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PACA Rights Destroyed by Oral Agreement Extending Payment Terms

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Introduction

The Perishable Agricultural Commodities Act ("PACA") confers a preferred "superpriority" status upon eligible sellers of fresh produce. They are the beneficiaries of a trust, consisting of all of the buyer's perishable agricultural commodity inventory and all products and proceeds, that is superior to the rights of all of the buyer's other creditors, including the buyer's secured lender with a floating security interest in all of the buyer's inventory.

However, PACA has rigorous eligibility requirements. One requirement limits a seller's credit terms to not more than 30 days. A seller that extends longer credit terms loses the benefits of the PACA trust. Applying this rule to credit sales sounds easy enough! But what happens when a PACA seller and a financially troubled buyer enter into a post-default settlement agreement that extends the seller's payment terms beyond the maximum 30-day period allowed by PACA? And what happens if that agreement was never reduced to writing?

In an article entitled "PACA Trust Survives E-mail Exchange Extending Credit Terms", that appeared in the January, 2004 *Business Credit*, this author discussed a court decision reaffirming the view of many courts (including the United States Courts of Appeal for the Seventh and Eighth Circuits) that a written agreement extending a seller's payment terms beyond 30 days stripped the seller of its PACA trust rights. However, the court noted that an oral agreement extending a produce seller's payment terms beyond 30 days did not destroy the seller's PACA rights.

Well, that did not end the matter! The wonderful thing about the law is that there is usually an alternate point of view that a court may follow. It is particularly fun when the author can remove his lawyer's hat and become a reporter of differing views among the United States Circuit Courts of Appeal on an issue of interest to the trade creditor community. That is precisely what recently occurred when the United States Court of Appeals for the Second Circuit, in *American Banana Co. v. Republic National Bank,* held that a seller lost its PACA trust rights because it had entered into a post-default oral forbearance agreement extending the seller's payment terms beyond the maximum 30-day period allowed by PACA.

The Second Circuit's decision could discourage many PACA sellers from working with financially troubled buyers. According to the decision, any post-default agreement, whether oral or written, that extends the buyer's obligation to pay the seller's invoices beyond 30 days abrogates the produce seller's PACA trust, at least in the Second Circuit. The holding benefits the buyer's other non-PACA creditors, who no longer have to deal with a PACA trust that skews the normal priority rules in bankruptcy, where PACA trust creditors would otherwise claim first "dibs" on the produce assets and proceeds and products.

The PACA Statute

Congress enacted PACA in 1930 to regulate the interstate sale and marketing of produce. Congress acted in the wake of unscrupulous brokers taking advantage of small farmers and growers by rejecting the produce in a declining market. The seller would be especially vulnerable to the perishability of its goods, the great distances between the seller and buyer and the expense and impracticality of recovering the seller's goods and otherwise enforcing its rights against the purchaser.

In the early 1980's, Congress reexamined PACA in response to a sharp increase in defaults among produce buyers and determined that produce sellers needed greater protection. As a remedy, in 1984, Congress amended PACA to include a floating non-segregated statutory trust for the benefit of produce suppliers, sellers and their agents that comply with all of PACA's requirements. Congress sought to protect sellers of perishable agricultural commodities, who often could not evaluate their buyers' creditworthiness before the sale. The PACA trust grants eligible produce suppliers a superpriority right of recovery of the purchase price of their goods over the claims of all other creditors, including secured creditors.

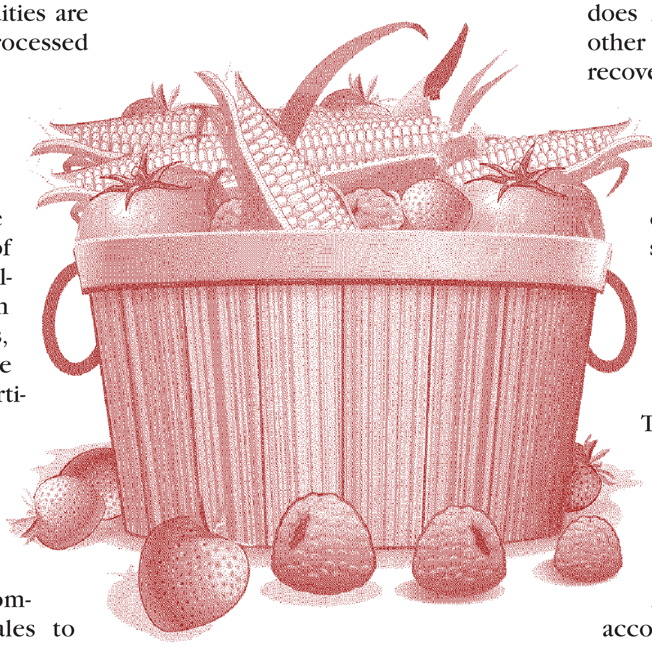
How PACA Works

The PACA trust applies only to perishable agricultural commodities. Perishable agricultural commodities are unprocessed or minimally processed fruits and vegetables, whether or not frozen or packed in ice. PACA eligibility for processed fruits and vegetables is determined by whether the processing converted the produce to a different kind or character of food. Preparation with oil disqualifies the product; water or steam blanching does not. Mushrooms, frozen fruits and vegetables are covered by PACA; marinated artichokes, salsa, applesauce, dried prunes and apricots, coated french fries and onion rings, and canned olives are not.

PACA does not regulate all sales of perishable agricultural commodities. PACA applies to sales 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 represents at least one ton of produce shipped, received or contracted for shipment or receipt on any given day.

An unpaid PACA seller must state in writing its intent to preserve PACA trust benefits within 30 days after (a) the expiration of the prescribed time for payment, ten days after delivery, as set forth in regulations promulgated by the United States Department of Agriculture; (b) the due date for such payment agreed to in writing by the parties before entering into the transaction; or (c) seller's receipt of notice of dishonor of the payment. A PACA seller can satisfy this requirement by including a statement in its bills or invoices that the goods are being sold subject to the PACA trust.

The PACA regulations further state that the maximum payment terms that qualify under PACA is 30 days after the buyer's receipt and acceptance of the goods. An agreement between the parties that extends the due date of the seller's invoices beyond the maximum 30-day period would disqualify the seller from the protections of the PACA trust. Whether disqualification from PACA requires a written agreement extending payment terms, or whether an oral agreement will suffice, was at issue in the *American Banana/ Republic Bank* case.



The PACA trust is a non-segregated "floating trust". 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 trust includes the produce supplied by the PACA supplier and all other 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, regardless of the source of the goods. 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. This allows the produce buyer to commingle PACA trust assets. Some courts have even held that when PACA produce proceeds are commingled with non-PACA proceeds, the PACA seller is still entitled to a full recovery from all proceeds (PACA and non- PACA alike) without tracing the proceeds of its produce. The buyer must then prove the proceeds were not from PACA goods and, therefore, not subject to the trust.

PACA Trust Beneficiaries vs. Secured Lenders

PACA also changes the normal bankruptcy claims priority rules. Where PACA does not apply, secured creditors and other lien creditors have a prior right to recover the proceeds of their collateral. Next in line for payment are administrative priority creditors whose claims arise during the bankruptcy case. Then come lower-level priority claims, such as certain wages, salaries, employment benefits and taxes, followed by pre-petition unsecured creditors at the bottom of the claims ladder.

The PACA trust distorts the priority rules by elevating unpaid PACA produce suppliers to the head of the line-they must be paid first! They have priority even over a secured creditor with a floating lien in the debtor's accounts and inventory. PACA trust assets are not part of a debtor's bankruptcy estate and the buyer lacks a sufficient interest in the PACA trust assets for any security interest to attach. Since the PACA trust arises upon delivery of the produce, an unpaid PACA seller retains title to the goods and the goods are not subject to the security interest of the buyer's secured creditors until the seller is paid in full. Secured creditors may be directed to disgorge collateral proceeds from trust funds otherwise payable to PACA creditors.

The *American Banana v. Republic National Bank* Case

Until its demise in September 1996, PMD Brokerage Corp. ("PMD") bought and sold produce at the New York City Terminal Market at Hunts Point, New York. PMD facilitated its business by opening up a checking account at HSBC Bank USA formerly known as Republic National Bank. All of the monies that PMD had deposited into the HSBC bank account were proceeds from the sale of produce covered by PACA's trust provision. HSBC had processed hundreds of PMD checks, made payable to dozens of payees, typically produce sellers, in the normal course of PMD's business.

In January 1996, HSBC provided PMD with overdraft privileges as the bank began to honor checks presented for payment against PMD's account in amounts greater than the available funds in the account. HSBC honored PMD checks by providing "daylight" overdraft accommodations. HSBC then used checks deposited by PMD to reduce overdraft balances in PMD's account.

In July 1996, several of PMD's customers began slowing their payments to PMD. This resulted in a tightening of PMD's cash position. Eventually, in September 1996, PMD ceased its operations. At that time, PMD owed $787,353.21 to produce sellers that were eligible for the PACA trust. The sellers had commenced enforcement efforts to obtain payment of their claims.

After ceasing operations, PMD proposed a debt-restructuring plan to the sellers and other PACA creditors. As part of the plan, PMD proposed monthly payments to PACA creditors that deferred full payment of their claims well beyond the maximum 30-day terms allowed under PACA. The PACA creditors, including the sellers, orally accepted the plan.

PMD defaulted on this arrangement, and the sellers were left with unpaid claims totaling $787,353.21. They sued HSBC, claiming that HSBC's receipt and application of the PACA trust funds in repayment of PMD's overdraft balance violated PACA.

The lower court awarded the sellers judgment in the amount of $278,967, plus interest. The sellers appealed, claiming they were entitled to judgment in the full amount owed by PMD, $787,353.21, on the theory that HSBC had violated PACA every time HSBC had applied PMD's deposit of PACA trust funds in reduction of PMD's overdraft balance owing to HSBC. HSBC also appealed, claiming it had no liability to the sellers, in part, because the sellers had waived their PACA rights by entering into a post-default agreement extending payment of their claims beyond the maximum 30-day payment terms allowed under PACA.

The Second Circuit ruled the sellers had lost their PACA trust rights when they had orally agreed to extend the payment of their invoices beyond the maximum 30-day period allowed under PACA. The Second Circuit's decision poses a major dilemma for PACA creditors attempting to work with financially troubled customers; any forbearance beyond 30 days risks loss of their PACA rights. The decision is also at variance with the 1999 Seventh Circuit Court of Appeals ruling, in *Greg Orchards & Produce Inc. v. Roncone,* and the Eighth Circuit Court of Appeals ruling, in *Hull Co. v. Hauser's Foods, Inc.,* that only a written, but not an oral, post-default extension agreement between a seller and buyer destroys the seller's PACA trust protection.

The Second Circuit found nothing in the PACA statute or regulations that treats a post-default oral agreement extending payment terms differently from a post-default written agreement extending payment terms. Any agreement that extends a seller's payment terms beyond the maximum 30-day period allowed by PACA, whether oral or written, forfeits the seller's PACA trust. Preserving PACA rights based on an oral extension agreement, while eviscerating PACA rights in the event of a written extension agreement, would produce the unacceptable result of favoring PACA sellers that orally extend their payment terms! The court simply would not hear of that!

Conclusion

There is a constant tension between eligible suppliers of perishable agricultural commodities, who have the benefit of the PACA trust in all of their buyer's produce inventory and proceeds, and the buyer"s other non-PACA creditors, whose rights are subordinate to the PACA claims. PACA rights are broad, but not automatic, and certainly not permanent! PACA eligibility requirements are tough; produce sellers must satisfy them in order to obtain the benefits of the PACA trust and they can lose them if they fall out of compliance with any of these requirements.

One of the conditions for PACA trust protection requires qualifying sellers to extend only short-term credit. That means a produce seller's payment terms cannot exceed the 30-day maximum allowed under PACA. Any longer credit terms forfeits PACA trust protection!

In light of the Second Circuit's recent decision, a PACA seller now has to be very careful in responding to a financially distressed buyer's proposal for forbearance of payment of the seller's past due claim. At least in the Second Circuit, any extension agreement, whether oral or written, can extinguish a produce seller's PACA rights.

Other circuit courts disagree with the Second Circuit. They have held that PACA rights are lost only where the produce seller and buyer have entered into a post-default written agreement extending the payment of the seller's invoices beyond 30 days. Oral extension agreements would not adversely affect PACA rights in the Seventh and Eighth Circuits and in courts outside the Second Circuit that follow the holdings of the Seventh and Eight Circuits. So for PACA creditors concerned about the loss of PACA protection in the event of an extension arrangement with their buyers, and for the buyer's other creditors pushing for the forfeiture of PACA rights, whether a case is pending in the less PACA-friendly Second Circuit (at least as to forbearance agreements), or the more PACA-friendly Seventh and Eighth Circuits (as to forbearance agreements) makes a big difference!

Sounds like a matter that will eventually require the intervention of the United States Supreme Court to settle the differences among the Circuit Courts! Stay tuned as developments unfold!

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