

What Every Business and Lender Should Know About PACA

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PACA stands for the Perishable Agricultural Commodities Act, a Depression-era federal statute that protects growers and suppliers of unprocessed fruits and vegetables. PACA creates a floating, non-segregated trust on buyer's accounts receivable and inventory. This provides PACA suppliers with a right to payment before all other creditors, including secured lenders with blanket liens. This super-priority status means that when a buyer purchases produce from a PACA supplier, it must account to the supplier before all other creditors. Until the buyer does, the trust operates by placing a lien on not only the inventory derived from the produce, but also on accounts receivable and proceeds from the sale of the produce. 7 U.S.C. 499e(c)(2); *In re Magic Restaurants, Inc.*, 205 F.3d 108, 111-12 (3d Cir. 2000). Since PACA can have harsh consequences for businesses and lenders that deal with PACA suppliers, it is important to be aware of its provisions. Front-end lenders also need to be mindful of ways in which they can protect their banks and guard against some of PACA's unforgiving provisions.

To establish a PACA trust, the goods in question must be fruits and vegetables which have not been altered from their original state (i.e., cucumbers but not pickles, cranberries but not cranberry sauce, onions but not onion rings). The supplier must also provide the buyer with written notice that the goods are sold subject to PACA, which usually is found on the invoice. Unless the parties agree otherwise, PACA requires prompt payment (usually within thirty days). Buyers who breach a PACA trust may be subject to interest and attorneys fees for collection costs and their principals may be personally liable if they knowingly played a role in dissipating the trust assets (i.e., spending it elsewhere). That is one of the many reasons why it is important to be mindful of accounts involving PACA suppliers.

Perhaps most importantly to lenders, courts have held creditors liable for breach of the trust when they "knew or should have known" that they were being paid with receivables that rightly belonged to the PACA supplier. *Consumers Produce Co., Inc. v. Volante Wholesale Produce, Inc.*, 16 F.3d 1374, 1382 (3d Cir. 1994). In *Volante*, the court stated that lenders must return the receivables from the PACA trust unless they could prove that they were a bona fide purchaser for value who did not know the receivables came from trust assets. *Id*; see also *Albee Tomato, Inc. v. A.B. Shalom Produce Corp.*, 155 F.3d 612 (2d Cir. 1998).

In bankruptcy, PACA's impact can be even greater. PACA supplier's claims in bankruptcy enjoy the same super-priority status as they do outside bankruptcy, but they also are not subject to avoidance in a preference action. Courts have held that, since the debtor is holding the funds in question for the benefit of PACA claimants, the funds are not part of the bankruptcy estate. Hence, when the suppliers are paid in full from available trust funds, they are excluded from any new value defense to a preference claim. See *In re Arizona*

Fast Foods, 299 B.R. 589 (Bankr. D. Ariz. 2003). Both the potential lender liability as well as the effects of PACA on a debtor's bankruptcy estate should make creditors mindful of a the PACA trust.

The good news, at least in Pennsylvania's federal courts, is that there is a limit to how far the PACA trust can extend. The trust corpus does not include vehicles and equipment purchased using PACA funds. *United Fruit & Produce*, 242 B.R. 295, 301. Moreover, real property similarly lies outside the trust since, like equipment, it is not inventory or proceeds from the sale of PACA products. *Chiquita Brands Co. N. Am., Inc. v. J & J Foods, Inc.*, 2004 U.S. Dist. LEXIS 22847, *31-34 (E.D. Pa. 2004). Thus, simply because assets held or purchased by a produce buyer can be traced to PACA trust receivables, it does not follow that those assets are part of the PACA trust. Outside of Pennsylvania, however, courts have found that real property, equipment and even the insurance proceeds of a PACA debtor are subject to the PACA trust. See *In re Kornblum*, 81 F.3d 280 (2d Cir. 1996); *J.A. Besterman Co. v. Carter's Inc.*, 439 F. Supp. 2d 774 (W.D. Mich. 2006); *In re Atlantic Tropical Market Corp.*, 118 B.R. 139 (Bankr. S.D. Fla. 1990); *Sam Wang Produce, Inc. v. EE Mart FC, LLC*, 2010 U.S. Dist. LEXIS 13608 (E.D. Va. 2010). It may not be long until the Third Circuit addresses this discrepancy.

So how can a lender wary of PACA protect itself on the front end? The best way is by including a loan provision requiring the debtor to keep a minimum amount, either in reserve or in the form of inventory, to cover eligible PACA claims. That way, the debtor will have funds on hand to cover PACA claimants and the lender will be able to recover from non-PACA assets.

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