New York Law Journal
Real Estate Trends
WWW.NYLJ.COM
An ALM Publication
VOLUME 259—NO. 30
WEDNESDAY, FEBRUARY 14, 2018

TRANSACTIONAL REAL ESTATE

The Perishable Agricultural Commodities Act

By
Peter E. Fisch

And
Mitchell L. Berg

While the Perishable Agricultural Commodities Act, 1930 (PACA), which was enacted to protect the interests of suppliers and sellers of perishable agricultural commodities, would appear to have little relevance to real estate transactions, it has become a matter of some concern to title insurance companies and lenders in loan transactions involving borrowers that purchase significant amounts of produce. PACA applies to fresh or frozen produce sold on credit to dealers, commission merchants or brokers (defined by PACA to mean those who purchase or receive 2,000 pounds or more in weight of perishable agricultural commodities in any day or who purchase more than $230,000 of such commodities in any year) 7 U.S.C. §499a(b)(6); 7 C.F.R. §46.2(x). Once perishable commodities are delivered to dealers, the commodities are held in trust until the supplier or seller is paid in full. PACA trusts are floating, non-segregated trusts that are created "at the moment the produce is shipped" from *any* supplier or seller and continue until the dealer pays *all* suppliers and sellers in full. *Chiquita Fresh N. Am.v. Long Island Banana Corp.*, 2016 U.S. Dist. LEXIS 14-982 (ADS) (AKT) (EDNY 2016) (quoting *Ger-Nis Int'l I*, 2007 U.S. Dist. LEXIS 18403, at *1). PACA trusts extend to the proceeds received by the dealer once the commodities are sold, including proceeds that are used by the dealer to pay other debts and obligations. 7 U.S.C. §499e(c)(1). Thus, a dealer who pays its debt to a lender in lieu of paying suppliers and sellers may be in breach of the trust and the lender may be required to disgorge such payments if the lender is not deemed a bona fide purchaser for value with no notice of the breach. See, e.g., *Am. Fruit & Vegetable Co., Inc. v. Ithaca Produce*, 848 F. Supp. 2d 375 (W.D.N.Y. 2011); Chiquita Fresh N. Am., LLC, 2016 U.S. Dist. LEXIS 14-982. This includes payments made to a lender of debt secured by a mortgage on real property, effectively making the lender's security interest junior to that of unpaid PACA sellers and suppliers.

As a result, lenders and title companies are often concerned that when the borrower is an entity subject to PACA, the PACA trust will effectively create a superpriority lien against real property that could prime a recorded mortgage lien. Title companies may also take the view that the PACA trust would take priority over mortgages on properties owned by entities related to the dealer.

Disgorgement of Proceeds Received by a Lender

Courts undertake a two-step analysis in determining whether to require a lender to disgorge debt service payments made by the dealer. The threshold question is whether the proceeds are the subject of the PACA trust. If so, then a court must determine whether the lender is a bona fide purchaser for value. If the lender is not a bona fide purchaser, a court may require that proceeds paid to the lender be disgorged and used to pay the PACA creditors, i.e. the unpaid sellers and suppliers. Chiquita Fresh N. Am., LLC, 2016 U.S. Dist. LEXIS 14-982, at *192-95.

PETER E. FISCH *and* MITCHELL L. BERG *are partners at Paul, Weiss, Rifkind, Wharton & Garrison. Felicia A. Siegel, an associate at the firm, and Hilary Kruce, divisional underwriting counsel at First American Title Insurance Company assisted in the preparation of this article.*

As to the first step, the lender must prove that one of the following is true: “(1) no PACA trust existed when the [underlying real property was] purchased; (2) even though a PACA trust existed at that time, the [real property was] not purchased with trust assets; or (3) although a PACA trust existed when the [real property was] purchased and the [real property was] purchased with trust assets, [the dealer] thereafter paid all unpaid sellers in full prior to the transactions involving the [lender], thereby terminating the trust.” *In re Kornblum & Co., Inc. v. Kornblum & Co., Inc.*, 81 F. 3d 280, 287 (2d Cir. 1996).

These factors, which have become known as the “Kornblum factors,” were identified in *In re Kornblum & Co. v. Kornblum & Co.*, a 1996 U.S. Court of Appeals for the Second Circuit case that has been widely cited in subsequent case law addressing PACA. 81 F. 3d 280 (2d Cir. 1996).

As stated above, the PACA trust is a floating, non-segregated trust. Thus, in analyzing the first Kornblum factor, even if a supplier claiming payment after the real property was purchased was not a supplier or seller of produce to the dealer at the time of the property purchase, the supplier has the ability to claim the proceeds of the PACA trust relating back to the date that the trust was formed. The fact that the earlier suppliers may have been paid in full is of no relevance; the PACA trust continues until *all* suppliers and sellers are paid in full. *Id.* at 286; see also Chiquita Fresh N. Am., 2016 U.S. Dist. LEXIS 14-982 at *198.

With respect to second Kornblum factor, a general principle of trust law creates a “constructive trust or an equitable lien upon real property which is acquired ‘by the wrongful disposition of trust property.’” Chiquita Fresh N. Am., 2016 U.S. Dist. LEXIS 14-982 at *200. Real property is deemed to have been purchased with PACA trust assets if such trust assets were used to make payments on a mortgage encumbering the property. For example, in *Chiquita Fresh North America v. Long Island Banana Corp.*, real property was purchased with a $300,000 cash payment and a purchase-money mortgage. The court held that mortgage payments were a “second-generation proceed” of the PACA trust because proceeds from the sale of produce were used, in part, to make payments on the mortgage and the mortgage payments were necessary for the debtor to acquire the property.

The Perishable Agricultural Commodities Act (PACA) has become a matter of some concern to title insurance companies and lenders in loan transactions involving borrowers that purchase significant amounts of produce.

Finally, with respect to the third Kornblum factor, it is insufficient for the suppliers or sellers to be paid in due course or in the ordinary course of business; payment in full is required to terminate the trust. Thus, unless all amounts outstanding, even if not yet payable, are paid in full, the lender would not be able to establish the third factor.

If the lender cannot satisfy any of the Kornblum factors, the lender may be required to disgorge the proceeds unless it is a bona fide purchaser for value, with no notice of the breach of the PACA trust. In *Consumers Produce Co. v. Volante Wholesale Produce*, the court held that the lender was a purchaser for value because PACA trust assets were received “in the ordinary course of business as monetary loan repayments.” *Consumers Produce Co. v. Volante Wholesale Produce, Inc.*, 16 F.3d 1374, 1380 (3d Cir. 1994) (citing Restatement (Second) of Trusts § 304).

Determining whether a lender had notice of a breach of the PACA trust is a more complicated task: the lender is deemed to be on notice if (i) the lender has actual knowledge of the breach of the PACA trust or (ii) the lender should have known of the breach, i.e., has constructive notice of the breach of the PACA trust. Consumers Produce Co., 16 F.3d at 1380 (citing Restatement (Second) of Trusts §297). The existence of the PACA statute and the fact that PACA trust assets have been commingled with non-trust assets do not place the lender on notice, and notice that a PACA trust exists does not equate to notice of a *breach* of the PACA trust. A lender may be deemed to have constructive notice of the breach, as determined at the time the payments in breach of the trust are made, only when a duty of inquiry exists. A lender has such a duty when the lender “has knowledge that a produce purchaser/trustee is not paying produce suppliers or is in financial difficulty.”

In *Consumers Produce*, the court held that the lender was on notice that the borrower was dealing with was a PACA trustee, but that the lender did not have constructive notice of the breach of the PACA trust. The PACA trustee, Volante

Wholesale made loan payments to its lender from 1988 through September 1990. Unpaid suppliers commenced an action against Volante at this time for failure to make payments beginning in June 1990. The lender was not required to disgorge payments made during the time the PACA trust was breached because the lender could not have learned about the breach of the PACA trust and Volante's overall financial difficulties: Volante failed to notify the lender of its receipt of notices of nonpayment and provided financial statements that artificially inflated the accounts receivable and made Volante appear more profitable (and there was no reason to doubt the accuracy of these statements), and Volante's checking account was overdrawn in a manner that was deemed common practice. Once the lender had reason to suspect financial difficulties, the court held that the lender undertook a reasonable inquiry that did not disclose any breach of the PACA trust.

Practical Approach to PACA

The issues surrounding PACA often arise in connection with the sale of businesses that have a food component, including restaurants and grocery stores, but also malls, country clubs and golf courses that serve food as part of the business. To minimize title companies' risk in issuing lender title policies, PACA is often included as an exception to coverage. In particular, title companies focus on the risks associated with the property owner or its related entities filing for bankruptcy and the potential creation of a superpriority lien in favor of PACA creditors in the bankruptcy proceeding. However, title companies are willing, at times, to underwrite the risk associated with PACA and remove the exception.

Title insurers are most likely to omit the PACA exception when the property owner hires a third-party operator to handle the produce and the food service aspect of the business because the property owner is not directly indebted to a PACA creditor. This is a common arrangement in assisted living facilities, where third-party operators are typically engaged to provide food service to the residents.

Lenders and title companies are often concerned that when the borrower is an entity subject to PACA, the PACA trust will effectively create a superpriority lien against real property that could prime a recorded mortgage lien.

On the other hand, title insurers are often reluctant to omit a PACA exception even when a property owner engages an operator to handle the day-to-day operations at the property (including food service) if the property owner and the operator are related parties (as in a so-called propco/opco structure). Title insurers typically take the position that debts owed to PACA creditors are aggregated within a corporate chain, from the top-most parent entity to and including all special purpose property-owning entities. This is because of the title company's concern with avoiding the risk associated with a bankruptcy and the fear that one entity in a corporate chain filing for bankruptcy means financial ruin for the rest of the chain. For the same reason, a title company may be reluctant to accept an indemnity from a related entity, even if creditworthy.

Where a third-party operator has not been hired, a title company may still be willing to underwrite the PACA risk where the portion of the business related to produce is relatively small and the financial strength of the property owner is relatively strong. There is no magic number to ensure a title company's comfort in this respect: a property owner must simply show that both the PACA exposure and the chance of the property owner filing for bankruptcy are low.

In view of the title companies' reservations in deleting the PACA title exceptions, lenders should be willing to accept the exception where the lender is comfortable with its own underwriting and the borrower's capacity to both satisfy its obligations under the loan and to pay amounts owing to sellers and suppliers in the ordinary course. The parties should also keep in mind that suppliers who are not being paid will not keep supplying produce indefinitely, and that this places a natural limit on the amount of the lender's exposure. If the lender insists on the deletion of the exception, the borrower will need to satisfy the title company that the risk of a superpriority lien is acceptably low based on the creditworthiness of the borrower or indemnitor and the magnitude of the produce purchased by the borrower.

Reprinted with permission from the February 14, 2018 edition of the NEW YORK LAW JOURNAL © 2018 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited. For information, contact 877-257-3382 or reprints@alm.com. # 070-02-18-17