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PERISHABLE AGRICULTURAL COMMODITIES ACT AND BANKRUPTCY ISSUES

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Introduction

The Perishable Agricultural Commodities Act ("PACA")[1] creates issues in bankruptcy cases. These materials identify some of those issues creditors, debtors and trustees should keep in mind in bankruptcy cases.

I. What is PACA?

PACA was first enacted in 1930. It was designed to protect the producers of perishable agricultural commodities who had to entrust their products to buyers or commission merchants who may be far away and depend on their fair dealing for payment.[2] PACA attempted to remove the expense and inconvenience of litigation by providing for filing complaints with the United States Secretary of Agriculture who is required to investigate complaints and render decisions in the form of reparation orders.[3]

In 1984, Congress added the imposition of a trust on perishable agricultural commodities ("PAC's") and all inventories of food or other products derived from PAC's and any receivables or proceeds from the sale of PAC's.[4] This is to provide additional protection for the PAC suppliers until they are paid for the PAC's. At that time there were increasing defaults by PAC buyers. PAC suppliers were facing unfair risk of nonpayment because they were required to quickly sell their PAC's to buyers whose credit worthiness could not be verified. PAC suppliers were not protected because they were behind secured creditors holding security interests in the buyers' inventories, proceeds, and receivables.[5]

To retain the benefits of the PACA Trust, a party claiming the benefits of the trust must comply with certain requirements.[6]

II. Remedies

PACA imposes liability for the full amount of damages sustained as a consequence of "unfair conduct" by any commission merchant, dealer, or broker. 7 U.S.C. § 499e(a). Unfair conduct is defined by PACA and includes failure to pay for PAC's and maintain the PACA trust. 7 U.S.C. § 499b(4). Failure to pay may result in the revocation of a PAC broker's license. *H.C. MacClaren, Inc. v. USDA,* 342 F.3d 584 (6th Cir. 2003).

The liability may be enforced by the Secretary of Agriculture or by a court of competent jurisdiction. The PACA supplier may also enforce any existing common law or statutory remedies that are available. They are not limited to the PACA remedies. See 7 U.S.C. 499e(b).

A PAC supplier may be able to recover attorney fees in enforcing the PAC suppliers' PACA rights since they may be considered sums owing in connection with the transaction. *Six L's Packing Co. v. Beale,* 524 Fed. Appx. 148; 2013 U.S. App LEXIS 7179 (6th Cir. 2013); *Bearden v. Great Lakes Produce & Mktg. LLC,* 2013 U. S. Dist. LEXIS 74408 (W.D. Mich. 2013). But there must be an agreement to pay the PAC supplier's attorneys fees. *LaGrasso Bros., Inc. v. Am. Foodservice, L.L.C.,* 2011 U.S. Dist. LEXIS 25213 (E.D. Mich. 2011).

A PACA supplier may seek damages from the individuals responsible for preserving the PACA trust for their benefit. This is usually the buyer's officers and/or directors. See *Arava USA, Inc. v. Karni Family Farm, LLC,* 474 Fed. App. 452; 2012 U.S. App. LEXIS 16162 (6th Cir. 2012). The principles for imposing liability for breach of a fiduciary duty by a trustee would apply. Thus, personal liability may be imposed upon corporate officers, shareholders and others, to the extent they control the trust assets. *Six L's Packing Co. v. Beale,* 524 Fed. Appx. 148; 2013 U.S. App LEXIS 7179 (6th Cir. 2013); *LaGrasso Bros., Inc.,* 2011 U.S. Dist. 25213 (E. D. Mich. 2011). The "trustees" will have personal liability if the PACA trust assets are not used to pay the PACA suppliers. *Indianapolis Fruit Co. v. Locavore Food Distribs., Inc.* 2011 U.S. Dist. LEXIS 106874 (E.D. Mich. 2011).

If a PACA trustee files bankruptcy, that is subject to being declared nondischargeable under 11 U.S.C. 523(a)(4) for defalcation while acting in a fiduciary capacity. Courts have limited the personal liability to the persons actually in control of the PACA trust assets. See *Bear Mountain Orchards, Inc.* Some courts require the PACA trustee have actual knowledge of his or her fiduciary duties under PACA. See *E. Armata, Inc. v. Parra (In Re: Parra*), 412 B.R. 99 (Bankr. E.D. N.Y., 2009).

A PACA supplier needs to protect its interest in the PACA trust assets in a Chapter 11 Debtor case filed by a PACA trustee. If a Chapter 11 disburses funds that may constitute PACA trust assets pursuant to a bankruptcy court order, the PACA supplier may be precluded by res judicata, collateral estoppel or laches from pursing the recipient of the funds. *J & S Produce v. Bahadur, Balan & Kazerski, Ltd.,* 1989 U.S. Dist. LEXIS 17737 (E.D. Mich., 1989).

A PACA supplier is not entitled to recover payments made to a secured lender from a PAC buyer if the lender was a bona fide purchaser, i.e. took value without notice of the breach of the PACA trust. *Battle v. Fresh Preps Distribution,* 873 F. Supp. 1062 (E.D. Mich. 1995); *Shippers Serv. Co. v. Fresh Louie's Produce Co., LLC,* 2010 U.S. Dist. LEXIS (E.D. Mich. 2010)

A PACA supplier can pursue an injunction to prevent the dissipation of assets that may impressed with a PACA trust. *Ram Produce Distribs. V. Moceri Produce,* 2008 U.S. Dist. LEXIS 128467 (E.D. Mich. 2008).

III. Protected Sales

A. What are perishable agricultural commodities?

PAC's are defined as fresh fruits and vegetables of every kind and character, whether or not frozen or packed in ice and includes cherries in brine as defined by the Secretary of Agriculture."[7] Some examples of products that are not PAC's are dried cranberries, see *Cox v. Decas Cranberries Prods, (In Re: Meyers Bakeries, Inc.)*, 402 B.R. 314 (Bankr. W.D. Ark. 2009); and batter-coated french fries, see *In Re: Long John Silvers Restaurants, Inc.,* 230 B.R. 29 (Bankr. D. Del. 1999). Apples processed into cider by the seller are not PAC's. *Bear Mt. Orchards, Inc. v. Mich-Kim, Inc.,* 2007 U.S. Dist. LEXIS 88983 (E.D. Pa. 2007).

B. What sellers are protected?

Suppliers or sellers of PAC's and their agents are protected by PACA. This includes farmers, brokers, and their agents. However PACA does not apply to transactions between a cooperative association defined in 12 U.S.C. 1141j(a) and its members.

IV. Buyers Subject to PACA

A. Purchasers of perishable agricultural commodities

PACA applies to "any commission merchant[8], dealer[9], or brokers".[10]

A bank that maintains deposit accounts for broker and is a secured lender to the broker is not a "dealer" that can be held liable for the broker's failure to pay a PAC supplier. *Val-Land Farms, Inc. v. Third Nat'l Bank,* 937 F.2d 1110 (6th Cir. 1991).

A dealer includes an entity in the business of buyer or selling in wholesale or jobbing quantities (defined as 2,000 pounds or more in weight in any day shipped, received or contracted to be shipped or received. 7 C.F. R. § 46.2(x); *Indianapolis Fruit Co. v. Locavore Food Distribs., Inc.* 2011 U.S. Dist LEXIS 106874 (E.D. Mich. 2011).

V. Seller Process Requirements.

In order to retain the benefits of the PACA trust, suppliers have to comply with certain requirements. Failure to strictly comply with the requirements will result in the loss of the benefits of the PACA trust. *Thomas A. Hails Co. v. Olson (In re N. Mich. Fruit Co.),* 433 B.R. 671 (W.D. Mich. 2010). These include:

1. Giving written notice of intent to preserve the benefits of the trust to the buyer within 30 days (a) after expiration of the time prescribed by which payment must be made as set forth in regulations issued by the Secretary of Agriculture, (b) after expiration of the time by which payment must be made as agreed in writing by the parties before entering the transaction, or (c) after the time the supplier has received

notice that an instrument used for payment has been dishonored.

2. The written notice to the buyer must set forth information in sufficient detail to identify the transaction which is subject to the trust.

3. If the payment time period agreed to between the parties is different from that established by the Secretary of Agriculture, a copy of the agreement has to be filed in the records of each party to the transaction. The maximum allowable payment term under PACA regulation is thirty days of the buyer's receipt and acceptance of the PAC's. 7 C.F.R. § 46.46(e)(1). PAC's are received when a buyer has ownership and control even if it does not have physical possession of the PAC's. *Six L's Packing Co. v. Beale,* 524 Fed. Appx. 148; 2013 U.S. App. LEXIS 7179 (6th Cir. 2013).

4. The terms of payment must be disclosed in the invoices, accountings, and other documents relating to the transaction.

The PAC supplier may also preserve the benefits of the trust by the following:

1. Using ordinary and usual billing or invoice statements to provide notice of the intent to preserve the trust. If the parties have an express agreement of a different payment time period than that established by the Secretary of Agriculture, the terms of payment must be disclosed in the statement.

2. The billing statement must include on the face the following language:

   "The perishable agricultural commodities listed on this invoice are sold subject to the statutory trust authorized by Section 5(c) of the Perishable Agricultural Commodities Act, 1930 (7 U.S.C. 499e(c)). The seller of these commodities retains a trust claim over these commodities, all inventories of food or other products derived from these commodities, and any receivables or proceeds from the sale of these commodities until full payment is received.". 7 U.S.C. § 499e(c)(4).

   PACA suppliers risk losing the benefits of the PACA trust if they enter into a pre-transaction, non-written agreement permitting they buyer to make payments more than 30 days after receipt and acceptance. *Heeren, LLC. v. Cherry Growers, Inc.*, 2015 U.S. Dist. LEXIS 171068 (W.D. Mich. 2015); *Heeren, LLC v. Cherry Growers, Inc.,* 2016 U.S. Dist. LEXIS (W.D. Mich 2016). PACA suppliers will lose the benefits of the PACA trust if they agree to payments more than 30 days after delivery of the PAC's. *Overton Distribs. v. Heritage Bank,* 340 F.3d 361 (6th Cir. 2003). PACA suppliers cannot agree to extensions after the produce is delivered. Post-default extensions beyond the 30 day payment requirement will result in the waiver of the PACA trust benefit. Allowing longer term credit arrangements would be contrary to PACA's goal of protecting PACA suppliers that sell PAC's on short term credit.

PACA suppliers must include the exact credit terms on their invoices and failure to do so may result in the loss of the PACA trust benefits. See *G & G Peppers, LLC v. Ebro Foods, nc. (In* re *Ebro Foods, Inc.* 449 B.R. 759 (N.D. Ill. 2011).

V. What Assets are Imposed with Trust?

The statutory language imposes the trust for the benefit of the PAC sellers upon "Perishable Agricultural Commodities received by a [buyer] in all transactions, and all inventories of food or other products derived from perishable agricultural commodities, and any receivables or proceeds from the sale of such commodities or products." PACA imposes a "floating trust" on all the buyer's PAC's and proceeds. *Sansone-Palmisano Co. v. M. Seaman Enterprises, Inc.,* 986 F. 2d 1010, 1012 (6th Cir. 1993).

PACA has been construed to extend the floating trust to all of the buyer's assets, unless it is shown that the buyer's assets were not purchased with trust funds. *J.A. Besteman Company v. Carter's, Inc.,* 439 F. Supp. 774 (W. D. Mich. 2006). The burden is on the buyer and to prove an asset was not purchased with trust funds. *J.A. Besteman Company v. Carter's, Inc.*, *Id.* at 778; *In re Cherry Growers, Inc.,* 576 B.R. 569 (Bankr. W.D. Mich. 2017).

NOTES

1. 7 U.S.C. §§ 499a-499t (2016).

2. PACA was enacted to regulate interstate and foreign commerce in the marketing of fresh fruits, and vegetables, live and dressed poultry and eggs. The primary purpose of PACA was to provide a practical remedy to small farmers and growers who were vulnerable to the sharp practices of financially irresponsible and unscrupulous brokers in perishable commodities.. *Chidsey v. Guerin*, 443 F.2d 584 (6th Cir. 1971); *United States v. Gilardi Truck & Transp.,* 1987 U.S. App. LEXIS 3579 (6th Cir. 1987).

3. 7 U.S.C. § 499e(c); *Chidsey v. Guerin*, 443 F.2d 584 (6th Cir. 1971).

4. A trust is imposed on these assets for the benefit of all unpaid suppliers or sellers of PAC's or agents involved in the transactions until full payment of the sums owing in connection with the transactions are received by the suppliers, sellers, or agents. 7 U.S.C. § 499e(c)(2).

5. *Sansone-Palmisano Co. v. M. Seaman Enterprises, Inc.,* 986 F. 2d 1010, 1012 (6th Cir. 1993).

6. See 7 U.S.C. §499e(c)(3) and (4).

7. 7 U.S.C. § 499a(b)(4). Fruits or vegetables manufactured into a food of a different character are not considered PAC's. The Secretary's regulations sets forth certain operations that are not considered as changing the commodity into a food of a different kind or character. 7 C.F.R. § 46.2(u).

8. A commission merchant is an entity that receives and sells another's PAC's on commission. 7 U.S.C. §499a(b)(5).

9 A dealer is a person who buys or sells PAC's, with certain exceptions such as a producer selling a commodity he has raised. 7 U.S.C. § 499a(b)(6). The Secretary of Agriculture has also implemented regulations defining the term "dealer". 7 C.F.R. § 46.2(m).

10. A broker is a person who negotiates the sales and purchases of PAC's on behalf of a vendor or purchaser. 7 U.S.C. § 499a(b)(7).

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BEST PRACTICES FOR DEALING WITH TROUBLED CUSTOMERS

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With interest rates on the rise, commercial borrowers may in the coming months and years grow more concerned with the prospects of remaining compliant with their financial loan covenants. As the costs of borrowing increase, some borrowers may begin to look for short-term ways to cover their financial obligations. A company's suppliers may, for example, begin to restrict inventory, limiting their ability to meet fluctuating demand for goods and services. Such an economic climate will also likely have an impact on a company's customers. The commitment to monitoring the financial health of one's customers and their ability to remain compliant with payment terms may make the difference between having liquidity to weather the tougher months ahead and being hung out to dry.

Signals of Distress

Dealing with troubled customers begins with recognizing the red flags that signal financial distress. If a customer begins making partial or delayed payments or otherwise begins to divert from a regular and customary track record of payment, this could be a sign that the customer is beginning to face difficulty servicing all of its obligations. Alternated payment methods and post-dated negotiable instruments (or checks that are returned for insufficient funds) can also be a warning sign. Although bank loan defaults by customers, and any corresponding work out measures (including forbearance agreements), may not be public information available to the trade creditors of the borrower, collection suits and judgments are publicly available and often easily accessible. Trade creditors should understand how to research the existence of such suits, or engage a lawyer or third party UCC service provider to search for public court records which may implicate customers.

Offering discounts for early payment, even where a supplier's payment terms ordinarily do not contemplate such discounts, can have a two-fold benefit to the supplier where it suspects financial distress in one or more of its customers. Obviously, an early payment would serve to ameliorate the concern that a customer's financial distress will impact the supplier. The refusal to take advantage of the discount, however, has the benefit of signaling to the supplier that the customer may have difficulty paying at all, and may give the supplier a head start on looking further into the customer's likelihood of remaining current.

Managing Credit Risk

There are a number of ways a supplier may hedge the risk of doing business with troubled customers. Like most legal solutions, the best defense against risk is to plan ahead before the risk materializes in the first place. One way to do so is through the use of a purchase money security interest under the Uniform Commercial Code. Such an interest secures the obligation to pay the price of goods sold, using the goods sold as the collateral securing the obligation. MCL 440.9103(1)(a)-(b). A supplier supplying goods to a customer on credit can use a purchase money security interest to secure payment of the goods. Moreover, when a creditor carefully complies with the procedures outlined by Article 9 the Uniform Commercial Code, such a security interest may take priority over other security interests in the goods sold, including a blanket "first-lien" security interest held by the lender of the customer. MCL 440.9324(1). Some vendors may also have recourse to mechanic's and toolmaker's liens which, when the proper procedure is complied with, will grant the vendor a similar first-priority interest in the goods sold to the customer.

The use of credit insurance can also guard against losses caused by lack of payment. Credit insurance ensures not only timely payment of invoices, but often insurers serve as an up-front resource to examining the credit-worthiness of customers. This is especially crucial in the case of a supplier who may be considering an expansion into international markets, where data about a foreign potential customer may not be widely available. Credit insurers often maintain research regarding the credit-worthiness of trade customers and can serve as a back-stop against potential losses from extending credit to relatively unknown parties. If market knowledge is of little concern, self-insuring through the use of a bad-debt reserve account may also leave suppliers with a sufficient safe-guard against non-payment.

A supplier facing multiple bad-debt customers may be tempted to factor its receivables in an effort to ensure some level of return for goods and services rendered. While factoring may always be a consideration, the steep discounts demanded and the rates charged by factoring companies may make factoring a drastic option for vendors whose customers may be experiencing temporary financial set-backs or who may have only a few troubled customers.

Critical vendors may be able to demand further assurances of payment. Requiring a standby letter of credit or third-party guaranty may not be an option for vendors supplying a small portion of a company's inventory or equipment. For those who command a large portion of a company's input, however, such vendors may have the necessary leverage to unload the risk of nonpayment onto the customer's principals (through the use of a third-party guaranty) or the customer's primary lender (through the use of a standby letter of credit).

Often a vendor can optimize payment of its receivables simply through a reevaluation of its payment terms, like for example, by reducing the term allowed for payment from 30 days to 20 days or less. Similar to payment discounts, a reduction in payment term allows the supplier both the advantage of earlier payment on many of its accounts but also can serve as an early indicator of financial distress, if a customer has unexplained trouble making timely payments. Some troubled accounts may warrant cash-on-delivery ("COD") or cash-in advance ("CIA") terms, which can be implemented independently or even in conjunction with a forbearance agreement for payment of past-due amounts. Finally, imposing credit limits to certain customers may assist a vendor in maintaining relatively low exposure to credit risk.

Preference Liability

The possibility of preference liability in a potential bankruptcy case of a customer should remain an item of consideration for any supplier implementing the above methods of managing risk. Generally, any payments made to a supplier on account of debt which existed before the time of the payment can be avoided in a bankruptcy case of the customer if the payment was made in the 90-day period prior to the customer filing a bankruptcy case and if the payment allowed the supplier to receive more than it would have in a hypothetical chapter 7 case if the payment had not been made. 11 U.S.C. 547(b).

The bankruptcy code permits certain affirmative defenses to this liability, including for a "contemporaneous exchange", under Section 547(c)(1); for certain transfers made in the ordinary course of business, under Section 547(c)(2); for certain documented purchase money security interests, under Section 547(c)(3); and for certain transfers that are covered by "new value" given by the vendor, under Section 547(c)(4). One of the chief exceptions is for contemporaneous exchanges. 11 U.S.C. 547(c)(1). If the vendor and the customer both intended the transfer to take place in the context of a contemporaneous exchange of cash (or other property) in exchange for the goods delivered or services rendered to the customer, and if in fact the exchange is substantially contemporaneous, the trustee in bankruptcy will likely be unable to avoid the transfer. *Id.* Note that in the above example where COD and CIA terms are implemented for current goods and services but in the context of a forbearance agreement which also requires payments for past-due amounts, it is possible that the COD or CIA payments made in the 90 days prior to the bankruptcy filing may be shielded from preference liability, section 547(c)(1), while other payments made under the agreement, since they are "on account of antecedent debt", 11 U.S.C. 547(b)(2), may be subject to avoidance (provided they meet the other elements of a preferential transfer under Section 547(b)).

Regardless of the likelihood of a customer filing a bankruptcy case, vendors should ordinarily avoid refusing payment of a receivable, even if the payment may result in preferential transfer liability. Since the worst case scenario is that a payment will be avoided and turned over to the trustee, payments should almost never be refused. A better practice would rather be to place an internal "hold" on such payments for 90 days after the date the payment was made in order to ensure that the amount remains available and liquid in the event a bankruptcy case is commenced and the transfer avoided.

Conclusion

A whole host of practices can and should be employed by vendors faced with potentially delinquent or defaulting customers, both to monitor customers and to reduce exposure to the risk of nonpayment. Vendors should develop a plan to address not only current payment terms but also to address what the vendor's next options should be in the event one or several of its customers begin facing financial difficulty. Legal counsel and a good financial adviser should be consulted to determine the best way to navigate the foregoing considerations in a manner compliant with applicable law and consistent with sound financial and business principles.

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