

Special Section: FOOD & BEVERAGE



USDA Raises Hurdles to Bankruptcy Sales of PACA-Regulated Produce Businesses

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One of the main advantages of purchasing a business out of bankruptcy is that the process can be quick, orderly and predictable. Yet, recently, the United States Department of Agriculture (“USDA”) has challenged the ability of debtors that are produce vendors to sell their businesses quickly unless they fully satisfy their obligations under the Perishable Agricultural Commodities Act (“PACA”). In doing so, the USDA has sought to elevate the claims of all produce suppliers to priority status in contravention of the priorities in the Bankruptcy Code. Purchasers and sellers of produce-related businesses in bankruptcy must both take additional precautions to ensure the sale is consummated without unexpected costs or delays.

Overview of PACA

PACA is a federal statute enacted in 1930 that establishes requirements for entities seeking to operate in the produce industry. It requires, among other things, that every dealer of “perishable agricultural commodities” be licensed by the Secretary of Agriculture, 7 U.S.C. § 499c(a), and that produce vendors “make full payment promptly” for any produce purchased in interstate and foreign commerce, 7 U.S.C. § 499b(4).

In 1984, PACA was amended to establish a trust in favor of produce suppliers. Specifically, PACA provides that a “commission merchant, dealer, or broker” that receives “perishable agricultural commodities” shall hold in trust for the benefit of all unpaid suppliers or sellers (1) the perishable agricultural commodities, (2) all inventory and other products derived therefrom, (3) the accounts receivable generated from the commodities, and (4) the proceeds from the sale of such commodities, which trust continues until all “sums owing in connection with such [perishable agricultural commodity] transactions” have been paid in full. 7 U.S.C. § 499e(c)(2).

The protections of PACA are afforded to “perishable agricultural commodities,” which are defined as “fresh fruits and fresh vegetables of every kind and character,” whether or not frozen or packed in ice, and cherries in brine. 7 U.S.C. § 499a(b)(4). This definition excludes fruits and vegetables that have been “manufactured into articles of food of a different kind or character.” 7

CFR § 46.2(u). The extent to which a fruit or vegetable can be manipulated and still qualify for the protections of PACA is regularly litigated.¹

A PACA trust is a floating, nonsegregated trust that is established as soon as the produce is delivered to the purchaser. 7 CFR § 46.46(b). In contrast to a standard trust, the assets that are subject to a PACA trust do not need to be traced, and the proceeds from the sale of produce can be commingled with proceeds from the sale of other assets.

Asserting and Perfecting PACA Claims

Unpaid produce sellers, suppliers or agents have standing to assert PACA claims. When asserting PACA claims, creditors often seek to recover more than the cost of the produce itself, such as shipping costs, freight charges, taxes, interest and attorney fees. The produce buyer may reduce the amount of the claim to be paid from the PACA trust by subtracting “contemplated expenses or advances” made by the buyer (e.g., expenses that the buyer already paid). 7 C.F.R. § 46.46(e)(5). There has been extensive litigation over the extent to which other charges (such as attorney fees, interest and shipping charges) are subject to the PACA trust.²

To perfect its claim, a PACA creditor must either (1) include language on its billing statements that the produce is sold subject to the PACA trust, or (2) provide written notice to the buyer of its intent to preserve the benefits



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of the PACA trust, along with sufficient information to identify the transaction subject to the trust. 7 U.S.C. § 499e(c); 7 CFR § 46.46(f). The written notice must be given within 30 days after (a) 10 days after delivery of the produce, (b) the payment due date agreed upon by the parties prior to the transaction, or (c) the date on which a seller receives notice that the payment (i.e., a check) has been dishonored. *Id.* While the supplier and buyer can agree on any payment terms, if the due date is more than 30 days after the buyer receives the produce, it will not qualify for PACA trust protection. 7 CFR § 46.46(e)(2).

PACA Claims in Bankruptcy

Upon a bankruptcy filing, all of the debtor's legal and equitable interests become property of the bankruptcy estate, 11 U.S.C. § 541, and the Bankruptcy Code sets forth a priority scheme for distribution of such assets to the debtor's creditors. If a debtor is holding assets in trust for someone else, such assets are not property of the estate and are not distributed pursuant to that priority scheme. Valid and perfected PACA claims, which are to be paid from the PACA trust, are thus paid ahead of all other creditors.³

While qualified PACA claims that are properly perfected are entitled to priority over all other creditors, other claims asserted by produce vendors are not. For example, claims that otherwise qualify for PACA trust protection yet were unperfected, or other produce-related claims that fail to satisfy the requirements of PACA (because, for example, the payment terms exceed 30 days), do not qualify for payment from the PACA trust.

USDA's Stance on PACA Claims in Two Recent Bankruptcy Cases

In two recent bankruptcy cases, the USDA has sought to elevate all produce-related claims (including unqualified PACA claims) to priority status and to condition the sale of a produce debtor's assets on the satisfaction of all such claims.

In the Contessa Premium Foods, Inc. ("Contessa") bankruptcy case,⁴ Contessa, a producer of frozen meals, sought to sell its business, including its corporate name, after a marketing process and auction. The successful bidder agreed to pay approximately \$51 million in cash and assumed liabilities. One of the sale closing conditions was that the purchaser obtain all essential licenses and permits to continue Contessa's

operations, including a PACA license. The USDA refused to grant the purchaser a new PACA license using the Contessa name unless Contessa fully paid all of its produce debt, including claims that did not qualify for the PACA trust. To permit the purchaser to get its PACA license, Contessa agreed to escrow \$1.5 million of sale proceeds.

Contessa then fully paid the claims of produce vendors that had qualified and perfected PACA claims, and asked the USDA to consent to the release of the \$1.5 million

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in escrow. The USDA withheld consent because the non-PACA-qualified produce claims remained outstanding. Accordingly, Contessa sought the court's determination that the funds could be returned for distribution under Contessa's plan of liquidation on the basis that all PACA trust claims had been satisfied and the other produce claims could not be paid outside the Bankruptcy Code's priority scheme.

The USDA objected, arguing that "PACA's requirement that a buyer promptly pay its suppliers for all perishable agricultural commodities makes no distinction between produce suppliers who have or who have not properly perfected their trust rights." The USDA distinguished between a produce supplier's private cause of action to obtain payment from a PACA trust, and the USDA's right to start administrative enforcement proceedings to sanction a licensee for violating PACA. Thus, it argued, Contessa's payment of all of its PACA trust claims did not cure its PACA violations, and it was entitled to commence a post-petition enforcement action against Contessa's terminated license. In addition, the USDA argued that Contessa's PACA license was encumbered as a result of its

failure to pay all of its produce debt, and that this encumbrance attached to the sale proceeds upon the free and clear sale of Contessa's assets. The USDA compared the PACA license to state liquor licenses, and the case law holding that transfers of liquor licenses can be conditioned on the payment of all state taxes and other liquor business-related claims.⁵

In response, Contessa argued that it had not sold or transferred its PACA license to the purchaser because its PACA license had been consensually terminated and a new license had been issued to the purchaser under the Contessa name at the closing of the sale. As a result, the USDA's alleged encumbrance of the PACA license was terminated. Moreover, Contessa argued that there was no authority under the Bankruptcy Code or otherwise to prioritize unsecured produce-related claims ahead of other unsecured creditors. The court agreed with Contessa and released the escrowed funds back to the estate.

Following the *Contessa* decision, the USDA again asserted its position that all produce-related debt needs to be satisfied in a sale of a debtor's assets in the bankruptcy case of Allen's Inc., an independent producer of canned vegetables ("Allen's").⁶ Allen's also sought to sell its business, including its accounts receivable, inventory and permits "to the extent transferable." The USDA objected to the sale, seeking clarifying language in the sale order that it would not affect the USDA's police or regulatory powers, or authorize the transfer of Allen's PACA license "without [Allen's] and the [p]urchaser complying with all applicable legal requirements under non-bankruptcy law governing such transfers or assignment." Allen's did not object to the USDA's request, and the sale was approved with the requested language preserving the USDA's rights. In addition, as part of the sale, the purchaser assumed the debtor's PACA claims and agreed to place \$7.7 million of the sale proceeds in an escrow account for the benefit of PACA creditors. While the issue has not been litigated in the bankruptcy case, the language proposed by the USDA certainly would allow it to demand that all produce debt be paid – regardless of whether it was protected by a PACA trust.

Lessons for Purchasers and Sellers of Businesses Subject to PACA

The USDA's position in these cases amounts to an attempt to circumvent the Bankruptcy Code's priority scheme and to

impose an additional burden on the parties to the sale of a PACA-regulated business. A purchaser will typically need to obtain a new PACA license in order to continue to operate the business. This gives the USDA a significant amount of leverage to demand that the debtor's PACA obligations be resolved to its satisfaction, and the USDA has demonstrated that it is willing to use that leverage to delay the issuance of a new PACA license and, thus, the closing of the sale. To avoid such a delay, parties must understand the scope of the debtor's produce debt, and there should be a sufficient

cash component to the purchase price to establish an escrow large enough to cover the PACA trust claims as well as *all* other produce claims. This will permit the sale to close promptly and will transfer the burden of resolving any disputes with PACA claimants and the USDA to the debtor.

1. See, e.g., *A&J Produce Corp. v. CIT Group/Factoring Inc.*, 829 F. Supp. 651 (S.D.N.Y. 1993); *Fleming Companies, Inc. v. United States Department of Agriculture*, 322 F. Supp. 2d 744 (E.D. Texas 2004).
2. See *Middle Mountain Land & Produce Inc. v. Sound Commodities Inc.*, 307 F.3d 1220, 1222–23 (9th Cir. 2002) (“The plain meaning of the PACA statute’s words ‘in connection with’ encompasses not only the price of the perishable agricultural commodities but also additional related expenses, including

- contractual rights to attorneys’ fees and interest, in a PACA claim.”); see also *In re Veg Liquidation, Inc.*, 516 B.R. 545 (Bankr. W.D. Ar. 2014) (discussing extent to which “contemplated expenses” can be excluded from PACA trust claim and finding that only expenses for which buyer previously paid could be deducted).
3. See e.g., *In re United Fruit & Produce Co.*, 242 B.R. 295, 298 (Bankr. W.D. Pa. 1999) (“PACA trust assets are not property of the estate.”); *In re Kornblum & Co.*, 81 F.3d 280, 284 (2d Cir. 1996) (“A PACA trust beneficiary is . . . entitled to claim trust property ahead of even creditors holding security interests in the property.”).
 4. See *In re Contessa Liquidating Co., Inc. (f/k/a Contessa Premium Foods, Inc.)*, Case No. 11-13454 (Bankr. C.D. Ca. 2011).
 5. See e.g., *In re Farmers Markets, Inc.*, 792 F.2d 1400 (9th Cir. 1986); *In re Anchorage Int’l Inn, Inc.*, 718 F.2d 1446 (9th Cir. 1983).
 6. See *In re Allen’s Inc. and All Veg, LLC*, Case No. 13-73597 (Bankr. W.D. Ar. 2014).