

## PACIFYING PACA LENDERS: THE SECOND CIRCUIT LIMITS LENDER LIABILITY

By Matthew B. Stein



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By 1930, the Great Depression was already having a devastating effect on the American farmer. Congress, believing that the American farmer needed greater financial protections, enacted the Perishable Agricultural Commodities Act (PACA). The statute protected the producers of unprocessed or minimally processed fruits and vegetables by mandating that all proceeds from the sale of any covered perishable commodity, as well as intermediate products and proceeds from their sale, were to be held in trust for the benefit of the unpaid producer.

In many circumstances, the secured lender whose borrower purchased goods subject to PACA was not as "secure" as it had believed. The secured creditor was now at risk for any loan payment that it received where the money was a trust asset and the borrower had not yet paid the corresponding debt to the producer. Naturally, lenders were forced to deal with the resulting implications and made lending terms stricter and more adverse to the implicated borrowers.

The trend among courts across the country, including the Second Circuit, is a retreat from the prior strict interpretation of the statute. Courts are now more willing to distinguish a forced disgorgement of trust assets from the mere receipt of trust assets, thereby limiting the effect of the statute's strict liability application. In a recent pair of cases, the Second Circuit held that PACA beneficiaries must prove lender liability by showing not only that the actions of the lender led to the breach, but also that the lender was complicit in the breach.

In both instances, the issue before the court was whether a bank was liable to the beneficiaries of a PACA trust where the borrower breached the trust in making loan payments to the bank. In a situation that would have previously resulted in a finding of liability, the court held that it is not the duty of a lender to ensure that a borrower preserves a PACA trust. The rationale supporting this holding was

### *From the Editor's Corner*

To continue to keep clients and friends of Ruskin Moscou Faltischek apprised of major issues regarding the Financial Services business climate, we bring you the latest edition of the *Financial Services Update*. This issue contains articles on *Requirement to File Notice of Lending* and *Pacifying PACA Lenders: The Second Circuit Limits Lender Liability*. The lien issues discussed in these articles are critical to secured lenders when making loans to businesses, particularly industries or loans related to the improvement of real property. In addition, this issue contains an article on *Vendors: Beware Of That Past-Due Account*. The discussion of preference claims contained in this article raises concerns that all vendors should be aware of. We encourage you to email us with your questions so we can devote future articles to issues you deem critical in your field. I hope to hear from you soon at [kdesalvo@rmfpc.com](mailto:kdesalvo@rmfpc.com).

— Karen J. DeSalvo

that the bank did not convert the PACA trusts by cashing the borrower's checks, because the mere action of honoring a check does not rise to a level as to attach liability. The court stated that, "to hold a bank liable for the preservation of trust assets would place a heavy and manifestly inappropriate burden on the banking industry."

Additionally, the court discussed the retention of interest and fees that the bank retained. The court found that the defendant bank was not liable for retention of fees and interest, holding that "it is not a per se breach of trust for a PACA dealer to use PACA funds to enter into "commercially reasonable" transactions with parties not protected by PACA, particularly where such transactions facilitate the PACA dealer's fulfillment of his obligations to PACA beneficiaries."

While PACA still requires a complex and fact-sensitive determination when entering into a secured loan, these decisions have continued the progression of cases in which the Second Circuit has limited the extent to which a lender is liable for a breach of a PACA trust.

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# VENDORS: BEWARE OF THAT PAST-DUE ACCOUNT

By Karen J. DeSalvo and Michael S. Amato



Karen J. DeSalvo



Michael S. Amato

Many vendors sell to buyers on an unsecured basis — only to find out later that a particular buyer is insolvent. In most instances, the vendor has continued to deliver goods to the buyer, even though the buyer has failed to timely pay for goods previously delivered. Issues regarding the receipt of payment on these past-due accounts can arise for the vendor after the delinquent buyer files a bankruptcy petition. The Bankruptcy Code provides that the buyer may avoid and recover any transfer (a) made to a vendor; (b) for a debt that existed prior to the date of the transfer; (c) which was made while the buyer was insolvent; (d) made within the 90 days immediately preceding the date the bankruptcy was filed; and (e) if that transfer permits the vendor to receive more than it would have received if the buyer was liquidated pursuant to Chapter 7 of the Bankruptcy Code. The practical effect of this statute is that once a bankruptcy case is filed, the buyer may

attempt to recover any payment made by the buyer within the 90 days immediately prior to the bankruptcy filing if the preceding conditions are met. These claims by the buyer against its vendors are called preference actions.

The purpose of this statute is to prevent the buyer from treating certain vendors better than others, and to ensure that any remaining assets of the company are distributed equitably. It is important to note that good faith is not a defense to a preference claim. Usually, it is those very vendors that have attempted to work with the buyer that are most susceptible to preference claims.

The Bankruptcy Code contains several defenses available to vendors in preference actions. The most commonly utilized defenses by vendors are: (a) contemporaneous exchange for value; (b) subsequent new value; and (c) that the transfer was made in the ordinary course of business.

A buyer may not avoid a transfer to the extent that the exchange was substantially contemporaneous and was intended by both the buyer and the vendor to be a contemporaneous

exchange for value. Common examples of contemporaneous exchanges are shipments that are made subject to cash being delivered to the vendors in advance of the shipment or cash on delivery (COD) arrangements.

Further, a transfer may not be avoided if the vendor granted additional credit to the buyer subsequent to the date that the vendor received the allegedly preferential transfer from the buyer. This is commonly referred to as the subsequent new value defense.

The most utilized defense to a preference claim (and the most litigated) is that the buyer made the transfer in the ordinary course of business. The ordinary course of business defense requires the vendor to establish three elements.

First, the obligation must have been incurred by the buyer in the ordinary course of its business. It requires only that the obligation arise through the ordinary business activities of both the buyer and the vendor.

Next, the vendor must establish that the transfer was made in the ordinary course of business between the buyer and the vendor. This is a subjective test which requires the vendor to analyze the history of the transactions between the buyer and vendor to establish the nature of the relationship. Courts will consider many factors in determining whether a payment was made in the ordinary course of business between the parties, including, but not limited to: (a) the length of the relationship between the parties; (b) whether the form and method of payment was the same or similar to previous payments; (c) whether the vendor engaged in any unusual collection activities; and (d) any and all other circumstances under which the payment was made. This element is fact-specific and is determined on a case-by-case basis.

Finally, the vendor must establish that the transfer was made according to ordinary business terms. This is accomplished by offering proof that the transfer was consistent with the prevailing practices of the particular industry in which the buyer and the vendor are engaged.

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## REQUIREMENT TO FILE NOTICE OF LENDING

By Matthew V. Spero

Lending to the construction industry requires an awareness and understanding of the law beyond those requirements that are ordinarily involved in the closing of a typical secured loan. Failure to undertake the proper precautions has left many a secured lender in an unsecured position. In New York, the Lien Law requires that lenders file a notice of lending in certain construction contexts to adequately protect their security interest; failure to do so will, invariably, affect the lender's ability to be repaid.

The Lien Law is intended to ensure that subcontractors who perform labor and/or provide materials for improvements of real property are compensated for the work performed and/or materials supplied. To this end, Article 3(a) of the Lien Law creates "trust funds" out of certain construction payments. Once a trust has been created, its funds may not be used for any non-trust purposes, including loan payments. Article 3(a) of the Lien Law defines trust funds as any of the following:

- Funds received by an owner or contractor in connection with an improvement of real property (including a home improvement loan) in New York State;
- Funds received by a contractor in connection with a contract for a public improvement in New York State; and
- Any right of action for any such funds due or earned or to become due or earned.

Problems can arise when the lender accepts an assignment of all of the contractor's accounts receivable as security for the loan and applies the accounts receivable it collects against its outstanding loan to the contractor. If all of the trust claims on the particular project have not been paid or discharged, the repayment of the lender's loan constitutes an

improper diversion and application of trust funds for a non-trust purpose, and the lender would be liable to the trust beneficiaries (e.g., unpaid subcontractors on the project).

Lenders, however, can protect themselves, pursuant to the Lien Law, by filing a notice of lending or notice of assignment with: (1) the office of the county clerk of the county where the real property being improved is situated; or (2) (a) the head of each department or bureau in charge of construction for the improvement to which the notice relates and (b) with the financial officer of each public corporation or other person in charge of the custody and disbursement of the corporate funds applicable to the contract for the public improvement.

While it is debatable whether a filed notice of lending, in fact, gives trust beneficiaries notice (since it may be unlikely that the trust beneficiaries would know to search for filed notices of lending in the first place), the filing provides these lenders with a defense to a claim of diversion of trust assets. Therefore, it is a necessity for all lenders to file such notices when dealing with certain borrowers in the construction industry or making loans where real property is going to be improved.

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Matthew V. Spero

**On February 16, 2005, Ruskin Moscou Faltischek's Financial Services, Banking and Bankruptcy Department presented a CLE/CPE program entitled "Insolvency: Know It Before You Need It" to a group of Long Island attorneys and business leaders at RMF's Uniondale offices.**

Pictured here are Stephen Mischo, Vice President, State Bank of Long Island, who moderated the program; James D. Glass, of counsel to Ruskin Moscou Faltischek; Jeffrey A. Wurst, chair of the firm's Financial Services, Banking and Bankruptcy Department; Karen J. DeSalvo, chair of the firm's Commercial Lending Practice Group; and Harold S. Berzow, chair of the firm's Business Reorganization Practice Group.



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Each of the above defenses are affirmative defenses that must be pled and proven by the vendor. To establish the ordinary course of business defense, it may be necessary to employ both a financial expert and an expert on industry practice. This can make preference litigation both time consuming and expensive.

While not always realistic, there are steps that vendors can take to prevent and/or limit exposure to preference claims. Companies may significantly reduce their exposure by requiring buyers to pay within invoice terms throughout their relationship. Alternatively, once it becomes apparent that a buyer is experiencing financial difficulties, it may be beneficial to change the payment terms to COD.



## ABOUT THE FIRM

Founded in 1968, Ruskin Moscou Faltishek, P.C. is one of the most respected and largest multi-practice law firms in the New York metropolitan area and is headquartered in Uniondale, New York. With 65 attorneys in 22 practice areas, the firm offers innovative legal services, keeping focus on the client's goals, in the areas of corporate & securities, corporate governance, employment, energy, environmental, financial services, banking & bankruptcy, business reorganization, commercial lending, health law, healthcare professionals, intellectual property, life sciences, litigation, municipal & regulatory affairs, real estate, construction, seniors' housing, technology, trusts & estates, and white collar crime & investigations. Clients include large and mid-sized corporations, privately held businesses, institutions and individuals.

The Financial Services Update is published to provide clients, colleagues and friends of Ruskin Moscou Faltishek, P.C. with information about developments in commercial lending and bankruptcy matters. It is not a substitute for legal advice and should not be construed as imparting legal advice generally or on specific matters.

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