded in removing the suit to the United States District Court, where it was contended by the government that it was entitled to full priority under the deed of trust,<sup>6</sup> notwithstanding the fact that under Virginia law mechanics' liens would have priority as to the improvements.<sup>7</sup>

The District Court, reversing a Special Master's ruling, accorded the government priority as to the entire obligation;<sup>8</sup> on appeal the United States Court of Appeals for the Fourth Circuit affirmed the decision in substance, but held that the governmental priority extended only to 90 per cent of the obligation. Thus it was held that the United States, a silent participant in a loan transaction, gains full priority over mechanics' lienors in contravention of the applicable local law. In order to reach this result, the courts pursued two lines of reasoning: the District Court's decision was based on "Federal Common Law," while the Circuit Court of Appeals applied the Federal Priority Statute.<sup>9</sup>

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<sup>5</sup>Neither the bank nor the SBA obtained written waivers of these liens.

<sup>6</sup>Sometime during the pendency of the suit the SBA obtained from the bank an assignment of the bank's interest in the note, in consideration of SBA's promise to turn over to it 10% of any sums realized.

<sup>7</sup>The value of the property before the improvements were made was established at \$25,000; in all, \$156,229 was spent on the improvements; the liquidation value was established at between \$78,000 and \$80,000.

<sup>8</sup>206 F. Supp. 878 (W.D. Va. 1962).

<sup>9</sup>31 U.S.C. § 191 (1958).

"FEDERAL COMMON LAW"

In an opinion that only indirectly indicated the basis of federal jurisdiction, the District Court relied primarily on *Clearfield Trust Co. v. United States*.<sup>10</sup> Since the United States was a party to the proceeding,<sup>11</sup> holding a deed of trust lien, the District Court reasoned that it was obliged to look beyond the Virginia statutes for a rule of law more compatible with the national interest. With the fetters of local real estate law thus cast aside, the logical inquiry was: What is the "Federal Law?"<sup>12</sup>

In 1827 Chief Justice Marshall declared, in the case of *Rankin v. Scott*, that "a prior lien gives a prior claim, which is entitled to prior satisfaction, out of the subject it binds. . . ."<sup>13</sup> Although *Rankin v. Scott* involved a dispute between private citizens, the case has been widely cited for the proposition that the federal law relating to federal priority is that "the first in time is the first in right."<sup>14</sup> Such was the conclusion of the District Court in the *Foodco case*. The Circuit Court of Appeals, however, noted that this federal common law principle is properly invoked only "in the absence of a statute to the contrary,"<sup>15</sup> and went on to base its arrival at substantially the same result, on what is known as the Federal Priority Statute.

THE FEDERAL PRIORITY STATUTE

Since 1799<sup>16</sup> there has been in effect what is popularly known as the Federal Priority Statute.<sup>17</sup> This enactment, widely cited and widely applied in bankruptcy and liquidation proceedings, but little reckoned with at the local level, provides:

"Whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of the executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be first satisfied; and the priority established shall extend as well to cases in which a debtor, not having sufficient

<sup>10</sup>318 U.S. 363 (1943).

<sup>11</sup>See 28 U.S.C. §§ 1345, 1441 (1958); *United States v. Bond*, 108 F.2d 504 (10th Cir. 1939), aff'g, *Bond v. Tom* 25 F. Supp. 157 (D. Okla. 1938).

<sup>12</sup>206 F. Supp. at 885.

<sup>13</sup>25 U.S. (12 Wheat) 177 (1827).

<sup>14</sup>E.g., *United States v. City of New Britain*, 347 U.S. 81 (1954).

<sup>15</sup>318 F.2d at 889.

<sup>16</sup>Act. of Mar. 3, 1797, ch. 20, § 5, 1 Stat. 515.

<sup>17</sup>Or unpopularity, depending upon which cause one espouses. 31 U.S.C. § 191 (1958).

property to pay all his debts, makes a voluntary assignment thereof, or in which the estate and effects of an absconding, concealed, or absent debtor or attached by process of law, as to cases in which an act of bankruptcy is committed."

The wording is so broad that, viewed without reference to the cases which construe it, the statute would apparently extend to any case in which the United States is a creditor and in which the debtor's estate is insufficient to pay all debts.<sup>18</sup> But certain express or implied limitations have been read into the statute.

In the first place, the state of insolvency which renders the statute operative must not consist of "mere inability of the debtor to pay all his debts. . . ."<sup>19</sup> The insolvency must be manifested by some "notorious act"<sup>20</sup> by the debtor, such as a voluntary assignment for the benefit of creditors, an attachment, or an act of bankruptcy.

In the second place, there is abundant dicta to the effect that the statute will not operate to divest a private lien which is *specific and perfected*.<sup>21</sup> Although the Supreme Court has never squarely so ruled,<sup>22</sup> there is a sufficient abundance of judicial consideration of the subject to make it at least conceivable that a private lien, specific and perfected according to state law, may yet prevail over a federal claim. Assuming, as private creditors would like to do, that this is the case, the next and most troublesome question is at what stage a given lien becomes "specific and perfected," and in particular whether a mechanics' lien is capable of meeting the tests of specificity and perfection which have been laid down by the courts.

With regard to specificity, the Virginia statute<sup>23</sup> requires the prospective lienor to record a memorandum under oath specifying: (1) the name of the owner of the property sought to be charged; (2) the name of the claimant; (3) the amount and consideration of his claim; (4) when the same is or will be payable; (5) a statement that he intends

<sup>18</sup>The statute has been given broad effect by most decisions. See, e.g., *United States v. City of New Britain*, 347 U.S. 81 (1954); *United States v. Gilbert Associates*, 345 U.S. 361 (1953); *United States v. Waddill, Holland & Flinn, Inc.*, 323 U.S. 353 (1945); *United States v. Emory*, 314 U.S. 423 (1941).

<sup>19</sup>*Conard v. Atlantic Co.*, 25 U.S. (1 Pet.) 386 (1828).

<sup>20</sup>*Prince v. Bartlett*, 12 U.S. (8 Cranch) 431 (1914); *United States v. Press Wire- less*, 187 F.2d 294 (2d Cir. 1951); *Nolte v. Hudson Nav. Co.*, 8 F.2d 859 (2d Cir. 1925).

<sup>21</sup>*United States v. Fidelity & Dep. Co. of Md.*, 214 F.2d 565 (5th Cir. 1954); *United States v. Atlantic Mun. Corp.*, 212 F.2d 709 (5th Cir. 1954); *United States v. Division of Labor Law Enforcement*, 201 F.2d 857 (9th Cir. 1953).

<sup>22</sup>See *United States v. Gilbert Associates*, 345 U.S. at 365.

<sup>23</sup>Va. Code Ann. § 43-4 (1950).

to claim the lien; and (6) a description of the property sought to be charged. Subsequently, within six months, he must file a chancery suit to enforce the lien,<sup>24</sup> and with it he must file a statement of account under oath, showing: (1) the amount and character of the labor and materials furnished; (2) the prices charged; (3) the payments made; (4) the balance due; and (5) the time from which interest is claimed.

It is difficult to conceive how a mechanics' lienor could be more *specific* than by following the requirements of Virginia law. The real obstacle placed in his path is the requirement that his lien be *perfected*. It is before this requirement that mechanics' liens invariably fall.<sup>25</sup> The applicable federal decisions intimate that in order for a mechanics' lien to be sufficiently specific and perfected to displace a federal claim, if indeed such a result is possible, it must be actually reduced to judgment in the foreclosure suit. As a practical matter, of course, if the suit has progressed to conclusion, the question is moot, at least as regards the mechanics' lienor. Moreover, at least one Supreme Court decision has held that the test is not met even where the foreclosure suit is concluded and the real estate is owned by a remote grantee.

This case, probably the most significant one illustrating the dilemma of the mechanics' lien, is *United States v. White Bear Brewing Co.*,<sup>26</sup> which involved the following chronological events: (1) a mechanic's lien was recorded for a specific amount encumbering real estate; (2) suit was instituted to enforce the lien; (3) federal taxes were assessed against the landowner; (4) the liens for these taxes were recorded; (5) the mechanic's lien was reduced to judgment; (6) the real estate was sold by order of court; (7) a deed was executed to a third party purchaser, who subsequently conveyed the real estate to another party; and (8) sixteen months later the United States instituted a suit seeking to subject the real estate to its tax liens. The District Court and Seventh Circuit Court of Appeals both held that the tax liens were subordinated to the mechanic's lien, and that the existing owner held the realty free and clear of the tax liens. The United States Supreme Court reversed without opinion.<sup>27</sup> There being no opinion, one can only surmise as to the Court's rationale. The United States was not "first in

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<sup>24</sup>Va. Code Ann. § 43-22 (1950).

<sup>25</sup>As a matter of fact, no case has been found which squarely holds that mechanics' liens are entitled to priority over a lien of the United States.

<sup>26</sup>350 U.S. 1010 (1956).

<sup>27</sup>The facts of this case are gleaned from the opinion of the Seventh Circuit Court of Appeals, 227 F.2d 359, and the vigorous dissenting opinion of Justices Douglas and Harlan, 350 U.S. 1010.

time," and the mechanic's lien had been properly prosecuted to conclusion.

In recent years, the Supreme Court has decided three other cases which reach substantially the same result as that in the *White Bear* case;<sup>28</sup> it is interesting to note that each of these cases, like *White Bear*, consists of a per curiam judgment of reversal, without opinion.

Along with its counterpart, the *White Bear* case has been widely cited as authority in various decisions which uphold federal priority as against various private liens. The case leaves little doubt that the mechanic's lien occupies an extremely precarious position; indeed, the courts have imposed such stringent tests that its subordination to federal tax claims is practically certain, regardless of relative chronology.<sup>29</sup>

The federal supremacy so clearly established as to tax liens was extended by the *Foodco* case to a federal lien acquired in the course of governmental participation in private business. The troublesome policy implications are more clearly delineated here; the government, which has gone into competition with private lenders, is allowed on the one hand to claim the benefit of local laws to establish its deed of trust lien,<sup>30</sup> and on the other hand to repudiate other local laws to effect its priority.

But the Supreme Court has apparently recognized no distinction between the government's position where it levies taxes and where it lends money. In *Small Business Administration v. McClellan*<sup>31</sup> it was held (1) that the Small Business Administration is "'an integral part of the governmental mechanism' created to accomplish what Congress deemed to be of national importance;" it was further held (2) that on insolvency the Small Business Administration is entitled to full governmental priority under the Federal Priority Statute, even

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<sup>28</sup>*United States v. Hulley*, 358 U.S. 66 (1958); *United States v. Vorreiter*, 355 U.S. 15 (1957); *United States v. Colatta*, 350 U.S. 808 (1955).

<sup>29</sup>"If anything is clearly discernible from the broad view of the federal priority picture, it must be that private security interests have been denuded of the protection bargained for or statutorily prescribed. The government as a creditor has acquired a supremacy almost impossible to characterize." *Tofel, Federal Priority: First in Time Is Not First in Right*, 7 N.Y.L.F. 380, 392 (1961).

<sup>30</sup>The Virginia deed of trust as a security device is entirely a creature of statute. By its use in compliance with Virginia law, the creditor avails himself of a lien which is flexible, and yet which guarantees the debtor reasonable protection. An equivalent lien created without resort to Virginia statutes results in a common law mortgage, cumbersome to use and difficult and expensive to foreclose.

<sup>31</sup>364 U.S. 446 (1960).

though it had agreed to share any funds collected with the local bank with which it participated on the loan.<sup>32</sup>

There are many who feel that the result reached in these cases is inequitable;<sup>33</sup> that there is created a perpetual uncertainty which raises unanswerable questions regarding the title to real estate; and that as a matter of fundamental fairness, the artisans who extend their credit to add value to the government's security should be able effectively to avail themselves of the only lien which the law affords them.<sup>34</sup> The solution is by no means clear; there are, however, two approaches to a solution which may merit consideration.

#### SUSTAIN SPECIFIC AND PERFECTED LIENS

In spite of several lower court decisions<sup>35</sup> suggesting that the strong wording of the Federal Priority Statute is tempered somewhat where competing private liens are both specific and perfected, it should be emphasized that the United States Supreme Court has never squarely so held. The lengths to which the Court has gone to sustain federal priority would almost suggest that such speculation is unwarranted, and that irrespective of state law, time sequence, specificity, "choateness" or any of the various rationales which have been superimposed by the court, the Statute means just what it says: "the debts due to the United States shall be first satisfied."

The judicial exemption of private liens which are specific and perfected, indulged in by some decisions, is justified on equitable principles (and it is in courts of equity that these cases of foreclosure and liquidation most often arise). So it would seem fitting for the Congress to amend the Federal Priority Statute to exempt specific and perfected

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<sup>32</sup>The Court followed its prior decision in *United States v. Emory*, 314 U.S. 423 (1941). Mr. Justice Reed's dissent in the Emory case reflects a point of view which, though still extant, has been rejected time and again by the Supreme Court, to-wit: that "government aid to a debtor may be a snare for his other creditors" no less deserving of governmental consideration. 314 U.S. at 438.

<sup>33</sup>See, e.g., the dissent of Haynsworth, J., in *United States v. Bond*, 279 F.2d 837, 849 (4th Cir. 1960): "When the tax lien seizes property, the real value of which has been largely enhanced by lienor's labor and materials, it appropriates values which the mechanic had created and which are his, in an economic sense, until he is compensated and his lien or right to lien is discharged. The seizure of such value seems an unjust enrichment of the United States at the expense of the mechanic, not that of the taxpayer."

<sup>34</sup>The Supreme Court of yesteryear took this view, and in giving effect to local mechanic's lien laws stated: "And this is just. Why should a purchaser or lender have the benefit of the labor and materials which go into the property and give it its existence and value?" *Davis v. Bilsland*, 18 Wall. (85 U.S.) 659 (1874).

<sup>35</sup>See note 21 *supra*.

private liens from its operation. The prospect, however, of this substantial amendment to a statute which has been in effect since the eighteenth century, is visionary indeed. Even so, the plight of the mechanic's lien would not necessarily be alleviated even by this action. According to the decisions, the mechanic's lien is endowed with virtually no specificity and is incapable of perfection;<sup>36</sup> it is perpetually inchoate. So whatever benefit might enure to other private lienors by such an amendment, the mechanic's lien would remain in a precarious position.

#### APPLY STATE LAW IN ADJUDICATING REAL PROPERTY LIENS

It is not amiss to point out that the several states, whatever their derelictions in other regards, have a legitimate and paramount interest in matters relating to the title to real estate within their respective boundaries. Sale, purchase and security transactions involving real estate are conducted, generally speaking, in reliance upon the applicable state laws governing deeds, mortgages, recordation, priorities and related matters.

The sanctity of local real estate usage conflicts rather spectacularly with the federal interests in a case such as *Foodco*. The question, then, is whether the uniformity called for by the *Glearfield Trust* case is of paramount importance to the point of supplanting local law; or whether the United States, insofar as it participates at the market place, is committed to the law merchant.<sup>37</sup>

Uniformity, it must be conceded, is not a fetish to be followed blindly. Congress has seen fit on many occasions to deem state law applicable to matters arising within the purview of a broad congressional enactment. For instance, the Social Security Act compels reference to state law in determining the family relationships incident to old age and insurance benefits.<sup>38</sup> The Small Business Act subordinates the United States to the liens of state and local taxes, as established by state law.<sup>39</sup> It is not inconceivable, then, to suppose that the

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<sup>36</sup>Mechanics' and similar liens are regarded as no more than "a caveat of a more perfect lien to come;" virtual possession of the encumbered property is required. *United States v. Waddill, Holland & Flinn, Inc.*, 323 U.S. 353 (1945).

<sup>37</sup>It was pointed out by Mr. Justice Holmes in *United States v. National Exchange Bank*, 270 U.S. 527, 534 (1925) that "The United States does business on business terms . . ." and "is not excepted from the general rule by the largeness of its dealings and its having to employ agents to do what if done by a principal in person would leave no room for doubt."

<sup>38</sup>42 U.S.C. § 416(h)(1).

<sup>39</sup>15 U.S.C. § 646.

United States might be required, where it encumbers real estate incident to a credit transaction, to recognize and comply with local lien laws. With such an end in view, the various federal enabling acts, or the Federal Priority Statute itself, might be amended. Until some effective action is taken, the mechanic's lien will continue to occupy its unenviable position when opposed by federal claims.

#### CONCLUSION

Federal financing, particularly of the type afforded by the Small Business Administration, is most often extended where comparable financing is unavailable from local sources. In many cases, local lenders, who are closely familiar with an applicant's situation, refuse to underwrite a venture which they deem speculative, only to find that the applicant subsequently acquires federal financing. Then, when the inevitable collapse occurs, the United States successfully asserts its priority, and quite often local laborers and materialmen, who have contributed to the property its essence, are left without an effective remedy. Thus is laid, in the words of Mr. Justice Reed,<sup>40</sup> "a snare" for private creditors.

Under Virginia law, a properly perfected mechanic's lien, to the extent of the improvements made to real estate, is well nigh invulnerable. However, its total vulnerability to federal liens, regardless of when or under what circumstances the latter may arise, should give pause to contractors, suppliers and laborers, and to the attorneys who advise them. The tests laid down by the United States Supreme Court divest the mechanic's lien of its intended status and render the question of lien priorities forever contingent upon federal participation; it is even arguable that senior lien interests vested under state law might be totally divested by the assignment of a junior lien to the United States.

The *sine qua non* of effective real estate development is that builders and suppliers be ready and willing to launch construction with some assurance of being paid. The intricacies of high finance and the law of real property do not and should not trouble the artisan who, by his labors, adds to the land that which neither contract nor court construction can take away.

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<sup>40</sup>See note 32 *supra*.



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