UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF NEW YORK

IN RE:

INTERCO SYSTEMS, INC.

CHAPTER 11

CASE NO. 93-20144

BACKGROUND

On January 26, 1993, three creditors of the debtor, Interco Systems, Inc., ("Interco") filed an involuntary Chapter 7 petition alleging that Interco was not paying its debts as they became due.

Interco interposed an answer, claiming that the indebtedness alleged by each of the petitioning creditors was in dispute, and requested that the petition be dismissed. At a pretrial conference on March 16, 1993, Interco indicated that it wished to remain in the Bankruptcy Court and attempt to reorganize under Chapter 11. Because Section 706(a) gives a Chapter 7 debtor acting in good faith the absolute right to convert to Chapter 11 if the case has not previously been converted, counsel for the petitioning creditors and Interco agreed to discuss Interco's desire to proceed in Chapter 11 as an alternative to conducting a trial of the issues under Section 303(h). To afford the parties time for such further discussion, a trial on the involuntary petition was scheduled for April 2, 1993. On April 1, 1993, a stipulation between Interco and the petitioning creditors was filed with the Court. The stipulation agreed that Interco would go forward with a voluntary Chapter 11 case. After some procedural matters were corrected, this case has gone forward in Chapter 11 with an order for relief date of January 26, 1993.

Interco's business can best be described as a buying group. In the late 1970's and throughout the 1980's, it organized "Subscribers," generally small to medium wholesale or retail distributors of electrical and plumbing supplies located all across the country, and placed orders on their behalf with "Suppliers," manufacturers or national wholesalers of plumbing and electrical supplies. Because Interco placed such large orders with the Suppliers, it was able to negotiate volume sales discounts ("VSD's") with the Suppliers, generally 3.4% of purchases, which were then split between the

Subscribers and Interco. Interco was also providing Suppliers with greater market penetration, since they might not otherwise obtain orders from many of the Interco Subscribers, which further justified the payment of VSD's. Although during this period, in many if not most cases, orders were actually placed directly by Subscribers with the Suppliers and the goods shipped directly to the Subscribers, nevertheless, Interco was paid for the goods by the Subscribers and it was Interco that was billed by and paid the Suppliers. As a result, during the 1980's when there were very few, if any, defaults in payment by Subscribers, Interco was able to generate substantial profits from its share of VSD's, sign up fees paid by new Subscribers and the significant float on monies received by Interco from the Subscribers before the Suppliers' invoices were due. In its best year, 1989, Interco handled purchases of in excess of $264,000,000, generating income before taxes of in excess of $2.9 million. After 1989, the recession hit; building was down nationwide; the volume of purchases decreased;and Subscribers began defaulting on their payments to Interco. However, Interco was still legally obligated to pay the Suppliers for the goods; it was not earning as much on the float; and it failed to react quickly to the change in the business environment and reduce its expenses. As a result, before taxes, Interco lost over $2,000,000 in 1990, $3,000,000 in 1991, $4,000,000 in 1992, and has lost significant monies to date in 1993. In addition, since 1990, the number of Interco Subscribers has fallen significantly from approximately 660 to 384. In 1992, it appears that Interco began trying to negotiate contracts with Suppliers which would provide that although the Suppliers would now bill and receive payment directly from the Subscribers, they would nevertheless still pay the VSD's to Interco, which Interco would continue to divide between it and the Subscribers. Under these contracts Interco would not have any credit risk in connection with purchases, but it would also no longer be supplying credit support to the Suppliers, an element of value which at least some of the Suppliers had relied heavily on. It is unclear how many Suppliers may have agreed to such terms, but it is clear that few, if any, such agreements were reduced to writing.

On April 28, 1993, the Office of the United States Trustee

(the "U.S. Trustee") filed a motion to convert or dismiss the case because of Interco's failure to file the statements and schedules required by Rule 1007. The U.S Trustee's motion was withdrawn after the required statements and schedules were filed on May 3, 1993. An initial Section 341 meeting of creditors was held on

May 11, 1993 which was attended by a number of Interco's major creditors. On May 12, 1993, the U.S. Trustee appointed a final committee of unsecured creditors (the "Creditors Committee").

By motion returnable May 19, 1993, Carlon, a division of Lamson & Session Co., ("Carlon"), one of the original petitioning creditors which claims an indebtedness due it of $389,143.00 and whose Vice President and Controller, Carl Miller ("Miller"), was later named the Chairman of the Creditors Committee, moved for the appointment of an examiner pursuant to Section 1104. The basis for the request was concern about dispositions of artwork owned by Interco, both before and after January, 1993, and the nature and extent of the various informal arrangements for the joint ownership of artwork and real estate which Interco claims to have with Clifford M. Davie ("Davie"), its chief executive officer, president and major shareholder. The motion for the appointment of examiner was adjourned to June 9, 1993.

On May 24, 1993, the Court authorized the employment of Nixon, Hargrave, Devans and Doyle ("Nixon"), as attorneys for the Creditors' Committee. On May 27, 1993, pursuant to Rule 2004, Nixon issued a notice of deposition to Interco and Davie to take their deposition on June 4, 1993. On June 9, 1993, the Carlon motion for the appointment of an examiner was withdrawn in view of the ongoing investigation and depositions being conducted by the Creditors Committee.

On April 7, 1993, the Court had issued its standard order in Chapter 11 cases which provided in this case that after May 5, 1993, no compensation could be paid to any insider of Interco without prior Court approval. By motion returnable May 19, 1993, Interco sought Court approval of a salary of $12,000 per month ($144,000 annualized) for Davie which was less than the $7552 per week ($392,704 annualized) salary that it had paid to Davie pre-petition. The motion was adjourned to

June 9, 1993 so that it would be heard with the motion for the appointment of an examiner, and the Creditors Committee would be afforded the opportunity during its investigation and depositions to inquire into the reasonableness of any salary to Davie. At the May 19, 1993 hearing, the Court ordered that no further salary be paid to Davie pending the June 9, 1993 hearing. At the June 9, 1993 hearing, the Court ordered that no further salary would be payable to Davie until after an evidentiary hearing requested by the Creditors Committee.

On June 14, 1993, the Creditors Committee filed a motion with the Court requesting that in accordance with Section 1112(b) the Interco case be converted to a Chapter 7 case, or, in the alternative, that a trustee be appointed pursuant to Section 1104(a). Presented with the Creditors Committee motion was an ex parte motion and proposed order for an expedited hearing requesting that the Court reduce the normal twenty day notice period required by Rule 2002 so that an expedited hearing could be held on June 18, 1993. The papers presented by the Creditors Committee alleged that as a result of the investigation being conducted by the Committee, its attorneys and accountants, Cortland L. Brovitz & Co., P.C. ("Brovitz"), sufficient evidence of improper or questionable transactions between Interco and various insiders had been uncovered which indicated that there might be immediate and irreparable harm to the estate and its creditors if current management were not replaced. In view of: (a) the nature and extent of the allegations contained in the moving papers; (b) the public attention focused on the Interco case and Davie as the result of numerous newspaper articles; (c) the Court's belief that Interco and its professionals, since the filing of the involuntary petition in January, 1993 and before, should have been expecting inquiries into these transactions and should have had detailed explanations already available; and (d) the allegation in the motion papers that the Creditors Committee, whose members hold approximately $4,000,000 of the $12,000,000 in unsecured debts scheduled by Interco, had unanimously voted that the request for conversion to Chapter 7 be made, the Court granted the request for an expedited hearing.

Full day evidentiary hearings were held on June 18, 21, 23, 28 and July 9, 1993, and oral argument by counsel was presented on July 14, 1993, at which time the Court reserved on this matter.

DISCUSSION

Section 1104(a)[1] provides that the Court shall order the appointment of a trustee in a Chapter 11 case either for cause, which may include, but is not limited to, fraud, dishonesty, incompetence or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or in the interest of creditors, any equity security holders and other interests of the estate. The determination as to whether to order the appointment of a trustee under this section is addressed to the sound discretion of the Bankruptcy Court. If the only request for relief by the Creditors Committee was for the appointment of a Chapter 11 trustee, based on the evidence presented to the Court and all of the prior pleadings and proceedings in this case, the Court would order the appointment of such a trustee, both for cause and as being in the best interests of the

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[1] Section 1104(a) provides:

> At any time after the commencement of the case but before confirmation of a plan, on request of a party in interest or the United States trustee, and after notice and a hearing, the court shall order the appointment of a trustee—
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> (1) for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause, but not including the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor; or
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> (2) if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate, without regard to the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor.

estate and all parties, including the creditors, equity security holders, Subscribers, Suppliers and other interested parties.

From the evidence presented by the Creditors Committee and Interco, it is clear that for several years the current management of Interco has had poor financial controls in place and simply does not have an adequate handle on the financial affairs of its business. Also, its failure during the recent hearings to produce, find or even confirm that certain important documents exist indicates that the current management of Interco simply does not have an adequate handle on much of its overall business relationships.

Further, from the evidence presented by the Creditors Committee and Interco of the transactions between Interco and Davie and entities related to or controlled by Davie or relatives of Davie, it is clear that some or all of these transactions may properly be categorized as fraudulent or dishonest, evidence incompetence or gross mismanagement of the affairs of Interco, or, when viewed together, be so questionable and improper that notwithstanding Interco's explanations for them there is cause, within the meaning and intent of Section 1104(a)(1), to remove current management and replace it with a trustee. These transactions include, but are not limited to: (a) the payment to Davie's sister, when her employment was terminated, of severance pay in the amount of approximately one year's salary at a time when Interco was experiencing substantial financial difficulties and suffering significant losses; (b) the cancellation of Davie's indebtedness to Interco in connection with artwork previously purchased with Interco's funds, but owned by Interco and Davie, when title to the artwork was transferred to Interco, which appears to indicate that although Davie had under the informal ownership and borrowing arrangement an upside if the artwork appreciated in value, he had no downside if the artwork decreased in value; (c) the reclassification of significant amounts ($169,000) previously shown as due from Davie on Interco's books, sometimes for over five years, to reflect that allegedly these items had, in fact, all along been proper company expenses, including interest payments, insurance premiums, Rolls-Royce automobile

expenses and political contributions; (d) the payment of a significant salary to Davie at times when Interco was experiencing substantial financial difficulties and suffering significant losses; (e) the numerous questionable transactions involving real estate investments in which Interco and Davie participated; (f) the payment of Davie's personal expenses from the funds of Interco or partnerships between Interco and Davie at a time when the funds were needed to operate Interco, preserve Interco's interest in the partnerships or pay creditors; (g) the unexplained losses in 1991 of over $1,300,000.00; and (h) the substantial accrued vacation pay that Davie took after the involuntary petition was filed and when Interco was clearly experiencing substantial financial difficulties, suffering significant losses, and in need of the funds to operate Interco or pay creditors.

Further, testimony presented both on behalf of the Committee and Interco itself indicates that Interco could not be viable, inside or outside the Bankruptcy Court, in the eyes of past, current or prospective Suppliers or Subscribers unless current management is replaced. Therefore, the appointment of a trustee, if the case were allowed to remain in Chapter 11, would clearly also be in the best interests of creditors, equity security holders and other interests of the estate within the meaning of Section 1104(a)(2).[2]

However, the relief requested by the Creditors Committee is not simply for the appointment of a Chapter 11 trustee pursuant to Section 1104(a), but is for an order converting this case to a Chapter 7 case pursuant to the provisions of Section 1112(b). The Committee has alleged that there is cause to convert the case to a Chapter 7 case including a continuing loss to or diminution of the estate and an absence of a reasonable likelihood of rehabilitation under Section 1112(b)(1) as well as the inability of Interco to effectuate a plan under Section 1112(b)(2). The determination to

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[2] The Court is aware of the seeming inconsistency of a finding that grounds exist for the appointment of a Trustee under Section 1104(a)(2) which somehow does not constitute cause under Section 1104(a)(1).

convert a case to a Chapter 7 case pursuant to Section 1112(b)[3] is also addressed to the sound discretion of the Bankruptcy Court and, in this Court's view, requires the Court to take into consideration all of the facts and circumstances of the debtor and the case. See Matter of Levinsky, 23 B.R. 210, 217 (Bankr. E.D.N.Y. 1982); Matter of Santiago Vela, 87 B.R. 229, 231 (Bankr. D. P.R. 1988).

Based on all of the evidence presented to the Court and all of the prior pleadings and proceedings in this case, the Court finds that there is cause, within the meaning and intent of Section 1112(b), to convert this case to a Chapter 7 case and that such a conversion would be in the best interests of creditors and the estate. Because of the nature of this case and because it has generated a great deal of public attention, I believe that it is important that the Court set forth the many factors which it considered in making its decision to exercise its discretion and convert this case for cause to a Chapter 7 case.

Those factors constituting cause are as follows:

1. Although some of the Interco Subscribers may still be placing orders with Suppliers, Interco has been unable to demonstrate that since the filing of the involuntary petition significant VSD's have in fact been legally earned and are payable to Interco as a result of all or a substantial number of these direct transactions between the

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[3] Section 1112 (b) provides:

> Except as provided in subsection (c) of this section, on request of a party in interest or the United States trustee, and after notice and a hearing, the court may convert a case under this chapter to a case under chapter 7 of this title or may dismiss a case under this chapter, whichever is in the best interest of creditors and the estate, for cause, including–
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> (1) continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation;
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> (2) inability to effectuate a plan.

Subscribers and Suppliers. The legal ability of Interco to collect any or a significant amount of allegedly earned VSD's from the Suppliers has not been sufficiently established. Mr. Bonadio, a principal of Interco's accountants Bonadio, Insero & Co., testified that post-petition, under generally accepted accounting principles, any allegedly earned VSD's not specifically acknowledged by Suppliers could not properly be accrued on Interco's books as revenue as a result of the ongoing direct transactions between Subscribers and Suppliers. This lack of confirmed revenue raises a fundamental question as to the viability of Interco as an ongoing business.

2. The witnesses who testified on Interco's behalf indicated that past, present and prospective Subscribers or Suppliers that would consider doing business with Interco essentially require that Interco have all of its financial problems fully resolved in a timely manner. These witnesses generally believe that this would require the cooperation of most, if not all, of its Subscribers and Suppliers and a timely and successful conclusion to these bankruptcy proceedings. However, it is clear that many of the Subscribers and key Suppliers do not intend to cooperate with any efforts by Interco to reorganize. This lack of cooperation by key parties, which would most likely result in protracted proceedings in this Court, raises an additional question as to the viability of Interco as an ongoing business.

3. It appears that the credibility of Interco in the marketplace with past, prospective and even present Subscribers and Suppliers has been almost completely destroyed. This appears to be the result of many events, including, but not limited to: (a) the substantial losses experienced by Interco for 1990, 1991, 1992 and 1993; (b) the inability of Interco to successfully reorganize outside of bankruptcy in 1992 despite its various attempts; (c) the substantial cash payments and transfers of artwork made by Interco to some Suppliers in 1992 to the exclusion of other creditors; (d) the

failure of Interco to keep its promises to many of its Suppliers; (e) the many questionable transactions between Interco and Davie and entities related to him which, notwithstanding the various explanations put forth on behalf of Interco and Davie, simply are never going to be satisfactorily explained to and accepted by many past, existing and potential Subscribers and Suppliers; (f) the presence of Interco in a bankruptcy proceeding with an active Creditors Committee which seeks its conversion and the attendant publicity; (g) the expressed unwillingness of many Suppliers to deal with Interco; and (h) the excessive salary paid to Davie in years when the company was experiencing significant financial difficulties and suffering substantial losses. This lack of credibility also raises a fundamental question as to the viability of Interco as an ongoing business.

4. Even if an appropriate Chapter 11 trustee could be found and appointed as urged by Interco, it appears that unlike in the usual situations where a Chapter 11 trustee is appointed, he or she would be asked not just to liquidate the business in an orderly manner or manage and propose a plan for a viable business where there is a disagreement between shareholders or partners or the business just needs a little better management. In this case, the trustee would basically be asked to build or, at best, rebuild a business with poor credibility in the marketplace; inadequate books and records and financial controls; a possibly inadequate staff for the task presented; probably inadequate working capital; few, if any, firm contracts with suppliers; and countless other handicaps. How long would such a task take if it could even be accomplished is a question which can not be answered by this Court. Beyond that, it appears that the trustee would be spending much of his or her time litigating all of the various issues in the case with the Creditors Committee which undoubtedly would continue to seek a conversion. As expressed previously, from all of the

testimony before the Court, it appears that only with the complete cooperation of all key entities, Subscribers, Suppliers and other creditors could Interco successfully rehabilitate itself and propose and have a plan confirmed which would be acceptable to creditors, in their best interests and feasible. However, there is no evidence before the Court that such cooperation would be forthcoming by all of the necessary entities to accomplish such a rehabilitation in a timely and cost effective manner on the facts and circumstances of this case.

5. Based on the unanimous request for conversion by the Creditors Committee, the representations by Nixon, its counsel, that the members of the Committee would not vote for any earn out plan proposed by Interco even if a trustee were appointed to operate the business, and the Committee's belief, from its contacts with other creditors, that many other creditors would also not vote for such a plan, there is a serious question as to whether Interco could ever propose a plan which would be accepted, pursuant to Section 1126, by the class of unsecured creditors. This raises a serious question as to whether Interco would ever be able to effectuate a plan, or if any plan could be proposed and confirmed, whether it would be able to be confirmed under Section 1129(b). Given the position of the Creditors Committee, confirming a plan under Section 1129(b), if it were possible, would likely be a difficult, time-consuming and expensive process, further dissipating the assets of the estate.

6. The books and records of Interco have not been adequately maintained. Interco's ability to answer the kinds of questions and provide the kinds of information, in a timely and cost effective manner, necessary to successfully reorganize in Chapter 11, even if a trustee were to be appointed, is deficient. This further indicates that it is unlikely that Interco can reorganize in a timely and cost effective manner.

7. Interco, during 1992 and 1993 before an order for relief was entered, made various attempts to reorganize outside of Bankruptcy Court. It brought in alleged new management in 1992 and consultants in 1992 and 1993. It tried to negotiate firm contracts with Suppliers for direct billing to Subscribers and made comprehensive payment proposals to many Suppliers, a number of which it defaulted on, but simply was not able to successfully reorganize its affairs. As a result, Interco has already had over a year to attempt to reorganize and has been unsuccessful.

8. The Creditors Committee, which holds approximately $4,000,000 of the approximately $12,000,000 of unsecured indebtedness scheduled by Interco, has unanimously requested that this case be converted to a Chapter 7 case. The Creditors Committee consists of entities and representatives of those entities which must, by this Court's standards, be considered sophisticated creditors. They have knowledge not only of Interco, but also of its position in the marketplace and the position of competing buying groups. Although the expressed desire of an active, organized and sophisticated Creditors Committee holding approximately one-third of the unsecured debt in a case and apparently acting in good faith in the exercise of its fiduciary duties is not the exclusive factor to be considered by a Court in making a determination under Section 1112(b), the expressed will of such a Committee is certainly an important factor to be considered by the Court.

9. Because it has actually only collected a small amount of VSD's, there has been no clear showing that Interco is presently generating any significant legally collectable revenue in the form of VSD's. However, it is clear that it is expending significant monies for payroll and other operating expenses and professional fees. Therefore, Interco has not demonstrated that there is not a continuing loss to or diminution of

the assets of its estate.[4] It is contemplated in Chapter 11 that a debtor, in exchange for a period of time to attempt to reorganize, will not deplete the assets of the estate without either the creditors' consent or a clear showing that such a continuing depletion will ultimately result in a more favorable situation. In the case of Interco, there continues to be costs and expenses being paid out of non-recurring assets, such as the recently received tax refund, which are not being offset by demonstrable revenue or profit. This is without the creditors' consent or a reasonably clear showing of sufficient current or future revenue to offset the continuing depletion of assets.

10. Interco's own schedules indicate that it is clearly insolvent. Therefore the real parties in interest in this case are the creditors. Their clear desire is to convert Interco to Chapter 7, marshal its remaining assets, avoid any legally avoidable transfers or transactions, liquidate the assets and distribute them to the creditors. The Creditors Committee has indicated that it anticipates significant costs in further investigating the affairs of Interco and avoiding various transfers and transactions and does not wish to see any available assets further reduced in value by Interco's continuing losses.

11. There does not appear to be any special public interest in Interco. It has few employees and does not provide a unique service since there are now a number of competing buying groups.

Interco may have been a pioneer in its field and a highly profitable company in the 1980's from which many, including the Rochester Area, may have derived substantial benefits. However, it is clear today that by its actions and inactions, whatever explanations may be made for them,

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[4] Although the Creditors Committee has the burden of proof on this issue, by the evidence presented, the burden was shifted to Interco to demonstrate that there has not been a continuing loss or diminution.

Interco is no longer a viable business which can reasonably be expected to reorganize in Chapter 11 within a reasonable period of time and in a cost effective manner. As Bankruptcy Judge Merritt S. Deitz, Jr. aptly said, "If there is not a potentially viable business in place worthy of protection and rehabilitation, the Chapter 11 effort has lost its raison d'etre and liquidation should occur." In re Ironsides, Inc., 34 B.R. 337, 339 (Bankr. W.D. Ky. 1983).

CONCLUSION

After considering all of the evidence presented to the Court and all prior pleadings and proceedings in this case and after considering all of the facts and circumstances of this case, this Court, in the exercise of its discretion, finds that the Interco Chapter 11 case should be converted to a Chapter 7 case for cause within the meaning and intent of Section 1112(b).

IT IS SO ORDERED.

/s/
HON. JOHN C. NINFO, II
UNITED STATES BANKRUPTCY JUDGE

Dated: July 19, 1993