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BANKRUPTCY LAW

Perishable Goods and the Bankruptcy Code: Things Are Getting Personal

Person in charge of company that buys agricultural products can be held individually liable for payment owed, and the amount is not dischargeable in personal bankruptcy

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In *Michael Farms v. Lundgren (In re Lundgren)*, the U.S. Bankruptcy Court for the Western District of Wisconsin issued a ruling that explains the potential personal liability of a person in control of a company that purchases perishable agricultural commodities when the seller of such commodities is not paid by the bankrupt company. No. 11962-13, Adv. Pro. No. 13-138, 2013 Bankr. LEXIS 5301 (Bankr. W.D. Wis. Dec. 17, 2013).

In that case, Bankruptcy Judge Furay declined to dismiss a complaint to determine the dischargeability of debts under Section 523(a)(4) of the Bankruptcy Code, based on the alleged dissipation of assets held under a trust established by the Perishable Agricultural Commodities Act, 1930, § 5(c)(4), as amended, 7 U.S.C.A. § 499e(c)(4) (PACA). In doing so, Judge Furay confirmed that a person in control of a company may be held personally liable for the amounts owed to a seller of perishable agricultural commodities without the need for the seller to pierce the corporate veil of the buyer or have a personal guarantee from the control person.

PACA

PACA originally was enacted in 1930 to promote fair trading practices in the shipping, handling and marketing of perishable agricultural commodities. Under PACA, dealers who receive perishable agricultural commodities hold them in trust for suppliers until they are paid, and such trust extends not only to perishable agricultural commodities, but also to, among other things, accounts receivable or proceeds from the sale of commodities and of food products derived therefrom. See *Consumers Produce Co. v. Masdea (In re Masdea)*, 307 B.R. 466, 474 (Bankr. W.D. Pa. 2004) (citing 7 U.S.C. § 499a). Generally, a dealer is defined for purposes of PACA as any person in the business of buying and selling in wholesale or jobbing quantities, as defined by the U.S. Department of Agriculture, any perishable agricultural commodity in interstate or foreign commerce.

Section 499e(c)(2) of PACA establishes that the purchaser of produce is the trustee of a non-segregated, floating trust in favor of the seller of the produce by providing, in relevant part, that:

> [P]erishable agricultural commodities received by a…dealer…and any receivables or proceeds derived from the sale of such commodities…shall be held by such…dealer… in trust for the benefit of the unpaid suppliers or sellers of such commodities…until full payment of the sums owed in connection with such transaction has been received by such unpaid suppliers [or] sellers.

7 U.S.C. § 499e(c)(2).

As a result of this trust in favor of the supplier, the purchaser has a fiduciary obligation to ensure that the supplier is

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paid from any proceeds generated from the sale of the product. The supplier's claim for payment from the proceeds has a higher priority of payment than the purchaser's secured creditors, employees and taxing authorities. See *Idahoan Fresh v. Advantage Produce*, 157 F.3d 197, 209 (3d Cir. 1998) ("The primary purpose of the statute was to protect unpaid sellers vis-à-vis secured creditors"). These proceeds are not property of the bankruptcy estate within the meaning of Section 541 of the Bankruptcy Code, but are held for the benefit of unpaid sellers. See *Merrill Farms Corp. v. H.R. Hindle & Co. (In re H.R. Hindle & Co.*), 149 B.R. 775, 785 (Bankr. E.D. Pa. 1993) (recognizing the concept of a floating trust eliminates the tracing requirement and that commingling of assets is contemplated). While the trust assets may be used by the buyer for other purposes, it remains the buyer's responsibility under PACA to ensure that it has sufficient assets to assure prompt payment for produce and that any beneficiary under the trust will receive full payment. *See C.H. Robinson Co. v. Alanco Corp.*, 239 F.3d 483, 488 (2d Cir. 2001).

PACA contains several prerequisites that must be complied with in order to receive PACA trust protection, including but not limited to the requirement that the unpaid supplier or seller give written notice of its intent to preserve the PACA trust to the purchaser. If the proceeds on hand are insufficient to cover the amount of the PACA claim, the PACA supplier may have a claim against the control person of the purchaser and such a claim may not be dischargeable should the control person file a personal bankruptcy.

Personal Liability of Control Person

An individual corporate officer or shareholder can be held liable for breaching his or her fiduciary duty to protect PACA trust assets under certain circumstances. See *Weis-Buy Services v. Paglia*, 411 F.3d 415, 421 (3d Cir. 2005) (recognizing that there is no requirement that supplier sue bankrupt purchaser prior to suing individuals). "Individual liability in the PACA context is not derived from the statutory language, but from common law breach of trust principles." Courts apply a two-part test to determine whether an individual has the requisite amount of control over PACA trust assets to be held individually liable, which requires courts to:

> (1) determine whether an individual holds a position that suggests possible fiduciary duty to preserve the PACA trust assets (e.g., officer, director, and/or controlling shareholder); and (2) assesses whether that individual's involvement with the corporation establishes that she was *actually* able to control the PACA trust assets at issue.

Bear Mountain Orchards v. Mich-Kim, 623 F.3d 163, 169 (3d Cir. 2010) (held that a person who was a 50 percent owner and officer of a corporation was not liable because she had no actual authority over how the company operated and who only performed basic clerical work on a part-time basis).

Section 523(a)(4) of the Bankruptcy Code

Section 523(a)(4) provides that:

> A discharge under section 727…of this title does not discharge an individual debtor from any debt…
> (4) for fraud or defalcation while acting in a fiduciary capacity.

A finding of nondischargeability under this section requires a showing that: (1) a fiduciary relationship existed between the plaintiff and the defendant; and (2) fraud or defalcation was committed by the defendant in the course of the relationship. For purposes of this section, money or property supporting the debt must have been entrusted to the debtor. A fiduciary relationship can be established either by an express trust or by a statutory trust that possesses the traditional hallmarks of an express trust. The relevant hallmarks of an express trust are: (1) the trust res must be identified by statute; (2) the statute must create fiduciary duties; (3) the statute must impose a trust on the funds prior to creating the debt; and (4) there must be a difference of a knowledge or power between fiduciary and principal which gives the former a position of ascendancy over the latter.

The *Michael Farms* Case

In *Michael Farms v. Lundgren (In re Lundgren)*, the plaintiff filed a complaint to determine the dischargeability of debts under Section 523(a)(4) of the Bankruptcy Code. The plaintiff's claims were based on the alleged dissipation of assets held under a trust established by PACA. The complaint alleged that Thomas J. Lundgren, a personal debtor who filed a petition for relief under the Bankruptcy Code, was the sole officer, director, shareholder and person in control of the assets of Spud City Sales. Further, the complaint alleged that Spud City was a produce dealer and commission merchant subject to PACA, and that the plaintiff sold $123,596 of produce to Spud City for which the plaintiff had never been paid. The plaintiff also claimed that PACA shifted the liability for payment from Spud City to the defendant by placing the defendant in a fiduciary capacity and that the defendant breached that fiduciary duty. The defendant filed a motion to dismiss on the basis that PACA does not impose fiduciary duties on him within the meaning of Section 523(a)(4) of the Bankruptcy Code.

The court in *Lundgren* found that the PACA trust qualified as an express trust because (1) section 499e(c)(2) of PACA clearly defined the trust res; (2) PACA imposes fiduciary duties owed by the purchaser to the seller; (3) the trust arises whether or not there is a defalcation or dissipation of assets by the buyer; and (4) the trust arises upon receipt of the perishable agricultural goods.

The court in *Lundgren* also found, for purposes of deciding the motion to dismiss, that the defendant was personally liable for the amounts owed to the seller from PACA trust assets and the failure to preserve or satisfy the obligations because the defendant was the sole officer, director, shareholder and person in charge of Spud City.

The court then concluded that a PACA trust *does* create fiduciary capacity for purposes of Section 523(a)(4) of the Bankruptcy Code, because of the following commercial realities embodied in both the PACA statute and its implementing regulations:

> Producers and shippers of perishable commodities are, for the most part, small size businesses. The process of growing[,] harvesting, packing and shipping perishables is a real gamble; costs are high, capital is tied up in farm land and machinery, and returns are delayed until the crop is sold. If the grower-shipper cannot realize any returns on the sale of the crop when due, he may not be able to survive. Thus, where business failures or reorganizations occur on the part of buyers of their crop, the growers are usually the parties least able to withstand the losses and inevitable delays which result from such actions.
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> Sellers of perishable agricultural commodities are often located thousands of miles from their customers. Sales transactions must be made quickly or they are not made at all. Many sales are consummated while the commodities are en route to a particular destination. Under such conditions, it is often difficult to make credit checks, conditional sales agreements, and tak[e] other traditional safeguards.

H.R. Rep. No. 98-543, at 3, *reprinted in* 1984 U.S.C.C.A.N. 405, 506. The court reasoned it is precisely this disparity of knowledge and power between the buyer and seller of agricultural commodities that gives the "former a position of ascendancy over the latter" sufficient to create implied fiduciary capacities in the defendant for purposes of Section 523(a)(4).

Because the court found that the PACA trust satisfied the requirements of an express trust, and that the defendant failed to pay the plaintiff as required, the complaint stated a claim for relief and the defendant's motion to dismiss must be denied.

The decision in *Michael Farms* is significant in that it reaffirms that a seller of perishable agricultural commodities who is not paid in full by a corporate buyer may have a claim against the person in control of the corporation (notwithstanding whether there is a personal guaranty or traditional grounds for piercing the corporate veil exist), and that the claim against the person in charge may not be discharged should the person later file a personal bankruptcy proceeding. ■