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Re-Establishing Priority of a Subordinated Purchase-Money Deed of Trust

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COMMENTS

RE-ESTABLISHING PRIORITY OF A SUBORDINATED PURCHASE-MONEY DEED OF TRUST

The agreement of a seller of land to subordinate his purchase-money deed of trust to construction financing has received extensive judicial treatment in a series of cases involving specific performance of executory land sale contracts containing such subordination provisions.[1] But the problems arising after execution of the land sale contract have received scant attention. No case has been discovered involving specific performance of an agreement to subordinate arising after the execution of the land sale contract. This is probably due in large part to the popularity of the so-called "automatic" subordination clause and the widespread practice of including within or endorsing upon seller's deed of trust a subordination agreement which authorizes the trustee (usually a title company) to execute the subordination. Neither practice requires any further affirmative action on the part of seller to effect the subordination.

Four cases have been reported at the intermediate appellate level involving the fully executed subordination.[2] Despite the importance of the problems involved, the opinions in these four cases are at best nebulous and unsatisfactory. The cases do contain some elements of a determination of rights and liabilities, which will be

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[1] Cummins v. Gates, 235 Cal. App. 2d 532, 45 Cal. Rptr. 417 (1965); Stockwell v. Lindeman, 229 Cal. App. 2d 750, 40 Cal. Rptr. 555 (1964); Burrow v. Timmsen, 223 Cal. App. 2d 283, 35 Cal. Rptr. 668 (1963); Kessler v. Sapp, 169 Cal. App. 2d 818, 338 P.2d 34 (1959); Roven v. Miller, 168 Cal. App. 2d 391, 335 P.2d 1035 (1959); Gould v. Callan, 127 Cal. App. 2d 1, 273 P.2d 93 (1954).

[2] Gill v. Mission Sav. & Loan Ass'n, 236 Cal. App. 2d 753, 46 Cal. Rptr. 456 (1965); Radunich v. Basso, 235 Cal. App. 2d 826, 45 Cal. Rptr. 824 (1965); Spaziani v. Millar, 215 Cal. App. 2d 667, 30 Cal. Rptr. 658 (1963); Collins v. Home Sav. & Loan Ass'n, 205 Cal. App. 2d 86, 22 Cal. Rptr. 817 (1962). Matthews v. Hinton, 234 Cal. App. 2d 736, 44 Cal. Rptr. 692 (1965) is usually cited in this connection, but will not be discussed here. The case involved "subordination" by a lessor of his reversionary interest to enable the lessee to obtain a loan to improve the property. Lessor joined in the execution of the deed of trust but not the promissory note. Lessor therefore hypothecated his property to secure a debt not personal to himself and could not complain when the lender, upon default and notice, foreclosed. It is submitted that this direct hypothecation is not the same thing as the waiver of priority which is involved in the cases cited first above, although it might produce similar results. *Matthews* is remarkable, however, for a bit of dictum which lends unnecessary support to the rule in *Gill*: that the lender has no duty of care to supervise the expenditure of loan funds in accord with the terms of a contract (the subordination agreement) with which it is not in privity. See also text accompanying note 24 *infra* to the effect that privity has no application to a discussion of priorities.

discussed, along with one case[3] from a trial court, from the standpoint of seller's remedies.

The usual context in which the subordination clause appears involves sale of an undeveloped tract of land to a buyer/developer who is acquiring for residential subdivision or commercial development. The seller will often prefer to take in cash only thirty per cent or less in the year of sale in order to spread his taxes, taking back a purchase money deed of trust from the buyer to secure the remainder. In actual fact it would appear that the individual seller usually does not discount this deed of trust.[4] A seller who subordinates his deed of trust to construction financing does so on the theory that the improvements, when completed, will actually add to rather than detract from his security. Furthermore, he can usually obtain a higher price for his land if he agrees to subordinate.

The buyer seldom wishes to postpone construction until the full purchase price of the land has been paid nor does he wish to divert any more cash (if he has it) than is necessary toward payment of the purchase price of the land. He may obtain an option to purchase (embodying the subordination clause) and negotiate his construction financing prior to exercising the option. The construction loan escrow will often parallel the land sale escrow.

Under the earlier cases, if the construction financing which the buyer was able to obtain appeared unsatisfactory or if for any other reason the seller felt unsure of his security, he might repudiate the executory contract of sale and resist specific performance on the ground that the subordination clause contained in the contract was indefinite, uncertain, or perhaps even unconscionable.[5] If the subordination clause was cast in the "automatic" form, uncertainty might not be far from unconscionability.

In *Burrow v. Timmsen*[6] the court relaxed the requirements for specific enforceability stating that if the material terms (maximum loan amount, maximum interest, maximum period of the loan and source of the loan funds) were expressly stated and other terms were reasonably ascertainable, the specific performance of the land sale contract containing the subordination agreement would be granted.[7]

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[3] Kiles v. Dobrow, Civil No. 128182, Super. Ct., Santa Clara County, Calif., Dec. 31, 1965.

[4] Hetland, *Real Property & Real Property Security: The Well-Being of the Law*, 53 CALIF. L. REV. 151, 160 n.37 (1965).

[5] Magna Dev. Co. v. Reed, 228 Cal. App. 2d 230, 39 Cal. Rptr. 284 (1964); Kessler v. Sapp, 169 Cal. App. 2d 818, 338 P.2d 34 (1959); Roven v. Miller, 168 Cal. App. 2d 391, 335 P.2d 1035 (1959); Gould v. Callan, 127 Cal. App. 2d 1, 273 P.2d 93 (1954).

[6] 223 Cal. App. 2d 283, 35 Cal. Rptr. 668 (1963).

[7] *Id.* at 288-89, 35 Cal. Rptr. at 671-72. The parties, however, expressly con-

Subsequent decisions[8] have followed the *Burrow* rule, indicating that the seller may not in the future walk away from the contract should the terms of the subordination clause appear to be inadequate for his protection.[9] Litigation involving executed subordination agreements may therefore be expected to increase.

If the total encumbrance is not excessive in relation to the value of the land when improved, and if the improvements are completed and sold or leased without incident no problem arises. But it is inherent in the nature of the transaction that until such time as the improvements are complete, or almost complete, the land will be overencumbered. If therefore the buyer/developer, prior to completion of construction, becomes insolvent and defaults on his payments to the construction lender, the seller faces the almost certain danger that his security will be at least partially, if not totally, exhausted to satisfy the now prior lender.

If the construction is not substantially complete at the time of buyer's default, seller is probably in no position to foreclose his junior lien. In most cases this would necessitate his sinking large sums in the project. Furthermore, part of the construction loan funds may have been diverted by the buyer for purposes of his own, such as paying his other creditors, and the land may be so overencumbered that the seller may not be able to finish the project at a profit even if he should want to foreclose. Seller's foreclosure is, therefore, usually not an acceptable remedy. The seller cannot proceed against the buyer even if the latter is solvent due to the bar of the anti-deficiency legislation.[10] Seller is usually in a position where

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tracted with reference to the "usual . . . form of subordination" of a particular title company. See also Cummins v. Gates, 235 Cal. App. 2d 532, 540, 45 Cal. Rptr. 417, 422 (1965); Stockwell v. Lindemann, 229 Cal. App. 2d 750, 756, 40 Cal. Rptr. 555, 558 (1964). Absent an express contractual reference supplying a means by which additional terms could be ascertained with a fair degree of certainty, would the *Burrow* rule still apply? See Magna Dev. Co. v. Reed, 228 Cal. App. 2d 230, 39 Cal. Rptr. 284 (1964). The agreement in the latter case was defective for failure to state essential terms. For a discussion by Justice Molinari see Magna Dev. Co. v. Reed, *supra* at 236, 242, 39 Cal. Rptr. at 289, 293.

8 Cummins v. Gates, 235 Cal. App. 2d 532, 45 Cal. Rptr. 417 (1965); Stockwell v. Lindemann, 229 Cal. App. 2d 750, 40 Cal. Rptr. 555 (1964).

9 Cummins v. Gates, 235 Cal. App. 2d 532, 540-41, 45 Cal. Rptr. 417, 422 (1965); Stockwell v. Lindemann, 229 Cal. App. 2d 750, 756-58, 40 Cal. Rptr. 555, 557-60 (1964). These cases appear to relax even the terms stated to be essential in *Burrow*, leaving maximum amount and rate of interest the only material terms, provided a method is stipulated in the contract ("upon such terms as are required by the lender thereof") or evidence of custom and usage is available to ascertain additional terms. It must be remembered that the agreement can always be avoided if it can be shown to be merely an agreement to agree.

10 CAL. CODE CIV. PROC. § 580b. As to whether Bargioni v. Hill, 59 Cal. 2d 121, 28 Cal. Rptr. 321, 378 P.2d 593 (1963) and Roseleaf Corp. v. Chierighino, 59 Cal. 2d 35, 27 Cal. Rptr. 873, 378 P.2d 97 (1963) signal the advent of a more relaxed § 580b rule in the future, see generally Hetland, *supra* note 4, at 159-65.

his only acceptable remedy is to proceed against the lender to reestablish the original priorities.

In *Collins v. Home Savings and Loan Association*[11] seller sued for a declaratory judgment respecting the priority of his purchase money deed of trust vis-à-vis the lender's construction loan deeds of trust. As the lender had already foreclosed, seller prayed for an accounting of the proceeds of the trustee's sale. Seller obtained judgment against the lender in the full amount of the debt underlying seller's deed of trust. The reasoning of *Collins* is nowhere made clear, but seller's deed of trust was nevertheless accorded priority. This declaration of priority is the basis of a judgment which may not properly be called damages. The court makes the point that the subdivision had been completed and the houses sold prior to the time of suit. Rather than permitting these subsequent transactions to be disturbed by the seller, the court appears to have substituted a lien on the proceeds of the lender's trustee's sale for a lien on the land.

The declaration of priority is based on the reasoning that the subordination agreement was expressly conditional. The *Collins* facts show three separate conditional elements; unfortunately for the purpose of analysis an identification of the controlling condition was not necessary to the decision. In a different factual context the operative effect of each of these conditions might be significant. The conditions of the subordination clause were summarized by the court as follows:

> 1. Condon Co. was to borrow not to exceed 80 per cent of the value of the lots as shown by the Certificate of Reasonable Value issued by the Veterans Administration "in connection with a construction loan obtained for the purpose of constructing on each lot a dwelling house with usual appurtenances";
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> 2. The interest on such loan was not to exceed 7 per cent per annum;
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> 3. Sellers' (respondents') deed of trust was subordinated to the lien of the construction loan obtained for the purpose above specified;
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> 4. The full face amount of the construction loan should be conclusively deemed to have been used for construction purposes;
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> 5. Sellers (respondents) would reconvey each lot (162 in all) so as to release it from the lien of their trust deed upon payment to them of $2,000 per lot, each such $2,000 to be applied toward payment of the obligation secured by the trust deed.[12]

The agreement was later modified by adding the language "and lot improvements thereto"[13] to item one. In addition the seller's deed of

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[11] 205 Cal. App. 2d 86, 22 Cal. Rptr. 817 (1962).

[12] *Id.* at 89-90, 22 Cal. Rptr. at 819. The effect, if any, of item 4 was not mentioned in the opinion and is beyond the scope of this discussion.

[13] *Id.* at 90, 22 Cal. Rptr. at 819.

trust provided that the lender should take back individual deeds of trust on each lot.[14] In fact the lender took back three blanket deeds of trust on three portions of the subdivision. An attempted second subordination agreement authorizing the three blanket deeds of trust was held invalid for lack of consideration. The emphasis on this point in the case indicates a vital assumption by counsel that prior to the execution of the second agreement no subordination had been achieved. The court's failure to rule directly on this point may indeed be due to this view of the case taken by counsel. In theory the assumption is correct. If it was in fact expressly made a condition that the construction loan was to be secured by individual deeds of trust on each of the lots, then the loan never conformed to the terms of the subordination agreement and the lender never did achieve priority. The conclusive effect of this line of reasoning is somewhat dimmed by the argument that this provision of the agreement was not material to the protection of seller's rights. Certainly it would hamper the partial reconveyances called for in the subordination agreement, but this is after all the buyer's problem.

The second conditional element in *Collins* is the interest provision. The maximum rate of interest was not to exceed seven per cent. Lender charged six per cent plus 13 1/2 "points," or percentage loan fee, for placing the loan. Testimony heard at the trial indicated that the loan fee was excessive, perhaps unconscionable, and that the lender had at least sufficient knowledge of facts which would put one on notice that the borrower did not have sufficient capability to carry out a project of this size.[15]

A determination of whether "points" charged for a construction loan are interest has not been made in this context by the California cases and was not made in *Collins*. Cases[16] interpreting the California usury law applicable to private lenders, however, have treated loan fees as interest. If points are considered interest, then the total cost of the loan including both interest and loan fees cannot exceed the maximum specified if the lender is to achieve priority.[17] It is arguable, of course, that the contracting parties did not intend that points should be included in interest. If they did so intend, the seven per cent rate is unreasonable.[18] But it is also possible to take the view that loan fees were not contemplated by

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[14] *Id.* at 92, 22 Cal. Rptr. at 820.

[15] *Id.* at 99, 22 Cal. Rptr. at 821. Plaintiff's cause of action against the lender for fraud was, however, decided in favor of the lender.

[16] *E.g.*, Williams v. Reed, 48 Cal. 2d 57, 307 P.2d 353 (1957) and cases cited therein.

[17] As to maximum amount of loan principal, see *e.g.*, Nat'l Title Ins. Co. v. Mercury Builders, 124 So. 2d 132 (Fla. Dist. Ct. App. 1960).

[18] But what of the more usual 9% figure?

the agreement at all,[19] but were to be paid out of pocket by the borrower to be later set off against his profit. In practice, however, this does not happen. The lender normally subtracts the loan fee, or part of it, from the first loan payment.

This suggests another point of view regarding "points" which may indeed have been the view adopted in *Collins*. If loan fees were not contemplated by the agreement, but were to be paid by the borrower, the payment of loan fees out of the construction loan funds constitutes a misapplication of funds in contravention of restrictions on their use, to be considered along with other possible misapplications such as lot advances, payment of subcontractors and materialmen for previous projects and excessive builder's profits.

The misapplication of funds in *Collins* is detailed by the court in its opinion:

1. $86,940 for loan fee or "points"
2. $75,000 lot advance, plus interest and fee, or $76,420
3. $158,607.36 paid to the parent company of the borrower as a fee for supervising construction.[20]

The court then says that as to the above items the construction loan was not prior. This determination must be based on a finding that the conditional language in the subordination agreement is expressly, or is interpreted as, *pro tanto* conditional. In other words, the seller has agreed to subordinate his purchase-money deed of trust to a construction loan *only to the extent that* the loan funds are applied to the purpose stated in the agreement.

Such a holding is quite reasonable if the language of the agreement itself will support such an interpretation. Alternatively, what would be the effect of language creating an absolute condition avoiding the subordination entirely rather than *pro tanto*? The point was not discussed by the court; fortunately for the seller, the total amount of funds misapplied exceeded the amount of his deed of trust. Decisions in other jurisdictions,[21] however, and dictum in one California case[22] indicate that where misapplication of funds is the

19 "Points" are not part of the principal and probably are not part of the interest. That "points" are not contemplated at all absent a specific provision therefore, see Lehnert v. Notlim Realty Corp., 251 N.Y. 340, 167 N.E. 463 (1929); Claypool v. German Fire Ins. Co., 32 Ind. App. 540, 70 N.E. 281 (1904).

20 205 Cal. App. 2d 86, 91 & nn.2 & 3, 92, 22 Cal. Rptr. 817, 820 & nn.2 & 3 (1962).

21 Lehnert v. Notlim Realty Corp., 251 N.Y. 340, 167 N.E. 463 (1929); Albert & Kernahan v. Franklin Arms, 104 N.J. Eq. 446, 146 A. 213 (1929); Claypool v. German Fire Ins. Co., 32 Ind. App. 540, 70 N.E. 281 (1904); Joralman v. McPhee, 31 Colo. 26, 71 Pac. 419 (1903). *Contra*, Iowa Loan & Trust Co. v. Plewe, 202 Ia. 79, 209 N.W. 399 (1926).

22 W. P. Fuller Co. v. McClure, 48 Cal. App. 185, 191 Pac. 1027 (1920).

operative fact, subordination will be avoided only to the extent of such misapplication.[23]

Although in a future case this might not afford complete satisfaction to the seller, the rule is probably consistent with the expectations of the parties. Seller is agreeing to take some risk, even if the full amount of the construction loan is applied to the proper purpose.

It is to be noted that none of the arguments for failure of subordination depend for their effect on the contractual privity of the lender. The lender is best described as a third party beneficiary of the subordination agreement between buyer and seller. He may fail to gain priority, or having gained it may lose it, if the buyer fails to perform a condition upon which the subordination depends. Furthermore, lender's knowledge of the buyer's misapplication or intended misapplication of funds is immaterial in the absence of fraud. By the same reasoning lender's lack of knowledge of the terms of the subordination agreement is a matter of lender's risk and can have no effect on priorities, assuming the seller has complied with the recording act. The latter point is illustrated by way of dictum in *Spaziani v. Millar.*[24]

To what extent need a subordination agreement be expressly conditional in order to be relied upon to re-establish seller's priority? In *Spaziani*, plaintiff attempted to apply the *Collins* reasoning to a case predicated on a theory of negligence. The court clearly held that no cause of action in negligence could be sustained against the lender who owed no duty of care arising from common law, contract or statute toward the seller. The case is unfortunate in many respects. Although it would appear from the evidence that plaintiff intended to create a conditional subordination agreement, her escrow instructions and deposit receipt, the only memoranda of the land sale contract, fail to support this interpretation.[25] Instead, they give the lender priority ab initio and not by a waiver by seller of a priority already obtained (both seller's and lender's liens were for purchase money).

Plaintiff sold two lots with existing houses on the front portion

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23 See cases cited note 21 *supra*. The Iowa decision was based on the reasoning that the loan company had no duty to supervise expenditure of funds by the borrower. Although the non-existence of a duty to supervise may be a correct proposition of law, it is submitted that this has no application to a suit to determine priorities, provided a valid condition to the original waiver had been created. The language is not quoted but the trial court interpreted the waiver as conditioned upon use.

24 215 Cal. App. 2d 667, 680, 30 Cal. Rptr. 658, 665 (1963).

25 *But see*, Comment, *Subordination of Purchase-Money Security*, 52 CALIF. L. REV. 157, 160 (1964).

of each lot. It was understood between buyer and seller that buyer intended to improve the rear portion of each lot and would obtain a construction loan for that purpose. The deposit receipt and escrow instruction which plaintiff signed showed that the rear portion of each lot was to remain free and clear. They also showed that plaintiff agreed to take a second deed of trust on the front portion of each lot, leaving the buyer free to place a first deed of trust on this part of the property. Plaintiff urged that the agreement between herself and the buyer and the escrow instructions (which were ambiguous)[26] showed that she had agreed to take a first deed of trust upon the entire property and to subordinate that to a construction loan, whether upon the front or rear portions or both is not clear. Whatever may have been the inducement for the sale, the court found that no fraud had been perpetrated on her and that she had agreed to take a second deed of trust without stipulating express conditions regarding the first deed of trust to which she would subordinate. She had, in effect, agreed not to be prior at all and it became therefore immaterial to decide whether she ever had been. Her theory that the lender owed her a duty to inform her of its intentions or alternatively to refrain from encumbering the property without her knowledge and consent was therefore without a foundation and the court's statement *obiter* that it would be immaterial whether lender was a bona fide encumbrancer is therefore correct.

In the recent California case of *Kiles v. Dobrow*[27] in the Superior Court of Santa Clara County, the subordination agreement upon which plaintiff relied to re-establish her priority was considerably broader than the *Collins* agreement. In this case plaintiff agreed to subordinate to a "construction loan," stipulating the maximum amount and rate of interest. Upon default of the borrower on the construction loan, and notice by the lender of its intention to foreclose, plaintiff sought a declaration of priority for her deed of

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26 The relevant language in the escrow instructions is as follows:

First Deed of Trust to File: Construction loan to come.

Second Deed of Trust to File: Executed by Buyer to secure Note in amount of $20,000.00 with interest thereon at the rate of 6% per annum payable monthly in favor of Mary Spaziani, a widow, Diana Spaziani, a single woman, and Linda Gloria Spaziani, a single woman, mother and daughters all as joint tenants, principal and interest payable in installments of $120.00 or more on the ___ day of each month, beginning 30 days from close of escrow. Interest credited to close of escrow.

Deeds of Trust are to cover the following described property: The South 150 feet of the North ½ of the West ½ of the East ½ of Lot 705 . . . .

Balance of property to remain clear.

Spaziani v. Millar, 215 Cal. App. 2d 667, 674, 30 Cal. Rptr. 658, 661 (1963). Although the point is outside the scope of this comment it should be here noted that a nonsuit as to the title company was reversed on a theory of negligence in failure to ascertain with certainty and/or to follow seller's instructions.

27 Civil No. 128182, Super. Ct., Santa Clara County, Calif., Dec. 31, 1965.

trust to the extent that "points" had been taken out of the construction loan. The court held that plaintiff had agreed to subordinate only to a "construction loan" and that "points" were not part of a construction loan within the ordinary meaning of that term. The decision seems at first blush to be consistent with the reasoning in *Collins*, but two contrary arguments immediately suggest themselves. In *Collins*, express restrictions were placed upon the use of the construction loan funds. The general term "construction loan" was not relied upon as sufficient to create a condition. In light of the usual principle in the law of contracts that language used to create a condition must be clear and unambiguous and the equitable concept that equity abhors a forfeiture, the language in *Kiles* seems too loose to be construed as an express condition. True, the phrase "construction loan" may be ambiguous, and considerable evidence was received in the *Kiles* case as to the meaning of the term as understood between the parties. But should not the resolution of the ambiguity go to the question whether payment of a loan fee, or "points," constitutes a misapplication of funds in contravention of an agreement expressly conditional, rather than to whether the agreement was in fact conditional?

Another objection to the *Kiles* decision may be found in the reasoning of some of the older cases from other jurisdictions. Following the principle that conditions must be expressly stated, numerous courts have held that conditions will be enforced only to the extent of the language used.[28] Where a purchase-money mortgage is subordinated to a construction loan mortgage, it has been held that the alteration in priorities is effective to the full amount advanced under the construction loan mortgage, whether entirely or only partially used for construction.[29] The rationale, of course, is that the language used subordinates the lien of the purchase-money mortgage to the lien of another particular mortgage, whether the maximum amount of the subsequent mortgage is stipulated or not.[30] This does not, however, empower the mortgagor to subordinate the prior lien to more than one subsequent mortgage,[31] nor apparently to a mortgage securing a loan no part of which is used for the purpose intended.[32] The latter decision may be supported on the reason-

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[28] Albert & Kernahan v. Franklin Arms, 104 N.J. Eq. 446, 146 A. 213 (1929); McConnell v. Mortgage Investment of El Paso, 157 Tex. 572, 305 S.W.2d 280 (1957); Claypool v. German Fire Ins. Co., 32 Ind. App. 540, 70 N.E. 281 (1904).

[29] Iowa Loan & Trust Co. v. Plewe, 202 Ia. 79, 209 N.W. 399 (1926); Katchen v. Bregman, 5 N.J. Misc. 1084, 141 A. 586 (1927).

[30] Albert & Kernahan v. Franklin Arms, 104 N.J. Eq. 446, 146 A. 213 (1929).

[31] McConnell v. Mortgage Investment of El Paso, 157 Tex. 572, 305 S.W.2d 280 (1957).

[32] York Mortgage Corp. v. Clotar Constr. Corp., 254 N.Y. 128, 172 N.E. 265 (1930). See Prentice v. No. American Title Guaranty Corp., 59 Cal. 2d 618, 381 P.2d 645, 30 Cal. Rptr. 821 (1963).

ing that the loan and mortgage are not those described in the subordination agreement, the same reasoning that applies when the construction loan is greater than the maximum amount specified in the subordination agreement. Even if the language in *Kiles*, therefore, may be construed to be conditional, does it describe a particular loan lien, or does it place restrictions on use?

The matter is further complicated by cases, some which hold that construction loan funds need not be traced to actual construction uses, holding that "points" are not part of a construction loan and do not constitute funds "advanced under the mortgage."[33]

The recent case of *Radunich v. Basso*[34] resulted in a declaration of priority of plaintiff's purchase-money deed of trust over a deed of trust securing a loan for the purpose of making the down payment to plaintiff. The decision of the trial court rested on a finding of fraud. Buyer and his agents and associates represented to seller that the lien of his deed of trust would not and could not be subordinated to the lien of any loan except one made for the purpose of land improvement or construction. Without informing seller (who never saw or signed the escrow instructions) they proceeded to obtain a loan to make the down payment and effected recordation of the lender's deed of trust as a lien prior to seller's. Rather than award damages for fraud (which would have been speculative) the court declared seller's lien to be prior, certainly a more equitable result.

The contract of sale, however, contained a subordination provision to the effect that seller's deed of trust was to be "*subordinate to land and improvement loan or loans*."[35] The trial court received evidence as to the meaning of this language. The District Court of Appeal held that the weight of this evidence, coupled with the findings of fraud and the judgment of the trial court, constituted an implied finding that the subordination clause applied only to loans for land improvement and construction. Whether this finding leads to the conclusion of law that the subordination language was expressly conditional is not made absolutely clear, but the language itself would seem to support such an interpretation. In view of the finding of fraud, the decision can be supported on two bases: Either plaintiff's lien (a) was subordinated to a lien to which he did not *agree* to subordinate (a case for declaration of priorities), or (b) was subordinated to a lien to which he did not *expect* to subordinate because the transaction had been misrepresented to him (a case of

33 Persky v. Puglisi, 101 Conn. 658, 127 A. 351 (1925).
34 235 Cal. App. 2d 826, 45 Cal. Rptr. 824 (1965).
35 *Id.* at 833, 45 Cal. Rptr. at 829. [Emphasis in original.]

fraud). It is submitted that the decision should be the same on either basis.

Note that in *Radunich* the lender was not and could not be a bona fide encumbrancer. The loan was arranged prior to the actual sale and during the time that seller was still the record owner of the property. Furthermore the lender had knowledge that the loan funds were to be used to make the down payment on the property. The court held that this was sufficient to constitute notice to the lender of facts which might affect his priority.

In order to complete the picture brief treatment must be accorded to a recent California case, which, while not in point of this discussion, serves to shed additional light on the problem of seller's remedies. In *Gill v. Mission Savings and Loan Association*[36] plaintiff seller proceeded on a theory of negligence. He sought to impose upon the lender the duty to supervise expenditure of loan funds to assure completion of construction in accordance with the plans and specifications. In affirming the judgment sustaining a demurrer to the complaint, the court held that in the absence of privity between seller and lender no duty arose. Although the result may be correct, it is submitted that absence of privity is not the answer. The complaint did not allege that the duty was contractually imposed or voluntarily assumed, nor that the seller relied on any promise by the lender. The gravamen of the complaint rests squarely on foreseeability; therefore the decision must be supported, if at all, on grounds of public policy. In view of the court's express statement that seller could have protected himself by the terms of his agreement, it is unlikely that the rule represented by *Gill* will be soon changed.

A few points bear remarking in connection with all of these cases. The necessity for careful draftsmanship is all too apparent. Express words of condition have been given effect by the courts and there is no reason to suppose that they will not continue to be given effect. Hence specificity of terms is all important. The courts have gone as far as they probably will go in upholding a condition where such was clearly the intent of the parties and can be supported by the language used. Once language is construed to be conditional, however, the court is faced with the added problem of interpreting the meaning of the condition. What are its limitations? Is it conditional absolutely, or *pro tanto*? Does it describe merely the incidents of a particular loan or does it place restrictions on use of loan funds? One of the more troublesome problems likely to continue for some time is the absence of any mention of "points" in many of these

[36] 236 Cal. App. 2d 753, 46 Cal. Rptr. 456 (1965).

agreements. Several approaches to this have been suggested which may serve until such time as the courts have an opportunity to decide a clear case.[37]

The use of a three-way (or more) subordination agreement which is signed by the lender is of doubtful value except as a protection from a bona fide encumbrancer argument. In light of the court's decision in *Gill* it is unlikely that any duty to supervise expenditure of construction loan funds can be imposed on the lender without separate consideration. A properly drafted subordination agreement more effectively assures supervision by the lender.

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[37] Several drafting suggestions and sample forms are set out in the following: CALIFORNIA CONTINUING EDUCATION OF THE BAR, CALIFORNIA LAND SECURITY AND DEVELOPMENT, 123-40 (1960); Fry, *Subordination Provisions in Land Purchase Agreements*, 37 CALIF. S. BAR. J. 381 (1962).