PRODUCING INEFFICIENCY: THE PERISHABLE AGRIGULTURAL COMMODITIES ACT

*BY MICHAEL ANTHONY SHAW**

Originally enacted in 1930, the Perishable Agricultural Commodities Act ("PACA") was intended to protect the interests of producers of perishable agricultural commodities when they bring their products to market. Over the course of five decades, it proved difficult to enforce the provisions of PACA as drafted and codified. Therefore, in the 1980s Congress determined to strengthen PACA, creating iron-tough statutory provisions in favor of producers of perishable produce, and simultaneously causing great difficulties for already-struggling purchasers of perishable produce. The most severe provision of the revised PACA virtually eliminates any possibility of a debtor produce company reorganizing under the U.S. Bankruptcy Code by imposing a trust on purchased produce and the proceeds thereof. Another provision of PACA, almost equally harsh for the modern-day produce business, is the ability of creditors under PACA to pursue claims against a debtor corporation's directors and officers if the creditors are unable to collect from the corporation itself. Therefore, PACA puts produce distributors at a double disadvantage compared to companies in other industries: bankruptcy reorganization is virtually eliminated as a possibility for a struggling company, and management (assuming that competent leaders can be found who are willing to bear this risk) is threatened with the possibility of industry-specific personal liability on the company's debts. As a result, in our current economy a struggling small or mid-level produce business stands virtually no chance of surviving through difficult periods. Congress should consider revisiting PACA to eliminate these provisions, and should seek an alternative means, such as a purchase-money security interest, to protect producers.

PACA and Its History

The purpose of PACA when it was first enacted by Congress in 1930 was, according to a more recent Congress, "to encourage fair trading practices in the marketing of perishable commodities by suppressing unfair and fraudulent business practices in marketing of fresh and frozen fruits and vegetables and cherries in brine and providing for collecting damages from any buyer or seller who fails to live up to his contractual obligations."[1] PACA's mechanism for promoting fair trading practices was to establish licensing procedures for participants in the produce industry, thereby providing sellers of produce with certain limited protections. In the early 1980s, Congress judged that the 1930 version of PACA lacked the enforcement provisions necessary to realize PACA's goal of fair trade and practices in the industry, and determined to strengthen these provisions. Congress believed that delayed payment was endemic in the perishable agriculture commodities market, and that there had been numerous instances of outright failure to pay.[2] The amended PACA attempted to solve these problems by impressing a trust upon perishable agricultural commodities that are received by purchasers.[3] Therefore, when a seller sells produce to a buyer (such seller and buyer referred to hereinafter as a "Produce Creditor" and "Produce Debtor," respectively), the produce sold, as well as any receivables or proceeds generated from that produce, is considered to be held in trust until the Produce Creditor is paid for the produce.[4] The amended PACA thereby created a "nonsegregated floating trust made up of all the firm's commodity-related liquid assets, under which there may be a co-mingling of trust assets."[5] The reason for creating this trust mechanism was Congress's perception that when a Produce Debtor went into financial difficulty, its secured creditors (e.g., lenders) were able to move quickly to claim their money, while Produce Creditors were not able to move as quickly, due to the fact that Produce Creditors tend to have less information about Produce Debtors, updated less frequently, than do lenders, and also are often located at a great distance from Produce Debtors.[6] Therefore, by the time a Produce Creditor could discover the Produce Debtor's business difficulties and attempt to retrieve the funds it was owed, the Produce Debtor's assets could already have been dissipated among the other creditors.[7] Under the new system, the produce and its proceeds are held in trust, and these trust assets are frozen until such time as the Produce Creditors have had the opportunity to make a claim on the funds they are due.[8] Other creditors are not able to levy on the trust assets, because the Produce Debtor is not their beneficial owner. By enacting these amendments to PACA, Congress intended to "reduce the difficult burden on commerce" which they believed resulted from the inability of Produce Creditors to collect the debts owed them.[9] Now, a Produce Creditor has the ability to recover money that it is owed even if the money has already been paid to a non-trust creditor, including non-trust creditors with otherwise-superior claims.[10]

In making life easier for Produce Creditors, however, the enactment of these new provisions to PACA in 1983 made life much more difficult for Produce Debtors. The primary difficulty added by these provisions were the new effective restrictions on a Produce Debtor's ability to reorganize when there are PACA claims in existence.

Bankruptcy Implications of PACA

The United States Bankruptcy Code provides a mechanism by which a business suffering from financial difficulties can reorganize in order to operate productively in the future, or, if this is impracticable, by which a systematic, orderly, and fair distribution of a bankrupt company's assets can be ensured. By allowing companies to reorganize through bankruptcy, the hope, in the words of the Supreme Court, is that a company "would continue to provide jobs, to satisfy creditor's claims, and to produce a return for its owners."[11] The Bankruptcy Code thus implicitly recognizes the "going concern" value of a business: a debtor's assets are generally

more valuable if used in a productive business than if broken up and sold piecemeal. The Supreme Court goes on to say that "the reorganization effort would have small chance of success, however, if property essential to running the business were excluded from the estate . . .. Thus, to facilitate the rehabilitation of the debtor's business, all the debtor's property must be included in the reorganization estate."[12]

The problem with PACA is that it prevents Produce Debtors from taking advantage of these fundamental aspects of a reorganization, virtually shutting the door on any possibility of successful reorganization and reemergence as a successful company. This is because under the Bankruptcy Code, property that is considered to be held in trust is excluded from an estate in bankruptcy.[13] As one bankruptcy court put it, "where trust benefits are properly preserved, a debtor merely holds legal title in trust for the sellers. The equitable interest in the property remains outside the estate. . . . Therefore, the beneficial interest in the assets subject to a PACA trust never become property of the estate."[14] Thus, a Produce Creditor, as beneficiary of a PACA trust, is guaranteed that it will be able to levy in full from all assets subject to the trust before any other creditor can look to such assets for payment.[15] The PACA bankruptcy trusts have been "universally recognized" to exclude all trust property from a bankruptcy estate.[16]

Therefore, a produce company which is in financial difficulty, and which has any significant debts covered by PACA (as almost all do, by the nature of their business), has no realistic hope of reorganization under the Bankruptcy Code. Under these PACA rules, not only are all proceeds of sale of the produce included in the trust excluded from the bankruptcy estate, but so are all other properties and assets purchased with such proceeds. Thus, to the extent purchased or paid for with trust funds, a company's trucks, cash, property, and additional produce, as well as other assets, can be excluded from the bankruptcy estate, reachable in the first instance only by the Produce Creditor.[17]

Bankruptcy courts in some jurisdictions have held that this would even allow a Produce Creditor to retrieve money from the employees of a Produce Debtor if the employees' salaries came from trust assets.[18] The inability to reorganize in bankruptcy, or even to guarantee to your employees that they will be able to keep their wages, places produce distributors in a precarious position. However, PACA's anti-commerce provisions extend beyond the bankruptcy realm and provide for the possibility of harsh penalties against individuals within a produce corporation, virtually eliminating the protection from liability normally enjoyed by agents acting within the scope of their employment.

Personal Liability Under PACA

Normally, an agent acting lawfully and in the course of his agency, including an officer or director of a corporation, is not personally liable on contracts he enters into on behalf of his principal/employer. Under PACA, however, an individual officer or director of a Produce Debtor can, in some circumstances, be held personally liable to a Produce Creditor.[19] Therefore, if a produce company is unable to pay its produce debts, and the trust assets remaining in the company or practicably traceable are insufficient to reimburse the Produce Creditors, the Produce Creditors can file suit against individuals within the debtor corporation, in their personal capacities, in an attempt to obtain the money they are owed. In the words of one Federal court, "case law generally holds that an individual in control of PACA trust assets may be liable for failure to preserve the *res* of the trust without regard to whether the failure was intentional or whether the individual was an otherwise responsible corporate officer."[20] This cannot fail to create an enormous disincentive for anyone to manage a produce-distribution company. Under PACA, there is essentially no defense mechanism left for the corporation or for the individuals running the corporation.

Conclusion

As discussed above, all proceeds of sales of produce, which often constitute virtually the entire revenue of a produce company, as well as all property generated from such proceeds, are considered to be held in trust under PACA for the benefit of Produce Creditors, and are therefore excluded from the Produce Debtor's bankruptcy estate. Since the Produce Creditors are not obligated to cooperate with any reorganization plan, and have little incentive to do so, the possibility of a Produce Debtor successfully reorganizing in bankruptcy is effectively non-existent. The Produce Debtor's funds can be distributed among the various Produce Creditors, and if one of them fails to receive all the funds that it is owed, as may often be the case, given that the company cannot (by hypothesis) pay its debts in the first place, then those Produce Creditors can go after the individuals running the corporation. This could in turn force the individuals to file for bankruptcy in an attempt to protect their personal assets. Moreover, as noted earlier, in certain jurisdictions payroll money received by employees of a Produce Debtor can sometimes also be reclaimed by a Produce Creditor. Therefore, all the money made by the individuals within the company, if such money can be shown to come from the trust assets, can possibly be reclaimed by the Produce Creditors. And because it is deemed trust money, these funds could be deemed outside of the bankruptcy estate when the individual files personal bankruptcy as well. Therefore, a situation is created under the current PACA provisions where neither a company, nor an individual officer or director, has any margin for error. In the current state of the produce market and the economy generally, a Produce Debtor has very little margin for error to begin with. PACA reduces that margin until it is close to zero, and makes it very difficult for a Produce Debtor to raise capital, attract and maintain employees, and grow and develop as a corporation over time.

The 1983 amendments to PACA overcompensated for the enforcement problems Congress was attempting to remedy. Far from aiding the produce market, a substantial new burden on commerce has been created by eliminating

virtually all protections for produce distributors. If it is indeed the case that some market failure renders Produce Creditors unable to protect their legitimate claims using the same legal tools available to creditors generally, Congress should consider replacing the trust mechanism and personal liability enacted in 1983 with some more balanced means of protecting Produce Creditors. One potential solution that comes to mind is to make use a form of security interest, either under Article 9 of the Uniform Commercial Code or sui generis, that would place Produce Creditors in the position of secured creditors with respect to the produce they supply, proceeds of its sale, and proceeds of proceeds. That way, Produce Creditors would be put on the same footing as the banks and lenders that Congress originally thought had an unfair advantage, without the perverse consequences of PACA in preventing reorganization and victimizing employees of Produce Debtors.

* Michael Anthony Shaw is an Associate with Luther, Oldenburg & Rainey in Mobile, Alabama.

Footnotes

[1] H.R. Rep. No. 98-543, at 3 (1983), *reprinted in* 1984 U.S.C.C.A.N. 405.
[2] *See id.*
[3] 7 U.S.C. § 499(e)(c); *Middle Mountain Land & Produce, Inc. v. Sound Commodities, Inc.,* 307 F.3d 1220, 1224 (9th Cir. 2002).
[4] 7 U.S.C. § 499e(c)(2).
[5] H.R. Rep. No. 98-543, *supra* note 2, at 5.
[6] *Id.* at 7.
[7] *Id.*
[8] *Id.*
[9] *Tanimura & Antle, Inc. v. Packed Fresh Produce, Inc.,* 222 F.3d 132, 135 (3rd. Cir. 2000).
[10] *C.H. Robinson Company v. Alanco Corp.,* 239 F.3d 483, 486 (2nd Cir. 2001).
[11] *U.S. v. Whiting Pools, Inc.,* 462 U.S. 198, 203 (1983).
[12] *Id.* (internal citations omitted).
[13] 11 U.S.C. § 541.
[14] *See In re Chipwich, Inc.,* 165 B.R. 135, 138 (Bankr. S.D.N.Y. 1994) (internal citations omitted).
[15] *See In re Long John Silver's Restaurants, Inc.,* 230 B.R. 29, 33 (Bankr. D. Del. 1999).
[16] *In re Churchfield,* 277 B.R. 769, 776 (Bankr. E.D. Cal. 2002).
[17] 7 U.S.C. § 499(e)(c); *In re Magic Restaurants, Inc.,* 205 F.3d 108, 111-112 (3rd Cir. 2000).
[18] *See In re Bear Kodiak Produce, Inc.,* 283 B.R. 577, 585-587 (Bankr. D. Ariz. 2002)(citations omitted).
[19] 7 U.S.C. § 499(e)(c); *Red's Market v. Cape Canaveral Cruise Line, Inc.*, 181 F.Supp.2d 1339, 1344-1345 (M.D. Fla. 2002).
[20] *Id.*