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## Ag “Distributor” Cannot Use PACA Trust to Jump Ahead of First-Lien Creditor, Circuit Court Rules

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The Sixth Circuit recently ruled that an agricultural “multi-service finance company” had no claim to the proceeds of produce held in trust pursuant to the Perishable Agricultural Commodities Act (“PACA”)<sup>1</sup> and could not circumvent the security interests of a senior lender. The unpublished decision,<sup>2</sup> which relied upon established law in the Ninth, Second, and Third Circuits (among others), serves as a reminder to financiers in the agribusiness space—and beyond—of the risks inherent in lending in an uncertain economic environment.

### **Background**

Prior to filing a chapter 11 bankruptcy, an ag producer, Spiech Farms, LLC (“Grower”), grew and processed blueberries, asparagus, and grapes, financed through a combination of loans and lines of credit with its lender (the “Bank”). As collateral for repayment, the Bank took a first-priority mortgage lien and a security interest in substantially all of the Grower’s assets.

To obtain additional cash after losing its blueberry crop to frost, Grower entered into a distribution agreement with Produce Pay, Inc. (“Produce Pay”) pursuant to which Grower would obtain short-term loans as an advance on anticipated customer payments, and had the opportunity to market its produce through Produce Pay’s online platform. The agreement characterized the transactions as a purchase of Grower’s produce by Produce Pay, however, Produce Pay did not take possession of the produce and, in fact, the produce had already been delivered to the intended customer at the time of each transaction with Produce Pay. Grower was obligated to repay the advance from Produce Pay regardless of whether the customer ultimately paid for the produce it received from Grower.

In addition to various contractual protections and remedies against the Grower, Produce Pay assumed that its share of proceeds from the produce would be protected by a PACA trust, which would be superior to all of the Bank’s pre-existing security interests and liens. Produce Pay filed a financing statement as part of its transaction with the Grower, which alerted the Bank to

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<sup>1</sup> 7 U.S.C. §§ 499a-499s.

<sup>2</sup> *Produce Pay, Inc. v. Spiech Farms, LLC (In re Spiech Farms, LLC)*, 2021 U.S. App. LEXIS 2522.

Produce Pay's asserted security interest in Grower's assets. Because the grant of a security interest was a breach of the existing loan agreement with Bank, Bank declared Grower to be in default and Grower's chapter 11 bankruptcy filing followed.

Produce Pay argued to the bankruptcy court that its claim, in excess of \$1 million, plus attorneys' fees, should all be paid from Grower's PACA trust—*before* Bank's claim, which was secured by Grower's assets. The PACA trust is a creature of statute that protects *sellers, dealers, and suppliers* of "perishable agricultural commodities"<sup>3</sup> by holding such commodities *and their proceeds* in trust in the event that the purchaser of such commodities does not pay. The effect of the PACA trust is to elevate such sellers, dealers, and suppliers above a senior-secured lender with respect to the commodities and their proceeds.

The bankruptcy court disagreed that Produce Pay's claim should be paid from the PACA trust ahead of the Bank, and the Circuit Court affirmed, for three reasons:

First, the court concluded that Produce Pay did not "sell" or "supply" perishable agricultural commodities so a PACA trust would not cover Produce Pay. Second, the court determined that Produce Pay did not take title to the produce pursuant to Article 2 of the UCC.<sup>4</sup> Finally, the court rejected Produce Pay's argument that it purchased Grower's accounts receivable. Relying on authority from the Second<sup>5</sup>, Ninth<sup>6</sup>, Fourth<sup>7</sup>, Fifth<sup>8</sup> and Third<sup>9</sup> Circuits, the Sixth Circuit concluded that, because Produce Pay assumed no risk of loss, Grower did not sell its accounts receivables to Produce Pay.

Accordingly, Produce Pay's PACA claim failed, including its request to recover attorneys' fees.

### **Takeaways**

Courts will look to substance over form. Creative financing agreements that contemplate the sale of future receivables, or marketing arrangements such as the Produce Pay agreement with Grower, may ultimately be characterized—and paid—as something different from what the parties call them. Particularly in the bankruptcy context, in which the court is specifically empowered to provide equitable relief, parties embarking upon such arrangements are well-served to consider the consequences of their deal in the context of insolvency. While a potential bankruptcy case should keep everyone honest, lenders should not hesitate to evaluate potential threats seeking to creatively circumvent security interests through PACA trusts or otherwise.

<sup>3</sup> A "perishable agricultural commodity" is any fresh fruit or vegetable, whether or not frozen or packed in ice, including cherries in brine, as defined by the USDA Secretary. 7 U.S.C. § 499a(b)(4).

<sup>4</sup> Under the U.C.C., (1) title can only pass *after* goods to a contract are identified; (2) title must pass *before* goods are delivered; and (3) delivery only occurs when a document of title is provided by the seller. U.C.C. § 2-401(1),(3).

<sup>5</sup> *Endico Potatoes, Inc. v. CIT Grp./Factoring, Inc.*, 67 F.3d 1063, 1066 (2d Cir. 1995).

<sup>6</sup> *S & H Packing & Sales Co. v. Tanimura Distrib., Inc.*, 883 F.3d 797, 808 (9th Cir. 2018) (en banc).

<sup>7</sup> *Nickey Gregory Co., LLC v. AgriCap, LLC*, 597 F.3d 591, 600–603 (4th Cir. 2010).

<sup>8</sup> *Reaves Brokerage Co. v. Sunbelt Fruit & Vegetable Co.*, 336 F.3d 410, 414–16 (5th Cir. 2003).

<sup>9</sup> *Major's Furniture Mart, Inc. v. Castle Credit Corp.*, 602 F.2d 538, 545 (3d Cir. 1979).

These issues will be of increasing relevance in the coming months as the economy may tip over into recession. In an environment where assets are losing—rather than gaining—value, mistakes in obtaining, perfecting, or enforcing a security interest in borrower assets will not be easily swept under the rug. Lenders in the ag space—and beyond—are well-served to review their portfolios now, with these principles in mind.

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