

SECOND CIRCUIT REJECTS SETOFF BETWEEN PACA MERCHANTS IN BANKRUPTCY CASES

Date: 29 January 2019

U.S. Restructuring & Insolvency and Agribusiness Alert

By: Margaret R. Westbrook, Brandy A. Sargent

In a recent opinion, the Second Circuit Court of Appeals held that a seller licensed under the Perishable Agricultural Commodities Act ("PACA") could not entirely setoff payables owed to a bankrupt PACA merchant against receivables owed by the debtor. The ruling is a reminder to PACA-regulated parties that otherwise common operational practices such as setoffs may not be recognized and enforceable in bankruptcy or in PACA-regulated transactions.

In *PACA Trust Creditors of Lenny Perry's Produce, Inc. v. Genecco Produce Inc.* the defendant ("GPI") and bankrupt merchant ("LPP") had a long history of purchasing PACA-covered goods from each other.[1] However, the parties did not usually pay one another for the purchases. Instead, they both maintained account records showing the various offsetting transactions. The practice was apparently unremarkable until LPP filed a voluntary bankruptcy petition in 2009. At that time, LPP owed GPI approximately \$263,000, and GPI owed LPP approximately \$204,000. GPI asserted the position that its setoff rights meant that it was actually owed money and had no payment obligation to LPP. LPP's other supplier/creditors argued otherwise, filing suit against GPI to recover the payable owed to LPP.

After several decisions from the U.S. Bankruptcy Court for the Western District of New York and appeals to the U.S. District Court for the Western District of New York, the Second Circuit upheld the primary determination by both lower courts: GPI could not setoff the entire amount it was owed under normal state law setoff rules typically recognized by the U.S. Bankruptcy Code because of the unique trust obligations created under the PACA statute.

When PACA-covered produce is sold, a trust in the produce and its proceeds automatically arises for the benefit of the supplier. If a party receives PACA-covered produce, it acts as a trustee for the benefit of the supplier and must pay for it under "PACA prompt" terms. Both the produce and any receivables related to it are held "in trust" for the benefit of the supplier. Because produce is hard to segregate and trace, if there is more than one supplier and funds are insufficient to cover the full amounts due and owing, the suppliers are generally treated as a group and entitled to recover pro rata from the available funds.

Outside of bankruptcy, trust beneficiaries have priority over other creditors in the PACA trust assets, including the buyer's secured creditors. Likewise, in bankruptcy the trust beneficiaries' interests are superior because the trust assets are not generally treated as property of the estate of the bankrupt debtor but are held separately for the benefit of PACA creditors. In this case, both GPI and LPP were licensed under PACA, and both parties took the steps necessary to preserve their PACA trust rights. The issue in this case was how the Court would address the offsetting arrangement in the bankruptcy context.

The Second Circuit confirmed that PACA's trust provisions benefited LPP's suppliers, effectively elevating their right to be paid above the rights of other creditors, including GPI's right to setoff. The Court further held that the Bankruptcy Code, while generally preserving setoff rights, requires that the debt and the right to payment in a setoff must be "mutual" (i.e., owed between the same parties *in the same capacity*). In its capacity as a buyer, GPI owed money to LPP as a fiduciary trustee. GPI did not occupy the same position in its capacity as a seller, destroying the mutuality required under the Bankruptcy Code.

GPI's rights were not entirely eliminated -- the Court held that GPI was entitled to recover its own pro rata share of LPP's PACA assets because GPI was itself a PACA creditor. However, because there were so many PACA creditors, the net effect was to severely limit GPI's position from a full offset.

The *Lenny's* decision may prompt PACA-covered parties to reexamine their contracting and payment practices, reconsidering any offsetting or netting of receivables and payables. The *Lenny's* decision did not specifically reach other PACA contracting issues, such as when and if a buyer can deduct damages related to one load of produce from amounts owed to the same seller for either that load or other loads. For an unreported examination of those issues see *Reser's Fine Foods, Inc. v. H.C. Schmieding Produce Co., LLC*. [2]

Notes:

[1] Appeal No. 17-1949(L), decided January 9, 2019

[2] Case No. 16-4150-SAC, Docket No. 96, Dist. Kansas (September 15, 2017).

KEY CONTACTS



MARGARET R. WESTBROOK
PARTNER

RALEIGH, CHARLOTTE
+1.919.743.7311
MARGARET.WESTBROOK@KLGATES.COM



BRANDY A. SARGENT
PARTNER

PORTLAND
+1.503.226.5735
BRANDY.SARGENT@KLGATES.COM

This publication/newsletter is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer. Any views expressed herein are those of the author(s) and not necessarily those of the law firm's clients.