Business Credit®

National Association of Credit Management

THE PUBLICATION FOR
CREDIT AND FINANCE PROFESSIONALS

February 2004

Preferences, Reclamation and PACA in One Case: A Three-Ring Circus

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Introduction

A credit manager and NACM member recently inquired whether his company's reclamation claim that was granted administrative priority status and paid in its customer's bankruptcy case could also be used as offsettable new value in any preference action by the customer's bankruptcy trustee. Oh no-those darn preferences again!

Another trip to the PREFERENCE ZONE where the big bad bankruptcy trustee can assert claims against diligent credit grantors for the recovery of payments of antecedent indebtedness by insolvent customers within 90 days of their bankruptcy filing. However, not to fear-trade creditors might have numerous defenses to any preference claim. The new value defense is one of the more frequently used preference defenses. A trade creditor can reduce preference exposure by all extensions of credit to or for the debtor's benefit following the alleged preferences.

And friends, the United States Bankruptcy Court in Arizona, in In re Arizona Fast Foods LLC, recently considered whether a trade creditor's extensions of credit during the preference period, that were paid post-petition as an allowed reclamation/administrative priority claim pursuant to court order, still qualify as offsettable new value reducing preference exposure? The court also approved an additional preference defense for unpaid sellers of perishable agricultural commodities who enjoy the special trust fund protections granted by the Perishable Agricultural Commodities Act ("PACA").

Preferences, reclamation and PACA all in one case! Only in the PREFERENCE ZONE!

An Overview of the Preference Statute

Section 547(b) of the Bankruptcy Code authorizes a trustee or debtor-in-possession to avoid payments and other transfers of assets made by a debtor to a creditor within 90 days of a debtor's bankruptcy filing. This is intended to prevent a debtor from favoring one general unsecured creditor over others and discourages creditors from engaging in unusual collection activity for payment of their claims.

A bankruptcy trustee or debtor-in-possession must satisfy all of the following requirements to recover a preference:

1. The debtor transferred its property to or for the benefit of a creditor;

2. The transfer occurred within 90 days of the debtor's bankruptcy filing (or within one year of the bankruptcy for payments to insiders);

3. The transfer paid antecedent existing indebtedness that the debtor owed its creditor;

4. The debtor was insolvent when the transfer was made. The Bankruptcy Code's balance sheet definition of insol vency governs: the debtor's liabilities exceed assets. The debtor or trustee is also afforded a presumption of insolvency within the 90-day preference period that makes it easier to prove insolvency; and

5. The creditor recovered more from the transfer than it would have received in a Chapter 7 liquidation of the debtor. This requirement is always satisfied unless unsecured creditors of the debtor receive a 100 percent distribution on their claims.

New Value Defense to a Preference Claim

There are several defenses that reduce or eliminate exposure on a preference claim. One of the more frequently asserted preference defenses is the new value defense arising under Section 547(c)(4) of the Bankruptcy Code. The new value defense reduces preference exposure by the amount of new credit the creditor had extended to or for the debtor's benefit subsequent to the preference.

In order to qualify as a preference defense, the new value cannot be secured by an otherwise unavoidable security interest. The new value also cannot be paid by an otherwise unavoidable transfer to or for the preference recipient's benefit.

The new value defense, like other preference defenses, is designed to encourage creditors to continue doing business with, and extending credit to, companies in financial distress. The defense protects creditors that replenished the debtor and its bankruptcy estate by extending new credit subsequent to the preference payment. The net effect is that the debtor's unsecured creditors are no worse off by the payment because the creditor had subsequently extended new credit that replenished the debtor and its estate.

Special Protection for Reclamation Creditors

Section 546(c) of the Bankruptcy Code is the statutory basis for a trade creditor's right to reclaim goods shipped on credit to an insolvent customer shortly before the customer files for bankruptcy. A trade creditor that satisfies all of the state law requirements for reclamation under Section 2-702 of the Uniform Commercial Code and the additional requirements for reclamation set forth in Section 546(c) might obtain a more favorable recovery on its pre-petition unsecured claim than the creditor would have otherwise received as a pre-petition general unsecured creditor in the customer's bankruptcy case. A trade creditor seeking preferred treatment of its reclamation claim must satisfy the following requirements when its customer files bankruptcy:

1. The creditor sent a written demand to reclaim its goods within ten days of the debtor's receipt of the goods. If the ten day period expires after the bankruptcy filing date, the creditor has twenty days from the debtor's receipt of the goods to send its reclamation demand;

2. The creditor had sold the goods on credit terms to the debtor in the ordinary course of the creditor's business;

3. The debtor was balance sheet insolvent when it received the goods; and

4. The debtor was in possession of the goods the creditor is seeking to reclaim.

If a creditor satisfies all of the requirements for reclamation, the bankruptcy court could order the buyer to return or pay for the goods, grant the creditor a security interest in the goods or other assets of the buyer to secure the buyer's obligation to pay for the goods, or grant the creditor a first priority administration expense claim for the amount of the reclamation claim that would be payable ahead of the claims of general unsecured creditors. Whatever relief the court awards, there is a greater likelihood that the creditor would realize more on its reclamation claim than it would have otherwise realized if its claim were treated as a general unsecured claim.

PACA Trust Rights

The Perishable Agricultural Commodities Act ("PACA") is a federal statute that grants special protections for unpaid sellers of perishable agricultural commodities. Perishable agricultural commodities are unprocessed or minimally processed fruits and vegetables, whether or not frozen or packed in ice.

A qualifying PACA seller is the beneficiary of a statutory nonsegregated floating trust in all perishable agricultural commodities sold to the buyer (whether by that supplier or other PACA suppliers) and all products and proceeds derived from the commodities, including all accounts receivable and other cash and noncash proceeds of the sale of the goods, regardless of whether they were derived from the seller's goods or from PACA goods purchased from third parties.

The trust impressed in favor of a PACA seller in the buyer's perishable agricultural commodity inventory grants the seller a prior right to the goods over the rights of all other creditors of the buyer, including the buyer's secured creditors with a security interest in the buyer's inventory. The trust is a nonsegregated floating trust. No tracing is necessary-a PACA seller's trust fund claim attaches to all of the debtor's perishable agricultural commodity inventory and all proceeds, whether or not they can be traced from the original PACA produce.

The trust arises in favor of the PACA seller upon delivery of the goods to the purchaser. The trust continues until the PACA seller's claim is paid in full.

The Arizona Fast Foods Case

On June 18, 2001, Arizona Fast Foods LLC ("Arizona Fast Foods"), a restaurant operator, filed Chapter 11 as a vehicle to liquidate its assets. Shamrock Foods Company ("Shamrock") was a major supplier of food products to Arizona Fast Foods for use in its restaurants. On October 9, 2001, Shamrock filed several claims in the Arizona Fast Foods bankruptcy case. The claims included (a) a PACA claim arising from Shamrock's sale of perishable agricultural commodities to Arizona Fast Foods for a total invoice price of $286,786 (the "PACA Claim"), and (b) a reclamation claim based on Shamrock's sale of goods, in the aggregate invoice amount of $113,276 (the "Reclamation Claim"), to Arizona Fast Foods within ten days of the Chapter 11 filing.

On November 9, 2001, Shamrock and Arizona Fast Foods entered into Stipulations for, among other things, allowance of Shamrock's PACA Claim in the amount of $286,786 and Shamrock's Reclamation Claim in the amount of $113,276. The Bankruptcy Court approved the Stipulation, and Shamrock received full payment of the PACA Claim and Reclamation Claim.

At the same time, the court approved a Chapter 11 liquidation plan for Arizona Fast Foods. The plan provided for the appointment of a liquidating trustee to pursue avoidance claims, such as preference claims. On July 3, 2002, the liquidating trustee filed a complaint to avoid and recover preferences from Shamrock. The trustee claimed that Shamrock had received avoidable preferences in the amount of $502,073.95 within 90 days of Arizona Fast Foods' bankruptcy filing. The trustee's preference claim included payments by Arizona from both PACA and non-PACA trust funds.

The court first held that the debtor Arizona's payments from PACA trust funds to Shamrock were not avoidable preferences, period! One of the elements of a preference claim is that the debtor transferred "an interest of the debtor in property". The courts have universally ruled that any property held by a debtor in a statutory PACA trust is not property of the debtor. As a result, a PACA supplier should not be exposed to preference exposure for PACA trust fund proceeds the debtor had paid to the supplier during the 90-day preference period.

Arizona Fast Foods had purchased certain produce from Shamrock that was within the purview of PACA. Arizona Fast Foods was required to hold all PACA proceeds in trust for Shamrock and all other PACA suppliers. These funds never became property of Arizona Fast Foods estate, and, instead, had to be turned over to PACA trust fund beneficiaries, such as Shamrock. Accordingly, any PACA trust funds paid to Shamrock within the 90-day preference period were not avoidable preferences. For the same reason, Shamrock's PACA Claim did not count as new value deductible from the preference claim under Section 547(c)(4) of the Bankruptcy Code because it was paid in full post-petition from available PACA trust fund proceeds.

The court also held that Shamrock's Reclamation Claim did not count as offsettable new value to reduce the liquidating trustee's preference claim. The Reclamation Claim was not deductible new value because it was paid post-petition by an otherwise unavoidable transfer.

Only new value by a creditor that replenishes the debtor for the diminution caused by the preferential transfer is counted to reduce preference exposure. If the new value was repaid by a transfer that is itself an avoidable transfer, and, therefore, subject to disgorgement, the debtor's estate was replenished by the paid for new value and such new value should count to reduce the preference claim. However, where the new value was repaid by an unavoidable transfer, which is not subject to recovery, such new value did not replenish the bankruptcy estate for the diminution caused by the prior preference and does not qualify as deductible new value.

The new value represented by Shamrock's Reclamation Claim was paid by an unavoidable transfer, the court-approved payment by Arizona, and did not replenish Arizona's bankruptcy estate. As a result, Shamrock's Reclamation Claim did not count as deductible new value that reduced the trustee's preference claim against Shamrock.

The bankruptcy court's decision in the Arizona Fast Foods case appears to follow the decision of the United States Bankruptcy Court for the Northern District of Illinois in the Login Bros. Book Company case discussed in a prior article in the October 2003 *Business Credit*. In that case, a preference defendant trade creditor's pre-petition extension of credit to the debtor, consisting of goods shipped on credit to the debtor, lost their eligibility as new value when the goods were returned to the creditor post-petition pursuant to a court order.

This holding has not been universally followed. The United States District Court for the Northern District of Illinois, in In re Energy Cooperative Inc., held that a creditor could assert the new value defense based on a pre-petition extension of credit that was paid post-petition. So the court's decision in Arizona Fast Foods that disqualified a trade creditor's reclamation claim as deductible new value where such claim was paid post-petition pursuant to a court order might not be the last word on this subject.

Conclusion

When you put preferences, reclamation and PACA together in one case, like Arizona Fast Foods, don't be surprised with an interesting decision. Only in the PREFERENCE ZONE FOLKS!

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