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Kentucky Law Survey: Mechanics' Liens

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MECHANICS' LIENS

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I. REVIEW OF KENTUCKY'S STATUTORY SCHEME

Persons who perform labor or who furnish materials for the improvement of real property in Kentucky have a right to a statutory mechanic's lien upon that property to secure payment for services and materials provided.[1] Statutes permitting the creation of mechanics' liens are designed to prevent unjust enrichment of the property owner at the worker's expense.[2] No right to a mechanics' lien arises, however, unless the improvements to an owner's[3] property are made pursuant to a contract with the owner or with the owner's written consent.[4] An owner who has agreed to the improvements may have no control over the selection of the persons who provide the labor and materials. Nonetheless, all of the laborers and materialmen[5] who contribute to the improvement acquire a right to assert a lien against the owner's property in the event they are not paid.[6] The total dollar amount of the mechanics' liens which may attach to improved property is limited by statute

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[1] KY. REV. STAT. §§ 376.010-.260 (Supp. 1978) [hereinafter cited as KRS].

[2] Comment, *Mechanics' Liens—Potential Pitfall for the Homeowner,* 62 KY. L.J. 278 (1973).

[3] The term "owner" as used in this article will ordinarily refer to the owner of record of real property. It should be noted that the Kentucky statutes also provide that when a person performs labor or furnishes materials for the improvement of a mineral leasehold, a mechanic's lien may be asserted against the lessee of the mineral leasehold. KRS § 376.140 (1971).

[4] KRS § 376.010(1) (Supp. 1978).

[5] A "materialman" has been defined as "a person who has furnished material used in the construction or repair of a building, structure, or vessel." BLACK'S LAW DICTIONARY 1128 (rev. 4th ed. 1968). A person's status as a materialman is determined as of the time the material is furnished and under the terms of the contract in effect at that time. Woodson Bend, Inc. v. Masters' Supply, Inc., 571 S.W.2d 95, 101 (Ky. Ct. App. 1978). Both laborers and materialmen are within the class of persons eligible to assert mechanics' liens. *See* KRS § 376.010(1) (Supp. 1978). The term materialman is used in this article in a broader sense to refer to all persons who may claim mechanics' liens.

[6] Comment, *supra* note 2, at 279.

to the amount of the original contract price.[7] The effect of a assertion of a mechanic's lien may be to impose liability on property owner for an amount equal to twice the original con tract price where, for example, an owner has made contrac payments in full only to learn that his contractor has not pai for the labor and materials furnished by subcontractors.[8]

In Kentucky, a mechanic's lien, if properly asserted, at taches to property at "the time of the commencement of th labor or the furnishing of the materials."[9] Attachment absen compliance with statutory notice provisions is insufficient t perfect a lien or to establish priority over other interests i realty. The statutory notices of which a claimant should b cognizant are: (1) preliminary notice; (2) notice to the owner and (3) final notice.

The preliminary notice[10] is a subscribed and sworn state ment filed by the claimant in the office of the clerk of th county in which the building or improvement is located.[11] Th notice must provide the following information: that the claim ant has furnished or expects to furnish labor or materials; th full amount of the claim that may be asserted;[12] a descriptio of the property intended to be subject to the lien; the name o

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[7] The lien shall not be for a greater amount in the aggregate than the contract price of the original contractor, and should the aggregate amount of the liens exceed the price agreed upon between the original contractor and the owner there shall be a pro rata distribution of the original contract price among the lienholders.

KRS § 376.010(1) (Supp. 1978).

[8] Comment, *supra* note 2, at 279. The Kentucky property owner's maximum lia bility under a construction contract is greater than that of an owner operating unde the "New York system" of mechanics' liens, but less than that of the owner operatin under the "Pennsylvania system." Under the New York scheme, the lien is limited t the amount due under the original contract. *Id.* Thus, if the owner has paid the gen eral contractor the full price, the materialmen had no right to a lien. *Id.* at 280 n.20 The Pennsylvania system, on the other hand, allows the lien to attach to the ful extent of the fair value of the materialman's contribution, regardless of the status o the account between the owner and the contractor. The owner's potential liabilit under the Pennsylvania system is, therefore, unlimited. *Id.* at 279.

[9] KRS § 376.010(1) (Supp. 1978); *see also* Weil v. B.E. Buffaloe & Co., 65 S.W.2d 704, 711 (Ky. 1933).

[10] The preliminary notice must meet the requirements set forth in KRS § 376.080(1). KRS § 376.010(2) (Supp. 1978).

[11] KRS § 376.080(1) (Supp. 1978).

[12] KRS § 376.010(2) (Supp. 1978).

the owner of the property; and whether the materials were furnished or the labor was performed under contract with the owner, contractor, or subcontractor.[13] The preliminary notice does not create a lien, but merely protects the materialman against claims of priority asserted by a mortgagee or other person having an interest in the realty.[14]

If a preliminary notice is filed and recorded by a materialman prior to the recordation of a mortgage for value, then the lien asserted by the materialman takes precedence over the interest of the mortgagee.[15] Absent a filing of the preliminary notice, however, the mortgage will generally be superior to the mechanic's lien, unless the mortgagee had actual notice of the materialman's claim prior to recording of the mortgage.[16] This rule, granting priority to real estate mortgages in most cases in which a preliminary notice was not filed, is unique; the materialman who does not file the preliminary notice is nevertheless accorded priority over all other encumbrances created after the attachment of the mechanic's lien.[17] Consequently, filing a preliminary notice is not a prerequisite to perfection of the lien.[18]

Only persons not contracting directly with the property owner or his agent must comply with the statutory provisions requiring the materialman to send written notice of his claim to the owner of the property.[19] On claims amounting to less than $1,000, notice must be given to the owner within seventy-five days after the last item of material or labor is furnished. On claims of more than $1,000, notice must be given within 120 days after furnishing the last item.[20] If, however, the materialman intends to assert a lien against "an owner-occupied single or double family dwelling or the appurte-

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[13] KRS § 376.080(1) (Supp. 1978).

[14] Grigsbey v. Lexington & E. Ry. Co., 150 S.W. 687, 688-89 (Ky. 1912).

[15] KRS § 376.010(2) (Supp. 1978).

[16] *Id. See also* notes 66-86 *infra* and accompanying text for a discussion of actual notice.

[17] *See* Staton Springs Park Co. v. Keesee, 289 S.W. 292, 294 (Ky. 1926).

[18] Grigsbey v. Lexington & E. Ry. Co., 150 S.W. 687, 688-89 (Ky. 1912).

[19] KRS § 376.010(3), (4) (Supp. 1978); *see also* Siler v. Corbin Bldg. & Supply Co., 176 S.W.2d 250, 251 (Ky. 1943).

[20] KRS § 376.010(3) (Supp. 1978).

nances or additions thereto," notice must be mailed to the owner-occupant of the property or his authorized agent not more than ten days after the *first* item of material or labor is furnished.[21]

All notices to the property owner must contain a statement of the materialman's intention to hold the property liable for his claim and must state the amount of the lien claim.[22] The purpose of this intermediate notice is to protect the owner against "hidden liens."[23] But for this notice requirement, the owner's property would be subject to all materialmen's liens for a period of six months after labor or materials were furnished.[24] Receipt of this intermediate notice enables the property owner to make arrangements with his general contractor to pay the lien claimants the amount due them before final payment on the contract is tendered to the general contractor.[25]

To protect and preserve a lien claim until the action is barred by the appropriate statute of limitations, a claimant must comply with the statutory provisions requiring final notice regardless of that claimant's contractual relationship with the property owner.[26] Within six months[27] from the date that

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[21] KRS § 376.010(4) (Supp. 1978). See notes 43-86 *infra* and accompanying text for a discussion of notice requirements to an owner-occupant.

[22] KRS §§ 376.010(3), (4) (Supp. 1978).

[23] *See* Comment, *supra* note 2, at 282 n.33. "Hidden liens" are liens asserted by those claimants not in privity with the owner. *Id.*

[24] A lien claim must be filed with the county clerk within six months after the materialman has performed labor or furnished materials. The right to a lien is dissolved if this statement is not filed in a timely manner. KRS § 376.080(1) (Supp. 1978). The six-month period may not be extended by furnishing labor or materials that are frivolous and unnecessary for completion of the contract. Vogt v. Cannon Elec. Co., 54 S.W.2d 338, 340 (Ky. 1932). The time limit may be extended, however, if the owner requests additional work. Walker v. Valley Plumbing, Inc., 370 S.W.2d 136, 139 (Ky. 1963).

[25] *See* Comment, *supra* note 2, at 282-83.

[26] Fugate v. Taulbee Lumber & Coal Co., 172 S.W.2d 61, 61-62 (Ky. 1943); Scheas v. Boston & Paris, 101 S.W. 942, 943 (Ky. 1907). The limitations period for enforcing a mechanic's lien is 12 months from the date that final notice is filed in the county clerk's office. KRS § 376.090(1) (1971). If the owner of the property against which the lien is asserted dies prior to the expiration of the 12 month period, the limitations period is extended for an additional six months from the date on which the owner's personal representative is qualified. *Id.* The limitations period for enforcing a mechanic's lien against public property is 30 days after the contractor files his

labor or material was last furnished, the lien claimant must file a subscribed and sworn[28] statement in the office of the clerk of the court in the county in which the building or improvement is situated.[29] The notice must contain the following:[30] the amount due the claimant, taking into account all known credits and setoffs;[31] a description of the property against which the lien is asserted;[32] the name of the owner of the property;[33] and whether the labor or materials were furnished under contract with the owner, contractor, or subcontractor. A statement may be amended to cure a material defect in the original statement, provided that such amendment also is filed within the six-month period.[34]

The claimant's petition to enforce a lien should be carefully drafted. All of the statutory prerequisites to assertion of a mechanic's lien must be alleged and the property charged must be described.[35] All lienholders or other persons having an interest in the property, and the property owner or his personal representative, heirs, or devisees, are necessary and proper parties to the action.[36] Ten days after the petition has

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protest with the public authority. KRS § 376.250 (1971).

[27] *See* note 24 *supra* for a discussion of the time limits within which a claim must be filed. Note, however, that a claimant who performs labor or furnishes materials for a public improvement in Kentucky must file the final notice with the county clerk within 10 days after the last day of the month in which the labor or materials were furnished. KRS § 376.230 (Supp. 1978).

[28] Under a previous version of the statute, it was held that an acknowledgement of the statement was not sufficient to meet the requirement that the statement be sworn. Indiana Quarries Co. v. Simms, 165 S.W. 422, 422-23 (Ky. 1914).

[29] KRS § 376.080(1) (Supp. 1978).

[30] *Id.*

[31] A recitation of the complete account is unnecessary; all that is required is a statement of the unpaid balance due. Dobson v. Thurman, 191 S.W. 310 (Ky. 1907).

[32] The description of the property must be sufficiently accurate to identify it. KRS § 376.080(1) (Supp. 1978). *See also* Headrick v. Waterbury, 126 S.W.2d 411, 412 (Ky. 1939); Powers v. Brewer, 38 S.W.2d 466, 470 (Ky. 1931). *But see* Mivelaz v. Johnson, 98 S.W. 1020, 1021-22 (Ky. 1907), in which the Court held that a mere error in describing the boundary of the property does not invalidate the lien.

[33] A mistake in the form of the owner's name does not affect the validity of a lien. Mivelaz v. Johnson, 98 S.W. 1020, 1021 (Ky. 1907).

[34] Andrews v. Wilson, 69 S.W.2d 343, 344 (Ky. 1934); Lebanon Lumber Co. v. Clarke, 152 S.W. 550, 551 (Ky. 1913).

[35] KRS § 376.110(1) (Supp. 1978).

[36] *Id.*

been filed, the court clerk refers the action to the master commissioner of the court for a hearing.[37] After hearing evidence of all claims asserted against the property in question, the master commissioner audits all lien statements and prepares a report "showing the amount due to each claimant, the nature and character of the respective liens, and the evidence upon which each claim was allowed."[38]

Once the master commissioner's report has been filed, the action proceeds as one in equity[39] but may be tried by a jury[40] if the contract was between the owner and the contractor.[41] After a lien against the real property has been satisfied, the lienholder must file a release in the office of the clerk of the county in which the lien was recorded within 60 days from the date of satisfaction.[42]

II. NOTICE TO THE OWNER-OCCUPANT OF A HOME

In 1974, the Kentucky statutes were amended to require a mechanic's lien claimant not contracting directly with the property owner to provide written notice to the owner-occupant of a single or double family dwelling of his intention to claim a lien[43] not more than ten days after the first item of material or labor is furnished. Two cases[44] recently were considered by the Kentucky Court of Appeals in which the meaning of "an owner-occupied single or double family dwelling" was at issue. In each case, a subcontractor filed a lien against

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[37] *Id.*

[38] KRS § 376.130 (1971).

[39] KRS § 376.110(1) (Supp. 1978).

[40] If the accounts or facts are too complicated, a trial by jury may be denied. McGuire v. Hammond, 405 S.W.2d 193, 194 (Ky. 1966); Reusch v. Hemmer, 33 S.W.2d 618, 619 (Ky. 1930).

[41] Scott v. Kirtley, 179 S.W. 825, 826 (Ky. 1915). If the lien claimant is a subcontractor having no contract with the owner, there is no right to a jury trial. Rieger v. Schulte & Eicher, 151 S.W. 395, 397-98 (Ky. 1912).

[42] KRS § 382.365(1) (Supp. 1978). If a timely release is not filed, an action for judgment releasing the lien may be filed by the property owner in circuit court, KRS § 382.365(2) (Supp. 1978), and the petitioner shall be entitled to recover reasonable attorneys' fees if a favorable judgment is rendered. KRS § 382.365(3) (Supp. 1978).

[43] 1974 Ky. Acts, ch. 173, § 1 (codified as KRS § 376.010(4) (Supp. 1978)).

[44] Smith v. Magruder, 566 S.W.2d 430 (Ky. Ct. App. 1978); Kinser Sheet Metal, Inc. v. Morse, 566 S.W.2d 179 (Ky. Ct. App. 1978).

a single family dwelling after the general contractor became insolvent. Notice of the lien claim was given to the owners within the 120-day period required by statute.[45] The validity of each lien was challenged on the basis that the owners were "owner-occupants" and that the claims of the subcontractors were defective since notice had not been provided within ten days after work commenced as required by the 1974 amendment.[46]

The first case, *Kinser Sheet Metal, Inc. v. Morse,* involved the construction of a single family dwelling not occupied by the owner until three days prior to the time that the subcontractor completed his work.[47] The second case, *Smith v. Magruder,* involved a lien for repairs to a single family dwelling which was rendered uninhabitable by a tornado in April, 1974. While the improvements were being made the owner of the residence temporarily resided in an apartment.[48]

Confronted with a problem of statutory construction in *Kinser* and *Smith,* the court attempted to ascertain the legislative intent underlying section 376.010(4). Although it was clear that the purpose of the 1974 amendment was to protect homeowners against "hidden liens,"[49] the meaning of "owner-occupied" was open to question. Recognizing that the mechanic's lien statutes have been liberally construed to protect persons furnishing labor or materials, the *Kinser* and *Smith* courts determined that the legislature intended "owner-occupied" to refer to "actual occupancy, and not constructive occupancy."[50] The *Kinser* court defined "owner-occupied" as "premises which are used and occupied as a dwelling house, though not necessarily on an absolutely continuous and uninterrupted basis."[51] Applying this definition, the court held that section 376.010(4) is not applicable to a new dwell-

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[45] *See* KRS § 376.010(3) (Supp. 1978). *See also* notes 20-21 *supra* and accompanying text for a discussion of the time requirements.

[46] KRS § 376.010(4) (Supp. 1978); 566 S.W.2d at 431; 566 S.W.2d at 180.

[47] 566 S.W.2d at 180.

[48] 566 S.W.2d at 430-31.

[49] 566 S.W.2d at 180; *see* Comment, *supra* note 2, at 282 n.33.

[50] 566 S.W.2d at 180. *See also* 566 S.W.2d at 431.

[51] 566 S.W.2d at 180-81.

ing under construction which is not occupied by the owner.[52] Consequently, the subcontractor's lien in *Kinser* was held to be valid.

In *Smith,* the court could have applied the *Kinser* definition of "owner-occupied" and rendered a decision against the lien claimant, since occupancy by the homeowner was merely interrupted. Instead, the court narrowly construed the statute and held that "actual physical occupancy at the time of the work is necessary to invoke the protection"[53] of section 376.010(4). As a result, "unless the owner *actually occupies* the dwelling where the goods or services are furnished, then the benefits of the statute are unavailable to him and he can be required to make double payment when his contractor defaults after payment by the owner."[54]

The *Smith* court's literal interpretation of "owner-occupant," requires results which the legislature surely did not intend. Consider, for example, the situation in which a subcontractor files a mechanic's lien against a double family dwelling on which improvements were made. If one unit of the double family dwelling was occupied by a tenant, and the owner of the dwelling (also a permanent resident of the structure) was away on a one-week vacation while the subcontractor's work was in progress, the subcontractor would not be required to comply with the ten-day notice provision because the owner did not actually occupy the dwelling when the improvements were made.

An analysis of the bases of *Kinser* and *Smith* indicates that there is more than one possible construction of section 376.010(4) and that the result in the hypothetical above is unnecessary and unwarranted. While the purpose of section 376.010(4), to protect homeowners from hidden mechanics' liens, was acknowledged by the *Kinser* court,[55] consideration was not given to the possibility that use of the word "occupant" to modify "owner" may have been intended to exclude absentee landlords from the class of owners protected by the

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[52] *Id.* at 181.

[53] 566 S.W.2d at 431.

[54] *Id.* at 432 (Lester, J., concurring) (emphasis added).

[55] 566 S.W.2d at 180.

amendment. "Occupant" has been defined as "one who occupies, an inhabitant, especially one in actual possession, as tenant, who has actual possession in distinction from landlord, who has legal or constructive possession."[56] It would be reasonable to conclude that the legislature employed "occupant" to exclude landlords from the statute's protection.

The *Smith* court's interpretation of the distinction between actual and constructive occupancy also may be subject to criticism. Actual possession[57] does not require continuous presence without regard to the surrounding circumstances. " '[T]o constitute an actual possession . . . it is only necessary to put [the property] to such use or exercise such dominion over it as in its present state it is reasonably adapted to.' "[58] Actual possession does not require a particular act in all circumstances; what constitutes actual possession "depends upon the character of [the property] and all of the circumstances of the case."[59] Indeed the *Kinser* court recognized that actual possession does "not necessarily [require occupancy] on an absolutely continuous and uninterrupted basis."[60] Thus, the court's interpretation of the distinction between actual and constructive occupancy may well have been misplaced. "Actual possession" need not have been interpreted to require exclusion of the owner in *Smith* from the "owner-occupant" category.

Since the Kentucky Supreme Court has not overturned the *Kinser* and *Smith* decisions, consideration should be given to amending section 376.010(4) to provide protection to owners of homes under construction and to those who temporarily reside elsewhere but intend to resume occupancy of the home in the near future. An owner in a *Smith* situation who contracts for a major improvement to his home and vacates the premises temporarily due to the scope of the work or the un-

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[56] Quist v. Duda, 67 N.W.2d 481, 487 (Neb. 1954) (quoting Parsons v. Prudential Real Estate Co., 125 N.W. 521, 523 (Neb. 1910)).

[57] Because "occupancy" is analyzed in terms of "possession" (*see* text accompanying note 55 *supra*) it is appropriate to address the requirements of "actual possession."

[58] Alabama State Land Co. v. Matthews, 53 So. 174, 175 (Ala. 1910).

[59] Olson v. Fedde, 107 N.W.2d 663, 666 (Neb. 1961).

[60] 566 S.W.2d at 180-81.

inhabitable nature of the dwelling is in greater need of protection from "hidden liens" than the owner who is making minor home improvements while occupancy is maintained. Section 376.010(4), therefore, should be amended to protect all temporarily displaced homeowners against the possibility of paying double the contract amount for improvements to property. The legislature should also consider an amendment to the statute to provide protection to owners in situations similar to that in the *Kinser* case. Otherwise, since the lien claimant generally need not give notice of a claim until 120 days after completion of the work, the owner is placed in the onerous "position of having to follow up his contractor and determine from each laborer or supplier (if he is aware of their [sic] identity) if his contractor has satisfied the obligations."[61] Although the laborers and suppliers "would have to determine the name and address of the owners"[62] and the type of unit or building involved, "[t]his obligation is insignificant compared to the safeguard that would be afforded the owner . . . ."[63] Furthermore, materialmen are in a better position to learn the business practices and financial reliability of the contractors with whom they deal than is the owner who may build a new home only once in a lifetime.[64]

To provide adequate protection to those who should benefit from the statutory notice requirement, section 376.010(4) could be amended, for example, to read as follows:

> No person who has not contracted directly with the owner [-occupant] or his authorized agent shall acquire a lien under this section on *a* [an owner-occupied] single or double family dwelling *used as a homestead by the owner* or the appurtenances or additions thereto unless he notifies in writing the owner[-occupant] of the property to be held liable or his authorized agent not more than ten (10) days after the first item of material or labor is furnished of the delivery of the material or performance of labor and of his intention to hold the property liable and the amount for which he will

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[61] 566 S.W.2d at 432 (Lester, J. concurring).

[62] *Id.*

[63] *Id.*

[64] *Id.* at 432-33.

claim a lien. *As used in this subsection, "homestead" shall include, but not be limited to, a single or double family dwelling under construction and shall include a dwelling used by the owner as a homestead but which is presently unoccupied due to a temporary absence.*[65]

By deleting the word "occupant" from the statute or by requiring expedited notice to the "owner *or* occupant" of a limited-capacity dwelling, the legislature would offer appropriate protection to small homeowners and guard against future inequitable results.

III. PRIORITY CONTESTS BETWEEN MECHANICS' LIENS CLAIMANTS AND MORTGAGEES

A. *What Constitutes "Actual Notice" to the Mortgagee*

A mechanic's lien claimant will prevail over a real estate mortgagee only if the mortgagee had actual or constructive notice of the lien prior to the recording of the mortgage,[66] or, in the case of a discretionary loan, prior to disbursement of all of the loan proceeds.[67] Constructive notice may be given by filing a preliminary notice of the lien claim with the court clerk in the county in which the property is located.[68]

During this past term, the Kentucky Court of Appeals in

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[65] Proposed deletions from the text of the existing statutory provision, KRS § 376.010(4) (Supp. 1978), have been placed in brackets. Proposed additions to that subsection are indicated by italics.

[66] If the mortgagee has actual or constructive notice of the mechanic's lien claim prior to the recordation of the mortgage, the mechanic's lien claim is accorded priority by statute. KRS § 376.010(2) (Supp. 1978). In two recent Kentucky Court of Appeals decisions, reference was made to a broad statement of the rule, applied in other jurisdictions, that the mortgage must have been recorded before commencement of labor or the furnishing of materials if this priority rule is to be invoked. Percy Galbreath & Son v. Watkins, 560 S.W.2d 239, 241 (Ky. Ct. App. 1977); Professional Constructors, Inc. v. Merchants Nat'l Bank & Trust Co., No. CA-959-MR (Ky. Ct. App. Dec. 9, 1977). This rule does not apply in Kentucky, because KRS § 376.010(2) (Supp. 1978) and the interpreting case law, Kentucky Lumber & Mill Work Co. v. Kentucky Title Sav. Bank & Trust Co., 211 S.W. 765, 768 (Ky. 1919), provide that a mechanic's lien is inferior to a mortgage unless the mortgagee had actual or constructive notice of the lien. The fact that work commenced on the project prior to recordation of the mortgage is inconsequential.

[67] Kentucky Lumber & Mill Work Co. v. Kentucky Title Sav. Bank & Trust Co., 211 S.W. 765, 768 (Ky. 1919); *see also* KRS § 376.010(2) (Supp. 1978).

[68] KRS § 376.010(2) (Supp. 1978).

Grider v. Mutual Federal Savings and Loan Association,[69] focused on the meaning of "actual notice." In *Grider,* a builder signed a note and mortgage to obtain a construction loan[70] from the appellee, Mutual Federal Savings and Loan Association. After the mortgage was recorded, the proceeds of the loan were disbursed to the builder in installments on July 5, July 31, and August 30, 1974. The appellants furnished materials to the builder for improvements to the mortgaged property, but failed to file a preliminary notice. Their claim to a lien, therefore, was based solely on the argument that the mortgagee had actual notice of their claim prior to disbursement of all the construction proceeds.[71]

On July 21, 1974, one of the materialmen, in a conversation with an officer of the appellee, requested assistance in collecting a debt of $800 from the builder for materials furnished. The appellee was not advised, however, that the builder was not paying his bills on time or that he was unable to do so. Nor was the appellee told that the materialmen intended to file a mechanics' lien. The appellee's past experience with the builder had been quite satisfactory, for the builder " 'had always paid his bills.' "[72] The materialmen argued that the mortgagee had received "actual notice" of the lien under the standard established in *Kentucky Lumber & Mill Work Co. v. Kentucky Title Savings Bank & Trust Co.,*[73] since it knew "that the [materialmen] had furnished materials or done labor, for which they had not been paid and for which they were entitled to assert the statutory lien."[74]

The materialmen's position finds support in *Johnson Lumber Co. v. Stovall,*[75] and in *Ideal Supplies Co. v. Un-*

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[69] 565 S.W.2d 647 (Ky. Ct. App. 1978).

[70] Because the court found that actual notice had not been given, it did not consider whether the loan involved in this case was "discretionary" or "obligatory." *Id.* at 649. *See* note 67 *supra* and notes 94-110 *infra* and accompanying text for a discussion of the distinction between "obligatory" and "discretionary" loans.

[71] 565 S.W.2d at 649.

[72] *Id.* at 648-49.

[73] 211 S.W. 765 (Ky. 1919).

[74] *Id.* at 768.

[75] 394 S.W.2d 930 (Ky. 1965).

derhill,[76] cases decided after *Kentucky Lumber* and cited in *Grider.*[77] In *Grider,* the Court stated that a mechanic's lien claimant could meet his burden of proof[78] on the actual notice issue by "showing that the builder was not paying the claims as they became due, *or* that he was unable to do so."[79] Yet, in *Collier v. Dillion,*[80] also cited in *Grider,*[81] the Court stated that "where the mortgagee knows there are unpaid claims, *and* that the owner is unable to pay them,"[82] the mortgagee is charged with actual notice of the mechanic's lien claim. It is interesting to note that the *Collier* Court relied on the *Kentucky Lumber* and *Ideal Supplies* decisions in determining what constituted "actual notice."[83]

The *Grider* court adopted the *Collier* definition of actual notice, holding that the mortgagee's knowledge of unpaid claims by persons entitled to assert a mechanic's lien is not sufficient to constitute actual notice. "[I]n order to have actual notice the mortgagee must know that there are unpaid claims for which a lien may be asserted and that the debtor is unable to pay such claims or that the claimant intends 'to file a lien.' "[84] While the appellee knew that the materialmen had claims against the builder which remained unpaid, it was not advised of appellants' intention to file a lien and was not aware of the builder's inability to pay those claims.[85] Thus, the *Grider* decision imposes on materialmen the task of informing a mortgagee of the fact of nonpayment. Additionally, the materialmen must reveal that the mortgagor-builder is unable to pay his debts or the decision requires the materialmen to state unequivocally their intent to file a lien.[86] Under

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[76] 281 S.W. 988 (Ky. 1926).

[77] 565 S.W.2d at 649.

[78] The mechanic's lien claimant has the burden of proving that the mortgagee had notice of the lien. Scheas v. Boston & Paris, 101 S.W. 942, 944 (Ky. 1907).

[79] Johnson Lumber Co. v. Stovall, 394 S.W.2d at 931 (emphasis added); *see also* Ideal Supplies Co. v. Underhill, 281 S.W. at 990.

[80] 230 S.W.2d 617 (Ky. 1950).

[81] 565 S.W.2d at 649.

[82] 230 S.W.2d at 618 (emphasis added).

[83] *Id.* at 618-19.

[84] 565 S.W.2d at 649.

[85] *Id.*

[86] 565 S.W.2d at 649.

Grider, an unpaid materialman who seeks priority over a recorded mortgage interest in realty should notify the mortgagee in writing that labor or materials have been furnished to the builder on the mortgaged property, that the builder owes a specific sum for said labor and materials, and that, if this debt is not paid, a mechanic's lien will be asserted against the mortgaged property. This notice offers maximum protection to the unpaid materialman and obviates the necessity of proving that the mortgagee received "actual notice" that the builder was unable to pay his bills.

B. *Priority Rules Applicable to Construction Advances*

A different rule of priority may be applied to the conflicting claims of a materialman and a real estate mortgagee when the mortgagee advances a portion of a construction loan to the mortgagor after the mortgage was recorded but after receipt of actual or constructive notice of a mechanic's lien claim. Kentucky courts have utilized two distinct approaches in resolving the conflicting claims of a mortgagee and a mechanic's lienor in such situations.

In 1919, a "mechanical"[87] approach was adopted by the Court in *Kentucky Lumber & Mill Work Co. v. Kentucky Title Savings Bank & Trust Co.*[88] In that case, the mortgagee had no notice of any lien claim at the time the mortgage was recorded, although the mechanics' lien claimants had already commenced labor and furnished materials. The mortgagee did, however, receive actual notice of mechanic's liens prior to making two advances (commonly known as "progress payments") on the construction loan.[89] The Court concluded that the mortgage attached to the property as the advances were made and could be enforced against the mortgagor only to the extent of such advances.[90] Thus, the mortgagee's claim was inferior to the mechanic's liens to the extent of the advances

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[87] G. OSBORNE, HANDBOOK ON THE LAW OF MORTGAGES § 117 (2d ed. 1970) [hereinafter cited as OSBORNE].

[88] 211 S.W. 765, 769 (Ky. 1919).

[89] *Id.* at 767-69.

[90] An advance becomes a mortgage "for value" within the meaning of KRS § 376.010(2) only when the advance is made. 211 S.W. at 769.

made subsequent to receipt of knowledge of the lien.[91] The Court justified this result on the basis that it would be inequitable to permit a mortgagee with notice of materialmen's claims against the property to destroy their liens by making later advances on the loan.[92]

The mechanical approach has been criticized for treating the mortgage " 'as arising at and from the *act of making the advance,* instead of from the previous executory agreement by which the land was bound as security for future advances.' "[93] In 1977, the Kentucky Court of Appeals ignored the mechanical approach of *Kentucky Lumber* and adopted the priority rule[94] used by the majority of courts.[95] This rule requires the court to ascertain whether a mortgage is "discretionary" or "obligatory." If a mortgage advance may be made at the option of the mortgagee and is thus discretionary, a mechanic's lien claimant will be accorded priority over that portion of the mortgagee's interest represented by advances made after the mortgagee received notice of the mechanic's lien claim. The mortgagee's claim will be superior only to the extent of advances made prior to the time he received notice of the mechanic's lien.[96] On the other hand, if the terms of the original mortgage loan mandate the later advances, the mortgagee's claim will have priority over mechanic's liens as to any future advance made, even though the mortgagee had notice of the lien when making the advance.[97]

The discretionary-obligatory approach has been criticized as giving the judiciary excessive latitude in characterizing a loan:

> There are few, if any, future advance clauses which an as-

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[91] *Id.*

[92] *Id.*

[93] OSBORNE, *supra* note 87, § 114 (quoting 3 G. GLENN, MORTGAGES § 399 (1943)).

[94] Professional Constructors, Inc. v. Merchants Nat'l Bank & Trust Co., No. CA-959-MR (Ky. Ct. App. Dec. 9, 1977), *rev'd,* 579 S.W.2d 100 (Ky. 1979); Percy Galbreath & Son v. Watkins, 560 S.W.2d 239, 241-42 (Ky. Ct. App. 1977).

[95] *See* OSBORNE, *supra* note 87, § 118-20.

[96] 560 S.W.2d at 241 (citing Professional Constructors, Inc. v. Merchant's Nat'l Bank & Trust Co., No. CA-959-MR (Ky. Ct. App. Dec. 9, 1977)); *see also* OSBORNE, *supra* note 87, § 120.

[97] OSBORNE, *supra* note 87, § 120.

> tute judge cannot, at will, classify on one side or the other of the line between obligatory and voluntary. When he has picked his label he has also picked his priority rule. The distinction amounts to an absence of rule; the judges are invited to pick and choose, case by case, ad hoc or ad hominem.[98]

The validity of this criticism is demonstrated by the court of appeals' decision in *Professional Constructors, Inc. v. Merchants National Bank & Trust Co.*, in which a majority of the court found that a construction loan was "obligatory" since a specific amount of money was loaned and the words "up to," "not exceeding," or other words of qualification were not contained in the promissory note or in the construction mortgage. Upon reexamination of the same documents, however, Judge Howerton sharply disagreed with this characterization.[99]

The rule of *Professional Constructors*, that a loan is discretionary only if it contains appropriate qualifying words,

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[98] *Id.*, quoting G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 930 (1965).

[99] No. CA-959-MR at 9. In his concurring opinion Judge Howerton remarked that the majority's conclusion "that Merchants was obligated to transfer $1,125,000.00 to the borrower, even if the amount was surplus to the cost of acquiring the land and constructing the improvements" was "simply . . . not correct." *Id.* The loan documents provided that the full amount of the loan would be disbursed to the borrower only if the property was developed without any defaults. Further evidence of the "discretionary" nature of the loan was found by Judge Howerton in the language of the loan agreement and the note:

> The loan agreement provided that Merchants was to lend to the borrower "such amount *not to exceed* the principal sum of $1,125,000.00 as shall be necessary for the purpose of . . . construction of the improvements thereon. The note held by Merchants provided that the maker was obligated to pay $1,125,000.00, *or so much thereof as shall be advanced to the* maker . . . ."

Id. (emphasis added).

The Kentucky Supreme Court reversed the court of appeals decision and summarily determined that the loan was discretionary because Merchants was under no obligation to disburse the full amount of the loan. Merchants Nat'l Bank & Trust Co. v. Professional Constructors, Inc., 579 S.W.2d 100, 102 (Ky. 1979). By treating the discretionary-obligatory loan issue in a perfunctory manner, the Court leaves in doubt whether Kentucky has abandoned the mechanical approach of *Kentucky Lumber* in favor of the"discretionary-obligatory" priority rule used by the majority of courts. *See* text accompanying notes 87-97 *supra* for an explanation of the two rules. If the Court intended to adopt the majority rule, it failed to fashion any definitive guidelines for use in determining whether a loan is "discretionary" or "obligatory."

does not fully resolve the difficulty of determining whether a loan is discretionary or obligatory. For example, courts have disagreed as to whether a loan may be regarded as "obligatory" when the agreement permits the mortgagee to refuse to make future advances after the mortgagor has defaulted.[100] In such cases some courts have held that the advances are discretionary and priority is given to intervening mechanics liens when the mortgagee made construction advances after default by the mortgagor.[101]

This latter approach was utilized by the Kentucky Court of Appeals in *Percy Galbreath & Son v. Watkins*,[102] where a mortgagee made advances to complete a construction project after default by the mortgagor and with knowledge of intervening mechanic's liens. The promissory note was for the principal sum of $193,000 or "as much thereof as may be advanced."[103] The construction agreement provided that in the event the borrower failed to complete the work the lender-mortgagee had the option of either using the undisbursed funds to complete the work itself, applying such funds toward retirement of the principal, or disbursing such funds to unpaid materialmen.[104] The court labelled the loan "discretionary" and held that the mechanic's lien claimants were entitled to priority over the mortgagee to the extent of sums advanced after the mortgagor's default.[105] The court based its decision on the optional nature of the advances as evidenced by the wording of the promissory note.[106]

Despite criticism, the "discretionary-obligatory" approach is preferable to a mechanical approach. A mortgagee who is bound to make periodic advances as of the date of the contractual commitment has, in effect, given value equal to the full amount of the construction loan. In such a case, when the contract is executed and the mortgage recorded prior to receipt of notice of potential claims by materialmen, the mort-

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[100] Annot., 80 A.L.R. 2d 179, 199 (1961).
[101] *Id.* at 201.
[102] 560 S.W.2d 239 (Ky. Ct. App. 1977).
[103] *Id.* at 241.
[104] *Id.*
[105] *Id.*
[106] *Id.*

gagee should be entitled to priority over such claims without regard to any subsequent notice of the mechanics' liens. By the same token, a mortgagee has no compelling need for protection with regard to advances made without prior contractual commitment and with knowledge of intervening materialmen's claims.[107] Indeed, to accord priority to the mortgagee in such a case would prejudice the rights of the other creditors of the mortgagor.[108]

Percy Galbreath leaves unresolved the extent of the continuing validity of the mechanical approach. In addition, there remains a problem in determining whether a loan should be viewed as "discretionary" or "obligatory" when the loan documents do not expressly make disbursements optional. Because the terms "discretionary" and "obligatory" are easily manipulated by the courts in the absence of any express characterization in the loan documents, guidelines should be formulated to assist the courts and future mortgagees in ascertaining the status of periodic construction loan payments.[109] In the formulation of such guidelines, accepted rules of contract interpretation should play an important role.[110] Of equal significance, however, are issues of public policy. Thus, courts should consider the relative protections necessary for institutional lenders and unpaid laborers and suppliers, based perhaps in part upon the influence and control these groups may independently exert on a builder-mortgagor and upon their respective capacities to bear the losses occasioned by a mortgagor's default.

IV. OTHER REMEDIES FOR UNPAID MATERIALMEN

A. *Right to an Equitable Lien*

Even if an unpaid materialman fails to perfect his

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[107] 560 S.W.2d at 242.

[108] OSBORNE, *supra* note 87, § 117a.

[109] *See* note 98 *supra* and accompanying text for an illustration of why guidelines are so essential.

[110] Thus, for example, emphasis may be placed on the intention of the parties to the agreement, to the extent to which that intention may be discernible. L. SIMPSON, LAW OF CONTRACTS 210 (2d ed. 1965). In addition, the words of a contract will generally be construed most strongly against the party who uses them. *Id.* at 212.

mechanic's lien or if the mortgagee has priority over a perfected mechanic's lien, the materialman nevertheless may be able to recover the amount due for services performed or materials furnished. For example, the court of appeals in *Professional Constructors, Inc. v. Merchants National Bank & Trust Co.*,[111] granted a materialman an equitable lien on undisbursed construction loan proceeds.[112] A property owner engaged in the construction of a manufacturing and commercial facility executed with a co-mortgagor a note and mortgage to Merchants National Bank in exchange for a $1,125,000 loan. After the mortgage was recorded, the owner-mortgagor entered into a lump sum contract with the appellant, Professional Constructors, Inc. (Pro Con), which was to serve as the general contractor for the project.[113]

Payment for construction costs was to be made in accordance with an elaborate system. On a monthly basis, Pro Con would complete and forward to the owner lien releases, lien waivers and an application and certificate for payment indicating the charges for the amount of work done. The owner and his co-mortgagor would check the work and draft checks payable to Pro Con or to Pro Con and the subcontractor or supplier. The appellee bank would then receive a copy of Pro Con's application together with instructions to transfer to the owner's account the funds necessary to cover the charges made. Each application showed that ten percent of the amount requested by Pro Con was to be held as retainage. The contract between Pro Con and the owner specified that the retainage would be paid to Pro Con upon satisfactory completion of the project.[114]

Pro Con completed its work and obtained a permanent certificate of occupancy on May 21, 1975. Because the owner had abandoned the project, Pro Con submitted its last request for funds to the co-mortgagor which failed to transmit this

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[111] No. CA-959-MR (Ky. Ct. App. Dec. 9, 1977), *rev'd*, 579 S.W.2d 100 (Ky. 1979).

[112] The Kentucky Supreme Court did not consider the equitable lien issue in its opinion in *Professional Constructors*. The issue was mooted by the Court's finding that the loan advances were discretionary rather than obligatory. 579 S.W.2d at 102.

[113] No. CA-959-MR at 1-2.

[114] *Id.* at 3-4.

request to the appellee bank. After receiving the certificate of occupancy on August 8, 1975, the bank declared the note and mortgage in default. At that time the bank possessed undisbursed loan proceeds in the amount of approximately $169,000. Subsequently, Pro Con filed a mechanic's lien for final labor and materials furnished in the amount of $71,621.41 and claimed an additional $50,848, the amount of retainage held by the appellee bank.[115]

The court of appeals concluded that Pro Con's asserted mechanic's lien was subordinate to the mortgage of the appellee bank,[116] because the loan made by the bank was "obligatory" rather than "discretionary"[117] and because the mortgage had been recorded prior to the commencement of labor or the furnishing of materials.[118] Consequently, Pro Con's claim of a statutory lien could not provide a basis for recovery. The court, however, raised *sua sponte* the issue of Pro Con's right

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[115] *Id.* at 4-5. The court of appeals concluded that there could be "no question" that Pro Con was entitled to recover the undisbursed retainage of $50,848, since this sum was held by the bank "for the use and benefit of Pro Con . . . ." No. CA-959-MR at 6. The Kentucky Supreme Court, however, denied Pro Con's claim to that fund, emphasizing its view that the loan was discretionary in nature and that the retainage could not be deemed to have been disbursed.

> The retainage was not placed in a special fund. It was not withdrawn from the bank, nor was it placed in Dues' bank account in any respect. Merchants [Bank] learned of the abandonment of the project and made no further distribution. There was no obligation on Merchants to distribute or deposit any money in Dues' account and none was distributed or placed in its account.

Merchants Nat'l Bank and Trust Co. v. Professional Constructors, Inc., 579 S.W.2d 100 (Ky. 1979). It would appear, therefore, that this harsh result might be avoided in cases in which the pertinent construction contract contains provisions requiring the owner-mortgagor either to instruct the bank-mortgagee to transfer the retainage funds to a special retainage account in the names of both the owner and general contractor, or to withdraw the amount of the retainage fund due as each disbursement is made by the bank-mortgagee. In the absence of a clear indication in the construction agreement between the owner and the general contractor that such disbursement or segregation of the retainage fund is mandatory, the general contractor's right to the retainage fund will be jeopardized. The Court has made it clear that mere knowledge of the retainage fund by the bank-mortgagee is insufficient to establish an equitable lien against funds held by the bank.

[116] The Supreme Court later reversed this finding, concluding that the loan was discretionary rather than obligatory. 579 S.W.2d at 103.

[117] *See* notes 96-110 *supra* and accompanying text for a discussion of the distinction between "discretionary" and "obligatory" loans.

[118] No. CA-959-MR at 2.

to an equitable lien for final labor and materials furnished, and held that Pro Con, as the general contractor, was entitled to an equitable lien on the undisbursed loan proceeds in the hands of the bank.[119]

A minority of courts will award equitable liens on undisbursed construction loan funds,[120] but only when "special or peculiar equities" are found to exist in favor of the lien claimant.[121] Failure to perfect a mechanic's lien does not foreclose one who has furnished labor, materials, or services for a construction project from seeking an equitable lien. On the other hand, "the right of subcontractors or materialmen to an equitable lien is not established merely by filing a mechanic's lien claim."[122] The rationale of the equitable lien remedy is that "it would be inequitable and unjust to withhold from those persons who have by their labor and materials enhanced the value of the property the loan fund which constituted a material inducement to them in supplying such labor and materials upon which they relied for reimbursement."[123] But for such a remedy, the lender's security would be unjustly enriched by the labor and materials furnished at the expense of the suppliers.[124] A contractor, subcontractor, or materialman claiming an equitable lien must prove that he justifiably relied on the construction loan fund for payment.[125]

The amount and sufficiency of evidence necessary to prove such justifiable reliance are, however, uncertain. In *Swinerton & Walberg Co. v. Union Bank*,[126] a California decision cited by the court in *Professional Constructors*,[127] the mere creation of the loan fund was found to have induced the

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[119] The amount of the equitable lien to which Pro Con was entitled was said to be a question for determination in further proceedings. An award of a summary judgment for the bank was reversed, and the case was remanded. *Id.* at 8.

[120] Annot., 54 A.L.R.3d 848, 853 (1973).

[121] Hall's Miscellaneous Ironworks, Inc. v. All S. Inv. Co., 283 So.2d 372, 374 (Fla. Dist. Ct. App. 1973).

[122] McBain v. Santa Clara Sav. & Loan Ass'n, 51 Cal. Rptr. 78, 83 (Dist. Ct. App. 1966).

[123] *Id.*

[124] *Id.*

[125] *See* Annot., 54 A.L.R.3d 848, 853-59 (1973).

[126] 101 Cal. Rptr. 665, 668 (Dist. Ct. App. 1972).

[127] No. CA-959-MR at 7.

suppliers to rely upon the fund for payment. Arizona courts, however, have taken a position contrary to that in *Swinerton,* holding that the "real question is whether the parties intended that the fund or property upon which the lien is claimed was to be security or collateral for payment."[128] Consequently, Arizona materialmen may be precluded from asserting an equitable lien when a provision in the construction loan agreement states that the fund is created for the sole protection of the borrower and lender, and not for the benefit of unpaid suppliers.[129]

A third approach to establishing justifiable reliance is reflected in the California case of *McBain v. Santa Clara Savings & Loan Association,*[130] in which the court stated that persons supplying labor or materials were entitled to an equitable lien if they had "been induced by either the borrower or the lender to rely on the construction loan funds for payment."[131] Such inducement may take the form of conversations between the suppliers and the lender or the borrower in which the suppliers are told that they are to be paid from the construction loan fund.[132] Furthermore, in *Miller v. Mountain View Savings & Loan Associaton,*[133] the California court determined that reliance upon this fund is justified when the lender utilizes a system of progress payments to the contractor from a loan fund in the hands of an escrow agent.

To prove entitlement to an equitable lien, a general contractor may also be required to establish that the construction

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[128] Pioneer Plumbing Supply Co. v. Southwest Sav. & Loan Ass'n, 428 P.2d 115, 121 (Ariz. 1967).

[129] *See, e.g., id.* at 122. *But see* Swinerton & Walberg Co. v. Union Bank, 101 Cal. Rptr. 665, 670 (Dist. Ct. App. 1972), in which it was determined that a construction agreement between a lender and a borrower did not foreclose a supplier's claim to the undisbursed loan proceeds, although it provided that the supplier had no right to the funds. The court said that an equitable lien "has an independent, noncontractual basis." *Id.*

[130] 51 Cal. Rptr. 78 (Dist. Ct. App. 1966).

[131] *Id.* at 89.

[132] *Id.* at 85-86. The Arizona courts have disagreed with the *McBain* position, stating that an equitable lien may only be awarded if the lender induced the contractor to rely on the construction loan fund. Pioneer Plumbing Supply Co. v. Southwest Sav. & Loan Ass'n, 428 P.2d 115, 121-22 (Ariz. 1967).

[133] 48 Cal. Rptr. 278 (Dist. Ct. App. 1965).

project is completed.[134] On the other hand, some courts have taken the position that completion of the construction project is not a condition precedent to an award of an equitable lien.[135]

The decision in *Professional Constructors* allowing Pro Con an equitable lien upon undisbursed loan funds can be supported under either a *Swinerton* or a *Miller* analysis.[136] The construction project was completed and all outstanding claims had been paid by Pro Con. Therefore, the second element necessary to establish an equitable lien claim under *Miller* was clearly present. While the court of appeals in *Professional Constructors* appeared to prefer the *Swinerton* approach that mere creation of a fund can induce suppliers to rely upon it,[137] it failed to state definitively the basis for its award of an equitable lien; the type of evidence necessary to establish justifiable reliance; and whether completion of construction is a condition precedent to assertion of such a lien.

On appeal, the Kentucky Supreme Court reversed the court of appeals' decision in *Professional Constructors*. After characterizing the loan as "discretionary," the Court rejected Pro Con's demand for an equitable lien against undisbursed, "discretionary" loan proceeds held by the mortgagee, since "the undistributed funds did not constitute a part of the loan until actual distribution had been made."[138] The Court's opin-

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[134] *See, e.g.*, J.G. Plumbing Serv., Inc. v. Coastal Mortgage Co., 329 So.2d 393 (Fla. Dist. Ct. App. 1976). There, the Florida court explained its decision, stating that "the market value of a partially constructed building will be substantially less than the total cost of the labor and materials which has [sic] already been incorporated into its construction. Under these circumstances, it cannot be said that the mortgagee has been unjustly enriched." *Id.* at 395.

[135] 51 Cal. Rptr. at 89.

[136] Since the issue of award of an equitable lien was not raised at the trial court level, it is not clear whether Pro Con would have been entitled to an equitable lien under the Arizona or the *McBain* views of proof of justifiable reliance.

[137] No. CA-959-MR at 7 (Ky. Ct. App. Dec. 9, 1977), *rev'd*, 579 S.W.2d 100 (Ky. 1979).

[138] 579 S.W.2d 100, 103 (Ky. 1979). If the bank had notice that Pro Con had filed a mechanic's lien or intended to do so (*see* text accompanying notes 68-86 *supra*), Pro Con's lien would have received priority over the mortgagee's interest, since each distribution was made subsequent to the mortgagee having received notice of the lien claim. "This avenue was abruptly closed" because Pro Con signed a release of lien prior to each distribution. 579 S.W.2d at 103. Subsequent to the filing of Pro Con's

ion seems to suggest that a claim for an equitable lien could be asserted successfully against undisbursed, "obligatory" loan funds.[139] Thus, to the extent that this interpretation is sound, the portion of the court of appeals' opinion relating to equitable liens remains significant. The law of equitable liens in the area of construction financing is clearly in the developmental stage, however, and numerous issues remain unresolved.

B. *Marshaling of Assets*

Charles White Co. v. Percy Galbreath & Son[140] began as a mortgagee's foreclosure action, brought by Percy Galbreath & Son, which held a mortgage on certain property and an assignment of rents from the lease of the property after completion of construction. Nineteen materialmen with recorded liens in excess of $130,000 were named as defendants. The special commissioner recommended a finding that Percy Galbreath had, after crediting $45,000 to it for rent collected after the building was completed, a superior lien in the amount of $170,260.57. A judicial sale of the property subject to the lease was held, and a high bid of $201,000 was entered. Before the circuit court approved the sale, several of the materialmen, appellants in this case, moved to compel the sale of the leasehold interest for first satisfaction of Percy Galbreath's debts, basing their motion on the doctrine of marshaling of assets.[141] On appeal, the court concluded that the equitable doctrine of marshaling of assets was not available in this case to protect materialmen with claims inferior to the mortgagee's.[142]

Marshaling of assets embraces the "two funds" rule:

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lien, the mortgagee bank made no further distributions on the loan. *Id.* at 102.

Once it had determined that the loan was discretionary, the Court could have responded that since the mortgagee had discretion in determining whether to make an advance, Pro Con did not justifiably rely on the loan fund for payment and thereby failed to satisfy a prerequisite to assertion of the claim for an equitable lien. *See* Annot., 54 A.L.R.3d 848, 853-59 (1973).

[139] 579 S.W.2d at 103.

[140] 563 S.W.2d 478 (Ky. Ct. App. 1978).

[141] *Id.* at 480.

[142] *Id.* at 481. The reasons for this decision are discussed in the text accompanying notes 153-56 *infra*.

> Where two or more creditors seek satisfaction out of the assets of their debtor, and one of them can resort to two funds, whereas another creditor has recourse to only one of the funds—for example, where a senior or prior mortgagee has a lien on two parcels of land, and a junior mortgagee has a lien on but one of the parcels—the former may be required to seek satisfaction out of the fund which the latter creditor cannot touch so that by this means of distribution both creditors may be paid, or the single-fund creditor may, if possible, have his claim satisfied out of the fund which is subject to the claims of both creditors.[143]

The marshaling of assets doctrine can provide significant relief to a junior encumbrancer, since it compels the paramount creditor to satisfy his debt out of the fund unavailable to the junior encumbrancer, thus resulting in little or no impairment of the security of the junior encumbrancer.[144]

As a general rule, the marshaling of assets doctrine may be invoked by a court of equity only if all of the following elements are present: (1) the litigants are creditors of the same debtor;[145] (2) there are two funds belonging to the debtor;[146] (3) only one of the creditors has a right to claim both funds;[147] (4) marshaling of assets is necessary to secure the claim of the junior creditor;[148] (5) complete satisfaction of the claim of the paramount creditor will not be jeopardized;[149] (6) the funds or properties to be marshaled are in existence at the time the equitable relief is sought;[150] (7) the junior creditor's equitable claim to marshal the assets has been asserted prior to the sale of the property against which the claim is made;[151] and (8) the rights of third parties will not be prejudiced by the claim.[152]

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[143] Annot., 76 A.L.R.3d 326, 327-28 n.2 (1977).

[144] *Id.* at 329.

[145] Comment, *Security—Limitations on the Application of the Two Funds Doctrine of Marshalling of Assets*, 3 WASH. & LEE L. REV. 158, 162, 163 n.22 (1941).

[146] Dixieland Realty Co. v. Wysor, 158 S.E.2d 7, 14 (N.C. 1967).

[147] *Id.*

[148] 53 AM. JUR. 2D *Marshaling Assets* § 12 (1970).

[149] Calhoun v. Federal Land Bank, 20 S.W.2d 72, 73-74 (Ky. 1929).

[150] Dixieland Realty Co. v. Wysor, 158 S.E.2d 7, 14 (N.C. 1967).

[151] 53 AM. JUR. 2D *Marshaling Assets* § 16 (1970).

[152] *See* Humphries v. Fitzpatrick, 69 S.W.2d 1058, 1061 (Ky. 1934).

The court in *Charles White Co.* concluded that two funds did not exist, since "a leasehold as security cannot be separated from the property for the purposes [sic] of marshalling of assets."[153] In reaching this decision, the court relied on the rule that the doctrine may not be invoked when complete satisfaction of the claim of the paramount creditor would thereby be jeopardized.[154] "Division of the two [realty and leasehold] would only decrease the value that the leasehold and the property would have as an entity; causing such a split to create two funds would run counter to the requirement that the use of the doctrine not prejudice the prior creditor."[155] Even if the leasehold could have been sold without prejudice to Percy Galbreath's claim, the appellants would still have been unsuccessful, since the motion requesting marshaling of assets was not made until the property had been sold, and, as a consequence, the rights of the highest bidder would have been prejudiced.[156]

The appellant materialmen might have prevailed if they had made their motion requesting marshaling of assets prior to the sale of the property and if the total of rents collected after foreclosure and prior to sale would have satisfied Percy Galbreath's claim. "[W]here rents and profits are collected by a receiver appointed in proceedings for the foreclosure of a senior mortgage, the senior mortgagee has two funds out of which he may satisfy his debt,—(1) the proceeds of the sale of the land, and (2) the rents and profits in the hands of the receiver."[157] A junior encumbrancer may, by using the marshaling of assets doctrine, "compel the senior mortgagee to satisfy his debt in the first instance out of the rents and profits, the result being to increase the surplus available to the

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[153] 563 S.W.2d at 481.

[154] *See* Calhoun v. Federal Land Bank, 20 S.W.2d 72, 73-74 (Ky. 1929).

[155] 563 S.W.2d at 481. Thus it would appear that the opinion in *Charles White Co.* does not absolutely preclude a junior encumbrancer from attempts to marshal property and the leasehold, if he can establish that a division of these assets will not decrease the value of the paramount creditor's security.

[156] *Id.* at 480-81.

[157] Annot., 95 A.L.R. 1037, 1044 (1935); *see also* Humphries v. Fitzpatrick, 69 S.W.2d 1058, 1060-61 (Ky. 1934).

junior mortgagee in the proceeds of the land."[158]

Since Percy Galbreath's lien did not consume the entire proceeds of the judicial sale of the property, the court was faced with determining the relative priorities of the claims of the nineteen materialmen. The special commissioner stated that priority was to be based on the order, by date, in which each materialman and laborer either began work or furnished materials, and the lower court adopted this recommendation.[159] Both the commissioner and the circuit court apparently thought[160] this order of priority was mandated by KRS § 376.010(1) which provides:

> [t]he lien on the land or improvements shall be superior to any mortgage or encumbrance created subsequent to the beginning of the labor or the furnishing of the materials, and the lien . . . shall relate back and take effect from the time of the commencement of the labor or the furnishing of the materials.[161]

The court of appeals held, however, that "the materialmen and laborers with perfected mechanic's liens share equally" in the proceeds of the sale.[162] To hold otherwise, the court noted, " 'could lead to a ridiculous race to the premises by materialmen seeking to be first to begin furnishing materials.' "[163] Moreover, to allocate priorities on a chronological basis would improperly favor those parts of the construction industry which, by virtue of the nature of the services or materials they provide, start work early in the building process.[164] For these reasons, the court construed the language of the statute stating that a lien "relate[s] back and take[s] effect from the time of the commencement of the labor or the

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[158] Annot., 95 A.L.R. 1037, 1044 (1935).

[159] 563 S.W.2d at 48-81.

[160] *Id.* at 482.

[161] KRS § 376.010(1) (Supp. 1978).

[162] 563 S.W.2d at 482. "Equally" does not mean that the contract price is divided among the lien claimants on an equal basis; "equally" means that the lien claims are of equal dignity—all lien claimants shall share in distribution of the contract price on a pro rata basis. *See* Schnute Holtman Co. v. Sweeney, 125 S.W. 180, 182-83 (Ky. 1910); KRS § 376.010(1) (Supp. 1978).

[163] 563 S.W.2d at 482, quoting 4 RICHARDSON, KENTUCKY PRACTICE § 1130 (1974).

[164] 563 S.W.2d at 482.

furnishing of the materials" to refer to the priority between a mechanic's lien claimant and creditors and not to the order of priorities among the mechanic's lienors.[165]

The result reached by the court of appeals in *Charles White Co.* represents a sound application of the principles of the equitable doctrine of marshaling of assets. In addition, the court's discussion of the relative priorities of materialmen with claims subordinate to that of a mortgagee is founded on compelling considerations of policy and practice. Pro rata sharing of all assets available to mechanics' lienors as a class achieves a fair result and avoids the disruption of the construction process by a stream of materialmen and laborers clamoring to be first to begin their work on a particular project. A rule mandating a shared interest in such assets may be viewed as a special rule applicable to mechanics' lien claimants. Thus, the rule would not be inconsistent with or violative of the policies underlying the general rule, which favors allocation of priorities among junior encumbrancers on a chronological basis.[166]

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[165] *Id.* The court found support for this view in that portion of the Kentucky law providing that, in the event that the aggregate amount of liens asserted exceeds the original contract price, "there shall be a pro rata distribution of the original contract price among the lienholders." KRS § 376.010(1) (Supp. 1978). Support was also found in Schnute Holtman Co. v. Sweeney, 125 S.W. 180, 181-83 (Ky. 1910).

[166] Note, *Mechanics' Liens and Surety Bonds in the Building Trades*, 68 YALE L.J. 138, 153 (1958).