Lender, Beware.

The Perishable Agricultural Commodities Act May Let Collateral Give You the Slip

by Candyce Vana Ingwersen

A lender who makes secured loans to produce buyers may have a false sense of security in its collateral. Under the Perishable Agricultural Commodities Act of 1930, as amended (PACA), a produce supplier may have a super-priority lien on the buyer's assets in front of the lender's duly perfected first priority security interest. Furthermore, the lender may be forced to disgorge loan payments received in the regular course of business. Bottom line: Know the risks or risk the loan. This article describes a PACA trust, alerts lenders to possible PACA trust claims, explains how a lender's perfected lien may be "primed" by an unpaid supplier, describes situations when a lender may be forced to disgorge loan payments, and offers some suggestions as to how lenders may be protected from credit risks created by PACA.

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A local convenience store owner approached a lender for financing. The store sold fresh fruit in addition to the usual array of convenience store products. Thus, the store was a produce buyer. Prior to extending any credit, the lender performed its normal due diligence regarding the borrower's business, financial status, and credit history. Satisfied, the lender granted the loan and required the convenience store owner to provide the bank with a first priority security interest in the business assets of the buyer, including its inventory, accounts receivable, and proceeds from the sale of inventory. The lender believed the loan was fully secured and that in a worst-case scenario, the collateral could be liquidated.

The lender was in for a surprise. With respect to certain collateral, when the produce buyer had difficulties paying its debts, the lender was no better off than an unsecured creditor. Even worse than losing the collateral, the lender had to disgorge loan payments received in the regular course of business from the borrower.

What Gives? Maybe the Lender

Under the Perishable Agricultural Commodities Act of 1930 (PACA), if a produce buyer fails to pay its suppliers on a timely basis at any time—before or after a loan is funded, a lender may lose its lien priority with respect to certain collateral. The produce buyer's unpaid suppliers may also be able to force a lender to disgorge loan payments if the suppliers qualify for protection under PACA. If the lender in the scenario had been on a first-name basis with PACA, some precautions could have been taken—including not making the loan at all.

PACA-Who?

As originally enacted in 1930, PACA did not pose a threat to lenders. Its mission was to regulate interstate commerce in perishable agricultural commodities and to encourage fair trading practices in the marketing of such commodities. From 1930 up to 1984, PACA focused on the licensing requirements of produce sellers. Not until 1984 did Congress recognize that PACA needed to be expanded to provide additional protection to produce suppliers. Congress acknowledged that produce buyers were not adhering to the terms of sales contracts by not paying their suppliers on a timely basis, or at all, and these payment defaults were resulting in financial hardships for produce suppliers.

To fix the problem, Congress added a provision that imposes a nonsegregated "floating trust" on perishable agricultural commodities, the products derived therefrom, and any proceeds from the sale of such items. As amended, PACA enabled produce suppliers to recover against buyers and made the suppliers' claims against the buyers superior to the claims of all secured and unsecured creditors of the buyers. Furthermore, it was Congress's intent to provide produce suppliers with the opportunity to recoup payments received by creditors from buyers if the buyers could not satisfy the debts owed to suppliers.

The PACA Trust

A PACA trust is an equitable floating trust created for the benefit of the produce supplier. It is formed upon the receipt and acceptance of perishable agricultural commodities by a buyer (subject to the provisions of PACA) and continues until the supplier receives full payment for such goods. A single PACA trust exists for the benefit of all produce suppliers to a particular buyer and continues to exist until all suppliers have been paid in full.

Furthermore, a trust created under PACA is intended to be a "floating trust," meaning it does not attach to any specific asset. "The PACA trust extends to all perishable agricultural commodities, any inventories derived from such commodities, and any receivables or proceeds from the sale of those commodities or inventory, regardless of whether the commodities were obtained through a cash or credit sale and regardless of whether payment had already been made for those commodities."[1] If a buyer uses PACA trust assets to purchase another asset without maintaining a sufficient reserve to satisfy all unpaid produce suppliers, such purchase constitutes an unlawful dissipation of PACA trust assets and the newly acquired asset may be subject to the claims of suppliers.[2] Thus, all unpaid suppliers, as PACA trust beneficiaries, hold a pro rata interest in the entire "floating trust" in all perishable agricultural commodities, receivables, and proceeds thereof.[3] Therefore, before making a loan to a produce buyer, a lender must determine if the buyer is purchasing "perishable agricultural commodities" and to determine that a lender needs to understand what are "perishable agricultural commodities."

Perishable agricultural commodities. Under PACA, perishable agricultural commodities are broadly defined to mean any fresh fruits and vegetables of every kind or character, whether or not frozen or packaged but excluding those fruits and vegetables that have been manufactured into "articles of food of a different kind or character."[4] Unfortunately, a review of PACA reveals no explicit definition of "fresh fruit and vegetables." Even though a federal regulation (7 C.F.R. §46.2(u)) has attempted to clarify some ambiguity in the definition of "perishable agricultural commodities," litigation has been needed to further clarify which goods are covered by PACA.

In the case of *In re L. Natural Foods Corporation*,[5] the court further defined "perishable agricultural commodities." In this case, a lender made loans to a produce buyer that were secured by a blanket lien on all business assets of the buyer including inventory and accounts. The buyer entered into contracts with a supplier for the purchase of dried apricots and prunes. Shortly after the buyer received such fruit, the buyer filed for bankruptcy. The buyer had not yet paid the supplier or the lender. The lender claimed a security interest in the buyer's inventory and accounts and filed a motion with the court so that it could liquidate the buyer's inventory and apply the proceeds thereof to the outstanding loan obligations of the buyer.

The supplier challenged the lender's security interest in the buyer's inventory and accounts, alleging that the supplier had a trust claim arising under PACA. The seller claimed that it was entitled to recover the amounts owed by the buyer under the purchase contracts from the proceeds of the apricots and prunes, notwithstanding any security interest of the lender in the buyer's inventory and receivables.

The Natural Foods case revolved around the definition of perishable agricultural commodities. The lender argued that the drying process employed by the supplier transformed the apricots and plums into "articles of food of a different kind or character" and, therefore, they were not perishable agricultural commodities within the meaning of PACA. Therefore, the lender asserted that the supplier was merely a general unsecured creditor of the buyer.

The court concluded that the process used by the supplier to dry the apricots and plums resulted in a fundamental change in the character of the fruit, such that the resulting dried apricots and prunes could not be considered "fresh fruits" within the meaning of PACA. Therefore, the transactions between the supplier and the buyer involving the sale of dried apricots and prunes could not have given rise to the creation of a PACA trust.[6]

PACA Trust Claim

Certain elements must be present in a transaction before a PACA trust claim can be created:

1. A buyer (a licensed commission merchant, dealer, or broker subject to the provisions of PACA) must receive perishable agricultural commodities through interstate commerce.
2. Such buyer's supplier(s) must prove that payment has not been received for such commodities.
3. Payments must be made in compliance with PACA within ten (10) days of receipt of the perishable agriculture commodities or according to a written payment schedule that has been agreed to by the buyer and the supplier.[7]

If all of the above elements are present, the supplier must file a notice to properly perfect its claim.

If the supplier's claim is valid, the supplier may proceed against the buyer and force the buyer to surrender the PACA trust assets to the supplier. Once the supplier has been paid in full in accordance with the terms of the sales contract, the trust claim is satisfied. If the PACA trust assets in the buyer's possession cannot satisfy the supplier's claims and the buyer has transferred some or all of the PACA trust assets to third-party creditors, the supplier may have the right to recover trust assets from such third-party creditors.

Recovery Theories

There are two theories under which a supplier may recoup payments from a lender: strict liability and trust principles. Under the strict liability theory, a lender must have actual or constructive knowledge of the PACA trust, have a security interest in the PACA trust assets, and demonstrate that the cash payments received were not encumbered by a PACA trust. Many courts have rejected the strict liability theory for the more equitable approach of applying ordinary trust law principles to PACA.

By applying ordinary trust law principles to a PACA claim, so long as a produce supplier remains unpaid, a PACA trust claim exists and a secured lender is prohibited from liquidating the buyer's accounts and inventory to satisfy any indebtedness of the buyer to the lender. However, if the lender qualifies under the "bona fide purchaser" exception, such lender could receive loan payments from the buyer without fear that a PACA claimant would later force the lender to disgorge such payments.

To qualify as a bona fide purchaser, the lender has the burden of demonstrating that the buyer transferred the trust property "for value" and that the lender was without actual or constructive notice of the breach of the PACA trust.[8] Although the transfer of a trust asset in satisfaction of an antecedent debt ordinarily is not for value, an exception exists if the transferred property is money or negotiable instruments.[9] However, a lender who receives loan payments from a buyer with knowledge that a PACA trust claim exists against such buyer, is not a bona fide purchaser because the lender had notice of the trust claim. Furthermore, by accepting loan payments from such buyer, the lender will be deemed to have notice of the breach of such trust. A lender who receives PACA trust assets through the enforcement of a security agreement and not as loan payments is not a bona fide purchaser because such transfers are not for value.[10] Therefore, under trust principles, a lender may receive loan payments without fear of being forced to disgorge loan payments if it has no notice of PACA claims but a lender may not foreclose on its collateral.

A lender is deemed to have notice if it has actual or constructive knowledge. Actual knowledge is real objective evidence of notice, whereas constructive knowledge is an indication that a lender should have known of an event. The amount of requisite knowledge required for constructive knowledge and the means of obtaining such knowledge varies among the courts. Even if a lender has actual knowledge of a PACA trust claim, such lender does not have notice of a breach of trust.[11]

A lender is deemed to have notice of the breach of trust if it knew or should have known of the breach. If a lender has actual knowledge that the PACA trust claim existed and that the buyer's actions were in breach of the trust, the lender has notice of the breach. If a lender does not have actual knowledge of the breach of trust, in what circumstances should a lender have known of such breach? Some courts say that if a lender could have learned of the breach of trust after performing a reasonable inquiry, the lender is deemed to have notice of such breach. The rationale behind this conclusion is that the lender probably had some warning signs that should have been a signal to perform an inquiry that would have discovered the buyer's breach of the PACA trust.

Duty of Inquiry

A lender suspecting that a buyer is having financial problems has a duty of inquiry. In the case of *Gargiulo v. G.M. Sales, Inc.*[12] a lender challenged a court order requiring the lender to disgorge loan payments made by the buyer to the lender in breach of the PACA trust. The lender argued that a reasonable inquiry would not have revealed any breaches of the PACA trust prior to the first notice being filed by a supplier. The court said that the lender's awareness of the buyer's financial problems raised a duty of inquiry on the part of the lender. If a reasonable inquiry would have revealed the breach of trust by the buyer, then the lender "should have known" of the breach and will be deemed to have had constructive knowledge of the breach of trust.

Before the court could decide if the lender should have known about the breach of trust, the court had to determine if the lender conducted a reasonable inquiry into the buyer's financial condition, and if such inquiry would have revealed the breach of trust. A reasonable inquiry is a subjective matter that depends on the nature of the transaction and the character of the trust property. Therefore, a lender may be deemed to have knowledge if it:

- Performs its duty of inquiry and discovers a breach of trust.
- Should have performed an inquiry but didn't or didn't perform its inquiry to the satisfaction of the court.

- Has actual knowledge of the breach of trust.

Once a lender performs its inquiry and shows that the buyer has breached the trust, any trust assets received by the lender (including loan payments) may be recouped by the supplier.

How to Prevent Spoilage

To minimize the risks involved with making a loan to a produce buyer regulated by PACA, a lender must ask the buyer some questions about its business practices and suppliers to determine if the buyer is regulated by PACA and if its suppliers qualify for protection under PACA.

- Does the buyer's inventory qualify as "perishable agricultural commodities"?
- In the normal course of business, when does the buyer pay its suppliers? Investigate the transactional history and current purchasing contracts of the buyer. Ask for copies of the buyer's existing purchase contracts.
- Does the buyer regularly pay later than the due date specified in the purchase contract?
- Have any suppliers not been paid for delivered goods? A lender should request the buyer to provide it with search results from the records of the Department of Agriculture to verify there are no current claims against it.[13]
- What is the value of the buyer's assets (other than its inventory and accounts)?

Such questions should expose any potential risks the lender may face with respect to PACA.

Once the risks are determined, a lender must decide if it can become comfortable making the loan. To achieve a certain comfort level with the produce buyer, a lender may choose to:

- Hold such buyer to a higher degree of financial stability.
- Use stricter covenants, terms and provisions in the loan documents.
- Be willing to make an unsecured loan or exclude inventory and accounts receivable from the collateral.
- Require such merchant to provide additional collateral (other than accounts receivable and inventory) for the loan.

As additional or alternate collateral, a lender may consider taking a pledge of investment accounts or cash collateral. Although a lien on investment accounts or cash collateral is more desirable than a lien on inventory and receivables, such collateral may consist of proceeds from the sale of inventory and thus potentially be subject to a PACA trust.

Even with additional collateral and stricter covenants, a lender may be hesitant to loan money to a buyer regulated by PACA unless the lender has an even higher comfort level. The lender may require the suppliers to opt out of certain provisions of PACA. The buyer and its suppliers could enter into a written agreement that allows the buyer to make payments to the supplier after PACA's 30-day payment period, thus denying the suppliers protection under PACA. The lender could require the suppliers to sign written waivers under which the suppliers waive their rights under the trust provisions of PACA. These suggestions may sound appealing to the lender, but it is unlikely that the suppliers will give up the protections afforded by PACA.

Notwithstanding the threat of a PACA trust claim, if a lender decides to approve a loan to a produce buyer, it can include provisions in its loan documents that would address some of its concerns caused by PACA. For instance, the lender may require the produce buyer to represent and warrant that, at the time of funding (and if the lender will be funding additional advances, at the time of each advance), the buyer does not have any unpaid suppliers, is not subject to PACA, and has not received notice of any trust claims made against it under PACA. If the buyer claims that it is not subject to PACA, the lender should require the buyer to provide the lender with evidence supporting that claim, such as an opinion letter by the buyer's legal counsel.

Covenants may be included in the loan documents to address PACA issues. The lender may require the buyer to notify the lender of any PACA trust claims made against the buyer and to comply with PACA at all times and to maintain bookkeeping entries that identify which assets may be subject to a PACA trust.. The buyer may be subject to financial covenants that monitor the buyer's cash flow. The lender also may require the buyer to provide accounts payable aging reports and searches from the Secretary of Agriculture's office on a periodical basis The lender should require the buyer to certify on a periodical basis that the buyer is in compliance with such covenants in the loan documents. Although such reports will not provide the lender with any protection, they should provide the lender with some warning that the buyer is not paying its produce suppliers.

The loan documents also could include a provision that requires the buyer to use the proceeds of the loan to pay its produce suppliers first. Upon receipt of notice by the lender of a PACA trust claim against the buyer, the loan documents could give such lender the right to satisfy the PACA trust claim for the benefit of the buyer. If a lender chooses to include such provision, the promissory note should allow the lender to re-advance for such purposes and the collateral documents should secure such future advances. Under the terms of the note and other loan documents, PACA could trigger an event of default. An event of default could include a filed trust claim, failure to pay a trust claim promptly, and any noncompliance with PACA. The buyer may insist on including a materiality clause and cure period in the default provisions. A materiality clause should set a PACA claim dollar amount as a threshold for triggering an event of default.

After performing its due diligence, a lender may deny the produce buyer's request for financing because of the risks created by PACA. But as listed in this article, there are precautions that a lender can take to prevent PACA from spoiling a loan to a produce buyer. Such precautions may reduce a lender's risk of losing its collateral or disgorging loan payments but such precautions may not be enough. So: Lender, beware. ❐

Notes

1 In re L. Natural Foods Corporation, No. 96-13194BR at 6 (E. PA. Bankr., Sep. 10, 1996). See also Endico Potatoes, Inc., 67 F.3d at 1066; In re Lombardo Fruit and Produce Co., 12 F.3d 806, 809 (8th Cir. 1993). The trust provision created by the 1984 amendments is codified at 7 U.S.C. §499e(c)(2),.

2 See Pereira v. Marine Midland Bank, N.A., (In re Al Nagelberg & Co., Inc.), 84 Bankr. 19 (Bankr. S.D.N.Y. 1988).

3 Berube, "Third Party Recipients of PACA Trust Assets: Are They Strictly Liable of Bona Fide Purchasers?" 45 Ark. L. Rev. at 384 (1992) [hereinafter, "Berube"]. See also In re Fresh Approach, Inc., 51 B.R. 412, 422 (Bankr. N.D. Tex 1985).

4 7 U.S.C.§499a(b)(4)(A).

5 In re L. Natural Foods Corporation, No. 96-13194BR at 6 (E. PA. Bankr., Sep. 10, 1996).

6 Id. Citing 7 U.S.C.§499e(c)(2). In support of its decision in the case, the court relied on Endico Potatoes, Inc. In that case, the court held that the processed potatoes did not qualify for trust protection under PACA because the final products had undergone a fundamental change from the fresh state of the vegetable. Endico Potatoes, Inc., 829 F. Supp. At 658.

7 Thomas J. Cunningham, "Perils of the Perishable Agricultural Commodities Act: Ambushed by the Turnip Man!," UCC Law Journal, Vol.27 at 144 (1994) [hereinafter, "Cunningham"]. Citing 7 C.F.R. §§46.46(aa)(5), 46.46(f)(2) (1993); 7 C.F.R. §46.2(aa)(11)(1993); 49 Fed. Reg. 45,737 (1984). Any agreement that provides for payment more than thirty (30) days from the date the perishable agricultural commodities are accepted will result in the loss of PACA protections. Cunningham at 144, 145, n.41. Citing In re Altabon Foods, Inc., 998 F.2d 718, 720 (9th Cir. 1993) (produce seller was not entitled to PACA protection because the agreement provided for payment period in excess of thirty days). See also John M. Himmelberg & Mitchell H. Stabbe, "The 1984 PACA Amendments after Six Years: Producing Sellers' Trust and Lenders' Disgust," 43 Ark. L. Rev. 523 at 538, 540. Payment terms must be honored or the seller risks losing trust protection because of the course of dealing establishes the actual terms of payment.

8 Gargiulo v. G.M. Sales, Inc., 11th Cir. 12/19/1997, No. 963646; see C.H. Robinson Co., 952 F.2d at 1314.

9 Gargiulo, 11th Cir. 12/19/1997, No. 963646; see C.H. Robinson Co., 952 F.2d at 1314; see also Consumers Produce Co. v. Volante Wholesale Produce, Inc., 16 F.3d 1374, 1380 (3d Cir. 1994). See also Restatement (Second) of Trusts § 304(2)(1959).

10 Gargiulo, 11th Cir. 12/19/1997, No. 963646; citing Consumers Produce Co., 16 F.3d at 1380 n. 3, 1382. One of the issues in Gargiula was whether the bank's use of a lock box to collect payments on the debtor's accounts receivable directly from the debtor's customers was a means of enforcing its security agreement (which covered inventory and accounts receivable) with the debtor/trustee, or whether such method of collection was the bank's standard method of doing business. See Consumers Produce Co., 16 F.3d at 1380 ("Because [the bank] received PACA trust assets in the ordinary course of business as monetary loan repayments, the transfer was for value.")

11 Berube at 392. "Notice of breach of trust will not be imputed simply because recipients have notice of the existence of a trust." Citing Restatement of Trusts §296 (1995).

12 Gargiulo, 11th Cir. 12/19/1997, No. 963646; citing Consumers Produce Co., 16 F.3d at 1383.

13 The Secretary of Agriculture is not authorized to release copies of notices to any party other than the buyer and the seller.