

Date of Meeting: May 16-17, 1958

Date of Memo: May 8, 1958

Memorandum No. 3

Subject: Study #24 - Mortgages for Future Advances

At the April meeting we gave this matter some consideration but deferred final action until a later point in the meeting, and then neglected to go back to it.

In the course of the discussion certain changes in proposed new Section 2975 of the Civil Code were discussed. I have since discussed the matter with Professor Merryman to get his views on the questions involved:

I enclose three items:

- (1) A copy of a proposed recommendation of the Commission relating to Mortgages to Secure Future Advances. This was sent to you prior to the April meeting. The Commission has not yet officially adopted the proposed recommendation.
- (2) A revision of proposed new Section 2975 drafted by Professor Merryman in the light of our discussion of the problem. This shows changes from the draft which was before the Commission at the April meeting in strike-out and underline. Professor Merryman is still of the view that the last paragraph should not be included for the several reasons advanced in the memorandum which I sent you prior to the April meeting.
- (3) A somewhat different draft of a proposed new Section 2975 which I

have prepared. I am sending this along to indicate a somewhat different approach to the drafting problem which might be taken, but I prefer Professor Merryman's draft.

Respectfully submitted,

John R. McDonough, Jr.
Executive Secretary

JRM:lmh
Enclosures

April 10, 1958

RECOMMENDATION OF THE CALIFORNIA LAW REVISION COMMISSION

Relating to Mortgages to Secure Future Advances

In a mortgage for future advances a present lien is created on the property used as security, but the parties agree that all or part of the loan secured is to be made in the future. The major legal problem arising under such mortgages is that of priority as between the mortgagee and one who acquires a lien on the property after the mortgage became effective but prior to one or more of the subsequent advances under it. Under the rules applied by a majority of American jurisdictions priority between subsequent advances and intervening liens is made to turn on a distinction taken between obligatory and optional advances. If the mortgagee is legally bound by the agreement between the parties to make subsequent advances, they are called obligatory and are entitled to priority even though the mortgagee had actual notice of the intervening lien when the advance was made. If the mortgagee is not under a legal obligation to make future advances they are called optional and are inferior in priority to intervening liens of which the mortgagee had actual notice when the advance was made. Record notice, however, is not enough.

Except for a statute enacted in 1957 which in some situations gives optional advances under a construction mortgage priority over an intervening mechanic's lien of

which the mortgages had actual notice, the California law on real property mortgages for future advances is decisional rather than statutory. The California courts have applied the general rules outlined above to such mortgages. After a careful study the Law Revision Commission's research consultant concluded that no change in our law respecting real property mortgages for future advances is necessary or desirable. His conclusion was subsequently concurred in by several attorneys of long experience in this field whose views were solicited by the research consultant at the request of the Commission. On the basis of its study of the matter the Commission has concluded that no change should be made in the law of this State respecting real property mortgages for future advances and respectfully so recommends to the Legislature.

Prior to 1935 the California law respecting personal property mortgages for future advances was also decisional rather than statutory. In that year the Legislature enacted Sections 2974 and 2975 of the Civil Code, both of which give the same priority to optional as to obligatory advances under mortgages of personal property for future advances, provided certain conditions are met. The condition specified in Section 2974 is that the mortgage state that it is for the purpose of financing the mortgagor during one or more production periods; that specified in Section 2975 is that the maximum amount to be secured be stated in the mortgage.

As the report of the Commission's research consultant shows, the origin of Sections 2974 and 2975 is obscure, their meaning is in many respects unclear, and they appear to overlap to a considerable degree. The major question left unanswered by these sections is what consequence follows when a personal property mortgage does not comply with the conditions specified in them. The research consultant concluded that the result is not that the mortgage is void but only that optional advances thereunder are not entitled to priority over intervening liens of which the mortgagee has actual notice at the time of the advance. This conclusion was concurred in by the experienced attorneys with whom the consultant discussed the question. However, the matter is one of such importance that it ought not to be left open until a case requires its authoritative decision.

The research consultant concluded that Sections 2974 and 2975 should be consolidated into a single new section which would retain the best features of each section while eliminating the existing ambiguities in them and which would have the substantive legal effect of giving optional advances the same priority as obligatory advances if the maximum amount to be secured is stated in the mortgage. The Commission concurs in this conclusion and has drafted a statute for this purpose (see proposed statute, *infra*). The new Section 2975 of the Civil Code which this statute would enact would, in the main, codify rather than change existing law with

respect to mortgages of personal property to secure future advances. Its salient features are the following:

1. If optional advances are to have the same priority as obligatory advances, the maximum amount to be secured must be stated. This continues in effect a provision presently found in Section 2975 of the Civil Code and serves to give subsequent lienors some notice of the potential maximum amount of the mortgagee's prior lien on the property. It should be noted, however, that the proposed statute limits the mortgagee's priority to the amount stated only with respect to advances and not with respect to accrued interest and expenditures made by the mortgagee to preserve the value of the security. Thus, the total amount entitled to priority over intervening liens including advances, accrued interest and expenditures to preserve the security, may exceed the amount stated in the mortgage.

2. The stated maximum amount refers only to advances outstanding at any given time; amounts previously advanced and repaid are not included. This provision is taken from present Section 2975. It permits flexibility in credit arrangements on an "open account" basis, under which sums are regularly advanced and repaid, but does not create any special hardship to the subsequent lienor who is on record notice when he acts that the mortgagee's lien for advances may be equal to the maximum amount stated.

3. Repayment in full of a mortgage of personal property for future advances does not discharge it. This provision is taken from Section 2974 which in turn merely codifies an earlier decisional rule. The justification for this provision is the same as that for disregarding amounts previously advanced and repaid. Of course, if a mortgagor who has repaid a mortgage for future advances in full desires to have it discharged he is entitled under Section 2941 of the Civil Code to have the mortgagee deliver a certificate of discharge or enter a satisfaction of record; a cross-reference to Section 2941 is included in proposed new Section 2975 to remove any doubt on this point.

4. The provisions that expenditures made by the mortgagee to preserve the security are entitled to the priority originally established by the mortgage and that accrued interest on an advance has the same priority as that of the advance itself are believed merely to codify existing law and are included to avoid any ambiguity on these matters which might otherwise be thought to exist. These provisions are, of course, applicable to all mortgages for future advances, whether or not the maximum amount to be secured is stated in the mortgage.

The Commission's recommendation would be effectuated by enactment of the following measure:

An Act to repeal Section 2974 and 2975 and to enact Section 2975 of the Civil Code, all relating to mortgages of personal property or crops to secure future advances.

The people of the State of California do enact as follows:

SECTION 1. Sections 2974 and 2975 of the Civil Code are repealed.

SEC. 2. Section 2975 of the Civil Code is enacted to read:

2975. Mortgages of personal property or crops may be given to secure future advances. If the maximum amount to be secured is stated in the mortgage, the lien for all advances to that amount, whether optional or obligatory, has the same priority as that originally established by the mortgage. If the maximum amount to be secured is not stated, the lien for all optional advances made after actual notice of intervening liens is inferior to them in priority.

The stated maximum amount means the maximum amount of advances secured at any one time, and does not include amounts already repaid or discharged, accrued interest, or necessary expenditures made by the mortgagee to preserve the security.

Repayment in full of amounts owing under the mortgage does not extinguish the mortgage. All such mortgages shall be discharged on demand of the mortgagor in conformity with the provisions of Section 2941 of this code.

Necessary expenditures made by the mortgagee to preserve the security constitute liens having the same priority as that originally established by the mortgage. Accrued interest on an advance has the same priority as the advance.

As used in this section future advances includes sums that may be advanced, expenditures that may be made other than expenditures by the mortgagee to preserve the security, and indebtedness or obligations that may be incurred subsequent to the execution of the mortgage.

MERRYMAN DRAFT

2975. Mortgages of personal property or crops may be given to secure future advances. If the maximum amount to be secured is stated in the mortgage, the lien for all advances to that amount, whether optional or obligatory, has the same priority as that originally established by the mortgage. If the maximum amount to be secured is not stated, the lien for all optional advances made after actual notice of intervening liens is inferior to them in priority. In all cases, necessary expenditures made by the mortgagee to preserve the security constitute liens having the same priority as that originally established by the mortgage. Accrued interest on an advance has the same priority as the advance.

The stated maximum amount means the maximum amount of advances secured at any one time, and does not include amounts already repaid or discharged, accrued interest, or necessary expenditures made by the mortgagee to preserve the security.

Repayment in full of amounts owing under the mortgage does not extinguish the mortgage. All such mortgages shall be discharged on demand of the mortgagor in conformity with the provisions of Section 2941 of this code.

~~Necessary-expenditures-made-by-the-mortgagee-to-preserve-the-security-constitute-liens-having-the-same-priority-as-that-originally-established-by-the-mortgage.--Accrued-interest-on-an-advance-has-the-same-priority-as-the-advance.~~

As used in this section future advances includes sums that may be advanced, expenditures that may be made ~~other-than-expenditures-by-the-mortgagee-to-preserve-the-security~~, and indebtedness or obligations that may be incurred subsequent to the execution of the mortgage.

McDONOUGH DRAFT

2975. Mortgages of personal property or crops or both may be given to secure future advances.

The lien for the following advances and expenditures made by the mortgagee under a mortgage for future advances has the same priority as that originally established by the mortgage:

1. All advances and expenditures made to preserve the security.
2. If the maximum amount to be secured is stated in the mortgage, all advances to that amount secured at any one time (that is, excluding amounts already repaid or discharged), whether optional or obligatory.
3. If the maximum amount to be secured is not stated in the mortgage, all obligatory advances and all optional advances made without actual notice of intervening liens.

Accrued interest has the same priority as the advance or expenditure to which it relates.

Repayment in full of amounts owing under a mortgage for future advances does not extinguish the mortgage. All such mortgages shall be discharged on demand of the mortgagor in conformity with the provisions of Section 2941 of this code.

As used in this section future advances includes sums that may be advanced, expenditures that may be made and indebtedness or obligations that may be incurred subsequent to the execution of the mortgage.