

THE INTERACTION BETWEEN THE PERISHABLE AGRICULTURAL COMMODITIES ACT AND THE BANKRUPTCY CODE: ANOTHER TRAP FOR THE UNWARY

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Introduction

Debtors, creditors and secured lenders are becoming more aware of the variety of state and federal statutes that can affect the ordinary expectations of distribution of assets from an insolvent enterprise. Some of the distribution variables should come as no surprise because they are listed in Section 104 of Article 9 of the Uniform Commercial Code (UCC §9-104). These “boilerplate” exceptions to Article 9’s usual distribution formula include landlords’ and mechanics’ liens, assignments of insurance policies, and the like.

One of UCC §9-104’s exclusions is particularly open-ended. UCC §9-104(a) provides that Article 9 does **not** apply to “a security interest subject to any statute of the United States . . .” Familiar federal exclusions under this subsection include the Ship Mortgage Act of 1920 (46 U.S.C. §§31321 et seq.) and the Federal Aviation Act of 1958 (49 U.S.C. §§1403 et seq.). Other federal statutes impinging on Article 9’s distribution pattern include environmental and labor-related legislation.

An older federal statute that has gained increasing recognition over the last 15 years is the Perishable Agricultural Commodities Act (“PACA”) (7 U.S.C. §§499a-499s). PACA gives certain sellers of particular products an interest in those products (and their proceeds) that trumps even the properly perfected secured creditor. PACA also empowers unpaid protected creditors to pierce the corporate veil and pursue the individuals responsible for the purchaser’s failure to pay. Finally, PACA grants the United States Department of Agriculture (“USDA”) the authority to license and regulate purchasers of perishable agricultural products, the power to enforce the rights of unpaid creditors, and the ability to sanction purchasers who fail to act in accordance with PACA and its regulations.²

Original Purpose and History

Nearly seventy years ago Congress concluded that sellers of certain perishable farm products suffered from seriously unfair treatment at the hands of their buyers. With the vagaries of selling commodities at some distance from where they were grown, farmers were unable to police their buyers. Buyers of large amounts of agricultural commodities could reject shipments on the ground that they were non-conforming with virtually no fear of challenge. The commodities could have deteriorated in the course of cross-country rail transit. Alternatively, an unscrupulous buyer could falsely claim such deterioration in the face of a declining market. The rejecting buyer had no duty even to attempt to resell the produce prior to the adoption of UCC §2-603.

Congress thus enacted PACA in 1930 to regulate commerce in perishable agricultural commodities. The purpose of the initial legislation was “for the protection of the producers of [such commodities] -- most of whom must entrust their products to a buyer or commission merchant who may be thousands of miles away, and depend for their payment upon his business acumen and fair dealing.” (H.R. Rep. No. 84-1196, S. Rep. No. 84-2507, at 2 (1955)).

PACA initially provided a means of regulating transactions subject to PACA by licensing buyers and permitting USDA intervention when a buyer failed to comply with its payment obligations. The statute specifically prohibited brokers from making fraudulent charges in connection with handling the

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² Two additional federal statutes provide substantially similar rights and remedies to sellers of other agricultural products. *See, e.g.*, the Packers and Stockyards Act, 1921 (7 U.S.C. §181 et seq.) and the Poultry Producers Financial Protection Act of 1987 (7 U.S.C. §197 et seq.).

commodities of another, shippers from failing to deliver in accordance with their contract with the grower, and buyers from refusing to accept delivery without reasonable cause. Pub. L. No. 71-436, §2(1)-(6). The primary penalty for failure by a licensed party, however, was suspension of its license for 90 days or revocation in the case of flagrant violations. Pub. L. No. 71-436, §8. While the original PACA also provided that the Secretary of Agriculture could issue an order awarding reparation to a seller in the event of a violation of the statute, collection of the award required institution of civil litigation in which the order counted only as prima facie evidence of the award. Congress amended PACA in 1934 to render the Secretary's order the equivalent of a final judgment unless the respondent appealed to the courts.

The original PACA also required "prompt payment" by the buyer of covered commodities. 7 U.S.C. §499b(4). However, the only remedies for violation of this provision were possible revocation of the buyer's PACA license and civil liability enforceable by the USDA as described above. 7 U.S.C. §§499e(a), 499h(a). The regulations currently define prompt payment in several categories ranging from ten days but never exceeding 30 days. 7 C.F.R. §46.2(aa)(1)-(10). The parties can agree on a greater time but any such agreement *must* be reduced to writing before entering into the transaction, and both parties must maintain a copy of the agreement in their records. 7 C.F.R. §46.2(aa)(11). Any such written agreement extending the payment terms will deprive an unpaid seller of the trust protections described below. 7 C.F.R. §46.46(e)(2).³

Mechanics of PACA

The 1984 Amendments

By 1983 Congress came to realize that sellers of perishable agricultural products were often unable to verify the creditworthiness of their buyers due to the need to market such commodities in a very short period of time. Moreover, buyers regularly purchased commodities on credit extended by secured creditors. In the event of insolvency of the buyer, the secured creditor could foreclose under UCC Article 9, an event that would frequently leave no remaining assets for the unpaid grower. (H.R. Rep. No. 98-543 (1983)). Congress concluded that such financing arrangements were "contrary to the public interest" and thus amended the original version of PACA. President Reagan signed the amendments into law on May 7, 1984. The 1984 amendments substantially increased the protection for unpaid sellers of such commodities by creating a non-segregated floating trust. New §499e(c)(2) provides that

Perishable agricultural commodities received by a commission merchant, dealer, or broker 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, shall be held by such commission merchant, dealer, or broker in trust for the benefit of all unpaid suppliers or sellers of such commodities until full payment of the sums owing in connection with such transactions has been received by such unpaid suppliers, sellers, or agents.

In effect, Congress created an entirely new "remedy for the seller of perishable commodities to an eventual debtor in bankruptcy, wherein the former, as an unsecured creditor, would otherwise be forced to await satisfaction of the claims of those creditors with security interests in inventory and proceeds." *In re Fresh Approach, Inc.*, 48 B.R. 926, 931 (Bankr. N.D. Tex. 1985).

The mere shipment of a perishable agricultural commodity now created a statutory trust on *all* the buyer's inventory of food or other products derived from such commodities, plus any proceeds thereof as soon as the buyer accepted the commodities. 7 C.F.R. §46.46(c). The "floating" aspect of this trust pertained to the fact that it extended to "all of the [buyer's] produce related inventory and proceeds thereof, regardless of whether the [seller] was the source of such inventory." *In re Fresh Approach, Inc.*, *supra* at 422; *see also Endico Potatoes, Inc. v. CIT Group/Factoring, Inc.*, 67 F.3d 1063 (2nd Cir. 1995).

³ Oral agreements extending payment terms beyond those provided in the regulations are unenforceable and do not deprive the seller of any statutory protections. *Idahoan Fresh v. Advantage Produce, Inc.*, 157 F.3d 197 (3rd Cir. 1998).

While the 7 U.S.C. §499e(c)(2) made *creation* of the statutory trust automatic, under the 1984 amendments the seller also had to comply with several steps to *preserve* its status as a trust beneficiary. Preservation of PACA trust claim required actions roughly analogous to perfection of a security interest. First, the grower had to give timely notice to its buyer of its intent to preserve the benefits of the trust. Second, the grower must also have filed the same notice with the USDA within 30 calendar days after the expiration of the time for payment. Unfortunately, there was no practical means by which secured creditors could determine whether a seller had filed the required notice with the USDA. While neither the notice nor filing requirements created by the 1985 amendments served the public notice function associated with the filing requirements of the UCC, they nonetheless had the practical effect of frequently limiting the occasions in which an unpaid grower could assert a trust claim.

The 1995 Amendments

In the years following the 1984 amendments a number of bankruptcy courts used arguably overly technical analyses of PACA's notification requirements to disallow trust claims asserted by unpaid sellers. For example, while notices sent prior to default were upheld (*In re Richmond Produce Co.*, 112 B.R. 364 (Bankr. N.D. Cal. 1990)), notices sent more than 30 days after payment was due would not be sufficient. See *In re Chipwich, Inc.*, 165 B.R. 135 (Bankr. S.D.N.Y. 1994). Similarly, several decisions denied trust status to sellers who had agreed to payment terms of more than 30 after receipt of the commodities (contrary to USDA regulations). See, e.g., *C.H. Robinson v. B.H. Produce Co.*, 723 F.Supp. 785 (N.D. Ga. 1989). At least one court held that notices that did not contain all other detailed information required by the regulations were inadequate. *In re D.K.M.G., Inc.*, 95 B.R. 774 (Bankr. D. Colo. 1989). Finally, the Ninth Circuit held in *In re Marvin Properties*, 854 F.2d 1183 (9th Cir. 1988) that the USDA's forwarding of a copy of the correct notice to the buyer was insufficient.

With these decisions in view, Congress made a number of changes to PACA in 1995. The most significant revision was to permit a new and much simpler means to preserve a PACA trust claim. Prior to these most recent amendments, a PACA trust beneficiary could preserve its benefits only by giving buyers the formal notice described above. 7 U.S.C. §499(e); 7 C.F.R. §46.46(f)(1) and (2). Now, however, unpaid growers may simply add to their invoices the following short statement of their intent to preserve their trust status: "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 receivable or proceeds from the sale of these commodities until full payment is received." 7 C.F.R. §46.46(f)(3).

With the enactment of this simplified trust "perfection" technique, the question has arisen whether an invoice containing both the appropriate statutory trust invocation language but also payment terms in excess of the time provided in the regulations disqualifies the seller from all trust benefits. A written agreement extending payment terms is enforceable but removes the seller from the trust provisions of PACA (see *Original Purpose and History*, above). Preprinted invoices often used by sellers typically contain language to the effect that payments are due in 30 days, which is often greater than the time allowed under 7 C.F.R. §§46.2(aa)(1)--(10). Only one reported decision has considered this question and in it the court concluded that the seller gave proper notice "[b]ecause the parties did not have a pre-transaction written agreement changing the times for payment . . . [and] the invoices contained all of the other required language" *Stowe Potato Sales, Inc. v. Terry's, Inc.*, 224 B.R. 329, 333 (W.D. Va. 1998).

Categories of PACA Transactions

What's a "Perishable Agricultural Commodity," Anyway?

The statutory definition of "perishable agricultural commodities" is straightforward: "fresh fruits and fresh vegetables of every kind and character," "whether or not frozen or packed in ice." 7 U.S.C. §499a(b)(4)(A).

The USDA's regulations add little to the common understanding of what is subject to PACA. The regulations make clear, however, that the subject fresh fruits and vegetables may undergo substantial processing without losing their protected character. While PACA does not protect growers whose commodities "have been manufactured into articles of food of a different kind or character," the statute continues to apply even after the commodities have been subject to, *inter alia* "blanching, chopping, . . . cutting, dicing, drying . . . polishing, precooling, refrigerating, shredding, . . ." (7 C.F.R. §46.2(u)).

Commodities typically falling within the ambit of PACA include a great variety of items. Certain processing of commodities, however, may deprive them of their protected status. A District Court has described that degree of "over processing" as follows:

[T]he minor processing which the regulations suggest is acceptable relates mostly to a change in form which does not change the essential nature of the item, such as slicing, or a change which is 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), *aff'd in part* 67 F.3d 1063 (2nd Cir. 1995).

Thus, processed foods that are *not* "perishable agricultural commodities" include oil-sprayed potatoes and potato salad as well as breaded cauliflower and onion rings (*A & J Produce, supra*⁴), batter-dipped french fries (*In re Long John Silver's Restaurants, Inc.*, 1999 WL 80938 (Bankr. D. Del. 1999)), and dried apricots and prunes (*In re L. Natural Foods Corporation*, 199 B.R. 882 (Bankr. E.D. Pa. 1996)).

What Transactions Are Covered

Despite Congress' intention to provide a broad remedy under PACA, the statute was not drafted to cover all transactions in the produce market. Four requirements must be met before the PACA trust can be asserted. First, there must be both a receipt and acceptance of covered goods by the buyer. Second, the goods must have been received in interstate commerce. Next, the commodities must be received by one of three covered entities, i.e., a commission merchant, a dealer, or a broker who is licensed under PACA. Last but not least, the seller must prove that it was not paid for the commodities in question.

These requirements are not difficult to meet. The definition of covered commodities is described above. A "buyer" for PACA purposes includes commission merchants, dealers, and brokers. Commission merchants receive commodities from another for sale on commission. 7 U.S.C. §499a(5). Brokers are those who engage in the business of negotiating sales and purchases of commodities on behalf of the seller or ultimate purchaser. 7 U.S.C. §499a(7). Finally, dealers encompass those who are engaged in the business of buying and selling commodities in wholesale or jobbing quantities. 7 U.S.C. §499a(6).

A split of authority exists on the issue of whether a restaurant can be a "dealer" within the scope of PACA. Bankruptcy Judge Helen Balik held that dealers may also include restaurants whose annual purchases reach the statutory minimum of \$230,000. *In re Magic Restaurants, Inc.*, 197 B.R. 455 (Bankr. D. Del. 1996). Judge Balik noted three factors supporting her conclusion. First, §499a(b)(6) does not expressly exclude restaurants from the definition of retailer; second, restaurants clearly buy commodities "for sale at retail" within the meaning that section; and, finally, a restaurant's customers, not the restaurant itself, is the consumer within the exclusion of 7 C.F.R. §46.2(j).

Less than a year later Bankruptcy Judge Judith Fitzgerald came to the opposite conclusion on virtually identical facts. *In re The Italian Oven, Inc.*, 207 B.R. 839 (Bankr. W.D. Pa. 1997). Judge Fitzgerald concluded that the PACA statute was ambiguous, thus justifying resort to the legislative and administrative histories surrounding the relevant provisions. The pertinent House Report submitted by the House Committee on Agriculture in 1995 stated that "[i]t is not the intent of the Committee that the definition of retailer be construed to include foodservice establishments such as restaurants . . ." 207 B.R. at 844 (quoting H.R. Rep. 104-207). Moreover, the USDA published its position on the issue of the applicability of PACA to restaurants in 1996:

⁴ Oil spaying may no longer disqualify potatoes from PACA protection because the USDA amended §46.2(u) of its regulations in 1996 to add "oil blanching" to the list of approved manufacturing processes.

Restaurants traditionally have not been considered subject to the PACA by USDA or Congress unless the buying arm of the restaurant is a separate legal entity, and is buying for and/or reselling the product to another entity. 207 B.R. at 844 (quoting 61 Fed.Reg. 13385, 13386 (March 27, 1996)).

No appellate court has yet ruled on this issue and it remains an open question. Given the clear evidence of Congressional intent, however, any accelerated move by the courts to extend PACA to restaurants would probably meet with a swift amendment to the statute to counteract such treatment.

The seller can establish the requisite “interstate commerce” with ease. Section 499(a)(3) defines this term to include “commerce between any State or Territory . . . and any place outside thereof; **or between points within the same State or Territory . . . but through any place outside thereof . . .**” (Emphasis added.) The courts have interpreted this jurisdictional prerequisite very broadly. The Circuit Court for the District of Columbia affirmed a finding by an administrative law judge that this requirement was met simply because the affected commodities typically moved in interstate commerce, and it would be an undue burden to prove that the particular commodities in question were not likewise intended to move in interstate commerce. *Produce Place v. USDA*, 91 F.3d 173 (D.C. Cir. 1996), *cert. den.* 117 S.Ct. 959 (1997); *see also J.R. Brooks & Son, Inc. v. Norman’s Country Market, Inc.* 98 B.R. 47 (Bankr. N.D. Fla. 1989) (PACA protections applied even though entire transaction was “intrastate” in nature); *In re Fresh Approach, supra* (majority of produce had come from out-of-state sources).

The final requisite to establishing a covered transaction, failure to pay, is not generally hard to establish.

What Assets Are In The Trust

One of the most litigated issues under PACA is the extent of the statutory trust. To what assets of the buyer is the unpaid seller entitled to look for payment?

Outside Bankruptcy

Section 499e(c)(2) defines the expanse of assets subject to the PACA trust: “[p]erishable agricultural commodities . . . 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 . . .” Congress specifically authorized the “floating” nature of the PACA trust to prevent the unpaid seller from losing its priority claim simply because the buyer dissipated the initial trust assets. *In re Mahan & Rowsey, Inc.*, 35 B.R. 898 (Bankr. W.D. Okla. 1983). Nor is the seller’s inability to trace the specific commodities sold to the defaulting buyer an impediment to recovery. 7 C.F.R. §46.46(c); *In re Fresh Approach, supra*. The buyer has the burden of proving that any of its assets are not PACA trust property. *Sanzone-Palmisano Co. v. M. Seaman Enterprises, Inc.*, 986 F.2d 1010 (6th Cir. 1993). The unpaid seller may thus recover from *all* PACA commodities and their proceeds remaining in the possession of the buyer, regardless of when the buyer acquired them. *In re Kornblum & Co., Inc.* 81 F.3d 280 (2nd Cir. 1996).⁵

Section 499e(c)(5) gives the federal courts a broad mandate to enforce PACA: “[t]he several district courts of the United States are vested with jurisdiction specifically to entertain (i) actions by trust beneficiaries to enforce payment from the trust, and (ii) actions by the Secretary [of the USDA] to prevent and restrain dissipation of the trust.” A few courts have allowed the sellers to seek injunctive relief (e.g., *Dole Fresh Fruit Co., v. United Banana Co.*, 821 F.2d 106 (2d Cir. 1987)) but others have limited such equitable relief to only the USDA (e.g., *Frio Ice, S.A. v. Sunfruit, Inc.*, 724 F.Supp. 1373 (S.D. Fla. 1989), *rev’d* 918 F.2d 154 (11th Cir. 1990)).

More typically, disgruntled sellers of agricultural commodities seek monetary relief, either in the federal district courts as specifically authorized by §499e(c)(5) or in an administrative reparation action before an

⁵ One Circuit Court of Appeals has held that the PACA trust does not reach commodities acquired prior to the final establishment of the trust. *Six L’s Packing Co. v. West Des Moines State Bank*, 967 F.2d 256 (8th Cir. 1992). This conclusion cannot be supported from the text of PACA, and has not been followed by other courts.

Administrative Law Judge of the Agricultural Marketing Service (a unit of the USDA). 7 C.F.R. §§47.1 et seq. Any party dissatisfied with the results of the administrative action may, however, appeal to the District Court within 30 days and receive a trial *de novo*. 7 USC §499g(c).

The extent of recovery allowed to the unpaid seller is the full amount of the value of all produce sold so long as it has met all the statutory requirements to establish the trust claim. If there are more than one unpaid seller of such commodities and a shortfall in PACA trust assets, then the PACA creditors must share the value of the trust assets on a pro-rata basis. *In re United Fruit and Produce Co.*, 86 B.R. 14 (Bankr. D. Conn. 1988). The courts have permitted payment of the attorneys' fees and costs of the sellers who have taken the lead in enforcing their PACA claims on behalf of all such creditors to prevent the "free rider" problem. *In re Milton Poulos, Inc.*, 94 B.R. 648 (Bankr. C.D. Cal. 1988), *aff'd* 107 B.R. 715 (9th Cir. B.A.P. 1989), *aff'd in part, rev'd in part*, 947 F.2d 1351 (9th Cir. 1991).

Inside Bankruptcy

All of the issues described above continue to be relevant when the defaulting purchasers seeks bankruptcy protection. Several additional questions must be answered, however, under the Bankruptcy Code.

Exclusion from Property of the Estate

Bankruptcy Judge John C. Ford of the Northern District of Texas answered the question of whether commodities subject to a PACA trust were "property of the estate" within the meaning of §541(a) and (d) of the Bankruptcy Code soon after the passage of the 1984 amendments. *In re Fresh Approach, supra*. Fresh Approach filed its Chapter 11 bankruptcy on February 13, 1985. One of its suppliers, Standard Fruit and Vegetable, moved for an order requiring the debtor to turn over any commodities on hand and their proceeds on the ground that they were not property of the estate. Standard Fruit had sent the notices required by PACA under the 1984 amendment to both the debtor and the USDA. Judge Ford first concluded that the amendments became effective upon enactment although the USDA had not issued implementing regulations. He then concluded that the inventory and proceeds impressed with the PACA trust were not part of the estate but were held for the sole benefit of unpaid sellers. Numerous other courts following *Fresh Approach* have reached the same conclusion. *See, e.g., In re United Fruit & Vegetable, Inc.*, 191 B.R. 445 (Bankr. D. Kan. 1996); *In re H.R. Hindle & Co.*, 149 B.R. 775 (Bankr. E.D. Pa. 1993); and *In re Milton Poulos, Inc., supra*.

Section 541(d) of the Bankruptcy Code makes it clear that property to which the debtor holds only legal title is not property of the estate. PACA trusts are governed by traditional trust rules and the effect of excluding PACA trust assets from the property of the bankruptcy estate is substantial: "a perfected PACA trust beneficiary is entitled to payment in full from the trust assets before payment to any other creditors, whether secured or unsecured." *In re Long John Silver's Restaurants, Inc., supra; see also In re Kornblum & Co., supra*. While the wisdom of "special interest" legislation such as PACA is dubious in the bankruptcy context where almost no one receives everything they are owed (*see In re H.R. Hindle & Co., Inc., supra*), it must nonetheless be enforced.⁶

The Effect of the Automatic Stay

Notwithstanding the universal conclusion that PACA assets are not property of the estate, the courts have just as regularly held that the automatic stay of §362(a) of the Bankruptcy Code applies to unpaid sellers seeking payment from trust assets. *In re United Fruit & Produce Co., supra; In re Superspuud, Inc.*, 77 B.R. 930 (Bankr. N.D. Fla. 1987).

⁶ Nor can the bankruptcy trustee avoid the statutory PACA trust by using the "strong-arm" provisions of §545 of the Bankruptcy Code. *In re Kelly Food Products, Inc.*, 204 B.R. 18 (Bankr. C.D. Ill. 1997).

Distribution by the Estate

If PACA trust assets are not property of the bankruptcy estate, several questions arise: first, who is responsible for determining the amount and validity of PACA claims; second, who oversees the distribution of the value of the PACA trust; and, finally, who is to be paid for these services?

Bankruptcy courts have rarely abstained from deciding issues related to PACA trusts on the ground of lack of jurisdiction. See, e.g., *In re Southland + Keystone v. Official PACA Creditors' Committee*, 132 B.R. 632 (9th Cir. BAP 1991); *In re Poulos, supra*; and *In re Fresh Approach, supra*. The decision in *In re United Fruit & Vegetable, Inc., supra*, in which the bankruptcy court abstained in favor of the District Court represents a notable and virtually unique exception. Similarly, almost all courts have allowed the Chapter 7 trustee in liquidation cases to handle PACA-related matters. In Chapter 11 cases, an official committee is often appointed pursuant to §1102 of the Bankruptcy Code to represent the PACA interests.

Finally, in those cases where the bankruptcy court has retained jurisdiction over the PACA trust, courts have split of the question of whether the Chapter 7 bankruptcy trustee is allowed to assess fees on the PACA assets that he or she administers. The early case of *In re Super Spud, Inc., supra*, held against the trustee. Later cases, however, have reached the opposite conclusion. “The bankruptcy trustee of the debtor’s estate has rendered substantial services in collecting the PACA receivable for the benefit of the PACA beneficiaries . . . The non-PACA creditors of this estate should not pay for these services and the trustee should not be forced to donate them.” *In re United Fruit and Produce Co.*, 119 B.R. 10, 13 (Bankr. D. Conn. 1990).

Responsible Party Liability

The use of the mechanism of a trust to enhance the rights of sellers of perishable agricultural commodities has the potential to expand the class of parties against whom the unpaid seller may proceed. While most buyers and brokers are corporate entities, they are operated by individuals who may personally bear fiduciary responsibilities to the creditors. In addition, breach of fiduciary duties has implications for dischargeability in bankruptcy.

In General

Even with their enhanced collection powers by virtue of PACA, unpaid sellers may still find their buyers without sufficient assets to pay PACA claims. Two additional routes of recovery have been exploited to fill this gap. The first is pursuit of third parties (such as secured creditors) who may have improperly received trust assets. The other is assertion of a claim against the individual or individuals who may have been personally responsible for the dissipation of trust assets.

One of the first cases to address the latter issue was *Morris Okun v. Harry Zimmerman, Inc.*, 814 F.Supp. 346, 348 (S.D.N.Y. 1993) in which the District Court held that the person “in the position to control the trust assets . . . who does not preserve them for the beneficiaries has breached a fiduciary duty, and is personally liable for that tortious act.” In other words, personal liability for PACA trust dissipation is based on position, not actual knowledge. If the buyer’s assets are insufficient to satisfy the liability, “others may be found secondarily liable if they had some role in causing the corporate trustee to commit the breach of trust.” *Shepard v. K.B. Fruit & Vegetable, Inc.*, 868 F.Supp. 703, 706 (E.D. Pa. 1994).

Specific acts found to be sufficient to impose personal liability include failure breach of duty to preserve assets (*Sunkist Growers, Inc. v. Fisher*, 104 F.3d 280 (9th Cir. 1997)), failure to provide oversight (*Shepard v. K.B. Fruit, supra*), failure to supervise operations (*Golman-Hayden Co., Inc. v. Fresh Source Produce, Inc.*, 27 F.Supp.2d 723 (N.D. Tex. 1998)); and the mere status of being sole shareholder, director and president of defaulting buyer (*Loi Banana Corp. of Brooklyn v. Central Brooklyn Produce Wholesalers & Commission Merchants, Inc.*, 1996 WL 391574 (E.D.N.Y. 1996)).⁷

⁷ Traditional alter-ego theories for piercing the corporate veil are not as likely to succeed. *Hiller Cranberry Products, Inc. v. Koplowsky*, 165 F.3d 1 (1st Cir. 1999).

Principals of defaulting buyers can take some solace, however, from *Farm-Wey Produce, Inc. v. Wayne L. Bowman Co., Inc.*, 973 F.Supp. 778 (E.D. Tenn. 1997) where the District Court held that mere status as an individual “responsibly connected” to the defaulting broker is not enough to ground liability. Even the best exercise of business judgment may result in resales to ultimate buyers who default: “not every bad business decision amounts to a breach of fiduciary duty. A fiduciary’s common law duty to beneficiaries is to exercise the skill and care of a person of ordinary prudence would exercise in dealing with his own property.” 973 F.Supp. at 784 (citing Restatement (Second) of Trusts §174). In addition, the court held that payment of ordinary operating expenses by a broker does not amount to “dissipation.”

Dischargeability Issues

Section 523(a)(4) of the Bankruptcy Code provides that an individual debtor will not be discharged from a debt “for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny.” The courts have distinguished between express trusts, constructive trusts and statutory trusts for dischargeability purposes. Breach of obligations in connection with an express trust are nondischargeable, those arising out of a constructive trust are dischargeable, while fiduciary obligations associated with statutory trusts may or may not be dischargeable. See *Matter of Marchiando*, 13 F.3d 1111 (7th Cir. 1994), cert. den. 512 U.S. 1205. PACA trusts fall into the third category and most decisions have held that, assuming that the sellers have established personal liability on one of the grounds described above, the associated fiduciary obligations are nondischargeable. See, e.g., *In re Zois*, 201 B.R. 501 (Bankr. N.D. Ill. 1996); *Morris Okun, Inc. v. Harry Zimmerman, Inc.*, supra; and *In re Snyder*, 184 B.R. 473 (D. Md. 1995).

PACA and SECURED CREDITORS

The priority of a PACA trust claimant vis-à-vis the interests of a properly perfected secured creditor in the same assets came to the attention of the courts soon after the enactment of the 1984 amendments. By 1993, the Sixth Circuit held that a PACA creditor’s interest in PACA trust assets was superior to any security interest in the same inventory. *Sanzone-Palmisano Co. v. M. Seaman Enterprises, Inc.*, supra. See also *Morris Okun, Inc. v. Harry Zimmerman, Inc.*, supra, and *In re Southland + Keystone v. Official PACA Creditors’ Committee*, supra.

The cases noted above made the clear the result of any competition between a secured creditor and an unpaid PACA seller for trust assets in existence. However, they did not resolve the issue of the priority of PACA claimants for payments already made to the lender. The first decision by a Court of Appeals on this issue was *C.H. Robinson Company v. Trust Company Bank*, 952 F.2d 1311 (11th Cir. 1992). In that case a group of five unpaid sellers sued two banks that had made secured loans to B.H. Produce Co. The produce company did not pay for the commodities it had purchased but did manage to repay portions of its loans from the banks. The sellers sued on the ground that the banks had received payments from a trust corpus in violation of the rights the trust beneficiaries. The banks, in turn, defended on the ordinary trust principle that they were bona fide purchasers without notice of any breach of the trust. The District Court generally held in favor of the banks and the sellers appealed. The Eleventh Circuit quoted from the Restatement (Second) of Trusts §284(1) to the effect that “a person who takes for value and without notice of the breach of trust, and who is not knowingly taking part in an illegal transaction, [takes] . . . free of the trust, and is under no liability to the beneficiary.” 952 F.2d at 1313.

Are transfers on account of antecedent debts, such as repayment of a loan, for value? The answer is “yes” if the transfers are in the form of a negotiable instrument or money. *Id.* at 1314 (citing Restatement (Second) of Trusts §304(2)). Did the banks in this case receive the loan payments without notice of the breach of trust? The District Court had found that they did and the unpaid sellers had not appealed this point so the Circuit Court affirmed the judgments in favor of the banks.

The following year a bankruptcy court confronted a slightly different situation in *In re H.R. Hindle & Co., Inc.*, supra. The lender in *Hindle* had set-off funds in its borrower’s accounts rather than receiving checks in payment of its loan. The lender also had a six-year relationship with its borrower, which at least raised the possibility that it knew it obtained the funds in violation of the PACA trust. Nonetheless, the court

denied the unpaid sellers' motion for summary judgment but placed the burden of proof for both good faith and value on the lender.

Two recent decisions by Courts of Appeals have indicated that trial courts should rarely grant summary judgment for lenders in actions by PACA claimants. The Eleventh Circuit held that payments received through the exercise of a lender's collection rights in a security agreement are never "for value" because they are not in the ordinary course of business. *Gargiulo v. G.M. Sales, Inc.*, 131 F.3d 995, 999 (11th Cir. 1997). The Second Circuit focused on the good faith defense of the lender in *Albee Tomato, Inc. v. A.B. Shalom Produce Corp.*, 155 F.3d 612 (2nd Cir. 1998). The court held there was a genuine issue of material fact whether the lender had actual or constructive notice that its payments were in violation of the PACA trust: "[the transferee] should know of a breach of trust when 'he [or she] knows facts which under the circumstances would lead a reasonably intelligent and diligent person to inquire whether the trustee . . . is committing a breach of trust . . .'" 155 F.3d 616 (quoting Comment A to Restatement (Second) of Trusts §297); see also *Gargiulo v. G.M. Sales, Inc.*, *supra* (holding that bank may have had a duty of inquiry when aware of financial difficulties of borrower).⁸

Lenders received some good news, however, in *In re Southland + Keystone v. Official PACA Creditors' Committee*, *supra* which held that a secured lender should be entitled to offset its "hard" costs of collection (i.e., outside attorneys' fees and expenses) against any award in favor of PACA claimants. The Bankruptcy Appellate Panel also held that the trial court had acted appropriately when it did not award attorneys' fees to the successful PACA Committee in that case.

Conclusion

Congress has proceeded systematically since 1930 to enhance the collection rights of growers of perishable agricultural commodities. These rights now prevail even over third parties with legitimate perfected security interests evidenced in the public record. The powers of a PACA beneficiary can even extend to payments received by third parties and to principals of a defaulting buyer.

It is important that attorneys representing growers insure that their clients follow the simple means by which to preserve their trust beneficiary status. It is imperative that clients lending to purchasers or brokers of such commodities be advised of the risks and take appropriate steps to protect their collateral positions against unexpected erosion. Frequent reports of accounts payable, regular collateral audits, and substantial borrowing base reserves may be advisable for lenders to buyers of perishable agricultural commodities. Such lenders may also need collateral in addition to their borrower's "soft assets" (inventory and accounts) such as real estate, equipment, and third party enhancements like letters of credit and collateralized guaranties

PACA has probably reached the end of its expansion. Nonetheless, many other special interests may seek similar preferences at the expense of consensual distribution schemes. Vigilance in the area of federalization of payment priorities will continue to be required.

⁸ Actions against third parties other than secured lenders have also cropped up. See, e.g., *Driscoll Potatoes, Inc. v. Robinson Potato Supply Company*, 1 F.Supp.2d 1268 (D. Kan. 1998) (summary judgment in favor of ESOP and its trustee denied because of genuine issue of fact on issue of good faith).