

**UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF NEW YORK**

In Re

KENNETH A. GLASGOW,

Debtor.

CASE NO. 91-21116

ROBERT S. COOPER, TRUSTEE,

Plaintiff,

A.P. NO. 93-2083

vs.

GERALD MADALENA & SALLY MADALENA,

Defendants.

DECISION & ORDER

BACKGROUND

On April 23, 1991, Kenneth A. Glasgow (the "Debtor") filed a petition initiating a Chapter 7 case, and on April 29, 1991, the Office of the United States Trustee appointed a Trustee (the "Trustee"). On his schedules, the Debtor listed a leasehold interest in property known as 2570 Baird Road, Penfield, New York ("2570 Baird Road") which he valued at \$250,000.00. The Debtor also listed Gerald Madalena as the holder of a first mortgage of \$258,000.00 on 2570 Baird Road and as the lessor of the property. On April 28, 1993, the Trustee commenced an adversary proceeding against Gerald Madalena and Sally Madalena (the "Madalenas"). The Trustee's complaint (the "Complaint") alleged and the Madalenas admitted in their Answer the following facts: (1) the Madalenas and the Debtor entered into a 75-year lease of the land at 2570 Baird Road (the "Lease"), which was dated May 19, 1989 and provided for a 75-year renewal option and an annual rent of \$1.00; (2) the Lease was recorded in the Monroe County Clerk's Office on September 14, 1989 in Liber 7730 of Deeds, Page 107; (3) the Madalenas conveyed the building and fixtures at 2570 Baird Road to the Debtor by warranty deed dated June 30, 1989, which was recorded in the Monroe

County Clerk's Office on September 14, 1989 in Liber 7730 of Deeds at Page 119; (4) the Debtor executed and delivered a \$250,000.00 promissory note (the "Promissory Note") and a Security Agreement (the "Security Agreement"), each dated May 19, 1980 in favor of the Madalenas; (5) the Security Agreement granted to the Madalenas a security interest in the building and fixtures located at 2570 Baird Road to secure the Promissory Note; and (6) the Security Agreement was recorded in the Monroe County Clerk's Office on September 14, 1989 in Liber 7730 of Deeds at Page 124.

The Complaint further alleged that the Security Agreement was not duly "perfected" because it was filed in the Monroe County Clerk's Office in the Liber of Deeds not in the Liber of Mortgages, and, therefore, the Trustee could avoid the lien of the Security Agreement pursuant to Section 544¹.

¹ Section 544 provides:

(a) The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by—

(1) a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists;

(2) a creditor that extends credit to the debtor at the time of the commencement of the case, and obtains, at such time and with respect to such credit, an execution against the debtor that is returned unsatisfied at such time, whether or not such a creditor exists; or

(3) a bona fide purchaser of real property, other than fixtures, from the debtor, against whom applicable law permits such transfer to be perfected, that obtains the status of a bona fide purchaser and has perfected such transfer at the time of the commencement of the case, whether or not such a purchaser exists.

The Complaint also sought to avoid both prepetition (\$6819.69) and postpetition (approximately \$54,557.52) payments made to the Madalenas on the Promissory Note secured by the alleged unperfected Security Agreement pursuant to Section 547, as preferential payments, and Section 549, as unauthorized postpetition payments. In their answer of June 3, 1993, the Madalenas set forth a number of affirmative defenses, the principal one being that the Security Agreement was properly recorded in the records of the Monroe County Clerk's Office, was discoverable by and through any competent search of those records and gave full and complete notice of the transaction to any and all interested parties.

The Court conducted pretrial conferences in this adversary proceeding on July 20, 1993, August 17, 1993 and October 19, 1993. At the October 19, 1993 pretrial during which the attorneys for the parties indicated that they did not believe that there were any disputed issues of fact, a scheduling order was entered which instructed the Trustee to file a motion for summary judgment by no later than October 29, 1993 or the case would be dismissed on the merits without costs. On October 29, 1993, the Trustee filed a Motion for Summary Judgment (the "Trustee Motion"), and thereafter the Madalenas filed a Cross-Motion for Summary Judgment (the "Madalena Cross-Motion").

The Trustee Motion asserted that the Madalenas should be estopped from claiming a mortgage on 2570 Baird Road, because the Madalenas had specific intentions not to create or file a mortgage. In support of this position that the Court should not now find the Security Agreement

(b) The trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502(e) of this title.

to be a mortgage, the Trustee alleges that the attorney for the Madalenas admitted during the pretrial conferences that to avoid having to incur the expense, time delays and uncertainties of possible zoning and resubdivision procedures, the Security Agreement was not labeled as a mortgage and when the Security Agreement was recorded no mortgage tax was paid as required by the provisions of Section 258 of the New York State Tax Law. The Trustee Motion further requested, even though no such allegations or requests were contained in the Complaint, that the Court find the Lease entered into between the Madalenas and the Debtor to be a sale rather than a true lease so that the Section 541 bankruptcy estate would include a fee interest in the land at 2570 Baird Road which would be free and clear of any interest of the Madalenas.

The Madalena Cross-Motion papers included an Affidavit of Gerald Madalena (the "Madalena Affidavit") which indicated that: (1) the Madalenas own a single undivided parcel of land in the Town of Perinton, New York, commonly known as 2570 and 2580 Baird Road on which two commercial/industrial buildings are located; (2) the Madalenas use 2580 Baird Road to operate several family owned businesses; (3) the Madalenas decided to sell or lease 2570 Baird Road since it was unnecessary for their business needs; (4) the Debtor wished to use 2570 Baird Road for his commercial leasing business; (5) a sale would have been made except that the town authorities in the town where the property is located indicated that formal resubdivision would be required in connection with any sale because there was only a single access to the properties and they inferred that structuring the transaction differently would avoid the cost and delay of resubdivision and related zoning procedures; (6) the Debtor was heavily into leasing and seemed to prefer it over a sale; (7) the Debtor's attorney was allowed to restructure the transaction to meet the Debtor's needs and desires; (8) although a mortgage tax was not paid, it would otherwise have been paid by the Debtor whose attorney structured the transaction; (9) "[i]t was not my intent to avoid creating a proper mortgage, and it was and is my belief that a proper security interest tantamount to a mortgage has

in fact been created" (Madalena Aff. at ¶8); and (1) the Lease is in fact a lease.

DISCUSSION

Although the New York Real Property Law contains numerous provisions concerning mortgages and even sets forth non-mandatory but suggested statutory forms of mortgages, it does not contain a definition of a mortgage. Nevertheless, it is clear that among the fundamental elements of a mortgage are that it be in writing and that it intend to and provide for the pledge of specified real property as collateral security for a specified debt and remedies upon default. The Security Agreement between the Debtor and the Madalenas satisfies these fundamental elements. Although the Trustee asserts that the parties did not intend the Security Agreement to be a mortgage because: (1) the Security Agreement was purposely not labeled as a mortgage; (2) the Security Agreement was not recorded in the Liber of Mortgages; and (3) no mortgage tax was paid when the Security Agreement was recorded, the Madalena Affidavit, the allegations of which the Court must take as true for purposes of this Motion for Summary Judgment,² clearly indicated the intent of the Madalenas that the Security Agreement provide them with the rights and remedies of a mortgage as to the building at 2570 Baird Road.

Although the Court cannot and does not condone the avoidance and failure of the parties to pay a mortgage tax in connection with this transaction, assuming one is required to be paid, Section 258 of the Tax Law and related laws does contain payment penalty provisions and restrictions on the exercise of certain rights and remedies in New York courts for the failure to pay the required

² The Trustee provided no evidence as to the Debtor's intent regarding the Security Agreement, but, as set forth above, the Debtor did list Gerald Madalena on his schedules as having a mortgage on 2570 Baird Road.

mortgage tax, but this Court can find nothing in New York law which indicates that a failure to pay a mortgage tax voids or invalidates the lien of a recorded mortgage.³

Equally, the Court cannot condone the parties attempting to avoid the local zoning or subdivision procedures. However, the avoidance here may have been with the tacit consent of the authorities since there appears to have been pre-closing discussions with the authorities, and this Court's understanding has always been that such compliance is monitored by the authorities checking all filed deeds. Here the filing of the warranty deed conveying the building at 2570 Baird Road should have resulted in an investigation and compliance action if the authorities believed it appropriate.

Based on the foregoing, the Court finds the Security Agreement for purposes of this adversary proceeding and bankruptcy case to be a mortgage in that it granted the Madalenas a lien on the building at 2570 Baird Road as security for the payment of the amounts due under the Promissory Note.

The Trustee asserts that he can avoid the lien of the Security Agreement on the building at 2570 Baird Road pursuant to his rights and powers under Section 544, because the Security Agreement was recorded in the Monroe County Clerk's Office in the Liber of Deeds rather than in

³ The Court is also at a loss to understand why, when reading the first paragraph of the Security Agreement, the Monroe County Clerk's Office would not have required the payment of a mortgage tax when it accepted it for recording. The first paragraph reads:

Kenneth Glasgow ("Guarantor"), whose residence address is 11 Grey Fawn, Pittsford, New York, hereby grants to Gerald and Sally Madalena, ("Guarantees"), doing business at 2580 Baird Road, Perinton, New York, as security for the prompt payment when due of the Indebtedness (as defined in Paragraph 1 below) and as security for the prompt payment of and performance of Guarantor's Obligations (as defined in Paragraph 1 below), a security interest in all of the Guarantor's right, title and interest in and to the building located at 2570 Baird Road, Perinton, New York ("Collateral").

the Liber of Mortgages. Whether the Trustee can avoid the lien of the Security Agreement depends on whether the Security Agreement could be avoided under New York law by a judgment creditor whose judgment became a lien on the building (Section 544(a)(1)) or by a bona fide purchaser for value of the building (Section 544(a)(3)). See *In re Euro-Swiss International Corp.*, 33 B.R. 872, 879 (Bankr. S.D.N.Y. 1983).

Under New York law, a judgment lien creditor does not have the benefits of the recording statute as to deeds and mortgages so that even an unrecorded mortgage taken for value has priority over a judgment lien creditor. *United States v. Certain Lands Located in Hempstead*, 41 F. Supp. 636, 637 (E.D.N.Y. 1941); *Meadowbrook Farm Apartments v. Carter*, 67 Misc. 2d 1093, 1094 (1971). Furthermore, a judgment lien is specifically subordinate to the lien rights of an unrecorded purchase money mortgage under Section 5203 of the New York Civil Practice Law and Rules ("CPLR"). In this case, although the Security Agreement may have been recorded incorrectly in the Liber of Deeds rather than Mortgages, it nevertheless was recorded, and to the extent that it has been found by the Court to be a mortgage, it is a purchase money mortgage within the meaning of Section 5205 of the CPLR. The Security Agreement secured the Promissory Note which clearly was executed and delivered as part of the purchase price being paid by the Debtor for assets acquired in the transaction between the Debtor and the Madalenas.

Therefore, the Trustee as a judgment lien creditor under Section 544 cannot avoid the lien of the Security Agreement on the building at 2570 Baird Road. See *Euro-Swiss*, 33 B.R. at 881.

Section 544(a)(3) also gives the Trustee the status, rights and remedies of a bona fide purchaser for value under New York State law. However, on the facts and circumstances of this case, the Court finds that the Trustee is also unable to avoid the Security Agreement as such a hypothetical purchaser. The Security Agreement was recorded in the Liber of Deeds rather than in the Liber of Mortgages. That may deprive the Security Agreement of some of the constructive notice

benefits of the New York recording statutes as to its status as a mortgage or lien on the building at 2570 Baird Road. However, by its being recorded in the Liber of Deeds, it would be discovered by any potential bona fide purchaser for value of the building or the underlying land, since under New York law any bona fide purchaser for value would have an obligation to search the record of deeds.⁴ The New York cases which deal with improper recording generally deal with improper indexing and hold that a party would not be required to look in the strange or unusual place where the instrument was in fact indexed. In this case, however, recording the Security Agreement in the Liber of Deeds meant that any prospective purchaser or mortgagee of the building or the land at 2570 Baird Road would have constructive notice of the Security Agreement, since they would be required to search the Liber of Deeds in order to achieve the status of a bona fide purchaser for value.

Section 544 is intended to protect the bankruptcy estate and its creditors from springing or hidden liens. *Euro-Swiss*, 33 B.R. at 879. The Madalenas' lien on 2570 Baird Road was never hidden but always was open and notorious and recorded where any party who might be negatively impacted by it would have discovered it.

As to the assertion by the Trustee made in the Trustee Motion but not in the Complaint that the Lease was in fact a sale of the land at 2570 Baird Road, the Court finds that on the facts and circumstances of this case the Lease was and is a true lease. Although the transaction between the Debtor and the Madalenas is somewhat unusual in its structure, the Lease as a part of the overall structure of the transaction was clearly intended to be a true lease so that the zoning and resubdivision requirements could be avoided. Furthermore, Exhibit A to the Complaint, an Abstract of Title to the 2570 Baird Road property, shows that on April 11, 1990 Chemical Bank recorded a

⁴ A bona fide purchaser has constructive notice of what may be revealed by an examination of the record, reasonable inquiry of those in actual possession or reasonable inquiry on the basis of all the circumstances. *Euro-Swiss*, 33 B.R. at 882.

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In the above case, the Court amends its prior Decision of February 28, 1994 on page 2, first paragraph, line 10 to read 1989 instead of 1980.

IT IS SO ORDERED.

/s/
HON. JOHN C. NINFO, II
U.S. BANKRUPTCY COURT JUDGE

DATED: March 1, 1994