UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF TENNESSEE
SOUTHERN DIVISION

In re:

TAPISTRON INTERNATIONAL, INC.	Case No. 01-14159 Chapter 11
Debtor	
TAPISTRON INTERNATIONAL, INC.	
Plaintiff	
v.	Adversary Proceeding No. 01-1208
RBI INTERNATIONAL, INC.	
Defendant	

MEMORANDUM

Appearances:

Thomas E. Ray, Samples, Jennings, Ray & Gibbons, PLLC, Chattanooga, Tennessee, Counsel for Plaintiff

Edward Hine, Jr., Law Offices of Edward Hine, Jr., P.C., Rome, Georgia, Co-counsel for Defendant

Bruce C. Bailey, Chambliss, Bahner & Stophel, P.C., Chattanooga, Tennessee, Co-counsel for Defendant

HONORABLE R. THOMAS STINNETT,
UNITED STATES BANKRUPTCY JUDGE

The defendant, RBI, asserted a perfected security interest in two tufting machines manufactured by the Chapter 11 debtor, Tapistron. As debtor in possession, Tapistron brought this action to avoid the security interests. The machines were sold, and the dispute attached to the sale proceeds. Tapistron and RBI filed cross motions for summary judgment. They raised the question of whether RBI had a perfected security interest in either machine at the time Tapistron filed its Chapter 11 case. The court held that RBI had a perfected security interest in machine 115 when Tapistron filed bankruptcy, but RBI never obtained a security interest in machine 1501. Docket Nos. 29 & 30. Both parties then filed motions to alter or amend the judgment. Fed. R. Bankr. P. 9023; Fed. R. Civ. P. 59(e). This memorandum deals with those motions.

The cross motions for summary judgment and the court's opinion and order did not deal with all the issues in this proceeding. They left out Tapistron's insider preference claim. Tapistron alleges that even if RBI had a perfected security interest when Tapistron filed bankruptcy, the security interest can be avoided as a preferential transfer to or for the benefit of an insider within one year before the bankruptcy. 11 U.S.C. § 547(b).

Because the order did not deal with all the issues, the court could have made it final and appealable only by complying with Rule 54(b). The court did not do that, and the order was not final and appealable. Fed. R. Bankr. P. 7054; Fed. R.

Civ. P. 54(b). For this reason, Rule 59 may not apply, but the court can treat the motions to alter or amend as coming under Rule 54(b). Rule 54(b) makes the order subject to revision at any time before a final order dealing with all the issues, and revision may be granted on grounds that might not justify revision under Rule 59. Fed. R. Bankr. P. 7054; Fed. R. Civ. P. 54(b); *Fayetteville Investors v. Commercial Builders, Inc.*, 936 F.2d 1462 (4th Cir. 1991) (Rule 54(b) & Rule 60); *Carter v. Rajotte (In re Rajotte)*, Adv. Proc. No. 399-0200A, Bankr. Case No. 87-06579-KL3-7 (Bankr. M. D. Tenn. Apr. 18, 2001) (Stinnett). The court begins with the motions as they relate to machine 115.

The security interest in machine 115 was created by a $50,000 note from Tapistron to RBI (the 50K note). RBI lent Tapistron another $200,000, and the two debts were rolled into one note for $250,000 (the 250K note). The parties did not intend to cancel or pay the 50K note because they meant to continue RBI's security interest in machine 115. The parties also intended that machine 115 would secure the entire $250,000 debt.

Tapistron's motion to alter or amend asks the court to decide whether machine 115 secures only the original $50,000 debt or the entire $250,000 debt. The court's opinion states that machine 115 secures the entire $250,000 debt. The court's order, however, does not include that conclusion. It states only that RBI had a perfected security interest in machine 115 at the time Tapistron filed its Chapter

11 case. As a result, the court's memorandum and order are unclear as to the extent of the debt secured by machine 115.

A decision on the amount secured by machine 115 was not necessary to decide the question raised by the summary judgment motions. The court could still put off a decision on the amount because it will be irrelevant if Tapistron avoids the security interest in machine 115 as an insider preference. Nevertheless, a decision on the amount secured may be a wise course of action for several reasons. It will provide a decision on all the relevant issues if either side appeals the final decision in this proceeding. The court needs to clarify its earlier opinion, and a decision may aid the parties in working toward a settlement, if that is still possible. For these reasons, the court takes this opportunity to render a clear decision on the issue. The court is free to revoke or adopt its earlier statement that machine 115 secures the entire $250,000 debt.

The people who handled the transaction for RBI and Tapistron intended to make machine 115 secure the 250K note. There were several methods that could have made machine 115 secure not only the 50K note but also the 250K note.

The 250K note could have included a cross reference to the 50K note that would have made the collateral for the 50K note secure the 250K note. But the 250K note does not include such a cross reference. *Compare Zimmerman & Jansen,* *Inc. v. Bigler (In re Bollinger Corp.)*, 469 F.Supp. 246, 26 UCC Rep.Serv. 1007 (W. D. Pa. 1979); *Dixie Ag Supply, Inc. v. Nelson*, 500 So.2d 1036, 4 UCC Rep.Serv.2d 1584 (Ala. 1986).

The 50K note could have included a dragnet clause that would have made machine 115 secure Tapistron's other debts to RBI. The 250K note could have included a cross collateral clause that would have made the collateral for any other debt to RBI also secure the 250K note. RBI and Tapistron apparently made an oral agreement equivalent to either or both of these clauses. An oral amendment to add a dragnet clause or a cross collateral clause is not enforceable, however, because such agreements should be in writing. Ga. Code Ann. § 11-9-204 (2000); *see In re Taylor*, 45 B.R. 643 (Bankr. M. D. Pa. 1985); *ITT Indus. Credit Co. v. Union Bank and Trust Co.*, 615 S.W.2d 2, 30 U.C.C.Rep.Serv. 1701 (Ky. Ct. App. 1981); *Texas Kenworth Co. v. First National Bank*, 564 P.2d 222, 21 U.C.C. Rep.Serv. 1512 (Okla. 1977); *Idaho Bank & Trust Co. v. Cargill, Inc.*, 665 P.2d 1093, 36 U.C.C.Rep.Serv. 691 (Idaho Ct. App. 1983).

This leaves the possibility of a new security agreement to make machine 115 secure the 250K note. The law requires such an agreement to be in writing. Ga. Code Ann. § 11-9-203(1)(a) (2000). There is no single document that makes machine 115 secure the 250K note. A security agreement can be made up of more than one document. *See, e.g,. In re Carmichael Enterprises, Inc.*, 334 F.Supp. 94, 9 U.C.C. Rep.Serv. 990 (N. D. Ga. 1971) *aff'd per curiam* 460 F.2d 1405, 11 U.C.C. Rep.Serv. 895 (5th Cir. 1972); *Still v. Peoples National Bank (In re Baker)*, 54 B.R. 743 (Bankr. E. D. Tenn. 1985). In this case, however, there is no group of documents that can be taken together to make out a written agreement for machine 115 to secure the entire 250K note. RBI does not have a written security agreement that makes machine 115 secure the 250K note.

RBI and Tapistron, operating without the involvement of their lawyers, failed to take the steps required by law to create an enforceable security agreement under which machine 115 would secure the entire 250K note. The result is that machine 115 secures only $50,000 of the debt as provided in the 50K note.

This brings the court to another question raised by the motions to alter or amend. RBI filed a financing statement to perfect its security interest in machine 115 in August 2000. In January 2001 RBI simultaneously filed a termination statement and a financing statement as to machine 115. The court decided that the termination statement did not terminate the security interest, and when Tapistron filed bankruptcy, the security interest was perfected by one or the other of the two financing statements.

Tapistron's motion to alter or amend asks the court to decide when the security interest was perfected, August 2000 or January 2001. 11 U.S.C. § 547(e)(1)(B) (time of perfection as time of transfer). The time of perfection is relevant to the insider preference claim. Tapistron will be required to prove insolvency at the time of the transfer. 11 U.S.C. § 547(b)(3). Tapistron has not filed a motion for partial summary judgment as to when the security interest was perfected (when the transfer occurred).

On the other hand, RBI has not objected to this procedure, the relevant facts appear to be undisputed, and a decision will aid the parties in preparing for trial. Furthermore, the court did not fully set out its reasoning behind the decision that the security interest continued to exist and was perfected after the filing of the termination statement. The court's reasoning on that point will necessarily involve the question of when the security interest was perfected.

Theoretically, the simultaneously filed financing statement and termination statement canceled each other out. That would leave the August 2000 financing statement as the one that is legally effective. In terms of notice, the theory is that a searcher could not give full credit to the termination statement because the new financing statement cast doubt on its effectiveness. The searcher (so the argument goes) would be required to ask the parties about the details and the intent of the transactions. The court disagrees.

A searcher might wonder about the intent of the parties and what kind of transaction caused them to file the financing statement simultaneously with the termination statement. The searcher could not assume that RBI no longer had any security interest; RBI could have taken a new security interest and perfected it by filing the new financing statement. The searcher might even assume the old security interest was re-perfected by the new financing statement. But the termination statement itself is clearly a termination statement. Without regard to the underlying transaction, the searcher could conclude that the August 2000 financing statement was no longer effective. The termination statement would have that effect at the least, as explained in the following discussion.

The effect of the termination statement and the new financing statement must be determined under Article 9 of the Uniform Commercial Code (the UCC). Ga. Code Ann. §§ 11-9-101– 11-9-507 (2000). The purpose of filing a financing statement is to give notice of the security interest so that it will have priority over claims by other entities who subsequently acquire interests in the collateral. *Deere & Co. v. Miller-Godley Auction Co.*, 249 Ga.App. 797, 549 S.E.2d 762, 44 UCC Rep.Serv.2d 953 (2001).

The purpose of a termination statement is less certain. A termination statement is obviously intended as a notice to third parties, but notice of what? A termination statement refers to a particular financing statement and the collateral covered by the financing statement. Ga. Code Ann. §§ 11-9-102(78) & 11-9-513; Ga. Code Ann. § 11-9-404 (2000). The termination statement may:

> (1) give notice of an *actual release* of the collateral – notice that the creditor no longer has a security interest in the collateral;
>
> (2) give notice of a *constructive release* of the collateral – notice that the secured creditor will not attempt to enforce the security interest against parties other than the debtor, even if the security interest continues to exist; or
>
> (3) give notice of *cancellation of the financing statement* referred to in the termination statement – notice that the financing statement is no longer effective as record notice or actual notice of the existence of the security interest.

As to third parties dealing with the debtor, a termination statement with any of these meanings would take away whatever priority the security interest had obtained from the terminated financing statement. This would benefit the debtor by making the property more valuable to him and to third parties, such as potential lenders or buyers. As to the secured creditor, however, a notice of release under (1) or (2) would reduce its options more than a cancellation of the financing statement under (3), as explained below.

If a termination statement is notice of actual or constructive release of the collateral, then as to third parties the secured creditor cannot enforce the security interest in the future. As to them, the security interest has ceased to exist. For example, suppose the secured creditor and the debtor agree that the creditor will retain its security interest but will file a termination statement. The secured creditor thinks it can file a later financing statement to re-perfect the security interest. This is not true, however, if a termination statement always indicates actual or constructive release of the collateral from the security interest. In that situation, third parties are entitled to assume the security interest in the collateral no longer exists and cannot be re-perfected.

A different result follows if the termination statement only cancels the earlier financing statement. The termination statement makes the financing statement ineffective as record notice or actual notice of the security interest. The security interest can still exist, the secured creditor can still enforce it to the detriment of any third parties whose rights are inferior, and the secured creditor can re-perfect the security interest by filing a new financing statement.

Major amendments to Article 9 took effect in July 2001. Ga. Code Ann. § 11-9-701. Even if the new statutes do not apply directly to the facts, the changes in the law may be useful in explaining the purpose of a termination statement under the prior statutes. The court begins its discussion with the prior statutes.

The primary statute was § 9-404. Ga. Code Ann. § 11-9-404(1) (2000). The statute required the secured party to file a termination statement when the security interest no longer secured anything – when there was no outstanding obligation or commitment left to secure. Thus, a required termination statement appeared to be notice of an actual release of the security interest.

The statute provided that the termination statement should be “to the effect that he [the secured party] no longer claims a security interest under the financing statement.” The termination statement filed by RBI included equivalent language.

Of course, the statute required a termination statement to include the file number of the financing statement under which the creditor claimed the security interest. The termination statement filed by RBI lists the number of the financing statement filed in August 2000 as to machine 115.

The word “termination” suggested the security interest could not be enforced in the future against third parties. Likewise, a required termination statement was apparently intended to give notice of the release of the collateral from the security interest. The statute, however, allowed the filing of a termination statement that was not required. For convenience, the court will refer to an unrequired termination statement as a consensual termination statement.

The parties could use a consensual termination statement for various purposes, not just to indicate actual or constructive release of the collateral. The secured creditor could file a consensual termination statement even if it and the debtor agreed that the security interest would remain enforceable between them and against third parties. This created a fundamental ambiguity in the statute as to the meaning of a termination statement.

It made the statutory standard for requiring a termination statement less convincing as evidence that a termination statement is notice of the release of the collateral. A person searching the UCC filings could not distinguish required termination statements from consensual termination statements. The searcher could not assume that every termination statement was a required termination statement and amounted to a notice of release of the collateral.

Furthermore, the statute's description of a termination statement did not clearly require the statement to indicate a release or extinguishment of the security interest. A termination statement was supposed to indicate that the secured creditor no longer claimed a security interest under the financing statement. A secured creditor generally would not claim a security interest under the financing statement (unless it was also the security agreement). The secured creditor would claim *perfection* of the security interest under the financing statement. A termination statement indicating that the creditor did not claim a security interest "under" a particular financing statement could be taken as indicating only the intent to make the financing statement ineffective.

In summary, the statute's description of what a termination statement was supposed to indicate did not exactly agree with the apparent purpose of a *required* termination statement as a notice of release. Perhaps this was the statute's method of dealing with the underlying ambiguity caused by the allowance of consensual termination statements. The message to be given by a termination statement – what it was supposed to indicate – was ambiguous because a termination statement might serve different purposes; it might be a required termination statement, but it might not. The one certain purpose of a termination statement would be cancellation of the earlier financing statement referred to in the termination statement. This message would be adequately stated by using the statutory wording as to what a termination statement was supposed to indicate.

One might argue that this reasoning overlooks the debtor's need for notice of an actual or constructive release of the collateral. The theory of the argument seems to be that a debtor could be protected only if every termination statement had that effect. The court does not agree. A termination statement could simply void the earlier financing statement and leave the security interest in existence. The termination statement would assure a third party that the earlier financing statement no longer had any effect as record notice or actual notice of the security interest, but the security interest could continue to exist. The court sees nothing wrong with this result if the secured creditor and the debtor intended it. How can the debtor complain that the termination statement did not extinguish the security interest as to third parties when the debtor agreed that it would not?

The amendments to Article 9 apparently recognized the problem with the meaning of a termination statement. Article 9 now includes a definition of termination statement. A termination statement is an amendment to a financing statement. It must indicate that it is a termination statement or that the referenced financing statement is no longer effective. Ga. Code Ann. § 11-9-102(78). There are at least three ways of reading this last statement.

First, a termination statement can be a termination statement, or it can indicate that the referenced financing statement is no longer effective, but it cannot be both. In this reading, a termination statement identified simply as termination statement indicates to third parties that the security interest does not exist, but the termination statement can limit this effect by stating that the referenced financing statement is no longer effective.

Second, when the statute provides that a termination statement can either identify itself as a termination statement or indicate that the referenced financing statement is no longer effective, the statute is stating equivalents, not alternatives. The second statement defines termination; termination indicates that the referenced financing statement is no longer effective.

The third interpretation is similar to the second. A termination statement can mean that the security interest is no longer enforceable against third parties, or it can mean that the referenced financing statement is no longer effective. A termination statement's wording need not attempt to explain which of the two it means. Thus, a third party who finds a termination statement in the UCC filings will know for sure only that the referenced financing statement is no longer effective.

Another amendment to Article 9 agrees with the second reading of the definition. As a general rule, filing a termination statement means "the financing statement to which the termination statement relates ceases to be effective." Ga. Code Ann. § 11-9-513(d).

The court believes the second or third interpretation of the amended statutes represent the law under the prior statutes. A termination statement under the prior statutes was not necessarily a representation that the security interest had been released or extinguished. For the reasons already given, the court concludes that a party who searched the UCC filings and found a termination statement could assume only that the referenced financing statement was rendered ineffective. He could not assume the security interest had been released or had ceased to exist for other reasons.

The court has not found another case dealing with the question of whether a termination statement prevents the secured party from re-perfecting the security interest against third parties if the secured party and the debtor intended to continue the security interest after the filing of the termination statement. The typical case deals with the lack of perfection as the result of filing the termination statement. *Koehring Co. v.Nolden (In re Pacific Trencher & Equipment, Inc.)*, 735 F.2d 362 (9th Cir. 1984); *In re Windsor Communications Group, Inc.*, 45 B.R. 770 (Bankr. E. D. Pa. 1985); *Rock Hill National Bank v. York Chemical Industries, Inc. (In re York Chemical Industries, Inc.)*, 30 B.R. 583 (Bankr. D. S. C. 1983).

One case may be relevant if given a broad reading. The creditor filed financing statements in two counties and later filed a termination statement in one of the counties. The court held that the financing statement in the other county remained effective. This result can be explained on the ground that the termination statement had no effect in the other county. Of course, if a termination statement means the security interest no longer exists, it effectively extinguishes the security interest as to third parties, and the secured creditor might not be allowed to prove it still exists and is perfected elsewhere by a different financing statement. The case necessarily rejects that reasoning. *Deutz-Allis Credit Corp. v. Ziegler*, 447 N.W.2d 395 (Table), 1989 WL 112304 (Wis. Ct. App. Jul. 7, 1989).

In another case, the creditor terminated its second financing statement but not its first. The court held that the first financing statement remained effective. The case may be distinguished, however, on the ground that the financing statements were actually for different security interests. *Nationsbank v. Martin Color-Fi, Inc. (In re Martin Color-Fi, Inc.)*, No. 98-10145-W, 1999 WL 33486094 (Bankr. D. S. C. Sep. 24, 1999) (applying Georgia law).

At least one court has said that a termination statement does not extinguish the security interest but leaves it effective only between the parties. In other words, it is notice of constructive release of the security interest. *J. I. Case Credit Corp. v. Foos*, 717 P.2d 1064, 1 UCC Rep.Serv.2d 250 (Kan. Ct. App. 1986).

Other courts have said that a termination statement releases the security interest. *Crestar Bank v. Neal (In re Kitchin Equipment Co.)*, 960 F.2d 1242 (4th Cir. 1992); *In re Silvernail Mirror and Glass, Inc.*, 142 B.R. 987 (Bankr. M. D. Fla. 1992). The court disagrees with the conclusion that a termination statement necessarily indicates the release of the collateral and therefore has the effect of a release. In addition to the reasons already given, Article 9 contained a separate provision for giving notice of the release of collateral. Ga. Code Ann. § 11-9-406. A consensual termination statement could have been used to give notice of a release, but a termination statement (consensual or required) in the statutory form would have been unclear as notice of a release.

The court should mention one decision by the Georgia Court of Appeals. In that case the debtor and creditor combined the balance of a purchase money secured debt with a new debt and executed a new note and security agreement making the purchase money collateral secure the combined debt. The secured creditor filed a termination statement. The court held the creditor lost the purchase money priority. This result was not based on the termination statement as proof the purchase money security interest had been released, at least as to third parties. The termination statement simply nullified the financing statement needed to create the purchase money priority. *Tuftco Sales Corp. v. Garrison Carpet Mills, Inc.*, 158 Ga.App. 674, 282 S.E.2d 159, 31 UCC Rep.Serv. 1775 (1981).

This brings the court finally to the question of when the security interest was perfected. The termination statement was not notice of actual or constructive release of the security interest. The termination statement simply nullified the earlier financing statement. The security interest continued to exist, as the parties agreed, and RBI had the ability to perfect it again as to third parties. This leads to the conclusion that the security interest was perfected by the filing of the new financing statement in January 2001.

This decision raises the question of whether the ineffectiveness of the earlier financing statement takes away RBI's continuous perfection argument. The argument is that the security interest was continuously perfected from the filing of August 2000 financing statement until the filing of Tapistron's bankruptcy. Even if the transfer occurred for preference purposes when the security interest was re-perfected in January 2001, it could not have preferred RBI because it only continued what RBI already had.

The counter-argument is that the termination statement requires the court to treat the situation as if the August 2000 financing statement never existed. Even if this is the correct result for UCC purposes, does it mean the court must follow it for purposes of applying the preference statute? 11 U.S.C. § 547(e).

RBI might also argue that if the transfer occurred in January 2001, the transfer is not avoidable as a preference because it did not cause a diminution of the assets that Tapistron had available to pay other creditors. The theory is that there was never an instant when other creditors could have established a claim to machine 115 ahead of RBI's security interest.

Since the parties have not addressed these issues, the court will not address them. The court decides only that a transfer occurred when RBI filed the new financing statement in January 2001.

As to machine 1501, RBI asks the court to reverse its decision that RBI failed to obtain a security interest in the machine. The court declines to do so. The Georgia courts have been strict with regard to the requirements for creating a security interest. The court thinks the Georgia courts would decide against RBI on the question of whether it ever obtained a security interest in machine 1501. The court will deny RBI's motion to alter or amend on this point.

Tapistron made a $25,000 payment on the principal of the debt. Tapistron's motion to alter or amend asks the court to decide whether the payment should be applied to the $50,000 debt or the combined debt of $250,000. The court can leave this question unanswered for the moment. The trustee may be able to avoid the security interest in machine 115 as a preferential transfer to an insider. If so, it will not matter how the $25,000 payment is attributed.

RBI's motion asks the court to apportion the sale proceeds between machine 115 and machine 1501 so that it can determine the value of its security interest in machine 115. The court has decided that RBI's security interest in machine 115 secures only $50,000. This may make it unnecessary for the court to deal with the apportionment question. If not, RBI can raise the question again later.

Finally, the court will also amend the order on the summary judgment motions to make it clear that RBI's security interest in machine 115 is still subject to the trustee's insider preference claim.

This Memorandum constitutes findings of fact and conclusions of law as required by *Fed. R. Bankr. P.* 7052.

ENTER:

BY THE COURT

R. THOMAS STINNETT
UNITED STATES BANKRUPTCY JUDGE

(Entered 7/30/03)