

## How PACA And PSA Super Liens Impact Real Estate Sales

By **Spencer Compton and Diane Schottenstein** (April 13, 2018, 1:19 PM EDT)

You are representing a buyer and/or a borrower or a lender in a multisite acquisition with financing to be secured by mortgages on properties supporting a portfolio of fast food restaurants. As you review your title commitments, one unfamiliar exception keeps popping up: "Any claim that the Title is subject to a trust or lien created under The Perishable Agricultural Commodities Act (7 U.S.C. §§499a, et seq.) (PACA) or the Packers and Stockyards Act (7 U.S.C. §§181 et seq.) (PSA) or under similar state laws."

What is this? Can I get it omitted from the loan policies?

Well, that depends...

Many real estate attorneys are unaware of PACA, or PASA, each of which creates a super lien in favor of agricultural growers, cattle and poultry producers. These statutes can affect a real estate transaction that, on its face, seems far removed from the farm or stockyard merely because it involves a restaurant owner, grocery store or warehouse. This article provides a brief background and explanation of PACA and PSA. For the level of nuance herein, PACA and PSA will be treated together because the two statutes are similar in nature, history and trust provisions, and while most of the case law interprets PACA, courts have recognized their similarity and have interpreted PSA in similar ways.[1]

Nonetheless, how do they differ?

PACA applies to the sale of perishable agricultural commodities in the form of produce, such as fresh fruit or vegetables. PACA risk in a transaction can be identified by knowledge of the use of the land or the business in which a party is engaged such as:

- Food and produce wholesalers, produce storage, grocery wholesalers, food service firms, produce dealers, food distribution facilities
- Food processing facilities, produce packing facilities, canners
- Supermarkets and grocery stores, and
- Restaurants, assisted living facilities, wineries, distilleries and breweries.

PSA applies to the sale of poultry, poultry products, livestock, dairy and meat products. PSA risk in a transaction can be identified by knowledge of the use of the land or business



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in which a party is engaged such as:

- Poultry farms
- Livestock or swine farms/producers
- Meatpacking/poultry packing facilities, and
- Supermarket and grocery stores

Where a transacting company has any of the following words in its name: "food," "produce," "packing," "distributor," "processor," "farm," "ranch," "feedlot," or any variations thereof, attorneys should be alert for PACA or PSA issues. Additionally, PACA/PSA issues may arise in transactions involving inter alia: schools, hospitals, nursing homes, assisted living facilities, hotels, motels, resorts, vineyards and corporate campuses with cafeterias.

### **Legislative History of PACA and PSA**

Because of their perishable nature, produce and livestock products must be sold promptly. Historically, agriculture producers and livestock sellers were routinely subject to abusive schemes by buyers who would claim the products were of inferior quality or other ruses to take advantage of the sellers' weak positions in a concentrated buyers' market.[2] At their inception in the 1930s, PACA and PSA provided a code of fair play, an aid to seller's contract enforcement and bright line delivery standards. The statutes established penalties to protect sellers from discriminatory and deceptive trade practices, price manipulation and failure to promptly pay.[3]

In the 1970s and 1980s, Congress strengthened these statutes by adding trust provisions requiring the middleman who transported the produce to the end user to hold the produce in trust for the unpaid produce. The trust is equivalent to a super lien priming a lender's mortgage or UCC filing made to secure a loan to a so-called dealer, broker or commission merchant as defined in the statute. The laws' super lien characteristics protect unpaid producers/suppliers of defined commodities from losing out to lenders who make loans to middlemen secured by liens attaching to property acquired before or after the goods are delivered to the middlemen or slaughterhouse. The super lien attaches to the proceeds and receivables generated by the sale of those commodities. The proceeds can include land and buildings bought with the funds from the sale of the commodities and the products derived from those commodities. The trust is automatically created and continues in favor of the supplier/producer and all subsequent producers from the moment that the products are first delivered to the dealer or other reseller of the commodities until payment has been made.[4]

Case law has established that both a restaurant and a retail grocery and their lenders are subject to PACA and PSA risks.[5] The PACA/PSA lien has been described as "infectious" because the use of its trust proceeds to acquire other property makes that acquired property subject to the PACA/PSA trust. Even if land or buildings are not initially bought with PACA or PSA trust funds, the pay-down of (or comingling with) a mortgage loan, property improvements or even property tax payments with PACA or PSA trust funds can result in a PACA/PSA claim, at least to some extent, impressed with the statutory trust.[6] The PACA/PSA lien can also affect a bankruptcy proceeding, in which context the lien has been described as a floating unsegregated trust.[7]

Because there is no requirement to file a written notification of a PACA/PSA lien (as there might be with a mortgage or UCC statement), there are no central sources in which to search for its existence. It is inchoate, hence the related title exception. To illustrate, a bank can make a loan secured by a mortgage only to discover later it has been primed by

a PACA/PSA lien; the bank's recorded first lien will not provide the security contemplated. In *In re Kornblum & Co.*,<sup>[8]</sup> the Second Circuit Court of Appeals sets out the critical issues in a litigation over the validity of a PACA super lien. The court found that "to prevail the creditor will bear the burden to establish either that (1) no PACA trust existed when the Units were purchased or (2) ... the Units were not purchased with trust assets; or (3) [the creditor] thereafter paid sellers in full prior to the transaction involving the Creditors, thereby terminating the trust."<sup>[9]</sup>

Lenders will be forced to return trust property they received unless they can establish their status as bona fide purchasers, (i.e., that they have received the property for value and without notice of trust.)<sup>[10]</sup> Although, under limited circumstances, it may be theoretically possible to prove that a lender is a bona fide purchaser, the courts are apt not to sustain this defense when raised by a secured lender who knew or should have known that the debtor was in the business of dealing in the applicable products and that the debtor failed to pay the producer at the time the loan was made.<sup>[11]</sup> Since the lender has a high burden of proof and there is a real chance of lender liability, a lender may be very concerned with any PACA or PSA issue.

Lender's counsel may want to insert particular loan provisions dealing with PACA/PASA issues. Additionally, banks should do sufficient due diligence to unearth any lurking PACA/PSA issues.

### **PACA/PASA Title Insurance Underwriting**

In recent years, title insurers have paid out significant claims arising out of PACA/PSA issues. As a result, these insurers increasingly raise PACA/PSA exceptions in title commitments to insure the purchase, lease or financing of property owned by an agricultural user such as a restaurant, grocery store, wholesaler, retailer, stockyard or cattle/pig farm. The title exception will most likely be in both the owner's and loan policy. The policy exception usually appears as follows:

Any right, interest or claim that may exist, arise or be asserted against the Title under or pursuant to PACA, PSA or any similar state laws.

This exception should be dealt with promptly. Persuading the title insurer to omit it can involve significant and time-consuming information gathering by your client, the proposed insured, and if it can't be omitted, a bank or purchaser might refuse to close.

There are a number of possible underwriting approaches. The property owner can submit evidence to the title insurer that the lien does not apply in accordance with the precept of the Kornblum decision. For guidance in this regard, look to *In re Bear Kodiak Produce*,<sup>[12]</sup> in which the evidence presented showed that all suppliers were paid in full up to and including the date of closing. Note that most produce invoices are paid at least 30 days in arrears, making such proof difficult if not impossible to provide. Alternatively, the title insurer might be persuaded to omit if it can be convinced that the statute does not apply to certain facts. For example, a protected product can be transformed into an unprotected product. Potatoes treated with oil are not entitled to PACA trust protection.<sup>[13]</sup> Dried fruits are not "perishable agricultural products."<sup>[14]</sup> Frozen onion rings, breaded cauliflower, pickles and other products whose fresh ingredients constitute less than 90 percent of their weight do not qualify for PACA protection.

To determine PACA/PSA applicability, the title insurance underwriter must resolve a series of cascading questions:

### **PACA: What Business is the Seller or Borrower or Both Engaged in?**

1. Is it a "dealer" (middleman), "broker" or "commission merchant" for agricultural commodities? The seller or borrower may be an apparent beneficiary of PACA, such as a farmer, but may also purchase and resell or broker the commodities, which would make him, to the extent that he's buying and selling, subject to the PACA trust.
2. If so, are the commodities "perishable"? Not all commodities are perishable agricultural commodities subject to PACA. There is a list on the USDA website. While it does not purport to be all-inclusive, it is a good reference.
3. To what extent have the food products been processed at the time of receipt by the middleman or sale by the broker or commission merchant? Minimal processing (such as cutting vegetables) may still leave the products and the proceeds from their sale subject to the trust, but transformation of the product may free it. Beverages derived from perishable commodities, such as juice and wine, are subject to the trust.
4. Is the seller or borrower a "retailer," such as a grocery store or a restaurant? If it is a retail dealer of perishable agricultural commodities, the PACA trust may not apply unless she (a) purchases over \$230,000 of perishable agricultural commodities in a year or (b) aggregates quantities of all types of produce totaling one ton (2,000 pounds) or more in weight in any day shipped, received or contracted to be shipped or received or (c) has been licensed as a dealer by the U.S. Department of Agriculture.
5. How many suppliers are involved and what are their payment arrangements?
6. For confirmation of whether a business is a PACA licensed dealer, check the USDA website. (Caveat: The fact that there is no license does not mean that the entity purchasing perishable agricultural commodities is not subject to PACA regulations or that there is no PACA trust.)

### **PSA: What Business is the Seller or Borrower or Both Engaged in?**

1. Is the seller or borrower a purchaser of live poultry, livestock or swine for slaughter? He may be an apparent beneficiary of PSA, such as a rancher or poultry farmer, but may also purchase the products for slaughter, which would make him, to the extent that he's buying and slaughtering, subject to the PSA trust. He may own the live animals, but may subcontract out, under "growing arrangements" (such as feedlots) the raising of the animals. If so, the grower may claim PSA trust rights in connection with such an arrangement.
2. How much poultry, livestock or swine does the seller or borrower buy or sell annually? A packer of livestock or swine with annual purchases of under \$500,000 is exempt from the PSA trust, as are poultry dealers with less than \$100,000 in average annual sales.
3. How many suppliers are involved and what payment arrangements are made?
4. With regard to PSA, the terms of payment are relevant and there are distinctions relating to whether the potential claimant is a seller or is a producer under a production agreement.

### **Identifying Properties that Raise PACA/PSA Issues**

(Caveat: Don't let this question be a "red herring." PACA and PSA trust rights may attach to any property of the seller or borrower, regardless of whether it is used for the purposes below. The list in item 1 below only provides further indicia of the potential for a trust to attach based on the seller's or borrower's business.)

1. What is the property used for? Certain uses will immediately indicate that the customer should be further vetted for PACA/PSA concerns. For example:

- Meatpacking/poultry packing facility (PSA)
- Poultry farm (PSA)
- Supermarket (PACA and PSA) -or-
- Restaurant (generally only PACA; few restaurants slaughter animals for the table)

2. Other property uses may require further investigation before ruling out PACA/PSA issues:

- Hotel or club with restaurant inside. Is there, at any level, a unity of ownership between the property owner and the restaurant operator?
- Cold storage facility. (It would not be subject to a PACA or PSA trust for mere storage, but the operator may also deal in produce.)

### **What is the Nature of the Transaction?**

The land may not be subject to a PACA trust, even if the business operated on it is that of a dealer. For example:

1. If the land is leased by the landowner to a PACA dealer and there is no unity of ownership between the landowner and the tenant operator (for example, a supermarket or restaurant).
2. If the sale is to a bona fide purchaser. (Note that the buyer may still be considered a PACA dealer, creating a PACA issue for the insuring of the buyer's new mortgage/deed of trust.)

If any of the answers to the foregoing questions are to be relied upon by the title insurer to omit the PACA/PSA exception, corresponding relevant factual statements will have to be incorporated into the title affidavit provided at closing.

As a last resort, where omitting the PACA/PSA exception from the loan policy is not an option and the transaction's closing hangs in the balance, if the underwriter's business credit analysis determines the PACA/PSA risk is minimal, a title insurer may accept a sufficiently robust indemnity to remove the exception. In order to so omit, the underwriter must conclude that (a) only a minimal amount of business income is derived from food, (b) there is a low percentage loan-to-value, and (c) the owner/borrower is financially sound. Alternatively, based on the due diligence the lender should have conducted prior to offering its commitment letter, the lender may be willing to live with the risk.

In conclusion, real estate practitioners should not underestimate the complexity and time involved in clearing a PACA/PSA exception from title. Conferring with the title insurer to determine whether there may be viable avenues of diligence to prove that the PACA/PSA statutes do not apply should be undertaken promptly upon receipt of the title insurance commitment.

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[1] (First Am. Corp. Underwriting, Background Information on Statutory Trusts Imposed by the Perishable Agriculture Commodities Act (PACA) and by the Packers and Stockyard Act (PSA), at 1 (2016).

[2] (Doug O'Brien et al., "Federal Laws Regulating Agricultural Sales," chap. 8 in The Farmer's Legal Guide to Producer Marketing Associations (Des Moines: Drake University Agricultural Law Center, 2005).

[3] (Jason R. Klinowski, The Nat'l Agric. L. Ctr., Secured Lending in the Produce Industry: What Every Bank Should Know, at 2 (2009)).

[4] (See First Am. Corp. Underwriting, at 1).

[5] (See Klinowski, at 2)

[6] (Brandy A. Sargent, Perishing Security: PACA and the Secured Lender, Presentation at ABA Business Law Section Spring Meeting, at 13 (Apr. 2015))

[7] (Terri J. Freedman et al., Secured Creditors May Not Be as Secure as They Think They Are: Understanding a Lender's Rights Under the Perishable Agricultural Commodities Act, N.J.L.J., Mar. 15, 2014, at 2).

[8] 81 F.3d 280 (2nd Cir. 1996)

[9] See *In re United Fruit & Produce Co.*, 242 B.R. 295 (Bankr. W.D. Pa. 1999).

[10] *Consumers Produce Co. v. Volante Wholesale Produce, Inc.* 16 F.3d 1374 (3d Cir. 1994); *C.H. Robinson Co. v. Tr. Co. Bank, N.A.*, 952 F.2d 1311 (11th Cir. 1992) (See Sargent, at 6).

[11] (See First Am. Corp. Underwriting, at 2).

[12] 283 B.R. 577 (Bankr. D. Ariz. 2002)

[13] See *A&J Produce Corp. v. CIT Grp./Factoring*, 829 F. Supp. 651, 658 (S.D.N.Y. 1993)

[14] See *In re L. Natural Foods Corporation*, 199 B.R. 882, 890 (Bankr. E.D. Pa 1996).