Construction Lending: The Mortgagee's Right to Inspect the Construction Project and Duty to Ensure Proper Disbursement of Construction Loan Proceeds

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NOTE

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INTRODUCTION

A mortgagee\(^1\) enters into a loan agreement with a mortgagor\(^2\) to provide the construction financing for a shopping mall. The mortgagor's contractor commences construction on the project as soon as the loan transaction is closed. The mortgagee disburses the loan proceeds directly to the contractor as draw requests are made and construction progresses on the mall. The mortgagee also monitors the progress of the shopping mall by making periodic inspections of the project.

During the course of the construction, two different problems can arise for which the mortgagor may claim the mortgagee is liable. A quantity defect\(^3\) arises if the construction loan fund is exhausted before the shopping mall is complete. A quality defect,\(^4\) on the other hand, occurs if the shopping

\(^1\) The terms "mortgagee" and "lender" are used interchangeably in this Note. Both refer to the financial institution that provides the construction financing secured by a mortgage on the property.

\(^2\) The terms "mortgagor" and "borrower" are used interchangeably in this Note. Both represent the entity or individual that has received the construction mortgage loan from the mortgagee and that has pledged the property as security for the debt.

\(^3\) The borrower's allegation in Garbish v. Malvern Fed. Sav. and Loan Ass'n, 517 A.2d 547, 550 (Pa. Super. Ct. 1986), illustrates a quantity defect. The savings and loan institution was accused of violating its fiduciary duty to the borrower for disbursing ninety percent of the construction loan proceeds while only forty percent of the project was completed. See also Daniels v. Big Horn Fed. Sav. & Loan Ass'n, 604 P.2d 1046, 1047 (Wyo. 1980) (where the builder "walked off the job leaving an unfinished house and unpaid bills").

\(^4\) An example of a quality defect is found in Butts v. Atlanta Fed. Sav. & Loan Ass'n, 262 S.E.2d 230, 231 (Ga. Ct. App. 1979), in which the mortgagor alleged that the mortgagee was liable for construction work that was poorly performed and not in accordance with the building's plans and specifications. See also Clark v. Kansas Sav. & Loan Ass'n, 608 S.W.2d 493, 494-95 (Mo. Ct. App. 1980) (rooms not built to specified dimensions); Davis v. Nevada Nat'l Bank, 737 P.2d 503, 505 (Nev. 1987) (unworkmanlike and deficient construction); Roundtree Villas Ass'n v. 4701 Kings Corp., 321 S.E.2d 46, 48 (S.C. 1984) (borrower claimed lender was liable for defects in the construction of roofs and balconies).
mall has severe structural deficiencies. Either type of defect in the construction project might require a substantial sum of money to remedy.

Borrowers’ claims or counterclaims against construction lenders are commonplace in today’s depressed and litigious real estate development industry. This Note addresses two of the possible construction lender liability issues relating to the preceding shopping mall scenario: (1) the legal consequences of the mortgagee’s periodic inspection of the construction project’s progress and (2) the legal obligations created when the mortgagee disburses the loan proceeds directly to the general contractor.

Part I of this Note analyzes the legal theories the borrower may rely on to hold the lender liable for quantity or quality defects in the construction project or for the improper disbursement of construction loan proceeds. Part II of this Note discusses lender liability based on the mortgagee’s right to inspect the construction project. Part III addresses the issue of lender liability based on the mortgagee’s disbursement of funds directly to the contractor. Part IV suggests several safeguards the mortgagee might use to protect itself from liability should either of the considered issues in Parts II and III arise.

This Note concludes by recommending against the imposition upon a lender of an additional duty or higher standard of care to inspect the construction project or to ensure defect-free construction when the lender disburses the loan proceeds directly to the builder, rather than to the borrower.

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5 This Note focuses on the extent of the lender’s liability to the borrower for quantity and quality defects that may arise during the construction phase of the project. Lenders’ liability to third parties who are not part of the debtor-creditor relationship, such as contractors, subcontractors, materialmen or suppliers, is beyond the scope of this Note. Likewise, this Note will not attempt to address a lender’s liability for financing the purchase of an existing building or home that may have preexisting structural defects. For a general discussion of this latter issue, see Craig R. Thorsenston, Note, Mortgage Lender Liability to the Purchasers of New or Existing Homes, 1 U.Ill.L.Rev. 191 (1988) (arguing that mortgage lenders should be held liable for failing to disclose relevant information to borrowers who are purchasing new or existing homes).

6 Ordinarily, the mortgagee has no implied contractual or tort duty to third parties who are not parties to the construction loan agreement. See Comet Dev. Corp. v. Prudential Ins. Co., 579 So. 2d 355 (Fla. Dist. Ct. App. 1991) (if mortgagee owed any duty to disburse the loan funds with reasonable care, it was owed to the owner of the building and not to the contractor); Strickland-Collins Constr. v. Barnett Bank, 545 So. 2d 476, 477 (Fla. Dist. Ct. App. 1989) (finding that the lender’s duty to disburse the loan funds was owed to the borrower and not to the general contractor); Equitable Mortgage Resources, Inc. v. Carter, 406 S.E.2d 494, 496 (Ga. Ct. App. 1991) (holding that construction lender owed no duty to subcontractor regarding disbursement of loan proceeds); Light v. Equitable Mortgage Resources, Inc., 383 S.E.2d 142, 143 (Ga. Ct. App. 1989) (recognizing that construction lender has no duty “to protect the subcontractor from the risks of doing business with its borrower”); cf. National Bank v. Equity Investors, 506 P.2d 20, 41 (Wash. 1973) (“Outside the contract, the major duty which a construction lender owes to any other party is the duty of good faith; though a loan may be inefficiently managed and with adverse consequences, neither inferior liens nor absolute guarantors have any recourse against the lender unless it is alleged and proved that the lender acted in bad faith.”).

7 See infra notes 11-44 and accompanying text.

8 See infra notes 45-78 and accompanying text.

9 See infra notes 79-137 and accompanying text.

10 See infra notes 138-50 and accompanying text.
Early in the trial process, courts should dispense with claims that frivolously attempt to establish the existence of an additional duty or higher standard of care on the lender's part.

I. LEGAL THEORIES USED TO IMPOSE UPON THE LENDER A DUTY TO ENSURE PROPER APPLICATION OF CONSTRUCTION LOAN PROCEEDS

Borrowers have used several legal theories in attempts to impose upon lenders a duty to ensure the proper application of construction loan proceeds or to protect the borrower from quantity or quality defects in construction projects. While establishing the existence of such a duty is the borrower's initial hurdle, it should be noted that even if a duty is imposed upon or assumed by the lender, and it is determined that this duty was breached, the borrower must ordinarily prove in addition that the breach was the proximate cause of the resultant quantity or quality defect. Only then will the lender be held liable for the improper or negligent disbursement of the construction loan proceeds.

The following theories have been used by borrowers in their attempts to establish that the lender had a duty to inspect the project and/or ensure proper application of the loan proceeds. Whether these theories have merit depends on the facts and circumstances of each case. In addition, an important, but not conclusive, factor is the amount of control the lender exercises over the borrower and the construction project.

A. The Mortgagor Has a Duty to Exercise Reasonable Care in Administering Construction Loan Proceeds

A few jurisdictions impose upon the lender a duty to use reasonable or due care in disbursing the construction loan proceeds. Florida is one

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11 A detailed analysis of each of these theories is beyond the scope of this Note. A brief discussion of several theories of lender liability is presented in this part of the Note. In addition, it is important to note that in most jurisdictions a duty of good faith is imposed upon the lender in performing its contractual obligations; such a duty, however, generally "does not obligate a lender to take affirmative actions that the lender is clearly not required to take under its loan documents." Parker v. Columbia Bank, 604 A.2d 521, 531 (Md. Ct. Spec. App. 1992). See also Wooden v. First Sec. Bank, 822 P.2d 995, 998 (Idaho 1991) (limiting scope of covenant of good faith and fair dealing to obligations imposed by parties' agreement). But see Nance v. Resolution Trust Corp., 803 S.W.2d 323, 332-33 (Tex. Ct. App. 1990) (citing Lovell v. Western Nat'l Life Ins. Co., 754 S.W.2d 298, 302 (Tex. Ct. App. 1988)) (holding that in Texas no duty of good faith and fair dealing is imposed unless created by express language in contract or special relationship of trust and confidence between parties; finding the lender-borrower relationship not to be such a special relationship).

12 The key to proving that the lender's action or nonaction was the proximate cause is "the foreseeability of the ultimate injury as a natural and probable consequence of the act or omission." Crum v. AVCO Fin. Servs., 552 N.E.2d 823, 831 (Ind. Ct. App. 1990); see also Bollinger v. Livingston State Bank and Trust Co., 187 So. 2d 784, 786 (La. Ct. App. 1966) (the breach must be the proximate cause of the injury, and it must also be true "that the injury actually was suffered and is compensable").

13 See Fikes v. First Fed. Sav. & Loan Ass'n, 533 P.2d 251, 261 (Alaska 1975) (lender has "a
jurisdiction that has held that the mortgagee has a “duty to use reasonable care to see that the funds advanced are used to pay for the materials and supplies and work done” on the construction project. The same Florida court, however, had previously recognized that the lender has no duty to supervise the development or to see to the proper completion of the construction project it finances.

Most courts are reluctant to impose upon the lender a duty to use reasonable care in inspecting the project or in disbursing the loan proceeds to the borrower based solely on the lender’s reservation of the right to inspect the project. Where the lender disburses the loan proceeds directly to the builder, however, certain authorities have held that a higher duty to the borrower may arise. Furthermore, should the lender insist on this method of disbursement and not obtain the borrower’s prior or joint approval of each payment, some jurisdictions will definitely impose a fiduciary duty upon the lender to ensure the proper application of the construction loan proceeds.

B. The Mortgagee Owes a Fiduciary Duty to the Mortgagor Because of an Implied Agency Relationship

Certain jurisdictions adhere to the principle that a mortgagee that controls the disbursement of the construction loan proceeds and pays the builder directly is an implied agent of the mortgagor. These
jurisdictions have held that a fiduciary duty arises on the part of the mortgagee as a result of the agency relationship. One court stated that the mortgagee's "conduct must be measured against the standard of care owed by a fiduciary."20

Generally, the fiduciary theory has been successfully alleged only where the mortgagee expressly stated or agreed that it would control disbursement and pay the builder directly without the borrower's joint participation or approval.21 Two jurisdictions, however, have imposed such a duty based solely on the mortgagee's control over the disbursement of the loan funds, regardless of the extent of the borrower's participation.22 The fiduciary theory has also been invoked, albeit unsuccessfully, where the lender has exercised its contractual right to periodically inspect the project.23

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special circumstances which may impose a fiduciary duty: [1] [if the lender] (1) took on any extra services on behalf of [the borrowers] other than furnishing the money for construction ; (2) received any greater economic benefit from the transaction other than the normal mortgage; (3) exercised extensive control over the construction; or (4) was asked by [the borrowers] if there were any lien actions pending.

_Id._ (citation omitted). Other jurisdictions have held that the duties owed to the mortgagor are the duties of an agent and of a fiduciary. See Prudential Ins. Co. v. Executive Estates, Inc., 369 N.E.2d 1117, 1124-28 (Ind. Ct. App. 1977) (mortgagee had a fiduciary duty to mortgagor arising from an express agreement, custom and practice in the real estate industry, and the existence of a principal-agent relationship); Bollinger v. Livingston State Bank and Trust Co., 187 So. 2d 784, 787 (La. Ct. App. 1966) (fiduciary relationship arose where bank undertook "to advance money and supervise construction as to quality and quantity as the agent of [mortgagor]" and where bank possessed the mortgage note and building contract); M.S.M. Corp. v. Knutson Co., 167 N.W.2d 66, 68 (Minn. 1969) (fiduciary relationship arose where mortgagee undertook to disburse funds for mortgagor under the construction contract); Garbish v. Malvern Fed. Sav. and Loan Ass'n, 517 A.2d 547, 553 (Pa. Super. Ct. 1986) (fiduciary duty arose where lender insisted on disbursing construction funds without borrower's participation and where lender held itself out as an expert in such disbursal); _see also infra_ notes 108-27 and accompanying text. _But see_ Wooden v. First Sec. Bank, 882 P.2d 995, 997-98 (Idaho 1991) (finding the construction loan agreement did "not impose any duty, fiduciary or otherwise, upon the bank to supervise the disposition of the loan proceeds"); Crum v. AVCO Fin. Servs., 552 N.E.2d 823, 829 (Ind. Ct. App. 1990), discussed _infra_ notes 101-11 and accompanying text; Parker v. Columbia Bank, 604 A.2d 521, 533 (Md. Ct. Spec. App. 1992) (recognizing the general rule that "the relationship between a bank and its customer does not ordinarily impose a fiduciary duty on the bank"); Gardner Plumbing, Inc. v. Cottrill, 338 N.E.2d 757, 759-60 (Ohio 1975) (holding that mortgagee-mortgagor relationship, where mortgagor exercises some control over disbursement of loan proceeds, does not make mortgagee liable as mortgagor's agent); Linder v. Citizens State Bank, 528 S.W.2d 90, 94 (Tex. Ct. App. 1975) (finding no fiduciary relationship results from the mortgagee's financing of the mortgagor's construction).

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20 Garbish, 517 A.2d at 554.
21 See Prudential, 369 N.E.2d at 1123-25 (express agreement existed, whereby mortgagee was mortgagee's agent, when the mortgagee assured the mortgagor it "would take care of" all liens and encumbrances); Garbish, 517 A.2d at 553-54 (lender orally claimed to be an expert in distributing construction funds and the court held that it would be judged by "the standard of care of an expert").
22 See Bollinger, 187 So. 2d at 787; M.S.M. Corp., 167 N.W.2d at 68; _infra_ notes 112-15 and accompanying text.
23 See, e.g., Clark v. Kansas Sav. & Loan Ass'n, 608 S.W.2d 493, 496 (Mo. Ct. App. 1980) ("making of periodic inspections . constitutes normal procedure for [lending institution] and does not impose upon lender a fiduciary duty"); _see also_ Thorstenson, _supra_ note 5, at 202-03 (discussing
C. Mortgagee Holds Construction Loan Proceeds in Trust for the Mortgagor

Another theory is that the lender holds the loan proceeds in trust for the borrower. One court has held that the duty of a lender that undertakes to disburse the loan proceeds directly to the builder is similar to the duty of a "trustee to hold and disburse funds of a trust estate." The court held that, like a trustee/agent, the lender "should be held liable to [the borrower] for a loss due to the neglect of the [lender] to properly conduct the business undertaken for [the borrower]." The lender, therefore, was "required to use reasonable care to see that mechanics and materialmen were paid by the contractor" and "to use ordinary care to protect [the borrower] from mechanics' liens."

Another court's application of the trust fund analogy held that the lender's duty "was merely to account for the funds belonging to its borrowers either by showing payment to them or to others for their benefit and advantage."

D. A Duty Arises from an Express Written or Oral Agreement

If the construction loan agreement provides that the lender will inspect the construction project or disburse the loan proceeds for the borrower's benefit, the express intention of the parties governs the debtor-creditor relationship and obligates the lender to perform any duty it assumes under the agreement. Moreover, if the lender makes oral representations to the borrower that the lender will perform some task for

liability issues concerning lender inspection provisions for new or existing homes); infra notes 45-78 and accompanying text.

Falls Lumber, 181 N.E.2d at 716; see also Sandpiper North Apartments, Ltd. v. American Nat'l Bank & Trust Co., 680 P.2d 983, 988 (Okla. 1984) (holding that statute incorporating trust fund doctrine could be invoked to impose liability upon lender that exercised control over the construction trust res). But see Butts v. Atlanta Fed. Sav. & Loan Ass'n, 262 S.E.2d 230, 231 (Ga. Ct. App. 1979) (refuting borrower's allegation that the lender held the loan proceeds in trust and that under the loan agreement the lender's inspection of construction progress was for the benefit of the borrower).

Falls Lumber, 181 N.E.2d at 716.

Id.

See Goodner v. Lawson, 232 S.W.2d 587 (Tenn. Ct. App. 1950). To show that payment to others, such as the builder, was for the "borrowers' benefit," the lender need only prove that the borrowers "consciously consented or agreed for the funds due them to be paid directly to [the third party]" in order to exempt the lender from possible liability claims. Id. at 590.

See Wooden v. First Sec. Bank, 822 P.2d 995, 997 (Idaho 1991) ("At common law, a mortgagee was generally not obligated to protect the interest of a mortgagor. A duty would exist only if there is an agreement creating a duty.") (citations omitted); Prudential Ins. Co. v. Executive Estates, Inc., 369 N.E.2d 1117, 1123-25 (Ind. Ct. App. 1977) (noting that ordinarily the mortgagee does not contractually obligate itself to inspect the construction of the project or to ensure the proper application of the loan proceeds; such an arrangement would be contrary to the mortgagee's position as a lender of funds rather than as an insurer of the mortgagor's project, and seldom, if ever, occurs).
the borrower, these representations may bind the lender 29 unless the oral statements are excluded as parol evidence.30

E. The Mortgagee Has an Implied Contractual Duty

The borrower may argue that the lender has an implied contractual duty. One court encountered the implied contract argument where the lender had made periodic inspections of the construction project.31 The court was not impressed with the borrower’s contention and held that an implied contract does not arise merely because the lender makes periodic inspections if the lender’s “financing activity does not extend beyond that of a conventional lender,” reasoning that such inspections are made for the benefit of the lender, not the borrower.32 This ruling illustrates the reluctance of courts to uphold the implied contractual duty argument where there is contrary or inconsistent evidence in the written agreement.33

F. The Mortgagee Assumes the Duty

Some borrowers have argued that the lender, by undertaking to inspect the construction project or by insisting on paying the third-party builder directly, assumes the duty to perform these undertakings for the benefit of the borrower.34 One court addressed the assumption of duty theory in regard to a lender that made periodic

29 See Falls Lumber Co. v. Heman, 181 N.E.2d 713 (Ohio Ct. App. 1961) (oral representation made by the lender “to take care of all matters respecting the proper disbursement of the funds” imposed upon the lender a duty to use “reasonable care” to see that all parties were properly paid and to use “ordinary care” to protect the borrowers from mechanics’ liens placed on their house); see also cases cited supra note 21.


31 See Butts v. Atlanta Fed. Sav. & Loan Ass’n, 262 S.E.2d 230, 232 (Ga. Ct. App. 1979); see also Ulrich v. Federal Land Bank, 480 N.W.2d 910, 912 (Mich. Ct. App. 1991) (finding that neither additional contractual duties nor a separate contract could be implied from bank’s “advertisements, internal policies, pamphlets, and various statements, all of which [were] extrinsic to the loan agreement.”).

32 Butts, 262 S.E.2d at 232.

33 Id.; cf. Davis v. Nevada Nat’l Bank, 737 P.2d 503, 505 (Nev. 1987) (where the lender ignored the borrower’s complaint of substantial construction deficiencies, the court imposed on the lender a duty implied by law. The lender’s liability did not arise “from the loan transaction, but from the [lender’s] later breach of a nonconsensual duty of care in the disbursement of construction loan proceeds. The duty the lender owed the borrower was not implicit in the contract; rather, it was implied by law, independent of the contractual relationship.”); see also infra notes 94-100 and accompanying text.

inspections of the construction project. In deciding whether the lender assumed the duty to make quality as well as quantity inspections for the benefit of the lender, the court cited the Restatement (Second) of Torts and held that ordinarily no duty to inspect arises unless the lender assumes such a duty. For the assumption of duty to work, evidence of some contractual obligation must be present. Interpreting the loan agreement, the court found no evidence that the inspections were undertaken for the benefit of the borrower. The lender, therefore, did not assume the obligation to inspect.

G. A Duty Arises Because the Lender Exerts Excessive Control over the Borrower

The control theory, which underlies the principles of several of the aforementioned theories, involves the situation in which the lender exercises excessive control over the borrower, the borrower’s business, or the construction project. Common law theories upon which lenders have been held liable due to excessive control “include fraud, duress, interference, bad faith and breach of fiduciary duty.” Evidence of excessive control by the lender over a borrower or a borrower’s business includes the existence of a joint venture relationship, a

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35 Id.
36 Id. at 775 n.3.
37 Id. at 775-76.
38 See Wooden v. First Sec. Bank, 822 P.2d 995, 997 (Idaho 1991) (holding that if the lender exercises complete control over disbursement of the funds, a duty to protect the interests of the mortgagor may be imposed). For an excellent discussion of the control theory, see generally Marshall C. Stoddard, Jr., Lyne A. Richardson and David E. Falik, Control Liability For Lenders: Recent Developments, in Commercial Law and Practice Course Handbook Series, Lender Liability Litigation 1990: Recent Developments (Practicing Law Institute ed., 1990).
39 See Stoddard, supra note 39, § 2.
40 Id. Stoddard defines a joint venture as a “common business undertaking where there is an agreement or understanding as to sharing profits and the right of joint control,” although these factors alone will not constitute a joint venture. Id. § A(1). A joint venture usually will not be found between the borrower and lender “unless there is a community of interest” between them and the lender is “too closely intertwined with the business undertakings of the borrower.” Because lenders usually include in the loan agreement language stating in effect that “the relationship between the borrower and lender shall not be construed as a joint venture, courts often reject the joint venture theory of liability.” Id. See also Armetta v. Clevetrust Realty Investors, 359 So. 2d 540, 543 (Fla. Dist. Ct. App. 1978) (holding that there was no joint venture because the lender did not anticipate any profits or losses “beyond those anticipated as interest charged on the money loaned”).
principal-agent relationship, a fiduciary relationship, or lender control of the borrower’s management or finances.

Borrowers have a vast assortment of legal theories and principles on which to base their lender liability claims for quantity or quality defects in the construction project or for misapplication of the construction loan proceeds. The success of these claims primarily depends upon the specific facts and circumstances surrounding the dispute. Nevertheless, it is important to recognize the fact that jurisdictions differ as to what additional duty or standard of care, if any, should be imposed on lenders in such cases. In determining whether a lender has a duty to inspect the construction project or a duty to ensure the proper disbursement and application of loan funds, most jurisdictions perform their analyses on a case-by-case basis with only minimal guidelines.

II. THE RIGHT TO INSPECT: THE LENDER’S RIGHT TO MAKE PERIODIC INSPECTIONS OF THE CONSTRUCTION PROJECT AND CONSEQUENT LIABILITY IMPLICATIONS

A construction lender ordinarily includes in its construction loan agreement a provision allowing the lender to inspect the progress of the construction project. When a construction project encounters quantity or quality defects, borrowers have attempted to construe the lender’s contractual right to inspect as a duty to ensure proper application of the

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42 See Stoddard, supra note 39, § B(1). The article refers to RESTATEMENT (SECOND) OF AGENCY § 14-O cmt. a (1957), which addresses when a lender may become a principal for the borrower’s obligations due to excessive control:

[If the lender] takes over the management of the debtor’s business either in person or through an agent, and directs what contracts may or may not be made, he becomes a principal, liable as any principal for the obligations incurred thereafter in the normal course of business by the debtor who has now become his general agent. The point at which the creditor becomes a principal is that at which he assumes de facto control over the conduct of his debtor, whatever the terms of the formal contract with his debtor may be.

Id.; cf. supra notes 19-23 and accompanying text (discussing the theory that the lender may become the implied agent of the creditor in some circumstances).

43 See Stoddard, supra note 39, § C(1) ("[W]here the lender offers financial advice and counseling, and reliance by the borrower is established, a fiduciary relationship may result."); see also supra notes 19-23 and accompanying text.

44 See Stoddard, supra note 39, § D ("Lender control issues often arise where loan agreements include provisions whereby a lender has the right to make financial decisions or influence management.").


46 For examples of quantity and quality defects, see supra notes 3-4.
construction loan proceeds for the completion of a project free of defects.  47

The main question courts must answer when confronted with such an allegation is whether the right to inspect is for the borrower’s benefit and thus imposes upon the lender the duty to monitor the construction project by making periodic inspections and to ensure proper application of the loan proceeds.  48 Most jurisdictions side with the lender on this issue, holding that the lender’s inspections are not for the benefit of the borrower, but rather are for the lender’s benefit.  49

In Henry v. First Federal Savings & Loan Ass’n,  50 a savings and loan association entered into a construction loan agreement with a borrower who was having a home built. As construction progressed on the house, a savings and loan employee conducted approximately six inspections of the property. After the house was completed, the borrower detected numerous quality defects. The borrower brought an action against the lender that included breach of contract and negligence claims.

Under the loan agreement, the lender had the right to enter the premises and conduct inspections “for its own protection,” and the agreement stipulated that the lender “assumed no responsibility for the completion of said building according to the plans and specifications.”

The court held that the clear and unambiguous language of the loan agreement precluded any finding that the lender had a duty to inspect for quality of workmanship or for the quantity of work completed before disbursing the construction loan funds: “[O]rdinarily the law does not impose a duty upon the mortgagee/lender to inspect the mortgaged property for the benefit of the mortgagor/borrower, unless the mortgagor/lender has otherwise assumed such a duty.”

To determine the extent of the lender’s obligation, the court looked to the construction loan agreement and found interpretation of the agreement to be “a question of law for the court” to decide.  54 The court was persuaded by the “clear and unambiguous” language of the loan agreement, which gave the lender the right to inspect for its own benefit and not as a duty owed for the benefit of the borrower, and affirmed the lower court’s granting of summary judgment for the lender.  55

47 See, e.g., Butts, 262 S.E.2d at 231-33.
48 Id.
49 See supra note 45 and accompanying text.
51 Id. at 773-74.
52 Id. at 775.
53 Id. at 774; see also supra notes 34-38 and accompanying text.
54 Id. at 775.
55 Id. at 775-76.
In *Light v. Equitable Mortgage Resources, Inc.*, the borrowers, who contracted with a developer to construct two homes, brought an action against the mortgage company that financed the construction project. The borrowers alleged that the mortgage company had negligently administered the loan and misappropriated the loan funds. In affirming the granting of the lender's motion for summary judgment, the court reasoned that where the lender undertook no duties for the benefit of the borrowers here, the lender owed the borrowers no duty with regard to the disbursements of the construction loan proceeds. The contractual provision giving the lender the right to inspect and withhold advances if it was not satisfied with the progress of construction *inured to the benefit of the lender*, and any failure of the lender to exercise that contractual right provided the borrowers no basis for complaint. Accordingly, the borrowers could have no claim against the lender for negligent disbursement of the loan funds.

In so ruling, the court emphasized that the lender "did nothing that it was unauthorized to do" under the loan agreement signed by the borrowers.

As *Henry* and *Light* indicate, the customary practice of inspection is ordinarily for the benefit of the lender, not the borrower. Most authorities appear to follow this same principle.

A minority of jurisdictions, including Mississippi, Alaska, Minnesota, Louisiana and Florida, impose some additional duty

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55 Id. at 143-44.
56 Id. (emphasis added).
57 Id. at 144.
58 See, e.g., cases cited supra note 45.
59 See Cook v. Citizens Sav. & Loan Ass'n, 346 So. 2d 370, 372 (Miss. 1977) (imposing upon the construction lender a duty to use reasonable diligence to ensure that funds are actually used to pay costs of construction).
60 See Fikes v. First Fed. Sav. & Loan Ass'n, 533 P.2d 251, 261 (Alaska 1975) (establishing the lender's duty as one owed to the borrower to administer loan proceeds in a conventional manner and with due care, including the duty to provide corroborating evidence of expenses incurred conducting on-site inspections of the project).
61 See M.S.M. Corp. v. Knutson Co., 167 N.W.2d 66, 68 (Minn. 1969) (holding that the duty of the lender is to properly apply and account for all proceeds intended to be expended for the benefit of the borrower).
62 See Bollinger v. Livingston State Bank and Trust Co., 187 So. 2d 784, 786-87 (La. Ct. App. 1966) (finding that once the bank exercised its right to inspect the project its duty to the homeowner became that of a fiduciary, and the bank was thereafter responsible for supervising construction for quality and quantity).
63 See Comet Dev. Corp. v. Prudential Ins. Co., 579 So. 2d 355 (Fla. Dist. Ct. App. 1991) (holding that the obligation of the construction mortgagee is a duty to disburse the funds with reasonable care for the benefit of the owner); Security & Inv. Corp. v. Droege, 529 So. 2d 799, 802 (Fla. Dist. Ct. App. 1988) (explaining that the nature of a construction loan imposes upon the
based on the lender's right to inspect. In general, these jurisdictions recognize the construction lender's affirmative duty to ensure the proper application of the construction loan proceeds. This line of reasoning impliedly imposes upon the lender a duty to inspect the construction project not only for its own benefit but for the borrower's benefit as well.

Security & Investment Corp. v. Droge, a Florida decision, illustrates that state's treatment of the right to inspect, and is also indicative of the Mississippi and Alaska stances on the issue. The Droge court found the construction lender's obligation to the borrower to be as follows: "A construction mortgage is essentially a mortgage to secure future advances, and the mortgagee assumes the duty to use reasonable care to see that the funds are used to pay for the materials and supplies and work done on the job." This may imply that in order to fulfill such a duty, the lender should make periodic inspections of the construction project, but the court, however, did not explicitly address this issue.

An earlier Florida decision to some degree contradicts the Droge holding. In Armetta v. Clevertrust Realty Investors, the court held that "provisions in the mortgage for inspection by the lender of the project do not give rise to a duty by the lender to the purchaser-mortgagor to see that the project is properly constructed." Absent any unusual circumstances, such a provision is "solely for the protection of the lender."

It is difficult to reconcile the Droge and Armetta holdings regarding the lender's duty to inspect. What is apparent, however, under the more recent Droge decision, is that the lender has a duty mortgagee a duty to use reasonable care in advancing funds to pay for necessary materials and supplies); Kalbes v. California Fed. Sav. & Loan Ass'n, 497 So. 2d 1256 (Fla. Dist. Ct. App. 1986) (describing the lender's duty as one owed to the owner and one requiring the exercise of reasonable care to ensure that payments to contractors are made properly).

See supra notes 61-62 and accompanying text.
Id. at 802.
Periodic inspections by the lender would seem to be the best and perhaps the only way to properly perform this duty.
Id. at 543.

The court cited Dunson v. Stockton, Whatley, Davin & Co., 346 So. 2d 603, 606 (Fla. Ct. App. 1977), for the proposition that under certain circumstances "the lender assume[s] complete control of the developer-borrower's building operations." Armetta, 359 So. 2d at 542. The Armetta court also distinguished Armetta from Connor v. Great Western Sav. & Loan Ass'n, 447 P.2d 609, 616 (Cal. 1968), in which "the lender had acted beyond the role of lender and had become an active participant, along with the developer, in the home construction enterprise." Armetta, 359 So. 2d at 542.
to see that the loan proceeds are properly disbursed to pay for the construction costs. Whether fulfilling this obligation requires periodic inspections has yet to be determined. 74

In Minnesota and Louisiana, the courts have imposed a fiduciary duty based solely on the lender's control over disbursement of the loan proceeds. 75 Other jurisdictions, in certain unusual circumstances, have imposed a higher duty of care due to the lender's oral representations to the borrower. 76 Even without such oral assurances, the duty to inspect the project for the borrower's benefit has in some cases been held to be implicit in the lender's obligation to the borrower. 77

While most jurisdictions recognize that a lender's right to inspect is for the benefit of the lender and not for the borrower, a few jurisdictions seem to imply that such inspections are for the borrower's benefit. 78 This determination will in each case depend upon the facts and circumstances surrounding the transaction.

III. LIABILITY BASED ON THE LENDER'S DISBURSEMENT OF CONSTRUCTION LOAN PROCEEDS DIRECTLY TO THE BUILDER

Construction lenders may disburse the construction loan proceeds to the borrowers, who in turn pay the contractors and suppliers as progress is made on the construction project. In such cases courts are generally reluctant to impose any liability upon the lender for improper application of the construction loan proceeds. 79

Where the lender disburses the construction loan proceeds directly to the builder without the borrower's joint approval, however, the

74 See supra note 69 and accompanying text.
75 See supra notes 63-64 and accompanying text; Bollinger v. Livingston State Bank and Trust Co., 187 So. 2d 784, 786 (La. Ct. App. 1966) (The bank assumed the duty to disburse funds without the prior approval of the borrower. Progress payments were made after inspection of the project by the bank to assure compliance with the specifications and also to assure that the required quantity of work had been performed.); M.S.M. Corp. v. Knutson Co., 167 N.W.2d 66, 68 (Minn. 1969) (finding lender has fiduciary obligation to borrower when it "undertakes to disburse funds for mortgagor under a construction contract"; lender's duty includes accounting for all funds expended on behalf of borrower).
77 See, e.g., cases cited supra note 21.
78 See supra notes 61-69.
79 See supra notes 61-77 and accompanying text.
76 See supra note 21.
77 See Prudential Ins. Co. v. Executive Estates, Inc., 369 N.E.2d 1117 (Ind. Ct. App. 1977). In Prudential, the court recognized that ordinarily "a mortgagee is not required to protect the interests of the mortgagor unless an agreement requires him to do so." Id. at 1123 (quoting 59 C.J.S. Mortgages § 298 (1949)). "But the mortgagee must place the mortgage proceeds in the hands of the mortgagor, or at least see they are applied in accordance with the mortgagor's intentions "and the mortgagor may direct or acquiesce in the disbursement of the proceeds of the loan by the mortgagee." Id. at 1123-24 (quoting 59 C.J.S. Mortgages § 297 (1949)); see also Wooden v. First Sec. Bank, 822 P.2d 995, 997 (Idaho 1991); Garbish v. Malvern Fed. Sav. & Loan Ass'n, 517 A.2d 547 (Pa. Super. Ct. 1986).
lender may be exposing itself to unwelcome liability if it does not take certain lending precautions. Jurisdictions are split over the issue of what duties, if any, a lender owes to a borrower when the lender controls the disbursement of the loan proceeds to the contractor, a party not subject to the loan agreement.

A. Jurisdictions Reluctant to Impose an Additional Duty upon the Lender That Disburses Construction Loan Proceeds Directly to the Builder

Daniels v. Big Horn Federal Savings & Loan Ass'n is helpful in analyzing the stances various jurisdictions have taken in determining what additional duty the lender undertakes when it disburses loan proceeds directly to the contractor. The Danielses, plaintiffs-borrowers, sued Big Horn Savings & Loan Association for the negligent disbursement of construction loan proceeds during the construction of the Danielses’ home. Big Horn disbursed the loan proceeds directly to the general contractor. Prior to the lender’s disbursal of the loan proceeds, Mr. Daniels had signed an acknowledgement form of the list of payments Big Horn was to make. After the loan proceeds were exhausted but the house only partially completed, the contractor walked off the job, leaving several unpaid bills. Another builder completed the house at a substantially increased cost to the Danielses. The original contractor had been having financial difficulties, of which the bank was aware.

The court acknowledged that Big Horn was obligated to disburse the loan proceeds with due care in order to protect the Danielses. The main issues the court considered, however, were whether the savings and loan owed a higher standard of care to the Danielses and whether this duty of care was discharged.

Finding no Wyoming precedent on the issue, the court looked to other jurisdictions for help and found a split of authority. Several of the jurisdictions consulted had concluded that the lender was

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10 See infra notes 138-50 (discussing ways in which a lender can protect itself).
11 See Daniels v. Big Horn Fed. Sav. & Loan Ass’n, 604 P.2d 1046, 1048-49 (Wyo. 1980) (basing the decision on a comparison of courts that concluded a duty to the borrower existed and courts that refused to hold the lender to any special duties arising from the disbursement of funds directly to the contractor).
12 604 P.2d 1046 (Wyo. 1980).
13 Id. at 1047-48.
14 Id. at 1047.
15 Id.
16 Id. at 1048-49.
obligated to protect the borrower's interest in the construction project. Other courts had disagreed.

After analyzing the other states' decisions, the *Daniels* court held that Big Horn was not liable for the negligent disbursement of the loan proceeds. Crucial to this determination was the fact that Big Horn did not expressly assume through written or oral agreement any duty of care to the borrowers. Furthermore, Big Horn had followed the usual and customary practices in administering the loan, including obtaining the borrowers' prior written approval of the disbursement procedure. The court, finding that the borrowers had "failed to show what duty of care Big Horn owed," affirmed summary judgment for the lender.

*Davis v. Nevada National Bank* presents a more definitive set of criteria for determining whether a construction lender should be held liable for the misapplication of loan funds. The *Davis* court listed the following elements to be considered when deciding whether to hold a lender liable under a construction loan arrangement:

1. the lender assumes the responsibility or the right to distribute loan proceeds to parties other than its borrower during the course of construction;
2. the lender is apprised by its borrower of substantial deficiencies in construction that affect the structural integrity of the building; (3) the borrower requests that the lender withhold further distributions of loan proceeds pending the satisfactory resolution of the construction deficiency;
4. the lender continues to distribute loan proceeds in complete disregard of its borrower's complaints and without any bona fide attempt to ascertain the truth of said complaints; and (5) the borrower ultimately is damaged because the substance of the borrower's complaints was accurate and the borrower is unable to recover damages against the contractor or other party directly responsible for the construction deficiencies.

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89 Daniels, 604 P.2d at 1050.
90 Id. at 1049-50.
91 Id. The court found that it was "unusual for a Wyoming lender to obtain lien waivers before the project is completed." Id. at 1050.
92 Id. at 1047.
93 Id. at 1050.
95 Id. at 506; see also Construction Lender Must Inspect Premises and Stop Payments on
The borrowers in *Davis* had instructed the bank to stop making payments to the contractor after "serious" construction deficiencies were discovered.96 Because the bank retained the funds pending distribution and distributed the loan proceeds itself, the court held that the lender was "not totally free to disregard the interests of its borrower."97

The court stated that a lender normally has no duty to exercise care in identifying quality or quantity deficient construction or to accede to a request by the borrower to withhold payment from a contractor for minor construction deficiencies. In this case, however, the court held that it would be "unjust to permit a lender, with impunity, to simply disregard a borrower’s complaint of substantial construction deficiencies affecting the structural integrity of a project."98

The *Davis* court noted that the bank’s liability did not arise from the loan transaction, but from its later "breach of a nonconsensual duty of care" in the disbursement of the construction loan proceeds.99 The bank’s duty was implied by law, independent of the parties’ agreement, and required the bank "to conduct a reasonable investigation" as to the validity of the borrower’s complaint.100 *Davis* thus illustrates not only the general reluctance of courts to impose lender liability based solely on direct disbursement provisions, but also the willingness of some courts to do so when certain aggravating factors are present.

*Crum v. AVCO Financial Services, Inc.*,101 is another example of a court’s reluctance to hold a lender liable for negligent disbursement where the lender controlled the disbursement of the construction loan proceeds. The *Crum* court held that a lender who "agrees to disburse loan proceeds is bound to exercise due care in the performance of this obligation. . . A [m]ortgagee who agrees to apply the proceeds for a certain purpose is liable for a failure to do so, or negligence in the performance of that duty."102 Despite finding that the lender had a duty of due care, the *Crum* court rejected the borrower’s arguments alleging lender liability for misapplication of the loan proceeds.103

The borrower pointed to a section of one of the lender’s loan documents entitled "Amounts Paid to Others on Your Behalf" as evidence of the lender’s control over disbursement.104 The borrower

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*Request, Court Says, 49 Banking Rep. (BNA) No. 1, at 25 (July 6, 1987).*

96 *Davis*, 737 P.2d at 504-05.

97 Id.

98 Id. at 506.

99 Id. at 505.

100 Id.


102 Id. at 827.

103 Id.

104 Id. at 828.
suggested that the title to this section meant "amounts paid for your [the borrower's] benefit." The court refuted this contention and found it was equally likely that the parties intended the phrase to mean "amounts paid by the lender as the borrower's representative."

The borrower also argued that the lender's agreement to disburse the loan proceeds created an agency relationship between the lender and the borrower, from which arose a fiduciary relationship that obligated the lender to act primarily in the borrower's interest. The court rejected this argument and stated that "[t]ypically, mortgagees are not agents for the mortgagor; they have not undertaken to exercise such power primarily for the benefit of the mortgagor." By looking at the lending industry's local customary procedures, the court was persuaded that "controlling the disbursement of loan proceeds [was] undertaken as a means of protecting the lender, not the borrower."

Furthermore, the court held that the existence and breach of a duty on the lender's part to ensure proper disbursement of the construction loan did not necessarily give rise to an inference that the lender proximately caused the borrower's injury. Liability could be found only where the lender's activity or inactivity was also proven to have proximately caused the quantity or quality defect.

### B. Jurisdictions That View Direct Disbursement of Loan Proceeds to the Contractor as a Basis for Imposing a Higher Duty upon the Lender

Two jurisdictions have held that a fiduciary duty arises on the part of the lender solely because the lender undertakes to disburse the loan proceeds for the borrower. In *M.S.M. Corp. v. Knutson Co.*, the Minnesota Supreme Court held that a fiduciary duty falls upon the lender if it disburses the loan proceeds directly to the contractor. The court found that the mortgagee has the duty not only to apply all of the proceeds to the use of the mortgagor without diverting them for unrelated obligations incurred by contractors or subcontractors, but also to account for all the

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105 *Id.*
106 *Id.*
107 *Id.* at 829.
108 *Id.*
109 *Id.*
110 *Id.* at 831.
111 *Id.*
112 *Id.*
113 *Id.*
114 *Id.*
116 *M.S.M. Corp.*, 167 N.W.2d at 68.
117 *Id.*
sums expended on behalf of the mortgagor and to furnish adequate proof of the amount paid and the purpose of the disbursement.\(^{115}\)

Another court likened the lender's control of disbursement to that of "a trustee holding and disbursing funds of a trust estate."\(^{116}\) The court relied on the general principles of agency law in finding that the lender had a duty to use reasonable care to ensure that the contractor paid the suppliers and subcontractors.\(^{117}\)

In *Garbish v. Malvern Federal Savings and Loan Ass'n*,\(^{118}\) the lender insisted on distributing the loan funds without providing the borrower any notice of how and when the funds were distributed.\(^{119}\) The court criticized this unusual demand and emphasized the lender's duty as an implied agent for the borrower.\(^{120}\)

The *Garbish* court based its holding on the fact that the savings and loan mortgagee exercised exclusive control over disbursing the loan funds to the builder.\(^{121}\) Not only did the mortgagee refuse to allow the mortgagor any control over disbursement, it also claimed to be an expert in distributing construction loan proceeds.\(^{122}\) When approximately ninety percent of the loan proceeds had been disbursed but only forty percent of the house was completed, the mortgagor brought suit against the mortgagee for trespass and assumpsit.\(^{123}\)

The court recognized that to protect the mortgagee from liability, the "loan funds must actually come into the hands of the mortgagor or his agent absent some other arrangement between the parties."\(^{124}\) Where the mortgagee controls disbursement, the court followed other jurisdictions that "have found the mortgagee liable for improper disbursement . . .," absent an express agreement governing the distribution, "on the theory that the mortgagee became the agent of the mortgagor."\(^{125}\) Because this

\(^{115}\) Id.

\(^{116}\) Falls Lumber Co. v. Heman, 181 N.E.2d 713 (Ohio Ct. App. 1961) (savings association required mortgagor to permit it to disburse the loan proceeds). See also supra notes 24-27.

\(^{117}\) Id. at 716.


\(^{119}\) Id. at 553.

\(^{120}\) Id.; see also Prudential Ins. Co. v. Executive Estates, Inc., 369 N.E.2d 1117, 1124 (Ind. Ct. App. 1977) (another unusual case in which the mortgagee orally represented to the mortgagor that it "would take care of" all liens and encumbrances).

\(^{121}\) *Garbish*, 517 A.2d at 553.

\(^{122}\) Id.

\(^{123}\) Id. at 550.

\(^{124}\) Id. at 551.

was an agency relationship, the court held that the lender owed the borrower "a fiduciary duty and its conduct must be measured against the standard of care owed by a fiduciary." Moreover, because the lender represented itself as an expert, it was judged by the higher standard of care of an expert fiduciary.

As the preceding section shows, there is no clear method for determining the extent of a lender’s liability should the lender directly disburse the loan proceeds to the builder. The crucial factors are the amount of control exercised by the lender over the disbursement and whether the lender demanded this control. Another critical factor is the extent of the borrower’s involvement in approving each of the builder’s draw requests.

Jurisdictions are split over these issues. Some jurisdictions are reluctant to impose liability, while others are not. In Davis v. Nevada National Bank, a five-prong test was used to evaluate the lender’s liability. Most jurisdictions, however, are not clear about the requisite elements for imposing a duty. In certain jurisdictions, a lender that controls disbursement automatically becomes an agent and fiduciary of the borrower. Other jurisdictions are not so quick to judge. Furthermore, one jurisdiction that imposed a duty on the lender was still unclear about the scope of the duty.

Nonetheless, in order to protect itself from the uncertainty surrounding the issue, a lender should adhere to certain basic guidelines when disbursing construction loan proceeds.

IV HOW A LENDER CAN PROTECT ITSELF FROM CLAIMS OF IMPROPER DISBURSEMENT OF LOAN PROCEEDS

Several practical measures can be taken by a lender to avoid liability for the improper disbursement or misapplication of construction loan proceeds.

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126 Id. at 554.
127 Id.
128 See supra notes 82-127 and accompanying text.
129 See supra notes 82-111 and accompanying text.
130 See supra notes 112-27 and accompanying text.
131 See supra notes 19, 82-93 and accompanying text.
132 See supra notes 19-23, 112-27 and accompanying text.
133 See supra notes 82-111 and accompanying text.
134 See supra notes 82-93 and accompanying text.
135 See supra notes 82-111 and accompanying text.
136 See supra notes 82-93 and accompanying text.
Obviously, the best safeguard, though usually the most difficult to achieve, is to prevent quantity or quality defects from arising in the first place. The lender cannot simply rely on the borrower to protect the lender's primary interest in repayment of the loan. The lender should closely monitor the disbursement of the loan proceeds and the progress of the construction project for its own benefit.\textsuperscript{138} The lender also must be aware of the creditworthiness and construction or development experience of the borrower. The lender should be alert for developers or contractors with bad reputations or financial difficulties.\textsuperscript{139} The lender should communicate with the borrower on a regular basis to keep abreast of any new information concerning the construction loan or project. Records of such communications should be preserved.

The lender should always include an exculpatory clause or merger clause in the loan agreement and any subsequent agreements between the lender and the borrower.\textsuperscript{140} Exculpatory clauses are generally valid unless contrary to public policy.\textsuperscript{141} As long as the terms of the exculpatory clause are unambiguous and conspicuously written in the contract, such a clause will be enforced.\textsuperscript{142} The lender should specifically exculporate itself from any obligation to inspect or monitor the construction project. This exculpatory clause should include language stating that any inspections the lender does perform are

\textsuperscript{138} Construction lenders must protect their own interests and ensure that the building or construction project, which is customarily their primary source of collateral, is properly completed so that it may be sold or leased. See generally Richard D. Jones, \textit{How to Spot Construction Warning Signs}, 1986 ABA \textit{BANKING J.} 100 (listing nine danger signals to help save a construction loan before it is too late); Donald H. Piser, \textit{Lending Management Vital to Construction Completion: Controlling Costs, Quality, Overruns Can Save on Loan Losses}, \textit{AM. BANKER}, Oct. 12, 1982, at 27 (discussing the importance of external construction loan management before and during the lending process).

\textsuperscript{139} In the lender's analysis of whether a developer or contractor is experiencing financial difficulties, it is very important to determine whether the developer or contractor has more than one company or project underway at the same time. Should these other companies or projects be having financial or cash flow problems, the developer or contractor may be tempted to divert funds to save these other companies or projects. Thus, up-to-date financial information on these other companies or projects is imperative.

\textsuperscript{140} See Parker v. Columbia Bank, 604 A.2d 521, 531 (Md. Ct. Spec. App. 1992) (holding that section in loan contract governing lender's duty to disburse is for lender's protection, not the borrower's; also finding that duty of good faith and fair dealing in a contract is breached only by bad faith in performance of that contract and does not bar the lender beyond the loan agreement's terms); Davis v. Nevada Nat'l Bank, 737 P.2d 503, 505 (Nev. 1987) (holding that although exculpatory clauses may relieve a lender of specific contractual duties, the lender cannot disavow duties implied at law and independent of the contract); Henry v. First Fed. Sav. & Loan Ass'n, 459 A.2d 772, 775 (Pa. Super. Ct. 1983) (holding that the unambiguous language of the lending contract disclaimed any duty on the part of the lender to inspect for construction deficiencies).

\textsuperscript{141} See, e.g., Merritt v. Nationwide Warehouse Co., 605 S.W.2d 250, 255 (Tenn. Ct. App. 1980) ("When the terms of a written instrument are unambiguous, the interpretation of the contract is a matter of law for the court," and the general rule is that exculpatory clauses are valid.).

\textsuperscript{142} \textit{Id.}
solely for the lender's benefit. If the lender insists on disbursing the loan proceeds directly to the builder, the same sort of exculpatory language should be included in the loan agreement.

Because several jurisdictions have imposed upon the lender a higher duty or standard of care where the lender disburses the loan funds directly to the third party builder, disbursement of the loan proceeds directly to the borrower is another safeguard the lender might wish to take. However, most jurisdictions will not impose a duty on the lender if the lender requires prior or concurrent approval from the borrower for disbursing funds to the builder. Therefore, where the lender does control the disbursement, it is important to obtain and document the borrower's written approval of the funding of each construction draw request.

The lender should also require the borrower to protect itself against quality or quantity defects in some other way, such as through the purchase of a surety or contract completion bond. This may provide the borrower an alternative form of protection: instead of pursuing the lender for redress of his grievances, the borrower may look to the surety company.

Although this list of safeguards is by no means complete, a point worth reemphasizing is the importance of preserving all documentation, including correspondence with the borrower and third parties, relating to the construction project. Should the lender find itself in court defending a claim that it misapplied loan proceeds or breached its duty to ensure completion of a construction project free of any quantity or quality defects, proper documentation of the loan arrangement, including the express written exculpatory provisions, will be invaluable.

CONCLUSION

Most jurisdictions have rejected the argument that a construction lender has a duty to inspect the borrower's construction project for the

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143 See supra note 140 and accompanying text.
144 See supra note 140 and accompanying text.
145 See supra notes 112-27 and accompanying text.
146 See supra notes 82-111 and accompanying text.
147 See supra notes 82-93 and accompanying text.
148 See Davis v. Nevada Nat'l Bank, 737 P.2d 503, 506 n.2 (Nev. 1987) (addressing the loan contract in terms of the fiduciary duty but expressing no opinion as to the legal effect of the contract language requiring the borrower to secure some sort of contract completion bond). Surety bonds "are common in the context of construction contracts where the surety guaranties to the owner that construction will be completed (performance bond) and that subcontractors and suppliers will be paid (payment bond)." JONATHON A. EDDY & PETER WINSHIP, COMMERCIAL TRANSACTIONS 66 (1985).
149 This includes all draw request forms with the borrower's approval evidenced by the borrower's signature.
150 See supra notes 140-44 and accompanying text.
borrower's benefit. Likewise, most courts have refused to hold the lender responsible for ensuring the proper application of the loan proceeds for the completion of a defect-free project. However, a few jurisdictions have held that the lender may have an implied duty to inspect for the borrower's benefit.

The minority and those jurisdictions that have not yet encountered the "for whose benefit" issue must realize that a lender's duty is to protect the assets of its shareholders and depositors, not those of its borrowers. "[I]f our financial institutions are to remain solvent, [it is most important] to prevent a conventional money lender from having to insure every business venture. This policy is particularly necessary in the construction lending business where risks are so great."

Moreover, lenders do not have the "specialized, technical competence to act as builders," and when they do not represent to borrowers that they have such expertise, it is unreasonable to require them "to acquire such competence ." Under such circumstances the lender would be unnecessarily duplicating the role of the developer-borrower. Consequently, the increased cost of financing, due to the lender's additional obligation, would merely be passed on to the developer-borrower.

An equally important concern is determining the duty and standard of care a lender owes the borrower when the lender disburses the construction loan proceeds directly to the builder. Absent an express agreement to the contrary or unusual circumstances, the theory that the lender that disburses loan proceeds directly to the builder thereby becomes an implied agent and/or fiduciary of the borrower is much too severe. Although the additional duties this theory imposes upon the lender can be avoided if the lender disburses the loan proceeds to the borrower, disbursement directly to the builder provides some benefits to the lender.

Courts must recognize that the lender disburses directly to the builder for its own administrative convenience and for its own benefit. The lender

\[\text{151 See supra notes 45-60 and accompanying text.} \]
\[\text{152 See supra notes 45-60, 82-111 and accompanying text.} \]
\[\text{153 See supra notes 61-69, 75-78 and accompanying text; see also supra notes 112-27 and accompanying text.} \]
\[\text{156 See supra notes 21, 39-44, 72, 118-27 and accompanying text (illustrating situations that may justify the imposition of a higher duty of care upon the lender).} \]
\[\text{157 See supra notes 19-23, 63-64, 75, 112-17 and accompanying text.} \]
is merely ensuring that the loan proceeds are used solely for the purpose of funding construction costs. If the lender follows the terms of the construction loan agreement, the lender should only be obligated to exercise reasonable care in disbursing the appropriate amount to the builder. No additional duty or higher standard of care should be imposed. Even without the borrower’s prior approval of each draw request, the duty of care owed by the lender should be limited to the standard of reasonable care.

The lender is the financier, not the insurer, of the construction project. Any extra duty imposed upon the lender only increases the costs of financing. The lender merely provides the funds, and any extra steps are undertaken strictly to protect its interest in repayment. Several jurisdictions have confused the lender’s duty to the borrower with the lender’s duty to its shareholders. To reduce this confusion, courts must recognize that claims that attempt to impose upon the lender a duty to inspect the construction project or to ensure the proper application of the loan proceeds are frivolous and unsound; where the lender adheres to the terms of the construction loan agreement and makes no unusual demands or representations, courts must dismiss such claims for failure to state a claim or must grant summary judgment in favor of the lending institution.

*Douglas C. Franck*

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161 See supra note 154 and accompanying text.

162 Where no duty is present, a valid claim cannot be stated. See Fed. R. Civ. P. 12(b)(6).
