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Robert Kratovil

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# MORTGAGE LENDER LIABILITY—CONSTRUCTION LOANS

Robert Kratovil\*

## INTRODUCTION

For centuries the question of lender liability in mortgage law has slumbered while other areas of the mortgage field were being vigorously explored. Now this area of the field has come to life. Plainly, in the near future many decisions will explore lender liability. This commentary will be confined to a very narrow issue in lender liability law, namely, the question of lender liability in a construction loan<sup>1</sup> where the lender elects to disburse the funds and mechanics' liens<sup>2</sup> arise. The question here explored is the extent of the lender's liability to the landowner for negligent disbursement of construction funds, especially where this results in the attachment of mechanics' liens to the mortgaged land.

To illustrate, an example: the construction lender disburses funds to the contractor who is building the borrower's house. But the bank has been inattentive and has paid bills for other projects out of the borrower's funds. Thus, the construction funds will be exhausted before the house is finished. There will be outstanding contractor's bills. The contractor will file a mechanic's lien against a property that is already burdened with the construction mortgage. As should be obvious, the combined liens will far exceed the value of the finished construction, and the risk of foreclosure will become very great unless the borrower is ready to step in with extra funds of his own.

Until recently in many jurisdictions the aggrieved borrower had no cause of action against the negligent lender. Courts seeking to create a remedy for

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\* Distinguished Professor of Law, The John Marshall Law School, Chicago, Illinois; formerly General Counsel for the Chicago Title Insurance Company; formerly instructor of real property law at DePaul University College of Law and at the American Savings and Loan Institute; J.D., DePaul University College of Law.

1. A construction mortgage has been defined "as one obtained for the purpose of financing construction under which the mortgage is empowered and obligated to disburse the funds to the builder or contractor as the construction progresses." Annotation, *Mortgage—Lender's Duty, In Disbursing Funds, To Protect Mortgager Against Outstanding Or Potential Mechanics' Liens Against The Mortgaged Property*, 30 A.L.R. 4th 134 (1984). A landowner enters into a construction loan because he needs the money to build a building. This means that the loan proceeds will be paid out in the course of construction since neither the general contractor nor the many trades involved will wait for their money until the building has been completed.

2. A mechanic's lien is a claim created by law for the purpose of securing priority of payment of the price or value of work performed and materials furnished in erecting or repairing a building or other structure, and as such attaches to the land as well as buildings and improvements erected thereon.

BLACK'S LAW DICTIONARY (4th ed. 1968).

the borrower in such cases have crafted unnecessarily technical and complex solutions founded on agency principles. Unfortunately, the simple solution of treating a mortgage like any other contract with duties of good faith and fair dealing imposed by the Uniform Commercial Code (UCC)<sup>3</sup> and modern contract law has not as yet found general acceptance in the courts.<sup>4</sup>

### I. THE CONSTRUCTION LENDING PROCESS

In almost every major real estate development in this country, the suppliers of labor and material are paid in monthly draws. At the time of each draw, the building is inspected by architects and engineers to see that the amount requested by the general contractor is warranted by the work in place, and that the work and materials comply with the plans and specifications approved for the job by all parties. At this point the lender also checks to be sure that the remaining construction funds suffice to complete the building. Thus the loan is kept "in balance," with funds disbursed equaling work completed and the loan balance suffices to complete the building.

This is standard practice in all states. Of course, the prudent lender will not entrust the disbursement of these funds to the borrower because borrower-developers are notorious for diverting funds paid to them to other jobs. Hence, the lender insists on controlling the disbursements.

In order to ensure that the balance is solid, and not subject to change, the prudent lender will obtain lien waivers not only from the general contractor and his subcontractors (electricians, plumbers, carpenters) but also from the material houses that furnished the material for construction. Thus, the construction lender protects his construction mortgage lien against the possibility of competing mechanics' liens.<sup>5</sup>

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3. The effect of provisions of this Act may be varied by agreement, except as otherwise provided in this Act and except that the obligations of good faith, diligence, reasonableness and care prescribed by this Act may not be disclaimed by agreement but the parties may by agreement determine the standards by which the performance of such obligations is to be measured if such standards are not manifestly unreasonable.

Uniform Commercial Code § 1-102(3). How the UCC provisions have become part of contract law generally is traced elsewhere. See *infra*, note 36.

4. See *infra* notes 19-22 and accompanying text (discussing cases which have found the construction lender liable for negligent disbursement of loan proceeds).

5. See R. KRATOVIL & R.J. WERNER, *MODERN MORTGAGE LAW AND PRACTICE* § 25.27(a), at 392-93 (2d ed. 1981). This section gives a brief discussion on how mechanics lien waivers function to protect the construction lender. It also warns the construction lender to be familiar with the distinction between partial and final waivers. *Id.* at 392 (emphasis added). During interval payments, the lender can demand a waiver from a contractor which essentially covers only materials and labor "furnished" to date, or at completion the lender can demand a final waiver, "which waives all liens for work and materials furnished or to be furnished." *Id.* at 393 (emphasis in original).

The construction lender does this for his own protection, for, while most states afford statutory lien priority to the construction lender's interest,<sup>6</sup> the statutory scheme is often upset by the courts.<sup>7</sup>

At this point it is important to remember an elementary proposition of law. Where money is loaned, the money becomes property of the borrower.<sup>8</sup> If I arrange to borrow money, surely I expect to receive the money. To be sure, I am obligated to repay the lender the equivalent of the money borrowed plus interest, but the money I borrowed is my money. So the construction lender is disbursing funds that legally belong to the borrower.<sup>9</sup> As a matter of common sense and common understanding, it is obvious that the law should insist that the construction lender paying out the borrower's funds should exercise reasonable care.<sup>10</sup> If I borrow a million dollars to build a

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6. Such states are generally referred to as "priority" states. Under this rule, if a mortgage is recorded prior to commencement of construction, it becomes a lien on the property and enjoys priority over any mechanics' liens that may later arise during the course of construction. R. KRATOVL & R.J. WERNER, *supra* note 5, at 393-94. It is obvious that if visible construction actually begins before the mortgage is recorded or becomes a lien, some or probably all of the mechanics' liens are intended to be prior and superior to the mortgage. *Id.* at 394. See also M. MADISON & J. DWYER, *THE LAW OF REAL ESTATE FINANCING*, § 4.02[6][a] (1981) (discussing divergence of law among priority states).

7. Even in the so-called priority states, the courts have at times used spurious arguments to give mechanic's lien claimants priority over construction loans. Kratovil & Werner, *Mortgages For Construction And The Lien Priorities Problem—The "Unobligatory" Advance*, 41 TENN. L. REV. 311 (1974) [hereinafter Kratovil & Werner, *The "Unobligatory" Advance*]. See *infra* note 14 and accompanying text.

This issue is not relevant to the narrow problem here discussed, except that it marshals a strong economic reason for the construction lender to disburse construction funds with care. However, even though prudent disbursement is in a lender's best economic interest, all too often a lender will lack the expertise to disburse the funds properly. Under current law in most states, the borrower is left unprotected from the lender's negligence and must face a number of mechanics' liens as well as the original mortgage at the end of the project.

8. A "loan" of money is a delivery of a sum of money to another under a contract to return at some future time an equivalent amount with or without an additional sum agreed upon for its use. See *Boerner v. Colwell Co.*, 21 Cal. 3d 37, 44 n.7, 557 P.2d 200, 204, 145 Cal. Rptr. 380, 384 (1978) (quoting *Milará v. Credit Discount Co.*, 27 Cal. 2d 335, 339, 163 P.2d 869, 871 (1945)); 45 AM. JUR. 2D, *Interest & Usury* § 117 (1969); Reitz, *Construction Lender's Liability To Contractors, Subcontractors and Materialmen*, 130 U. PENN. L. REV. 416, 422 (1981).

9. Generally, "[w]hen the consideration for a mortgage is a loan by the mortgagee to the mortgagor, the loan funds must actually come into the hands of the mortgagor or his agent absent some other arrangement between the parties." *Garbish v. Malvern Fed. Sav. & Loan Ass'n*, 517 A.2d 547, 551 (Pa. Super. 1986), *appeal denied*, 533 A.2d 712 (Pa. 1987). See also *Prudential Ins. Co., Etc. v. Executive Estates*, 174 Ind. App. 674, 685, 369 N.E.2d 1117, 1123-24 (Ind. Ct. App. 1978) (absent agreement to the contrary, "the mortgagee must place the mortgage proceeds in the hands of the mortgagor" (citing 59 C.J.S. *Mortgages* § 297, at 369-70 (1949)). In the context of construction financing, however, the lender retains control over the disbursements of the loan funds for his own protection. R. KRATOVL & R.J. WERNER, *supra* note 5, at 311.

10. Since the disbursement of the funds is part of the construction lender's performance of the contract, under elementary law, the lender is under a duty to perform with due care and

building, my reasonable expectation is that when the job has been completed, I will have clear title to a building worth \$1,000,000, subject only to the construction mortgage. For the construction lender to hand me a title search that shows my building is also subject to \$500,000 in mechanics' liens is a cruel joke. To argue that the law allows this is to argue for an unacceptable injustice.

As has been said, all construction loan documentation contains provisions requiring that the loan be kept in "balance." This means that the construction lender is willing to put just so much money at risk, and not a penny more. In other words, the borrower has borrowed up to the hilt. In such a situation, if substantial mechanics' liens attach, the risk that the landowner will lose the property through foreclosure becomes very great. The modern contract law requirements of good faith and fair dealing, if imposed, would surely require that when the construction lender disburses funds, he must take care that he does not do so in such a way that the borrower's loss becomes probable or even certain.

## II. THE EFFECT OF STATUTES: A MEASURE OF PROTECTION, BUT ONLY FOR THE LENDER

The most common statutory provision defining priority as between a construction mortgage and a mechanic's lien resulting from construction is one that gives a recorded mortgage priority over any mechanics' liens if the mortgage is recorded prior to the visible commencement of construction.<sup>11</sup> States with such statutes are the so-called "priority states."<sup>12</sup> The obvious purpose of the "priority" statute is to relieve the construction lender of the burden of checking mechanic's lien documentation. It is, moreover, common knowledge that mechanic's lien law confers the benefit of liens not only upon the general contractor, but upon subcontractors,<sup>13</sup> including in some

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should be held liable for negligent performance. See *infra* notes 25-34 and accompanying text. To leave the building burdened with huge mechanics' liens means that the borrower will inevitably lose the building. This would be a gross violation of the construction lender's obligation of good faith and fair dealing. Professionals must be expected to be held liable for negligent performance. See, e.g., *Aetna Ins. Co. v. Hellmuth, Obata & Kassabaum, Inc.*, 392 F.2d 472 (8th Cir. 1968) (holding an architect liable for negligent supervision of a construction contract); *Rozny v. Marnul*, 43 Ill. 2d 54, 250 N.E.2d 656 (1969) (holding a surveyor liable for negligently misallocating the corners of a vacant lot); *Stotlar v. Hester*, 92 N.M. 26, 582 P.2d 403 (N.M. Ct. App. 1978), *cert. denied* 92 N.M. 180, 585 P.2d 324 (1978) (holding appraiser liable for negligence in preparing an appraisal). See *Kratovil, Cardozo Revisited: Liability To Third Parties; A Real Property Perspective*, 7 U. PUGET SOUND L. REV. 259 (1984).

Whether the law or a title insurance policy protects the lender against mechanics' liens is immaterial. For the construction lender to contend that, because he is protected he need not have regard for the borrower's problems, is a savage and untenable contention.

11. See *supra* note 3 and accompanying text.

12. See *supra* note 6 (discussing priority state statutes).

13. "As a general rule the mechanics' lien statutes give subcontractors the right to a lien, although under some statutes, mostly early ones, such right is, or at one time

jurisdictions, not only subcontractors, but sub-subcontractors and sub-sub-subcontractors.<sup>14</sup>

Hence, theoretically, lenders in priority states may disburse progress payments as construction goes forward without demanding lien waivers from the contractors. Whatever protection exists, however, extends only to the construction lender. The landowner is not protected, even though his interests are at least as much at risk.<sup>15</sup>

Nonetheless, even for the construction lender, the result in the priority states can be unpredictable. When, in any priority state a large lender, Chase Bank, for example, is pitted against Henry Brown, the local plumber, it is likely that, despite the statute, the courts will reach into the "deep pocket" and hold that Henry Brown has priority.<sup>16</sup> Today, most title insurance

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was, denied to them. It has been stated that the rights of a subcontractor are neither superior nor inferior to those of the contractor, where the subcontractor does or furnishes what the contractor agreed to furnish. . . . A lien may be filed by a subcontractor even though the contractor has previously filed a lien for the entire contract."

57 C.J.S. *Mechanic's Liens* § 98, at 608 (1948) (footnotes omitted).

14. "Under some statutes, but not under others, a subcontractor of a subcontractor is entitled to a mechanic's lien." 57 C.J.S. *Mechanic's Liens* § 99, at 609 (1948) (footnotes omitted).

15. See, e.g., *Spurlock v. Fayette Fed. Sav. & Loan Ass'n*, 436 N.E.2d 811 (Ind. Ct. App. 1982) (lender had no duty to obtain lien waivers prior to disbursing funds); *Armetta v. CleveTrust Realty Investors*, 359 So. 2d 540, 543 (Fla. Dist. Ct. App.), *cert denied* 366 So. 2d 879 (Fla. 1978) (lender owed no duty to supervise construction); *Gardener Plumbing, Inc. v. Cottrill*, 44 Ohio St. 2d 111, 115-16, 338 N.E.2d 757, 760 (1975) (lender had no duty to insure that contractor had paid the subcontractor, materialmen, and workers); *Linder v. Citizens State Bank of Malakoff, Texas*, 528 S.W.2d 90, 94 (Tex. Civ. App. 1975) (no fiduciary relationship exists between mortgagor-mortgagee); *Goodner v. Lawson*, 33 Tenn. App. 676, 687, 232 S.W.2d 587, 591 (1950) (lender owed no duty to protect against mechanics liens when disbursing funds).

16. One tool that has been used by the courts to evade the plain language of priority statutes is the distinction between "optional" and "obligatory" advances. *Kratovil & Werner, The "Unobligatory" Advance*, *supra* note 7, at 314-15. Developers often run into financial difficulties, lengthy delays and numerous problems that may necessitate that the lender take over the project, complete it, and hope to save the investment. *Id.* at 313. Although the lender obviously would like to keep his priority for the funds needed to finish the project, "[t]his will not be possible in many states if those expenditures are deemed to be 'optional' as opposed to 'obligatory' advances." *Id.* at 313-14.

Disbursements are considered "optional" when made with actual (or in some states with constructive) notice of intervening liens. *Id.* at 314. When advances are deemed optional, they will not relate back to the filing of the mortgage lien, but rather will be deemed junior to mechanics' liens previously filed. R. KRATOVIL & R.J. WERNER, *supra* note 5, § 25.12, at 374-75. See, e.g., *Housing Mortgage Corp v. Allied Constr.*, 374 Pa. 312, 97 A.2d 802 (1953) (construction loan disbursement made before it was due was held to be optional); *Community Lumber Co. of Baldwin Park v. California Publishing Co.*, 215 Cal. 274, 10 P.2d 60 (1932) (payment conditioned upon satisfaction of intervening mechanics' liens rendered disbursements non-compulsory); *Home Sav. & Loan Ass'n v. Sullivan*, 140 Okla. 300, 284 P. 30 (1929) (advances held to be optional because condition of mortgage allowed lender to withhold funds until it could be ascertained that all laborers and materialmen were paid and building reached stage of completion satisfactory to loan company); *J.I. Kislak Mortgage Co. v. William*

companies, having been burned severely in relying on such a statute, will no longer insure the construction lender against mechanics' liens, even in a priority state. Thus, the lender's only sure protection is to get lien waivers before trouble arises.

In contrast to the priority states, there are some states that offer either limited protection or no protection at all against mechanics' liens.<sup>17</sup> Missouri, for instance, follows a particularly barbarous rule. There, from the mere fact that the loan is a construction loan, the construction lender is deemed to have subordinated his mortgage to the mechanics' liens.<sup>18</sup>

Finally, as has been noted above, even where statutory protection exists, it extends only to the construction lender. The hapless landowner is left to fend for himself in a situation where, typically, he has been forced to surrender all control over disbursement of the funds he has borrowed. When disaster strikes, and the landowner finds himself with a half-finished building burdened by two sets of loans, the lawyers are called, and the search for a controlling precedent begins.

### III. LENDER LIABILITY THROUGH THE UCC: THE RIGHT RESULT THROUGH THE RIGHT MEANS

In spite of the grim picture painted in Part II, there are quite a number of cases holding the lender liable if his negligent disbursement results in the filing of mechanics' liens.<sup>19</sup> The most successful approach has been to argue

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Matthews Builder, Inc., 287 A.2d 686 (Del. Super. Ct. 1972), *aff'd* 303 A.2d 648 (Del. 1973) (disbursements rendered optional by provision in construction loan agreement which stated that disbursements would not be made until mortgagor provided lender with satisfactory documentation of prior disbursements); *New York & Suburban Fed. Sav. & Loan Ass'n v. Fi-Pen Realty Co.*, 133 N.Y.S.2d 33 (Sup. Ct. 1954) (advances held optional because provision of construction loan agreement which provided that upon default of borrower disbursement obligation ceased).

17. KRATOVIL, *MODERN MORTGAGE LAW & PRACTICE*, § 214, at 138-40 (1972) (describes and categorizes various approaches of the states).

18. *See, e.g., H.B. Deal Constr. Co. v. Labor Discount Center, Inc.*, 418 S.W.2d 940 (Mo. 1967). In that case the Supreme Court of Missouri stated that the state follows the "first spade rule" which dates a properly-filed mechanic's lien to the date of the commencement of construction or improvement. *Id.* at 951. The court added that when the construction lender chooses to also disburse the funds directly to the contractors and subcontractors the lender is deemed to have waived any priority over the mechanics' liens. *Id.* at 952-54. Under Missouri's rule, a construction lender is considered to have subordinated his lien created by the mortgage to mechanics' liens simply by the act of making a construction loan. *Kratovil & Werner, The Unobligatory Advance, supra* note 7, at 313 n.2.

19. *See, e.g., Speights v. Arkansas Sav. & Loan Ass'n*, 239 Ark. 587, 393 S.W.2d 228 (1966) (mortgagee who exercised control over construction loan disbursement was held liable to labor material claimants when contractor abandoned project and failed to pay claimants); *Hummel v. Wichita Fed. Sav. & Loan Ass'n*, 190 Kan. 43, 372 P.2d 67 (1962) (mortgagee who had orally agreed to see that builder paid labor and material bills held liable); *Arten v. Citizen's Homestead Ass'n*, 163 So. 2d 403 (La. Ct. App.), *application denied sub nom Piton v. Citizen's Homestead Ass'n*, 246 La. 584, 165 So. 2d 482 (1964) (stating that a lending agency may be held liable for improper disbursements of funds); *M.S.M. Corp. v. Knutson Co.*, 283 Minn.

an agency theory.<sup>20</sup> These cases have held that there is an implied agency in the lender-borrower relationship where the lender becomes the agent of the borrower by retaining control over the disbursement of construction funds.<sup>21</sup> As such, it is an elementary point of law that negligent disbursement should lead to liability for damages.<sup>22</sup>

Few courts, though, have had the courage to adopt a contract theory. This is not surprising in light of black-letter property principles. According to old black-letter contract law, a mortgage is not a contract, it is a property interest.<sup>23</sup> Thus, the lawyers seek precedent in the field of property law where the UCC imposed principles of contractual good faith and fair dealing do

527, 167 N.W.2d 66 (1969) (mortgagee held liable for wrongfully diverting funds to satisfy contractor's collateral debt); *Cook v. Citizens Sav. & Loan Ass'n*, 346 So. 2d 370 (Miss. 1977) (mortgagee liable for its lack of reasonable diligence in paying construction expenses with construction funds); *First Nat'l Bank of Greenville v. Virden*, 208 Miss. 679, 45 So. 2d 268 (1950) (mortgagee liable for failing to give contractor control of funds while not diligently paying for accumulating construction costs).

20. See, e.g., *Prudential Ins. Co. v. Executive Estates*, 174 Ind. App. 674, 690, 369 N.E.2d 1117, 1127 (1978) (mortgagor-mortgagee relationship "combine[s] with principles of equity and agency law" to create a duty on the part of lender to protect interests of the borrower); *Falls Lumber Co. v. Herman*, 114 Ohio App. 262, 181 N.E.2d 713, 716 (1961) ("It certainly is reasonable to conclude that one who undertakes to act for another in the disbursing of funds is answerable for failure to do so with due care [since] . . . [a]n agent owes to his principal the use of such skills as maybe required to accomplish the object of his employment."); *Garbish v. Malvern Fed. Sav. & Loan Ass'n*, 358 Pa. Super. 282, 517 A.2d 547, (1986) (analyzes two lines of cases, and holds lender to duty of care under agency theory).

21. Indeed, it is arguable that exclusive control of the borrower's funds has been a key factor for courts that have implied a duty of care on the part of the lenders. For example, in *Prudential*, the court stressed.

A mortgagee-lender who insists on controlling disbursement of the loan proceeds in order to protect its own interests (mortgage lien), deprives the mortgagor of possession of the loan proceeds for which he has bargained, and in doing so must equitably be considered as the mortgagor's agent saddled with a duty to use reasonable care to protect the principal's interest.

369 N.E.2d at 1128.

Also stressed is the fact that such lenders, along with retaining exclusive control of the loan funds, hold themselves out as experts in the construction business.

Thus, in *Garbish*, the court held:

Where the mortgagee obtains exclusive control of the mortgage fund as well as other funds of the mortgagors which funds are to be distributed for payment of labor and material . . . and when the exclusive control of the fund is obtained because the mortgagee represents itself to be expert in the distribution of such funds, the mortgagee will be held to the standard of care of an expert.

517 A.2d at 554. See also *Falls Lumber*, 181 N.E.2d at 715 (lender held liable as mortgagor's agent since it held "itself out to the community as skilled in conducting all phases of such transactions").

22. For example, it is the general rule that, due to their fiduciary relationship, an agent is liable to his principal for wrongful use of the principal's property which is in the agent's possession. See RESTATEMENT (SECOND) OF AGENCY § 342 (1957). As to construction loans the decisions are in conflict. R. KRATOVIL & R.J. WERNER, MODERN MORTGAGE PRACTICE § 25.26 (2d ed. 1981).

23. KRATOVIL, REAL ESTATE LAW § 369 (6th ed. 1974).



not necessarily apply. But, to argue that the duties of good faith and fair dealing should not apply in the field of construction lending is to argue for injustice.

Further, it is evident that the agency theory will not come to the rescue of the borrower in all courts. For example, in a leading Wyoming case<sup>24</sup> the court cited authorities that required the lender to protect the borrower, including the agency theory.<sup>25</sup> In waiving these aside, the court stated that "it is unusual for a Wyoming lender to obtain lien waivers before the project is completed."<sup>26</sup> This statement betrays total ignorance of the facts of construction life. Big deals pay out over a period of many months and if disaster strikes, it will strike long before the building is completed. Moreover, the court seems to have overlooked the fact that Wyoming has adopted the UCC and has thus committed itself to apply modern contract law.

As a general rule, there is implied in every contract for work or services under the UCC and under modern contract law a duty to perform skillfully, carefully, diligently, and in a workman-like manner, and negligent failure to observe any of these conditions is a tort as well as a breach of contract.<sup>27</sup> Thus, a person who contracts to make repairs can be held liable for his negligence in doing the work. In such case, the contract is mere inducement, creating the state of things which furnishes the occasion of the tort; the contract creates the relation out of which grows the duty to use due care.

However, where an action is brought for the negligent breach of a contractual duty, the nature of the duty owed and the consequences of its breach must be determined by reference to the contract which created the duty.<sup>28</sup> Further, the rule has emerged that liability may be predicated on a negligent failure to act, as well as upon an action negligently performed.<sup>29</sup>

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24. *Daniels v. Big Horn Fed. Sav. & Loan Ass'n*, 604 P.2d 1046 (Wyo. 1980).

25. *Id.* at 1048-49.

26. *Id.* at 1050.

27. *See, e.g., Woodward v. Chirco Constr. Co., Inc.*, 141 Ariz. 514, 515, 687 P.2d 1269 (1984) (Supreme Court of Arizona held that injured purchaser of a negligently constructed home may proceed to recover both in contract and in tort); *Ehrenhaft v. Malcom Price, Inc.*, 483 A.2d 1192 (D.C. 1984) (architectural malpractice can give rise to cause of action in tort or in contract or both); *Caceci v. Di Canio Constr. Corp.*, 72 N.Y.2d 52, 526 N.E.2d 266, 270 (1988) ("courts will imply a covenant of good faith" and require that every contract be performed "in a skillful manner"); *Colton v. Foulkes*, 259 Wis. 142, 146-47, 47 N.W. 2d 901, 903 (1951) (although the nature of the duty breached was created by contract, negligent performance thereof can be a basis for suit in tort since every contract creates a duty of care, reasonableness, and skillful and diligent performance).

28. *See Orkin Exterminating Co., Inc., v. Stevens*, 130 Ga. App. 363, 203 S.E.2d 587 (1973); *Colton v. Foulkes*, 259 Wis. 142, 47 N.W. 901 (1951).

29. The sound rule appears to be that where there is a general duty, even though it arises from the relation created by, or from the terms of, a contract, and that duty is violated, either by negligent performance or negligent nonperformance, breach of the duty may constitute actionable negligence. 57 Am. Jur. 2d *Negligence* § 47, at 395-97 (1971).

*See, e.g., Presser v. Siesel Construction Co.*, 19 Wis. 2d 54, 59, 119 N.W.2d 405, 408 (Wis. Ct. App. 1963) ("the negligent performance or nonperformance of a duty created by a contract may constitute actionable negligence").

Therefore, based firmly on the express provisions of the UCC, modern contract law requires of every party to every contract good faith and fair dealing, and freedom from unconscionability.<sup>30</sup> These obligations, moreover, extend to bank lenders.<sup>31</sup>

This is all hornbook law. Elaborate citation of authority is unnecessary. It also has, however, direct application to construction loans. In the context of a construction loan, good faith and fair dealing would require that the construction lender maintain an up to date file of lien waivers, without which the landowner faces the possibility of his property becoming overburdened by a set of mechanics' liens on top of the existing construction mortgage lien.

Obviously, for breach of these obligations, fairness demands that the lender should be liable. It is not necessary for present purposes to determine whether this liability is a tort liability as well as a contractual liability. The purpose here is to establish that liability exists.

The duties of good faith and fair dealing are fundamental. They cannot be avoided. If an exculpatory clause relieves the lender of the obligation to obtain lien waivers, it cannot withstand attack.<sup>32</sup> Section 1-102 of the UCC

30. The UCC provides that the obligation of good faith, diligence, reasonableness and care cannot be disclaimed by agreement. UCC § 1-102 (1978). *See also id.* at § 1-203 (imposing obligation of good faith in the performance of every contract or duty within the UCC).

31. *See, e.g.,* K.M.C. Co., Inc. v. Irving Trust Co., 757 F.2d 752, 759 (6th Cir. 1985) (lender acted in bad faith when it failed to notify borrower that it would cease to advance funds); C-K Enterprises, Inc. v. Depositor's Trust Co., 438 A.2d 262, 264 (Me. 1981) (bank acted in bad faith when it closed accounts without giving reasonable notice); Weinberg v. Farmers State Bank of Worden, 752 P.2d 719, 731 (Mont. 1988) (bank acted in bad faith when it failed to extend line of credit to borrower based on loan agreement); Noonan v. First Bank Butte, 740 P.2d 631, 634 (Mont. 1987) (bank acted in bad faith when it submitted incomplete financial statements to prospective assignee of one of bank's mortgages).

There is another section of the UCC that underscores the liability of the bank that fails to use due care:

Variation by Agreement; Measure of Damages; Certain Action Constituting Ordinary Care

The effect of the provisions of this Article may be varied by agreement except that no agreement can disclaim a bank's responsibility for its own lack of good faith or failure to exercise ordinary care or can limit the measure of damages for such lack or failure; but the parties may by agreement determine the standards by which such responsibility is to be measure if such standard are not manifestly unreasonable.

UCC § 4-103(1).

Here again, the possibility of drafting an exculpatory clause that will stand up is remote. *See, e.g.,* Hy-Grade Oil Co. v. New Jersey Bank, 138 N.J. Super. 112, 350 A.2d 279 (1975) (court refused to enforce parties' agreement which could have allowed bank relief from liability for its own negligence).

32. *See* 17 AM. JUR. 2D *Contracts* § 173, at 531 (1964). Prosser & Keeton spell out the problems of those who seek to exculpate:

If an express agreement exempting the defendant from liability for his negligence is to be sustained, it must appear that its terms were brought home to the plaintiff; and if he did not know of the provision in his contract, and a reasonable person in his position would not have known of it, it is not binding upon him, and the

provides that the obligations of good faith, diligence, reasonableness and care prescribed by the Code cannot be waived. This is in accord with the rule that the parties cannot "draft around" a provision if the statute forbids it. Again, the section provides that the parties by agreement may determine the standards of care, but care there must be. And it is certain that no disclaimer would withstand attack unless it told the borrower in plain language what the results might be if the lender failed to demand lien waivers. That today's negligence law is totally intolerant of exculpatory clauses has been made clear by a leading case.<sup>33</sup>

UCC principles should be applied in all areas of real property law as was done, for example, in the case of *Kendall v. Ernest Pestana, Inc.*<sup>34</sup> There, the Supreme Court of California, making reference to the UCC in footnotes,<sup>35</sup> held that a lessor's objection to sublease tenants must be commercially reasonable. Unconscionability, moreover, has been a basis for decisions in the areas of mortgage accelerations, implied warranties of habitability, and lease assignments.<sup>36</sup> Clearly, unconscionable behavior is no longer to be tolerated, even in real property law.

Nonetheless, the real property bench and bar have sought tenaciously to ignore the existence of the UCC. This is a futile endeavor. Once the legislature has declared, as a matter of state policy, that conscionability, good faith, and fair dealing are basic principles of the state law, all competing decisional law stands overruled. A state cannot have two conflicting policies on the

agreement fails for want of mutual assent. It is also necessary that the expressed terms of the agreement be applicable to the particular misconduct of the defendant, and the courts have strictly construed the terms of exculpatory clauses against the defendant who is usually the draftsman. If the defendant seeks to use the agreement to escape responsibility for the consequences of his negligence, then it must so provide, clearly and unequivocally, as by using the word "negligence" itself. Further, on the basis either of common experience as to what is intended, or of public policy to discourage aggravated wrongs, such agreements generally are not construed to cover the more extreme forms of negligence, described as willful, wanton, reckless or gross, or to any conduct which constitutes an intentional tort.

W. KEETON, D. DOBBS, R. KEETON & D. OWEN, *PROSSER & KEETON ON THE LAW OF TORTS* § 68, at 483-84 (5th ed. 1984).

33. *Henningsen v. Bloomfield Motors, Inc.*, 32 N.J. 358, 161 A.2d 69 (1960). For commentary on this seminal case, see Note, *Sales: Implied Warranties: Lack of Privity and Disclaimers—Henningsen v. Bloomfield Motors, Inc.*, 48 CALIF. L. REV. 873 (1960); Note, *Sales—Warranty—Privity Not Essential in Warranty Action; Disclaimer of Implied Warranties Void as a Matter of Public Policy*, 14 RUTGERS L. REV. 829 (1960).

For commentary on the existing law of disclaimers and exculpatory clauses, see Burgess, *Consumer Adhesion Contracts and Unfair Terms: Critique of Current Theory and a Suggestion*, 15 ANGLO-AM. L. REV. 255 (1986); McCormack, *Warranties & Disclaimers*, 62 TULANE L. REV. 549 (1988).

34. 209 Cal. Rptr. 135, 709 P.2d 837 (1985).

35. *Id.* at 845, n.15.

36. See Kratovil, *Unconscionability—Real Property Lawyers Confront a New Problem*, 21 JOHN MARSHALL L. REV. 1 (1987) (traces movement of UCC contract concepts into general contract law).

same proposition. Today if a court cites and relies on an earlier precedent that sanctions unconscionability, it is clearly in error.

Lawyers, so fond of arguing from a "case in point," are devastated by the notion that each precedent must be examined to see if it truly conforms to the notion that courts must examine the facts to see where justice under current doctrines lies. But legal historians of the future will surely label our time as the time when *stare decisis* finally died. *Caveat emptor* law died.<sup>37</sup> Residential pro-landlord law died.<sup>38</sup> Pro-lender law is dying, as the courts hamstring accelerations.<sup>39</sup> And the doctrine of lender liability begins to flourish.

#### IV. CONCLUSION

The position taken in this article is neither surprising nor unusual. All professionals, be they physicians, lawyers, land surveyors, architects, accountants, or professionals in other fields are being held to higher standards of skill and care. The upward surge in professional insurance premiums offers grim testimony to this fact. Nor do the views here expressed place any undue burden on lenders. In construction loans, if the job is big enough, and if the general contractor is strong enough, surety bond coverage is available.<sup>40</sup> Title insurance coverage is also available, either in the so-called "interim certification" form, where the company makes a monthly check of the lender's disbursements and lien waivers, or in the deluxe escrow payout form, where the company receives the loan disbursements and pays the money to the trades, gathering up all required lien waivers and insuring that

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37. See, e.g., *Carpenter v. Donahue*, 154 Colo. 78, 388 P.2d 399 (1964) (court implied a warranty of habitability in sale of a newly constructed dwelling, thus overcoming traditional rule of *caveat emptor*); *Redarowicz v. Ohlendorf*, 92 Ill. 2d 171, 441 N.E.2d 324 (1982) (extending implied warranty of habitability to subsequent purchasers of newly constructed dwelling).

38. See, e.g., *Javins v. First Nat'l Realty Bank*, 428 F.2d 1071 (D.C. Cir. 1970), *cert denied*, 400 U.S. 925 (1970) (recognizing, for first time in a residential lease, an implied warranty of habitability measured by standards of applicable housing code); *Glasoe v. Trinkle*, 107 Ill. 2d 1, 479 N.E.2d 915 (1985) (recognizing an implied warranty of habitability regardless of absence of an applicable housing code).

39. See, e.g., *Clark v. Lachenmeier*, 237 So. 2d 583 (Fla. Dist. Ct. App. 1970) (court of equity may refuse to foreclose mortgage when acceleration of due date would render acceleration unconscionable, inequitable and unjust).

40. See generally R. KRATOVIL & R.J. WERNER, *supra* note 5 § 25.27 (discussing other methods of providing protection against mechanics' liens). There are, for example, surety companies that offer construction protection, yet there are difficulties. Bonding companies will bond only triple-A contractors. As the saying goes, they will only bond contractors who do not need bonding. Bonding companies tend to raise technical objections. As one bonding company executive said to this author, the bonding company's premiums are set on the basis of strict compliance with the bonding contract, and any deviation provides the bonding company a defense to liability. The premiums are higher than title insurance company fees. Also, bonds on the main job do not cover tenant work, which, in an office building job, may run as high as 20% of the cost of construction.

disbursements are lien free. There remain, however, the lenders who do not check mechanic's lien waivers. When one of these general contractors goes broke, mechanics' liens are filed. These lenders should, and probably will, wind up with personal liability to the landowner.

In any event, it is clear that the matter of lender liability has received inadequate attention and the time is ripe for a fresh look at the problem. One conspicuous problem is the stubborn refusal of the real estate bench and bar and mortgage lenders to admit that modern law requires good faith and fair dealing, even in real property matters. Old forms of documents that fail to recognize this simple fact will be picked apart by courts that refuse to enforce unconscionable provisions. Huge judgments will compel lenders to re-evaluate their procedures.

The new law equates justice with fairness. The old law equates justice with black letter law that rests on precedents, which, in turn, rest on even older precedents, at times reaching back to the times of Lord Coke. What present society's problems have to do with those of Shakespeare's England is difficult to fathom. Of course it is time-saving and thought-saving to make a current issue turn on a "case in point." Our task, however, is not to make life easy for the bench and bar, but to do justice even though this takes time and work. The task of seeking justice is not a new one. For centuries, men of wisdom and probity have devoted their lives to the quest for justice. Can we do less?