

## PACA And Bankruptcy: What Secured Lenders Must Know



*Law360, New York (May 27, 2014, 4:11 PM ET)* -- The Perishable Agricultural Commodities Act has many ramifications for secured lenders who provide financing to borrowers that own goods that fall within its scope, particularly in bankruptcy. Because PACA provides its beneficiaries — unpaid suppliers and sellers of perishable agricultural commodities and products — with superior rights over other creditors through the establishment of a trust, secured lenders must be careful not to rely on the standard language in bankruptcy orders that cleanse assets of liens. Accordingly, secured lenders should familiarize themselves with the statute and should develop strategies to mitigate the risk of unpaid PACA claims owed by their borrowers, especially in a downside scenario.

In order to fully understand the potential effects of PACA in bankruptcy, it is necessary to understand the objective and function of PACA generally. PACA was enacted by Congress in 1930 with the goal of protecting suppliers and sellers of agricultural goods from the effects of nonpayment by certain third parties. To further bolster its protective purpose, Congress amended PACA in 1984 to establish a statutory trust for the benefit of all unpaid suppliers or sellers of perishable agricultural commodities or products.

Significantly, the trust is a floating, nonsegregated trust established upon delivery of subject goods to the buyer. The trust continues until the goods are paid for in full. Assets subject to the trust do not need to be traced, and proceeds of such assets and any commingled produce purchased with such proceeds are all subject to the trust. As noted above, this statutory trust provides its beneficiaries with superior rights over other creditors, including secured lenders.

### Scope of PACA

Given the protections afforded by the PACA trust, it is important that secured lenders understand the statute's scope. PACA defines perishable agricultural commodities as "fresh fruit and fresh vegetables of every kind and character," whether or not frozen or packed in ice, and cherries in brine. 7 USC § 499(b). While determining what qualifies as a fresh fruit or fresh vegetable does not seem difficult, it is harder

to pinpoint when subsequent manipulation of a fresh fruit or fresh vegetable will remove it from PACA's scope. The text of the statute itself is purposefully ambiguous, defining neither "fresh fruit" nor "fresh vegetable" explicitly.

Regulations promulgated by the United States Department of Agriculture, meanwhile, provide that "fresh fruits and vegetables" include all produce generally considered as perishable, whether or not packed in ice or held in common or cold storage, but do not include any perishable fruits and vegetables that have been "manufactured into articles of food of a different kind or character." Where the USDA has not provided express guidance, courts have looked largely to whether or not subsequent treatment of the product has resulted in the loss of the "essential nature" of the fresh fruit or fresh vegetable, or if the treatment was simply "meant only to temporarily preserve the fruit or vegetable, such as freezing or adding a preservative chemical." *A&J Produce Corp. v. CIT Group/Factoring Inc.*, 829 F.Supp. 651, 658 (S.D.N.Y. 1993).

The Ameriserve Food Distribution Inc. and Fleming Companies Inc. bankruptcy cases provide a good lesson for secured lenders regarding the sometimes surprising scope of PACA. In Ameriserve, a hotly litigated issue was whether or not suppliers of battered and coated frozen potato products (i.e., frozen french fries) were entitled to PACA claim protection. The court upheld Ameriserve's position that claims relating to battered and coated frozen potato products were not entitled to PACA protection. The value of such claims exceeded \$11 million dollars in the aggregate. As a result, such claimants had unsecured, nonpriority claims in the bankruptcy case.

Following the Ameriserve bankruptcy, the Frozen Potato Products Institute petitioned the USDA for a written opinion on whether battered and coated frozen potato products were entitled to PACA protection. After a lengthy notice and comment period, the USDA published a rule that added battering and coating to its list of acceptable processes. Battering and coating, the USDA rationalized, were processes similar to those already allowed by existing USDA regulations, such as oil blanching and adding ascorbic acid.

Subsequently, in the Fleming case, the plaintiff argued that the Secretary of Agriculture overstepped his authority by including battering and coating as processes that did not change the character of fresh fruits and vegetables. The court, however, reasoned that coating and battering "preserve the crispness and color of french fries that are left under heating lamps" and "neither coating nor battering changes the taste or texture of a potato product." As a result, the court upheld the new rule.

The Ameriserve and Fleming cases clearly demonstrate that the categorization of a product as a "fresh fruit or fresh vegetable" can change based on the needs of the marketplace and lobbying efforts. As a result, a secured lender should not assume that agricultural goods subject to the secured lender's lien do not fall within PACA's scope because such goods are frozen, battered or otherwise manipulated. Indeed, secured lenders need to be aware of these developments in order to protect themselves against the superior rights of PACA claimants.

### **Who Can File a PACA Claim?**

PACA protects suppliers and sellers of certain commodities against non-payment resulting from transactions with a “commission merchant, dealer or broker.” The definitions of “commission merchant,” “dealer” and “broker” are set forth in the statute, but include generally wholesale buyers and purchasers of agricultural goods (subject to certain dollar thresholds).

A PACA claim can be asserted by an unpaid supplier, seller or agent of perishable agricultural commodities or products against buyers who have not timely made payments on such delivered commodities and products. In order to preserve its claim, a PACA creditor must either (1) provide notice in writing to the buyer of its intent to preserve the benefits of the PACA trust, along with “information in sufficient detail to identify the transaction subject to the trust” or (2) on its usual billing or invoice statement, provide the terms of payment and boilerplate language established by the Secretary of Agriculture stating that the commodities on the invoice are sold subject to the PACA trust.

Written notice of the intent to preserve the PACA trust must be given by the PACA creditor to the buyer within 30 calendar days after (i) 10 days following acceptance of the perishable commodities or products, as prescribed by the Secretary of Agriculture, (ii) the expiration of the payment due date agreed upon in writing by the parties, or (iii) the time the supplier, seller or agent has received notice that the payment instrument promptly presented for payment has been dishonored.

Importantly, the payment terms between the supplier and purchaser cannot exceed 30 days; if they do, the goods will not qualify for PACA coverage. Some courts, however, have read the 30-day rule liberally and allowed PACA claims where extensions of payment terms were oral or allowed partial PACA claim status to a portion of goods that had payment terms within the appropriate time period.

In light of the foregoing, secured lenders may want to include a covenant in their loan documents that requires their borrowers to provide timely notice of any PACA claims they receive. This will enable such lenders to estimate more accurately the outstanding PACA liability of their borrowers and, in connection with asset-based transactions, implement appropriate reserves.

### **Payment of PACA Claims**

Generally, the amount of a PACA beneficiary’s claim is not strictly limited to the cost of the commodity itself. Instead, “full payment of the sums owing in connection with the [commodities] transaction” can be part of the PACA claim. 7 U.S.C. § 499(e)(c)(2). When calculating the amount of a PACA claim, a claimant will try to include any and all costs associated with the transaction, including shipping costs, freight charges and taxes.

As noted above, the implementation of borrowing base reserves is one way for secured lenders to mitigate the risk of unpaid PACA claims. However, lenders and their auditors should examine carefully the extra costs that can be included by PACA claimants when establishing such reserves. In fact, such supplemental charges may often exceed the net cost of the PACA commodities, so ignoring such amounts can be costly.

In addition, PACA claim amounts can be limited by the terms of a pre-transaction written agreement between the parties, the parties' course of dealing and, importantly, the subtraction of certain allowable deductions. The USDA regulations provide that "[t]he amount claimable against the trust by a beneficiary or grower will be the net amount due after allowable deductions of contemplated expenses or advances made in connection with the transaction by the commission merchant, dealer or broker." 7 C.F.R. § 46.46(e)(5).

Therefore, a PACA beneficiary's claim must be limited to the net amount due by a claimant on a given produce transaction after the subtraction of any and all allowable deductions. In bankruptcy proceedings, certain PACA claims are often contested by the debtors on the basis that the claim amounts do not reflect the subtraction of expenses incurred, and advances made, by the debtor. Lenders should pay close attention to the ancillary costs that suppliers include in their PACA claims to determine whether deductions are appropriate.

### **Implications of the PACA Trust in Bankruptcy**

The fact that PACA claimants are the beneficiaries of a trust also has important ramifications in the bankruptcy context. Indeed, PACA does not grant claimholders a priority lien over PACA assets. Rather, PACA's trust status means that PACA assets are not technically a part of the debtor's bankruptcy estate, and therefore not subject to bankruptcy's priority scheme. Consequently, a PACA claim is entitled to payment ahead of all other creditors in the bankruptcy proceeding.

Any secured lender providing exit financing to a debtor that owns PACA goods, or financing the acquisition of assets from a debtor that owns PACA goods, must be aware of this distinction. Indeed, the secured lender cannot solely rely on the "free and clear of liens" language found in a typical sale order or plan of reorganization because the PACA trust does not give rise to a lien. Instead, the language in the sale order should include explicit language providing that the assets are sold free of all "claims and judgments" and should specifically reference all PACA claims.

In addition, secured lenders providing exit or acquisition financing should insist that the applicable order of the bankruptcy court explicitly provide that any PACA claims will be paid solely out of a separate escrow account established for that purpose. This will help mitigate the risk that the assets of the reorganized debtor, or the assets purchased by the buyer, will be claimed as trust assets.

While PACA creates certain risks for secured lenders, understanding those risks and learning how to mitigate them through appropriate review and documentation, can reduce a lender's exposure to PACA pitfalls.

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