SELECTED TOPIC

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A Chapter 11 Debtor's Right to Use Cash Collateral Trumps PACA Trust Rights

Trade creditors oftentimes have great difficulty collecting their general unsecured claims against financially distressed customers. Creditors should, therefore, take advantage of any rights that can enhance their recoveries.

Fresh produce sellers enjoy very valuable rights under the Perishable Agricultural Commodities Act ("PACA"). The PACA statute grants eligible suppliers of perishable agricultural commodities a statutory trust in all of a buyer's/debtor's perishable agricultural commodity inventory, and all related products and proceeds, that is entitled to a higher priority than even the rights of the buyer's secured lender with a floating lien on all of the buyer's inventory. As a result, PACA trust claimants have a much greater chance of obtaining full payment of their claims than if they relied on their lower priority general unsecured claims and even their higher priority administrative priority claims under Bankruptcy Code section 503(b)(9) for goods sold to and received by a debtor within 20 days of a bankruptcy filing.

However, there are limits on a PACA seller's trust rights. The United States Bankruptcy Court for the Western District of Michigan (the "Bankruptcy Court") recently addressed these limits in the context of a contested cash collateral motion in *In re Cherry Growers, Inc.* The Bankruptcy Court held that a creditor could not invoke its PACA trust rights to stop a debtor from using cash that is part of a PACA trust until full payment of the creditor's PACA claim. The court allowed the debtor to use PACA trust assets, including cash, as long as the debtor adequately protected the PACA claimant's interest in the trust assets from any diminution in value resulting from the debtor's use of these assets during the Chapter 11 case.

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The PACA Statute

Congress adopted PACA in 1930 to regulate the interstate sale and marketing of produce and remedy the practice of dishonest brokers taking advantage of small farmers and growers by refusing to accept produce in a weak market. Congress was concerned that a produce seller would be especially vulnerable due to the distances between the seller and a produce buyer, the perishability of the seller's goods, and the expense and impracticality of a seller seeking to recover its goods and otherwise enforce its claim in the event the buyer failed to pay for the goods.

Congress amended PACA in 1984 in response to a sharp increase in defaults by produce buyers. The amendment added a statutory trust for the benefit of produce suppliers, sellers and their agents that comply with all of PACA's requirements. This was designed to protect produce sellers from distressed buyers whose creditworthiness the seller frequently could not verify prior to any produce sale.

A PACA trust grants eligible produce suppliers an enhanced super priority right of payment of the purchase price of their goods over the claims of all other creditors, including secured creditors. PACA trust assets cannot be subject to the security interest of the buyer's secured creditor until the seller is paid in full because a produce buyer lacks a sufficient interest in PACA trust assets for any security interest to attach to these assets. As a result, PACA creditors can compel the buyer's secured creditor to disgorge collateral proceeds derived from PACA trust funds.

How PACA Works

Only the sale of perishable agricultural commodities gives rise to a PACA trust. Perishable agricultural commodities include unprocessed or minimally processed fruits and vegetables, irrespective of whether the produce is frozen or packed in ice. A seller's eligibility for PACA protection for fruits and vegetables subject to any processing depends on whether the processing converted the produce to a different kind or character of food.

PACA only applies to sales of perishable agricultural commodities to licensed commission merchants, brokers and dealers. Commission merchants and brokers buy and sell produce on behalf of third parties. A dealer is engaged in the business of buying or selling in wholesale or jobbing quantities, which require at least one ton of produce shipped, received or contracted for shipment or receipt on any given day.

PACA requires that an unpaid produce seller must, within 30 days of the due date of a payment owing by the buyer, take certain actions to preserve its PACA trust benefits. A PACA seller can satisfy this requirement by including a statement in the seller's bills/invoices that the goods are being sold subject to the PACA trust. The regulations implementing PACA also state that PACA eligibility is contingent on a seller agreeing to payment terms of not more than thirty (30) days after its buyer's receipt and acceptance of the goods. A seller is disqualified from PACA trust protection if the seller and buyer enter into an agreement that extends the due date of the seller's invoices beyond this 30-day period.

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A PACA trust is a non-segregated "floating trust" that arises in favor of a PACA seller upon delivery of the produce to the purchaser. The trust continues until a PACA seller's claim is paid in full. The trust includes the produce supplied by all PACA suppliers, all food products derived from such produce, and all accounts receivable and other cash and noncash proceeds from the sale of these goods. While the buyer holds legal title to all of the assets subject to a PACA trust, PACA sellers retain an equitable interest in such assets.

Unlike other trust beneficiaries, PACA trust beneficiaries have no obligation to trace their trust claims from their PACA produce sold to any specific buyer of PACA covered goods. This enables a produce buyer to commingle PACA and non-PACA trust assets without any loss of PACA trust rights.

Some courts have even extended PACA trust status to a debtor's non-PACA assets. These courts relied on the debtor's prior commingling of PACA and non-PACA proceeds and the debtor's prior use of PACA proceeds to either purchase, and/or pay indebtedness secured by, non-PACA assets. In the *Cherry Growers* case, a PACA creditor similarly claimed a PACA trust interest in all of a debtor's assets, perishable and non-perishable, because the debtor had previously used the proceeds of PACA trust assets to pay debts secured by the debtor's equipment and real estate.

Bankruptcy Financing

When a debtor files its Chapter 11 case, it usually seeks court approval to either enter into a post-petition financing arrangement with its pre-petition secured lender or alternative lender or, at a minimum, utilize the cash and other property encumbered by the secured lender's pre-petition security interests. The Bankruptcy Code requires a debtor to adequately protect its secured lender for any diminution in value of the lender's collateral arising from the debtor's use of the collateral during the Chapter 11 case.

> The debtor can continue to use trust assets as long as it adequately protects the PACA creditor from any diminution in value of trust assets during the case.

Although the Bankruptcy Code does not define "adequate protection," it requires a debtor to propose some package of concessions that will preserve the secured creditor's interest in its collateral pending the outcome of the bankruptcy case. According to Bankruptcy Code section 361, a debtor can provide adequate protection for use of its lender's collateral by: (i) making periodic cash payments to the lender; (ii) granting the lender an additional or replacement lien in other property of the debtor; or (iii) granting the secured creditor such other means of relief so that the secured creditor will realize the indubitable equivalent of its interest in the property.

Facts and Procedural History in the *Cherry Growers* Case

On August 31, 2017 (the "Petition Date"), Cherry Growers, Inc. (the "Debtor") filed its Chapter 11 case in the Bankruptcy Court. Prior to the Petition Date, a produce supplier, Farm Fresh First, LLC ("FFF"), had sold raw apples, which are perishable agricultural commodities protected by PACA, to the Debtor on open account. FFF asserted a PACA trust claim in the amount of $337,159.18. On the Petition Date, the Debtor had cash proceeds from the sale of its perishable agricultural commodity inventory as well as additional cash derived from non-PACA assets, such as the Debtor's co-manufacturing business[1] and a real property lease.

The Debtor filed several first-day motions, including a motion (the "Motion") permitting the Debtor to use the cash proceeds of the collateral of its secured lender, Huntington National Bank ("Huntington"). Huntington asserted a claim against the Debtor in the amount of approximately $8.4 million that was secured by Huntington's setoff rights in the Debtor's bank accounts with cash totaling approximately $240,000 on the Petition Date. Huntington also asserted a security interest in the Debtor's equipment and a mortgage on the Debtor's real estate.

FFF sought to block the Debtor's use of cash and other assets that FFF had claimed were subject to a PACA trust. FFF argued that the Debtor could not adequately protect FFF's trust interest because all of the Debtor's perishable and non-perishable assets (the latter including cash from the Debtor's co-manufacturing business and rent from the Debtor's real estate lease), were trust assets and not property of the Debtor's bankruptcy estate.

The Bankruptcy Court's Decision

The Bankruptcy Court granted the Motion and also allowed the Debtor to use its other non-cash assets that FFF had asserted were part of its PACA trust claim. The court noted that outside of bankruptcy, a produce supplier cannot invoke its PACA trust rights to prevent a buyer from using trust assets to operate its business. Instead, PACA grants the supplier an enhanced right to payment of its claim from trust assets prior to payment of any other creditor's claim, whether secured or unsecured. The court found it should be no different when a produce buyer files a Chapter 11 bankruptcy case. A PACA creditor, like FFF, cannot strip PACA trust assets from a debtor's bankruptcy estate and prematurely impede the debtor's reorganization efforts as long as the debtor adequately protects the creditor's interest in PACA trust assets from any diminution in value resulting from the debtor's use of these assets during its Chapter 11 case.

The court relied on the broad definition of property of the debtor's estate under Bankruptcy Code section 541[2] and a debtor's authority under Bankruptcy Code section 363[3] to use property of the estate. While FFF asserted a PACA trust interest in all of the Debtor's assets, the Debtor had a sufficient legal interest to include them in its bankruptcy estate and apply the concepts of "cash collateral" and "adequate protection" to these assets. FFF's PACA trust interest in all of the Debtor's assets was an equitable interest held concurrently with the Debtor's legal interest in the same assets. As a result, the Debtor could continue to use trust assets as long as it adequately protected FFF's interest in these assets from any diminution in value resulting from the Debtor's use of the assets. The Bankruptcy Court concluded that the Debtor had adequately protected any trust interest that FFF had asserted due to a substantial equity cushion resulting from PACA trust assets worth approximately $9 million that far exceeded FFF's PACA trust claim capped at $337,159.18.

Conclusion

As the *Cherry Growers* decision makes clear, there are limits to a produce supplier's PACA trust rights. The Bankruptcy Court held that a PACA trust creditor cannot hijack a debtor's restructuring efforts by trying to preclude a debtor from using PACA trust assets during the debtor's bankruptcy case. The debtor can continue to use trust assets as long as it adequately protects the PACA creditor from any diminution in value of trust assets during the case. A PACA trust creditor can then seek to block the debtor's use of trust assets by either contesting the debtor's ability to provide adequate protection, or moving for an injunction prohibiting the debtor from continuing to use and dissipate trust assets, which is hard to obtain.

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1. "Co-manufacturing" was described during the hearing on the cash collateral motion as "The customer provides the product. [The Debtor] provide[s] the labor **and the facilities** to turn basically, my understanding is, applesauce and cherries into—or apples and cherries into the—. . . consumable products. And they're never our—those products are never ours. We just provide the services and we charge a service fee for turning the fruit into the final product." (emphasis added in original).

2. Bankruptcy Code section 541 defines "property of the estate" very broadly and includes all property wherever located and by whomever held, including property for which the debtor only holds a legal and not an equitable interest on the date of commencement of the debtor's bankruptcy case.

3. Bankruptcy Code section 363 concerns a debtor's authority to use, sell or lease estate property (including cash) outside of the ordinary course of business.

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