RESTAURANT FAILURES –

WHAT TO DO WHEN YOUR IRON CHEF MELTS

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The Perishable Agricultural Commodities Act ("PACA")

The Perishable Agricultural Commodities Act ("PACA"), 7 U.S.C. § 499e(c), is a federal statute originally enacted in 1930 to prevent unfair trading practices in produce. It requires, among other things, that dealers of "perishable agricultural commodities" (generally, fresh and frozen fruits and vegetables) be licensed by the United States Secretary of Agriculture and the United States Department of Agriculture ("USDA"), and that produce vendors pay, promptly and in full, for any produce purchased in commerce.

In 1984, PACA was amended to further protect produce sellers by granting a statutory trust in the assets of the produce buyer. The purpose of the statutory trust is to encourage prompt payment to produce sellers, and to prevent the claims of sellers of perishable goods from being subordinated to secured lenders. Specifically, Congress stated that secured financing arrangements in which produce proceeds are used as security and diverted from the produce sellers to lenders are against the public interest and a burden on commerce. Unpaid produce sellers may bring a civil action in order to recover the assets in trust, which extends personal liability to individual shareholders, officers or directors of the buyer who are in a position to control PACA-trust assets and who fail to preserve such assets.

Application of PACA to Restaurants

The PACA trust is imposed on any "merchant, dealer or broker" of produce. A produce "dealer" is subject to the PACA trust in the following circumstances:

(1) The buyer is licensed under PACA;
(2) The buyer purchases or contracts to purchase at least 2,000 pounds of produce in one day; or
(3) If "buying any such commodity solely for sale at retail", the buyer purchases or contracts to purchase at least 2,000 pounds of produce in one day and at least $230,000 worth of produce in one calendar year.

7 C.F.R. 46.2(m) & (x).

Typically, people think of grocery stores or fresh food markets as merchants or dealers of produce. For approximately 70 years under PACA, restaurants that purchased perishable goods were assumed to be excepted the imposition of a PACA trust on its assets. The USDA, who is responsible for administering PACA, in fact stated that it was not its intent to subject foodservice establishments to the regulations of PACA. H.R. Rep. 104-207, 104th Cong., 1st Session (1995).

Courts, however, took a different view. The first case to consider PACA's applicability to restaurants was *In re Magic Restaurants*, 197 B.R. 455 (Bankr. D. Del. 1996). In *Magic Restaurants*, a creditor who supplied the debtor with produce prepetition sought the immediate payment of its pre-petition claim or a turnover of the produce. The court found that under the plain language of PACA, that a restaurant with the requisite volume of business fits the definition of both "retailer" and dealer." Since the *Magic Restaurants* case, three Courts of Appeals (including the 3rd Circuit, affirming the *Magic Restaurants* decision) have held that the statute is clear that the definition of "dealer" encompasses restaurants. *See In re Magic Rest., Inc.*, 205 F. 3d 108 (3d Cir. 2000); *Royal Foods Co. v. RJR Holdings, Inc.*, 252 F.3d 1102 (9th Cir. 2001) (holding that a restaurant that buys the requisite quantities of produce is a "dealer" under PACA even if the produce is only used in the preparation of commercial meals and not resold in unprocessed form); *In re Old Fashioned Enters., Inc.*, 236 F. 3d 422 (8th Cir. 2001).

Another line of cases has emerged to consider the imposition of the PACA trust on restaurants purchasing less than $230,000 of produce; those trying to impose the trust have argued that because the exemption only applies to dealers that sell the produce at retail, and restaurants sell instead altered or

cooked produce at retail, that the exemption does not apply. Courts have summarily rejected this argument, and have held that where a restaurant purchases less than $230,000 of produce in a calendar year, that the PACA trust does not apply. *See Fresh Pick NY, Inc. v. Dover Gourmet Corp.*, 2013 U.S. Dist. LEXIS 126873 (E.D.N.Y., Sept. 5, 2013), *citing J. Ambrogi Food Distribution v. Top Dog America's Bar & Grille of PA, Inc.,* 2005 U.S. Dist. LEXIS 14139 (E.D. Pa., July 15, 2005) and *Bix Produce Co., v. Bilimbi Bay Min., LLC,* 2006 U.S. Dist. LEXIS 50513 (D. Minn., July 24, 2006).

Assets of the PACA Trust

The scope of the PACA trust is as follows: (1) the produce items received by a purchaser in all transactions, (2) all inventories of food or other products derived from produce, and (3) any receivables or proceeds from the sale of produce or its products. Section 5 of 499e(c) provides:

> Perishable agricultural commodities received by a commission merchant, dealer, or broker in all transactions, and in all inventories of food or other products derived from perishable agricultural commodities or products, shall be held by such commission merchant, dealer, or broker in trust for the benefit of all unpaid sellers or suppliers of such commodities or agents involved in the transaction, until full payment of the sums owing in connection with such transactions has been received by such unpaid suppliers, sellers or agents.

The trust is a non-segregated "floating" trust that applies to all of the buyer's produce in inventory and all proceeds from the sale of the produce. *Sanzone – Palmisano Co.,* 986 F. 2d 1010, 1012 (6th Cir. 1993). The trust extends to all produce inventory even when purchased from a comingled account. *Id.* at 1010; *Tom Lange Co. v. Kornblum & Co. (In re Kornblum & Co.),* 81 F.3d 280 (2d Cir. 1996); *In re Atlantic Tropical Market*, 118 B.R. 139 (Bankr. S.D. Fla. 1990).

As a general proposition, all assets of a produce buyer are presumed to be imposed with the PACA trust. More specifically, courts have found that the following assets are subject to, and are held in trust for, produce sellers: Real Property (where a produce buyer commingles trust funds with payments to purchase or maintain property); Equipment (where a produce buyer uses trust funds to make payments on debts secured by its equipment and other personal property; Proceeds from the Sale of Meals (considered "products derived" from produce and therefore subject to trust); Insurance Proceeds (inventory sale proceeds paid insurance premiums and therefore proceeds from the policy are also impressed with trust).

The PACA trust arises upon the buyer's purchase of produce and continues in existence until all PACA creditors are paid in full. There is no burden on the seller to trace the sales of its produce down the stream of commerce. However, there is a burden imposed on any party seeking to show that an asset is free from the trust.

The Second Circuit has established a test used to establish or challenge whether an asset is part of the trust, which test is widely accepted. *In re Kornblum*, 81 F. 3d 280 (2d Cir. 1996). The party challenging the scope of the trust must show the following:

(1) No PACA trust existed when the asset was purchased or acquired;
(2) Even though a PACA trust existed at the time, the asset was not purchased or acquired with trust funds; or
(3) Although a PACA trust existed when the asset was purchased or acquired and the asset was purchased with trust funds, the produce purchaser thereafter paid all unpaid sellers in full prior to the transactions involving the PACA creditor, thereby terminating the trust.

Asserting a PACA Claim

Unpaid produce sellers and suppliers have standing to assert PACA claims for the cost of the produce sold and other amounts incurred "sums owing in connection" to the produce sold. Based on this statutory language, PACA creditors often seek to recover not just the cost of the produce sold but also shipping costs, freight charges, taxes, interest, and attorney's fees. The produce buyer may reduce the amount of the claim to be paid from the trust by subtracting "contemplated expenses or advances", or expenses that the buyer already paid. There has been much litigation over the type of costs that are considered "in connection" with a PACA claim. *See e.g. Coosemans Specialties, Inc. v. Garguilo*, 485 F. 3d 701 (2d Cir. 2007); *Middle Mt. Land & Produce, Inc. v. Sound Commodities, Inc.*, 307 F. 3d 1220 (9th Cir. 2002); *In re Veg Liquidation, Inc.*, 516 B.R. 545 (Bankr. W.D. Ar. 2014).

In order to perfect a PACA claim, a creditor must either (a) include specific language on the face of its invoices or billing statements that the produce is sold subject to the PACA trust or (b) provide written notice to the buyer of the intent to preserve the benefit of the PACA trust. 7 U.S.C. § 499e(c).

A PACA creditor using the "invoice method" must be licensed by the USDA. The language on the invoice must read: "The perishable agricultural commodities listed on this invoice are sold subject to the statutory trust authorized by section 5(c) of the Perishable Agricultural Commodities Act, 1930 (7 U.S.C. 499e(c)). The seller of these commodities retains a trust claim over these commodities, all inventories of food or other products derived from these commodities, and any receivables or proceeds from the sale of these commodities until full payment is received." 7 U.S.C. §499e(c)(4).

A PACA creditor using the written notice provision must give notice within 30 days after (a) 10 days after delivery of the produce, (b) the payment date agreed upon by the parties prior to the transaction, or (c) the date on which a seller receives notice that the payment has been dishonored.

The maximum payment term allowed for coverage under the PACA trust is 30 days. A recent change to the Regulations provides that a seller's agreement to accept past-due payments over time does not result in an extension of payment terms or a waiver of trust rights. *See* 7 C.F.R. 46.46(e)(3), which changes previous case law that has held that a written agreement for payment over time constitutes a waiver of trust rights when received more than 30 days past the date of delivery.

PACA Claims in Bankruptcy

Upon a bankruptcy filing, all of a debtor's legal and equitable interests become property of the bankruptcy estate pursuant to 11 U.S.C. §541. Any assets that a debtor holds in trust for another do not become property of the estate and are not distributed pursuant to the bankruptcy code's priority scheme. Accordingly, PACA trust assets are not property of the debtor's estate. *See* 49 Fed. Reg. at 45738 ("If a buyer or receiver declares bankruptcy… trust assets are not to be considered part of the estate to be distributed to other creditors or sold unless all trust beneficiaries have been paid." PACA provides that all unpaid produce sellers are to be paid ahead of other creditors, including administrative claimants. However, only qualified, properly perfected PACA claims are afforded this treatment. Claims of produce sellers who have not perfected their claims (by providing notice as detailed above) or do not otherwise satisfy the PACA requirements do not qualify for payment from the trust in bankruptcy.

Purchasing and Selling Businesses Subject to PACA

In two recent bankruptcy cases, the USDA has sought to elevate all produce-related claims (qualified and unqualified) to priority status and to condition the sale of a produce debtor's assets on the satisfaction of such claims. *See In re Contessa Liquidating Co., Inc., (f/k/a Contessa Premium Foods, Inc.),* Case No. 11-13454 (Bankr. C.D. Ca. 2011); *In re Allen's Inc. and All Veg, LLC,* Case No. 13-73597 (Bankr. W.D. Ar. 2014). The USDA compared PACA licenses to state liquor licenses, and has relied on case law holding that the transfers of liquor licenses can be conditioned on the payment of state taxes and other business-related claims. Because the purchaser of a PACA regulated business will need a license to continue operations, the USDA has significant leverage in this regard.

Cash Collateral Issues in the Food Service Industry

Section 552(a) of the Bankruptcy Code provides: "[e]xcept as provided in subsection (b) of this section, property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case." 11 U.S.C. § 552(a). Among the exceptions set forth in § 552(b) is that proceeds of pre-petition collateral are subject to liens to the extent provided in the applicable security agreement. Thus, a pre-petition lien covering food and beverage inventory would typically extend to the post-petition proceeds of the sale of food and beverage inventory.

However, bankruptcy courts have found that in a restaurant, only a portion of the receivables generated are from the use of the food and beverage inventory, and accordingly, the lenders secured lien may not extend to all receivables generated post-petition. For example, the court in *In re Cafeteria Operators, L.P.*, 299 B.R. 400 (Bankr. N.D. Tex. 2003) noted that the post-petition revenue generated by a restaurant "represents, in large part, the proceeds of Debtors' post-petition toil and effort" as opposed to the diminution in value of its inventory, and that only the portion of the revenues specifically related to the disposition of that food and beverage inventory constitutes the proceeds of that inventory.

The court in *In re Timothy Dean Restaurant & Bar*, 342 B.R. 1 (Bankr. D.D.C. 2006) reached a similar conclusion with respect to hotel room service charges, noting that "the room *service* charges here fall within the service industry to an even greater extent than a typical restaurant bill." The court went on to explain that if the bank could establish that the charges were partially or wholly attributable to the sale of food inventory, the bank could have asserted a lien on those proceeds, but that the bank had not provided any evidence regarding the portion attributable to the disposition of food inventory. A party asserting a security interest has the burden of proof under § 363(p), which can pose a challenge for a secured creditor in the context of a cash collateral dispute.

Landlord Rights and Issues

A lease may be terminated pre-petition or prior to the bankruptcy petition date of the tenant. This effectively removes the lease from the bankruptcy estate – but the lease must be completely terminated (as defined under applicable state law) and not subject to redemption or any similar right. If the tenant files for bankruptcy during the applicable cure period, the lease will not be considered terminated and will be an executory contract that is part of the debtor's bankruptcy estate. There is some risk that a lease terminated prepetition may be reinstated as a fraudulent transfer under Section 548 of the Bankruptcy Code after a bankruptcy filing.

After a tenant's bankruptcy filing, the automatic stay under Section 362 operates to prevent:

- The commencement or continuation of judicial or similar proceedings against the debtor
- Enforcement of any prepetition judgment
- Any act to obtain possession or of property of the estate or to exercise control over property of the estate
- Acts to create, perfect or enforce liens
- Collection actions
- Setoffs (including application of a security deposit to outstanding obligations)

A party may request and obtain relief from the automatic stay, after notice and a hearing, for one of two reasons:

- Cause, including adequate protection (may include failure to pay post-petition rent or comply with other obligations, determined on a case by case basis)
- Lack of equity in property/not necessary for an effective reorganization

Administrative Rent

"Administrative rent" is the portion of rent that is entitled to administrative expense priority and is typically paid in full in chapter 11 bankruptcy cases. What constitutes administrative rent and when administrative rent is paid varies among jurisdictions. There are two types of administrative rent allowed under the Bankruptcy Code:

- Rent arising from and after the order for relief until the debtor decides whether to assume or reject the lease (11 U.S.C. §365(d)(3)).
- Rent that constitutes an actual and necessary cost of preserving the bankruptcy estate (11 U.S.C. § 503(b)(1)(A)).

There is a greater burden under Section 503, but unlike Section 365, it allows for a landlord to obtain administrative priority rent after the rejection of the lease where the tenant remains in possession.

"Stub Rent" is the rent due between the petition date and the first post-petition rent payment date. Courts are split on the treatment of stub rent as an administrative expense.

- "Billing Date" Jurisdictions (Third, Sixth and Eighth Circuits)
    - Look to date rent becomes due and payable under the lease. If the date is prior to the petition date, then the stub rent is not an obligation that arises

"from and after" the petition date and is therefore not an administrative expense under Section 365(d)(3).
    - There is a disagreement in billing date jurisdictions as to whether Section 503(b)(1) will afford administrative expense priority to stub rent when Section 365(d)(3) does not.
- "Accrual Date" Jurisdictions (Second, Fourth, Ninth Circuits, DC Bankruptcy Court)
    - Stub rent is an administrative expense under Section 365(d)(3)
    - Prorate the rent of the month straddling the petition date into prepetition and post-petition portions – the post-petition portion of that month's rent must be "timely" paid.
        - But, a court may allow the payment to be deferred until the effective date of the plan of reorganization. *See In re Circuit City Stores, Inc.*, 447 B.R. 475 (Bankr. E.D.Va. 2009).

There are also two approaches to the end date of administrative rent under Section 365(d)(3) (which controls rejection or assumption). Bankruptcy courts do have equitable authority to approve rejection retroactively, effective the date the motion was filed.

- Billing approach – if rent is due on first day of month and the debtor rejects the lease on the second day of the month, the entire month's rent is entitled to administrative priority.
- Accrual approach – only the period through the date of rejection is entitled to administrative rent priority.

<u>Assumption/Assignment/Rejection</u>

There are three options for treatment of a lease under the Bankruptcy Code:

- Assumption – Assume lease for the continued use by debtor or for the assignment to a third party
- Assignment – Assign lease to a third party
- Rejection - Reject lease and return premises to landlord

Unexpired leases of nonresidential real property are deemed rejected under Section 365(d)(4) unless they are assumed by the earlier of 120 days after the order for bankruptcy relief or the date of the plan confirmation order.

The court may extend the assumption deadline for an additional 90 days for cause upon a motion filed before the initial 120 day period. Subsequent extensions are only granted "upon prior written consent of the lessor." As a landlord, should you consent to an extension? If the debtor is likely to assume the lease, then cooperation is conducive to the long-term relationship and the landlord will have a lesser burden to prove administrative rent. However, if the landlord is anxious to regain control of the premises or the debtor is likely to reject the lease eventually, then consenting may not make sense.

If a lease is assumed while in default, the debtor must, under Section 365(b)(1):

(1) Cure the default, or provide adequate assurances that it will promptly cure the default
(2) Compensate the landlord or any actual or pecuniary loss resulting from the default, or provide adequate assurances of such compensation;
(3) Provide adequate assurance of future performance.

The debtor is not, however, required to cure non-monetary defaults that are impossible to cure as a condition of assumption or defaults arising from the failure to satisfy a penalty relating to a nonmonetary default. Section 365(b)(1)(A), (b)(2). Additionally, there is no cure of *ipso facto* defaults – that is, a provision in the lease providing for automatic default or termination upon the event of bankruptcy is not enforceable. Section 365(e).

Cure amounts include all outstanding amounts due under the lease. Depending on the lease term, it may include unpaid rent, interest, late fees and penalties, attorney's fees, other monetary obligations (e.g., utilities, insurance), any actual pecuniary loss.

If the lease is in a shopping center, under Section 365(b)(3), a debtor must provide adequate assurance:

(1) Of the source of rent and other consideration due under the lease;
(2) That any percentage rent due under the lease will not decline substantially;
(3) That assumption is subject to all provisions of the lease, including provisions such as radius, location, use or exclusivity; and
(4) That assumption will not disrupt any tenant mix or balance in the shopping center.

In order to assign a lease to a third-party, the debtor must first assume the lease in accordance with Section 365. Anti-assignment provisions in leases are generally not enforceable under Section 365(f); however, assignee must provide adequate assurance of future performance, whether or not there has been a default in the lease. Section 365(f)(2)(B). A landlord can object to whether the assurances provided are adequate.

If a lease is rejected, the landlord will be entitled to a rejection claim against the debtor for the remaining rent due under the lease over the course of its term, except that a rejection claim is subject to a limitation imposed by Section 502(b)(6).

Recovery of Premises/Improvements

Upon deemed rejection, the debtor must immediately surrender the property to the lessor. Section 365(d)(4). If the debtor does not comply with the landlord, there are several options on how the lessor might attempt to enforce the rejection. The bankruptcy court may invoke contempt for failure to comply with the court ordered rejection and issue a surrender order. There is some question about whether the landlord must seek relief from the bankruptcy court, or whether the lease is considered terminated (and the stay lifted) so that the landlord may invoke self-help or seek eviction through a state court.

Landlords are well advised to order a UCC search upon learning of a tenant's bankruptcy to determine who actually owns the furniture, fixtures and equipment and whether there are any third-party liens. Counsel should also consult state law to determine if the landlord has lien rights in any of the FF&E.

If the landlord wants the tenant to remove FF&E, it may seek a mandate from the court that the tenant does so when the lease is rejected and the premises are surrendered. Issues related to FF&E at the premises are often resolved by negotiations between the debtor and landlord with the tenant conveying the FF&E to a landlord in exchange for a reduction in the landlord's claim against the bankruptcy estate or other compensation. In a chapter 7 proceeding, if a trustee has filed a "no asset report", then the debtor's interest in any FF&E is deemed abandoned and the landlord is free to pursue its remedies under state law in the FF&E.

Sales of Restaurant Franchises

Franchisors often wield significant control over sales of restaurant franchises in bankruptcy. This control results from the fact that significant value generally rests in the applicable franchise agreement. In order to extract this value, the franchise agreement must be assumed and assigned to a purchaser. This presents several issues.

First, the Debtor must cure all defaults. 11 U.S.C. § 365(b)(1). Obligations owed to franchisors are often significant and will include royalties, advertising fund contributions, and other amounts owed under the franchise agreement. In addition, franchisees often fall behind on non-monetary obligations, including updating signage. It is typically impractical to attempt to sell a restaurant as a going concern without the franchise rights. Accordingly, these significant cure requirements reduce proceeds available to pay secured and other creditors.

Second, most courts to address the issue have held that unlike most executory contracts, a franchisor must consent to the assignment of its agreement. This is because federal trademark law excuses the franchisor from accepting performance from a party other than the debtor, and without exception, franchise agreements contain licenses to use intellectual property of the franchisor. 11 U.S.C. § 365(c); *see In re Kazi Foods of Michigan, Inc.*, 473 B.R. 887 (Bankr. E.D. Mich. 2011) (assumption prohibited because applicable law prohibits assignment of franchise without consent under applicable trademark law). By utilizing this veto power, a franchisor can often control the identity of qualified purchasers at a § 363 sale of a restaurant business.

Restaurant Franchisor Debtors – Rejection of Franchises

Where the Debtor is the franchisor, it may seek to reject unprofitable stores and sell its assets free and clear of liens under § 363. Conventional wisdom had been that a franchisor could reject license agreements, sell its assets, and prevent franchisees from continuing to use its marks. However, in *In re Crumbs Bake Shop, Inc.*, 522 B.R. 766 (Bankr. D.N.J. 2014), the bankruptcy court held that a sale of licensee could continue to use trademarks pursuant to § 365(n) of the Bankruptcy Code following rejection. The court in *Crumbs* found that notwithstanding the fact that trademarks did not fall within the definition of "intellectual property," such licenses nonetheless fell within the ambit of § 365(n), which protects licensees following rejection and allows continued use of intellectual property provided that royalties are paid.

Sales Tax Priority

Some jurisdictions have priority statutes that allow unpaid sales tax liens to jump ahead of other perfected security interests. For example, D.C. Code Ann. § 47-2012 provides an express priority for D.C. sales tax as follows:

> Whenever the business or property of any person subject to tax under the terms of this chapter, shall be placed in receivership or bankruptcy, or assignment is made for the benefit of creditors, or if said property is seized under distraint for property taxes, all taxes, penalties, and interest imposed by this chapter for which said person is in any way liable shall be a prior and preferred claim. Neither the United States Marshal, nor a receiver, assignee, or any other officer shall sell the property of any person subject to tax under the terms of this chapter under process or order of any court without first determining from the Collector the amount of any such taxes due and payable by said person, and if there be any such taxes due, owing, or unpaid under this chapter, it shall be the duty of such officer to first pay to the Collector the amount of said taxes out of the proceeds of said sale before making any payment of any moneys to any judgment creditor or other claimants of whatsoever kind or nature. Any person charged with the administration or distribution of any such property as aforesaid who shall violate the provisions of this section shall be personally liable for any taxes accrued and unpaid which are chargeable against the person otherwise liable for tax under the terms of this section.

In re WPG, Inc., 266 B.R. 773 (Bankr. D.D.C. 2001) discusses the breadth of this statute. It "gives the Districts claim for sales taxes 'a first priority in terms absolute.'" *Quoting Pearlstein v. U.S. Small Business Admin.*, 719 F2.d 1169 (D.C. Cir. 1983). This means that D.C. sales taxes are entitled "to a priority over a prior perfected security interest." *WPG citing Malakoff v. Washington*, 434 A.2d 432 (D.C. 1981). Thus, at least in the District of Columbia, parties need to be aware of any outstanding sales taxes in contemplating a sale of a restaurant in bankruptcy, which can take yet another bite out of proceeds available to pay secured claims.