UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF NEW YORK

In Re:

Interco Systems, Inc., **CASE NO. 93-20144**

Debtor.

C. BRUCE LAWRENCE, TRUSTEE,

Plaintiff,

vs.

ALEXANDRIA LIGHTING & SUPPLY, INC.	**A.P. NO. 95-2154**
ALMEIDA ELECTRICAL, INC.	**A.P. NO. 95-2163**
CAPITAL ELECTRIC SUPPLY CO.	**A.P. NO. 95-2110**
CENTENNIAL DISTRIBUTORS, INC.	**A.P. NO. 95-2100**
CHRIS HAYNES ELECTRIC SUPPLY	**A.P. NO. 95-2220**
COLEMAN ELECTRIC COMPANY, INC.	**A.P. NO. 95-2011**
CONSOLIDATED SUPPLY CO.	**A.P. NO. 95-2157**
ELKHART SUPPLY CORPORATION	**A.P. NO. 95-2122**
ERIE SUPPLY CO., INC.	**A.P. NO. 95-2130**
ESP PLUS, INC.	**A.P. NO. 95-2133**
INTERSTATE ELECTRIC SUPPLY	**A.P. NO. 95-2172**
JON JAY ELECTRIC	**A.P. NO. 95-2266**
KOVALSKY-CARR ELECTRIC SUPPLY CO., INC.	**A.P. NO. 95-2097**
KOYM ELECTRIC SUPPLY	**A.P. NO. 95-2295**
MARVEL LIGHTING CORP.	**A.P. NO. 95-2065**
MASTRO ELECTRIC SUPPLY CO.	**A.P. NO. 95-2192**
MESCO CORPORATION	**A.P. NO. 95-2294**
MOHAWK ELECTRICAL SUPPLY	**A.P. NO. 95-2208**
MOLINE ELECTRICAL SUPPLY	**A.P. NO. 95-2205**
NORMAN PLUMBING SUPPLY CO.	**A.P. NO. 95-2183**
NORTH VALLEY DISTRIBUTING	**A.P. NO. 95-2188**
PATTON WHOLESALE DISTRIBUTORS, INC.	**A.P. NO. 95-2193**
RAMSEY ELECTRIC SUPPLY CO.	**A.P. NO. 95-2213**
ROEKEL COMPANY	**A.P. NO. 95-2316**
ROSE ELECTRIC SUPPLY CO.	**A.P. NO. 95-2270**
THE VAN ATTA SUPPLY CO.	**A.P. NO. 95-2289**
and	
WEBER ELECTRIC SUPPLY, INC.	**A.P. NO. 95-2244**

Defendants.

BACKGROUND

On January 26, 1993, three "Supplier" 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, the case went forward in Chapter 11 with January 26, 1993 deemed to be the order for relief date.

On June 14, 1993, the Creditors Committee formed in the Chapter 11 case filed a motion pursuant to Section 1112(b) which requested that the Interco case be converted to a Chapter 7 case, or, in the alternative, that a trustee be appointed pursuant to Section 1104(a) (the "Conversion Motion"). 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 the Conversion Motion.

By a written decision issued on July 19, 1993 the Court determined that the Interco Chapter 11 case should be converted to a Chapter 7 case for cause, and thereafter on July 21, 1993 the

designation of the Office of the United States Trustee appointing C. Bruce Lawrence as Trustee (the "Trustee") was filed with the Court.

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 made such large purchases with the Suppliers, it was able to negotiate volume sales discounts ("VSD's") with the Suppliers, between 1% and 13% 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 in excess of $2,000,000 in 1990 and $3,000,000 in 1991.

In 1992 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 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 upon.

In January, 1995 the Trustee commenced in excess of 350 separate adversary proceedings to recover alleged avoidable preferences, post-petition transfers and fraudulent conveyances. Among these adversary proceedings were the above-captioned cases where the Trustee included in each Complaint a cause of action to recover, as an avoidable preference, payments made by Interco to the defendant Subscriber in November, 1992, a date which was within ninety days of the filing of the involuntary petition against Interco.

In each of the above-captioned cases[1], the defendant Subscriber interposed an Answer which alleged that with respect to the Trustee's cause of action to avoid the November, 1992 payments, these payments were distributions of VSD's made to the defendant Subscriber in the ordinary course of the business of both Interco and the Subscriber. Therefore, it was alleged that such payments were not avoidable preferences because of the exception set forth in Section 547(c)(2)[2].

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[1] The *Coleman Electric Company, Inc., Marvel Lighting Corp.* and *Rose Electric Supply Co.* cases have now been settled.

[2] Section 547(c)(2) provides:

The trustee may not avoid under this section a transfer–
(2) to the extent that such transfer was–

(A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;

(B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and

On April 27, 1995 an Omnibus Motion for Partial Summary Judgment (the "Summary Judgment Motion") was filed on behalf of the defendants which alleged that: (1) under its written agreements with Subscribers[3], Interco agreed to make "quarterly distributions of discounts received from Suppliers. Such distributions will be made within 45 days after the end of each calendar quarter"; (2) the payments made to the defendants in November, 1992 were within 45 days after the end of the third quarter 1992 and represented the VSD's which each defendant was entitled to under its Subscriber Agreement with Interco, based on orders placed by each defendant; (3) Interco had always made such quarterly distributions to each defendant in the past pursuant to the terms of its Subscriber Agreement; (4) none of the defendants had in any way pressured Interco to make the November 1992 payments which were made pursuant to the terms of the Subscriber Agreements; (5) the payments in November, 1992 were necessary for Interco to keep the buying group in place, so that they were made by Interco in the exercise of sound business judgment; (6) the November, 1992 payments to each of the defendant Subscribers were made by Interco within the ordinary course of its business, since they were made pursuant to the terms of the Subscriber Agreements; and (7) the November, 1992 payments were received by each of the defendant Subscribers in the ordinary course of its business, since they were received pursuant to the terms of its Subscriber Agreement with Interco. Based upon these alleged facts, the defendant Subscribers asserted that the November, 1992 payments were not avoidable preferences because they were made within the ordinary course of business within the meaning and intent of the exception set forth in Section 547(c)(2).

(C) made according to ordinary business terms.

[3] Attached as Exhibit A to an April 17, 1995 Affidavit in Support of the Summary Judgment Motion made by John M. Tetens, President of one of the defendants, North Valley Distributing, (the "Tetens Affidavit") is a copy of a Service Agreement which defendants have alleged in the Motion is representative of the agreements entered into between Interco and the Subscribers (hereinafter the "Subscriber Agreement").

The Trustee opposed the Summary Judgment Motion and alleged that: (1) the Summary Judgment Motion was premature in that the Trustee was hampered by: (a) poor records maintained by Interco; (b) a lack of cooperation from Interco personnel as a result of the conversion by the Court of the case from Chapter 11 to Chapter 7; and (c) the lack of an opportunity to conduct necessary discovery; (2) by the summer of 1992, Interco was operating outside the ordinary course of its business since it was losing money and was severely in default on its payments to Suppliers; (3) prior to receipt of the November, 1992 payments, each of the defendant Subscribers knew of Interco's financial difficulties and its defaults on its payments to Suppliers because of a November 4, 1992 Memorandum sent by Interco to the Subscribers[4]; (4) in October, 1992 Interco terminated its prior centralized billing method and required its Suppliers to bill the Subscribers directly and the Subscribers to pay the Suppliers directly[5]; and (5) notwithstanding Interco's failure to have paid Suppliers in excess of $12,000,000, Interco made the November, 1992 payments to the defendant Subscribers in the amounts which represented the VSD's which Interco and each Subscriber had allegedly earned from Suppliers for the third quarter of 1992. Based upon these alleged facts, the Trustee asserted that the November, 1992 payments to the defendant Subscribers were not made in the ordinary course of Interco's business within the meaning and intent of Section 547(c)(2).

DISCUSSION

Set forth in the decisions of now retired Chief Bankruptcy Judge Beryl E. McGuire and

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[4] A copy of this Memo was included as Exhibit "H" to the Trustee's opposition to the Summary Judgment Motion and as Exhibit "B3" to the Tetens Affidavit.

[5] A second November 4, 1992 Memorandum from Interco to all of its Subscribers, a copy of which was attached to the Trustee's Opposition to the Summary Judgment Motion, directed the Subscribers to pay all invoices on and after October 19, 1992 directly to the respective Supplier.

United States District Judge Richard J. Arcara in *In re Roblin Industries, Inc.*, 127 B.R. 722 (Bankr. W.D.N.Y. 1991), *aff'd*, No. 91-CV-523A (W.D.N.Y. Mar. 29, 1995), *appeal filed,* (2d Cir. Apr. 28, 1995); Chief Bankruptcy Judge Michael J. Kaplan in *In re D.J. Management Group, Inc.*, 164 B.R. 831 (Bankr. W.D.N.Y. 1994); and in the cases they cited, are the requirements which a defendant must prove in order to fall within the exception to an avoidable preference as set forth in Section 547(c)(2)[6].

For the reasons set forth below, the Court does not believe that the Subscriber defendants have proven by a preponderance of the evidence that the November, 1992 payments were made by Interco in the ordinary course of its business or financial affairs, as required by Section 547(c)(2)(B), to the extent that such payments do not represent the redistributions of VSD's received or collected by Interco from its Suppliers.

As set forth above, the representative Subscriber Agreement provides that "Interco will make quarterly distributions of discounts received from Suppliers." That this contractual provision should be interpreted literally to mean that the discounts must have been received or collected from the Suppliers is supported by the following: (1) a May 14, 1991 Memorandum from Interco to all electrical Subscribers, a copy of which was attached as Exhibit C to the Tetens Affidavit, indicated that redistributions of discounts by Interco depended upon their having been received from Suppliers because the Memorandum advised that: (a) the timing of the payment of VSD's to Interco by one Supplier, Tork, affected the timing of the payments by Interco to Subscribers; (b) distributions were not being made of VSD's from Picoma and Anamet because they had not been collected from those Suppliers; and (c) payments of VSD's from Royal, American Metal Moulding and Laribee, each of

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[6] Defendant must prove each of the three elements of Section 547(c)(2) by a preponderance of the evidence. 11 U.S.C. §547(g); *see also J.P. Fyfe, Inc. of Florida v. Bradco Supply Corp.*, 891 F.2d 66, 69-70 (3d Cir. 1989).

which had filed Chapter 11, would not be made until the accounts with those Suppliers were settled; and (2) several representative agreements between Interco and Suppliers (CRP Radiator Specialty Company and Paragon Electric Company, Inc.) included in Exhibit B to the Trustee's Opposition to the Summary Judgment Motion, indicated that Interco generally collected VSD's by deductions from the remittances which it made each month to the Supplier.

From the foregoing, the Court cannot conclude that the defendant Subscribers have met their burden to prove, by a preponderance of the evidence, that it was the ordinary course of Interco's business to pay VSD's to Subscribers if it had not actually received or collected the discounts from the respective Supplier. Rather, the documentary evidence before the Court on the Summary Judgment Motion indicated that it was Interco's contractual obligation under the Subscriber Agreements as well as its practice to only redistribute VSD's received or collected from the Suppliers in accordance with the agreements between Interco and the Suppliers.[7]

To the extent that the November, 1992 payments to any of the defendant Subscribers represented their earned share of VSD's actually received or collected by Interco from a Supplier, in accordance with the terms and conditions of the applicable agreement between that Supplier and Interco, the Court believes that the three elements of Section 547(c)(2) would be met. Any such payments would clearly then have been within the terms of both the Subscriber and Supplier Agreements and what appears to have been Interco's practice in implementing those Agreements.

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[7] *See Matter of Tolona Pizza Products Corp.*, 3 F.3d 1029, 1032 (7th Cir. 1993) (Posner, J.) ("[T]he most important thing is not that the dealings between the debtor and the allegedly favored creditor conform to some industry norm but that they conform to the norm established by the debtor and the creditor in the period before, preferably well before, the preference period."); *accord In re Roblin Industries, Inc.*, No. 91-CV-523A, at 10 (W.D.N.Y. Mar. 29, 1995) (Arcara, J.) ("The preference section discourages `unusual action' that may favor certain creditors or hasten bankruptcy by alarming other creditors and motivating them to force the debtor into bankruptcy to avoid being left out.").

Therefore, notwithstanding Interco's financial difficulties at the time, its change of billing methodology, any knowledge on the part of a defendant Subscriber of Interco's financial difficulties, or even demands by a defendant Subscriber that Interco make a quarterly payment to it pursuant to the terms of its Subscriber Agreement, such payments would be in the ordinary course of the business of both Interco and the Subscriber. Payments by Interco to Subscribers of VSD's received or collected from Suppliers pursuant to and in accordance with the terms of the Subscriber and Supplier Agreements would not be unusual or outside of the ordinary course of Interco's business just because Interco was experiencing severe financial difficulties.

CONCLUSION

The Motion for Partial Summary Judgment on behalf of each of the defendants is denied without prejudice. Each of these adversary proceedings will be set down for a pretrial conference in accordance with the Court's standard practice in adversary proceedings. The denial of the Motion for Partial Summary Judgment is specifically without prejudice to the right of any of the defendant Subscribers to bring a later motion for partial summary judgment which clearly sets forth sufficient evidence from which the Court can determine that either: (a) all or any part of the November, 1992 payment which was received represented VSD's which the Subscriber was entitled to receive by reason of Interco's receipt or collection of VSD's from one of its Suppliers in accordance with the terms and conditions of Interco's Agreement with that Supplier; (b) it was the ordinary course of Interco's business to distribute VSD's not received or collected from a Supplier; or (c) the defendant had a Subscriber Agreement with Interco which required Interco to pay it VSD's even though they were not received or collected from a Supplier.

IT IS SO ORDERED.

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HON. JOHN C. NINFO, II
U.S. BANKRUPTCY JUDGE

Dated: September 14, 1995