legal factor

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Hidden Liens and Trusts: The PACA Trust Problem

Hidden liens and trusts are always a problem for factors. And a PACA trust is one example of a hidden trust that factors should be wary of. PACA trust problems occur when a factor purchases the accounts of a business that sells fresh fruit and vegetables. The problem is that if the producer of the fresh fruit or vegetables has not been paid by the factor's client, then the factor may lose its right to the proceeds of the receivables that it purchased.

PACA stands for the Perishable Agricultural Commodities Act. The Act is intended to protect producers of fresh fruit and vegetables. The Act is Congress' attempt to remedy the problem of producers not be being paid by brokers, while the broker's secured creditors are paid from the proceeds of the produce. PACA creates a trust in the perishable assets including the receivables generated from sales of the produce. The Act specifically provides the following:

> Perishable agricultural commodities received by a commissioned merchant, dealer, or broker 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, shall be held by such commissioned merchant, dealer or broker 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 transaction has been received by such unpaid suppliers, sellers or agents . . . .

The trust that the Act creates is the problem. The producers and suppliers who are protected by this trust have a priority in the inventory and proceeds of the inventory including accounts receivable even over the claims of the secured creditors of the brokers. Congress allows this trust to be commingled with non-trust assets without destroying the trust.

Here is an example of how a PACA trust is supposed to work. A farmer sells fresh fruit and vegetables to a broker on credit. The broker then sells the produce on credit to a retail outlet like a grocery store. The broker obtains a loan on the accounts and grants the lender a lien on the accounts receivable due from the grocery store. If the farmer is not paid what it is owed, then under PACA, the farmer has a superior right to the accounts receivables and the proceeds thereof over the lender. If a factor is not careful, this can result in significant losses.

The obvious defense for a factor is to claim that they are not a secured lender,

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but a purchaser of an asset. As a result, so the argument goes, the trust should attach to the money that the factor paid the broker to purchase the receivables, not to the receivables themselves. To prevail, the factor has to prove that they are bona fide purchasers for value of the trust assets. More specifically, common trust law governs the PACA trust and being a bona fide purchaser for value allows the factor to purchase accounts receivable free of any claim by a PACA beneficiary. All the factor has to do is to prove that it purchased its interest in the accounts for value, in good faith, and without notice that the transfer was in breach of a PACA trust. A transfer cannot be "for value," however, if it is for repayment of a preexisting debt.

And this is where the real problem with this defense occurs. In reported opinions, this defense rarely, if ever, succeeds. The problem is that if this transaction is actually a secured loan disguised as a factoring arrangement, then the factor cannot be a bona fide purchaser for value because the transfer is for repayment of a preexisting debt. The court's analysis is essentially the same as it always is when the "loan versus sale" issue arises in factoring. Court's decide based on how much of the risk of nonpayment on the accounts stays with the client and how much is transferred to the factor. Among the facts the court considers are (1) whether this a recourse deal, (2) whether the factor is granted a blanket lien securing collateral for any losses, (3) whether there is a personal guaranty for any losses suffered by the factor, and (4) whether the language in the agreement refers to the transaction as a loan or a sale. Almost all of the courts have held that the factor is really loaning money, not purchasing receivables, so the defense fails and the factor loses big.

Congressional policy seems to be the driving force behind these decisions. Courts have recognized that this result may have a negative impact on the availability of funding, but Congress enacted the policy and courts are merely interpreting Congress' intent. Also, because case law holding that a factoring arrangement is actually a loan can have far reaching implications for factors dealing with other issues—e.g. usury or bankruptcy issues—some courts have narrowed their holdings to only apply to PACA trust issues.

If available, a more effective defense may be to argue that the PACA trust does not apply because the fruit and

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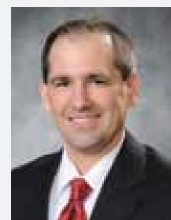

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