



Why Every Lender Must Understand PACA's Thorny Implications

By: Jeffrey A. Wurst and Jonathan S. Bodner
Ruskin Moscou Faltischek, PC
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Few things concern lenders as much as the fear of hidden liens.

In 1930, Congress enacted the Perishable Agricultural Commodities Act ("PACA") to protect farmers who suffered dearly during the dust bowls of the 1920's. In 1984, PACA was amended to add protections to qualifying sellers of fresh and frozen fruits and vegetables by adding statutory trust provisions also making them PACA trust beneficiaries.

PACA trusts are floating, non-segregated trusts, created upon sellers sending certain proscribed statutory notices to buyers, which, among other things, provide that the produce is sold subject to the PACA trust. In light of the trust created, PACA imposes fiduciary duties upon purchasers and their controlling agents, each as trustees, to preserve the PACA trust property until the sellers as trust beneficiaries are repaid in full.

Since the enactment of the 1984 amendments, a wide body of case law has developed involving the application of PACA in a variety of contexts and disputes, including bankruptcy proceedings. While PACA trust assets do not become property of a debtor's bankruptcy estate, bankruptcy courts are empowered to administer PACA trust assets. Accordingly, PACA creditors often assert their claims in bankruptcy proceedings and are paid ahead of other secured and unsecured creditors through the bankruptcy process. One issue that continues to arise in bankruptcy proceedings, and one that raises the hair on the backs of lenders, is when PACA creditors assert trust claims seeking first priority rights to the proceeds of bankruptcy asset sales.

In *Lange v. Kornblum (In re Kornblum)*, 81 F.3d 280 (2nd Cir. 1996), PACA creditors commenced an action seeking to include the proceeds from the sale of the debtor's ("Kornblum") cooperative units located in the Hunts Point Terminal Market, Bronx, New York, the largest wholesale produce market in the world. Significantly, the Kornblum units were acquired by Kornblum three years *prior* to the time that the claim of a PACA creditor arose, but after the debtor commenced business as a produce dealer. The United States Court of Appeals for the Second Circuit held that because PACA creates a non-segregated, "floating" trust, a single PACA trust exists for the benefit of all PACA creditors, and the trust exists from the moment produce is received and continues in existence until all PACA creditors have been paid in full. Accordingly, the Second Circuit Court of Appeals remanded the case to the United States District Court for the Southern District of New York for a determination as to whether the Kornblum units were PACA trust assets, with the "burden of proof" as to whether certain assets were acquired from the sale of produce being on the party against whom the PACA claim was asserted. The Second Circuit further held that a party seeking to defeat a PACA claim in such a dispute must establish one of the following: (i) no PACA trust existed at the time of the asset purchase, (ii) even if a PACA trust existed at the time of the asset purchase, the assets were not purchased with PACA trust monies, or (iii) although a PACA trust existed at the time of the asset purchase and the assets were purchased with PACA trust monies, the debtor paid all unpaid produce sellers in full (thereby satisfying the trust) prior to the transaction involving the PACA claimants. The Second

Circuit's ruling in *Kornblum* has been adopted by Federal Courts facing similar disputes involving PACA claims.

Despite almost twenty years since *Kornblum*, secured lenders continue to face challenges defending their first priority secured liens in cases where PACA creditors assert claims.

The debtor in *Hunts Point Tropicals, Inc., f/k/a Valdivia Produce Corp., d/b/a Hunts Point Tropical, S.D.N.Y. Bankr. Case No.: 11-12265(SCC)*, owned and operated three cooperative units in the Hunts Point Market. It filed a Chapter 11 proceeding with: (i) a pre-petition Bank having a claim of approximately \$800,000 secured by a perfected lien on all of the debtor's assets, including the units, and (ii) approximately forty creditors asserting pre-petition PACA claims aggregating over \$1.4 million. The debtor sold the units pursuant to Section 363 of the Bankruptcy Code for \$805,000. The PACA creditors commenced an adversary proceeding against the Bank to determine the priorities of the PACA creditors and the Bank. Discovery revealed that the debtor initially purchased the units in 2003 for \$900,000, comprised of \$300,000 cash and \$600,000 of secured financing. Both the Bank and the PACA creditors moved for summary judgment.

The Bankruptcy Court applied *Kornblum* to the facts and denied the motions for summary judgment holding that issues of material fact existed as to: (i) whether the debtor operated as a produce dealer prior to purchasing the units, and (ii) whether the \$300,000 paid to purchase the units were proceeds from sales of produce or personal monies from the debtor's principals. Ultimately, after sixteen months of litigation, discovery, motion practice and mediation, the Bank and the PACA creditors reached a settlement that provided for the Bank to receive forty-two (42%) percent, and the PACA creditors to receive fifty-eight (58%) percent, of the funds available for distribution. The Bank suffered a substantial loss.

A similar issue may be developing again in the Hunts Point Market. On March 4, 2014, The Alphas Company of New York, Inc. ("Alphas") filed a Chapter 11 proceeding in the United States Bankruptcy Court for the Southern District of New York, *Case No.: 14-10510(ALG)*. On June 5, 2014, the Bankruptcy Court entered an order converting the proceeding to Chapter 7. Alphas' bankruptcy filings indicate that it owns cooperative units in the Hunts Point Market. Alphas' bankruptcy filings further indicate a pre-petition loan in the amount of \$250,000 secured by Alphas' units, as well as claims by PACA creditors exceeding \$500,000. It is likely that after the Bankruptcy Court approves a 363 sale of Alphas' units, a *Kornblum* analysis will be necessary to determine the allocation of the sale proceeds as between the secured lender and the PACA creditors.

While *Kornblum* addresses whether an asset becomes a PACA trust asset at the time of purchase (and remains a PACA trust asset thereafter), lenders must be aware that an asset not subject to a PACA trust at the time of purchase can subsequently become an asset subject to PACA trust claims (i.e., when a purchaser of produce used the proceeds from the sales of produce to pay down the mortgage on real property that was not otherwise subject to a PACA trust). Courts consistently hold that while PACA allows for comingling of PACA trust assets (i.e., proceeds from produce sales with non-PACA trust assets), once PACA trust assets are comingled, the buyer has the burden of proof to establish which assets are not subject to the PACA trust. At least one Federal Court has held that a debtor's real estate was subject to PACA trust claims where the debtor could not meet its burden of proof and demonstrate that it did not use the proceeds from sales of produce to make its mortgage payments.

Lenders must be facile with PACA and its implications and take certain steps to avoid ultimately litigating a *Kornblum* dispute. Most lenders try to avoid lending into potential PACA situations, however, sometimes the PACA issue is latent, sneaks up, and unwittingly "bites" the lender. Imagine making a loan to a borrower in the business of manufacturing

pre-prepared foods. When the loan was made, the borrower used canned – processed tomatoes, and unbeknownst to the lender, later switched to fresh tomatoes. That is correct – PACA claims may prime the bank’s prior secured lien. Thus, a lender must monitor the borrower after making the loan to ensure the borrower does not later become subject to PACA.

Moreover, in these highly competitive times, it is difficult to resist a new borrower, especially if a lender can get comfort that PACA will not be an issue. If a lender, knowing the implications and risks, makes the business decision to lend to a borrower where PACA may become implicated, the lender must: (i) perform diligence regarding the origins of all of the borrower’s funds and assets prior to issuing the loan, (ii) perform diligence as to the existence of any PACA debt at the time of issuing the loan, (iii) require the borrower to satisfy all PACA debts prior to issuing the loan, and (iv) carefully monitor the borrower’s business operations and accounts payable to PACA creditors subsequent to issuing the loan. By taking these steps, and others, lenders may mitigate their risk of having to defend a PACA claim priority dispute.



Jeffrey A. Wurst and Jonathan S. Bodner
Ruskin Moscou Faltischek, PC

Jeffrey A. Wurst is a senior partner and the chair of the Financial Services, Banking & Bankruptcy department at Ruskin Moscou Faltischek, P.C., Uniondale, NY. He can be reached at 516-663-6535 or at jwurst@rmfpc.com.

Jonathan S. Bodner is an associate in the Financial Services, Banking & Bankruptcy department at Ruskin Moscou Faltischek, P.C., Uniondale, NY. He can be reached at 516-663-6686 or at jbodner@rmfpc.com.