DePaul Business and Commercial Law Journal

Volume 2
Issue 4 *Summer 2004: Symposium - Emerging Trends in Commercial Law: Surviving Tomorrow's Challenges*

Article 7

The Perishable Agricultural Commodities Act and Its Effect on Secret Liens

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Mr. Mark Duedall

MR. DUEDALL: Good afternoon, my name is Mark Duedall. I am a lawyer at Alston & Bird. I am going to start out by talking about Perishable Agricultural Commodities Act ("PACA") a little bit, one of the secret liens near to my heart.

I guess an initial word about secret liens is I do not like secret liens. I do not like them for the same reason that I do not like that there are eighteen exceptions to the automatic stay in section 362(b) of the Bankruptcy Code. It seems to me that these exceptions to the automatic stay and secret liens are really just special interest ways to cannibalize an equality of distribution structure that the Bankruptcy Code of 1978 set up.

It seems to me that this is a kind of dovetailing as the world moves more toward the American system because of the use of American forms of syndicated debt, securitized debt, derivatives, and things of that nature. These exceptions always seem to pop up from time to time and sometimes pop up a great deal more. Secret liens, as well as exceptions from the automatic stay, are the exceptions that make bankruptcy cases a great deal harder today than they once were. Even though I do not like secret liens, I try to enforce them. However, I do try to get around them when I represent a debtor or a creditor's committee.

Probably one of the main items I am going to be talking about today is not really so much secret liens per se but the traps that are involved in secret liens. What general bankruptcy practitioners may not know about these secret liens but what may come in very handy either in knowing how to get around these secret liens or in knowing how to advise your client, who might be the secret lienor, of what might be a very good settlement.

There are a lot of exceptions to these exceptions, and we will talk about those today. So, hopefully, you will be able to recognize them

* This is an edited version of the transcript from fourth panel at the DEPAUL BUSINESS AND COMMERCIAL LAW JOURNAL SYMPOSIUM, *Emerging Trends in Commercial Law: Surviving Tomorrow's Challenges*, held on April 15, 2004.

when you represent a debtor or a committee. On the other hand, you will be able to recognize them when you represent a creditor that has one of these secret liens so that you can understand the strengths and weaknesses of your position. Knowing the details can be very difficult, but it also can be very valuable and can sometimes get you a much better result than you otherwise would get for your client.

With that, let us talk a little bit about PACA. It is an old statute from the 1930s; however, the trust provisions of PACA, which are really PACA's teeth, were only codified in 1984. The trust provisions are the most interesting and the most powerful part of PACA. What the statutory trust of PACA creates is a floating, nonsegregated trust over a variety of the debtor's assets for the benefit of sellers of perishable agricultural commodities.

The trust is very broad. It covers the produce the debtor owns, the products of the produce, and any receivables and proceeds therefrom. So it covers a lot of the assets that the debtor may have. Being able to assert a PACA trust—which is not really a lien but a trust interest, though still under the category of secret liens—at the start of a bankruptcy case or at any time of a bankruptcy case is a very good way to get your client paid, or at least get your client paid a substantial amount of what might be owed. Plus, it is also a good way to derail a bankruptcy case, if it is the right kind of a bankruptcy case. Let us talk about what kind of cases it comes up in.

Primarily, PACA issues come up in restaurant cases, but they also come up in food distributor cases. One of my earlier experiences with PACA was in *In re AmeriServe Distribution, Inc.,*[1] which is a Delaware bankruptcy case, being handled by the Kirkland & Ellis firm here in Chicago.

AmeriServe was at that time either the largest or the second largest food distributor in America. It distributed all of the food to every Chick Fil-A, Burger King, Arby's, as well as to the Tricon entities. Tricon is now known as Yum! Brands, Inc., but at that time Tricon consisted of Taco Bell, Pizza Hut and Kentucky Fried Chicken. This is why you sometimes see a combination of those restaurants all in one. AmeriServe was a failed rollout. It had combined a lot of food distributors with bad systems and bad cash management, which turned the company into one very large food distributor with bad systems and bad cash management. The company fell into bankruptcy quite suddenly. It fell into bankruptcy so suddenly, as a matter of fact, that two items of bill came out of that case.

1. *In re* AmeriServe Food Distrib. Inc., 267 B.R. 668 (Del. 2001).

First, this was a case known as an "NCAA" champion. It is a case where they had certain bonds issued to the public market that paid not "No Coupon At All." As soon as the bonds were placed, they fell into default. That is why it is called an "NCAA" champion.

It was also a case in which the company fell into bankruptcy so fast that it did not have traditional debtor in possession, or "dip" lending; it had to get dip lending from Burger King and from Tricon by virtue of being their sole supplier. It had the ultimate leverage over Burger King and Tricon by virtue of being their sole supplier. So Burger King and Tricon became involuntary dip lenders as opposed to restaurant operators. They drafted the dip financing agreement on one page just before the bankruptcy as a commitment to loan AmeriServe thirty-million dollars on the basis of a term sheet loan. So it was an interesting case from that standpoint. From a PACA standpoint, one of the largest groups of creditors of AmeriServe was the PACA creditors.

Very early in the case, we formed a kind of informal PACA creditors' committee, not recognized by the court and not recognized by the United States Trustee's Office. We recognized on our own that we would have a lot more power bargaining together than bargaining separately. The PACA creditors in that case were owed upwards of fifty-million dollars.

The advantage of the PACA trust is that the debtor's money is not the debtor's own. It is encumbered by the PACA trust. The PACA trust requires money either be segregated immediately or turned over immediately for the benefit of the PACA creditors. In this case, all AmeriServe had was thirty-million dollars in dip financing. One of the items that AmeriServe owed was fifty-million dollars to the PACA creditors.

Our position early in the case and during all of the initial hearings was nothing can be spent and all of the money must be set aside for the benefit of the PACA creditors. Even in Delaware, the most debtor-friendly of all jurisdictions, that argument carried a great deal of weight. While the judge, of course, was going to let AmeriServe use its cash to pay its utilities and employees and continue to buy products, the judge put us on the front burner of creditors to deal with. And we were able to convince the judge not to approve a lot of other motions that would have impaired the PACA creditor's rights to collect their money.

In a case like *AmeriServe*, which was a belly flop in Chapter 11 and on the verge of going into Chapter 7 at any given time, for the PACA creditors to get in there early was very important. What the debtor wanted to do was to spend the money for its operations and require a

PACA reconciliation process that would take ninety days. That was not acceptable to us as given the precarious nature of the case, there may not be any funds left in ninety days. We were able to avoid some of the relief the debtor wanted, such as the debtor's request to pay to critical pre-petition vendors. Our position was, and it succeeded, that no pre-petition or post-petion creditor could be paid with PACA funds. So we were able to stop a great deal of relief that would have harmed our client's interest through the PACA trust by generally throwing rocks at the debtor.

One of the issues in representing PACA creditors is whether the goods in question qualify for the protections of PACA. Fresh fruits and vegetables of every kind or character are covered by PACA. However, if the food becomes mixed or adulterated with other food to create articles of food of a different kind or character, then it is not covered by PACA. Of course the federal regulations that govern PACA talk about this a lot. The federal regulations are a bit scary because they talk about what food can still be covered by PACA. Thus, you get to see what actually happens to food. Gassing and heating food for insect control and ripening, adding ascorbic acid and other agents to retard oxidation, is the stuff covered by PACA. That is the food we are eating on a daily basis.

One of the larger issues in PACA that is still out there is the french fries debate. Often when chain restaurants and franchises goes into bankruptcy, one of the issues is whether french fries fall under PACA. The issue is whether potatoes qualify under PACA. Of course potatoes qualify under PACA. But are they adulterated? Do they become something different when they become french fries?

So the question is what are french fries? One of the leading cases on this french fries debate is a case out of Delaware called *In re Long John Silver's Restaurants*.[2] The case involved something called the crispy fries, which was Long John Silver's way of gaining market share. The opinion talks about what french fries had to go through to become crispy fries. They were put through a process called oil blanching, which is inactive enzymation, and then they were detoured from production to become crispy fries. They were put through a slurry of water, which is typically called a batter, to suspend batter solids in that slurry of water. So it is kind of an interesting process. In that case, the Court concluded that crispy french fries were not covered by PACA because they had been sufficiently adulterated.

2. *In re* Long John Silver's Rest. Inc., 230 B.R. 29, 35 (Bankr. D. Del. 1999).

The bottom line is that the french fries issue comes up a lot in PACA. However, I have found that not everyone knows that PACA has some pretty strict provisions on what qualifies as PACA goods. When the goods become adulterated, they can no longer qualify for PACA status. French fries are a prime example that most people are aware of.

One thing that I have never been challenged on is some of the other goods delivered to chain restaurants. Part of this has to do with the fact of knowing how chain restaurants make their food. When we talk about chain restaurants, we talk about the Denny's, the Chili's, and the Outbacks. Those entities, when they prepare their side dishes, are not cutting corn and beans, and mixing them in the butter. That food all comes prepackaged from the food distributors. One of the things I have been able to do successfully is to make a list of items that the distributor supplied to the restaurant that are covered by PACA. No one will dispute that corn and beans are covered by PACA. The list also shows what that corn is.

The other issue that I have never been challenged on, but I have challenged others on and been somewhat successful, is whether that material has been sufficiently adulterated or changed so that it no longer qualifies for the protections of PACA. If you ever come across this issue, you want to think about this sub-issue, which is that we need to figure out whether it does qualify for PACA. When you are representing a debtor, or a creditor's committee, or any party that is seeking to reduce a PACA claim, that is worth doing. You can knock out a substantial amount of the PACA claim. By the same token, if you represent a food distributor, you want to be aware of this so that you can advise your client of the risks involved in asserting this PACA claim and the likelihood for success.

Often clients will simply think they are not covered by PACA because they get paid in full. Generally speaking, that is true. However, with cases like *Long John Silver's* out there, as well as with the general statutory regulatory scheme, they need to understand what is the nature of their food. Is still covered by PACA?

One additional item on *Long John Silver's*. A debtor and creditor's committee will often cite the *Long John Silver's* case and argue that french fries are not covered by PACA. First, it is not true; it depends on the nature of the fries, whether they are french fries, crispy fries, et cetera. Second, the *Long John Silver's* case was called into great question by the Delaware District Court a few years later in the *AmeriServe* case. The *AmeriServe* case dealt with lots of goods that were clearly PACA and lots of goods that may not have been PACA, including the french fries lobby. In *AmeriServe*, the court noted in *Long John Silver's* the issue had been whether the curly fries or the crispy fries qualified for PACA status. The parties in *Long John Silver's* had to get expert testimony. Long John Silver's, the debtor, who was trying to argue that the french fries were not covered by PACA, brought in its expert approximately two days before trial, gave the other side one day to take its expert's deposition. That expert's testimony was largely based on hearsay, Internet research, sending an associate to the library, and talking with friends and associates in the business. So the Delaware District Court recognized that there had been some serious procedural irregularities in *Long John Silver's*, to call into question the expert's credibility. So *Long John Silver*'s is a case that should be called into question as well. It is not reported, although it is now on Lexis and Westlaw, and it is an important one.

One of the other items in PACA is whether the vendor has lost the qualifications or the benefits of PACA by virtue of its credit terms. What is required is that the vendor only extend thirty day terms to the purchaser. If the vendor extends anything more than thirty day terms to the purchaser, then the vendor will lose the benefit of the PACA rights. This is also something I have not seen debtor or creditor's committee raise that much. However, it really should be raised because it is a valid way to knock out a PACA claim if that is your goal.

Interestingly, there is also one recent case from Texas in which a string of e-mails went back and forth between the vendor and the soon-to-be-debtor. They talked about extending the credit terms and revising the business relationship. The question was whether there was a written agreement to modify those credit terms beyond thirty days because what was required was a written agreement, not an oral understanding. So there the Court had to rely on Electronic Signatures in Global and National Commerce Act. I thought that was kind of interesting. It was a little bit of an intersection between PACA and what some of the professors talked about this morning. I did not think PACA would apply to that, but it certainly does.

If anyone has questions about PACA, or if you want to have a little interaction with it, please raise them at this time or raise them when I come back up. In closing, the bottom line is that this is pretty dry, boring stuff. However, in a restaurant bankruptcy, in a food distributor bankruptcy, this is really important. It is important to know about it so that you could protect the clients.