

## Why PACA matters to restaurants

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By Robert A. Guy, Jr.

If you've never heard of PACA, you're not alone. For many years, this little-known acronym has been insignificant to the restaurant industry. And it probably would have remained so, destined to restaurant obscurity, were it not for a recent ruling by a federal court of appeals, the import of which is to give PACA substantial implications for restaurant owners and their businesses.

PACA stands for the Perishable Agricultural Commodities Act, a nearly 70-year-old law that was first enacted by Congress during the Great Depression. PACA creates standards of fair dealing between dealers of perishable agricultural commodities and requires that dealers and certain other classes of businesses be licensed by the Department of Agriculture.

Most important, PACA creates a trust in favor of suppliers of fresh fruit and produce, requiring that buyers hold the agricultural goods and proceeds in trust until suppliers have been paid in full.

The result is that, when a business has financial difficulties and cannot afford to pay all creditors, fruit and produce suppliers usually get paid first and in full.

### **Decision holds some restaurants liable to suppliers**

In a significant decision issued in March 2000, the U.S. Court of Appeals for the 3rd Circuit found that certain restaurants can be held liable under the trust requirements of PACA. The decision is the first by a higher court to address whether PACA applies to restaurants and reverses a long-standing interpretation of the statute by the U.S. Department of Agriculture that excluded restaurants from PACA and its licensing requirements.

Traditionally, only a restaurant with a buying arm, which is a separate legal entity buying for and reselling to the restaurant, has been considered subject to PACA. The Court of Appeals' ruling came in the case of Magic Restaurants Inc., a restaurant chain that filed for bankruptcy in Delaware. In the Magic case, the Court of Appeals found that Magic was required to comply with the PACA trust because it was a "dealer" under the statute. Restaurants that annually purchase more than \$230,000 of fresh fruit and produce in "wholesale or jobbing" quantities totaling one ton or more in any given day fit within the definition and are subject to the trust.

Strikingly, the Court of Appeals noted in its opinion that the result of its decision may be that restaurants like Magic, which have failed to obtain dealer's licenses from the USDA, have potentially been in violation of PACA for as much as the entire time that the statute has existed.

While the court found this result troubling, it nevertheless concluded that the plain language of PACA mandates that restaurants meeting the threshold for "dealers" are subject to the statute.



### **Business bankruptcies could be affected**

The decision could affect many of the business bankruptcies filed in the United States, because it governs litigation in Delaware, a favorite site for bankruptcy filings. The decision may also have a ripple effect on courts across the country, as it is the first issued by a Court of Appeals. Further, the decision opens the door for the potential application of PACA to other institutional buyers of fruit and produce that may not have traditionally been considered “dealers.”

### **Restaurant operators could be held individually liable**

The decision has a significant incidental effect that should not be overlooked. Courts have often held that senior managers or owners who are “controlling persons” of the company buying produce can be held individually liable if the company fails to preserve sufficient assets to pay PACA trust claims.

Thus, where a restaurant fails to maintain sufficient PACA assets to repay its suppliers, the suppliers may now be able to pursue claims against the individuals running the restaurant.

### **Implications of PACA for restaurants**

These claims would not exist outside of PACA, and the implications for restaurants and their owners are clear. When facing a deepening financial crisis with too little money to pay all creditors, a restaurant and its senior decision makers should evaluate carefully before choosing not to pay fruit and produce suppliers; the priority of these trust claims in bankruptcy and the potential for individual liability are risks that cannot be ignored.

The 3rd Circuit’s decision in Magic is probably not the last word on the controversy of whether PACA applies to restaurants. The Magic opinion comes on the heels of several inconsistent rulings by lower courts, and because the Magic case was decided in March, at least one lower court has chosen not to follow its holding.

In addition, the USDA, which administers PACA through its Agricultural Marketing Service, does not appear to be requiring that restaurants obtain PACA licenses at present, although this may change. In the meantime, restaurants and their suppliers should be aware of the changing law and should consider giving the invoices of their fruit and produce suppliers a high priority.

### **About the Author**

Robert A. Guy Jr. is an attorney with the Nashville law firm of Waller Lansden Dortch & Davis, A Professional Limited Liability Company. The information contained in this article is provided for general information purposes, and should not be construed as legal advice. As always the reader should consult a qualified attorney for specific legal guidance.

For additional information, please feel free to contact Bobby Guy at (615) 850-8933 or via e-mail at [bguy@wallerlaw.com](mailto:bguy@wallerlaw.com).

***Robert A. Guy, Jr. is not certified as a business bankruptcy specialist by the Tennessee Commission on Continuing Legal Education and Specialization.***