PACA AND REAL PROPERTY: FOLLOW THE FRUIT

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[1] Originally enacted in 1930, the Perishable Agricultural Commodities Act ("PACA" or the "Act") has been amended over the years in a number of ways to address the changing landscape of the produce industry. Developing case law and industry reaction has further expanded the reach of the Act to impact property and parties never mentioned in the Act. This article discusses the history of PACA and how cases interpreting the Act can affect real estate and related transactions.

PACA HISTORY

Congress enacted PACA in order to protect producers of "perishable agricultural commodities" from the unfair activities of commission merchants, dealers, and brokers who would wrongfully reject shipments of such commodities during periods of declining prices. *George Steinberg & Son, Inc. v. Butz*, 491 F.2d 988, 990 (2nd Cir. 1974). As originally enacted, PACA contained two major protections. First, the Act prohibited certain unfair practices by "commission merchants," "brokers," or "dealers," including unfair counting and weighing, rejection, or dumping of perishable agricultural commodities. 7 U.S.C. § 499b; *In re Magic Rest., Inc.*, 205 F.3d 108, 110 (3rd Cir. 2000). Second, the Act mandated a licensing program for commission merchants, brokers, and dealers of perishable agricultural commodities, providing the Secretary of Agriculture with the power to refuse, suspend, or terminate a license based on conduct in violation of Section 499b of the Act, among other things. 7 U.S.C. §§ 499c, 499d, 499h; *Magic Rest.*, 205 F.3d at 110-11.

Although PACA was an improvement in the protection of agricultural suppliers, by the early 1980s certain shortcomings in the Act had become apparent. The problems reflected changes in the financial structure of the agriculture industry: (a) climbing overhead costs, including the costs of debt servicing, resulting in an increase in delayed payments; (b) an increase in hidden security agreements which resulted in diversion of money away from suppliers; and (c) increases in business failures and bankruptcies with no meaningful recovery to suppliers. Regulations under the Perishable Agricultural Commodities Act, 49 Fed. Reg. 45,735, 45,737 (Nov. 20, 1984). As the legislative history of the Act reflects, sellers of agricultural commodities were "unsecured creditors and receive little protection in any suit for recovery of damages where a buyer has failed to make payment as required by the contract." H.R. REP. (Agric. Comm.) No. 98-543 (1983) at 3. To remedy these shortcomings, in 1984 Congress amended PACA to create a trust for the benefit of unpaid sellers and suppliers of perishable agricultural commodities (the "PACA Trust"). *Id.* at 1; 7 U.S.C. § 499e(c)(1). The PACA Trust was modeled after a similar provision that was added to the Packers and Stockyards Act, 7 U.S.C. § 181 *et seq.* H.R. REP. No. 98-543 at 2.

PERISHABLE AGRICULTURAL COMMODITIES

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The PACA Trust, like other sections of the Act, applies only to transactions involving the "perishable agricultural commodities." The Act itself generally defines these as fresh fruits and fresh vegetables of every kind and character, "whether or not frozen or packed in ice." 7 U.S.C. § 499a(b)(4). The federal regulations implementing PACA further define "fresh fruits and fresh vegetables":

> Fresh fruits and fresh vegetables include all produce in fresh form generally considered as perishable fruits and vegetables, whether or not packed in ice or held in common or cold storage, but does not include those perishable fruits and vegetables which have been manufactured into articles of food of a different kind or character. The effects of the following operations shall not be considered as changing a commodity into a food of a different kind or character: Water, steam, or oil blanching, battering, coating, chopping, color adding, curing, cutting, dicing, drying for the removal of surface moisture; fumigating, gassing, heating for insect control, ripening and coloring; removal of seed, pits, stems, calyx, husk, pods rind, skin, peel, et cetera; polishing, precooling, refrigerating, shredding, slicing, trimming, washing with or without chemicals; waxing, adding of sugar or other sweetening agents; adding ascorbic acid or other agents to retard oxidation; mixing of several kinds of sliced, chopped, or diced fruit or vegetables for packaging in any type of containers; or comparable methods of preparation.

7 C.F.R. § 46.2(u). One might think that this definition is expansive enough to cover any kind of agricultural product, but there are decisions which hold that certain agricultural products are not covered by PACA. *See Regal Mktg., Inc. v. All Am. Farms, Inc.*, (No. R-99-0108, 1999 WL 33314097 (USDA Nov. 10, 1999)) (citing a number of Department of Agriculture decisions finding that peanuts, pecans, coconuts and chestnuts are not covered by PACA). Other decisions address the issue of whether agricultural products are "fresh" or have been manufactured into food of a different kind or character. *See Endico Potatoes, Inc. v. CIT Grp./Factoring, Inc.*, 67 F.3d 1063, 1071 (2d Cir. 1995) (products containing less than ninety percent fresh ingredients, such as cream cheese with scallions, cole slaw, and potato salad are not entitled to PACA protection); *In re L. Nat. Foods Corp.*, 199 B.R. 882, 888-90 (Bankr. E.D. Pa 1996) (dried apricots and prunes are not entitled to PACA protection); *In re Fleming Cos., Inc.*, 316 B.R. 809, 813-14 (D. Del. 2004) (canned fruit not entitled to PACA protection). A number of decisions formerly addressed the issue of whether french fries were entitled to PACA protection, but those decisions were overruled in 2003 when the PACA regulations were amended to include "battering and coating" as processes which do not change the product into food of a different kind or character. *See Fleming Cos., Inc. v. USDA*, 322 F. Supp. 2d 744, 752 (E.D. Tex. 2004); aff'd 164 Fed. App'x. 528 (5th Cir. 2006).

COMMISSION MERCHANTS, DEALERS, AND BROKERS

The PACA Trust also applies only to perishable agricultural commodities received by a commission merchant, dealer, or broker. A commission merchant is a person "engaged in the business of receiving in interstate or foreign commerce any perishable agricultural commodity for sale, on commission, or for or on behalf of another." 7 U.S.C. § 499a(b)(5). A broker is a person "engaged in the business of negotiating sales and purchases of any perishable agricultural commodity in interstate or foreign commerce for or on behalf of the vendor or the

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purchaser," but does not include independent agents "negotiating sales for and on behalf of the vendor and if the only sales of such commodities negotiated by such person are sales of frozen fruits and vegetables having an invoice value not in excess of $230,000 in any calendar year." 7 U.S.C. § 499a(b)(7); 7 C.F.R. § 46.2(n).

In contrast, a dealer is generally a "person engaged in the business of buying or selling in wholesale or jobbing quantities . . . any perishable agricultural commodity in interstate or foreign commerce." 7 U.S.C. § 499a(b)(6). Wholesale or jobbing quantities are "aggregate quantities of all types of produce totaling one ton (2,000 pounds) or more in weight in any day shipped, received, or contract to be shipped or received." 7 C.F.R. § 46.2(x). There are exceptions to the general definition of "dealer." First, no producer is considered a dealer with respect to sales of perishable agricultural commodities raised by that person. 7 U.S.C. § 499a(b)(6)(A); 7 C.F.R. § 46.2(m)(3). Second, no person buying perishable agricultural commodities solely for sale at retail is considered a dealer until the invoice cost of such purchases in any calendar year are in excess of $230,000. 7 U.S.C. § 499a(b)(6)(B); 7 C.F.R. § 46.2(m)(2). Finally, no person buying any perishable agricultural commodity (other than potatoes) for canning or processing within the state they are grown is a dealer unless the product is frozen, packed in ice, or consists of cherries in brine. 7 U.S.C. § 499a(b)(6)(C); 7 C.F.R. § 46.2(m)(4); *Anthony D'Acquisto v. Fruit Cups, Inc.*, (No. 2-5772, 1981 WL 32227. **1-2 (USDA Dec. 14, 1981)). If a person is not otherwise considered a "dealer" for PACA purposes, but secures a license under 7 U.S.C. § 499c, the person is considered a dealer while the license is in effect. 7 U.S.C. § 499a(b)(6).

The definition of "dealer" has since been expanded to cover restaurants which meet the "wholesale and jobbing quantities" and "$230,000" per year requirements. *See e.g., J. Ambrogi Food Distribution Inc. v. Top Dog America's Bar & Grille of PA, Inc.*, No. Civ.A.05-337, 2005 WL 1655891, at **4-5 (E.D. Pa. July, 14 2005). Furthermore, some commentators suggest that the definition of "dealer" could be expanded to include prisons, hospitals, nursing homes, and other large purchasers of PACA commodities. *See Magic Rest.*, 205 F.2d at 117 (Rendell, J. dissenting); 3 HOWARD RUDA, ASSET BASED FINANCING; A TRANSACTIONAL GUIDE, § 30.07[2] (Matthew Bender 2018). PACA rights and obligations can flow through the manufacturing and distribution chain, often to parties who are not obviously significant participants in the produce industry.

PACA TRUST

The PACA Trust is a nonsegregated "floating" trust comprised of (a) perishable agricultural commodities received in all transactions, (b) all inventories of food and other products derived therefrom; and (c) all receivables or proceeds from the sale of such commodities and food or products derived therefrom. 7 C.F.R. § 46.46(b); 7 U.S.C. § 499e(c)(2). However, the PACA Trust provisions do not apply to transactions between members of agricultural cooperatives and the cooperative. 7 U.S.C. § 499e(c)(2); H.R. REP. 98-543 at 6 (explaining that such transactions are essentially "in-house" and free from the difficulties of normal commercial dealings). The PACA Trust is created immediately upon transfer of ownership, possession, or control of the covered goods. 7 C.F.R. § 46.46(c). Parties who comply with the PACA Trusts' requirements are eligible beneficiaries of the trust until they are paid in full. *Id.* Payments made by a later dishonored check are not considered paid. 7 U.S.C. § 499e(c)(2). In some courts, "full payment" may include attorneys' fees (if they are provided for by the contract between the parties), interest, and shipping fees. *Country Best v. Christopher Ranch*, LLC, 361 F.3d 629, 632 (11th Cir 2004); *Prestige Produce, Inc. v. Silver Creek, Inc.*, No. CV 04-491, 2006 WL 581262, at *5 (D Idaho Mar. 9, 2006);

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Lincoln Diversified, Inc. v. Mangos Plus, Inc., No 98 Civ 5593 RWS, 2000 WL 890198, at *2 (S.D.N.Y. July 5, 2000).

PRESERVATION OF PACA TRUST BENEFITS

Although the PACA Trust arises automatically, potential beneficiaries will lose the benefits of the trust unless they comply with the Act's notice and timing requirements. The Act provides two methods by which a beneficiary can preserve its rights. Originally, the unpaid supplier, seller, or agent could give a written notice of intent to preserve the PACA Trust benefits and include the following information for each shipment (a) the names and addresses of the trust beneficiary, seller-supplier, commission merchant, or agent and debtor; (b) the date of the transaction, commodity, invoice price, and terms of payment (if different than provided by the regulations), (c) the date of receipt of notice that a payment was dishonored (if applicable), and (d) the amount past due and unpaid. 7 C.F.R. § 46.46(f). The written notice has to be given within thirty calendar days (1) after the expiration of the time for payment under PACA's regulations (in the case of a simple sale, ten days after receipt and acceptance per 7 C.F.R. § 46.2(aa)); (2) after expiration of the time for payment agreed to by the parties in writing before entering into the transaction (which cannot be longer than thirty days and still qualify for trust protection (7 C.F.R. § 46.46(c)(2)); or (3) after the supplier, seller or agent receives notice that a payment has been dishonored. 7 C.F.R. § 46.46(f)(2); 7 U.S.C. § 499e(c)(3).

A second method of preserving PACA Trust benefits, available only to PACA licensees, was added in 1995. Licensees may include the following language in their invoice or other billing statement, along with the terms of payment if they differ from the PACA regulations and the parties have agreed to such terms in writing before the transaction:

> The perishable agricultural commodities listed on this invoice are sold subject to the statutory trust authorized by section 5(c) of the Perishable Agricultural Commodities Act, 1930 (7 U.S.C. 499e(c)). The seller of these commodities retains a trust claim over these commodities, all inventories of food or other products derived from these commodities, and any receivables or proceeds from the sale of these commodities until full payment is received.

7 C.F.R. § 46.46(f)(3)(i); 7 U.S.C. § 499e(c)(4). This “invoice” method of PACA Trust preservation has since been extended to include parties using Electronic Data Interchange (“EDI”) methods of transmitting transaction information 7 C.F.R. §§ 46.46(f)(4) and (f)(5). Significantly, however, nothing in the Act requires a PACA “notice” to be recorded in any real estate or other central filing office, such as a secretary of state's office. Therefore, unlike mechanics liens or security interest, the existence or extent of PACA Trust claims may not be information that is publicly ascertainable (although the U.S.D.A. Agricultural Marketing Service does maintain a publicly searchable database of PACA licensees, that database does not contain information regarding payment statistics).

PACA TRUST IMPACT ON REAL ESTATE

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Use and commingling of PACA Trust assets is not per se prohibited. 7 C.F.R. § 46.46(b). The party claiming the benefit of the PACA Trust must establish the details of the transaction, but detailed tracing is not required; pro-rata distribution to all claimants establishing their rights is contemplated. 49 Fed. Reg. at 45,738. The onus is on the commission merchant, broker, or dealer to preserve the trust assets and assure that all eligible transactions are covered, even if disputed. *Id.* Failure to maintain PACA Trust assets is a violation of the Act, 7 U.S.C. § 499b, and can subject individuals in a position of control of trust assets to personal liability, including, possibly, denial of a bankruptcy discharge. *See* Nicole Leonard, *The Unsuspecting Fiduciary: The Curious Case of PACA and Personal Liability*, 25-MAY AM. BANKR. INST. J. 32 (2006); Michael D. Sousa, *Are You Your Produce Vendor's Keeper? The Perishable Agricultural Commodities Act and § 523(a)(4) of the Code*, 15 J. BANKR. L. & PRAC. 6, Art. 3 (Dec. 2006). This potential for liability extends beyond the produce company's principals because of the PACA Trust's expansive reach and its potential to impact (i.e. "infect") property received or possibly even owned by other parties.

THE BROAD EXTENT OF "PACA PROCEEDS"

Because the PACA Trust extends beyond the produce itself to "products and proceeds", courts have been willing to "follow the fruit" and extend the PACA Trust to other assets acquired with the use of PACA Trust proceeds. As the Second Circuit explained in one of the first cases fully addressing the issue:

> Throughout this opinion, we refer to assets acquired with the cash proceeds of trust property as being included among the "proceeds" of that property. The same result follows, however, whether one views an asset purchased with the cash proceeds of a trust property as a second-generation "proceed" (thereby falling within the statutory definition of trust property), or as the product of a wrongful dissipation of trust assets (thereby becoming a part of the trust by operation of law).

In re Kornblum & Co., Inc., 81 F.3d 280, 284 n.2 (2nd Cir. 1996). In *Kornblum*, a commission merchant/dealer had obtained certain commercial real estate cooperative certificates prior to entering into transactions with the complaining PACA Trust creditors. When the dealer eventually ended up in bankruptcy, its trustee tried to sell the membership certificates and the creditors objected on the basis that the maintenance payments on the units were paid with PACA Trust proceeds and therefore imposed themselves with the PACA Trust. Considering the matter on appeal, the court held that a party claiming that assets are not imposed with the PACA Trust must establish that: (1) no PACA Trust existed when the assets were purchased; (2) even though a PACA Trust existed at that time, the assets were not purchased with trust assets; or (3) although a PACA Trust existed when the assets were purchased and the assets were purchased with PACA Trust assets, all unpaid sellers were thereafter paid in full prior to the transaction in question, thereby terminating the PACA Trust. Subsequent cases have also imposed the PACA Trust on real property and other assets. *See, e.g.*, Decision & Order, *The Bank of New York, as Trustee, for the benefit of CWMBS, Inc. v. Kim*, Index No. 1443-2008 (N.Y. Sup. Ct. filed Apr. 3, 2013) (County of Rockland); *Mid-Valley Produce Corp. v. 4-XXX Produce Corp.*, 833 F. Supp. 193 (E.D.N.Y. 1993); *Chiquita Fresh N. Am., LLC v. Fierman Produce Exch., Inc.*, 198 F. Supp. 3d 171 (E.D.N.Y. 2016); *Epic Fresh Produce, LLC v.*

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Olympic Wholesale Produce, Inc., 2018 WL 1311994 (N.D. Ill. Mar. 7, 2018). The *Epic Fresh* opinion is particularly instructive as to the possible reach of the PACA Trust. In *Epic Fresh*, the District Court imposed a preliminary injunction against transfer of any of an extensive list of assets, including commercial and residential real property, office equipment, automobiles, severance and retirement benefits, and bank accounts. 2018 WL 1311994 at *7-10.

The cases have further held that third parties (often lenders, although the cases are *not* confined to lending relationships) may be forced to turn over an asset or disgorge funds received that are imposed with the PACA Trust, unless the recipient can establish a defense. The most common defense, developed from general trust principals, is commonly identified as the *bona fide purchaser defense*: i.e., that the party received the asset or obtained the payment (a) for value and (b) without notice of the breach of the trust. *See Restatement (Second) of Trusts* § 284 (1959); *Consumers Produce Co., Inc. v. Volante Wholesale Produce, Inc*., 16 F.3d 1374, 1382 (3rd Cir. 1994); *Nickey Gregory Co., LLC v. AgriCap, LLC*, 597 F.3d 591, 606 (4th Cir. 2010).

“Value” is given if “money is paid or other property is transferred or services are rendered as consideration for the transfer of trust property.” *Restatement (Second) of Trusts § 298; Endico Potatoes*, 67 F.3d at 1068. See also *Mid-Valley Produce*, 833 F. Supp. at 196 (wife's residence imposed with PACA Trust to the extent she received PACA Trust proceeds without providing consideration). A secured lender may receive an ordinary loan payment “for value”. *See, e.g., Consumers Produce*, 16 F.3d at 1380 (citing *Restatement (Second) of Trusts* § 304). However, seizure or foreclosure would not constitute a transfer for value. See, *e.g. C.H. Robinson Co. v. Trust Co. Bank, N.A.*, 952 F.2d 1311, 1315 (11th Cir. 1992) (distinguishing between ordinary loan payments and enforcement of a security interest); *Consumers Produce*, 16 F.3d at 1382 (same).

What constitutes a transfer “without notice” is not completely consistent across the reported cases. The Third Circuit in *Consumers Produce* focused on Section 297(a) (at comment a) of the *Second Restatement of Trusts* which considers both actual and constructive notice of a breach, and includes a duty to inquire whether the trustee is breaching the PACA Trust:

> A third person has notice of a breach of trust not only when he knows of the breach, but also when he should know of it; that is when he knows facts which under the circumstances would lead a reasonably intelligent and diligent person to inquire whether the trustee is a trustee and whether he is committing a breach of trust, and if such inquiry when pursued with reasonable intelligence and diligence would give him knowledge or reason to know that the trustee is committing a breach of trust.

Consumers Produce, 16 F.3d at 1383. Other courts have instead referred to the current Restatement (Third) of Trusts Section 108, which provides that a third party is neither required to inquire into the extent of a trustee's power nor ensure that assets transferred to the trust are properly applied to trust purposes. *Skyline Potato Co., Inc. v. Hi-Land Potato Co., Inc.*, 188 F. Supp. 3d 1097, 1124 (D. N.M. 2016); *Spada Properties, Inc. v. Unified Grocers, Inc.*, 38 F. Supp. 3d 1223, 1235 (D. Or. 2014). Under either standard, however, a party, such as a lender, with significant information about unpaid PACA claims may be considered to have notice of a breach of the PACA Trust. Compare *Consumers Produce*, 16 F.3d at 1385 (under *Restatement (Second) of Trusts* the lender undertook a reasonable inquiry and did not know and should not have known of the breach of the PACA

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Trust) with *Nickey Gregory*, 597 F.3d at 605-606 (lender that had undertaken an examination of borrower's financial condition had notice of substantial unpaid PACA Trust obligations).

EFFECT ON TITLE INSURANCE

Following cases like *Kim* and *Chiquita Fresh*, title insurance companies have become increasingly concerned that PACA Trust claims, which are not required to be recorded in any real estate records, could nonetheless impact lender's and owner's title policies. Accordingly, a number of national title companies have begun to include title exceptions for PACA Trust claims (as well as claims under similar statutes such as the Packers and Stockyards Act) on such policies. Each title company will likely have its own underwriting criteria and may be willing to remove the exception from the final policy in certain circumstances, such as proof that the PACA Trust does not apply (possibly using a *Kornblum* type of analysis) or, in the case of a lender's title policy, upon receiving an affidavit of the owner and/or upon receiving an indemnity from the party seeking removal.

CONCLUSION

Although PACA was originally enacted in 1930, its impact on real estate transactions has only recently emerged. As discussed herein, evolving case law has given rise to uncertainty as to the reach of the PACA Trust and the assets affected thereby. In a lending context, this uncertainty has given rise to additional drafting and due diligence considerations and, in a title insurance context, the changing legal landscape has prompted title companies to add a standard exception to their owner's and lender's policies for PACA and similar federal and state statutes. Given these new developments, real estate practitioners may want to consider early on in a transaction how PACA and similar statutes may affect their client's rights and interests.

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NOTES:

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