

PACA AND BANKRUPTCY

By

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Bankruptcy Priority Scheme

One of the central provisions of the Bankruptcy Code is the ordering of claims against the debtor in accordance with a priority scheme. These priorities set the order of payment and, hence, directly affect the amount that creditors receive from the limited assets of a bankruptcy estate. The following are the most commonly encountered categories of claims in a business bankruptcy case, in the order of priority accorded them under the Bankruptcy Code:

Secured claims: Claims that are secured by the debtor's property, but only to the extent of the value of the collateral.

Administrative claims: Costs of administration of the bankruptcy estate, including fees of professionals, and claims of creditors extending credit post petition.

Gap claims: When a bankruptcy case is commenced by the filing of an involuntary petition, claims arising between the date of the filing of the petition and the date that an order for relief is entered, i.e., the court grants the petition, are entitled to priority behind the claims of administering the case after the order for relief is entered.

Wage claims: Wages, salaries or commissions earned within 90 days prior to the bankruptcy filing, but limited to \$4,650.00. The balance of the claim is treated as a general unsecured claim.

Employee benefits claims: Claims arising out of the failure to make contributions to employee benefit plans, accruing within 180 days prior to the bankruptcy filing. These claims are limited by a complicated formula that essentially caps the total of all employee benefits claims and priority wage claims to \$4,650 times the number of employees eligible for the employee benefits plan.

Tax claims: As a general rule, all tax claims are entitled to priority. On occasion, a tax claim may be excluded from priority treatment pursuant to a complicated formula set forth in the Bankruptcy Code.

General unsecured claims: All claims that are neither secured by collateral nor entitled to priority treatment. Most trade claims fall into this class.

Since most claims arising from the sale of goods are neither secured nor priority claims, they generally get paid last in the bankruptcy priority scheme. PACA allows those

creditors with valid PACA claims to bypass the priority claim to the extent of their claims.

Property of Estate

Upon the filing of a bankruptcy petition, whether voluntary or involuntary, an estate is created, which generally consists of “all legal or equitable interests of the debtor” in property as of the commencement of the case and all property that the estate acquires after the commencement of the case.

As a general matter, assets held by the debtor in trust for another do not become property of the bankruptcy estate in any meaningful economic sense since the equitable interests (which is the real value in the assets)¹ in the property belong to someone other than the debtor.

The PACA Statutory Trust and the Bankruptcy Code

PACA establishes a trust in favor of suppliers of perishable agricultural commodities. The trust was not part of the original PACA statute,² but was incorporated in it in 1984. The statute spells out the Congressional intent in establishing the trust, as follows:

(1) It is hereby found that a burden on commerce in perishable agricultural commodities is caused by financing arrangements under which commission merchants, dealers, or brokers, who have not made payment for perishable agricultural commodities purchased, contracted to be purchased, or otherwise handled by them on behalf of another person, encumber or give lenders a security interest in, such commodities, or on inventories of food or other products derived from such commodities, and any receivables or proceeds from the sale of such commodities or products, and that such arrangements are contrary to the public interest. This subsection is intended to remedy such burden on commerce in perishable agricultural commodities and to protect the public interest.³

Section 499e(c)(2) of the Perishable Agricultural Commodities Act establishes the trust and provides, in relevant part:

¹ Legal title alone has little, if any, value. The equitable owner of assets is the person or entity entitled to the economic benefits of the property.

² The statute was first enacted in 1930.

³ 7 U.S.C. § 499e(c)(1).

(2) 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 or agents involved in the transaction, until full payment of the sums owing in connection with such transactions has been received by such unpaid suppliers, sellers, or agents.⁴

The special protection afforded suppliers of perishable agricultural commodities is reflected in the way that PACA interacts with the Bankruptcy Code. To the extent that a supplier is entitled to payments from a PACA trust, its claim, in essence, is a claim against assets that are not part of the bankruptcy estate. As such, the claim bypasses the bankruptcy priority scheme.

Where a produce supplier has a valid PACA claim, therefore, it is entitled to receive payment before all other creditors, including secured creditors and taxing authorities. This rule extends to produce suppliers that obtain an attachment against a debtor's assets in order to collect on the debt created from the sale of its perishable agricultural commodities. All valid PACA claims will be paid ahead of the lien of the attaching supplier, although the supplier will still be able to participate in the PACA trust to the extent it has a valid PACA claim.⁵

The PACA Statute and Regulations

The Secretary of Agriculture is granted the authority to establish regulations for the interpretation and implementation of the provisions of PACA. The statute itself, in the first instance, determines the rights and liabilities of the supplier and its customer. To the extent there is any ambiguity or gap in the statute, the Secretary of Agriculture may resolve the ambiguity or fill in the gaps with regulations. Those regulations generally will be valid as long as they are not in conflict with the statute.

Where there is an ambiguity or gap in the statute, courts will look to see if there is a regulation that resolves the ambiguity or fills in the gap. If there is such a regulation, the courts will generally follow the regulation. They will do this even if they might have interpreted the statute differently than the regulation does. Where there is no regulation,

⁴ 7 U.S.C. § 499e(c)(2).

⁵ *In the Matter of United Fruit and Produce Co., Inc.*, 119 B.R. 10 (Bankr. D. Conn. 1990). The supplier's attachment will still be valid against any non-trust assets it attaches.

the courts are free to interpret the statute as they deem appropriate, consistent with established rules governing the interpretation of statutes.

In determining the rights and liabilities of the parties under PACA, therefore, you must look both at the statute itself and the regulations adopted by the Secretary of Agriculture. In most instances, the regulations will be deemed valid, but careful attention must be paid as to whether they conflict with the statute. A regulation that itself is subject to multiple interpretations can be interpreted with more precision by viewing it against the backdrop of the statute itself. Of course, to the extent there are any ambiguities left after apply both the statute and the regulations, the issue will be left to the courts to decide.⁶

What is a Perishable Agricultural Commodity?

The term “perishable agricultural commodity” is defined very simply in the statute as “fresh fruits and vegetables of every kind and character” “whether or not frozen or packed in ice.” It also includes “cherries in brine as defined by the Secretary in accordance with trade usages.”⁷

The regulations in turn define “fresh fruits and vegetables”. “frozen fruits and vegetables” and “cherries in brine” as follows:

(u) Fresh fruits and fresh vegetables include all produce in fresh form generally considered as perishable fruits and vegetables, whether or not packed in ice or held in common or cold storage, but does not include those perishable fruits and vegetables which have been manufactured into articles of food of a different kind or character. The effects of the following operations shall not be considered as changing a commodity into a food of a different kind or character: Water, steam, or oil blanching, battering, coating, chopping, color adding, curing, cutting, dicing, drying for the removal of surface moisture; fumigating, gassing, heating for insect control, ripening and coloring; removal of seed, pits, stems, calyx, husk, pods rind, skin, peel, et cetera; polishing, precooling, refrigerating, shredding, slicing, trimming, washing with or without chemicals; waxing, adding of sugar or other sweetening agents; adding ascorbic acid or other agents to retard oxidation; mixing of several kinds of sliced, chopped, or diced fruit or vegetables for packaging in any type of containers; or comparable methods of preparation.

⁶ For a good discussion of the interplay of PACA and the regulations that supplement it, see *Fleming Companies, Inc. v. United States Department of Agriculture*, 322 F. Supp. 2d 744 (E.D. Texas 2004).

⁷ 7 U.S.C. § 499a(b)(5).

(v) Frozen fruits and vegetables include all produce defined in paragraph (u) of this section when such produce is in frozen form.

(w) Cherries in brine means cherries packed in an aqueous solution containing sulphur dioxide or other bleaching agent of sufficient strength to preserve the product, with or without the addition of hardening agents.⁸

To constitute a perishable agricultural commodity, therefore, the product must meet the following criteria:

- It must be a fruit or vegetable, whether in fresh or frozen form; and
- It may not have been manufactured into an article of food “of a different character.”

The regulation then provides a laundry list of those processes which will not be deemed to make the food “of a different character.” These are set forth in the regulation quoted above, but are worth repeating here:

Water, steam, or oil blanching, battering, coating, chopping, color adding, curing, cutting, dicing, drying for the removal of surface moisture; fumigating, gassing, heating for insect control, ripening and coloring; removal of seed, pits, stems, calyx, husk, pods rind, skin, peel, et cetera; polishing, precooling, refrigerating, shredding, slicing, trimming, washing with or without chemicals; waxing, adding of sugar or other sweetening agents; adding ascorbic acid or other agents to retard oxidation; mixing of several kinds of sliced, chopped, or diced fruit or vegetables for packaging in any type of containers; or comparable methods of preparation.

These regulations were recently challenged with regard to the question as to whether coated and battered french fries constitute perishable agricultural commodities. First, it should be noted that french fries without the coating and battering would qualify under the statute because:

- It is a fruit or vegetable.
- Prior to freezing it would by any standard be considered fresh.
- The statute specifically excludes freezing from those processes that would make the potato something other than fresh.
- The statute states that the fruit or vegetable may not be manufactured into a food of a different character. The regulations, in turn, make it clear that cutting or dicing a potato will not make it into a fruit or vegetable of a different character.

⁸ 7 CFR § 46.2(u), (v), (w).

In *Fleming Companies, Inc. v. United States Department of Agriculture*,⁹ Fleming Companies had argued that the Secretary of Agriculture exceeded his authority when he added “battering” and “coating” to the processes that were allowable taking the product outside of the definition of perishable agricultural commodity. In deciding that the regulation was proper, the court first described the process of coating and battering a potato product. Noting first that the potatoes were coated and battered to preserve their crispness, the court described the process as follows:

To coat and batter a potato product, one dips potato strips into a mixture of water and natural vegetable starch. Then, a crisping or chemical leavening agent is added to the potato product. Finally, the potato product is “air blown to remove all but a thin layer of coating, oil-blanched, and . . . finally frozen.”¹⁰

The court further noted that coating and battering “preserve the crispness and color of french fries that are left under heating lamps” and that consumers eat them because “neither coating nor battering changes the taste or texture of a potato product.”¹¹

The *Fleming* decision makes sense in light of the way that the battering and coating process was employed in the production of french fries. One must wonder whether there are not certain battering and coating processes that might change the character of the potato sufficiently enough to take the fruit or vegetable outside of the purview of a perishable agricultural commodity. The argument was made in *Fleming* that the battering and coating made the french fries something other than “fresh”, as required by the statute. One could imagine a process that might be broadly considered to constitute battering or coating that would take the product outside of the definition of “fresh”, despite the broad language in the regulation to the contrary.

A good example of a dividing line between a process that might not alter the character of the product as “fresh” and a process that would be contained in the regulations themselves. One of the permitted processes is “drying for the removal of surface moisture.” The plain implication is that drying beyond the removal of surface moisture would not be permitted. In other words, removing the surface moisture is not deemed to change the essential character of the fruit or vegetable from “fresh” to something else, yet the transformation to dried fruits and vegetables would take the product outside of the definition of perishable agricultural commodity.

⁹ 322 F. Supp. 2d 744 (E.D. Texas 2004).

¹⁰ 322 F. Supp. 2d at 751 (citations omitted).

¹¹ 322 F. Supp. 2d at 751.

How is the Supplier Protected?

PACA imposes an obligation on certain purchasers of perishable agricultural products to pay the supplier from the proceeds of the sale of those products. The trust provisions of PACA, quoted above, establish a trust in favor of the supplier. As a general matter, the trust consists of the product itself, the accounts receivable generated from the product and all money collected from the sale of the product.¹² The purchaser has a fiduciary obligation to the supplier to ensure that the supplier is paid from any proceeds generated from the sale of the product. The supplier must be paid before anyone else, including the purchaser's bank, its employees and the taxing authorities.

The purchaser's fiduciary obligation only exists to the extent there are proceeds.¹³ If the goods rot and therefore go unsold, then the seller cannot make a claim under the PACA trust for those goods, although the contractual obligation to pay to pay still exists.¹⁴ But, to the extent there are proceeds, it does not matter whether they have been commingled with proceeds from the sales of other perishable agricultural commodities or even with assets that have nothing to do with perishable agricultural commodities at all. Where proceeds from more than one supplier of perishable agricultural commodities are commingled, the suppliers will share in the fund. Where these proceeds are commingled with proceeds that are not entitled to PACA protection, the burden is on the buyer to show which of the proceeds are not subject to the PACA trust.¹⁵

Once the existence of proceeds from the sale of the supplier's product is determined, then the supplier is entitled to payment therefrom, ahead of any other creditor. Should the proceeds be insufficient to pay all creditors asserting valid PACA claims, then the supplier will share in the proceeds on a pro rata basis with other creditors holding valid PACA claims. If the proceeds are insufficient to cover all PACA claims, the PACA suppliers may also have claims against the principals of the purchaser, as discussed more fully below.

¹² The trust can also consist of property purchased with the cash proceeds of a sale of perishable agricultural commodities. *Tony Vitrano Co. v. National Produce Co.*, 815 F. Supp. 23 (D.D.C. 1993).

¹³ The trust extends to the perishable agricultural commodities themselves, all inventory derived therefrom and accounts receivable, cash and other sale proceeds. Because of the perishable nature of the product, there normally will be little, if any, product of any value for the trust to attach. As such, these materials will refer to the trust assets as the proceeds and not the perishable agricultural commodities themselves.

¹⁴ *In re Perry Zois*, 1996 Bankr. LEXIS 1464 (Bankr. N.D. Ill. 1996).

¹⁵ *In re George Zois*, 201 B.R. 501 (Bankr. N.D. Ill. 1996).

Who is Responsible?

PACA places the fiduciary responsibility to pay suppliers on “commission merchants”, “dealers” and “brokers”. The statute, in turn, defines each of these terms as follows:

Commission merchant: “Any person engaged in the business of receiving in interstate or foreign commerce any perishable agricultural commodity for sale, on commission, or for or on behalf of another.”

Dealer: “Any person engaged in the business of buying or selling in wholesale or jobbing quantities, as defined by the Secretary, any perishable agricultural commodity in interstate or foreign commerce, except that (A) no producer shall be considered as a ‘dealer’ in respect to sales of any such commodity of his own raising; (B) no person buying any such commodity solely for sale at retail shall be considered as a ‘dealer’ until the invoice cost of his purchases of perishable agricultural commodities in any calendar year are in excess of \$230,000; and (C) no person buying any commodity other than potatoes for canning and/or processing within the State where grown shall be considered a ‘dealer’ whether or not the canned or processed product is to be shipped in interstate or foreign commerce, unless such product is frozen or packed in ice, or consists of cherries in brine.”

Broker: “Any person engaged in the business of negotiating sales and purchases of any perishable agricultural commodity in interstate or foreign commerce for or on behalf of the vendor or the purchaser, respectively, except that no person shall be deemed to be a ‘broker’ if such person is an independent agent negotiating sales for and on behalf of the vendor and if the only sales of such commodities negotiated by such person are sales of frozen fruits and vegetables having an invoice value not in excess of \$230,000 in any calendar year.”

Under the foregoing definitions, entities that participate in the purchase or sale of perishable agricultural commodities in wholesale or jobbing quantities generally come within the purview of those entities that have imposed on them the trust obligations created by the statute. The regulations define “wholesale or jobbing quantities” as “aggregate quantities of all types of produce totaling one ton (2,000 pounds) or more in weight in any day shipped, received, or contracted to be shipped or received.”¹⁶

The major area of dispute that the courts have addressed is whether an entity that is selling to the ultimate consumer is a “dealer” within the meaning of statute. The statute specifically states that an entity that buys product solely for sale at retail shall not be considered to be a dealer if its sales do not exceed \$230,000 in any calendar year. But what about an entity that is selling to the end user that is not deemed to be selling the product at retail? Such is the case with restaurants, which the majority of courts have held is a dealer within the meaning of the statute even if its sales are not in excess of the

¹⁶ 7 CFR § 46.2(x).

\$230,000 threshold applicable to retailers.¹⁷ To qualify as a dealer, however, the restaurant still needs to be buying in “wholesale or jobbing quantities”, as defined in the regulations.

Personal Liability of Principals

While the statute speaks in terms of commission merchants, dealers and brokers, liability is not limited to the corporate entity that purchases the perishable agricultural commodity. It has been generally held that not only is the corporate buyer itself responsible for complying with the terms of PACA, but individuals in a position to control the payment to PACA suppliers from funds received from the sale of perishable agricultural commodities are personally liable if the corporation fails to make the payment.¹⁸ The liability of the individual is considered to constitute a “defalcation while acting in a fiduciary capacity” and, as a result, should he or she file a personal bankruptcy, PACA claims that comply with the terms of the PACA statute will not be discharged and will survive their bankruptcy.¹⁹

The question of whether an individual is in control is not easily defined, but the courts have taken a rather unsympathetic position on this issue when individuals have claimed that they were not responsible. For example, in *Weis-Buy Services, Inc. v. Paglia*,²⁰ the Court held that a 25 percent shareholder who no longer was employed by the corporate buyer and whose responsibilities did not encompass ordering products or disbursing corporate funds when he did work for the company was still personally liable for failure of the corporation to pay the PACA suppliers from the proceeds of the sale of the perishable agricultural commodities. The Court based liability solely on the fact that the shareholder had signatory authority on the bank account and permitted the corporation to use his signature stamp on checks (which required a dual signature), even though he did not actively participate in signing the checks.

¹⁷ See *In re Old Fashioned Enterprises, Inc.*, 236 F. 3d 422 (8th Cir. 2001); *In re Magic Restaurants, Inc.*, 205 F. 3d 108 (3d Cir. 2000) (note the dissent, which argued that restaurants are in the business of preparing and selling meals, not buying or selling perishable agricultural commodities); *Royal Foods Co. v. L.R. Holdings, Inc.*, 1999 U.S. Dist. LEXIS 18010 (N.D. Cal. 1999). But see, *In re Reservoir Dogs, Inc.*, 2001 U.S. Dist. LEXIS 16879 (N.D. Ill. 2001)

¹⁸ See *Hiller Cranberry Products, Inc. v. Koplowsky*, 165 F. 3d 1 (1st Cir. 1999); *Weis-Buy Services, Inc. v. Paglia*, 307 F. Supp. 2d 682 (W.D. Pa. 2004).

¹⁹ Section 532(a)(4) excepts from discharge all debts involving “defalcation while acting in a fiduciary capacity.” In order to be found to be guilty of defalcation while acting in a fiduciary capacity, it is not necessary that the person have personally benefited from the misconduct. *In re Zois*, 201 B.R. 501 (Bankr. N.D. Ill. 1996).

²⁰ 307 F. Supp. 682 (W.D. Pa. 2004).

Liability of the individual not only can be based on the type of passive activity (or perhaps, more appropriately, lack of activity) found in the *Weis-Buy* case, but the individual will be held personally liable even if he or she used the sale proceeds for legitimate business purposes. Personal liability under PACA requires only that the sale proceeds be used for some purpose other than repayment to the seller. The only possible defenses for nonpayment to a PACA seller, therefore, appear to be the following:

- The seller did not comply with the terms of PACA.
- The sale proceeds were insufficient to pay the seller in full.
- The goods were not sold, due to spoilage or some other reason.

Things the PACA Supplier Must and Cannot Do

In addition to the requirement that the goods sold be perishable agricultural commodities and that the buyer be a commission merchant, dealer or broker, the seller of perishable agricultural commodities must also comply with a notice requirement and a terms-of-sale requirement in order to take advantage of the benefits of the PACA trust.

Notice Requirement

In order to qualify for the PACA trust, the produce supplier must provide timely notice of its intention to preserve its rights under PACA with regard to the goods in question. The Secretary of Agriculture has adopted regulations governing both the content and the timing of the notice:

Notice of intent to preserve benefits under the trust must be in writing, must include the statement that it is a notice of intent to preserve trust benefits and must include information which establishes for each shipment:

(i) The names and addresses of the trust beneficiary, seller-supplier, commission merchant, or agent and the debtor, as applicable,

(ii) The date of the transaction, commodity, invoice price, and terms of payment (if appropriate),

(iii) The date of receipt of notice that a payment instrument has been dishonored (if appropriate), and

(iv) The amount past due and unpaid.²¹

As to timing, the regulations provide:

Timely filing of a notice of intent to preserve benefits under the trust will be considered to have been made if written notice is given to the debtor within 30 calendar days:

(i) After expiration of the time prescribed by which payment must be made pursuant to regulation,

(ii) After expiration of such other time by which payment must be made as the parties have expressly agreed to in writing before entering into the transaction, but not longer than the time prescribed in paragraph (e)(2) of this section, or

(iii) After the time the supplier, seller or agent has received notice that a payment instrument promptly presented for payment has been dishonored.²²

Both the statute²³ and regulations²⁴ provide for an alternative method of notice, which is to include the following language in the invoice or billing statement:

“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.”

Terms of Sale

The terms of sale are important for two reasons. First, assuming that a notice of intent to preserve the trust benefits is not set forth in the invoice or billing statement, separate written notice must be provided to the debtor within 30 calendar days after payment is

²¹ 7 CFR § 46.46(f)(1).

²² 7 CFR § 46.46(f)(2). This regulation tracks the statute’s language concerning timing. 7 U.S.C. § 499e(c)(3).

²³ 7 U.S.C. § 499e(c)(4).

²⁴ 7 CFR § 46.46(f)(3)(i).

due. Unless the parties agree otherwise, payment normally shall be considered due within 10 calendar days after delivery of the goods.²⁵ If the parties want to vary from this 10-day rule, their agreement to do so must be in writing and must be entered into before the transaction. In addition, the regulations provide that “any such agreement shall be filed in the records of each party to the transaction and the terms of payment shall be disclosed on invoices, accountings, and other documents relating to the transaction.”²⁶

If a check paid within terms is later dishonored, then the 30-day time period runs from the date that the supplier receives notice of its dishonor.

While the parties are permitted to agree to a date other than the default 10-day period provided by the regulations, they may not agree to a date that is more than 30 days after the date the goods are accepted for delivery.²⁷ Should they do so, the supplier will lose the benefits of the trust.

If the parties agree to a payment date of 30 days or less, but later agree in writing to extend the time for payment beyond the 30-day period, some courts have held that that subsequent agreement to extend makes the shipments ineligible for the trust.²⁸ Thus, an attempt by a creditor to work with a buyer that may be experiencing financial difficulties may backfire if the parties enter into a formal arrangement to extend the payment date. Even an exchange of emails or other correspondence that evidences an agreement to extend the time may result in a loss of trust benefits.²⁹ The best thing for the seller to do in these circumstances is to reach an informal, oral understanding as to when payment is expected.

²⁵ The regulations provide that prompt (i.e., timely) payment shall be deemed to be made by a buyer of produce if paid “within 10 days after the day on which the produce is accepted.” 7 CFR § 46.2(aa)(5). Among other things, “acceptance” occurs when the goods are unloaded. 7 CFR § 46.2(dd)(1). There are a multitude of other ways of calculating prompt payment, depending on the type of seller and the type of buyer. These timeframes are more fully set forth at 7 CFR § 46.2(z) and (aa).

²⁶ 7 U.S.C. § 499e(c)(3).

²⁷ 7 CFR § 46.46(e)(2).

²⁸ *Patterson Frozen Foods, Inc. v. Crown Foods International, Inc.*, 307 F. 3d 666 (7th Cir. 2002); *In re Lombardo Fruit and Produce Company*, 12 F.3d 806 (8th Cir. 1993).

²⁹ If the benefits are lost, the supplier will not only lose its priority claim in the debtor’s assets, but also its claim against the debtor’s principals. *Patterson Frozen Foods, Inc. v. Crown Foods International, Inc.*, *supra*.

Enforcement of PACA Claims in Bankruptcy Court

While the assets that are part of the PACA trust technically are not part of the bankruptcy estate, the automatic stay would apply to any effort to obtain possession of the trust assets from the debtor or from the debtor's account debtors. Enforcement of rights against a PACA trust should be sought by filing a complaint or motion with the bankruptcy court.,³⁰ In many cases, the debtor or trustee will set up a program to deal with PACA claims on a global basis, which has as its central focus a procedure for identifying and resolving valid PACA claims and the amounts to be shared by the PACA creditors.

PACA and Preferences

The existence of a valid PACA claim should ordinarily constitute a defense to an action to recover an avoidable preference pursuant to section 547 of the Bankruptcy Code. Briefly, section 547 allows a trustee or debtor-in-possession³¹ to recover from a creditor payments made to the creditor within 90 days prior to the filing of a bankruptcy petition. The right to recover from the creditor is subject to certain defenses, primarily that the payment was made in the ordinary course of business or that the creditor extended new credit after receiving the payment. Where the creditor had a valid PACA claim as of the date of the payment, it may defend on other grounds.

In order for a payment to be recoverable as a preference, the trustee or debtor-in-possession must prove (1) that the payment made to the creditor was from property of the debtor, and (2) that the creditor received more on account of such payment than it have received in a Chapter 7 case if it had not received the payment. Where there is a valid PACA claim, these elements will, in most cases, be absent. First, under the theory that PACA proceeds do not belong to the debtor in the first place, the creditor would argue that the payment was not made from property of the debtor at all. Second, the creditor would argue that to the extent of its valid PACA claim it did not receive more than it would have been entitled to receive in a Chapter 7 case, since in a Chapter 7 case it would have had priority over all other creditors.

³⁰ Technically, Rule 7001 of the Federal Rules of Bankruptcy Procedure would require the filing of a complaint to resolve a PACA dispute since it involves a claim to ownership of property.

³¹ The Bankruptcy Code grants to a trustee the right to bring a preference action. Unless a trustee has been appointed, a debtor in a Chapter 11 case has the right to bring the preference action.

PACA and Dischargeability

As noted previously, a creditor that has a valid PACA claim but is not paid in full from the corporate buyer may have a claim against the persons in control against the corporation and that, in most courts, this claim will not be discharged should that person later file a personal bankruptcy proceeding.

A claim for “defalcation while acting in a fiduciary capacity”³² – the basis for objecting to the dischargeability of a PACA claim – is not automatically excepted from discharge. In order to have the claim survive bankruptcy, the creditor must file a complaint objecting to the discharge of that debt.³³ Ordinarily, the complaint must be filed within 60 days after the first date set for the meeting of creditors under section 341 of the Bankruptcy Code.³⁴

PACA Web Resources

The following web addresses, sponsored by the Department of Agriculture, contain useful information about PACA:

The PACA home page for the Department of Agriculture can be found at: <http://www.ams.usda.gov/fv/paca.htm>.

A list of local PACA offices of the Department of Agriculture can be found at: <http://www.ams.usda.gov/fvpaca/office.htm>.

Information on protecting trust rights under PACA can be found at: <http://www.ams.usda.gov/fvpaca/protect.htm>.

³² 11 U.S.C. § 523(a)(4).

³³ 11 U.S.C. § 523(c)(1).

³⁴ Fed. R. Bank. Proc. 4004(a).