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PACA’s Priority: A Potential Problem for Secured Lenders

Every secured lender hates to hear it: Yet another statutory scheme could potentially cause the lender to lose its first priority security interest in certain collateral. While the Perishable Agricultural Commodities Act (PACA) has been around since 1930, it is often forgotten or overlooked by many lenders. However, to the extent that a lender's collateral includes perishable agricultural commodities, such as when the borrower is a restaurant or grocery store, PACA can present significant risks for a lender.

PACA Basics

PACA was introduced to protect growers and suppliers of fruits and vegetables, who had suffered immensely during the 1920s. In 1984, PACA was amended to add additional protections for suppliers, including provisions for the creation of a statutory trust. Pursuant to these provisions, a floating, non-segregated trust is created in favor of suppliers selling perishable agricultural commodities in their original state (e.g., fresh corn but not canned corn). The PACA trust effectively operates as a lien on the perishable agricultural commodities purchased by the buyer (i.e., the lender's borrower) and any accounts or proceeds derived from such commodities. In short, a PACA supplier has a right to be paid before all other creditors, including secured creditors with a blanket lien on a borrower's assets.

Priority Under PACA

In order to establish a PACA trust, the supplier must provide the buyer with written notice that the goods are sold subject to PACA. Once such notice is provided, the burden is on the buyer to establish that certain goods are not subject to the PACA trust. Further, to the extent the buyer’s assets are commingled, there is a risk that all assets will be deemed to be part of the PACA trust. For example, if a buyer uses proceeds from the sale of produce to pay its mortgage, the underlying real estate could be considered to be part of the PACA trust. Unless otherwise agreed, PACA also requires a buyer to make prompt payment to the PACA supplier, generally within 30 days.

Buyers that breach a PACA trust can face major consequences. A buyer may be responsible for steep interest rates, attorneys' fees and collection costs, and a buyer's principals may even be held personally liable if they knowingly dissipate

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the PACA trust assets.

Perhaps most importantly, courts have held that a buyer's lenders are liable for breach of the PACA trust when they knew or should have known they were being paid with receivables that should have gone to a PACA supplier. A lender may be forced to return funds it received from the borrower unless the lender can prove that it did not know that the receivables came from PACA trust assets. To avail itself of this defense, a lender generally must show it conducted a thorough investigation of the matter, including contacting potential suppliers within the borrower's sale and distribution channels. Further, to the extent that a lender is holding funds in a borrower's deposit account and is entitled to a right of setoff, such right may be materially impaired by PACA. Lenders may not garnish PACA trust funds for repayment of any obligations owed by a borrower.

PACA and Bankruptcy: A New Case Introduces Uncertainty

PACA has historically had a powerful presence in bankruptcy proceedings. While PACA suppliers continue to have the same super-priority status they have outside of bankruptcy, they also are not subject to avoidance actions under the preference provisions of the Bankruptcy Code. This is because courts have held that because the PACA trust is established for the benefit of the PACA suppliers, the funds in the trust were never meant to benefit the debtor and therefore never part of the bankruptcy estate. Further, PACA suppliers often assert that they have a first priority claim in any proceeds derived from the sale of a debtor's assets in bankruptcy. While lenders have defeated this assertion in certain cases, they still face an uphill battle when battling a PACA supplier in a bankruptcy case.

However, PACA suppliers are not immune from the discharge provisions of bankruptcy. In the fall of 2022, the U.S. Court of Appeals for the Eleventh Circuit ruled that a Florida grocery store owner could discharge debts owed to a produce supplier through a bankruptcy proceeding. In *Spring Valley Produce Inc. et al v. Nathan Forrest et al*, the produce supplier argued that the debts it was owed by the debtor were nondischargeable because PACA overruled the Bankruptcy Code's normal discharge provisions and, even if it did not, the debts arose from fraud or defalcation while the debtor was acting in a fiduciary capacity. The court analyzed what constituted a "fiduciary capacity" under the Bankruptcy Code and held that, while PACA "imposes some trust-like duties," PACA does not qualify for the fiduciary exemption to discharge in bankruptcy. Further, the court held that PACA does not require a produce buyer to keep trust assets segregated from its other assets.

The produce buyer has appealed the 11th Circuit's decision to the U.S. Supreme Court, which has yet to decide whether it will hear the case.

What Should a Secured Lender Do?

Given the above, there are ways a lender can protect itself from potential loss as a result of the PACA provisions.

First, a lender needs to undertake careful and thorough diligence if there is any possibility that its borrower will be purchasing fresh or frozen produce. Even if a borrower is not currently purchasing either, the lender should be aware of any potential for the borrower to purchase fresh or frozen produce (e.g., a borrower purchasing canned tomatoes could switch to purchasing fresh tomatoes). Second, if a lender decides to move forward with a borrower subject to PACA, the lender should include representations, warranties and covenants that require a borrower to provide the lender with certain information regarding its operations and suppliers and to pay all third parties in full in a timely manner. A lender can also establish a reserve to ensure funds will be available to pay any PACA supplier in the event of financial distress. Finally, it is important that lenders work with experienced legal counsel to ensure that any underlying loan agreements adequately protect the lender's interest in light of the potential issues that may arise under PACA.

Please contact Sara McNamara, Robert Heinrich or your Reinhart attorney if you have any questions about PACA or its impact on liens.