ORIGINAL

In the

Supreme Court of the United States

UNITED STATES OF AMERICA, PETITIONER,	)	
V.	)	No. 77-1359
KIMBELL FOODS, INC., ET AL., RESPONDENTS.	)	

Washington, D. C.
January 8, 1979

Pages 1 thru 45

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UNITED STATES OF AMERICA, Petitioner,	:	
v.	:	No. 77-1359
KIMBELL FOODS, INC., ET AL., Respondents.	:	

Washington, D. C.
Monday, January 8, 1979

The above-entitled matter came on for argument at 11:23 o'clock, a.m.

BEFORE:

WARREN E. BURGER, Chief Justice of the United States
WILLIAM BRENNAN, Associate Justice
POTTER STEWART, Associate Justice
BYRON R. WHITE, Associate Justice
THURGOOD MARSHALL, Associate Justice
HARRY A. BLACKMUN, Associate Justice
LEWIS F. POWELL, JR., Associate Justice
WILLIAM H. REHNQUIST, Associate Justice
JOHN PAUL STEVENS, Associate Justice

APPEARANCES:

STEPHEN R. BARNETT, ESQ., Deputy Solicitor General, Department of Justice, Washington, D. C. 20530, on behalf of the Petitioner.

VERNON O. TEOFAN, ESQ., 820 United Fidelity Building, 1025 Elm Street, Dallas, Texas 75202, on behalf of the Respondents.

C O N T E N T S

P R O C E E D I N G S

MR. CHIEF JUSTICE BURGER: We will hear arguments next in No. 77-1359, United States against Kimbell Foods.

Mr. Barnett, you may proceed.

ORAL ARGUMENT OF STEPHEN R. BARNETT, ESQ.,

ON BEHALF OF THE PETITIONER

MR. BARNETT: Mr. Chief Justice, and may it please the Court:

The question in this case is whether a private lien that has not become specific and definite, that has not become choate before a federal lien attaches to the same property, takes precedence over that federal lien.

QUESTION: Do I get it, Mr. Barnett, specific and definite is simply synonymous with choate?

MR. BARNETT: Well, I use the words, Mr. Justice Brennan, so as not to rely completely on the technical term developed by this Court, but for functional purposes, I think choate is the word, for better or worse.

QUESTION: Does this mean that the claim must be reduced to judgment?

MR. BARNETT: No, Mr. Justice Powell, we do not take that position. The Crest Finance case, which we distinguish here, made clear that when the amount of a lien is evidenced by notes, notes bearing face values, that lien is choate as the Government conceded and as the court held in that case, even

though it was not reduced to judgment. Thus, if the future advances that Kimbell made in this case, the future advances had been evidenced by notes as were the inventory advances that Kimbell made in 1966 and 1968, this would then be a different case and Kimbell then would have a choate lien with respect to those future advances. But the future advances here were not evidenced by notes. The lien does not have to be reduced to judgment when it is this kind of a lien, but there is a significant, a crucial difference between having a debt evidenced by notes and having it simply be an open account where the amount is indicated perhaps in one amount on the seller's books and in another amount on the purchaser's books, where there are all sorts of uncertainties and possible defenses with respect to the amount that are not ironed out until there is a judgment.

QUESTION: Mr. Barnett, would it be an equally appropriate phrasing of the question to say that this is a case where the Government requests that this Court extend the choateness doctrine that has previously applied in tax areas to non-tax activities of the Federal Government to give it priority there?

MR. BARNETT: To reply, I would accept your statement, Mr. Justice Rehnquist, except for the last phrase, to apply in those cases the same rules of first in time and choateness, to give the Government priority, therefore, when it prevails under those rules, and to give the other party priority when it

prevails under those rules.

QUESTION: Do you think the Fifth Circuit decision in this case was a violation of the "first in time, first in right" rule?

MR. BARNETT: In this case?

QUESTION: Yes.

MR. BARNETT: Not a direct violation, but this Court has made clear in its decisions that there is a violation of this Court's interpretation of the "first in time, first in right" rule, as embodying the choateness approach to determining when a lien arises.

QUESTION: But that has previously been applied by this Court only in the tax area, is that correct?

MR. BARNETT: That is true.

QUESTION: So you are asking us to extend it in this case from the tax area to the field of commercial lending by the Government?

MR. BARNETT: That is correct.

And, as we point out, commercial lending is an activity of the Federal Government. The SBA is not, as the court below said and as Respondent says, simply another commercial lender. The SBA makes loans for matters of policy, not simply to make a profit. The SBA operates under a statute which provides that it shall make loans [15 U.S.C. 636(a)(1)] to small business concerns where financial assistance is not

otherwise available on reasonable terms from non-Federal sources.

In the record of this case, on the SBA loan guarantee application at A-73, that policy is stated as the first of the SBA's loan policies, quote, "The SBA will not extend financial assistance if the funds are otherwise available on reasonable terms from normal lending sources or the personal resources of the principals."

QUESTION: Mr. Barnett, what way does that argument cut? What you are saying, I suppose, is: the Government is willing to take greater risks in lending than private lenders do, so why should it then need greater protection than private lenders?

MR. BARNETT: Well, it takes greater risks, but it needs protection that is consonant with those risks.

This Court, in the area of tax liens, decided, bringing the rule over from the insolvency statute, that the Government needed the kind of protection reflected in the "first in time, first in right" rule as adumbrated by the choateness principle. We submit that, unless Congress says otherwise, it is appropriate to give the Government the same protection here. A dollar coming in on recovery of an SBA lien is the same to the Government as a dollar collected on taxes. In fact, Congress replenishes the amount that the SBA loses.

This is not in the record, but Congress has in every

year since the establishment of the SBA, as I understand it, appropriated at least enough to cover the amount that the SBA lost.

So that, if the SBA does not recover on its security and it does in fact take security for virtually all its loans, Congress ends up appropriating the money.

QUESTION: Yes, but it takes security that would not be sufficient to induce a commercial lender to advance the funds, doesn't it? It starts from the premise that it is willing to take some additional risks.

MR. BARNETT: That is true. And the question here is -- you are correct -- to what extent that would justify imposing on the Government, this Court imposing on the Government, when Congress has not done so, risks greater than had been imposed on the Government in the context of Federal tax liens.

QUESTION: The rule, I suppose, would be that it has to follow the same precautionary procedures any other lender has to follow. It has to search the title and if it had searched here it would have found there was a protected lien.

MR. BARNETT: That is the rule that is contended for here, but the rule that has previously been established with respect to interest of the Federal Government by this Court --

QUESTION: Yes, but the difference there, as I understand it, is that the Government has no way of protecting itself in the tax case. He doesn't know who is going to fail to pay

his taxes. But here, before they advance the money, they can go out and make a title search like any other lender can. And why shouldn't they have that obligation?

MR. BARNETT: Well, because Congress has not said so, for one thing. The rule that has been laid down in the tax lien area has been followed by the Courts of Appeals and was unanimously followed by --

QUESTION: But you just told Justice Rehnquist you are asking us to extend that rule to --

MR. BARNETT: I am asking this Court to extend it since this Court has not done so, but the Courts of Appeals found no difficulty at all in concluding that the reasons this Court had given for the rule in the tax lien context were equally applicable to contractual reasons.

QUESTION: I just suggest to you they are not equally applicable, because in one case the Government can check titles and in the other case it can't. Isn't that a justification for a rather different approach to the problem?

MR. BARNETT: It may be. It was not one of the rules this Court gave for its doctrine in the tax lien area.

QUESTION: Doesn't the Government expect to lose some money on its SBA loans?

MR. BARNETT: Indeed it does. It loses approximately 4% in the latest year. The question is whether it should lose more because of a rule adopted by this Court, or whether Congress

should make that decision.

QUESTION: Or whether this Court should confine the rule to the tax area where it now is,and let Congress determine whether it should be extended further.

MR. BARNETT: On what basis would Congress start? This Court has to make some Federal law today. Does it apply the previous rule, or does it reach out and apply, for example, the state law or the UCC or one of the concoctions of the Fifth Circuit and then tell Congress to go from there?

QUESTION: Does the Government, in theory, at least as far as the statutes are concerned, expect to collect all its taxes?

MR. BARNETT: Expect to collect all its taxes? I am sure,as a matter of practical prediction, it doesn't expect to.

QUESTION: It knows that some taxpayers are going to be bankrupt, for example.

MR. BARNETT: True.

QUESTION: And some are going to evade and never be caught.

MR. BARNETT: Right. And, despite that, this Court, by laying down certain rules prior to the Tax Lien Act in 1966, gave the Government a certain measure of protection. Now, Congress in that Act limited the protection in certain very specific ways.

Our position here is that the Government, with respect

to its contractual liens, should be accorded the same traditional protection, and if Congress wants to specifically limit that, Congress is the body that should do it. And it is quite significant, we contend, that when Congress did act in the Tax Lien Act in 1966, it dealt specifically with the question of liens for future advances, which is involved here. And it gave only very limited protection to those liens. It provided that a lien for future advances is protected only if the advances are made -- that is, is given priority --

QUESTION: Couldn't Congress do the same thing in this area?

MR. BARNETT: Well, they could precisely, but what the court below has done, and what Respondent urges this Court to do, is something very different, something that would give much less protection to the Federal lien than Congress decided to give to the Federal tax liens in the 1966 Act.

QUESTION: Mr. Barnett, along with what my brother, Stevens, was talking about, you don't want us -- You say that the SBA loses a lot of money. You don't want us to encourage them to lose more, do you?

MR. BARNETT: Exactly not.

QUESTION: Well, wouldn't we be doing that if we tell them don't use normal care by checking them, by checking to see if there is a lien outstanding?

MR. BARNETT: I don't think the Court would be telling

them not to use normal care. The SBA does check. The question is, what rules it must check under. In this case, if it had checked it might well have decided to make the loan anyway. Indeed, it was aware of --

QUESTION: Mr. Barnett, if it had checked, it would have required that the other lien be waived in order -- It's a pretty obvious thing for the lender to do, isn't it?

MR. BARNETT: It might have made that request or demand. It is equally possible that Kimbell would have refused.

QUESTION: Oh, that's highly unlikely on these facts, don't you think? They were going to pay off the outstanding indebtedness. They could have easily said cancel your outstanding lien. I think it is really very unrealistic to assume they wouldn't have been able to clean it up.

MR. BARNETT: And then Kimbell would have continued to make loans on the same basis? I don't --

QUESTION: Or asked for additional security, just like any outstanding balance. I think that's highly unrealistic.

MR. BARNETT: But Kimbell here might well have, conceivably might have said, "If you pay us off, we will release our collateral." But Kimbell here was also demanding that it keep its collateral with respect to the future advances.

QUESTION: When you say "demanding," they just didn't talk about it. As I understand that footnote in the opinion, they didn't really have a very sophisticated understanding of

what was going on.

MR. BARNETT: But there is no reason to assume that Kimbell would have agreed to make future advances without keeping some collateral for that.

QUESTION: Perhaps not. But the Government surely could have said, "If we are going to give you $300,000, we want to use $20,000 to pay off the existing indebtedness," which they did, "and we also want you to terminate that protected lien."

I'm sure that would have happened.

MR. BARNETT: But maybe if the borrower -- Okay, we are not assured of being able to purchase future inventory on credit --

QUESTION: So we are going to turn down the $300,000 because we may need to borrow $5,000 in the future? That's very unrealistic too, isn't it?

MR. BARNETT: Well, I concede that the SBA here could have demanded of Kimbell that it release its collateral. It is not entirely clear to me, and certainly there would be cases in which it would not be clear, that the prior lender would be willing to release collateral. So it is not simply a question of making the SBA be more careful, but of protecting some of the loans, the admittedly risky loans, that the SBA does make, because that's its business, to make risky loans. And the question here is the measure of protection that the SBA will

have, and whether that measure is to be reduced as the Court of Appeals rule here would reduce it, to a much greater extent than Congress in the Tax Lien Act reduced the protection of Federal tax liens.

Indeed, we find it ironic that the reason why the choateness rule is said here to be no longer worth following, the reason why two Circuits, the Fifth and Ninth, have abandoned it, is said to be the Tax Lien Act of 1966 which modified it in the area of tax liens. But yet, the very rule that that Act adopted for future advances which are involved here, is much more protective of the Government's interests than the rule that is proposed here.

QUESTION: But the rule you want, Mr. Barnett, that you defend, certainly gives the Government more protection than the Tax Lien Act.

MR. BARNETT: Yes, it does, and Congress is --

QUESTION: Considerably more. Not only -- right across the board, except with respect to future advances.

MR. BARNETT: That is true, Mr. Justice White, and Congress is fully able to --

QUESTION: May I ask you another question. If a private lender had made this same loan that the SBA did, in the face of an inventory financing scheme, how would the private lender have come out on these facts, under the Uniform Commercial Code?

MR. BARNETT: On these facts, the private lender would have lost, would have had his lien subordinated --

QUESTION: Under the Uniform Commercial Code, a perfected inventory arrangement calling for future advances, would take precedence over a later perfected mortgage.

MR. BARNETT: Over an intervening perfected mortgage.

QUESTION: Over a later perfected mortgage.

MR. BARNETT: Later to the initial agreement, prior to the advance --

QUESTION: Yes. And so that the private lender, if he had lent under these conditions here, would have been on notice that there would be future advances, and he would take subordinate to them.

MR. BARNETT: Would have been on notice that there could be future advances. These were optional, but yes would have taken subordinate to those future advances that they would have made. That is correct.

QUESTION: Is that the rule in all the states, under state law? Or is it in forty-nine states, or what?

MR. BARNETT: That raises the question of how uniform is the Uniform Commercial Code. It is the rule in Texas, the Court here held. It is fairly clearly the rule under the 1972 Amendments to the Uniform Commercial Code. But, as I understand it, those amendments have been adopted by only some twenty-one states, to date. So, it is not at all clear that that is the

rule in the forty-nine states that have adopted --

QUESTION: I suppose if the question is -- Of course, Federal law applies here. The question is from what sources do you draw the Federal law, I suppose.

You are saying just take the Tax Lien Law and apply it. But you don't want the Tax Lien Law, because that's now been replaced by a statute.

MR. BARNETT: No, no. We are saying take the common law principles that this Court developed on the basis, first, of the insolvency statute, and then of the Tax Lien Law. The Court of Appeals --

QUESTION: Calling it common law, doesn't give it any greater or less substance than just saying it is a Federal rule that was crafted in this Court.

MR. BARNETT: That's true.

QUESTION: So, the question is now in the ordinary commercial settings, from what source should a rule be drawn?

MR. BARNETT: That's true. The Court of Appeals didn't decide --

QUESTION: Should be brought by comparison with some area that Congress has already discarded? I mean the rule -- that we -- for tax liens, Congress has already put aside.

MR. BARNETT: We don't agree with that characterization of it.

QUESTION: Why don't you? What is it that Congress --

MR. BARNETT: Congress has modified it and limited it. There are, indeed, as the --

QUESTION: So, you now look to the statute, not to our cases to say --

MR. BARNETT: Not in all cases. There are certain lacunae in the statute, as the Second Circuit pointed out in the MacArthur Village case, that might still be governed by this Court's previous decisions.

But Congress, against the background of this Court's previous decisions of the choateness rule and the first in time rule, crafted limited exceptions in the statute.

The question here is whether the Court should take a quite different approach and adopt the UCC as the governing Federal rule in this case.

QUESTION: That is the choice.

MR. BARNETT: That's the choice, although it is not the choice the Court of Appeals chose.

QUESTION: I would disagree, apparently, both with my brother, White, and you, Mr. Barnett. I would think the Court of Appeals' opinion can be justified on the basis of following the law of Texas.

MR. BARNETT: But the law of Texas is the UCC.

QUESTION: Right, but it would follow not because the UCC was in existence in forty-nine states, but because this particular Federal question of lien priority should be

determined by reference to state law.

QUESTION: It is a Federal rule.

QUESTION: It is a Federal rule, but it can be a reference to state law rather than to UCC.

MR. BARNETT: The reason why that is not a good idea, we would submit, is because state law is varient, and the very reason why this Court decided in Clearfield Trust that the choice of law questioned here was a Federal question in the first place. It was primarily the need for uniformity. The Court has since emphasized that in the Lake Misere case and in Miami v. Volusia County.

QUESTION: And we have the Yazell case on the other side of the scale.

MR. BARNETT: Yes.

QUESTION: And Household Finance.

MR. BARNETT: But a rule that simply incorporated the law of various states with respect to this question, which is very much a question of the nationwide operation of the program and which is rather close to questions of commercial paper, would undermine the purpose of uniformity.

QUESTION: Wasn't the Yazell case an SBA case?

MR. BARNETT: I think it was.

Also, it would undermine here, we would submit, another reason for the application of Federal law in the first place, which is the principle of Federal supremacy, if you will,

recognized by this Court in the New Britain case, that Federal property interests should not be subjected to the sway of state law.

QUESTION: Mr. Barnett, are you familiar with the position the Government took in the argument of Butner in the case arising out of the second mortgage situation in North Carolina? The question is whether in determining whether the second mortagee has to reduce the property to possession, whether this should be governed by a Federal rule or by reference to state law. And the United States in that case, where it is a creditor, argued that the reference should be the state law, the Federal rule should be that we refer the matter to state law.

I am just wondering if there is any basic difference between the two kinds of situations in connection with the need for uniformity?

MR. BARNETT: I am sorry I am not familiar with that case, so I can't say.

Even with respect to the UCC, when it is argued here that the UCC should be adopted, there are various kinds of uncertainties that that would create, which I think the Court should be aware of. For example, in addition to the fact that the UCC rules may vary very considerably in different states, there is the question of what would be the scope of this asserted adoption of the UCC? For example, the Court of Appeals here

said we are adopting the UCC with respect to when the state lien arises. We are not adopting it, at least not yet, with respect to the relation-back question. And we leave for another day the question of whether we would apply the UCC in cases of other kinds of liens, mechanic's liens, repairman's liens, which the Court said raise entirely different questions.

Well, if the UCC is to be embraced by this Court as the governing code of Federal law in these cases, where does the embrace stop? Does it or does it not include those repairman's liens and mechanic's liens and state tax liens, and the questions that they raise?

Respondent would apparently say that this Court should limit the embrace to the consentual liens, which arise under the UCC.

On what basis would that limit be established? Would this Court be telling the other Federal courts that they cannot use the UCC with respect to those other liens? That they must, or what?

There would be considerable uncertainties engendered, which are illustrated, of course, by the Crittenden case, which I will have occasion to discuss in greater detail later.

QUESTION: Aren't they greater there than in this case because in Crittenden, as I understand the Fifth Circuit's opinion, we don't know what the Georgia law was. But here, I thought Judge Gee was quite clear as to what the Law of Texas was.

MR. BARNETT: But even if we knew what the Georgia law was, the proposal might be to adopt the UCC, even if the Georgia law is different.

QUESTION: I certainly don't read the Fifth Circuit's opinion, in this case, as saying that in Kimbell Foods.

MR. BARNETT: With respect to when the state lien arises I read the opinion as saying, "We will follow UCC principles on that."

It happens that Texas here had adopted the UCC, but I find nothing in this case to indicate that the Fifth Circuit is saying, "We will follow state law if that law happens to diverge from the UCC."

While I agree, Mr. Justice Rehnquist, that the problems in Crittenden are more complicated, my point is, where would adoption of the UCC stop? Would it not engender all sorts of such problems? Which to adopt where the UCC varies from state law? To what extent to follow the UCC?

QUESTION: In that respect, if you just followed the law of each state, at least you might have some common understanding in the state what the rule was.

MR. BARNETT: You would have in the state, but you would have a complete overturning of the principle of uniformity.

QUESTION: What principle is that? That's the question in this case -- one of the questions in this case -- whether to have a uniform rule, and why shouldn't the SBA, in

operating in the various states as a lender, act like any other lender? Why should somebody -- a bank -- furnishing inventory financing have to say, "Well, I guess we are good against every kind of a lender except the Federal Government or the SBA"?

MR. BARNETT: Well, because Congress has not said so, for one thing. That precise approach was opposed --

QUESTION: I know, that's bootstrapping. You just don't know --

MR. BARNETT: That precise approach was made to Congress in the drafting of the 1966 Tax Lien Act, as cited in our brief here. It was proposed that Federal tax liens --

QUESTION: That's taxes. That's a distinctive area.

MR. BARNETT: Well, is it or isn't it? That's the case here.

QUESTION: Suppose it isn't.

MR. BARNETT: Well, then, we would cite the need for uniformity in which this Court relied --

QUESTION: What need is that? I don't understand that need.

MR. BARNETT: Well, need is that a Federal Agency operating a nationwide program has to have some ability to rely on nationwide standards.

QUESTION: It obeys the speed limit that is employed in every state. It doesn't want a national speed limit.

MR. BARNETT: No, it uses similar forms. Its

attorneys are transfered from one state to another.

QUESTION: Household Finance manages in all fifty states.

MR. BARNETT: It is not the Federal Government.

QUESTION: You are saying that there is a need, not that the Government is sovereign, but it needs because of some peculiar difficulties of operating in all fifty states.

MR. BARNETT: Also because this Court has recognized that that is a reason for applying Federal law in --

QUESTION: Not yet, not yet.

MR. BARNETT: In Clearfield Trust --

QUESTION: Not yet, in this commercial area.

MR. BARNETT: True, but in Clearfield Trust the proposition was that the need for uniformity is the reason for making it a question of Federal law, in the first place, in a commercial area such as this.

I would like to reserve the remainder of my time.

MR. CHIEF JUSTICE BURGER: Mr. Teofan.

ORAL ARGUMENT OF VERNON O. TEOFAN, ESQ.,

ON BEHALF OF THE RESPONDENTS

MR. TEOFAN: Mr. Chief Justice, and may it please the Court:

While it may not have seemed readily apparent from the Government's abbreviated statement of the issue presented in this case, this isn't simply a case of a choate Federal lien

versus an inchoate private lien. This case is entirely different from any of the cases on which the Government relies. The two competing liens that you had in this case were both created and perfected under the Uniform Commercial Code of the State of Texas in favor of private lenders. This wasn't a Government lien from the inception. The first lien was created in favor of Kimbell Foods. It was perfected in 1966 and 1968, long before the second party, the Republic National Bank, acquired its security interest, much less had it perfected, and at least two years prior to the time that the SBA purchased an individed 90% interest.

QUESTION: Are you arguing, Mr. Teofan, that if Texas was the only state that had this code and the other forty-nine states had a different uniform code, the case would be the same?

MR. TEOFAN: Yes, based on United States v. Vermont.

What the SBA is arguing in this case is that in 1961, five years after Kimbell perfected its lien, when it purchased its 90% interest in the Republic National Bank security interest, that invested that Republic National Bank security interest with Federal lien rights and sovereign prerogatives, which relayed it all the way back to when the lien was first taken by the Republic National Bank, and by applying the choateness test, at that point in time, bootstraps the Republic National Bank security interest into a first position.

The Fifth Circuit rejected that logic and refused to extend the choate lien test into this kind of situation.

Now, when I was reviewing this Court's opinions in United States v. City of New Britain and United States v. Vermont, I realized that I had missed a very basic point in briefing this situation for Kimbell.

In United States v. the City of New Britain, in that case, you have competing local water rent lands and local tax lands competing with the Federal tax lands. The Court there laid down the basic rule that in determining what is first in time and, therefore, first in right, you must determine which lien attached first and which lien became choate. It didn't say that test only applied to the private lien and not to Government lien.

So, then, you come to United States v. Vermont, a unanimous decision by this Court, the opinion written by Mr. Justice Stewart. In that case, the two liens you had competing with each other were a Federal tax lien and a Vermont tax lien which arose under a statute that was patterned after the Federal tax lien and whose wording was identical.

The Vermont tax lien had been assessed first, the Federal lien some months later. The Government, in that case, argued that the Vermont lier was inchoate and urged that a different standard of choateness be applied to the state lien than

to the Government lien. This Court rejected that. Both liens arose under identical statutes, and this Court held the Vermont lien first in time and prior in right.

The basis of the Vermont case, essentially, is this. When you have two competing liens which arise under the same statute, such as we have here, or substantially identical statutes, the reasonable rule is to look to the statute for priority, and that's uniform.

I submit that this Court can dispose of this case in favor of Kimbell just by reiterating that the Federal common law rule is that where the liens arise under the same statute, or under substantially identical statutes, you look to the statute for priority. That's uniform, that's non-discriminatory and unquestionably just.

That point is not specifically covered in the brief and neither is the point with relation to some subsequent Congressional action. After the brief --

QUESTION: Does the SBA make the direct loan?

MR. TEOFAN: Yes.

QUESTION: And under what law do you suppose the lien arises when it makes a direct loan?

MR. TEOFAN: The basic proposition -- We have no quarrel with it -- is that it is Federal law that governs. But when the SBA enters into a field of consentual loans it should be governed by the same law as all the rest of us.

QUESTION: Let's say in this case it was a direct loan by the SBA. Let's assume that it had been. Under what law would the lien arise?

MR. TEOFAN: It would have arose under Texas law. Its security agreement, it would have perfected it under Texas law.

QUESTION: What makes you think so?

MR. TEOFAN: Because the SBA, when they make these kinds of loans --

QUESTION: If the statute said it shall be perfected when the money is paid out, it would be perfected. Does the statute indicate that the SBA should follow state law, or not?

MR. TEOFAN: Yes, I think the -- and I am not positive on it -- but I think the SBA statute says that the lien shall be recorded and perfected in accordance with state law.

QUESTION: It does say that?

MR. TEOFAN: I think so. I know that they do, and I know that the SBA, Congress has admonished the SBA to make --

QUESTION: I would think that would be a rather important matter for you to argue, if that were true in this case, if Congress certainly intended to accommodate the laws of each individual state.

MR. TEOFAN: I think the regulations may direct the SBA offices to file their liens in accordance with state law. Perhaps counsel for the Government --

QUESTION: Even at that, it sounds to me a rather substantial matter.

MR. TEOFAN: I would be happy to look it up and submit something to this Court, with your permission.

QUESTION: Maybe Mr. Barnett will have something to say in response.

QUESTION: Perhaps you could do it while you are having lunch.

MR. TEOFAN: I will try.

The question came up, what standard is supposed to be applied by the SBA in making loans? Are they expected to have great losses? Congress has admonished the SBA to make only loans of such sound value, or so secured as to reasonably assure repayment.

As pointed out by this Court in Yazell, SBA activity is very localized. It is done by local offices and by agents who are experienced in the law of those localities.

Just before lunch, I want to point out one other piece of legislation. The Fifth Circuit, in refusing to extend the choateness rule of this area, looked to a recent act of Congress as a barometer of what was going on in the commercial world, and also what Federal intent was with relation to Federal priority. And it referred to the Tax Lien Act of 1966, which abolished a lot of the priorities established by the choateness rule.

Well, after the briefs were filed in this case, in November of last year, there was enacted the new Bankruptcy Act which goes into effect, for the most part, in October of 1978. In that Bankruptcy Act, Congress has done away completely with all Federal priority, except for taxes accruing within three years of the filing of the petition.

The old subsection 64(a)(5), giving the Federal Government priority for non-tax debts, has been abolished.

QUESTION: But that doesn't have retroactive effect in this case.

MR. TEOFAN: No, sir, this is not a bankruptcy case. I refer to that merely as an indicator of governmental policy on Federal priority status.

QUESTION: That doesn't get to how Government priority is to be established. It didn't do away with priority, for example, that the Government would have under a perfected lien in bankruptcy, did it? And it didn't answer how -- to what law would you look to determine whether the lien is perfected.

MR. TEOFAN: No, it does not answer those questions. I just referred to it as an indicator that the super priority which has been furnished to the Government in previous cases has been done away with and does not carry the same import that it did previously.

I will resume after lunch.

Thank you.

MR. CHIEF JUSTICE BURGER: We will resume then at 1:00 o'clock.

(Whereupon, at 12:00 o'clock, Noon, the Court recessed , to reconvene at 1:00 o'clock, p.m., the same day.)

AFTERNOON SESSION

(1:01 p.m.)

MR. CHIEF JUSTICE BURGER: Mr. Teofan, you may continue.

ORAL ARGUMENT OF VERNON O. TEOFAN (Resumed)

ON BEHALF OF THE RESPONDENTS

MR. TEOFAN: Mr. Chief Justice, and may it please the Court:

During the lunch hour, I did run up to the library and attempt to find the basis for my belief that SBA loans are perfected in accordance with state law. I knew that I had seen it somewhere and I knew that they did. What I did finally remember was that in U.S. v. Yazell, which is an SBA case arising out of Texas, this Court in that case said there is no problem in complying with state law; in fact, SBA transactions in each state, specifically, and in great detail, adapted to state law and it refers to Note 35.

Note 35 is the Financial Assistance Manual of the Small Business Administration, SBA 500. It is replete with admonitions to follow state law carefully. Thus, Section 401.03 reads, "Compliance with applicable law. When the United States disburses funds it is exercising a constitutional functional power and its rights and duties are governed by Federal rather than local law. However, it is frequently necessary in the obtaining of a marketable title or enforceable security

interest in property to follow local procedural requirements and statutes. Accordingly, care should be used in following or meeting all applicable requirements and statutes of the state in which the property is located, including the filing and re-filing, recording and re-recording of any documents."

And then the footnote --

QUESTION: That's an SBA regulation, is it?

MR. TEOFAN: Yes. The Financial Assistance Manual of the Small Business Administration. In the short time that I had, that's the best that I could come up with.

QUESTION: That's not bad.

MR. TEOFAN: Thank you.

QUESTION: There is in this case no defensible reason to override state law.

MR. TEOFAN: That's exactly our position in this case.

QUESTION: That's what the last paragraph on here says. I know the hard way.

MR. TEOFAN: Yes.

In their brief and in the argument, the Government here strongly insists that there is a coherent, well-established, well-understood body of precedent that would establish that the choateness rule should be applied in this case, and therefore urges this Court to not deviate from that rule but extend it into this new field of consentual security interest under the

Uniform Commercial Code.

First of all, such contention is not well taken. There exists no such coherent well-established, well-understood body of precedent. This Court has never extended the choate lien test rule outside the context of the Federal Insolvency Statute or the Federal Tax Lien Act. In both of those fields, Congress has greatly reduced Federal priority.

This Court has never held in any case that the choate lien test applies to a consentual security interest held or acquired by the Government. Neither this Court nor any lower court has ever held the choateness test applicable in a case involving a Federal consentual lien versus a private consentual lien, a Federal security agreement interest under the Uniform Commercial Code versus a private security interest under the Uniform Commercial Code. There has been no extension of that choate lien test into this area. Consequently, there is no evil for the Government to correct by legislation. This field has not been covered.

The five Circuit Court of Appeals cases relied on by the Government,as establishing this precedent at the time the transactions were entered into,all involve a competing statutory special interest lien created by a state statute which either grants that lien super priority or relates it back to a point in time that has no reasonable connection with the establishment of the lien. We don't have that in this case.

The choateness rule was developed primarily to prevent the special interest lien creditors from getting a leg up on the Government in the collecting of its taxes in the exercise of a sovereign power.

Now, what the Government is trying to do in this case is to take the choate lien test and relate it back and give the Government a leg up on the private lender. And it is not required. What they are attempting to do is to perpetrate a reverse evil that the choateness rule was originally fashioned by this Court to prevent.

Such coherent well-established body of precedent was not even well-understood by the attorneys and the representatives of the Government and the SBA at the beginning of this case. In the Government's answer to Kimbell's complaint and in the detailed pre-trial agreement that was filed with the court, absolutely no mention whatsoever is made of choateness. No issue is reserved as to whether or not Kimbell's lien is choate.

During the trial of this case, counsel for the Government stood up and announced to the trial court that its position was the same as the Republic National Bank's. The primary line of defense had nothing to do with choateness or Federal super priority. It was,one,Kimbell had either expressly or impliedly agreed that its lien would be inferior to the lien of the Republic National Bank, or number two, that under applicable state law, future advances were not covered under the

security agreement. That was rejected by the Fifth Circuit as not here before the Court.

It was not until after the case was actually tried and briefs were submitted to the trial court that the issue of choateness was ever raised. So, if it was such a well-established, well-understood body of precedent, why did it appear in the case so late?

I think the law review articles that have been written by the authorities with relation to the choateness rule demonstrate that it is not a clear body of law. Even counsel in this case is somewhat unclear as to what is or is not a choate lien. In the original brief, he took the position that Kimbell's lien could not be choate because it was not reduced to judgment.

QUESTION: Of course, you could say that about lots of groups of decisions of this Court, couldn't you, in other fields of the law?

MR. TEOFAN: Say what, Your Honor?

QUESTION: That it isn't all that clear.

MR. TEOFAN: What we are trying to do here is to fashion a Federal rule that is a little bit clearer, at least clearer and fairer than the choateness test.

QUESTION: I notice you didn't say "crafted," which is the word that was used before.

MR. TEOFAN: Even the Government doesn't know when a

lien is choate. They say there is a big difference between a security interest that secures a debt owing on a promissory note, which it now says may be choate because of its concession made in the Crest Finance case, but that doesn't apply where the debt is secured by an open account. It says if you have got a piece of paper that says it's a promissory note, that's good, it's choate. If your pieces of paper are invoices submitted on a weekly basis, plus statements of account, they say that is no good, that's inchoate.

And why do they say that? They say that because there are many challenges that a creditor who purchases goods on open account can make. Therefore, there are many contingencies and until it is reduced to judgment it can't be choate. But that is sort of specious reasoning. The same applies to a promissory note.

In the Crest case, you had a series of promissory notes. Payments had been made on those notes. Additional interest had accrued. The debt secured was not the face of the promissory note. You had to go to the books and records of the Government and you had to go to the books and records of the finance company to determine what the balance outstanding was on any given day.

And anybody who has tried a case on a promissory note knows that ingenious counsel can come up with as many defenses to a suit for the balance of a promissory note as he can for a

suit based on an account.

So, if a suit -- We submit, Your Honor, that if a security interest securing the balance on promissory notes is not choate, so also should be held for the purpose of choateness in this area if it applies, is the balance owing on an open account.

At any given point in time, you can determine the amount of the lien, the property to which it attaches, the name of the secured party and the name of the debtor.

The other point, with relation to security interests under the code, is that some of the cases that indicated that a lien will be deemed choate if it is enforceable by summary proceedings.

It is to be noted under the Uniform Commercial Code that upon default a security interest can be enforced by summary proceedings. The creditor goes out, picks up the property and sells it. No judicial action is required.

The Government argues that what we really need to do here is take the rule that will give us the stability and certainty, so that people who are engaged in commercial lending will know where they stand. And they say that we can get that way through the choate lien test.

We submit that is not correct. If you take their argument that a lien becomes -- that a private lien becomes a Federal lien when it is acquired by the Government, and it

relates all the way back to when it was first created, and then you apply the choateness test there, what you have is uncertainty foretold.

First of all, the man who makes a loan for extending credit, he will not know if the Government will ever come in and guarantee a loan, insure a loan, or buy somebody's loan, or get a direct loan sometime in the future three or four years.

If the Government does come in and acquire a loan some years in advance, then that creditor will not know to what date that lien relates back, because there is absolutely nothing that requires the recordation of a Government guarantee or a Government security interest; even after the Government acquires it, nothing need really be filed of record. And as far as the commercial community is concerned, there is absolutely no notice to anybody that there may be a Federal lien floating out there somewhere.

The other uncertainty, the third uncertainty, is to what collateral will the Federal lien attach when it relates back? Property is sold, a lot of people have shipped in additional merchandise to the debtor, like Kimbell did in this case. Kimbell's security interest is a purchased money security interest. It secures the payment price of merchandise which Kimbell actually shipped in. If the lien relates back prior to that time and Kimbell's lien is no good, that's an uncertainty.

And the other uncertainty would be the amount of the

debt that would be secured at the time the Federal lien was given effect. The amounts balance. If the loan was originally $300,000, it could be down to $20. If it were originally $300, and it had future advances clauses, it could go up to $600.

Too much uncertainty would be created by applying the choateness rule in this concept of consentual liens. The performance of a proprietary or commercial function by the Government, as distinguished from sovereign function, such as collecting taxes. You just wouldn't know where you stood.

Now, they make an argument in their brief that this will not create any economic adverse effects on private loans to small businesses. Common sense and experience tell every one of us that whether you are loaning money or selling products, if a private lender sells to a specific portion of a market and loses money, one of two things is going to happen. He is either going to increase the cost of that service to the customer or he is going to curtail doing business in that segment of the economy.

The Government has intimated that if this Court were to adopt the priority rules that have been incorporated by Congress in the Tax Lien Act of 1966, that Kimbell would lose because the advances were made more than 45 days after the Federal lien. That argument is based on the premise that the Federal lien was filed when it was originally filed in favor of Republic National Bank.

We submit that at that time it was not a Federal lien. Under the decision of this Court in Markson?, there is no debt due and owing to the Government.

QUESTION: Do you know what the SBA practice is when they buy a participation in the loan? Is there any filing done under the state loan then?

MR. TEOFAN: Naming the SBA? Nothing naming the SBA.

QUESTION: Could any lender ever discover that what he thought was a good lien against the Republic National was now no longer a good lien because the Government has bought part of it?

MR. TEOFAN: He would have to search the records daily --

QUESTION: What records?

MR. TEOFAN: In the case of the Uniform Commercial Code, he could search the records --

QUESTION: I know, but I just asked you, would the SBA do any filing whatsoever when it bought into the Republic loan?

MR. TEOFAN: It need not.

QUESTION: Well, does it or doesn't it?

MR. TEOFAN: It does. In this case, it did.

QUESTION: Did it file in the state? Why did it file?

MR. TEOFAN: When it acquired an undivided 90% interest in Republic's loan in 1971, on, I believe it was, January

18th or 28th, the latter part of January of '71, it filed a UCC-3, which is an assignment statement, with the Secretary of State of Texas.

QUESTION: Why did it do that?

MR. TEOFAN: The reason you file those kinds of things, Your Honor --

QUESTION: I know the reason private people do. I wonder why the SBA did.

MR. TEOFAN: They may not have trusted Republic National Bank, after their initial encounter in this case, and didn't want Republic National Bank to be put in a position to either release or prejudice that lien.

The reason you file a UCC-3 is to prevent the original secured party from doing anything that would affect the assignee's rights. The UCC-3 doesn't create any rights. It is purely a notice instrument.

QUESTION: But it needn't have?

MR. TEOFAN: It needn't have.

QUESTION: In which event, the person making future advances might think that it was perfectly good against Republic, which it was, but not against the United States.

MR. TEOFAN: Right. That's exactly what happened to Kimbell in this case. Kimbell was owed $18,000 when the Republic lien was created, and at the end of the road they were still owed $18,000. There was no big increase or decrease in

the amount of debt that was secured.

Mr. Justice White, you are perfectly right, there is no way that a private lender out there, making a loan, feeling that he is first in secured, can ever know that five years later the Government is going to come in and assert some rights and relate them back and make themselves superior to his lien.

QUESTION: Kimbell is not an insolvent in this case, is it?

MR. TEOFAN: Okay Supermarket, Your Honor, was the debtor. It is not an insolvent. Insolvency is not an issue in this case, neither is bankruptcy, neither is federal tax liens.

Thank you, very much.

MR. CHIEF JUSTICE BURGER: Do you have anything further, Mr. Barnett?

REBUTTAL ORAL ARGUMENT OF STEPHEN R. BARNETT, ESQ.

ON BEHALF OF THE PETITIONER

MR. BARNETT: Mr. Chief Justice, and may it please the Court:

The statement from the SBA manual that my brother quotes makes clear that the rights that were required in Yazell -- makes clear that the rights of the SBA arise under Federal law. "When the United States disburses its funds it is exercising a constitutional function or power and its rights and duties are governed by Federal rather than local law. However,

it is frequently necessary in the obtaining of a marketable title or enforceable security interest in property to follow local procedural requirements and statutes, and so forth.

QUESTION: Is there anything in the SBA Act that says precisely when a Federal lien arises?

MR. BARNETT: The only thing in the SBA Act that relates to liens is the section that we have quoted in our brief and discussed, which provides that SBA liens are specifically subordinated to state and local liens for property taxes. Congress specifically did that.

QUESTION: So, what makes you think that it is by virtue of the Federal law that a lien arises, I mean, by some specific provision of the Federal law?

MR. BARNETT: Well, a lien does not arise under a state law or the UCC. A lien arises, as in this case, from the security agreement. The security agreement is filed under state law or the UCC, but the UCC does not create the lien. And that is the falacy in my brother's argument.

QUESTION: What gives it a rank in the priority?

MR. BARNETT: That is the question in this case, whether the Federal law does and the question in this case --

QUESTION: There isn't anything in the Federal law that just says it, is there?

MR. BARNETT: This Court has relied on the first in time rule as Federal law, for one thing. And the --

QUESTION: But there is nothing in the SBA Act?

MR. BARNETT: Nothing in the SBA Act, except that specific provision which does subordinate SBA liens, but only for a carefully tailored exception.

As you were pointing out, Mr. Justice White, the SBA may not have to file under state law, but it does, and that is the answer to my brother's contention that people may never know when they are dealing with SBA.

QUESTION: But it is also an answer to your argument about uniformity. They don't seem to put so much store in uniformity if they instruct all their local people to be awfully careful about state law.

MR. BARNETT: Well, as a matter of convenience, and as a matter of allowing other people to rely in the commercial world, they do file, but it doesn't follow that their lien is thereby created under state law. And it doesn't follow that state law should govern their priority rights.

QUESTION: What if they didn't file?

MR. BARNETT: That is not this case and we are not here defending a situation in which the SBA lien has not been filed.

QUESTION: You are just talking about a practice, though.

MR. BARNETT: Yes, that is the practice.

QUESTION: But what if they didn't follow their

practice in a particular case? What about the other -- rights of other people?

MR. BARNETT: We would have -- I, at least, would have difficulty defending that situation, Mr. Chief Justice.

QUESTION: Why? The lien has arisen under Federal law.

MR. BARNETT: I think there are reliance rights that the Government would have to respect. I think it is the Government's practice and should be the Government's practice to --

QUESTION: To look to state law, to look to non-uniform state law, so that people operating in that commercial market will know where they are.

MR. BARNETT: To comply with the local procedures and forms, is all. Not to be bound by state law as to Government rights and priorities.

QUESTION: But they did tell them to watch the state laws and follow them.

MR. BARNETT: So far as the procedures and forms are concerned.

QUESTION: "In drafting service provisions, counsel should carefully consider the applicable laws of the state." That's what this regulation says.

MR. BARNETT: True, but that does not imply that state law governs the rights, as the earlier part of the regulation

says, "The state law governs the Government's rights."

QUESTION: Mr. Barnett, the second sentence of that Footnote 35 from the Yazell case, which you just read from, says, "However, it is frequently necessary in the obtaining of a marketable title or enforceable security interest in property to follow local procedural requirements and statutes."

Now, what does that carve out from the general Federal principle that you are talking about?

MR. BARNETT: I don't think it carves anything out, except as a matter of the Government's discretionary decision to follow the state procedures.

QUESTION: But it says it is frequently necessary to obtain an enforceable security interest.

MR. BARNETT: This is an abundance of caution in a manual that the SBA is directing to its employees. It is not a statement of applicable law being made in court or elsewhere.

Thank you.

MR. CHIEF JUSTICE BURGER: Thank you, gentlemen.

The case is submitted.

(Whereupon, at 1:24 o'clock, p.m., the case was submitted.)