Tough Law

By Priscilla Grannis

Recent developments: bankruptcy, PACA, and personal liability

You've just learned a produce company that owes you $500,000 for purchased produce has gone belly-up. There's a shortfall and the company has insufficient PACA trust assets to pay you and other PACA creditors in full. Are you out of luck for the balance due, or are there other avenues of recovery?

The PACA statute does not address this issue directly, but case law has determined that PACA trust creditors can look to those individuals who *controlled or were in a position to control* the company's trust assets to recover the shortfall. The legal theory at work here is that these individuals breached their fiduciary duty to ensure the company preserved and maintained sufficient assets for the benefit of its PACA trust creditors, and therefore may be held personally liable for this tortious act.

Defining Personal Liability

Numerous appellate and district courts have determined that individuals who are in a position to control PACA trust assets, and who breach their fiduciary duty to preserve those assets, may be held personally liable under PACA. These courts have consistently held that "liability attaches first to the licensed commission merchant, dealer or broker …[i]f, however the assets of [that dealer] are insufficient to satisfy the PACA liability, then others may be held secondarily liable if they had some role in causing the corporate trustee to commit the breach of trust" *(Golman-Hayden Co. v. Fresh Source Produce, Inc.)*.

Two recent decisions, however, address the issue of personal liability in a somewhat different light. Specifically, the courts are looking at the issue of "position to control." At first glance, it appears the two decisions are diametrically opposed to one another; but a closer examination of the decisions reveals that based upon the facts of each case, they are harmonious.

The Houston's Finest Case

The first decision was issued by the U.S. District Court for the Southern District of Texas, in *Ruby Robinson Co., Inc., et al. v. Kalil Fresh Marketing, Inc. d/b/a Houston's Finest Produce Company, John C. Kalil, Bryan Herr and Sam Petro, Jr.* Houston's Finest ceased business operations owing PACA trust creditors about $1.7 million. The corporation had insufficient funds to pay its PACA trust creditors in full, so the creditors looked to the principals of Houston's Finest for the shortfall.

All but one of the trust creditors eventually settled with principals John Kalil, Sam Petro, Jr., and Brian Herr. However, the remaining creditor decided to pursue its claim in court against two of the principals, Sam Petro and Brian Herr, alleging they controlled or were in a position to control the trust assets of Houston's Finest and breached their fiduciary duty to preserve those assets for PACA trust creditors.

Key Elements

Can I reach the responsible individuals when a company folds without the assets to meet its PACA trust obligations?

- courts have long held that individuals who control or are in a position to control a company's trust assets may be held personally liable for any shortfall in trust assets
- passive shareholders with actual authority may not be able to escape liability based on a failure to exercise their rights and obligation to control the company
- special circumstances and/or "context" regarding how a company is managed can be used by the courts in determining personal liability.

To learn more about each key element, look for the symbols throughout the article.

LEGAL-EASE

In support of its argument, the trust creditor provided a copy of a stock purchase agreement, executed several years earlier, in which the two individuals each purchased a 25 percent interest in the company. In addition to ownership rights, the stock purchase agreement provided that the two principals would be members of the board of directors, officers of the company, and most importantly, would have "input and authority over certain aspects of the business," including decisions as to accounts and terms granted to those accounts, equipment purchases, major personnel changes, as well as sales and buying strategies. Although the principals did not dispute that they were shareholders of Houston's Finest, they argued that they were never officially elected to the board or appointed officers, were not involved in the daily activities of the company, and never exercised control over the assets.

The *Houston's Finest* court did not base its decision on whether the individuals were officers or directors of the company, as that relationship may be insufficient to create individual liability. Rather, in ruling that the two individuals were personally liable, the trial court followed the Fifth Circuit's *Golman-Hayden* reasoning that "[a passive shareholder] may not escape liability based on a real or claimed failure to exercise his right and obligation to control the company."

The *Houston's Finest* court stated that "even if such authority was not exercised, both [individuals] were shareholders with a contractual right to control PACA trust assets by virtue of their authority over the operations of Houston's Finest." The court's closing remarks pointed out that these two individuals were fully aware that PACA was "tough law" and "strictly regulated" as both were involved in other PACA-governed companies. Thus, the decision "holding [these individuals] secondarily liable for breach of the PACA trust fulfills the goals of PACA." (An appeal of this decision is currently pending before the Fifth Circuit Court of Appeals.)

The Bear Mountain Case

About one month after the trial court's decision in *Houston's Finest*, the Third Circuit Court of Appeals issued its ruling affirming the lower court's decision in *Bear Mountain Orchards, Inc. et al. v. Mich-Kim, Inc. t/a Ellis Fleischer Produce Co., et al.* On paper, Fleischer Produce was a corporation operated by a husband and wife team. The trial court granted summary judgment against the corporate entity and Mr. Fleischer in favor of the PACA creditors, but denied summary judgment against the wife.

Accordingly, a bench trial followed to determine whether the wife was secondarily liable based on her role as an officer of Fleischer Produce. The court determined the wife was not personally liable; although she was an employee of the company, "she was not involved in any of the fundamental business decisions, and there was no evidence she had any managerial role in the operation of the company" and further, there was no evidence she had been "actively involved in running the corporation." The PACA trust creditors appealed this decision.

The Third Circuit affirmed this decision finding that "individual liability under PACA turns not on whether [an individual] nominally held an officer [...] position, nor even the size of her shareholding, but whether [the individual] had the authority to direct the control of (i.e. manage) PACA assets held in trust for the producers." In reaching this decision, the Appellate Court looked to its earlier decision in *Weis-Buy Services, Inc. v. Paglia*, in which it found that "individual officers and shareholders, *in certain circumstances*, may be held individually liable for breaching their fiduciary duties under PACA" (emphasis added).

The Third Circuit rejected the plaintiff's position that an individual who is an officer, director, or shareholder is automatically in a position to control PACA trust assets. Instead, the Court found that the "context" of how each corporation is actually managed is vital to determine personal liability. The Court established a "position of control" test to determine what those "certain circumstances" might be: first, the court must "determine whether an individual holds a position that suggests a possible fiduciary duty to preserve the PACA trust assets" and secondly, "assess whether that individual's involvement with the corporation establishes that he/she was *actually* able to control the PACA trust assets at issue."

Even though this was a "mom-and-pop" operation, testimony at trial revealed the wife, though she had the authority to sign checks, did so only at the direction of her husband or the office manager; that she was

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not involved in any of the corporation's major business decisions nor its day-to-day management; that the office manager supervised her work; and that she only worked part-time.

Testimony also revealed she did not make suggestions on how to organize or manage the business, nor did her husband consult with her before closing the business—he made an after-the-fact announcement. Based upon these specific facts established during the trial, the Court found the wife was a "mere subordinate" and "had no actual ability to manage the corporation, and therefore, no power to control its use of PACA trust assets." The court noted that absent these findings, it would have had no problem holding the wife personally.

Concluding Thoughts

As stated at the beginning of this article, the decisions in *Houston's Finest* and *Bear Mountain* appear to be at odds with each other and previous decisions on the issue of personal liability. Such is not the case; whether the individuals were directors or officers of Houston's Finest was irrelevant to the Court's decision in *Houston's Finest*.

Instead, the Court looked at the evidence proffered—the Stock Purchase Agreement—and determined that the individual defendants had the contractual authority to control Houston's Finest. The Court looked at "certain circumstances" and the "context" of the case and determined that the individuals' failure to exercise their authority did not excuse them and was a breach of their duties as PACA trustees to preserve trust assets for the company's PACA trust beneficiaries, for which they were personally liable.

In *Bear Mountain*, the Court also determined that the official status of the defendant was not dispositive unless her official title also came with the authority and ability to control or manage the company and its assets. Since the wife had no authority or management responsibilities, the Court found that she was not secondarily liable for the company's shortfall.

In conclusion, courts look at "certain circumstances" and "context" before determining whether an individual will be found secondarily liable for a company's shortfall. Personal liability most likely will be found in those "certain circumstances" where the individual has the actual authority and ability to control or manage a company.

A title, whether formal or informal, absent actual authority and the ability to control trust assets may not be sufficient to hold an individual personally liable. However, an individual with actual authority to control or manage trust assets cannot escape personal liability simply because he/she fails to exercise that authority. As they say, "PACA is a tough law." BP

Priscilla W. Grannis is an agricultural and PACA attorney with Rynn & Janowsky, LLP. She has expertise enforcing trust rights under PACA and significant experience managing multiparty PACA litigation in U.S. district and bankruptcy courts. Prior to her legal career, Grannis was a professional opera/concert singer, and was also employed as a human resources manager.

ONLINE

For information on related topics, reference the following articles in the Blue Book Online Services Learning Center:

"Claiming Your Piece of the Pie" – April 2009
"Invoicing and Trust Preservation" – October 2010

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