Buchalter

Lender Alert

February 2018

Ag Lenders Face New PACA Liability Over the Substance of Transactions

Joseph M. Welch, Esq.

The Ninth Circuit (sitting *en banc*) recently overruled established case law and expanded trust rights under the Perishable Agricultural Commodities Act (PACA).[1] Even before considering the commercial reasonableness for removing assets from a PACA trust, the Ninth Circuit *now* requires a "threshold true sale inquiry" focusing primarily on the transfer of risk between the parties.[2] If there is no true sale (as with secured loans) then "the court's inquiry stops there and the assets remain in the trust." If there is a true sale then the court will consider whether the transaction is commercially reasonable: those not commercially reasonable remain in the trust while those that are both true sales *and* commercially reasonable will provide buyers with "assets free and clear of the trust." Unless reversed by the Supreme Court, the Ninth Circuit's rulings will likely hurt PACA lenders (and beneficiaries) over the long term.

Background

Growers sold tomatoes on credit to a distributor (Tanimura Distributing), which, in turn, sold them on credit to certain third parties.[3] Tanimura transferred its resulting accounts receivable to AgriCap Financial through a transaction AgriCap described as a "Factoring Agreement" or sale of accounts.[4] Tanimura's business failed and Growers did not receive payment in full for their tomatoes. Growers sued Tanimura alleging: (1) the Factoring Agreement was merely a secured lending arrangement structured to look like a sale; (2) the accounts receivable and proceeds, therefore, remained trust property under PACA; (3) because the accounts receivable remained trust property, Tanimura breached the PACA trust and AgriCap was complicit in the breach; and (4) under PACA the PACA-trust beneficiaries, including Growers, held an interest superior to that of any secured lender.

AgriCap moved for summary judgment, arguing what it (and many others) considered controlling Ninth Circuit authority: a trustee is allowed to remove assets from a trust in any commercially-reasonable way without breaching the trust.[5] The district court granted summary judgment in favor of AgriCap on such authority. On appeal, a three-judge panel of the Ninth Circuit affirmed the district court, whereupon a majority of active judges in the Ninth Circuit agreed to rehear the appeal *en banc* and reconsider the underlying Ninth Circuit authority that AgriCap and the courts relied upon.[6]

The Ninth Circuit ultimately vacated the judgment favoring AgriCap and remanded to the district court for a new "threshold" determination on whether the transaction between Tanimura and AgriCap was a true sale or a secured loan. While commercial reasonableness still matters in the Ninth Circuit, its protections against PACA trusts are now limited to "true sales." The Ninth Circuit further clarified: "To the extent that our *en banc* opinion today contradicts *Boulder Fruit*, we overrule *Boulder Fruit*."

Significance of Recent Ruling

This change in law is significant for many reasons. As explained by the three-judge dissent:

> If a PACA trustee borrows money from a lender (using the trust assets as collateral) in order to pay the growers, but the money runs out before all the growers are paid, does the lender have an obligation to make the unpaid growers whole? The majority says yes: if the trustee fails to reimburse the growers, the lender is on the hook. The majority posits that the growers have a priority lien on their produce, which allows the trust to accept the benefit of a loan agreement but disregard the obligation to repay it.[7]

The dissent advances several reasons for why the majority's opinion is "critically flawed" and explains how lenders facing additional risks will either refuse to engage in certain transactions altogether or impose more severe terms to account for the heightened risks. In any event, unless and until the Supreme Court reverses, the Ag community must observe this new legal landscape and plan accordingly.

Joseph M. Welch is a Shareholder in the firm's Insolvency and Financial Law Group in Orange County. Mr. Welch is a member of the California Lawyers Association, Agribusiness Committee and a Certified Bankruptcy Specialist by the State Bar of California Board of Legal Specialization. He can be reached at 949.224.6257 or jwelch@buchalter.com.

[1] *S & H Packing & Sales Co. v. Tanimura Distrib.*, 2018 U.S. App. LEXIS 4216* (9th Cir. Feb. 22, 2018) (or 2018 Westlaw 1003855 (9th Cir.)).

[2] The transfer-of-risk analysis is considered "key, but not the sole, factor." *Id.* at *10. Other factors to consider include: "the right of the creditor to recover from the debtor any deficiency if the assets assigned are not sufficient to satisfy the debt, the effect on the creditor's right to the assets assigned if the debtor were to pay the debt from independent funds, whether the debtor has a right to any funds recovered from the sale of assets above that necessary to satisfy the debt, and whether the assignment itself reduces debt." *Id.* at *20.

[3] *Id.* at *4.

[4] "Factoring is the 'commercial practice of converting receivables into cash by selling them at a discount." *Id.* at *4, fn. 2 (internal citations omitted).

[5] *Id.* at *6 citing *Boulder Fruit Express & Heger Organic Farm Sales v. Transportation Factoring, Inc.*, 251 F.3d 1268 (9th Cir. 2001).

[6] *Id.* at *8; *S & H Packing & Sales Co., Inc. v. Tanimura Distrib., Inc.*, 850 F.3d 446, 450-51 (9th Cir.), *reh'g en banc granted*, 868 F.3d 1047 (9th Cir. 2017)

[7] *Id.* at *43.