Recent Legislation: Real Property--Mortgages to Secure Future Advances

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Recent Legislation

REAL PROPERTY — MORTGAGES TO SECURE FUTURE ADVANCES

The recent amendment to section 5301.23 of the Ohio Revised Code should have a substantial effect upon the status of the open-end mortgage contract in Ohio. To fall within the purview of the statute, the contract must state, in substance or effect, that the parties intend it to secure unpaid balances arising from loan advances made by the mortgagee at the request of the mortgagor. In addition, provision must be made to limit the total amount of indebtedness to be secured. Also, the mortgagor may, in his discretion, further limit the amount secured to a sum not less than the amount of the unpaid balance at any time, provided he gives written notice of his decision to the mortgagee and records such notice as an amendment to the mortgage. Where there is more than one open-end mortgage secured by the same property, the mortgagee first to record his lien on the property securing the mortgage will have priority over those who subsequently record.

1 Effective September 15, 1965.

2 The open-end mortgage is basically a contractual agreement between two parties whereby specific property of the mortgagor is pledged to secure present and future obligations running from the mortgagor to the mortgagee.

3 Ohio Rev. Code § 5301.23 (B) [hereinafter cited as Code] provides:

Whether or not it secures any other debt or obligation, a mortgage may secure unpaid balances of loan advances made by the holder of the mortgage at the request of the mortgagor or his successor in title after the mortgage is delivered to the recorder for record to the extent that such unpaid balances, in the aggregate and exclusive of interest accrued thereon, do not exceed the maximum amount thereof which the mortgage states may be outstanding at any time. A mortgage shall secure such unpaid balances only if it states, in substance or effect, that the parties thereto intend that it shall secure the same and further states the maximum amount of such unpaid balances, in the aggregate and exclusive of interest accrued thereon, which may be outstanding at any time. All mortgages arising under divisions (B), (C), (D), and (E) of this section shall contain at the beginning of the instrument or indenture the following language: "OPEN-END MORTGAGE; Total Indebtedness Not to Exceed §________.”

4 Code § 5301.23 (B), as amended, provides:

The mortgagor or his successor in title may limit the unpaid balance of advances referred to in division (B) of this section which are secured by the mortgage to an amount not less than the amount of such unpaid balances outstanding at the time of delivery of a notice to that effect to the recorder for record if such notice is executed by him in the manner provided in section 5301.01 of the Revised Code and a copy thereof is served upon the holder of the mortgage prior to the delivery of such notice to the recorder for record. Any such notice shall be recorded and indexed by the recorder as an amendment of the mortgage.

5 Code § 5301.23 (A).
By implicitly overruling *Spader v. Lawler* and *Second Nat’l Bank v. Boyle,* the statute resolves a conflict which has long existed in Ohio. Prior to its adoption, Ohio subscribed to the view that constructive notice to the original mortgagee of an intervening encumbrance was sufficient to render the claim of the mortgagee subject to the claim of the intervening lienor. However, it should be noted that in the past, the actual notice requirement was applied to laborers and materialmen with respect to mortgage advances made to eliminate prior encumbrances or to make improvements on the mortgaged property.

Even though there was ample reason for the adoption of this statutory exception to the Ohio common law, the inevitable result of this conflict between common law and statutory law was confusion and inequity. One who considered himself to be neither a laborer nor a materialman, but who in fact performed work similar to either, could never be entirely certain of his legal status. In addition, to burden the laborer and materialman with statutory notice requirements beyond those imposed upon other creditors was discriminatory and unjust. The most detrimental effect of this conflict, however, was not in the confusion which it created, nor in the unfortunate inequities which resulted from it, but in its tendency to reduce the practical value of the entire open-end mortgage device.

Ohio Revised Code section 5301.23 provides that the lien of the

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6 17 Ohio 371 (1848).
7 155 Ohio St. 482, 99 N.E.2d 474 (1951).
9 CODE § 1311.14. Prior to 1915, with respect to building construction contracts, any mortgages given or recorded after the commencement of the excavation, construction, or improvement should be junior to all mechanic’s liens on the job, and . . . a mortgagee took his mortgage subject to the liens of all lienholders who furnished labor or material for the excavation, construction, or improvement, regardless of whether the same was furnished before or after the mortgage was recorded. This had the effect of stopping building operation entirely, unless a method were to be devised whereby the improvement could be finished by means of a mortgage loan secured after the work had commenced. 36 OHIO JUR. 2d, Mechanic’s Liens § 116 (1959). (Emphasis added.)

The “method” devised was an exception to the constructive notice doctrine previously espoused by the Ohio judiciary, in the form of a new statutory notice requirement. After 1915, any laborer or materialman who claimed a lien on the mortgaged property by virtue of his labor, machinery, material, or fuel was required to give the mortgagee who had entered into a mortgage agreement for future advances, actual, written notice of his claim, or the intervening lien would be held subordinate to subsequent advances claimed by the original mortgagee. CODE § 1311.14. See, e.g., Krollman Lumber Co. v. Hullenbrand, 50 Ohio L. Abs. 636 (C.P.), *modified*, 64 Ohio App. 549, 29 N.E.2d 61 (1940); Zimpher v. Schwartz, 64 Ohio App. 7, 27 N.E.2d 499 (1940).

10 See discussion in note 9 *supra*.
11 Note, 47 IOWA L. REV. 432, 450 (1962).
original mortgagee shall be prior in right to that of a subsequent intervening lienor, unless the original mortgagee had received written notice of the intervening lien prior to making the subsequent advances.\textsuperscript{12} Where the mortgagee is obligated by the terms of the open-end contract to make subsequent advances at the request of the mortgagor, his lien will be prior in right to any intervening lien, irrespective of notice to him of this encumbrance.\textsuperscript{13}

In general, the statute should increase the effectiveness of the mortgage to secure future advances. Complete elimination of the legal significance of constructive notice in this context is of paramount importance. The provision that written notice is necessary to render the lien of the original mortgagee subject to the claim of the subsequent lienor\textsuperscript{14} eliminates the undesirable uncertainty which previously existed with respect to the subject of priority. Equally important is the fact that the mortgagor may not reduce the total amount of indebtedness under the contract in the absence of written notice to the mortgagee.\textsuperscript{15} Thus the mortgagee is assured that all future advances are secured by the mortgaged property up to the total amount of indebtedness stated in the contract.

\textsuperscript{12} CODE § 5301.23 (D), as amended, provides:

Except as provided in division (D) of this section, a mortgage securing unpaid balances of advances referred to in and made in accordance with the provisions of divisions (B) and (C) of this section shall be a lien on the premises described therein from the time such mortgage is delivered to the recorder for record for the full amount of the unpaid balances of such advances that are ultimately and actually made under such mortgage, plus interest accrued and to accrue thereon, regardless of the time when such advancements are made. If an advance is made by the holder of a mortgage to the mortgagor or his successor in title after such holder receives written notice of a lien or encumbrance on the mortgaged premises which is subordinate to the lien of the mortgage and if such holder is not obligated to make such advance at the time such notice is received, then the lien of the mortgage for the unpaid balance of the advance so made shall be subordinate to such lien or encumbrance. If an advance is made by the holder of a mortgage to the mortgagor or his successor in title after such holder receives written notice of work or labor performed or to be performed or machinery, material, or fuel furnished or to be furnished for the construction, alteration, repair, improvement, enhancement, or embellishment of any part of the mortgaged premises and if such holder is not obligated to make such advance at the time such notice is received, then the lien of the mortgage for the unpaid balance of the advance so made shall be subordinate to a valid mechanic's lien or other valid lien for the work or labor actually performed or machinery, material, or fuel actually furnished as specified in such notice.

\textsuperscript{13} Ibid. On the question of priority with respect to obligatory advances, Ohio has traditionally subscribed to the view that the lien of the original mortgagee shall prevail over all intervening encumbrances. See, e.g., Kuhn v. Southern Ohio Loan & Trust Co., 12 Ohio App. 184 (1919), aff'd, 101 Ohio St. 34, 126 N.E. 820 (1920).

\textsuperscript{14} See note 12 supra.

\textsuperscript{15} See note 4 supra.
However, in spite of the beneficial effect that section 5301.23 should have on the mortgage to secure future advances, several problems remain. First, notice requirements lose their importance when the original mortgagee's subsequent advances are "obligatory" rather than "discretionary." However, nowhere does the statute expressly define either term. Most courts define the word "obligatory" in terms of a duty assumed by the mortgagee to make future advances at the request of the mortgagor.\(^\text{16}\) However, are subsequent advances any less obligatory where the mortgagee reserves the right to make them, and must, in fact make them to protect his initial investment? If so, then the mortgagee may be placed in the unenviable position of being forced to make future advances in order to protect his initial interest, even though he knows at the time, through actual notice, that an intervening claim has arisen. Because the mortgagee was not bound by the terms of the contract to make these future advances, they may be considered optional for the purpose of notice requirements in determining priority. While the injustice of this situation should be readily apparent, nevertheless, with no definitive statutory word on the subject to guide them, Ohio courts might overlook this potential inequity.

Another problem may arise when the intervening encumbrance is made expressly subject, by the terms of the contract, to an optional future advance made under a prior open-end contract. Assuming that the intervening encumbrancer gives actual notice, and the optional mortgagee makes subsequent advances, a direct conflict would exist between the intent of the parties to the intervening agreement, and Ohio Revised Code section 5301.23, which provides that the intervening encumbrancer shall prevail. It has been held in at least one case\(^\text{17}\) that the intervening lien will take priority, notwithstanding the terms of the agreement. The result, in the absence of statute, is a subtle trap for the unwary mortgagee.

A different problem is presented when neither the mortgagee making optional future advances nor the intervening lienor records his interest in the manner required by statute. It might seem that the principle of "first in time, first in right" might control. However, the real question is whether the original advance and subsequent advances made under the initial contract should be considered one mortgage, or whether each subsequent advance should be considered a new mortgage. While the former view might be unduly

\(^{16}\) See Annot., 138 A.L.R. 566 (1942).

\(^{17}\) Boswell v. Goodwin, 31 Conn. 74 (1862).
harsh on the intervening lienor, the latter might work an oppressive burden on the mortgagee.

The manner in which the Ohio courts resolve these unanswered questions will, in large measure, determine whether future legislation in this area is needed.

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