

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF NEW YORK

IN RE:

EDGEWOOD PROPERTIES
DEVELOPMENT, LLC

CASE NO. 00-60659

Debtors

Chapter 11

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Hon. Stephen D. Gerling, Chief U.S. Bankruptcy Judge

**MEMORANDUM-DECISION, FINDINGS OF FACT,
CONCLUSIONS OF LAW AND ORDER**

The Court has under consideration a motion filed by BSB Bank & Trust Company (“BSB”) on January 23, 2001, seeking an order determining the validity, priority or extent of its lien with respect to \$92,000 being held in escrow by BSB.¹ The monies represent a portion of the proceeds paid in settlement of the claim of Edgewood Properties Development, LLC (“Debtor”) against Michigan Miller Insurance Company (“MMIC”). On February 2, 2001, Orchard Earth & Pipe Corporation (“Orchard”) filed the affidavit of its president, Forrest E. Tarolli (“Tarolli”), responding to BSB’s motion and asserting that it had a superior interest in the monies being held in escrow by virtue of services it rendered on behalf of the Debtor.

The Court heard oral argument on the motion at its regular motion term in Syracuse, New York, on February 6, 2001. The matter was consensually adjourned to April 3, 2001,² to allow the parties an opportunity to file memoranda of law. Following further argument on April 3, 2001, the motion was submitted for decision as of April 20, 2001.

¹ BSB’s notice of motion seeks an order determining the validity, priority and extent of its lien while its prayer for relief seeks an order authorizing it to release \$92,000 from escrow. While the former relief requires an adversary proceeding pursuant to Rule 7001(2) of the Federal Rules of Bankruptcy Procedures (“Fed.R.Bankr.P.”), the Court has opted, without objection from any party, to treat the application as a contested matter pursuant to Fed.R.Bankr.P. 9014.

² The motion was originally adjourned to March 6, 2001; however, due to the cancellation of the Court’s calendar for that date, it was rescheduled for April 3, 2001.

JURISDICTIONAL STATEMENT

The Court has jurisdiction over the parties and subject matter of this contested matter pursuant to 28 U.S.C. §§ 1334(b), 157(a) and 157(b)(1), (b)(2)(A), (K) and (O).

FACTS

The Debtor operates a resort and hotel complex in the Town of Alexandria, Jefferson County, New York. On February 18, 2000, an involuntary petition was filed against the Debtor for relief under chapter 11 of the Bankruptcy Code, 11 U.S.C. §§ 101-1330 (“Code”). An Order for relief was granted on March 23, 2000.

According to the Debtor’s schedules, BSB holds a secured claim of \$3,421,371, based on, *inter alia*, a first mortgage on the Debtor’s real property in Alexandria (“Premises”), as well as a security interest in personal property owned by the Debtor. On December 23, 1997, BSB and the Debtor executed a mortgage (“Mortgage”) in the amount of \$3 million, which was recorded in the Jefferson County Clerk’s Office on December 24, 1997. *See* Exhibit A of BSB’s Motion.³

Paragraph 5 of BSB’s Mortgage requires that the Debtor, as borrower, maintain insurance on the improvements on the Premises against fire and other hazards. It further provides that

³ On December 17, 1997, the Debtor had executed a Commercial Security Agreement in connection with the loan of \$3 million. *See* Exhibit C of BSB’s Motion. On December 23, 1997, BSB also received an assignment of all leases, rentals and profits, including the daily rental charges for rooms from the property to secure the indebtedness. *See* Exhibit D of BSB’s Motion.

In the event of loss, Borrower shall give immediate notice to the insurance carrier and to Lender. Borrower hereby authorizes and empowers Lender as attorney-in-fact for Borrower and on behalf of Lender and Borrower, as their respective interests may then appear to make proof of loss, to adjust and compromise any claim under insurance policies, to appear in and prosecute any action arising from such insurance policies, to collect and receive insurance proceeds, and to deduct therefrom Lender's expenses incurred in the collection of such proceeds; provided however, that nothing contained in this paragraph 5 shall require Lender to incur any expense or take any action hereunder and further provided that Borrower may act on its own behalf in the event Lender takes no action and Borrower's rights under such policies may therefore be prejudiced. Borrower further authorizes Lender, at Lender's option (a) to hold the balance of such proceeds to be used [after deducting BSB's expenses] to be released in trust to Borrower for the cost of reconstruction or repair of the Property or (b) if such sums are not sufficient for such reconstruction or repair and Borrower has not evidenced proof of having other available funds together with such proceeds to complete such reconstruction or repair, or if the obligation secured hereby is at such time in default to apply the balance of such proceeds to the payment of the sums secured by this Instrument, whether or not then due, in the order of application set forth in paragraph 3 hereof.

On or about January 8, 1998,⁴ the Debtor's facility was damaged due to a severe ice storm. The initial payment on BSB's Mortgage was due January 22, 1998, and was allegedly paid February 11, 1998. See ¶ 2 of the Affirmation of Harvey D. Mervis, Esq., filed April 20, 2001 ("Mervis Affirmation"). In February 1998 it is alleged that Orchard, as a subcontractor of AJM Building Corporation, furnished labor and materials in connection with the renovations/repairs to the Premises following the ice storm. It is also alleged that sometime in July of 1998 Orchard

⁴ Although the parties did not specify the exact date of the ice storm, according to news reports, it occurred on January 8, 1998. See, e.g., Frederic Pierce, *Ingenuity, Teamwork Keep Supper Hot for Ice Storm Victims. A Crew of Alexandria Bay Chefs Turns Canned Donations and the Contents of Thawing Freezers into Meals*, THE POST-STANDARD, Syracuse, NY, Jan. 19, 1998.

was requested to submit a bid for further repairs of certain pump stations also damaged in the storm. Orchard submitted a bid of \$92,000 for those repairs on or about July 24, 1998. *See* Exhibit B, attached to Tarolli's Affidavit. It is alleged that Orchard completed its work on the pump stations by late February 1999. *See* ¶ 11 of Tarolli's Affidavit. It is Orchard's position that it is owed at least \$92,000 in connection with the repair of the damages caused by the ice storm. *See id.* at ¶ 12. Orchard contends that officers of the Debtor indicated that it would be paid for its services upon settlement of the Debtor's insurance claim with MMIC. It is alleged that Orchard filed a mechanic's lien on October 19, 1999, and commenced a foreclosure action against the Debtor in December 1999.

According to BSB's payment history for the Debtor on its loan, the Debtor failed to make any payments on the Mortgage between January 1999 and June 1999. *See* Mervis Affirmation at ¶ 2. It appears that on July 21, 1999, the Debtor cured the arrears, paying BSB for January - July 1999. *See id.* According to BSB's records, the remainder of the 1999 monthly payments were also made several days late. The payment due January 22, 2000, was made on February 18, 2000, along with the Debtor's February payment. Its March 2000 payment was not credited until July 31, 2000. Between April 2000 and June 2000 its payments were also a few days late each month. It appears that between August 2000 and December 2000, the Debtor's payments were timely. However, its payments for January and February 2001 were not made until March 22, 2001.

On April 19, 2000, the Debtor filed a motion seeking authorization to use certain cash collateral in which BSB had a security interest. On April 25, 2000, BSB filed a cross-motion seeking relief from the automatic stay and adequate protection. In seeking relief from the

automatic stay, BSB makes no reference to any default by the Debtor at that time.

The Court signed an Order on June 29, 2000, *inter alia*, granting BSB's request for adequate protection. In addition to requiring the Debtor to make its regular mortgage payments, the Order provides that in the event of a default,

after notice of such to Debtor by BSB with opportunity to cure of no less than five days, and after expiration of the cure period, the automatic stay under U.S.C.362(a) shall immediately vacate and terminate without further notice and BSB shall be authorized to exercise any or all of its rights under the mortgages without further application to the court.

On December 29, 2000, the Debtor filed a motion seeking approval of a settlement and compromise of its claim against MMIC in the amount of \$310,000. An Order granting the Debtor's motion was signed on January 30, 2001. Allegedly, MMIC issued a check in March 2001, which was processed by BSB on March 22, 2001. *See* ¶ 3 of Mervis Affirmation. Of the \$310,000, all but \$92,000 was applied to BSB's claim. The \$92,000 was ordered held in escrow pending a determination by this Court of the extent of BSB's lien on that sum. It is that issue which is now before the Court.

ARGUMENTS

Orchard contends that pursuant to § 254(4) of the New York Real Property Law ("NYRPL"), BSB was required to hold the insurance proceeds in trust for payment over to the Debtor to cover the cost of repairs. BSB maintains that NYRPL § 254(4) is inapplicable. It contends that it has application only in the situation where a mortgage is silent on the subject of

providing hazard insurance protection for the mortgagee. In this case, the Mortgage contains such a provision. BSB makes the argument that whether one relies on the language in ¶5 of the Mortgage or the language in NYRPL § 254, the Debtor has no right to the proceeds. Quoting the language of the statute, BSB argues that “if and so long as there exists any default by the mortgagor in the performance of any of the terms or provisions of the mortgage on his part to be performed the mortgagee shall not be obligated to pay over any of said insurance money received by him.” N.Y. Real Prop. Law § 254(4) (McKinney’s 1989 & Supp. 2001). It is BSB’s position that at the time the check from MMIC was issued in March 2001, the Debtor was in default and, therefore, BSB was entitled to apply the proceeds exclusively to the mortgage debt.

Orchard makes the argument that if BSB is allowed to keep the monies, it will be unjustly enriched as a result of the repairs completed by Orchard. Orchard maintains that it has the right to enforce its mechanic’s lien against the Debtor and that that right is separate from any right it might have against its general contractor, AJM. Citing to §§ 70 and 71 of the New York Lien Law (“NYLL”), Orchard contends that it has a “trust claim” against any insurance proceeds received by the Debtor as owner of the Premises and the Debtor’s right of action with respect thereto. *See* Orchard’s Memorandum of Law, filed February 27, 2001 at 9. BSB responds that any right the Debtor, as owner of the Premises, has in the insurance proceeds “is subject to the conditions in the mortgage that give BSB prior right to the proceeds.” *See* BSB’s Memorandum of Facts and Law, filed on February 27, 2001, at 3. BSB contends that

it is well established New York law that the mortgagee clause of a casualty policy insures the mortgagee under an independent contract of insurance wherein the mortgagee is treated as a separate party, “having distinct rights and entitled to receive the full amount of the insurance money, without any regard whatever

to the owner of the property.”

Id., citing *Goldstein v. National Liberty Ins. Co. of America*, 256 N.Y. 26, 32 (N.Y.1931) (quoting *Hastings v. Westchester Fire Ins. Co.*, 73 N.Y. 141).

Relying on *Canron Corp. v. City of New York*, 89 N.Y.2d 147, 652 N.Y.S.2d 211 (N.Y.1996), Orchard contends that BSB’s claim to the insurance proceeds is inferior to that of Orchard. Orchard makes the argument that in connection with the contract between the Debtor and AJM/Orchard, a “Constructive Lien Law Trust” was created to protect those who expended labor and material in making the repairs to the Premises, and that the Debtor and BSB should not be able to derive a “functional benefit” from the proceeds by having them used to reduce the mortgage debt. Instead, Orchard contends that the Debtor was required to purchase the insurance to pay for any repairs that might be necessary in the event of damage to BSB’s collateral from fire or other hazards such as the ice storm. It is Orchard’s position that the Debtor has a right of action to receive the proceeds to pay AJM and Orchard and that right of action is an asset of the trust to which Orchard’s lien attaches.

BSB distinguishes *Canron*, pointing out that in *Canron* the insurance had been provided for the benefit of the owner. In this case, the insurance was provided for the benefit of the mortgagee, BSB, not the Debtor/owner. The Debtor has not received any of the proceeds.

Finally, Orchard asserts that the Court should apply the doctrine of equitable liens with respect to the insurance proceeds from which it was promised it would be paid. According to Orchard, “[i]t would not be equitable and seemingly [it would be] against public policy to allow Edgewood to obtain the benefit of having its property fully restored while being paid the value of Orchard’s improvements in the manner and to the extent that insurance proceeds are applied

against Edgewood's mortgage debt to BSB." Orchard's Memorandum of Law at 21.

DISCUSSION

It is to be noted that Section 254 purports to construe the *usual covenant* (emphasis in the original) by a mortgagor to provide fire insurance protection for the mortgagee-and it is controlling when the mortgage is otherwise silent on the subject. However, there is nothing in the present Section 254, or as herein intended to be amended, which would prevent lenders from making other appropriate provision for such a contingency.

1965 NEW YORK STATE LEGISLATIVE ANNUAL 358, 361; *see also Williams v. Wisner Bldg. Co., Inc.*, 121 Misc. 32, 33 (N.Y. Sup. Ct. 1923), *aff'd* 208 A.D. 783 (N.Y. App. Div. 1924) (noting that NYRPL § 254(4) "is only applicable when the parties have not otherwise provided for a different construction of the insurance clause"); *Seligman v. Burg*, 233 A.D. 221, 224 (N.Y. App. Div. 1931) (indicating that the parties are free to contract with one another "in a manner different from that stated in the statute.").

In this case, the Mortgage executed by the Debtor and BSB contains a section entitled "Hazard Insurance." *See* Exhibit A of BSB's Motion at ¶ 5. It gives BSB two options: (1) to hold the insurance proceeds and to release them in trust to the Debtor for the cost of the repairs to the Premises or (2) if the proceeds are not sufficient to complete the repairs and the Debtor is without funds to complete the repairs or if the Debtor is in default, then BSB has the option of applying

the proceeds to the mortgage debt.

Case law indicates that a determination of the rights of a mortgagee such as BSB against the insurer to any proceeds is to be measured at the time of the loss. *See Whitestone Savings and Loan Assn. v. Allstate Ins. Co.*, 28 N.Y.2d 332, 334, 321 N.Y.S.2d 862 (N.Y. 1971); *Builders Affiliates, Inc. v. North River Ins. Co.*, 91 A.D.2d 360 (N.Y. App. Div. 1983). The question is whether the time of loss is also determinative of the rights of the Debtor under the terms of the Mortgage with respect to the insurance proceeds.

The facts indicate that the ice storm occurred approximately two weeks before the Debtor's first mortgage payment was due. Therefore, the Debtor was not in default at the time of the loss. However, it is BSB's position that it is not the date of loss which is relevant, but rather the date that the insurance check was issued and/or processed by BSB. According to BSB, the Debtor's payment history from the inception of the loan indicates a pattern of late payments, which would have allowed it to accelerate the debt. Indeed, on the date that BSB allegedly processed the check from MMIC, namely March 22, 2001, BSB received payment from the Debtor for the previous months of January and February, along with the March payment. BSB also points out that the filing of Orchard's mechanic's lien on October 19, 1999, also entitled BSB to declare the mortgage debt due and payable.

There is no evidence that BSB ever sought to exercise its rights relating to any such default, either prepetition or postpetition with respect to the Premises until June 7, 2001, when it notified the Debtor of its default in not making the May 2001 payment when due. Its course of conduct in accepting the late payments over an extended period of time, in the opinion of the Court, constitutes a waiver of the right to now assert that the Debtor was in default at the time

BSB received/processed the check from MMIC on March 22, 2001. *See Ford v. Waxman*, 50 A.D.2d 585 (N.Y. App. Div. 1975) (noting that knowledgeable acceptance of late payments on a mortgage over an extended period constitutes a waiver of the right to insist upon timely payments).

The mortgagor in *Builders Affiliates* had commenced an action against the insurers, and the action was finally settled on January 12, 1981, for \$30,000. The mortgagor claimed entitlement to the insurance proceeds since it had repaired the premises to its prefire condition. *See Builders Affiliates*, 91 A.D.2d at 362. The mortgagee contended that the mortgagor was not entitled to the proceeds because it was in default under the terms of the mortgage. The court noted that while the mortgage was \$30,367.59 in default at the time of the fire on December 7, 1972, the mortgagor had cured the default some eleven months later. The mortgagee later declared the entire unpaid balance due and payable because of the mortgagor's continuing default and on March 18, 1974, commenced a foreclosure action. *See id.* at 365. The court found that the entire principal had been "continuously due and payable since at least March 18, 1974, by reason of [the mortgagor's] default . . ." *Id.*; *see also Centerbank v. D'Assaro*, 158 Misc. 2d 92, 94 (N.Y. Sup. Ct. 1983) (indicating that the date of declaration of default and demand was the date of service of the summons and complaint in the foreclosure action). Because the debt exceeded the amount of the proceeds and the mortgagee had previously declared the mortgagor in default and had commenced a foreclosure action against it, the court concluded that the mortgagor was not entitled to any of the monies which were ultimately received some seven years later, despite the fact that it had incurred expenses in repairing the property.

In this case, BSB did not exercise its right to declare a default and to accelerate the debt

pursuant to the Court's Order of June 28, 2000, until June 7, 2001, despite the Debtor's history of late payments and despite its contention that the Debtor was in default as of March 22, 2001. At the time the insurance check was issued and/or processed, BSB had not declared the Debtor in default nor made any demand for the full amount of the mortgage debt. The Court concludes that under the terms of the Mortgage, specifically ¶ 5(b), BSB cannot exercise its option with respect to the insurance proceeds to apply them to the mortgage debt based on any alleged default by the Debtor. In addition, none of the parties contend that the Debtor was without sufficient funds to complete the repairs, provided that the insurance proceeds, totaling \$310,000, were made available to it. Therefore, BSB was not entitled to exercise the other option set forth in ¶ 5(b) and apply the monies to the mortgage debt.

Accordingly, the Court must shift its focus to ¶ 5(a) of the Mortgage, which allows BSB to release the monies in trust to the Debtor to cover the cost of reconstruction or repair of the Premises. In this case, the insurance proceeds are not trust assets for the benefit of Orchard by virtue of Article 3-A of the New York Lien Law.⁵ See *Valsen Construction Corp. v. Long Island Racquet & Health Club, Inc.*, 228 A.D.2d 668, 669 (N.Y. App. Div. 1996) (finding that a contractor who had performed labor and services in connection with fire damage to certain property did not fall "within the class of contractors that the statute seeks to protect" in that it did not have a lien on the property at the time it was damaged). Orchard's services were not rendered

⁵ Specifically, NYLL § 70(5)(f) provides that "[t]he assets of the trust of which the owner is trustee are the funds received by him and his rights of action for payment thereof as proceeds of any insurance payable because of the destruction of the improvement or its removal by fire or other casualty, except that the amount thereof required to reimburse the owner for premiums paid by him out of funds other than trust funds shall not be deemed part of the trust assets" N.Y. Lien Law § 70(5)(f) (McKinney 1993 & Supp. 2001).

with respect to an improvement which was subsequently destroyed by fire or other casualty. Its services were provided after the damage occurred to the Premises for which MMIC made its payment.

However, the Court finds that the insurance proceeds are trust assets based on the language found in ¶ 5 of the Mortgage. “The elements of an express trust are an explicit declaration of trust, a clearly defined trust res and an intent to create a trust relationship.” *In re Mason*, 191 B.R. 50, 55 (Bankr. S.D.N.Y. 1996) (citation omitted). According to the terms of the Mortgage, the proceeds were “to be released in trust to [the Debtor]” This constitutes a declaration of trust. The \$92,000 is currently being held by BSB in escrow and is a “clearly defined trust res.” It is clear from the language of ¶ 5 that there was an intent to create a trust relationship in that the Debtor was entitled to receive the monies for the intended benefit of those who provided services in connection with the restoration of the Premises to the condition which existed prior to the ice storm. As Orchard provided such services, it is deemed to be a beneficiary of the insurance proceeds to the extent of the value of the services it rendered in repairing the damage done to the Premises on or about January 8, 1998. To the extent that Orchard is able to establish the amount it is owed in this regard, those monies are not subject to BSB’s mortgage lien and should be paid accordingly.

IT IS SO ORDERED.

Dated at Utica, New York

this 23rd day of August 2001

STEPHEN D. GERLING
Chief U.S. Bankruptcy Judge