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**Secured Lending in the Produce Industry:  
What Every Bank Should Know**

by

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## **Secured Lending in the Produce Industry: What Every Bank Should Know**

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### **INTRODUCTION**

One of the most misunderstood and hotly contested areas of litigation under the Perishable Agricultural Commodities Act<sup>1</sup> (the “PACA”) involves balancing the rights of a secured lender against an unpaid PACA trust beneficiary. A significant contributing factor to the misunderstandings appurtenant to such litigation is the shortage of controlling case law. In an effort to guide litigants through such a dispute, this article provides an explanation of the PACA trust and its limits. Further, this article will introduce and analyze the key decisions addressing the rights of secured lenders and unpaid PACA trust beneficiaries.

The background section of this article will explore the legislative history behind the PACA and it will illustrate and explain the two prong analysis both the courts and the litigants must apply in order to properly determine the scope of the PACA trust. An illustration and explanation of the analytical process a trial court must navigate during its decision making process is also presented. The analysis section presents a discussion of the major Circuit level decisions addressing the priority of secured claims between PACA trust beneficiaries and banks.

The analysis section will further identify and discuss the burdens of proof and defenses appurtenant to any litigation involving the rights of a secured lender and an unpaid PACA trust beneficiary. Finally, the conclusion will provide a guide for secured lenders to utilize during the risk analysis and decision making process they employ prior to extending credit to prospective produce company borrowers. The same will help align the realities of secured lending in the produce industry with the public policies behind the PACA and the common law interpreting the same.

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<sup>1</sup> 7 U.S.C. §§ 499a-499t (2003 & Supp. 2006).

## BACKGROUND

### SUMMARY OF THE PERISHABLE AGRICULTURAL COMMODITIES ACT

Congress enacted the PACA in 1930 to provide a comprehensive scheme for the regulation of traders of fresh fruit and vegetables and:

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 providing for collecting damages from any buyer or seller who fails to live up to his contractual obligations.<sup>2</sup>

Stated another way, the PACA “provides a code of fair play. . . . and an aid to agricultural traders in enforcing their contracts.”<sup>3</sup> The PACA requires produce buyers to make “full payment promptly” for any produce they purchase<sup>4</sup> and gives rise to civil liabilities in favor of the unpaid seller against buyers who fail to make said payments promptly.<sup>5</sup>

In 1984, Congress determined that the increase in nonpayment and delinquent payment by produce buyers threatened the financial stability of the produce industry. Congress recognized that under the prevailing law “sellers of fresh fruits and vegetables [were] unsecured creditors and receive[d] little protection in any suit for recovery of damages where a buyer ha[d] failed to make payment required by the contract.”<sup>6</sup> Specifically, Congress recognized that due to the produce “sellers’ status as unsecured creditors, the [produce] sellers recover, if at all, only after banks and other lenders who have obtained security interests in the defaulting purchaser’s inventories, proceeds and receivables.”<sup>7</sup>

To redress this imbalance, Congress amended the PACA in 1984 to provide further protection to sellers of produce. Specifically, Congress added Section 499e(c) to the PACA to impress a trust in favor of the sellers on the inventories of commodities, the products derived therefrom, and the proceeds of the sale of such commodities and products.<sup>8</sup> Section 499e(c) of PACA provides that:

[p]erishable agricultural commodities received by a commission merchant, dealer, or broker in all transactions, and all inventories if food or other products derived from perishable agricultural commodities, and any receivables or proceeds from the sale of such commodities or products shall be held by such commission merchant, dealer or broker in trust for the benefit of all unpaid

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<sup>2</sup> H. R. Rep. No. 543, 98th Cong. 2d Sess. 3 (1983), reprinted in 1984 U.S.C.C.A.N. 405, 406.

<sup>3</sup> 49 Fed. Reg. at 45737.

<sup>4</sup> 7 U.S.C. § 499b(4).

<sup>5</sup> *Id.* at § 499e(a); *In re Carpenito Bros.*, 46 Agric. Dec. 486 (1987), *aff’d* 851 F.2d 1500 (D.C. Cir. 1988). *See also* *Endico Potatoes v. CIT/Factoring*, 67 F.3d 1063, 1066-67 (2d Cir. 1995).

<sup>6</sup> H. R. Rep. No. 543, 98th Cong. 1 St. Sess. (1983), reprinted in 1984 *U.S. Code Cong. & Admin. News*, 405, 407.

<sup>7</sup> *Endico Potatoes, Inc. v. CIT Group/Factoring, Inc.*, 67 F.3d 1063, 1067 (2d Cir. 1995)(citing *JSG Trading Corp. v. Tray-Wrap, Inc.*, 917 F.2d 75, 77 (2d Cir. 1990) and H. R. Rep. No. 543 at 3 reprinted in 1984 U.S.C.C.A.N. 406 - 407).

<sup>8</sup> H. R. Rep. No. 543, at 4, reprinted in 1984 U.S.C.C.A.N. at 407.

suppliers or sellers of such commodities . . . until full payment of the sums owing in connection with such transactions has been received by such unpaid suppliers, sellers or agents.<sup>9</sup>

This provision imposes an express, non-segregated “floating” statutory trust on the perishable commodities and their derivatives in which a produce buyer as trustee holds its produce-related assets in trust as a fiduciary until the produce buyer makes full payment to the unpaid seller/trust beneficiary.<sup>10</sup> The foregoing trust provision also permits the commingling of trust assets without defeating the trust.<sup>11</sup> Through the PACA trust, the sellers of perishable commodities maintain a right to recover against the purchasers that is superior to all other creditors, including secured creditors.<sup>12</sup>

### SCOPE OF THE TRUST: A Two-Part Analysis

In analyzing the scope of a PACA trust, it is important to note that “[t]rusts created under the PACA are statutory trusts, and common law trust principles are not applicable if they conflict with the language of the statute, the clear intent of Congress in enacting the statute, or the accompanying regulations.”<sup>13</sup> Furthermore, the PACA requires the produce buyer to maintain trust assets so that such assets are freely available to satisfy all outstanding obligations to sellers of produce.<sup>14</sup> Any act or omission which is inconsistent with the buyer’s responsibility to maintain trust assets, including any act which results in the diversion of trust assets or which prejudices the ability of unpaid sellers to recover money owed, is unlawful.<sup>15</sup> “[A] PACA trust in effect imposes liability on a trustee, whether a corporation or a controlling person of that corporation, who uses the trust assets for any purpose other than repayment of the supplier. This includes use of the proceeds from the sale of perishables for legitimate business expenditures, such as payment of rent, payroll, (sic) or utilities.”<sup>16</sup> To this end, the officers of a corporation responsible for its financial dealings are personally liable to PACA trust creditors for any dissipation of the PACA trust assets by virtue of their directing the corporate trustee to breach its fiduciary duties.<sup>17</sup>

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<sup>9</sup> 7 U.S.C. § 499e(c)(2).

<sup>10</sup> *Id.* at § 499e(c); *Frio Ice S.A. v. Sunfruit*, 918 F.2d 154, 156 (11th Cir. 1990).

<sup>11</sup> 7 C.F.R. § 46.46(c).

<sup>12</sup> *Endico Potatoes, Inc. v. CIT Group/Factoring, Inc.*, 67 F.3d 1063, 1067 (11th Cir. 1995) (citing 7 U.S.C. § 499e(c)(1); *Tom Lange Co. v. Lombardo Fruit & Produce Co.*, 12 F.3d 806, 809 (8th Cir. 1993)).

<sup>13</sup> *C.H. Robinson Co. v. Alanco Corp.*, 239 F.3d 483 (2d Cir. 2001).

<sup>14</sup> 7 C.F.R. § 46.46(e).

<sup>15</sup> 7 U.S.C. § 499(b)(4) (emphasis added).

<sup>16</sup> *Morris Okun, Inc. v. Zimmerman*, 814 F.Supp. 346, 349 (S.D.N.Y. 1993) (also holding that “an individual who is *in a position to control* the *trust assets* and who does not preserve them for the beneficiaries has breached a fiduciary duty, and *is personally liable* for that tortious act.”) (emphasis added).

<sup>17</sup> *Sunkist Growers v. Fisher*, 104 F.3d 280, 283 (9th Cir. 1997) (agreeing with prior district court decisions, the Court stated: “individual shareholders, officers, or directors of a corporation who are in a position to control PACA trust assets, and who breach their fiduciary duty to preserve those assets, may be held personally liable under the Act.”);

### *When The Trust Starts*

Generally, the PACA trust commences by operation of law upon the seller's delivery of the produce and continues until the produce buyer makes full payment for the produce.<sup>18</sup> Once delivery of the produce has occurred, failure of the buyer (as trustee) to maintain trust assets sufficient to make full payment promptly to the trust beneficiaries is unlawful.<sup>19</sup> The trust provisions of the PACA are similar to, and based upon, the trust provisions of the Packers and Stockyards Act, 7 U.S.C. §§ 181-229 (1980) (the "PSA"). The courts interpret the trust provisions of both Acts similarly and, therefore, look to the PSA for guidance in interpreting the PACA.<sup>20</sup>

The principal benefit of the trust for a produce seller is that when a buyer fails to pay or becomes insolvent, the seller is placed first in line among creditors to receive the trust *res*, which consists of all assets of the debtor unless and until the debtor proves a particular asset was acquired with something other than the proceeds of the debtor's dealings in produce.<sup>21</sup> The PACA trust *res* serves as a fund from which unpaid produce sellers can be assured payment. By operation of trust law, while a buyer of produce has legal title to the PACA trust *res*, equitable title remains with the seller of the produce.

The initial establishment of the trust occurs upon the commencement of the buyer's buying and selling of produce and exists continuously throughout the life of the buyer's business until all the produce sellers are paid in full.<sup>22</sup> Any assets purchased while the trust is in existence is assumed to be purchased with trust assets and will, therefore, become part of the trust fund available to satisfy the claims of the qualified unpaid sellers.<sup>23</sup> When produce buyers commingle trust assets with funds not subject to the trust, the trust is impressed upon the entire commingled fund for the benefit of the trust beneficiaries.<sup>24</sup> The PACA was designed to insure that a produce buyer's secured lender and other third parties do not receive and retain proceeds from the sale of produce when the debtor's produce suppliers have not been paid. The USDA has recognized that Congress intended unpaid sellers to recover trust assets that are transferred to third parties including secured lenders.<sup>25</sup>

In 1996, the Second Circuit entertained a dispute between a licensed dealer of perishable agricultural commodities and certain unpaid PACA trust beneficiaries, the resolution of which involved analyzing the scope of the PACA trust.<sup>26</sup> At issue in *In re Kornblum & Co.* was whether the PACA trust was in existence in 1986 when the produce buyer/debtor purchased unit shares in the Hunts Pointe Terminal Produce Cooperative Association, thereby making said unit

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<sup>18</sup> 7 C.F.R. § 46.46(d)(1), 7 U.S.C. § 499e(c)(2).

<sup>19</sup> 7 U.S.C. § 499b(4).

<sup>20</sup> See *In re Fresh Approach*, 48 B.R. 926, 931 (Bankr. N.D. Tex. 1985).

<sup>21</sup> *Frio Ice*, 918 F.2d at 156. See *In re Monterey House*, 71 B.R. 244, 249 (Bankr. S.D. Tex. 1986); *Fresh Approach*, 51 B.R. at 420-22.

<sup>22</sup> *In re Kornblum & Co.*, 81 F.3d 280 (2d Cir. 1996) (the trust arises from the date the produce debtor first deals in fresh produce and does not terminate until all trust beneficiaries are paid in full).

<sup>23</sup> *Sanzone-Palismano v. M. Seaman Enterprises*, 986 F.2d 1010, 1013-14 (6th Cir. 1993).

<sup>24</sup> *Id.* at 1013-1014, See also *In re Gotham Provision*, 669 F.2d 1000 (5th Cir. 1982).

<sup>25</sup> 49 Fed. Reg. 45736 (Nov. 20, 1984). See 44 U.S.C. § 1507.

<sup>26</sup> *In re Kornblum & Co.*, 81 F.3d 280 (2d Cir. 1996).

shares PACA trust property from which the unpaid PACA trust beneficiaries are entitled to seek satisfaction of their claims. The produce buyer/debtor filed bankruptcy in 1991 and the unpaid PACA trust beneficiaries filed adversary complaints in 1992, “contending that the [produce buyer/debtor’s] interest in the units constituted property of the statutory trust created for their benefit by PACA and seeking to be paid out of the proceeds from the sale of the units.”<sup>27</sup>

Following the Eighth Circuit’s reading of the PACA,<sup>28</sup> the produce buyer/debtor argued that its Hunts Pointe Terminal units were not PACA trust assets because they were purchased prior to its transactions with any of the unpaid PACA trust beneficiaries and thus cannot be the proceeds of the produce supplied by said unpaid PACA trust beneficiaries.<sup>29</sup> The unpaid PACA trust beneficiaries argued that the *res* of a PACA trust is not so limited.<sup>30</sup>

Specifically, the unpaid PACA trust beneficiaries argued that:

a single PACA trust arises upon the sale of Produce on credit to a Produce Debtor. Upon the occurrence of subsequent sales of Produce to that Produce Debtor on credit, new unpaid Produce suppliers join the undifferentiated pool of trust beneficiaries, and the Produce purchased from these suppliers becomes the property of the single PACA trust. Thus, according to the Creditors, all of the Produce Debtor's Produce (and derivatives or proceeds) are held in a single trust of which all of the Produce Debtor's PACA creditors are beneficiaries. Only when every existing beneficiary has been paid in full does the PACA trust cease to exist and the Produce Debtor become the equitable owner of any remaining trust assets.<sup>31</sup>

Faced with the two competing interpretations of the scope of the PACA trust, the Second Circuit turned to the plain language of § 499e(c)(2). In so doing, the Second Circuit noted that:

§ 499e(c)(2) directs that commodities received . . . in *all transactions*, and *all inventories* of food or other products derived [therefrom], and *any receivables or proceeds* from the sale of such commodities or products, shall be held . . . in trust for the benefit of *all unpaid suppliers or sellers of such commodities or agents involved in the transaction*, until full payment of the sums owing in connection with *such transactions* has been received.<sup>32</sup>

Analyzing the above, the Second Circuit further noted that:

the emphasized language points to a single, undifferentiated trust for the benefit of all sellers or suppliers of Produce except the phrase “involved in the

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<sup>27</sup> *Id.* at 282-83.

<sup>28</sup> *See* Six L's Packing Co. v. West Des Moines State Bank, 967 F.2d 256, 259 (8th Cir. 1992) (indicating that a PACA trust does not include property acquired "before [the PACA beneficiary] first entered into a PACA-qualified transaction with [the Produce Debtor]").

<sup>29</sup> *In re Kornblum & Co.*, 81 F.3d 280, 284 (2d Cir. 1996).

<sup>30</sup> *Id.* at 285.

<sup>31</sup> *Id.*

<sup>32</sup> *Id.* at 286 (emphasis in original).

transaction,” which we do not read as countermanding the clear import of the balance of the statutory language. Rather, we read this phrase as having the meaning, in context, of "involved in any such transaction," thereby harmonizing with the balance of the language in § 499e(c)(2).<sup>33</sup>

Finding ample support in favor of the unpaid PACA trust beneficiaries' broad interpretation of the PACA, the Second Circuit noted that “the regulation promulgated by the Secretary of Agriculture to implement the statutory trust, 7 C.F.R. § 46.46, clearly delineates a single, undifferentiated trust for the benefit of all sellers and suppliers.”<sup>34</sup> Accordingly, the Second Circuit held that “a single PACA trust exists for the benefit of all the sellers to a Produce Debtor, and continues in existence until all of the outstanding beneficiaries have been paid in full.”<sup>35</sup>

In making the aforementioned ruling, the Second Circuit expressly considered “the district court's concern that the Creditors' interpretation of PACA would effectively preclude Produce Debtors ‘from obtaining secured loans on warehouse equipment, furniture, trucks and any other real or personal property.’”<sup>36</sup> To this end, the Second Circuit noted that “this is a legitimate policy consideration that might be advanced in support of an amendment to § 499e(c)(2), but it does not dissuade us from our reading of the statute as presently written.”<sup>37</sup>

The net result of *In re Kornblum & Co.* is that the Second Circuit placed the burden of establishing the existence or non-existence of the PACA trust squarely on the produce buyer/debtor.<sup>38</sup> Therefore, the debtor bears the burden of proving that:

- (1) no PACA trust existed when the [asset(s) at issue] was purchased;<sup>39</sup>
- (2) even though the PACA trust existed at that time, the [asset(s) at issue] was not purchased with trust assets, or;
- (3) although a PACA trust existed when the [asset(s) at issue] was purchased and the [asset(s) at issue] was purchased with PACA trust assets, the debtor thereafter paid all suppliers in full prior to the transactions involving the [unpaid PACA trust beneficiaries] thereby terminating the trust.<sup>40</sup>

As the Second Circuit clearly recognized, only after the produce buyer/debtor pays all the unpaid PACA trust beneficiaries in full can there be any distribution of the produce buyer/debtors' assets to other creditors, including secured lenders, where the failed entity derived all of its assets from transactions in produce.

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<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

<sup>36</sup> See *supra* note 3 (citing *Kornblum II*, 177 Bankr. at 192).

<sup>37</sup> *Kornblum*, 81 F.3d at 284.

<sup>38</sup> *Id.* at 287.

<sup>39</sup> See also *Driscoll Potatoes, Inc. v. Robinson Potato Supply Co.*, 1 F.Supp.2d 1268, 1271 (D. Kan. 1998) (recognizing that the fact that no account is delinquent is immaterial; a PACA trust is presumed to exist unless the PACA buyer has no outstanding invoices on its books.).

<sup>40</sup> *Kornblum*, 81 F.3d at 287 (2d Cir. 1996).

### *What Assets Are In Trust? (No Tracing Required)*

Under the express language of the PACA statute, the trust is composed of the:

[p]erishable agricultural commodities received by . . . [the debtor] in all transactions, and all inventories of food or other products derived from perishable agricultural commodities, and any receivables or proceeds from the sale of such commodities or products.<sup>41</sup>

The House Report that accompanied the legislation stated as follows:

[t]he trust impressed by section 5(c)(2) is a nonsegregated “floating trust” made up of all a firm's commodity related liquid assets, under which there may be commingling of trust assets. Under this provision there is no necessity to specifically identify all of the trust assets through each step of the accrual and disposal process. Since commingling is contemplated, all trust assets would be subject to the claims of unpaid suppliers. . . . to the extent of the amount owed to them.<sup>42</sup>

The *Atlantic Tropical Market* Court considered this legislative history when it correctly found the only role tracing plays in a PACA situation is where the debtor-purchaser has superior knowledge of the origin of the funds used to acquire each of its assets.<sup>43</sup> Due to it having such superior access to the facts, Congress placed on the produce debtor the burden to “track the status of the trust fund and to provide evidence of other origin of purchases of assets.”<sup>44</sup> Further illustrating the importance of superior access to the proof, the U.S. Supreme Court held that “[p]resumptions shifting the burden of proof are often created to reflect judicial evaluations of probabilities and to conform with a party’s superior access to the proof.”<sup>45</sup>

*The Sanzone-Palmisano Co.*, Court recognized “that in most cases it will be virtually impossible for a PACA debtor to trace the origin of the disputed assets. . . . [w]e believe that this is the outcome that Congress intended.”<sup>46</sup> In *Sanzone-Palmisano Co.*, after finding the produce supplier had established the validity of its PACA trust interest, the Sixth Circuit remanded to the district court with instructions, stating it was the Debtor’s burden to “prove which seized assets

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<sup>41</sup> 7 U.S.C. § 499e(c)(2) (1986 & Supp. 1998).

<sup>42</sup> H.R. Rep. 98-543, at 5, 1984 U.S. Code Cong. & Admin. News 407, 409 (emphasis added). See *In re Atlantic Tropical Market*, 118 B.R. 139, 142 (Bankr. S.D. Fla. 1990); *In re Richmond Produce*, 112 B.R. 364, 368 (N.D. Cal. 1990) (“[t]he unpaid sellers are not required to trace and the trust arises immediately upon delivery.”).

<sup>43</sup> *In re Atlantic Tropical Market*, 118 B.R. 139, 142 (Bankr. S.D. Fla. 1990).

<sup>44</sup> *Id.* (citing *In re Al Nagelberg & Co.*, 84 B.R. 19 (S.D.N.Y. 1988); *In re Fresh Approach*, 51 B.R. 412, 422 (Bankr. N.D. Tex. 1985) (“[s]hould a dispute arise, it will be the Debtor's burden to establish which, if any, assets are not subject to the PACA trust.”); *In re N. Merberg & Sons*, 166 B.R. 567, 570 (Bankr. S.D.N.Y. 1994); *In re: Milton Poulos, Inc.*, 94 B.R. 648, 652-53 (Bankr. C.D. Cal. 1988), *aff'd* 107 B.R. 715 (9th Cir. BAP 1989) (“the debtor or bankruptcy trustee, rather than the trust beneficiary, is responsible for determining which assets, if any, are not subject to the trust.”)); *See Six L's Packing v. West Des Moines State Bank*, 967 F.2d 256, 258 (8th Cir. 1992) (“the burden is on the PACA debtor... to show that the disputed [asset] is from a non-trust source”).

<sup>45</sup> *International Brotherhood of Teamsters v. United States*, 431 U.S. 324, 359 n. 45 (1977).

<sup>46</sup> *Sanzone-Palimano v. M. Seaman Enterprises*, 986 F.2d 1010, 1013-14 (6th Cir. 1993) (emphasis added).

were not purchased with funds from the sale of produce.”<sup>47</sup> In fact, the Sixth Circuit unequivocally stated “[a]ll of the seized assets that cannot be traced to a non-trust source [by the Debtor] are part of the trust *res* and are subject to [supplier's] trust claim.”<sup>48</sup>

### *No Per Se Exemptions From the PACA Trust*

In 1999, the U.S. Bankruptcy Court for the Western District of Pennsylvania applied the aforementioned two prong analysis to resolve the issue of whether the scope of the PACA trust included the debtor’s vehicles and equipment.<sup>49</sup> Resolving this case in favor of the secured lender, the *In re United Fruit & Produce* Court held that:

[a]lthough the PACA language imposing a trust is powerful and invasive, it imposes a trust only upon a limited and defined collateral. The corpus of the trust consists of the produce, inventories of food or other products derived from the produce and any receivables or proceeds from their sale. It does not include vehicles and equipment.<sup>50</sup>

In so holding, the *In re United Fruit & Produce* court reasoned that “the intent of PACA is not violated by recognition of the liens of [secured lenders] who provide purchase money financing to enable the Debtor to purchase equipment for business use and take a security interest in solely the vehicles or equipment for which they provide financing.”<sup>51</sup> From a public policy standpoint, the court recognized the necessity to “balance the public's interest in preserving the stability of commercial transactions with the interests of the PACA trust beneficiaries in assuring that sufficient funds are maintained in the trust.”<sup>52</sup>

*In re United Fruit & Produce* does not establish a black letter rule making the produce debtor’s vehicles and equipment *per se* exempt from a PACA trust. To the contrary, the *In re United Fruit & Produce* court based its holding upon the fact that the produce debtor utilized funds borrowed from its bank to purchase the vehicles and equipment. As a result, the trial court found that the produce buyer/debtor did not purchase its vehicles and equipment with PACA trust assets or any proceeds derived from such assets.

In 2002, the U.S. Bankruptcy Court for the District of Arizona similarly addressed the issue of whether the scope of the PACA trust included a debtor’s equipment.<sup>53</sup> To this end, the *In re Bear Kodiak* court refused to follow the holding in *In re United Fruit & Produce* and recognized that it “has found no case authority which supports the [secured lender’s] claims that certain types of assets are exempt from a PACA trust simply because of the character of the

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<sup>47</sup> *Id.* at 1014.

<sup>48</sup> *Id.* (emphasis added). See also *Tony Vitrano Company v. National Produce*, 815 F. Supp. 23 (D.D.C. 1993).

<sup>49</sup> *In re United Fruit & Produce Co.*, 242 B.R. 295 (W.D. Pa. 1999).

<sup>50</sup> *Id.* at 301-302; See also *Chiquita Brands Company North America, Inc. v. J&J Foods, Inc.*, 2004 U.S. Dist. LEXIS 22847 at 32 (E.D. Pa. 2004) (following the reasoning in *In re United Fruit & Produce Co.* and holding that real property itself does not fall within the statutory definition of a PACA trust asset.).

<sup>51</sup> *Id.* at 302. (emphasis added).

<sup>52</sup> *Id.*

<sup>53</sup> *In re Bear Kodiak Produce, Inc.*, 283 B.R. 577 (Dist. AZ 2002) (holding that the debtor’s equipment was part of the PACA trust and thus available to the PACA creditors in satisfaction of their claims).

asset.”<sup>54</sup> The *In re Bear Kodiak* Court further noted that it “agree[ed] with the rationale evinced by the Second Circuit in *Kornblum*”<sup>55</sup> and expressly adopted the holding in *Kornblum* that:

the assets of a PACA buyer are presumed to be part of a PACA trust unless it is shown that: (1) no PACA trust existed when the asset in question was purchased; or (2) the asset was not purchased with PACA trust assets; or (3) subsequent to purchasing the asset, the buyer paid in full all suppliers, thereby terminating the trust.<sup>56</sup>

After correctly noting that the burden of proof is on the party opposing a claim that the debtor’s assets are subject to the PACA trust,<sup>57</sup> the *In re Bear Kodiak* Court noted that the secured lender failed to introduce any documentary evidence in support of its allegations that the equipment at issue was not subject to the PACA trust and relied exclusively on the declaration and testimony of the debtor’s principal.<sup>58</sup> As a result, the court ultimately determined that the secured lender failed to satisfy its burden of proof and allowed the PACA trust beneficiaries to utilize the proceeds from the sale of the debtor’s equipment to satisfy their claims ahead of the secured lender.

## BALANCING THE RIGHTS OF A SECURED LENDER AND AN UNPAID PACATRUST BENEFICIARY

In many cases, the U.S. District and Bankruptcy Courts face the responsibility of resolving hotly contested litigation wherein a secured creditor is claiming the corpus of a PACA trust ahead of the trust's beneficiaries. The foregoing dispute falls squarely within the scope of the statute because it is the exact “wrong” which Congress sought to remedy by enacting the PACA and its amendments. However, the resolution of such an issue, and thus the balancing of the rights of a secured lender and an unpaid PACA trust beneficiary, requires a trial court to interpret the PACA and apply non-conflicting principles of trust law.

### *Statutory Interpretation*

In interpreting a statute, we begin with “the language of the statute itself.”<sup>59</sup> Where the terms of a statute are unambiguous, the judicial inquiry is complete, except “in rare and exceptional circumstances.”<sup>60</sup> Further, a court should only reject the plain meaning of a statute if

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<sup>54</sup> *Id.* at 582.

<sup>55</sup> *Id.*

<sup>56</sup> *Id.* at 583.

<sup>57</sup> *Id.* (citing *Sanzone-Palmisano Company v. M. Seaman Enterprises, Inc.*, 986 F.2d 1010, 1014 (6th Cir. 1993)).

<sup>58</sup> *Id.*

<sup>59</sup> *In re Kornblum & Co.*, 81 F.3d 280, 285 (2d Cir. 1996) (quoting *Consumer Prod. Safety Comm'n v. GTE Sylvania*, 447 U.S. 102, 108 (1980); *See United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 241, 109 S.Ct. 1026, 1030, 103 L. Ed. 2d 290 (1989); *Matala v. Consolidated Coal Co.*, 647 F.2d 427, 429 (4th Cir. 1981) (stating the basic principles of statutory interpretation and applying them to §§ 203(b)(3) of the Federal Coal Mine Health and Safety Act of 1964). *See also* *Buckeye Production Credit Association v. Farm Credit Administration*, 787 F. Supp. 578, 1992 W.L. 57606, 10 n.18 (E.D. Va. 1992) (noting, in interpreting the Farm Credit Act, that “the best and most reliable indication of legislative intent is the statutory language itself”).

<sup>60</sup> *See* *Rubin v. United States*, 449 U.S. 424, 430, 101 S.Ct. 698, 701, 66 L. Ed. 2d 633 (1981) (quoting *Tennessee Valley Authority v. Hill*, 437 U.S. 153, 187 n.33, 98 S.Ct. 2279, 2298, 57 L. Ed. 2d 117 n.33 (1978)). *See also* *Ron Pair Enterprises*, 489 U.S. at 242, 109 S.Ct. at 1031 (plain meaning of legislation conclusive except in rare

there is substantial evidence supporting a contrary interpretation.<sup>61</sup> For purposes of statutory interpretation, courts presume the words of a statute are to be used according to their ordinary meaning unless a different use is clearly indicated.<sup>62</sup>

As noted above, the PACA and its amendments serve to “provide suppliers and sellers of fruits and vegetables, or their agents, [with] a self-help tool that will enable them to protect themselves against the abnormal risk of losses resulting from slow-pay and no-pay practices by buyers or receivers of fruits and vegetables.”<sup>63</sup> To this end, Congress clearly set forth the legislative intent of the PACA within the statute as follows:

“[i]t is hereby found that a burden on commerce in perishable agricultural commodities is caused by financing arrangements under which [produce debtors] who have not made payment for perishable agricultural commodities purchased. . . . encumber or give lenders a security interest in, such commodities, or. . . . any receivables or proceeds from the sale of such commodities or products, and that such arrangements are contrary to the public interest. This subsection is intended to remedy such burden on commerce in perishable agricultural commodities and to protect the public interest.”<sup>64</sup>

As illustrated above, Congress made very clear that PACA is a remedial statute where it expressly stated “[t]his subsection is intended to remedy such burden on commerce in perishable agricultural commodities and to protect the public interest.”<sup>65</sup> Under general jurisprudence, it is well settled that “[r]emedial legislation should be given a liberal construction to effectuate its statutory purpose.”<sup>66</sup> Also, “the fact that a statute can be ‘applied in situations not expressly anticipated by Congress does not demonstrate ambiguity. It demonstrates breadth.’”<sup>67</sup>

### *Key Trust Principles*

In addition to statutory interpretation, a trial court must also consider ordinary trust principles in order to balance the rights of a secured lender and an unpaid PACA trust beneficiary. The following are key trust principles the trial courts must often consider and apply:

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circumstances where literal application of a statute would lead to a result demonstrably at odds with congressional intent); *Griffin v. Oceanic Contractors, Inc.*, 458 U.S. 564, 571, 102 S.Ct. 3245, 3250, 73 L. Ed. 2d 973 (1982); *In re Forfeiture Hearings as to Caplin & Drysdale, Chartered*, 837 F.2d 637, 641 (4th Cir. 1988) (where a statute's language is unambiguous, court's task of statutory construction ends unless enforcement of statutory language would contravene clearly expressed legislative intent); *Hoechst Aktiengesellschaft v. Quigg*, 917 F.2d 522, 526 (Fed. Cir. 1990)

<sup>61</sup> *Matala*, 647 F.2d at 430. *See also* *Ford Motor Credit Co. v. Cenance*, 452 U.S. 155, 158 n.3, 101 S.Ct. 2239, 2241, 68 L. Ed. 2d 744 n.3 (1981) (“Absent a clear indication of legislative intent to the contrary, the statutory language controls its construction.”).

<sup>62</sup> *Matala*, 647 F.2d at 429.

<sup>63</sup> 49 Fed. Reg. 45, 735, 45, 737 (1984).

<sup>64</sup> 7 U.S.C. § 499e(c)(1) (emphasis added).

<sup>65</sup> *Id.* (emphasis added).

<sup>66</sup> *Hull Co. v. Hauser Foods*, 924 F.2d 777, 782 (8th Cir. 1991); *See* *Tcherepnin v. Knight* 389 U.S. 332, 336 (1967); *International Nutrition v. U.S. Department of Health*, 676 F.2d 338, 341(8th Cir. 1982).

<sup>67</sup> *Pennsylvania Dept. of Corrections v. Yeskey*, 524 U.S. 206, 212 118 S.Ct. 1952, 1956 (1998) (quoting *Sedima S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 499, 105 S.Ct. 3275 (1985)).

### Definition of a Trust

A trust, as the term is used in the Restatement of this Subject, when not qualified by the word ‘charitable,’ ‘resulting,’ or ‘constructive,’ is a fiduciary relationship with respect to property, subjecting the person by whom the title to the property is held to equitable duties to deal with the property for the benefit of another person, which arises as a result of a manifestation of an intention to create it.<sup>68</sup>

### Bona Fide Purchaser

- (1) If the trustee in breach of trust transfers trust property to, or creates a legal interest in the subject matter of the trust in, a person who takes for value and without notice of the breach of trust, and who is not knowingly taking part in an illegal transaction, the latter holds the interest so transferred or created free of the trust, and is under no liability to the beneficiary.
- (2) In the Restatement of this Subject such a transferee is called a ‘bona fide purchaser.’<sup>69</sup>

### Notice of Existence of Trust

If the trustee transfers trust property in breach of trust to a transferee for value, the transferee takes free of the trust although he has notice of the existence of the trust, unless he has notice that the trustee is committing a breach of trust in making the transfer.<sup>70</sup>

### What Constitutes Notice of Breach of Trust

A person has notice of a breach of trust if

- (a) he knows or should know of the breach of trust, or
- (b) by statute or otherwise he is subjected to the same liabilities as though he knew or should have known of the breach of trust, even though in fact he did not know and had no reason to know of the breach of trust.<sup>71</sup>

### Present Value

If money is paid or other property is transferred or services are rendered as consideration for the transfer of trust property, the transfer is for value.<sup>72</sup>

### Satisfaction of Antecedent Debt as Value

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<sup>68</sup> Restatement (Second) of Trusts § 2 (1959).

<sup>69</sup> *Id.* at § 284.

<sup>70</sup> *Id.* at § 296.

<sup>71</sup> *Id.* at § 297.

<sup>72</sup> *Id.* at § 298.

- (1) Except as stated in Subsections (2) and (3), if the trustee transfers trust property in consideration of the extinguishment of a pre-existing debt or other obligation, the transfer is not for value.
- (2) If the trustee transfers trust property in consideration of the extinguishment in whole or in part of a pre-existing debt or other obligation, the transfer is for value if
  - (a) the trust property transferred is a negotiable instrument or money, or
  - (b) the transferee held security for the debt or other obligation and surrendered the security, or
  - (c) there has been such a change of circumstances that it would be inequitable to deprive the transferee of the property although the debt or other obligation were revived.
- (3) If the trustee transfers trust property in consideration both of the extinguishment of a pre-existing debt or other obligation and of the payment of money or transfer of other property or the rendition or services, the transfer is for value.<sup>73</sup>

## ANALYSIS

As illustrated below, the interpretation of PACA and the balancing of the rights of a secured lender against an unpaid PACA trust beneficiary is a relatively complex and fact intensive process. Notwithstanding, it appears that the Second and Third Circuits have considered the foregoing issue more often than any other Circuit, and their decisions form the basis for almost every subsequent court decision on this issue since 1995.

### *Second Circuit*

In 1995, the Second Circuit resolved a dispute between certain unpaid PACA trust beneficiaries and a secured lender that financed the operations of a licensed dealer in perishable agricultural commodities.<sup>74</sup> At issue in *Endico Potatoes* was the trust law principle that “a bona fide purchaser of trust assets receives the assets free of any claim by the trust beneficiaries.”<sup>75</sup>

In *Endico Potatoes*, a secured lender and a licensed dealer in perishable agricultural commodities entered into an Accounts Receivable Financing Agreement.<sup>76</sup> Under this agreement, the secured lender made loans and advances to the produce buyer on a revolving basis.<sup>77</sup> As security for the same, the produce buyer granted the secured lender a continuing lien and security interest in all of the produce buyer’s equipment, inventory, accounts receivable and related assets.<sup>78</sup> When the produce buyer filed for bankruptcy the secured lender, based on its Accounts Receivable Financing Agreement, claimed the corpus of a PACA trust ahead of the trust’s beneficiaries. This dispute set the stage for the Second Circuit to address the issue of

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<sup>73</sup> *Id.* at § 304.

<sup>74</sup> *Endico Potatoes, Inc. v. Cit Group/Factoring, Inc.*, 67 F.3d 1063, 1065 (2d Cir. 1995).

<sup>75</sup> *Id.* at 1068.

<sup>76</sup> *Id.*

<sup>77</sup> *Id.*

<sup>78</sup> *Id.*

whether the produce buyer's assignment of its accounts receivable to the secured lender and the secured lender's loan advances to the produce buyer constitutes a purchase for value or whether the exchange provided the secured lender with nothing more than a security interest in the same.<sup>79</sup>

Upon consideration of both the PACA and the Restatement (Second) of Trusts § 284 and § 298, the Second Circuit held that the secured lender must demonstrate that:

- (1) it obtained its interest in the [produce debtor's] accounts receivable for value;
- (2) without notice that the transfer was in breach of the trust, and;
- (3) in good faith.<sup>80</sup>

With the aforementioned burden of proof in mind, the Second Circuit analyzed the substance of the relationship between the secured lender and the defunct produce buyer. The Second Circuit's analysis involved the following factors:

- (1) the right of the [secured lender] to recover from the [produce buyer] any deficiency if the assets assigned are not sufficient to satisfy the debt;
- (2) the effect on the [secured lender's] right to the assets assigned if the [produce buyer] were to pay the debt from independent funds;
- (3) whether the [produce buyer] has a right to any funds recovered from the sale of assets above that necessary to satisfy the debt, and;
- (4) whether the assignment itself reduces the debt.<sup>81</sup>

Before applying this test to the facts in *Endico Potatoes*, the Second Circuit recognized that at the root of all the aforementioned factors is the transfer of risk<sup>82</sup> and held that:

[w]here the lender has *purchased* the accounts receivable, the borrower's debt is extinguished and the lender's risk with regard to the performance of the accounts is direct, that is, the lender and not the borrower bears the risk of non-performance by the account debtor. If the lender holds only a security interest, however, the lender's risk is derivative or secondary, that is, the borrower remains liable for the debt and bears the risk of non-payment by the account debtor, while the lender only bears the risk that the account debtor's non-payment will leave the borrower unable to satisfy the loan.<sup>83</sup>

After applying the aforementioned test, the Second Circuit, *inter alia*, found that the primary risk of the produce buyer's customer's non-payment of the receivables at all times remained on the

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<sup>79</sup> *Id.*

<sup>80</sup> *Id.*

<sup>81</sup> *Id.* at 1068 - 69 (citing *Major's Furniture Mart, Inc. v. Castle Credit Corp.*, 602 F.2d 538, 543-46 (3d Cir. 1979); *Levin v. City Trust Co.*, 482 F.2d 937, 940 (2d Cir. 1973); *Hassett v. Sprague Electric Co.*, 30 Bankr. 642, 647-48 (Bankr. S.D.N.Y. 1983); *In re Evergreen Valley Resort, Inc.*, 23 Bankr. 659, 660-61 (Bankr. D. Me. 1982).

<sup>82</sup> *Id.* at 1069.

<sup>83</sup> *Id.*

produce buyer and the assignment alone did not reduce the produce buyer's obligations to the secured lender.<sup>84</sup> Accordingly, the Second Circuit held that the secured lender did not obtain any interest in the produce debtor's accounts receivable in exchange for value, but only held a security interest in those accounts. Therefore, the secured lender's security interest was subordinate to the rights of the unpaid PACA trust beneficiaries.<sup>85</sup>

In conclusion, the *Endico Potatoes* Court set forth the proper analytical process for the trial court's determination of whether a secured lender qualifies as a bona fide purchaser of trust assets and is thus entitled to receive said assets free of any claim by the trust beneficiaries. Again, the key to the aforementioned analysis is the transfer of risk from the borrower/produce buyer to the secured lender.<sup>86</sup>

### *Third Circuit*

In 1994, the Third Circuit addressed the bona fide purchaser defense as defined in the Restatement (Second) of Trusts.<sup>87</sup> In so doing, it clarified the difference between a secured lender's receipt of PACA trust assets in the ordinary course of business and a secured lender's seizure of PACA trust assets through the enforcement of a security agreement.

In *Consumers Produce*, the secured lender provided a term loan for the purchase of the debtor's business, which was a produce dealer subject to the provisions of PACA. The secured lender also provided the debtor with a line of credit for short-term working capital needs.<sup>88</sup> Importantly, the term loan and the line of credit were secured by a first priority lien against the debtor's assets, including real property, all attachments thereto, all equipment, vehicles, furniture, fixtures and intangibles, and all accounts, contract rights, and inventory.<sup>89</sup> Stated another way, the secured lender's security interest in the debtor included those assets subject to the PACA trust.<sup>90</sup> From Spring of 1988 until September 14, 1990, the debtor made principal and interest payments to the secured lender on both the term loan and the line of credit in the ordinary course of business.<sup>91</sup>

When the debtor went out of business in October of 1990, the trial court appointed a trustee to collect the debtor's accounts receivable and otherwise marshal the PACA trust assets.<sup>92</sup> Once it was determined that a significant shortfall in the debtor's ability to fully satisfy its PACA creditors existed, the PACA creditors sued the secured lender seeking to disgorge the debtor's prior loan payments to the secured lender. To this end, the secured lender employed the bona fide purchaser defense and further claimed that it took all payments without notice of the

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<sup>84</sup> *Id.*

<sup>85</sup> *Id.*

<sup>86</sup> *See also*, *A&J Produce Corp. v. Bronx Overall Economic Development Corp.*, 2008 U.S. App. LEXIS 19348 (2d Cir. 2008) (following *Endico Potatoes, Inc. v. Cit Group/Factoring, Inc.*, 67 F.3d 1063 (2d Cir. 1995)).

<sup>87</sup> *Consumers Produce Co. v. Volante Wholesale Produce*, 16 F.3d 1374 (3d Cir. 1994).

<sup>88</sup> *Id.* at 1378.

<sup>89</sup> *Id.*

<sup>90</sup> *Id.*

<sup>91</sup> *Id.*

<sup>92</sup> *Id.*

debtor's breach of trust.<sup>93</sup> In order to balance the rights of the secured lender against the unpaid PACA trust beneficiary, the Third Circuit addressed each issue in turn.

### **Bona Fide Purchaser Defense**

First, the *Consumers Produce* Court applied ordinary trust principles as it addressed the secured lender's bona fide purchaser defense. The bona fide purchaser defense is defined by the Restatement (Second) of Trusts as follows:

#### Bona Fide Purchaser

- (1) If the trustee in breach of trust transfers trust property to, or creates a legal interest in the subject matter of the trust in, a person who takes for value and without notice of the breach of trust, and who is not knowingly taking part in an illegal transaction, the latter holds the interest so transferred or created free of the trust, and is under no liability to the beneficiary.
- (2) In the Restatement of this Subject such a transferee is called a 'bona fide purchaser.'<sup>94</sup>

In its analysis, the Third Circuit noted that "the transfer of trust assets in satisfaction of a pre-existing debt is normally not for value; however, an exception exists where the trust property transferred is a negotiable instrument or money. This exception arises from the necessity 'for practical business transactions that the payee of money in due course of business shall not be put upon inquiry at his peril as to the title of the payor.'"<sup>95</sup> Armed with the foregoing, the Third Circuit ultimately found that the secured lender received the PACA trust assets at issue in the ordinary course of business as monetary loan repayments, thus the transfers were for value.<sup>96</sup> In so holding, the Third Circuit expressly noted that:

[w]hile loan repayments in the ordinary course of business are "for value," we note that when secured lenders use their security agreement to foreclose on property or otherwise enforce their contractual rights, they essentially force the transfer of trust property in satisfaction of an antecedent debt. Any such transfer, including transfers of negotiable instruments and money, through the exercise of rights under a security agreement is not for value. Most trust assets such as inventory or accounts receivable will be converted to money before being transferred. To hold otherwise would essentially permit secured creditors to "trump" unpaid beneficiaries of PACA trusts by simply enforcing their security agreement outside of the formalities of bankruptcy.<sup>97</sup>

Stated another way, the Third Circuit held that "the 'for value' portion of the bona fide purchaser standard only protects secured lenders who receive PACA trust assets in the ordinary

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<sup>93</sup> *Id.*

<sup>94</sup> Restatement (Second) of Trusts § 284 (1959).

<sup>95</sup> *Consumers Produce Co.*, 16 F.3d at 1380 (citing Restatement (Second) of Trusts § 304 (1959)).

<sup>96</sup> *Id.*

<sup>97</sup> *Id.* (citing *C.H. Robinson Co. v. Trust Co. Bank, N.A.*, 952 F.2d 1311, 1315 (11th Cir. 1992)).

course of business. Lenders who seize PACA trust assets through the enforcement of a security agreement will *not* be protected by the bona fide purchaser defense because such a transfer will not be ‘for value.’”<sup>98</sup> The Third Circuit further held that, “[a]pplying the ‘for value’ portion of the bona fide purchaser defense thus complies with the PACA statute’s legislative finding that secured financing arrangements involving PACA trust assets are a burden on commerce. The defense protects unpaid suppliers from the seizure of PACA trust assets by secured lenders while maintaining ordinary credit relations that provide liquidity to the produce industry.”<sup>99</sup>

### Notice of Breach

Lastly, the Third Circuit addressed the issue of whether the secured lender accepted the debtor’s loan payments with notice of the debtor’s breach of trust.<sup>100</sup> To this end, courts have repeatedly stated that all potential transferees have constructive knowledge of the PACA trust because it was created by a federal statute.<sup>101</sup> This fact is even recited in the PACA’s legislative history wherein it states “[t]he Committee believes that the statutory trust requirements will not be a burden to the lending institutions. **They will be known to and considered by the prospective lenders in extending credit.**”<sup>102</sup>

Notwithstanding the above, the Third Circuit recognized that “the PACA statute provides secured lenders with notice of the statutory trust, not notice of the breach of the trust by a PACA trustee.”<sup>103</sup> In addition, it is *notice of the breach of trust* that is required for liability to attach under traditional trust law.<sup>104</sup> The appropriate legal standard for determining whether a lender with a security interest in PACA trust assets has notice that a produce purchaser is breaching the PACA trust by making its loan payments in the ordinary course of business is set forth in the Restatement (Second) of Trusts § 297(a)<sup>105</sup>, as follows: “[a] person has notice of a breach of trust if (a) he knows or should know of the breach of trust.”<sup>106</sup> The test for determining whether the secured lender knew or should have known of the debtor’s breach of trust is similarly found in the Restatement (Second) of Trusts. Under the Restatement (Second) of Trusts:

[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

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<sup>98</sup> *Id.* (emphasis added).

<sup>99</sup> *Id.*

<sup>100</sup> *Consumers Produce Co.*, 16 F.3d at 1380 (referencing Restatement (Second) of Trusts § 304 (1959)).

<sup>101</sup> *See, e.g., C.H. Robinson Co.*, 952 F.2d at 1315; *In re Gotham Provision*, 669 F.2d at 1011 *cert. denied* 459 U.S. 858 (1982).

<sup>102</sup> H.R. Rep. No. 543, 98th Cong., 2d Sess. 4 (1983), *reprinted in* 1984 U.S. Code Cong. & Admin. News 405, 407 (emphasis added); *C.H. Robinson Co.*, 952 F.2d at 1315.

<sup>103</sup> *Consumers Produce Co.*, 16 F.3d at 1381 (citing *C.H. Robinson Co. v. Trust Co. Bank, N.A.*, 952 F.2d 1311 (11th Cir. 1992)).

<sup>104</sup> *Id.* (citing Restatement (Second) of Trusts § 304 (1959) (emphasis added)).

<sup>105</sup> *Id.* at 1382.

<sup>106</sup> Restatement (Second) of Trusts § 297(a).

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.<sup>107</sup>

Simply put, “a duty of inquiry arises when a person knows facts which under the circumstances suggest (1) that the person is dealing with a trustee and (2) that the trustee may be committing a breach of trust. If a duty of inquiry exists, and such inquiry would have disclosed the breach of trust, a person ‘should have known’ of the breach of trust. The existence and the extent of a duty of inquiry depend on the character of the transaction and the character of the trust property. In the PACA context, a duty of inquiry arises when a [secured lender] has knowledge that a produce purchaser/trustee is not paying produce suppliers or is in financial difficulty.”<sup>108</sup>

The Third Circuit charged the secured lender with the burden of proving it was a bona fide purchaser with respect to the loan payments received from the debtor during the period in question.<sup>109</sup> This burden necessarily includes whether the secured lender possessed notice of the debtor’s breach of trust under the aforementioned duty of inquiry analysis. To this end, the secured lender in *Consumers Produce* satisfied its burden of proof through proffering evidence that, *inter alia*, it performed a detailed review of the debtor’s financials – borrowing base certificates, accounts receivable summaries, account aging reports, quarterly financial statements, annual financial statements prepared and reviewed by independent certified public accountants - prior to extending loans and credit.<sup>110</sup> Based on the secured lender’s proffer, the Third Circuit affirmed the district court’s finding that the secured lender undertook a reasonable inquiry into the debtor’s financial condition and the same did not disclose the debtor’s breach of trust.<sup>111</sup> Therefore, the secured lender was found to be “a bona fide purchaser for value and discharged its burden of showing that it was without notice of the breach of the PACA trust by the [debtor] in relation to the loan repayments made in the ordinary course of business. As such, [secured lender was] not required to disgorge the loan payments received in breach of the PACA trust.”<sup>112</sup>

## CONCLUSION

In light of the foregoing points and authorities, a bank would be well advised to carefully perform its due diligence when assessing the risk associated with providing financing to produce companies. Specifically, a secured lender must understand that it is dealing with a trustee and take care not to extend credit in exchange for an illusory first lien holder position. To guard against the same, secured lenders should inquire into and otherwise analyze two key areas prior to extending loans and credit to a produce company.

First, the secured lender must examine the proposed collateral to ensure that it is not trust property. This analysis requires the application of the *In re Kornblum & Co.* test, wherein the produce company must show the secured lender that: (1) no PACA trust existed when the asset

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<sup>107</sup> *Consumers Produce Co.*, 16 F.3d at 1383 (citing Restatement (Second) of Trusts § 297 comment a 1959) (emphasis in original)).

<sup>108</sup> *Id.*

<sup>109</sup> *Id.* at 1383.

<sup>110</sup> *Id.*

<sup>111</sup> *Id.* at 1385.

<sup>112</sup> *Id.*

in question was purchased; or (2) the asset was not purchased with PACA trust assets; or (3) subsequent to purchasing the asset, the buyer paid in full all suppliers, thereby terminating the trust. The due diligence required to perform the aforementioned test will allow a secured lender to know whether it may claim a first lien holder position in the proposed collateral ahead of an unpaid PACA trust beneficiary.

Secondly, the secured lender must also make a reasonable inquiry into the prospective borrower's financial position. The purpose of this inquiry is to discover the existence of a breach of trust that may defeat the secured lender's ability to protect any and all loan payments it expects to receive in the ordinary course of business moving forward. The issue here is whether a lender with a security interest in PACA trust assets – accounts receivable, inventory, equipment, real estate, etc. - has notice that a produce purchaser is breaching the PACA trust by making its loan payments in the ordinary course of business. Simply put, the test is whether the secured lender knew or should have known of the debtor's breach of trust.

The secured lender in *Consumers Produce* satisfied its burden of proving that it neither knew nor should have known of the debtor's breach of trust through submitting evidence that it performed a detailed review of the debtor's financials – borrowing base certificates, accounts receivable summaries, account aging reports, quarterly financial statements, annual financial statements prepared and reviewed by independent certified public accountants - prior to extending loans and credit to the debtor therein. Conversely, the secured lender in *In re Bear Kodiak* failed to satisfy its burden of proving that it neither knew nor should have known of the debtor's breach of trust because the secured lender failed to introduce any documentary evidence in support of its allegations that the equipment at issue therein was not subject to the PACA trust. Instead the secured lender relied exclusively on the declaration and testimony of the debtor's principal. The foregoing was found to be insufficient and the PACA trust beneficiaries were allowed to utilize the proceeds from the sale of the debtor's equipment to satisfy their claims ahead of the secured lender.

In light of the above, it is clear that a secured lender must take notice of the unique situation presented by a prospective produce company borrower. Armed with a clear understanding of the steps required to safeguard its interest, a secured lender can make wise lending decisions that will withstand the challenge of an unpaid PACA trust beneficiary. Absent such precautionary steps, an unpaid PACA trust beneficiary will recover ahead of a secured lender almost every time. This is the result Congress intended.