

FINDINGS OF FACT

Debtor filed a voluntary petition for relief under Chapter 7 of the Bankruptcy Code on August 26, 1993. In his schedules filed with the Court, Debtor listed James M. Showalter as holding a secured claim in the amount of \$22,500.00. Debtor also listed as personal property 6,000 shares of common stock in a company know as International Auto Processing, Inc. ("IAP"). On September 30, 1993, Mr. Showalter filed a proof of claim in the case in the amount of \$22,901.19. The proof indicates that only \$6,000.00 of the claim is secured, while the remaining \$16,901.00 is unsecured.

James M. Showalter is the President and Chief Executive Officer of IAP, and he has held these positions in the company for approximately three and one-half years. Before holding these positions, he was employed by Panda Motor Corporation, the parent corporation of IAP.

IAP's operations are located in Brunswick, Georgia. The company is in the business of storing, detailing and installing accessories on foreign automobiles imported into the United States. The automobiles are made ready for shipment to the various dealers which are serviced by the port of Brunswick. IAP currently has contracts in place with certain manufactures, including Hyundai, Lexus, Mitsubishi and Saab. These contracts have a duration of only for one year and have been represented to be terminable at will.

Prior to 1992, IAP operated at a loss. However, its income statement has

shown steady improvement since 1989, when the company suffered a \$1,400,000.00 loss. In 1990, IAP lost \$800,000.00, and in 1991, it almost broke even. In 1992, IAP had its first profitable year when it earned \$425,000.00. Additionally, IAP took a non-cash charge against earnings of \$396,000.00 in 1991 and \$510,000.00 in 1992 as annual depreciation expense. IAP also has \$12,000,000.00 in debt outstanding, which it has apparently serviced without incident.

IAP has approximately 181,818¹ shares of common stock outstanding. Of that amount, Panda Motors currently owns approximately 96%, so that IAP is a subsidiary of Panda Motors. Debtor's 6000 shares represent approximately 3.3% of the outstanding stock, and a third party, Ken Hurta, owns the remaining 882 shares.

Debtor was, at one point, employed by IAP, but he ceased working for the company sometime before he filed his bankruptcy petition. In September of 1991, Mr. Showalter loaned Debtor \$20,000.00, secured by Debtor's 6000 shares of IAP common stock. The indebtedness is evidenced by a promissory note ("Note") dated September 6, 1991, and the Note calls for monthly payments of interest with a lump sum payment of principal due in January 1992. Debtor has not tendered any of the payments called for under the Note and is therefore in default.

¹Neither party introduced into evidence the actual number of shares which IAP currently has outstanding. There was, however, testimony which indicated that debtor's 6000 shares represents 3.3% of the outstanding stock. Accordingly, I arrived at a total of 181,818 shares outstanding by dividing Debtor's 6000 shares by 3.3%.

Mr. Showalter's security interest in the stock is evidenced by a stock pledge agreement wherein Debtor unconditionally granted Mr. Showalter a security interest in and security title to the stock. *See* Plaintiff's Exhibit 2. Additionally, Mr. Showalter took possession of the stock certificate representing Debtor's ownership interest in the 6,000 shares of IAP stock. Mr. Showalter remains in possession of the certificate today.

Every share of IAP common stock, including the 6,000 shares to which Debtor holds legal title, is subject to a transfer restriction contained in a stock sale agreement made by all of IAP's shareholders and IAP itself. Accordingly, the following legend appears on the stock certificate representing Debtor's 6000 shares:

The shares of stock represented by this Certificate are subject to an outstanding and unexpired purchase option and to all of the terms and conditions of that certain Stock Redemption or Sale Agreement dated April 25, 1986, are not transferable on the books of the Corporation or otherwise unless the terms and provisions contained in said Agreement are first fully observed. . .

See Plaintiff's Exhibit 4. The agreement itself is entitled "Stock Redemption or Sale Agreement of Shareholders of International Auto Processing, Inc." (hereinafter "Stock Sale Agreement"), and it provides, in relevant part, that "no shareholder shall sell, assign, convey, transfer or otherwise encumber all or any portion of the common capital stock of the Corporation now owned or hereafter acquired by him, without the prior written consent of the Company," unless the shareholder complies with the following procedures set forth in the agreement:

- 1) The offering shareholder must deliver a written offer to IAP, and to all of the other

shareholders, offering to sell the shares which the shareholder wishes to sell, or otherwise encumber, at the price and upon such terms as the offering shareholder is willing to sell or otherwise encumber the shares to a third party.

- 2) If either IAP or some number of the other shareholders accepts the offer, then all terms of purchase will be identical to that offered to the third party
- 3) IAP has the first right of refusal. It has 30 days from the receipt of the written offer to purchase all of the offered stock. In the event that the corporation chooses to exercise its option, it must give written notice setting a closing date for the sale within 30 day of the date of said written notice.
- 4) In the event that the corporation does not exercise its option within 30 days after receipt of the offer, the other shareholders shall have a further 30 days to exercise their option to purchase all of the offered stock. If the shareholders choose to exercise their option to purchase the shares from the offering shareholder, they must give written notice which sets a closing date for the sale within 30 days of the date of said notice.
- 5) If neither the corporation nor the shareholders exercise their option to purchase the offered shares, then the offering shareholder is free to sell or otherwise encumber all or any part of the subject shares of stock. If, however, the shareholder fails to transfer or otherwise encumber the offered shares to a third party within 90 days following the date of the offer, all untransferred or unencumbered shares again become subject to the terms and restrictions of the agreement.

- 6) Any transferee, assignee or lienor of shares transferred or otherwise encumbered pursuant to the agreement shall become a party to the agreement.

See Plaintiff's Exhibit 3.

The evidence revealed that Debtor did not comply with the terms of the Sale Agreement when he granted Mr. Showalter a security interest in his 6000 shares of IAP stock. Neither the Debtor nor Mr. Showalter gave notice to, or sought written approval from, IAP, Panda Motors or any of the other shareholders, before the stock was encumbered with Mr. Showalter's security interest. In fact, it appears that Mr. Showalter obtained the \$20,000.00, which he loaned to Debtor, from IAP without IAP's or Panda Motors' knowledge. IAP and Panda Motors have subsequently become aware of the transaction and have agreed to forgive the debt in exchange for Debtor's 6000 shares of IAP common stock.

Expert testimony as to the value of IAP and Debtor's 6000 shares of stock in IAP was heard from both sides. Mr. Showalter testified on his own behalf as an expert, and Barnett Bank called Ronald Adams, Vice-President of Barnett Bank, as its expert. Both witnesses agreed that, while IAP has no book value (ie. the amount by which total assets exceed total liabilities), it has substantial value under a net present value method of valuation. Mr. Showalter opined that the corporation had an optimistic net present value of \$7,200,000.00, using a cashflow multiplier of 5 and a discount rate of 8%. Mr. Adams, on the other hand, found the net present value of IAP to be approximately \$9,000,000.00, using an annual free cashflow of approximately \$900,000.00 (1992 earnings plus all non-cash

charges to income, such as depreciation) and a discount rate of 9%. Mr. Adams did not utilize a cash flow multiplier, opting instead to carry the cashflow out indefinitely (ie. \$900,000 divided by 9%). Thus, the witnesses' difference of opinion as to the value of IAP stems primarily from their use of different discount rates and Mr. Showalter's use of a cashflow multiplier.

As for other sales or pledges of IAP common stock, Mr. Showalter testified to the following transactions:

- 1) In 1988, Panda Motors paid \$1,000,000.00 for 36,200 shares of IAP stock, or \$27.62 per share.
- 2) In 1989, Panda Motors paid \$1,000,000.00 for 103,000 shares of IAP common stock, or \$9.71 per share.
- 3) The highest price at which IAP common stock has ever changed hands is \$56.69 per share.
- 4) Two other shareholders have pledged their shares of IAP stock for loans from the company. One pledged 6000 shares as security for a \$20,000.00 loan, while the other pledged 6000 shares for a \$50,000.00 loan.

In support of his Motion to Abandon, Mr. Showalter argues that, due to the perfected security interest which he holds in the stock, the principal and interest due to him under the Note, and the stock transfer restriction, the stock is not an asset from which payment could be made to the unsecured creditors of Debtor's estate. Accordingly, Mr. Showalter contends that the stock is of inconsequential value and burdensome to the estate,

and should therefore be abandoned to Debtor pursuant to Section 554 of the Bankruptcy Code. The Chapter 7 Trustee joins Mr. Showalter in this position.

Barnett Bank disagrees and makes essentially three arguments in support of its objection to the motion. First, it contends that Mr. Showalter's security interest in the stock is invalid because the transaction was not in compliance with the Stock Sale Agreement. Second, Barnett contends that IAP's and Panda Motor's subsequent tacit approval of the transaction effectively waived these parties' rights under the buy-sell agreement so that they cannot seek to enforce the agreement against Debtor's 6000 shares of the stock. Finally, Barnett contends that, notwithstanding the security interest or the buy-sell agreement, the stock has a potential value which substantially exceeds the debt owed to Mr. Showalter.

CONCLUSIONS OF LAW

Taking Barnett Bank's arguments in seriatim, I reach the following conclusions.

1. Validity of Mr. Showalter's Security Interest

An agreement between the shareholders of a corporation and the corporation itself, placing restrictions upon the transferability of the corporation's stock, is valid and enforceable under Georgia law, provided the restrictions in the agreement are for a reasonable purpose and the manner in which the restrictions operate are not manifestly unreasonable. *See e.g.*, O.C.G.A § 14-2-267; Helmly v. Schultz, 219 Ga. 201, 131 S.E.2d

924 (1963); Brown v. Momar, Inc., 201 Ga. App. 542, 545, 411 S.E.2d 718, 722 (1991). Such restrictions are likewise enforceable against subsequent transferees of the stock "if the restriction . . . is noted conspicuously on the front or back of the certificate . . ." O.C.G.A. § 14-2-267(b).

Neither party suggests that the Stock Sale Agreement is, in any manner, manifestly unreasonable, and, as set forth above, the stock certificate representing Debtor's shares gives unambiguous notice that the shares are subject to the Stock Sale Agreement. Thus, it is clear that the restrictions contained in the Agreement are valid and enforceable against Debtor, as well as any transferee of Debtor's shares.

Furthermore, as set forth above, the Stock Sale Agreement prohibits a shareholder from, among other things, encumbering "in any manner" the common stock of IAP, without first obtaining the prior written consent of IAP or complying with the right first refusal procedures set forth in the agreement. This language clearly covers the pledging or granting a security interest in the stock, as Debtor did in favor of Mr. Showalter. Having previously found that Debtor did not obtain prior written consent from IAP or comply with any of the procedures set forth in the agreement before granting Mr. Showalter a security interest in his stock, I conclude that Mr. Showalter's security interest in the stock was obtained in direct violation of the Stock Sale Agreement.

As to the effect of this violation, a basic principle of secured transactions law is that a debtor cannot grant greater rights in a piece of collateral than the debtor

possesses. In other words, a secured party's security interest in a piece of collateral attaches only to the extent of the interest which a debtor has in the collateral. *See e.g.*, O.C.G.A. § 11-9-203 (a); First National Bank & Trust Co. v. Smithloff, 119 Ga. App. 284, 167 S.E.2d 190 (1969). *See also* Garner v. First Nat. Bank & Trust Co., 465 F.Supp. 372 (S.D.N.Y. 1979); Franke v. Third Nat. Bank & Trust Co., 31 Ohio App.3d 189, 509 N.E.2d 955 (1986). This principle has led the Ohio Court of Appeals to hold that a pledgee of stock holds the same rights as the shareholder of record, and as a result, the pledgee's interest in the stock is subordinate to any restrictions placed upon the pledgor as shareholder, including a buy-sell agreement or stock purchase agreement. Bancohio National Bank v. Nursing Center Services, Inc., 61 Ohio App.3d 711, 717, 573 N.E.2d 1122, 1125 (1988).

The stock restrictions at issue in Bancohio, however, did not purport to restrict a shareholder from granting a security interest or pledging his shares, as the restriction in the instant case does. Thus, while it is clear that Mr. Showalter's interest in Debtor's stock is subject to the Stock Sale Agreement, the more difficult question is whether the security interest is somehow rendered void or voidable by the express provision in the Stock Sale Agreement prohibiting the granting of such interests. The only case located by this court, which deals with this precise issue, is Matter of Hill, 981 F.2d 1474 (5th Cir. 1993)². On facts very similar to those of the instant case, the Fifth Circuit held that a

²The Georgia Supreme Court was also faced with this precise issue in Avant v. Sandersville Production Credit Ass'n, 243 Ga. 173, 253 S.E.2d 176 (1979) *affirmed in part, vacated in part by* Bloodworth v. Sandersville Production Credit Ass'n, 245 Ga. 40, 262 S.E.2d 804 (1980), but was able to side-step it by concluding that the stock transfer restriction in question was not enforceable because it had not been properly adopted by the corporation. Additionally, in construing a provision of a corporate bylaw which provided that a shareholder had no right to sell his stock to a third party without first offering it to the other shareholders of the corporation, the Georgia Supreme Court stated in dictum that, if a shareholder failed to comply with this

transfer restriction in the articles of incorporation of a Louisiana corporation, providing that no shareholder shall sell, transfer, hypothecate or assign her stock without first offering the stock to the remaining shareholders, rendered a purported pledge of the stock by a Chapter 7 debtor *voidable* by the corporation, the other shareholders of the corporations, as well as the trustee of the Chapter 7 estate. Hill, 981 F.2d at 1480, 1488.

The debtor in Hill owned 25 shares in a closely-held Louisiana Corporation, which he pledged to a bank as additional security for an outstanding debt. In doing so, the debtor failed to comply with the procedures set forth in a transfer restriction contained in the corporation's articles of incorporation, which provided that "[n]o shareholder shall sell, transfer, hypothecate, assign, or in any manner convey his stock" without first offering the stock to the remaining shareholders at book value. The stock certificates bore a legend reflecting this restriction.

After the debtor had pledged the stock to the bank, the bank gave the corporation notice of its interest in the stock, and indicated its intention not to sell the stock at that time. Approximately a year and a half later, the bank notified the corporation that it intended to sell the stock, and the corporation responded by formally repudiating the validity of the debtor's pledge. Soon thereafter, the debtor filed a petition under Chapter 7 of the Bankruptcy Code. The bank filed a motion to lift stay as to the stock, and the Chapter 7 trustee responded by filing an adversary proceeding seeking to have the bank's security

provision, any attempted sale of the shares would be "without right". Helmly v. Schultz, 219 Ga. 201, 203, 131 S.E.2d 924, ? (1963). The Court did not, however, give any indication as to what the term "without right" means.

interest in the stock declared null and void.

The Fifth Circuit began by reviewing the bankruptcy court's ruling that the Chapter 7 trustee had standing to bring the adversary proceeding under 11 U.S.C. Section 544(b). The Fifth Circuit agreed with the ruling, reasoning that:

Even though "the Trustee has no independent power of avoidance, but may act only upon the right of one unsecured creditor holding an allowable claim, against whom the transfer or obligation was invalid under state law," the claim of John Pico - an unsecured creditor and stockholder in [the corporation] who is entitled to claim the benefit of the transfer restriction - supplied the necessary derivative standing.

Id. at 1478. (*quoting* in part the opinion of the bankruptcy court below)

The Court then concluded that the purported pledge was prohibited by the transfer restriction, and as a result, the bank's security interest in the debtor's stock, while not an absolute nullity, was voidable by the corporation, the other shareholders of the corporation, and the Chapter 7 Trustee. Id. at 1488. Accordingly, the court entered judgment in favor of the trustee and declared the security interest null and void, thereby freeing the stock to be included among the unencumbered assets of the estate. Id.

Critical to the Court's ruling was the fact that an unsecured creditor in the case who was also a shareholder in the corporation. This fact allowed the Chapter 7 trustee to gain standing to challenge the bank's security interest under section 544(b). The Court

recognized that a Chapter 7 Trustee does not have "an independent power of avoidance" and therefore needed a mechanism to become privy to the rights granted to the shareholders of the corporation under the transfer restriction. That mechanism was section 544(b).

The transfer restriction at issue in the instant case grants rights only to IAP and its shareholders. A review of the case file reveals that neither IAP nor its shareholders hold an unsecured claim against Debtor's estate. Section 544(b), therefore, is unavailable to the Trustee as a mechanism for gaining privity to the rights which the Stock Sale Agreement grants IAP and its shareholders.

Thus, even assuming that the result reached by the Fifth Circuit is the proper result under Georgia law, neither Barnett Bank nor the Chapter 7 Trustee have the legal standing to avoid Mr. Showalter's security interest. The only holding in this case which would free Debtor's stock of Mr. Showalter's security interest is a holding that the security interest is null and void, and I conclude that the Fifth Circuit was correct in its determination that a stock pledge in violation of a transfer restriction is not an absolute nullity. Accordingly, Mr. Showalter's interest in Debtor's stock is valid as against the Chapter 7 Trustee.

2. Waiver of Rights Under the Stock Sale Agreement

It is undisputed that IAP and Panda Motors became aware of Mr. Showalter's security interest in Debtor's stock subsequent to Mr. Showalter obtaining the interest, but took no steps to enforce its rights under the Stock Sale Agreement. Therefore,

there is perhaps sufficient evidence to find that IAP and Panda Motors waived their rights under the Stock Sale Agreement with respect to the granting Mr. Showalter's security interest. Such a finding does not, however, lead to the conclusion that these parties have waived any rights under the Agreement with respect to a subsequent sale of Debtor's stock. The granting of a security interest and the transfer of legal ownership in the stock of a corporation are fundamentally different transactions. The former gives a third party an interest in the stock only for the purpose of securing a debt, while the latter gives a third party legal ownership in the corporation. Consequently, it would be perfectly reasonable for IAP and Panda Motors, as beneficiaries under the Stock Sale Agreement, to choose not to enforce their rights under the Agreement when Debtor granted a security interest in the stock, but to exercise such rights when an actual sale of the stock is contemplated. Accordingly, any sale of Debtor's stock by the Chapter 7 Trustee would have to be subject to the Stock Sale Agreement.

3. Valuation of IAP Stock

Mr. Showalter's security interest in the stock secures a debt in the amount of \$22,901.19. Thus, if the value of Debtor's stock is less than this amount, then the stock would not be an asset from which payment to unsecured creditors could be made. If, on the other hand, the value of the stock is greater than this figure, the stock may indeed have value to Debtor's estate.

As set forth above, expert testimony placed the value of IAP at between \$7.2 million and \$9 million. At the lower figure of \$7.2 million, IAP's per share price is

approximately \$39.60, while at the higher figure, IAP's per share price is \$49.50. These per share prices place the total value of Debtor's 6000 shares at between \$237,600.24 and \$297,000.30. Previous sales of IAP stock are fairly consistent with these valuations. As noted above, IAP stock has changed hands at \$ 9.70 per share, \$27.62 per share, and \$56.69 per share. These per share prices yield the following values for Debtor's 6000 shares: \$58,200.00, \$165,720.00, and \$340,140.00.

These figures strongly suggest that Debtor's stock is worth significantly more than the \$22,901.19 which Mr. Showalter is owed. Of course, such a determination is extremely difficult to make given that IAP is a closely-held corporation whose shares are not traded on any organized exchange. Moreover, I agree with Mr. Showalter's contention that the Stock Sale Agreement and Panda Motors' 96% stake in the company reduce the value of Debtor's stock, which represents a very small minority stake in IAP. Nevertheless, the testimony of both witnesses, as well as the previous sales of IAP stock, strongly suggest that the value of 6000 shares of IAP stock, taken in the abstract, far exceeds the \$22,901.19 in debt which encumbers Debtor's shares. I therefore conclude that Debtor's 6000 shares of IAP stock, although encumbered by a perfected security interest in the amount of \$22,901.19, as well as a Stock Sale Agreement, are assets which have the potential to yield a dividend to the unsecured creditors of Debtor's estate.

Accordingly, the Trustee will be instructed to auction Debtor's 6000 shares of common stock in IAP shares to the highest bidder. Mr. Showalter is, of course, free to bid on the shares at the auction.

ORDER

Pursuant to the foregoing Findings of Fact and Conclusions of Law, IT IS THE ORDER OF THIS COURT that James M. Showalter's Motion for Abandonment is hereby DENIED.

IT IS FURTHER ORDERED that Trustee conduct a public auction of James Warren Phillips' 6000 shares of common stock in International Auto Processing, Inc.

Lamar W. Davis, Jr.
United States Bankruptcy Judge

Dated at Savannah, Georgia

This ____ day of February, 1994.