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# The Open-End Mortgage-Future Advances: A Survey

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## COMMENTS

### THE OPEN-END MORTGAGE—FUTURE ADVANCES: A SURVEY

The relation of a mortgage to the obligation which it secures gives rise to many issues in the law of mortgages. The mortgage to secure future advances, or deed of trust in the nature of a mortgage as security for future debts, has been litigated upon and discussed in all of the jurisdictions throughout the country.<sup>1</sup> This seems to be the basis of the so-called *Open-End Mortgage*<sup>2</sup> which is no more than the security interest given by a borrower to secure an indebtedness providing for payments by the mortgagee in future installments,<sup>3</sup> or to include additional obligations on behalf of the borrower-mortgagor.<sup>4</sup>

The popularity of this credit device has become recognized by the practitioners who deal with finance and security transactions<sup>5</sup> as well as legal writers of the day.<sup>6</sup> The continued use of the open-end mortgage has given rise to such descriptive words as *Dragnet Clause*,<sup>7</sup> *Anaconda Mortgage*,<sup>8</sup> or just plain *Mortgage to Secure Future Advances*,<sup>9</sup> all of

<sup>1</sup> Validity of Mortgage Securing Unlimited Future Advances, 81 A.L.R. 631 (1932).

<sup>2</sup> The term "open-end mortgage" seems to be one used by the practitioner, but the writer was unable to find any legal authority for this terminology. Mortgage to secure future advances seems to be the accepted legal terminology.

<sup>3</sup> This has been commonly referred to as a construction loan. The borrower becomes indebted to the lender for the full amount of the loan upon execution and the lender becomes obligated to advance money at various stages of construction. *Tompkins v. Little Rock & Ft. S. Railway*, 15 Fed. 6 (1882); *Crane v. Deming*, 7 Conn. 387 (1829); *Hyman v. Hauff*, 138 N.Y. 48, 33 N.E. 735 (1893); *Good v. Woodruff*, 208 Ill. App. 147 (1917).

<sup>4</sup> These additional obligations may be *obligatory* on behalf of the mortgagee or merely *optional*. See footnote 17 infra.

<sup>5</sup> Mintz, *Open-End Mortgages*, The Ohio Savings and Loan Record, November 1954, p. 17; Russell and Prather, *Open-end Advances and the Federal Lien*, Legal Bulletin of the U.S. Savings and Loan League, Sept. 1954; Russell and Prather, *The Flexible Mortgage Contract*, Legal Bulletin of the U.S. Savings and Loan League, Sept. 1953.

<sup>6</sup> Updike, *Mortgages*, 30 N.Y.U.L. Rev. 807 (1955).

<sup>7</sup> *First v. Byrne*, 238 Iowa 712, 28 N.W. 2d 509 (1947); *Walters v. Merchants & Manufacturers Bank*, 218 Miss. 777, 67 So. 2d 714 (1953). When a mortgage is given to secure a specific indebtedness and is extended to all other debts that may be owing or may thereafter be contracted by the mortgagor it is called a "Dragnet Clause." It is to be carefully scrutinized and strictly construed against the mortgagor since "Dragnet" clauses are not highly regarded in equity.

<sup>8</sup> *Berger v. Fuller*, 180 Ark. 372, 21 S.W. 2d 419 (1929). The description is given where the mortgage is given to secure "any indebtedness of whatsoever sort or nature

which terms have the connotation of payments to be made by the lender at some time in the future after the debt is created, or the extension of the debt to obligations not yet in existence at the time of the transaction.

This type of financing has been found to be advantageous from the point of view of both the borrower and lender primarily to provide for the construction, repair or improvement of mortgaged property. The borrower can avoid short-term, high-rate consumer financing, and FHA Title I loans which are restricted to home improvements for limited purposes.<sup>10</sup> This results in the borrower getting credit on the easiest possible terms at the lowest possible cost. The borrower may also save interest on the surplus of the loan until ready to use it, thereby allowing an opportunity to invest it in the interim. Refinancing charges are saved<sup>11</sup> and, correspondingly, the higher rates of interest incident to such transactions are eliminated.

The future advance may be repaid at the *same* monthly payment rate over an extended period of time or at an increased monthly payment over the original terms of the first mortgage. Either of these two methods avoids the restriction placed upon borrowers under FHA Title I loans of repayment within 3 years and 32 days.<sup>12</sup>

The marketability of property with a first mortgage, especially if securing bonds, also creates quite an advantage to the borrower. Thus this type of financing will allow the borrower to buy better merchandise and improve the security so as to enhance the value of his original investment.

The lender, in dealing with the same parties, can determine their past record of performance, and continuous dealings for the future will be promoted, resulting in increased business for the lender. The expense and inconvenience of executing a new security on each new transaction is eliminated, and the mortgagee has the ability to advance the money as the

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that may be due from mortgagors to mortgagees at the time of foreclosing this mortgage." The court said in the Berger case, ". . . by their broad and general terms they enwrap the unsuspecting debtor in the folds of indebtedness embraced and secured in the mortgage which he did not contemplate. . . ." Both the "Dragnet Clause" and "Anaconda Mortgage" are broad extensions of the mortgage to secure future advances.

<sup>9</sup> 1 Jones, Mortgages § 446 (8th ed., 1928).

<sup>10</sup> In order for the V.A. to insure a mortgage to secure future advances the loan must be used only for repairs and structural improvements, it cannot exceed \$2,500 and it must mature in three years and thirty-two days. 48 Stat. 1246 (1934), as amended, 12 U.S.C.A. § 1703 (Supp., 1954).

<sup>11</sup> Shaker Savings Association of Ohio charges \$2.50 for a title letter to protect the Association against possibility of any change in the title and \$10.00 service charge for handling the transaction.

<sup>12</sup> On a \$1,000 three-year Title I Loan, for example, you would have to pay \$31.94 per month. Under an open-end mortgage the same \$1,000 advanced at 4½ per cent interest would cost only \$7.56 per month if the mortgage continued for another 15 years.

value of the property is increased, thereby getting a security commensurate with the outlay.

Examples of how this credit device is being used are: construction or improvement loans with installments to be advanced as the work progresses, mortgages by way of indemnity for prospective indorsements, guarantees and accommodations of commercial paper to be issued by the mortgagor, fluctuating current balances under lines of credit established with the mortgagee, and as security for a bond issue or a series of bond issues.<sup>13</sup>

#### VALIDITY

The validity of the mortgage to secure future advances as a security interest is fully recognized today<sup>14</sup> in the absence of statute as long as it was entered into in good faith.<sup>15</sup> The extent of its validity will then depend upon its classification and the jurisdiction in which it is to be interpreted. Generally, the mortgagee's duty under the transaction may be classified as obligatory or optional, giving rise to either *obligatory advances* or *optional advances*.

The mortgage may take one of several forms or a combination thereof. First, it may state a certain amount has been presently loaned when in fact a balance is to be advanced at a later time,<sup>16</sup> or it may declare a definite sum, part of which is to be disbursed by the mortgagee at specified intervals or time. Then again, the contract might provide it is to secure future advances without stating a limit. So in order to fully appraise any subsequent purchaser or second creditor of the true nature of the transaction, it may be best to state it is for future advances and also set a maximum limit.

The particular format adopted and the intention of the parties ex-

<sup>13</sup> Osborne, Handbook of the Law of Mortgages § 113 (1951). The writer is not familiar with the extent of the practical use of mortgages to secure future advances; however, it is settled that they may be used with chattels as well as realty for security. *Frank H. Buck Co. v. Buck*, 162 Cal. 300, 122 Pac. 466 (1912); *Preble v. Conger*, 66 Ill. 370 (1872); *Speer v. Skinner*, 35 Ill. 282 (1864) (no distinction between a mortgage on real estate and chattels).

<sup>14</sup> *The Commercial Bank v. Cunningham*, 41 Mass 270, 274 (1883) ("We think it clear that a mortgage made bona fide, for the purpose of securing future debts, expected to be contracted in the course of dealings between the parties, is a good and valid security."). See also *U.S. v. Hooe*, 3 Cranch (U.S.) 73, (1805); *Frank H. Buck Co. v. Buck*, 162 Cal. 300, 122 Pac. 466 (1912); *Tapia v. Demartini*, 77 Cal. 383, 19 Pac. 641 (1888); *Collins v. Carlile*, 13 Ill. 254 (1851); *Everist v. Carter*, 202 Iowa 498, 210 N.W. 559 (1926); *First Nat'l Bank of Jackson v. Taulbee*, 279 Ky. 153, 130 S.W. 2d 48 (1939); *Batten v. Jurist*, 306 Pa. 64, 158 Atl. 557 (1932).

<sup>15</sup> *Tapia v. Demartini*, 77 Cal. 383, 19 Pac. 641 (1888); *Speer v. Skinner*, 35 Ill. 282 (1864); *First Nat'l Bank of Jackson v. Taulbee*, 279 Ky. 153, 130 S.W. 2d 48 (1939).

<sup>16</sup> See footnote 26 *infra* relating to possibility of fraud upon subsequent purchasers and encumbrancers.

pressed therein can give rise to the *obligatory advance*, which binds the mortgagee, by his contract, at the inception to lend a definite amount of money to be paid out in future installments to the mortgagor or a third party. Or it can give rise to an *optional advance*, which is one the mortgagee is not obliged to make and presumably one which he is not entitled to make other than upon the specific request or with the consent of the mortgagor.<sup>17</sup>

The validity of the mortgage to secure *obligatory* future advances under the common law has been upheld repeatedly by the courts. The obligation accrues on the delivery of the notes and mortgage, and the lien attaches on recordation.<sup>18</sup> As it has been stated:

A mortgage or judgment may be taken and held as a security for future advances and responsibilities to the extent of it, when this is a constituent part of the original agreement; and the future advances will be covered by the lien, in preference to the claim under a junior intervening incumbrance, with notice of the agreement.<sup>19</sup>

The mortgage to secure *optional* future advances as long as entered into *bona fide* is valid;<sup>20</sup> but as to how far the extent of its validity reaches is somewhat of a question, and the intervention of a second creditor or subsequent purchaser complicates the problem somewhat.<sup>21</sup> And it may be noted that the validity of the mortgage to secure future advances is not affected by the fact that the advances are to be made in materials for building instead of money.<sup>22</sup>

The validity of the mortgage to secure future advances arises basically out of original contract, and it is definitely settled that as between the original parties, mortgagor and mortgagee, the legal significance given to such a transaction affects those parties. But as between the mortgagee and the transferee of the original mortgagor the mortgagee will not be protected as to future advances to said transferee.<sup>23</sup>

<sup>17</sup> Priority of lien may well depend upon whether or not the advance was optional or obligatory on behalf of the mortgagee.

<sup>18</sup> Crane v. Deming, 7 Conn. 387 (1829); Good v. Woodruff, 208 Ill. App. 147 (1917); Schimberg v. Waite, 93 Ill. App. 130 (1900).

<sup>19</sup> 4 Kent, Commentaries on American Law 175 (14th ed., 1901).

<sup>20</sup> Lovelace v. Webb, 62 Ala. 271 (1878); Crane v. Deming, 7 Conn. 387 (1829); The Commercial Bank v. Cunningham, 41 Mass. 270 (1883).

<sup>21</sup> After the second lien or encumbrance attaches the question of priority arises. The question as to which lien will prevail is dealt with *infra* page 81.

<sup>22</sup> Tapia v. Demartini, 77 Cal. 383, 19 Pac. 641 (1888); Brooks v. Lester, 36 Md. 65 (1872).

<sup>23</sup> Walker v. Whitmore, 165 Ark. 276, 262 S.W. 678 (1924): "The word 'Grantor,' as used in the clause . . . both in its legal meaning and its common acceptation, refers to the person executing the deed of trust of which the clause . . . is a part."

## DESCRIPTION OF THE DEBT

The debt is considered the life of the mortgage so that the invalidity of the debt or obligation would make the mortgage unenforceable and, correspondingly, the non-existence of a debt between the parties prevents a conveyance from becoming operative as a mortgage and attaching as a lien. With this in mind the question arises as to what is the nature of the debt which is secured by a mortgage for future advances.

The general form of the obligation has been touched upon previously. Courts have been liberal to construe the agreement to include future advances,<sup>24</sup> for parol evidence may be used to prove an oral agreement that future advances were to be included.<sup>25</sup> But it has been generally held that the debt must be described or defined with such accuracy as to make identification reasonably possible and certain.<sup>26</sup>

If the nature and amount of the incumbrance is so described that it may be ascertained by the exercise of ordinary discretion and diligence this is all that is required.<sup>27</sup>

The purpose of these general rules is to preclude fraud upon creditors. The main objection to the form of mortgage to secure future advances that states a definite sum in excess of that which is actually advanced or required under the original terms (overstatement of the obligation) seems to be the danger to creditors and third parties who may want to deal with the debtor. Unless there can be found the intention to perpetrate fraud or deceive, such a mortgage will be upheld<sup>28</sup> in the absence of statute to the contrary. And where the mortgage expressly provides for future advances, it has been held not to be uncertain as to the debt, although it fails to express the amount.<sup>29</sup> The big objection to this form being the

<sup>24</sup> Citizen's Savings Bank v. Kock, 117 Mich. 225, 75 N.W. 458 (1898); Keyes v. Bump's Adm'r, 59 Vt. 391, 9 Atl. 598 (1887) (the intent to secure future advances is to be gathered from the whole instrument).

<sup>25</sup> Langerman v. Puritan Dining Room Co., 21 Cal. App. 637, 132 Pac. 617 (1913); Dunn v. Burke, 139 Ill. App. 12 (1907).

<sup>26</sup> Harper v. Edwards, 115 N.C. 246, 20 S.E. 392 (1894) (reference in a mortgage to a note secured by it without specifying its contents).

<sup>27</sup> 1 Jones, Mortgages § 450 (8th ed., 1928). The description of the debt must inform creditors and subsequent purchasers as to the amount insofar as it directs attention to the sources of correct information and not mislead or deceive as to its nature or amount. Goff v. Price, 42 W.Va. 384, 26 S.E. 287 (1896).

<sup>28</sup> Tully v. Harloc, 35 Cal. 302 (1868) (held to be *constructive fraud* against subsequent encumbrancers except for the amount of the present advance); Matz v. Arick, 76 Conn. 388, 56 Atl. 630 (1904); Nazro v. Ware, 38 Minn. 443, 38 N.W. 359 (1888) (overstatement with intention to defraud); Holt v. Creamer, 34 N.J. Eq. 181 (1881).

<sup>29</sup> Lovelace v. Webb, 62 Ala. 271 (1878); Frank H. Buck Co. v. Buck, 162 Cal. 300, 122 Pac. 466 (1912); Michigan Insurance Co. of Detroit v. Brown, 11 Mich. 265 (1863); Witezinski v. Everman, 51 Miss. 841 (1876); Kelly v. Falconer, 45 N.Y. 42 (1871); Batten v. Jurist, 306 Pa. 64, 158 Atl. 557 (1932); Jones, Mortgages § 364 (8th ed., 1928).

possibility of substitution of either debts other than those described or fictitious debts.<sup>30</sup>

The debt may therefore be spelled out specifically as to time, amount and purpose, thereby creating little or no doubt in the minds of the parties, third parties, or the courts as to what was intended; or it may be indefinite and unlimited as to time and amount so as to create a *Dragnet Clause* or *Anaconda Mortgage*<sup>31</sup> on the other hand. But as long as the tests described above are met, the description will be legal.

A mortgage given to secure a debt existent at the making of the mortgage, or contemporaneous therewith, is valid, even as against subsequent purchasers and creditors, although it does not explicitly state the amount of such debt or liability, provided there are means of ascertaining such amount. And extrinsic evidence is admissible for the purpose of showing the debt which the mortgage was intended to secure.<sup>32</sup>

#### PRIORITIES

A problem inherent in the field of open-end mortgaging is that of priority of liens. A simple factual situation will be illustrative. The mortgagee, pursuant to a prior recorded mortgage to secure future advances, lends additional amounts of money. However, prior to this advance but subsequent to the execution and recording of the mortgage a second encumbrance or lien attaches to the property. The question arises as to which lien shall take priority in the security, that of the advance made pursuant to the first open-end mortgage, or that of the second encumbrance or lien? The answer will be dependent on whether the advance was obligatory under the mortgage agreement; or if optional, did the mortgagee have notice, actual or constructive, of the second encumbrance, when he made the advance?<sup>33</sup>

It seems to be a uniform principle throughout the country that when the mortgagee is contractually obligated to make the advances, and such advances are properly made, they will take precedence over any lien or encumbrance arising after the date of the recording of the mortgage.<sup>34</sup>

<sup>30</sup> *New v. Sailors*, 114 Ind. 407, 16 N.E. 609 (1888).

<sup>31</sup> See footnotes 7 and 8 supra.

<sup>32</sup> *Durfee, Cases on Mortgages* 41 (1915).

<sup>33</sup> The lien of the prior mortgage will, of course, prevail against all subsequent purchasers or encumbrancers whose rights do not attach until after the advances are made, and against all who are not bona fide purchasers for value without notice. 4 *Pomeroy, Equity Jurisprudence* § 1199 (5th ed., 1941).

<sup>34</sup> *Preble v. Conger*, 66 Ill. 370 (1872); *Waverly Co-op Bank v. Haner*, 273 Mass. 477, 173 N.E. 699 (1930); *Whelan v. Exchange Trust Co.*, 214 Mass. 121, 100 N.E. 1095 (1913); *Kuhn v. Southern Ohio Loan and Trust Co.*, 101 Ohio St. 34, 126 N.E. 820 (1920); *Land Title and Trust Co. v. Shoemaker*, 257 Pa. 213, 101 Atl. 335 (1917); *Kingsport Brick Corp. v. Bostwick*, 145 Tenn. 19, 235 S.W. 70 (1921); *Cedar v. Roche Fruit Co.*, 16 Wash. 2d 652, 134 P. 2d 437 (1943); *Good v. Woodruff*, 208 Ill. App. 147 (1917); 1 *Jones, Mortgages* § 454 (8th ed., 1928); *Osborne, Handbook on the Law of Mortgages* § 120 (1951).

It is considered that because of the mortgagee's obligation to pay out the money, the mortgage debt is regarded as being in existence from the beginning.<sup>35</sup> Another theory is that the lien arising out of the payments made under such an agreement relates back to the date of the mortgage.<sup>36</sup> This rule is not abrogated if the mortgagee had notice of the existence of the subsequent encumbrance when he made the advance. As one court stated in discussing whether record notice would postpone an obligatory advance to a prior recorded lien or encumbrance:

Upon what principle, then of equity or public policy, can it be said that such mortgagee must again search the records before making each advance to the mortgagor? The search would be a vain thing, since the advance or further loan would remain obligatory, whatever the state of the title disclosed.<sup>37</sup>

Such reasoning is of equal validity if the mortgagee had actual notice of a subsequent lien or encumbrance before he made the obligatory advance.

The same unanimity of opinion is not found when the advances made under the mortgage are purely optional, i.e., that the mortgagee has no right to make the advance or is not obligated to do so.

When optional advances are made with *notice* of a lien or encumbrance which has attached to the security subsequent to the execution of the mortgage, but prior to the advance, the advance will be junior to the prior lien or encumbrance. The majority of jurisdictions require that such notice be actual.<sup>38</sup> It would seem from the cases that actual notice would be any information made known to the prior mortgagee of the existence of the subsequent encumbrances.<sup>39</sup> But at least one jurisdiction required at least an intimation be made to the mortgagee that no further advances are to be made, which would be something more than a mere knowledge in the mortgagee of such subsequent interest in the creditor.<sup>40</sup> Certainly, a

<sup>35</sup> Kuhn v. Southern Ohio Loan and Trust Co., 101 Ohio St. 34, 126 N.E. 820 (1920); Kratovil, Real Estate Law § 332 (2d ed., 1953).

<sup>36</sup> Land Title and Trust Co., v. Shoemaker, 257 Pa. 213, 101 Atl. 335 (1917).

<sup>37</sup> Kuhn v. Southern Ohio Loan and Trust Co., 101 Ohio St. 34, 126 N.E. 820 (1920).

<sup>38</sup> DuBois v. First Nat'l Bank of Denver, 43 Cal. 400, 96 Pac. 169 (1908); Schmidt v. Zahndt, 148 Ind. 447, 47 N.E. 335 (1897); Everist v. Carter, 202 Iowa 498, 210 N.W. 559 (1926); Axel Newman Heating and Plumbing Co. v. Sauers, 234 Minn. 140, 47 N.W. 2d 769 (1951); U.S. Nat'l Bank of Portland v. Embody, 144 Ore. 488, 25 P. 2d 149 (1933); Cedar v. Roche Fruit Co., 16 Wash. 2d 663, 134 P. 2d 437 (1943); Elmen-dorf-Anthony Co. v. Dunn, 10 Wash. 2d 29, 116 P. 2d 253 (1941); Imhoff v. Title Insurance and Trust Co., 113 Cal. App. 2d 139, 247 P. 2d 851 (1952); Oakes v. Weingartner, 105 Cal. App. 2d 598, 234 P. 2d 194 (1951); In re Harris, 156 Misc. 805, 282 N.Y. Supp. 571 (Surr. Ct., 1935); 1 Jones, Mortgages § 456 (8th ed., 1928); Osborne, Handbook on the Law of Mortgages § 119 (1951).

<sup>39</sup> See also 19 R.C.L., Mortgages § 212 (1929).

<sup>40</sup> Patch v. First Nat'l Bank, 90 Vt. 4, 96 Atl. 423 (1916); McDaniels v. Colvin, 16 Vt. 300 (1844). This Vermont rule seems to have been codified and defined; at least in respect to the priorities between advances made under a first mortgage and a prior

written notice to the first mortgagee of the subsequent lienor's claim would be advisable in any actual notice jurisdiction.

The rationale for the majority view can best be summed up in the words of one authority:

The arguments for the majority view are that the operation of the recording laws are prospective, not retrospective, and therefore should constitute no notice to the first mortgagee who should not have to keep on examining the records after he has satisfied all of the law's requirements as to his own mortgage; that it is unjust for a man to lose his security by the mere registration of a subsequent lien, i.e., by no act of his own; that as a practical matter the majority rule is better calculated to subserve the business convenience which called the practice into being; that this is especially true where continuous dealings with frequent advances are contemplated; that the hardship on the first mortgagee through having to make new examinations of title before each later advance, added to these considerations, more than balance any hardship on the later encumbrancers through having to give actual notice; that so far as inconvenience to the later claimant is concerned, since ordinarily he has to make an investigation before acquiring his interest it would seldom be much additional trouble to give the required actual notice. . . .<sup>41</sup>

A minority of jurisdictions hold that optional advances made with only record notice of liens or encumbrances created subsequent to the execution and recording of the mortgage but prior to the advance will be junior to such liens and encumbrances.<sup>42</sup> The rationale being that the mortgage can only take effect as a lien when the debt is created, and consequently, the mortgagee, when making the advances, is charged with record notice of any valid lien or encumbrance which may have attached subsequent to the execution of the mortgage.<sup>43</sup> This view, however, has

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second mortgage, as a notice in writing from the second mortgagee to the first mortgagee. Vt. Stat. (1947) § 8756.

<sup>41</sup> Osborne, *Handbook on the Law of Mortgages* § 119 (1951); see also 4 *American Law of Property* § 16.74 (1952); *Ackerman v. Hunsicker*, 85 N.Y. 43 (1881).

<sup>42</sup> *Ladue v. Detroit M. & R. Co.*, 13 Mich. 380 (1865); *Spader v. Lawler*, 17 Ohio 371 (1848); *The Bank of Montgomery County's Appeal*, 36 Pa. 170 (1860); *Ter-Hoven v. Kerns*, 2 Pa. 96 (1845). However, a recent case in Pennsylvania indicates a possible future shift in that jurisdiction to the actual notice rule; see *Housing Mortgage Corp. v. Allied Construction Co.*, 374 Pa. 312, 97 A. 2d 802 (1953).

<sup>43</sup> For an excellent and well reasoned defense of this position see the opinion in *Ladue v. Detroit M. & R. Co.*, 13 Mich. 380 (1865). Speaking of an optional open-end mortgage and rejecting the actual notice theory, the court stated that it (the mortgage) constitutes, of itself, no binding contract. Either party may disregard or repudiate it at his pleasure. It is but a part of an arrangement, merely contemplated as probable, and which can only be rendered effectual by the future consent and further acts of the parties. It is but a kind of conditional proposition, neither binding, nor intended to bind either of the parties, until subsequently assented to or adopted by both. The court, therefore, reasons that any advance made under the terms of the optional open-end mortgage are in fact, and in legal effect, subsequent to an intervening encumbrance, and that, therefore, the recording of the intervening encumbrance should be notice to the mortgagees. See also *Freutel v. Schmitz*, 299 Ill. 320, 132 N.E. 534 (1921), wherein it is also stated that a lien attaches when the advance is made. However, it is not certain whether the advance was obligatory or purely optional.

been criticized on the grounds that the lien attaches not from the act of making the advance, but from the previous executory agreement by which the land was bound as security for future advances.<sup>44</sup>

Also, there had been some authority to the effect that advances made under an open-end mortgage took priority over prior liens or encumbrances regardless whether the advance was optional or obligatory or whether the mortgagee has actual or constructive notice.<sup>45</sup> But it is doubtful whether this rule would be followed today except possibly in Texas.<sup>46</sup>

It does not always follow that advances which are not obligatory are then optional and subject to being postponed to prior liens or encumbrances of which the mortgagee had actual (or constructive) notice when he made the advances. There is some authority to the effect that if the mortgagee has the right to make future advances at his option to protect his security, then he shall be considered in the same position as an obligatory mortgagee and afforded the same priority.<sup>47</sup>

Similar decisions have been reached when a mortgagee obligated to make advances is released from such obligation by a breach of the mortgagor, but continues to make the advances.<sup>48</sup> Such advances made after a breach by the mortgagor are treated the same as obligatory advances and not as optional on the theory that the mortgagee can waive the breach of condition and continue to make the advances to protect his security or obtain the fruits of a valuable contract.

Finally, it has been held that if an advance is made under an open-end mortgage but the mortgagee has executed second and third mortgages to secure the advance, he shall be estopped from asserting their priority as advances under the first mortgage.<sup>49</sup> It is also probable that the priority of

<sup>44</sup> 4 Pomeroy, *Equity Jurisprudence* § 1199, n.17 (5th ed., 1941). But it is difficult to see how any executory agreement has arisen when the mortgagor is not bound to accept an advance and the mortgagee is not bound to make one.

<sup>45</sup> See *Grey v. Helm*, 60 Miss. 131 (1882) and *Witezinski v. Everman*, 51 Miss. 841 (1876), both modified by *North v. McClintock*, 208 Miss. 289, 44 So. 2d 412 (1950) wherein the actual notice rule as to optional future advances was laid down; *Gordon v. Graham*, 22 Eng. Rep. 502 (Ch., 1716), overruled in *Hopkinson v. Rolt*, 11 Eng. Rep. 829 (H.L., 1861).

<sup>46</sup> *First Nat'l Bank v. Zarafonitis*, 15 S.W. 2d 155 (Tex. Civ. App., 1929); *Law Sprinkle Mercantile Co. v. Hause*, 184 S.W. 737 (Tex. Civ. App., 1916); *Freiberg v. Mogale*, 70 Tex. 116, 7 S.W. 684 (1888); *Willis v. Sanger*, 15 Tex. Civ. App. 655, 40 S.W. 229 (1897). But see *Cisco Banking Co. v. Keystone Pipe and Supply Co.*, 277 S.W. 1060 (Tex. Com. App., 1925), wherein it is stated that "notice" of a prior lien will postpone a future advance to the prior lien.

<sup>47</sup> *Rowan v. Sharp's Rifle Mfg. Co.*, 29 Conn. 282 (1860); *Cedar v. Roche Fruit Co.*, 16 Wash. 2d 663, 134 P. 2d 437 (1943); *Lidster v. Poole*, 122 Ill. App. 227 (1905). See also *Bellamy and Sons v. Cathcart*, 72 Iowa 207, 33 N.W. 636 (1887).

<sup>48</sup> *Landers-Morrison-Christenson Co. v. Ambassador Holding Co.*, 171 Minn. 445, 214 N.W. 503 (1927); *Hyman v. Hauff*, 138 N.Y. 48, 33 N.E. 735 (1893).

<sup>49</sup> *Garey v. Rufus Lillard Co.*, 196 Okla. 421, 165 P. 2d 344 (1945).

federal tax liens which arise between the execution and recording of the mortgage and the making of the advance will be considered in the light of the state law as to the priority between liens and advances.<sup>50</sup>

Illinois is an example of a state wherein the various rules relating to priorities of advances made under an open-end mortgage have been codified. An Illinois statute provides that as to subsequent purchasers and judgment creditors, every such mortgage shall be a lien only from such time the monies are advanced *unless* the mortgagee is by contract obligated to make such advances, or unless the monies are advanced within eighteen months after the recording date of the mortgage.<sup>51</sup> As to obligatory advances, this statute does no more than restate the common law position previously existing in Illinois,<sup>52</sup> and almost unanimously existing elsewhere. It can be seen, however, that optional advances are given the same consideration as obligatory ones, i.e., that for the eighteen-month period they will take precedence over any liens or encumbrances arising before the advance but after the execution and recording of the mortgage. This would be because the lien of the advance relates back to the recording of the mortgage.<sup>53</sup> After the eighteen-month period it would seem that optional advances will fall under the minority doctrine which states that since the advance only takes effect as a lien when the advance is made, record notice of any prior lien or encumbrance will postpone the advance to such lien or encumbrance.<sup>54</sup>

It should be noted that this section has never been tested as to its constitutionality. A provision in the section exempts mechanics lienors from its provisions and allows their claims to have priority as laid down in the Mechanics Lien Act.<sup>55</sup> It is possible that this may be objected to as

<sup>50</sup> *United States v. Hooe*, 3 Cranch. (U.S.) 73 (1805); *People's Bank v. United States*, 98 F. Supp. 874 (N.D. Ga., 1951), rev'd on other grounds 197 F. 2d 898 (C.A. 5th, 1952).

<sup>51</sup> Ill. Rev. Stat. (1955) c. 30, § 37a.

<sup>52</sup> *Preble v. Conger*, 66 Ill. 370 (1872); *Good v. Woodruff*, 208 Ill. App. 147 (1917); *Schimberg v. Waite*, 93 Ill. App. 130 (1900). See also *Lidster v. Poole*, 122 Ill. App. 227 (1905), wherein it was held that advances which were not obligatory, but made to protect the security, cannot be said to be optional advances.

<sup>53</sup> It is doubtful, because of this "relation-back" theory in the statute, that actual notice of a subsequent lien or encumbrance would postpone an optional advance made during the eighteen-month period to such liens or encumbrances.

<sup>54</sup> This would seem to be the previous view in Illinois. An early Illinois case in which the mortgagee had actual notice held that "notice" would postpone the optional advance to a second mortgage. *Frye v. Bank of Illinois*, 11 Ill. 367 (1849). But later cases held that the lien attached only when the advance was made. Thus, a recorded second lien or encumbrance would postpone the advance to it. See *Freutel v. Schmitz*, 299 Ill. 320, 132 N.E. 534 (1921); *Schaeppi v. Glade*, 195 Ill. 62, 62 N.E. 874 (1902); *Schulze v. Houfes*, 96 Ill. 335 (1880); 1 *Reeve*, Illinois Law of Mortgages and Foreclosures § 227 (1932).

<sup>55</sup> Ill. Rev. Stat. (1955) c. 82, § 16.

class legislation, particularly in view of the fact that Section 37A of Chapter 30 allows an optional advance an eighteen-month priority over liens and encumbrances other than mechanics liens which it did not possess at common law. Thus, it could be argued that mechanics lienors are afforded a special privilege which other encumbrancers and lienors are not allowed.<sup>56</sup> If so, it would seem that the entire Section 37A would fall, because if the Act were held valid and the mechanics lienors' privilege was stricken, a class which the legislature did not wish to affect would fall within the purview of the Act.<sup>57</sup> However, this is something for future litigation to establish.

#### STATUTES

Less than one-third of the states have enacted legislation pertaining to future advances in light of open-end mortgages.<sup>58</sup> The Illinois statute in so far as it effects priority between the first mortgagee and subsequent purchasers and encumbrancers as well as mechanics lienors has already been discussed, and several of the other statutes and their effect upon this type of financing will now be discussed.

The history of the Maryland statute dates back to 1825,<sup>59</sup> and follows through to the statute which is operative today.<sup>60</sup> The Act provides that no mortgage to secure future loans or advances is valid unless the amounts and time for disbursement be specifically stated in the mortgage. This gives the mortgage draftsmen in the state of Maryland little leeway in describing a debt in an open-end mortgage with the exception of Baltimore and Prince George's Counties.<sup>61</sup> The lien in total attaches upon execution and not even actual notice of a subsequent encumbrance before all advances are made will defeat the mortgagee.

Massachusetts, in 1946, enacted a law on what is termed "*Flexible or*

<sup>56</sup> See Ill. Const. Art. IV, § 22; *Manowski v. Stephan*, 233 Ill. 409, 84 N.E. 365 (1908).

<sup>57</sup> *Mathews v. The People*, 202 Ill. 389, 67 N.E. 28 (1903); Sutherland, *Statutes and Statutory Construction* § 306 (1891).

<sup>58</sup> For a discussion of the effect of these various statutes on the problem of priority of liens see Russell and Prather, *The Flexible Mortgage Contract*, *Legal Bulletin of the U.S. Savings and Loan League*, Sept. 1953.

<sup>59</sup> Act of 1825, Ch.50., The statute was enacted to eliminate creditors of the mortgagor from being defrauded. *Cole, Trustee v. Albers and Runge*, 1 Gill (Md.) 412, 424 (1843).

<sup>60</sup> Md. Code. Ann. (Supp., 1947) Art. 66.

<sup>61</sup> Md. Code Ann (1939) Act 66, § 3, provides that in Baltimore and Prince George's Counties only the amount of the debt must be specified at the time of execution of a mortgage, but does not require stating the times when the future advances are to be made. See *Welsh v. Kuntz*, 196 Md. 86, 75 A. 2d 343 (1950), for an interpretation of Section 3 of Article 66, Code, 1939 in conjunction with Md. Code Ann. (Supp., 1947) Art. 66.

*Adjustable Mortgages of Real Estate.*"<sup>62</sup> The statute covers money advanced by the mortgagee to the mortgagor

to be expended for paying for repairs or replacements to, or for taxes or other municipal liens, charges or assessments on, the mortgaged premises . . . [to be] . . . equally secured with and have the same priority as the original indebtedness, *to the extent that the aggregate amount outstanding at any one time when added to the balance due on the original indebtedness shall not exceed the amount originally secured by the mortgage.*<sup>63</sup>

This Act seems to limit this type of priority strictly to the type of advance which is *necessary* to protect the security of the mortgagee and, then only, to the extent of the original loan so as to protect subsequent purchasers and creditors as to any amount advanced over and above their *caveat* by way of record notice. But as long as the mortgagee stays within these limits he should be protected even if the future advance is optional.

North Dakota has provided in its regulation of the operation of Building and Loan Associations for the advancement of money:

for maintenance, repairs, modernization and improvement of real estate, on which the association owns a first mortgage lien, up to the original amount of said mortgage or twenty-five hundred dollars, whichever may be the lesser . . . provided the said first mortgage *by its terms* reserves in the association the right to make such advances or additional loans and provided further that such advances or loans are used for the purpose stated herein. Such advances or loans shall be deemed to be merged, incorporated in and become a part of and secured by said first mortgage and the association shall have a good and valid first lien against such real estate. . . .<sup>64</sup>

North Dakota has put a limit on the amount, (\$2,500) and required a provision in the original agreement for future advances, as well as limiting the purpose for which this type of financing can be used, but compliance allows the mortgagee to prevail over all subsequent purchasers and encumbrancers.

The laws of Connecticut provide that the amount advanced cannot exceed the amount of the full loan therein authorized, but that it will receive the same priority as if it had been advanced at the time the mortgage was delivered as long as the original instrument contained a description of the loan.<sup>65</sup> Also, it is necessary that the original agreement provide for future advances, and that the time for pre-payment cannot extend beyond the maturity of the original mortgage debt.<sup>66</sup>

<sup>62</sup> Mass L. Ann. (Supp., 1953) c. 183, §28A.

<sup>63</sup> Ibid. Emphasis added.

<sup>64</sup> N.D. Rev. Code (Supp, 1953) § 7-0414. Emphasis added.

<sup>65</sup> Conn. Gen. Stat. (1949) c. 361, § 7194. A model form of description is provided within the statute.

<sup>66</sup> Conn. Gen. Stat. (Supp., 1951) c. 282, § 1145b.

In Kentucky, an open-end mortgage shall:

... secure payment of all renewals and extensions of said loan and the note evidencing it, and payment of all additional notes evidencing additional loans, in no event to exceed two thousand dollars in addition to the original amount loaned, made to the original mortgagor or mortgagors or to their successors in title, provided that such mortgage contains a provision that it secures, in addition to the original amount of said loan stated therein, all renewals and extensions of said loan. . . .<sup>67</sup>

Thus, Kentucky has put a limit upon future advances to the extent of \$2,000 over and above the original debt, and recognizes their validity as long as the original agreement provides for them. It may be noted also that the statute provides for advances to the original mortgagor's successors in title.

#### CONCLUSION

The use of the open-end mortgage to secure future advances is becoming more popular. As a method of financing it gives rise to advantages not only from the borrower's point of view but that of the lender as well. There has been increased activity to inform the public of the existence of such a manner of financing for owners of new as well as old homes.<sup>68</sup> The validity of an open-end mortgage has certainly been well recognized, but the priority which the lender holds is not completely settled uniformly today. The mortgagee who lends money under this type of financing can learn from the cases that in order to protect himself fully he must act in good faith, provide for the future advances at the outset, and set a limitation on the debt. Proper description of the debt, which is such an essential element to a mortgage, can give rise to the type of protection which the mortgagee seeks in order to insure that his security interest covers the extent of his outlay to the mortgagor.

The mortgagee further requires a note to evidence the advance and an affidavit that there are no other liens on the property, except the first mortgage. If there is an *obligatory* advance the rights of all parties are settled, but the *optional* advance gives rise to the problem of notice to the first mortgagee as affecting his rights of priority.

As long as the requirement of good faith is upheld in the open-end mortgage the law should not only recognize the validity of this type of financing, but it should encourage its use.

<sup>67</sup> Ky. Rev. Stat. (1953) §382.520.

<sup>68</sup> Better Homes and Gardens, October 1955, p. 174; Fortune, Sept., 1949, p. 18; 90 Architectural Forum 103 (June 1949)