Michigan Law Review

Volume 64 | Issue 6

1966

The Relative Priority of Small Business Administration Liens: An Unreasonable Extension of Federal Preference?

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The Relative Priority of Small Business Administration Liens: An Unreasonable Extension of Federal Preference?

During the past three decades, the priority of the federal government as against state and private creditors competing for the assets of debtors has been greatly strengthened.[1] In terms of relative growth, the expansion of federal priority has been comparable to the increased commercial involvement of the United States. In more recent years, Congress and the judiciary have recognized that this increased governmental commercial activity necessitates a restriction in sovereign prerogatives.[2] However, contrary to this general trend toward the contraction of sovereign prerogatives and for reasons appearing unsatisfactory to most commentators,[3] the "sovereign prerogative"[4] of priority to the assets of a debtor has been expanded rather than limited. One agency in particular, the Small Business Administration, has increasingly utilized this prerogative in order to collect its loans when faced with the claims of competing creditors. It is the thesis of this comment that the priority which has been judicially accorded the SBA is now extended beyond reasonable bounds and should be severely restricted.

I. Background of Federal Priority

The expansion of federal priority can be attributed to two basic doctrines, one based upon statute[5] and the other a creation of the

1. See, *e.g.*, Bernhardt, *Government Priority for Repayment of Monies Advanced to Contractors*, 20 Ref. J. 35 (1946); Kennedy, *From Spokane County to Vermont: The Campaign of the Federal Government Against the Inchoate Lien*, 50 Iowa L. Rev. 724 (1965); Kennedy, *The Relative Priority of the Federal Government: The Pernicious Career of the Inchoate and General Lien*, 63 Yale L.J. 905 (1954); Plumb, *Federal Tax Collection and Lien Problems* (pts. 1-2), 13 Tax L. Rev. 247, 459 (1958).

2. For a judicial limitation of a sovereign prerogative, see Victory Transp. Inc. v. Comisaria General de Abastecimientos y Transportes, 336 F.2d 354 (2d Cir. 1964). See generally Note, 63 Mich. L. Rev. 708 (1965). Among the many legislative restrictions are the Court of Claims Act, 28 U.S.C. § 1491 (1964); Federal Tort Claims Act, 28 U.S.C. § 1346 (1964); Suit in Admiralty Act § 2, 41 Stat. 525 (1920), as amended, 46 U.S.C. § 742 (1964). See generally Reeves, *Good Fences and Good Neighbors: Restraints on Immunity of Sovereigns*, 44 A.B.A.J. 521 (1958).

3. See, *e.g.*, Kennedy, *From Spokane County to Vermont: The Campaign of the Federal Government Against the Inchoate Lien*, 50 Iowa L. Rev. 724 (1965); Reeve, *The Relative Priority of Government and Private Liens*, 29 Rocky Mt. L. Rev. 167 (1957); Note, 63 Colum. L. Rev. 1259 (1963). *But see* Note, 108 U. Pa. L. Rev. 909 (1960).

4. "The right of priority of payment of debts due to the government, is a prerogative of the crown well known to the common law." United States v. State Bank, 31 U.S. (6 Pet.) 29, 34 (1832). The United States has accorded federal priority by statute, see Rev. Stat. § 3466 (1875), 31 U.S.C. § 191 (1964), and this statutory priority of the United States now appears to exceed the crown prerogative recognized in England. See Salter, *Priority Accorded the Sovereign in Bankruptcy: The American and British Views*, 63 Com. L.J. 354 (1958).

5. Rev. Stat. § 3466 (1875), 31 U.S.C. § 191 (1964) [hereinafter cited as R.S. § 3466] reads in full:

judiciary.[6] Section 3466 of the Revised Statutes of 1875, which has been the principal weapon of the federal government, grants a "priority"[7] for all United States claims against the estate of a decedent whose debts exceed his assets, and against insolvent living persons whose insolvency is manifested by voluntary assignment, the commission of an act of bankruptcy, or attachment by a creditor of the estate of an absent debtor.[8] The judiciary has broadened the scope and impact of this statute to allow its use by most federal agencies,[9] to make it applicable even though the United States was not the debtor of record when the bankruptcy petition was filed,[10] and to make it applicable to property previously encumbered.[11]

The other primary weapon of the government, the judicial doctrine of the inchoate lien, has developed generally as a doctrine supplementing two federal statutes—the general priority statute discussed above and the tax lien statute of the Internal Revenue Code.[12] Essentially, this doctrine strengthens the federal government's rights under these statutes by providing that any lien of a competing credi-

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> Whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of the executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be first satisfied; and the priority established shall extend as well to cases in which a debtor, not having sufficient property to pay all his debts, makes a voluntary assignment thereof, or in which the estate and effects of an absconding, concealed, or absent debtor are attached by process of law, as to cases in which an act of bankruptcy is committed.

See generally Kennedy, *The Relative Priority of the Federal Government: The Pernicious Career of the Inchoate and General Lien*, 63 YALE L.J. 905, 908-19 (1954).

6. The doctrine of the inchoate and general lien was originated by the United States Supreme Court in Spokane County v. United States, 279 U.S. 80 (1929). See generally Kennedy, *supra* note 3; Kennedy, *supra* note 5; Note, 63 COLUM. L. REV. 1259 (1963).

7. It has often been stated that R.S. § 3466 creates no lien. See, *e.g.*, United States v. Oklahoma, 261 U.S. 253, 259 (1923); United States v. Menier Hardware No. 1, Inc., 219 F. Supp. 448, 451 (W.D. Tex. 1963). See also cases cited in Kennedy, *supra* note 5, at 911 n.37. However, Supreme Court decisions since 1929 have rendered these statements virtually meaningless. See authorities cited note 6 *supra*.

8. See generally Blair, *The Priority of the United States in Equity Receiverships*, 39 HARV. L. REV. 1 (1925).

9. See, *e.g.*, SBA v. McClellan, 364 U.S. 446 (1960); United States v. Remund, 330 U.S. 539 (1947) (Farm Credit Administration); Luther v. United States, 225 F.2d 495 (10th Cir. 1954), *cert. denied*, 350 U.S. 947 (1956) (Commodity Credit Corporation). *But cf.* Sloan Shipyards Corp. v. U.S. Fleet Corp., 258 U.S. 549, 570 (1922) (federally owned private corporation cannot claim priority in bankruptcy).

10. W. T. Jones & Co. v. Foodco Realty, Inc., 318 F.2d 881 (4th Cir. 1963); 3 COLLIER, BANKRUPTCY ¶ 64.501 (14th ed. 1964).

11. See, *e.g.*, United States v. Gilbert Associates, Inc., 345 U.S. 361 (1953); Spokane County v. United States, 279 U.S. 80 (1929); W. T. Jones & Co. v. Foodco Realty, Inc., *supra* note 10.

12. INT. REV. CODE OF 1954, § 6321:

> If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to such tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.

tor must be specific and perfected before it will be recognized in a contest against the government. Therefore, the government takes priority over any competing creditor who does not have a "choate"[13] lien against the debtor's property.[14] A recent Supreme Court clarification of the inchoate lien doctrine declared that the tests for a "specific and perfected lien" differ according to whether the United States claim is premised on the general priority statute or the tax lien statute.[15] Although the primary impetus for this doctrine and the priority statutes has been to secure adequate public revenue,[16] the Court promulgated the less stringent requirements for a lien competing against the federal tax lien.[17] The somewhat questionable result is that, although taxes are its primary source of revenue, the Government's tax lien is theoretically less effective than the other types of liens it may assert.

The SBA, which makes extensive use of both the inchoate lien doctrine and R.S. § 3466, was created in 1953[18] to foster the actual and potential capacity of "small business"[19] through a number of varied programs[20] designed to provide financial assistance, general

13. "Choate" has been equated with "specific and perfected" and is generally understood to mean "complete." In Letter From Alfred F. Conard to Editor, 42 A.B.A.J. 608 (1956), the word is termed "a flag of the new freedom from etymology."

14. This rule is somewhat modified for distributions under the Bankruptcy Act, where § 64(a) controls. See, *e.g.*, Massachusetts Bonding & Ins. Co. v. New York, 259 F.2d 33 (2d Cir. 1958); United States v. Gargill, 218 F.2d 556 (1st Cir. 1955). However, § 64(a)(5) incorporates R.S. § 3466 by indirect reference. See authorities cited note 26 *infra*. See generally Rogge, *The Differences in the Priority of the United States in Bankruptcy and in Equity Receiverships*, 43 HARV. L. REV. 251 (1929).

15. United States v. Vermont, 377 U.S. 351, 358 (1964).

16. See SBA v. McClellan, 364 U.S. 446, 451-52 (1960); Price v. United States, 269 U.S. 492 (1926).

17. For a lien to be specific and perfected when competing against a tax lien, it must clearly identify the lienor, the property subject to the lien, and the amount of the lien. In addition to these three qualifications, a lien competing against R.S. § 3466 priority is not considered specific and perfected unless the debtor has also been divested of possession or title. See United States v. Gilbert Associates, Inc., 345 U.S. 361, 366 (1953). Concerning this last element of choateness, Professor Kennedy has commented: "To speak of a lienor with title is of course to utter a legal solecism, but the incongruities of the doctrine of the inchoate and general lien have never been a handicap to its development." Kennedy, *supra* note 5, at 918 n.88 (1954).

18. 67 Stat. 232 (1953). The SBA had only temporary status until 1958, when Congress made it a permanent establishment and expanded its scope considerably. 72 Stat. 384 (1958), as amended, 15 U.S.C. §§ 631-47 (1964). For a thorough presentation of the historical development of the SBA, see Barnes, *What Government Efforts Are Being Made To Assist Small Business*, 24 LAW & CONTEMP. PROB. 3-8 (1959).

19. "Small businesses" are defined under regulations issued by the SBA. The important criteria are generally the number of employees and the dollar volume of business transacted. Small Business Size Standards Regulation, 13 C.F.R. § 121.3-10 (Supp. 1965). Statutory enabling authority for the issuance of such regulations is found in 72 Stat. 384, 15 U.S.C. § 632 (1958).

20. Among the programs are direct loans for such purposes as construction of plant and purchase of equipment, loans made by regular credit channels but guaranteed by the SBA, "pool loans" made to corporations formed by a number of small business concerns, disaster loans to aid victims of floods and similar disasters, long-term invest-

business counselling, and assurance that a fair proportion of government contracting would be done with small businesses.[21] As the SBA was conceived, it was not intended to supplant or compete with private credit sources but rather to supplement sources of term credit, fill the existing credit gaps, and encourage more lending by existing credit sources.[22] Like all sources of credit, however, the SBA has been faced with the problem of collecting from delinquent debtors, and has undertaken to utilize the inchoate lien doctrine and the general priority statute for this purpose. The remainder of this comment will discuss the use of these weapons by the SBA and the undesirable effects that have resulted from that use, and will recommend changes which appear beneficial.

II. Utilization by the SBA of R.S. § 3466 and the Doctrine of the Inchoate Lien

A. *Implementation of R.S. § 3466*

The development of the Small Business Administration's priority among creditors appears to have received its initial impetus from *SBA v. McClellan*,[23] the first United States Supreme Court case considering the relative priority of SBA claims. In *McClellan*, the SBA executed a deferred participation agreement with a bank providing for an assumption by the SBA of a seventy-five per cent share of any loss accruing to the bank on the loan.[24] The bank thereafter made the loan to the debtor, who executed a note payable to the bank. After

ment loans for small business development, loans to state and local development companies, active programs for procuring government contracts for small business concerns, and programs for management and technical assistance. See generally Gilbertson, *Small Business Financing Under the Small Business Act and the Small Business Investment Act of 1958*, 8 Kan. L. Rev. 538 (1960); McCallum, *Loans by the Small Business Administration*, 13 Bus. Law. 349 (1958).

21. See 72 Stat. 384, as amended, 15 U.S.C. § 631 (1964), which recognizes the strength of small business concerns as a major factor in assuring national economic well-being and the preservation of full and free competition.

22. See 72 Stat. 387, 394 (1958), 15 U.S.C. §§ 636, 642 (1964), declaring as congressional policy that no financial assistance shall be extended unless not otherwise available on reasonable terms. *But see* The Wall Street Journal, Aug. 27, 1965, p. 8, col. 1, for an editorial contending that the actual practice is not so limited.

23. 364 U.S. 446 (1960).

24. Participation loans are made jointly by the SBA and a private lending institution. There are two types of participation loans—immediate and deferred. In the case of an immediate participation loan, which is to be used only when deferred participation loans are not available, the SBA purchases a certain percentage of the loan at the time it is granted. In a deferred participation loan, the private institution makes and administers the entire loan, and the SBA merely agrees to purchase from the bank a fixed portion of the outstanding balance at any time during the stated period. A direct loan from the SBA to a business concern may be made only if no participation credit is available. See generally Small Business Act § 7(a), 72 Stat. 387 (1958), 15 U.S.C. § 636 (1964). The participation loan program has since been discontinued in favor of a guaranty program and Congress is currently considering a bill which would enable the SBA to liquidate this program by selling the participation guarantees to private investors. See The Wall Street Journal, March 2, 1966, p. 6, col. 1.

an involuntary petition in bankruptcy had been filed against the debtor, the SBA took assignment of the note, filed a claim for the unpaid balance, and asserted priority for its seventy-five per cent interest in the note.[25] The Supreme Court held that R.S. § 3466 and the bankruptcy statute were to be read *in pari materia*; thus, the SBA was accorded a preference over other general creditors included within section 64(a)(5) of the Bankruptcy Act.[26] Furthermore, it was held that the preference was not voided by the SBA's having contracted to give twenty-five per cent of its seventy-five per cent priority recovery to the participating bank.[27]

Several important implications are found in the *McClellan* decision. First, the holding that the SBA is entitled to the priority of the United States seems to have established the concept that *all* agencies of the federal government are entitled to R.S. § 3466 priority[28] in the absence of a specific legislative provision to the contrary.[29] Second, the approval of the SBA agreement giving the participating bank twenty-five per cent of the preferred recovery indirectly extends the federal priority statute to nongovernmental entities cooperating with the federal government.[30] Third, the grant of priority to the federal government, in disregard of the general rule that the rights of creditors are fixed when bankruptcy proceedings are commenced,[31] appears to establish a preference for debts in which the United States has an equitable interest at the date of the bankruptcy petition in addition to those debts legally owned by the Government.[32]

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25. The SBA sought priority only for its portion of the loan, since it has been established that sovereign priority cannot be used for the benefit of debts owing to private parties. See SBA v. McClellan, 364 U.S. 446, 451 (1960); Nathanson v. NLRB, 344 U.S. 25, 27-28 (1952). See also note 99 *infra* and accompanying text.

26. In bankruptcy proceedings the priority of debts owing to the United States is governed by § 64(a) of the Bankruptcy Act rather than R.S. § 3466. The Bankruptcy Act provides for five classes of creditors who are to be fully paid before any other general creditors. The United States is within the fourth class when seeking tax debts and within the fifth class when seeking other debts qualifying for priority granted by other federal laws. In *McClellan*, the Supreme Court declared that the general priority provided in R.S. § 3466 is recognized by § 64(a)(5) of the Bankruptcy Act, thereby placing the United States within the fifth class of preferred creditors when seeking debts qualifying for R.S. § 3466 priority. See SBA v. McClellan, *supra* note 25, at 451; 3 COLLIER, BANKRUPTCY ¶ 64.501 (14th ed. 1964).

27. 364 U.S. at 451.

28. This conclusion seems warranted in light of recent decisions which have unanimously granted priority to the litigating agencies. See cases cited note 9 *supra*. These cases appear to have overruled United States v. Guaranty Trust Co., 280 U.S. 478 (1930), which denied United States priority for a railroad loan made under the Transportation Act of 1920, 41 Stat. 456. The *McClellan* Court quoted with approval an earlier rejection of *Guaranty Trust* as follows: "'[O]nly the plainest inconsistency would warrant our finding an implied exception to . . . so clear a command as that of § 3466.'" 364 U.S. at 453. *But see* notes 87-88 *infra* and accompanying text.

29. For example, the Reconstruction Finance Corporation is prohibited from using R.S. § 3466. See 62 Stat. 262 (1948), 15 U.S.C. § 603(a) (1964).

30. See 364 U.S. at 451-52. *But see* note 99 *infra* and accompanying text.

31. United States v. Marxen, 307 U.S. 200, 207 (1939).

32. See 364 U.S. at 450. *But cf.* United States v. Marxen, *supra* note 31 (Federal

More recent litigation involving the SBA has resulted in further expansion of the application of R.S. § 3466. In *W. T. Jones & Co. v. Foodco Realty, Inc.*,[33] the SBA joined in an $85,000 participation loan made by a bank to the debtor, secured by a trust deed on land and improvements valued at $25,000. A contractor who had added $54,500 worth of improvements to the mortgaged land initiated proceedings to enforce his mechanic's lien, claiming priority to the land and improvements on the basis of state law.[34] The SBA intervened and successfully urged the application of R.S. § 3466 priority for its claim, even though that claim was inferior to the mechanic's lien under Virginia law and the application of the priority left the contractor unpaid. Many previous decisions involving federal priority had favored an unsecured federal claim over a claim preferred by state law,[35] but the decision by the Court of Appeals for the Fourth Circuit in *Foodco* is significant for its disregard of the relative priority under state law of the state-created security interest taken by the federal government. Furthermore, as the SBA priority claim had been premised on R.S. § 3466, the court held that it would be inconsistent to allow the SBA to claim the benefit of the common-law rule that first in time is first in right,[36] and declared itself "bound . . . to give effect to the long-standing congressional declaration of priority,"[37]

Housing Administration denied priority because it did not become an assignee of the debtor's note until after the bankruptcy petition was filed). The Supreme Court in the *McClellan* case distinguished *Marxen* on the ground that the SBA participation loan gives the government a more direct interest in the debt than a FHA indemnity contract. This distinction would seem to exalt form over substance, because in each instance the note is originally payable to the private lending institution, and the government invests no funds until the note is assigned to it. However, the participation loan forms have recently been changed in an effort to avoid the problem raised by the *Marxen* holding. The loan form now states that upon the bankruptcy of the lender the loan becomes "immediately and simultaneously" payable to the SBA. Interview with Roger L. Campbell, Assistant General Counsel for the Small Business Administration, Jan. 20, 1966.

33. 318 F.2d 881 (4th Cir. 1963).

34. *Id.* at 884 n.4.

35. See, *e.g.*, Illinois *ex rel.* Gordon v. Campbell, 329 U.S. 362 (1946); United States v. Waddill, Holland & Flinn, Inc., 323 U.S. 353 (1945); United States v. Texas, 314 U.S. 480 (1941).

36. The court's reasoning in this regard appears sound, since the "first in time" test would result in denial of the federal government's priority if its lien were subsequent to the competing lien, whereas the chronology of the competing claims does not affect priorities under R.S. § 3466. However, in a later case involving competition between an SBA lien and an antecedent state lien, the Court of Appeals for the Third Circuit avoided an inconsistency in the results dictated by R.S. § 3466 and the "first in time" test by integrating the inchoate lien test with the "first in time" test. As the state lien was found inchoate and thus ineligible for competition with the federal lien, the court was able to apply the "first in time" test to prefer the federal government. *In re* Lehigh Valley Mills, Inc., 341 F.2d 398 (3d Cir. 1965). See generally note 130 *infra* and accompanying text, where the combining of the inchoate lien doctrine with the "first in time" test is criticized.

37. 318 F.2d at 889.

which it viewed as a repudiation of the old common-law rule in situations meeting the conditions of R.S. § 3466.

B. *The SBA and the Inchoate Lien*

The doctrine of the inchoate lien, which has been vigorously criticized by commentators,[38] has also contributed to the development of the Small Business Administration's strength as against competing creditors. The *Foodco* case demonstrates the typical role of the doctrine as a supplement to the federal priority legislation.[39] Finding the mechanic's lien to be inchoate due to the lack of title or possession,[40] the court granted priority to the SBA, since all federal claims based on R.S. § 3466 prevail over any competing inchoate liens.[41] However, in dictum the court acknowledged that it is improbable that any mechanic's lien, even one characterized as "choate," could prevail over a federal claim.[42]

In its recent decision in *In re Lehigh Valley Mills, Inc.*,[43] the Court of Appeals for the Third Circuit added another dimension to the proliferating doctrine of the inchoate lien. Together with two banks, the SBA had made a participation loan of $100,000 to the debtor, taking as security a second mortgage on real estate and a security interest in various personalty. As the first mortgage exhausted the real estate, the federal government sought priority for its claim to the proceeds from the debtor's personalty by separately urging R.S. § 3466 priority and the doctrine of the inchoate lien. The court accorded the two doctrines an independent status, refused to apply R.S. § 3466, and granted the SBA preference upon finding the competing state tax lien inchoate and therefore inferior to the federal security interest.[44] In this case, which appears to be the first federal circuit court decision using the inchoate lien doctrine to test a lien competing with the SBA's contractual security interest,[45] an analogy was

38. See authorities cited note 3 *supra*.

39. See generally notes 12-17 *supra* and accompanying text.

40. 318 F.2d at 887-88.

41. See note 17 *supra*.

42. 318 F.2d at 886. This dictum supports the belief of many commentators that the Supreme Court holdings make it improbable that a rival lien would ever be favored over a federal claim premised on R.S. § 3466, since a lien is inchoate until the lienor attains possession and title, and at that moment the lien dissolves. See Kennedy, *supra* note 3, at 727; Note, 63 COLUM. L. REV. 1259, 1271 (1963). Supporting the commentators is the history showing that in the nearly four decades since the inchoate lien doctrine was read into the federal priority statute, no lien has yet been found by the Supreme Court to meet the standards of choateness requisite to overcome federal priority. Therefore, in the context of claims premised on R.S. § 3466, to speak of the doctrine of the inchoate lien seems to be a misnomer, since a choate lien is nonexistent. See note 17 *supra*.

43. 341 F.2d 398 (3d Cir. 1965).

44. *Id.* at 401.

45. A holding similar to that in *Lehigh* is United States v. Menier Hardware No. 1,

made to federal tax lien cases which had utilized the "three factor" test—definiteness as to identity of the lienor, property bound by the lien, and amount of the lien—for determining choateness.[46] The court then applied this test for a lien competing against the SBA's contractual lien.[47] Although no reason was advanced why choateness is only a prerequisite for the privately held lien, the court in *Lehigh* assumed without discussion that the federal lien need not be choate.[48] Thus, the federal lien was held to be superior to the inchoate state lien under the "first in time" test, because the state lien was rendered inoperative by its inchoate status.[49]

Based on the foregoing cases, the following conclusions can be drawn concerning the extension of SBA priority: (1) The priority granted by R.S. § 3466 is directly available to the SBA and indirectly available to certain nongovernmental entities cooperating with the SBA; (2) priority in bankruptcy can be obtained for those debts legally or equitably owned by the SBA at the time of the filing of the bankruptcy petition; (3) the federal government may claim priority regardless of the priority accorded by state law to a security interest taken by the government; (4) either R.S. § 3466 or the inchoate lien doctrine may be invoked in favor of the federal government's contractual liens; (5) it is doubtful whether any lien will be favored over a United States claim based on R.S. § 3466.

These judicial developments represent a highly successful court record for the SBA over the past two years and a remarkable increase in the power to collect debts owing to the SBA. The need for federal funds to carry on a program such as Congress envisioned when it enacted the Small Business Act cannot be denied, but it is questionable whether these funds should be sought by means of the SBA's aggres-

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Inc., 219 F. Supp. 448 (W.D. Tex. 1963), in which the SBA's contractual security interest was found superior by testing the competing lien by the standards of the inchoate lien doctrine. The Third Circuit has since applied the *Lehigh* rationale in holding the federal lien superior in United States v. Oswald & Hess Co., 345 F.2d 886 (3d Cir. 1965). *Cf.* United States v. Latrobe Constr. Co., 246 F.2d 357 (8th Cir. 1957).

46. *E.g.*, United States v. Acri, 348 U.S. 211 (1955); United States v. City of New Britain, 347 U.S. 81 (1954).

47. See 341 F.2d at 401, where the court refers to United States v. City of New Britain, *supra* note 46. In the latter case a city tax lien had been found to be choate under the three-factor test. Seemingly unaware of the additional element of choateness when used in connection with a R.S. § 3466 claim, the Third Circuit never mentioned the necessity of the lienor's having title or possession. See generally note 17 *supra* and accompanying text.

48. The state lien was held to be inchoate because of uncertainty as to amount, since the state had not received a judgment and the lien was not summarily enforceable. It would appear that an application of these tests to the federal contractual lien would lead to the conclusion that it is inchoate. *Cf.* INT. REV. CODE OF 1954, § 6331; Note, 43 TEX. L. REV. 418, 420 (1965).

49. "That test [the first-in-time test] requires that a lien competing with one of the Federal Government must be choate . . . ." 341 F.2d at 401.

sive assertion of the sovereign prerogative of priority to a debtor's assets.[50]

III. Appraisal of Federal Priority as Employed by the SBA

A. *The Congressional Intent of Section 17 of the Small Business Act*

Section 17 of the Small Business Act[51] was enacted in 1958 for the purpose of subordinating security interests of the SBA to state and local tax liens, provided applicable state law preferred the tax liens.[52] The following discussion will attempt to demonstrate that this congressional intent has been subverted by judicial interpretation of section 17 and by the present application of R.S. § 3466 and the doctrine of the inchoate lien.

The original draft of the bill which eventually became section 17 explicitly denied the SBA the use of R.S. § 3466;[53] however, the Senate Subcommittee on Small Business, relying on a letter from the administrator of the SBA,[54] redrafted the bill.[55] In recommending

50. This question has been underscored by the Supreme Court's recent rejection of an SBA attempt to avoid a state coverture law and its criticism of the SBA's "zealous pursuit of the balance due on a disaster loan." The SBA's position was characterized as "seeking the unconscionable advantage of recourse to assets for which it did not bargain." United States v. Yazell, 86 Sup. Ct. 500, 503 (1966).

51. Small Business Act § 17 (1958), 72 Stat. 396, 15 U.S.C. § 646 (1964):

> Any interest held by the Administration in property, as security for a loan, shall be subordinate to any lien on such property for taxes due on the property to a State, or political subdivision thereof, in any case where such lien would, under applicable State law, be superior to such interest if such interest were held by any party other than the United States.

52. See S. Rep. No. 1714, 85th Cong., 2d Sess. 10 (1958):

> It [§ 17] is designed to place SBA claims against the assets of small-business borrowers in a subordinate position to the claims of State and local tax liens against such assets. This provision is consistent with other provisions of law and clarifies the position of the SBA in actions brought to realize its interest in the assets of borrowers who have defaulted under SBA loans.

See also H.R. Rep. No. 2135, 85th Cong., 2d Sess. 6 (1958):

> This amendment added to the House bill a new section making SBA's security interest in property subordinate to State and local tax liens on such property in any case where Small Business Administration's interest would be subordinate to such tax liens, under State law, if it were an interest held by a person other than the United States.

53. "Be it enacted . . . that any debt due the Administration which is outstanding . . . shall not be entitled to the priority available to the United States pursuant to section 3466 of the Revised Statutes (31 U.S.C. 191)." S. 3319, 85th Cong., 2d Sess. (1958). This bill, introduced by Senator Payne of Maine, apparently was precipitated by the SBA's assertion of priority over a lien held by the city of Eagle Lake, Maine. See 104 Cong. Rec. 2470 (1958).

54. Letter from Wendell B. Barnes to Honorable J. W. Fulbright, May 27, 1958, in *Hearings Before Subcommittee on Small Business of the Senate Committee on Banking and Currency*, 85th Cong., 2d Sess., Vol. 3, pt. 2, at 553-54 (1958). This letter constituted the bulk of the testimony on the proposed bill.

55. See note 51 *supra*. The form enacted, which was suggested by Administrator Barnes in his letter to Senator Fulbright, *supra* note 54, was designed specifically "to give priority to State and local tax liens over mortgage claims asserted by the Small Business Administration" while retaining R.S. § 3466 priority against nongovernmental creditors.

the adoption of the present more restrictive form of section 17, the committee appears to have made two important assumptions: (1) that the federal priority afforded by R.S. § 3466 was relevant only to *unencumbered assets* of the debtor,[56] and (2) that the SBA urged priority for its security interests only when the interest was created prior to the attachment of a competing state or local tax lien.[57] The committee intended to augment the strength of state and local governments by giving their tax liens priority over SBA security interests which existed *prior* to the tax liens whenever state law granted priority to such liens.[58] Thus, it appears that Congress must have intended the SBA to have a "sovereign preference" only when the SBA, without a security interest, competed against a creditor without a state or local tax lien for the unencumbered assets of an insolvent debtor undergoing administration.[59]

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56. See letter cited note 54 *supra*, in which the Administrator commented as follows:

> S. 3319 excludes the Administration from use of [§ 3466] in the distribution of the *unencumbered assets* of any debtor of the United States . . . . This priority is *not applicable to property which is subject to a lien of any kind.* The captioned bill, therefore, offers little of practical value to local taxing authorities . . . .
>
> The real source of conflict is property which is subject to both an Administration mortgage, or deed of trust, and to a local tax lien. Since such property is encumbered, the priority of [§ 3466] does not come into play. (Emphasis added.)

The quoted statement, which constituted the bulk of the testimony on this point, was never challenged.

57. See letter cited note 54 *supra*, in which the SBA Administrator stated:

> Until recently, we avoided difficulty in most of our summary foreclosures . . . by yielding to the demands of local tax authorities . . . . In following this practice, we recognized that, in many cases, our mortgages might be superior to such tax liens. It has long been an established rule that . . . the lien which attaches *first in point of time* is the superior. . . . However, there was doubt about the applicability of this rule to our mortgages; and, as long as this doubt existed, we felt justified in our policy of avoiding challenge to local tax authorities. On January 20, 1958, the . . . Third Circuit decided . . . that a mortgage lien held by the United States stands in the same position as a tax lien held by the United States, and is therefore superior to State or local tax liens, which are later in point of time (United States v. Ringwood Iron Mines, Inc., 251 F.2d 145 . . .). In view of this holding, *we reluctantly concluded* that we have a duty to insist upon the superiority of our mortgages in all cases where they are prior, *in point of time*, to State or local tax liens. (Emphasis added.)

If the SBA was reluctant to claim priority when its lien was prior in time, the committee would have necessarily assumed that priority would not be asserted when the federal security interest was later in time.

58. See the House and Senate Reports quoted in note 52 *supra*. The same conclusion was made by a federal district court when it upheld the priority of state and local tax liens. See United States v. Christensen, 218 F. Supp. 722, 723, 729 (D. Mont. 1963), where it is stated:

> The parties agree that the obvious purpose of this statute was to place the SBA in the position of a private party with respect to the relative priority of its mortgage liens. . . .
>
> As in the case of federal tax liens, the priority of mortgage liens, held by an agency of the United States, and state tax liens is governed by the principle that the first in time is first in right . . . . As noted, this principle has been abrogated . . . to the extent of the taxes themselves by 15 U.S.C.A. § 646.

59. In addition to this sovereign preference, priority not related to sovereignty was also contemplated where state law did not assert absolute priority for state tax liens. For an example of state law denying priority to state tax liens subsequent to competing liens or mortgages, see Jefferson Standard Life Ins. Co. v. United States, 247

Recent cases, however, have failed to carry out the intent of the congressional committee. The Court of Appeals for the Third Circuit has refused to apply section 17 to give priority to states in situations involving capital stock taxes,[60] corporate loan taxes,[61] corporate net income taxes,[62] and city service charges.[63] In each instance state priority was denied because the taxes were not on "any particular or specific property."[64] Furthermore, the court said in dictum that section 17 also required the state lien to be on "the particular property in controversy."[65] Thus, that court has limited the effect of section 17 to situations where the state lien arises on the particular property in controversy because of taxes due on that particular property.[66]

This interpretation of section 17 may be defensible in light of the language of the statute, but it does not appear to be warranted by legislative history or congressional policy. Many times throughout the hearings on section 17, reference was made to the granting of priority to "any" and "all" state and local tax liens;[67] at no time was there an indication that only a very restricted group of property tax liens were to be favored.[68] Furthermore, Congress recognized that state and local governments cannot function without revenue[69] and

F.2d 777 (9th Cir. 1957) (construing California law). As previously noted, the intended restriction on sovereign priority has not materialized. SBA priority may be asserted in all situations, subject to the limited restriction indicated in the text accompanying notes 60-66 *infra*.

60. See *In re* Lehigh Valley Mills, Inc., 341 F.2d 398 (3d Cir. 1965).

61. *Ibid.*

62. *Ibid.*

63. United States v. Oswald & Hess Co., 345 F.2d 886 (3d Cir. 1965).

64. See *In re* Lehigh Valley Mills, Inc., 341 F.2d 398, 401 (3d Cir. 1965); United States v. Oswald & Hess Co., *supra* note 63, at 888.

65. *In re* Lehigh Valley Mills, Inc., *supra* note 64, at 400.

66. See also two similar holdings by Pennsylvania state courts, which were the sole authority cited by the *Lehigh* court in drawing its conclusions on the meaning of § 17: Girard Trust Corn Exch. Bank v. Herbert Elkins, Inc., No. 4426, Court of Common Pleas No. 4, Philadelphia, February 14, 1964; First Nat'l Bank v. Scranton Battery Corp., No. 649, Court of Common Pleas, Lackawanna, July 31, 1964. *But cf.* United States v. Christensen, 218 F. Supp. 722 (D. Mont. 1963), where the court favored the state and local property tax liens. Although these tax liens would seemingly meet even the restrictive tests applied by the Court of Appeals for the Third Circuit, the court indicated that it assumed a much broader interpretation of § 17. See note 58 *supra*.

67. See notes 52, 56, and 57 *supra*.

68. Under the *Lehigh* test, even the property taxes would not be preferred if the failure to pay created a general lien on all of the debtor's property.

69. See the remarks made by Senator Payne in introducing S. 3319, which eventually became § 17 of the Small Business Act:

> This modification is in accordance with custom and usage in this country where taxes have always taken precedence over debts. The fact that an agency of the United States Government is the creditor should not alter the situation. This legislation is necessary to . . . assure fair treatment to States and localities when they must compete with the Small Business Association for the remaining assets of a debtor. 104 CONG. REC. 2470 (1958).

Cf. Mutual Benefit Life Ins. Co. v. Siefken, 1 Neb. (Unof.) 860, 861, 96 N.W. 603 (1901).

designed section 17 to prohibit the SBA from interfering with their revenue collections.[70] Finally, upon a consideration of the relative importance of state and local governmental functions and the relative insignificance of property taxes to total state revenue,[71] the incongruity of the Third Circuit's restricted interpretation becomes readily apparent.

Although the *Lehigh* court said nothing to indicate that the doctrine of the inchoate lien might also be used to test the priority of a state or local tax lien qualifying for section 17 priority, the history of the expansion of that doctrine strongly suggests the possibility.[72] If a qualifying state or local tax lien were required to be choate before section 17 could be utilized, then a state tax lien would be subordinate to SBA security interests even if the bill representing section 17 had been enacted as first introduced.[73] If the judiciary should endorse this hypothesis, the past restrictive interpretations of section 17, which are seemingly contrary to congressional intent, would become irrelevant by virtue of a more complete subversion of congressional intent.

B. *Inequitable Consequences Resulting From the Assertion by the SBA of R.S. § 3466 Priority and the Inchoate Lien Doctrine*

1. *R.S. § 3466*

It would appear difficult to justify the assertion by the SBA of priority under R.S. § 3466, in light of the lack of a historical basis for such a use of the section[74] and in light of the inequitable results which are frequently occasioned by the granting of such a priority.

70. This purpose behind the redrafting of § 17 to its present form is clearly indicated in the statement of Administrator Barnes:

> Senator Payne, the author of the bill, explained his intent is to give priority to State and local tax liens over mortgage claims asserted by the Small Business Administration against the property of a borrower who is in default on a loan made by the Administration. I favor such a reform; but I do not believe that the bill, as drafted, will accomplish it . . . . In its stead, I wish to make a proposal [this proposal was enacted as § 17] which will, I believe, accomplish the reform desired by Senator Payne.

71. For instance, in 1963 property taxes constituted a mere three per cent, on the average, of total revenue for all states. Furthermore, five states have no state property tax, and in ten other states the property tax constitutes less than one half of one per cent of total state revenue. See U.S. BUREAU OF THE CENSUS, DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 430 (85th ed. 1964).

72. For examples of past expansion, see notes 43-49 *supra* and accompanying text; Rialto Publishing Co. v. Bass, 325 F.2d 527 (9th Cir. 1963) (trustee in bankruptcy successfully invoked doctrine of inchoate lien to attack a lien against debtor's property). See generally Kennedy, *The Inchoate Lien in Bankruptcy: Some Reflections on Rialto Publishing Co. v. Bass*, 17 STAN. L. REV. 793 (1965).

73. See the tests for choateness, note 17 *supra*, and the improbability that any lien will be found choate, note 42 *supra* and accompanying text. If a lien is inchoate, the question of applicability of § 17 would never be reached, even if § 17 had been enacted as originally proposed. See note 53 *supra* and accompanying text.

74. See, *e.g.*, United States v. State Bank, 31 U.S. (6 Pet.) 29, 35 (1832); Rorke v. Dayrell, 4 Durn. & E. 402, 100 Eng. Rep. 1087 (K.B. 1791).

With respect to the historical use of the sovereign prerogative in bankruptcy, it should be noted that England, the original source of our federal government's prerogative, has appropriately limited the governmental preference to situations involving obligations arising from "public acts."[75] When the government deals with private parties in its role as tax collector, its primary purpose is gathering revenue, and in carrying out this activity it has no choice of debtors.[76] On the other hand, the primary purpose of the SBA is to encourage lending to small businesses on reasonable terms.[77] Furthermore, the SBA not only has a choice of debtors but also has been admonished by Congress to make only loans which are "of such sound value or so secured as reasonably to assure repayment."[78] Thus, a consideration of the reasons for recognizing sovereign priority and of the policy behind the Small Business Act leads to the conclusion that the extraordinary priority afforded the Government by R.S. § 3466 should not be extended to the SBA.[79]

Although the above reasons for precluding the use of R.S. § 3466 by the SBA were rejected by the Supreme Court in *SBA v. McClellan*,[80] other decisions have recognized their validity. In two earlier cases the Supreme Court held that R.S. § 3466 had been impliedly rejected by subsequent congressional acts having purposes and granting powers seemingly inconsistent with federal priority.[81] Further-

75. Crown Proceedings Act, 1947, 10 & 11 Geo. 6, c. 44. See Salter, *Priority Accorded the Sovereign in Bankruptcy: The American and British Views*, 63 COM. L.J. 354 (1958). Indeed, Congress has often recognized the commercial nature of many governmental activities and has consented to the imposition of the same standard of liability on the Government as on the other party to the transaction. See statutes cited note 2 *supra*. An authoritative judicial ruling recently denied sovereign immunity from suit in federal court to a foreign government in a situation where the activity giving rise to the suit was not of a public nature. See Victory Transp. Inc. v. Comisaria General de Abastecimientos y Transportes, 336 F.2d 354 (2d Cir. 1964). The decision is in accord with the prevailing view in most other countries. See Note, 63 MICH. L. REV. 708, 710 (1965).

76. See Note, 63 MICH. L. REV. 944, 949 (1965).

77. See Gilbertson, *Small Business Financing Under the Small Business Act and the Small Business Investment Act of 1958*, 8 KAN. L. REV. 538, 539, 552 (1960).

78. See Small Business Act § 2[7](a)(7), 72 Stat. 396 (1958), as amended, 15 U.S.C. § 636(a)(7) (1964).

79. Davis v. Pringle, 1 F.2d 860, 864 (4th Cir. 1924), *aff'd*, 268 U.S. 315 (1925): "[T]he contractual operations of the federal government and of the states have become so extensive and so involved with the business of private citizens that priority to the federal government and to the states, except for taxes, would operate as an oppressive hardship on other creditors of bankrupts." See MacLachlan, *Improving the Law of Federal Liens and Priorities*, 1 B.C. IND. & COMM. L. REV. 73 (1959); Salter, *supra* note 75; *cf.* Note, 1964 U. ILL. L.F. 828, 833 (1964).

80. 364 U.S. 446, 453 (1960).

81. United States v. Guaranty Trust Co., 280 U.S. 478 (1930) (Transportation Act of 1920 impliedly rejected federal priority for debts created thereunder); Mellon v. Michigan Trust, 271 U.S. 236 (1926) (Federal Control Act deemed to give Director General of Railroads no greater rights than other creditors). The Supreme Court in *Guaranty Trust* found that the basic purpose of the statute was to aid railroad credit, just as aid to the credit of small business concerns is the underlying purpose of the

more, the sole precedent cited for the Supreme Court's rejection in *McClellan* of the argument that governmental priority is inconsistent with the basic purposes of the Small Business Act was *United States v. Emory*,[82] in which the Court denied the contention that no priority was intended for debts of the Federal Housing Administration. The Court reasoned in *Emory* that the FHA, by claiming federal priority, would not inhibit the extension of credit by contractors, but, on the contrary, would encourage such lending, because the loans were frequently paid by the lending institutions directly to the suppliers furnishing goods and services.[83] As was acknowledged by the Fourth Circuit in *Foodco*,[84] it has not been the practice of the SBA to require loan money to go directly to those selling to the debtor; thus, the underlying theory of *Emory* would not seem to support the *McClellan* holding.[85]

The SBA practices discussed in *Foodco* not only undermine the theory supporting *Emory*, but also highlight a major inequity resulting from the SBA's claim of preference. Relying upon abundant Virginia law establishing priority for those improving real estate by adding their goods and services,[86] the contractor in *Foodco* added

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Small Business Act. The Court held that this purpose was totally inconsistent with a claim of federal priority, because the preference would make it more difficult to borrow money from potential lenders aware of this federal preference.

82. 314 U.S. 423 (1941).

83. *Id.* at 431. Beyond the policy argument expressed above, the Supreme Court in *Emory* emphasized two factors in distinguishing United States v. Guaranty Trust, 280 U.S. 478 (1930). The Court noted that the National Housing Act considered in *Emory* provided for loans without security and for little or no interest, whereas the Transportation Act loans considered in *Guaranty Trust* provided that adequate security must be given for all loans and required the charging of 6% interest. The Small Business Act, like the Transportation Act, requires the SBA to take adequate security on all loans, note 78 *supra*, and for an interest rate of 3-5½%. Thus, the Court's reliance on *Emory* in according federal priority to the SBA appears questionable.

84. See note 33 *supra* and accompanying text.

85. See note 83 *supra*. Reliance on *Emory*, a case involving FHA loans, appears even more questionable after the recent Supreme Court pronouncement limiting the SBA's right to disregard state law. In United States v. Yazell, 86 Sup. Ct. 500 (1966), the Court held that the SBA must abide by a Texas coverture statute. The decision was premised on the acquiescence by SBA in the application of Texas law implied from the SBA's individual negotiation with the lender. In contrasting instances where federal law is correctly applied, the Court distinguished "nationwide act[s] of the Federal Government, emanating in a single form from a single source" and illustrated the difference by comparing the individually negotiated SBA loans to the FHA loans made on contract forms which are identical throughout a particular state. *Id.* at 504. Although in *Yazell* state law was competing with federal common law rather than a statute such as R.S. § 3466, the Court's reasoning, coupled with its warning that not even statutory sovereign preferences have been held absolute, *id.* at 505, suggests that the use of R.S. § 3466 may be improper where the SBA has individually negotiated for collateral security. In SBA v. McClellan, 364 U.S. 446 (1960), where the Supreme Court approved the invocation of R.S. § 3466 by the SBA, the loan was made without collateral. It would thus not require repudiation of the ruling in *McClellan* if the Court should hold § 3466 inapplicable in any case where the SBA has bargained for a state-created security interest.

86. See note 34 *supra*.

$54,500 worth of improvements to the land mortgaged to the participating bank. Because the loan was made by the local bank, the contractor had no reason to be aware of the Small Business Administration's participation and equity.[87] When proceedings for foreclosure of the mechanic's lien were instituted, the bank assigned the note and mortgage to the SBA, which in turn successfully asserted R.S. § 3466 priority in derogation of the contractor's security. It may be doubted that Congress ever intended to "secure . . . public revenue" in such a manner.[88]

A possibility of a further inequity is suggested by the application of R.S. § 3466 to an SBA mortgage. In *Foodco*, where a mechanic's lien was competing against a prior mortgage in favor of the SBA, the court's decision favoring the SBA could have been premised on the familiar and orthodox rule that the first in time is the first in right.[89] However, the court applied R.S. § 3466 to the SBA mortgage claim, distinguishing the "first in time" test as a common-law rule applicable only when the insolvency necessary to activate R.S. § 3466 is nonexistent.[90] Although the priority statute may be literally susceptible of application to all kinds of governmental claims, the unfortunate implication of the *Foodco* reasoning is that the SBA's mortgages are to be accorded priority regardless of when they were negotiated and regardless of recordation.[91] This result would be contrary to both

87. The loan agreement made no reference to the SBA and the mortgage was recorded in the name of the private bank.

88. The usual justification for federal priority is that expressed in Price v. United States, 269 U.S. 492, 500 (1926): "To secure adequate public revenue to sustain the public burdens." The comments of the Colorado Supreme Court made in reference to a case where a mechanic lienor lost to a federal tax lien seem appropriate:

> I am at a loss to understand how justice could possibly be served by appropriating the labor and materials of workmen to the payment of the tax delinquency of another under the circumstances disclosed by the record in the case at bar. About the only rule we can think of that could support such a result is the one referred to by Mr. Justice Burke in *People v. Kilpatrick*, 79 Colo. 303, 245 Pac. 719, as follows:
>
> "The good ole rule, the simple plan,
> That they should take who have the power
> And they should keep who can."

United States v. Vorreiter, 134 Colo. 543, 551, 307 P.2d 475, 479 (1957). See also United States v. Latrobe Constr. Co., 246 F.2d 357, 363 (8th Cir. 1959), where the court felt compelled to answer the equitable claims of the party losing to the government lien by noting that the losing party acted after the mortgage had been recorded in the name of the United States.

89. See, *e.g.*, Southwest Engine Co. v. United States, 275 F.2d 106 (10th Cir. 1960); United States v. Ringwood Iron Mines, Inc., 251 F.2d 145 (3d Cir.), *cert. denied*, 356 U.S. 974 (1958). The *Southwest Engine* case reaches the "first in time" test by equating the contractual security with the tax lien and then applying the rule stated in United States v. City of New Britain, 347 U.S. 81 (1954), which involved competing tax liens.

90. See W. T. Jones & Co. v. Foodco Realty, Inc., 318 F.2d 881, 888-89 (4th Cir. 1963). *But see In re* Lehigh Valley Mills, Inc., 341 F.2d 398, 401 (3d Cir. 1965), where the court rejected the inconsistency argument advanced by the *Foodco* court. See generally note 36 *supra*.

91. R.S. § 3466 gives priority to the federal government regardless of when its debt arises so long as it exists at the time the priority attaches. See note 32 *supra* and accompanying text.

existing precedent[92] and the reasonable expectations of parties dealing with the mortgagor. Carried to its ultimate conclusion, this rationale would allow a second mortgage held by the SBA to prevail over a first mortgage on the same property held by a private entity.[93]

Further unjust consequences of SBA priority are demonstrated by the *McClellan* decision.[94] The creditors competing for the assets of the bankrupt borrower could reasonably have assumed that they were entitled to share the debtor's assets equally with the lending bank.[95] After the bank unsuccessfully sought priority, however, it assigned the unsecured note to the SBA; this assignment resulted in subordination of general creditors to a $12,266 debt,[96] an outcome which clashes with the Bankruptcy Act's attempt to achieve a fair distribution of assets. Although the *McClellan* result is favorable to the participating bank, it should be pointed out that participating banks unfamiliar with these priority rules may also be injured by the SBA preference. It is established that a participating bank may not claim priority for its share of the loan;[97] thus, the bank would also be subordinated to the Small Business Administration's portion of the loan even though it had contributed to the SBA program and had thus furthered the basic purposes of the Small Business Act.

Although the participating institution can protect itself to some extent by contracting with the SBA for a portion of the amount ultimately recovered by the SBA, this procedure reveals additional inequities resulting from the Small Business Administration's use of R.S. § 3466. Under this ancillary contract, a nongovernmental entity is indirectly given the advantages of federal priority. In *Nathanson v. NLRB*,[98] the Supreme Court denied federal priority to the National Labor Relations Board when it sought to assert governmental priority for employees' claims under a backpay order against a bankrupt em-

92. See United States v. County of Iowa, 295 F.2d 257 (7th Cir. 1960); United States v. Roessling, 280 F.2d 933 (5th Cir. 1960); Southwest Engine Co. v. United States, 275 F.2d 106 (10th Cir. 1960); United States v. Ringwood Iron Mines, Inc., 251 F.2d 145 (3d Cir.), *cert. denied*, 356 U.S. 974 (1958). *But cf.* United States v. City of New Britain, 347 U.S. 81, 85 (1954); *In re* Lehigh Valley Mills, Inc., 341 F.2d 398, 401 (3d Cir. 1965). The latter case was subsequent to the *Foodco* decision and presents a theory which gives the United States priority in nearly every situation, whether or not the debtor is insolvent. See note 42 *supra* and accompanying text.

93. A first mortgage, at least in a lien theory state, seems vulnerable as an inchoate lien when tested against the rigorous standards imposed by the Supreme Court in such cases as Illinois *ex rel.* Gordon v. Campbell, 329 U.S. 362 (1946), and United States v. Waddill, Holland & Flinn, Inc., 323 U.S. 353 (1945). See also Bank of Wrangell v. Alaska Asiatic Lumber Mills, Inc., 84 F. Supp. 1, 2 (D. Alaska 1949).

94. See note 23 *supra* and accompanying text.

95. Bankruptcy Act, 30 Stat. 563 (1898), as amended, 11 U.S.C. § 104 (1964).

96. See note 27 *supra* and accompanying text.

97. See SBA v. McClellan, 364 U.S. 446, 451 (1960); Nathanson v. NLRB, 344 U.S. 25, 27-28 (1952); W. T. Jones & Co. v. Foodco Realty, Inc., 318 F.2d 881, 889-90 (1963).

98. 344 U.S. 25 (1952).

ployer. The Court reasoned that "it does not follow that because the Board is an agency of the United States, any debt owed it is a debt owing the United States within the meaning of R.S. § 3466 . . . . There is no function here of assuring public revenue. The beneficiaries of the claims are private persons . . . ."[99] The Supreme Court, while reaffirming the reasoning of *Nathanson*,[100] rejected a similar argument made in the *McClellan* case, distinguishing the latter on the factual difference that the money sought "was loaned by . . . and due to, the United States."[101] Nevertheless, to grant priority to a debt legally owned by the United States but equitably owned by a private creditor, while denying priority to a debt created by a federal agency but owned by a private person, seems to exalt form over substance and result in discrimination among competing private creditors. Furthermore, this discriminatory grant of federal priority to a private bank is without underlying policy support[102] and is logically indefensible, except to the extent that the ancillary contract for a portion of the SBA's preferred recovery induced the bank's participation.[103]

In summary, the recent extension of R.S. § 3466 priority to mortgages held by the SBA has little support in either the historical basis of R.S. § 3466 or the purposes of the Small Business Act, and has led to many inequities; moreover, the potential for the further expansion of the sovereign priority, with an attendant increase in the hardships thus created, appears large.

2. *Doctrine of the Inchoate Lien*

In two recent decisions, the Court of Appeals for the Third Circuit utilized the doctrine of the inchoate lien to hold a prior state tax lien inferior to a contractual security interest.[104] This combination of the inchoate lien doctrine and a government contractual security interest appears to have little supporting precedent or justification.

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99. *Id.* at 27-28.

100. SBA v. McClellan, 364 U.S. 446, 451 (1960).

101. *Ibid.*

102. Such a use of the federal priority in no way helps "to secure adequate public revenue," see note 88 *supra*, since to assert priority for a private bank benefits only that particular bank in its collection of revenue.

103. See Note, 108 U. PA. L. REV. 909, 914-15 (1960). Although such an expectation may have been an inducing factor in the contract in the *McClellan* case, it offers no justification for the SBA's promise to give the bank 10% of its preferred recovery in *Foodco*, in which the contract was not made until after the bank loan was made and bankruptcy initiated. In fact, the promise of 10% of the priority recovery appears to have been a gift by the SBA to the bank, since the only "consideration" given by the bank was an assignment of its uncollectible 10% interest in the loan.

104. United States v. Oswald & Hess Co., 345 F.2d 886 (3d Cir. 1965); *In re* Lehigh Valley Mills, Inc., 341 F.2d 398 (3d Cir. 1965).

a. *Federal Common Law*

Before scrutinizing the consequences flowing from this extension of the inchoate lien doctrine, one must question the appropriateness of applying *any* federal common-law rule.[105] The question of defining the proper bounds of the federal common law has plagued the judiciary ever since the Supreme Court declared in *Erie R.R. v. Tompkins*[106] that, "except in matters governed by the Federal Constitution or by Acts of Congress, the law to be applied in any case is the law of the state."[107] In *Clearfield Trust Co. v. United States*,[108] the Supreme Court limited the *Erie* doctrine by holding that the constitutional authority for the issuance of United States commercial paper entitled the federal judiciary to create uniform rules governing that paper.[109] Emanating from the sweeping rationale of this limitation of *Erie* have been a number of decisions favoring federal decisional law over state statutory rules in the area of the federal government's security transactions.[110] Re-

105. This inquiry is not relevant to a claim premised on § 3466, since the Constitution's supremacy clause would require the application of the relevant federal statute.

106. Erie R.R. v. Tompkins, 304 U.S. 64 (1938).

107. *Id.* at 78. Although it is arguable that the *Erie* diversity doctrine is not directly applicable in the SBA cases since jurisdiction rests on the basis of a federal question, it is generally believed that the reasoning of *Erie* pervades all cases in the federal courts regardless of the ground for federal jurisdiction. See Maternally Yours, Inc. v. Your Maternity Shop, Inc., 234 F.2d 538, 540 n.1 (2d Cir. 1956), where the court stated:

> But despite repeated statements implying the contrary, it is the *source* of the right sued upon, and not the ground on which federal jurisdiction over the case is founded, which determines the governing law. See Hart & Wechsler, The Federal Courts and the Federal System (1953) 690-700. Thus the Erie doctrine applies, whatever the ground for federal jurisdiction, to any issue or claim which has its source in state law.

108. 318 U.S. 363 (1943). See generally Clark, *State Law in Federal Courts: The Brooding Omnipresence of Erie v. Tompkins*, 55 YALE L.J. 267 (1946); Friendly, *In Praise of Erie—And of the New Federal Common Law*, 39 N.Y.U.L. REV. 383 (1964).

109. In *Clearfield* the Supreme Court considered whether the federal government was prohibited from recovering money paid on a forged check because of its failure to notify the defendant of the forgery within the time prescribed by state law. The Court's disregard of state law was premised primarily on the constitutional and statutory source of the power to issue checks and on the vast scale of the exercise of this power in the different states. The Court reasoned that the decisional rule should not be determined by state law because the federal government's rights and duties should be uniform throughout the nation. See generally Comment, 6 B.C. IND. & COMM. L. REV. 898, 900-06 (1955); Note, 53 COLUM. L. REV. 991 (1953). *Clearfield* became the principal case supporting the growth of a new, but more restricted, federal common law. Even where nondiversity federal jurisdiction exists, however, federal common law is the proper rule of decision only when the question relates to a federal function of overriding importance. See Hart, *The Relations Between State and Federal Law*, 54 COLUM. L. REV. 489, 509-15 (1954); Mishkin, *The Variousness of "Federal Law": Competence and Discretion in the Choice of National and State Rules for Decision*, 105 U. PA. L. REV. 797-801 (1957); Note, 50 VA. L. REV. 1236-37 (1964).

110. See, *e.g.*, United States v. Sylacauga Properties, Inc., 323 F.2d 487 (5th Cir. 1963); United States v. Helz, 314 F.2d 301 (6th Cir. 1963); United States v. View Crest Garden Apts., Inc., 268 F.2d 380 (9th Cir. 1959). *But see* Bumb v. United States, 276 F.2d 729 (9th Cir. 1960) (upholding the use of state law for determining the validity of an SBA mortgage). See generally Comment, *supra* note 109, at 909-13.

cently, in *United States v. Yazell*,[111] the Supreme Court more clearly defined the *Clearfield* doctrine by introducing a new consideration —the extent of individual negotiation—for determining whether, in any given situation, uniform implementation and protection of federal interests demands the application of federal common law.[112] Characterizing the problem as one presenting the "inevitable conflict between federal interest and state law,"[113] the Court held that the SBA must abide by the Texas coverture statute in collecting a note secured by a mortgage which had been "individually negotiated in painfully particularized detail, and . . . with specific reference to Texas law."[114] Mr. Justice Fortas' opinion makes it clear that the basic issue of whether there is a "federal interest" sufficient to pre-empt state law will not be answered by a mere showing of constitutional or congressional authority for the underlying act.[115] Rather,

111. 86 Sup. Ct. 500 (1966). The SBA, negotiating through local counsel familiar with Texas law, made a disaster loan to Mr. and Mrs. Yazell, who returned a note and mortgage signed by each of them. Following default by the Yazells, the SBA sought enforcement of the mortgage against Mrs. Yazell's personal property. The Texas coverture statute denies married women the power to mortgage their personal property. The SBA contended, however, that this statute should be disregarded in favor of a federal common-law rule granting women such power. The SBA predicated its argument on *Clearfield*.

112. The consideration of whether the federal interest is sufficient to warrant application of a federal rule has been the initial step in analyzing whether federal or state law should be controlling. If sufficient federal interest is found, then the courts typically weigh the federal and state interests to determine whether it is necessary to disregard completely the applicable state law. See National Metropolitan Bank v. United States, 323 U.S. 454 (1945); Clearfield Trust Co. v. United States, 318 U.S. 363 (1943). See generally Note, 50 VA. L. REV. 1236, 1241-43 (1964).

113. 86 Sup. Ct. 500, 502 (1966).

114. *Id.* at 503.

115. In the past the lower federal courts have indicated that sufficient federal interest could be demonstrated by a mere reference to federal authority and financial interests. See, *e.g.*, United States v. Helz, 314 F.2d 301 (6th Cir. 1963). This has been especially true in the area of federal contracts. See Polfcher, *The Choice of Law, State or Federal, in Cases Involving Government Contracts*, 12 LA. L. REV. 37 (1951); Note, 45 CALIF. L. REV. 212 (1957). The looseness with which courts approached the analysis of a sufficient federal interest has prompted one commentator to state:

> [T]he Supreme Court, even during the years while it has been diligently tending *Erie*, has, almost unconsciously as it were, been allowing a vast new growth of nonstatutory federal decisional law to spring up and run wild. Since *Erie* it has been discovered, for example, that the law applicable to any transaction to which the Federal Government, in any of its capacities, is a party is federal law; if there is no applicable federal statute, the court is free to improvise and need not follow the law of any state.

Gilmore, *Legal Realism: Its Cause and Cure*, 70 YALE L.J. 1037, 1046-47 (1961).

The failure of the courts to define the federal interest carefully also prompted Mr. Justice Douglas, the author of *Clearfield*, to issue a warning against the broad interpretation of the *Clearfield* doctrine:

> As respects the creation by the federal court of common-law rights, it is perhaps needless to state that we are not in the freewheeling days antedating *Erie R. Co. v. Tompkins*, 304 U.S. 64. The instances where we have created federal common law are few and restricted. In *Clearfield Trust Co. v. United States*, 318 U.S. 363, we created federal common law to govern transactions in the commercial paper of the United States; and we did so in view of the desirability of a uniform rule in that area. *Id.*, p. 367. But even that rule was qualified in *Bank of America v. Parnell*, 352 U.S. 29.

Wheeldin v. Wheeler, 373 U.S. 647, 651 (1963).

"solicitude for state interests" demands a showing of "clear and substantial interests of the national government"[116] by consideration of such factors as: (1) whether the underlying federal act is one "emanating in a single form from a single source" rather than an "individually negotiated contract";[117] (2) whether the related program is one "which [is] and must be uniform throughout the Nation";[118] (3) whether the implementation of state law will raise the additional problem of *which* state law is applicable;[119] and (4) whether the burden of complying with state law would hinder the federal program.[120] Testing the SBA loan program by these criteria reveals that generally the loans are individually negotiated,[121] the loan collection process is tailored to meet the peculiar situation of each borrower,[122] situations involving competing state laws arise infrequently,[123] and SBA personnel are directed to comply with state law.[124] These factors support the Court's conclusion that SBA loans do not involve a sufficient federal interest to warrant disregarding the "quaint doctrine" of coverture.[125] It would seem that a consideration of the same factors should provide a sound basis for distinguishing the federal tax lien

116. 86 Sup. Ct. at 507.

117. *Id.* at 504. The Court cited Clearfield Trust Co. v. United States, 318 U.S. 363 (1943) and United States v. Helz, 314 F.2d 301 (6th Cir. 1963), as examples of cases where the federal act issued on a single form from a single source. The latter case presented the same basic issue as *Yazell*; the only difference was that the loan had been made by the FHA rather than the SBA. The Court found this difference significant because FHA loan contracts are made on a single form common to all loans made in a particular state rather than on contracts arrived at through individual negotiation.

118. 86 Sup. Ct. at 507. The Court distinguished these cases involving federal acts demanding uniform treatment: Clearfield Trust Co. v. United States, *supra* note 117 (remedial rights with respect to federal commercial paper); United States v. Allegheny County, 322 U.S. 174 (1944) (taxing of property of the United States); D'Oench, Duhme & Co. v. FDIC, 315 U.S. 447 (1942) (rights of FDIC as an insurer).

119. The Court, at 509 n.34, cited Royal Indemnity Co. v. United States, 313 U.S. 289 (1941), as an example of Supreme Court adoption of state law. In *Royal Indemnity* there was no question of which state law to apply, since the contract was made and was to be performed in a single state.

120. 86 Sup. Ct. at 509. For instance, the treasury would be greatly inconvenienced if required to meet state rules prior to the creation of federal tax liens. *Cf.* United States v. Union Cent. Life Ins. Co., 368 U.S. 291 (1961).

121. See 86 Sup. Ct. at 504. It would seem that the participation and guaranty loans underwritten by the SBA would be even more individualistic, as they are negotiated for the SBA by independent lenders who are primarily interested in local law. See generally note 24 *supra*.

122. Such factors as the collateral taken, the other property owned by the borrower, and the utility of different creditors' remedies would vary the collection procedure.

123. No SBA case has been discovered in which a conflict-of-laws question arose.

124. See 86 Sup. Ct. at 509 n.35, where the Court quoted from the *Financial Assistance Manual of the Small Business Administration*, SBA-500, which the Court characterized as "replete with admonitions to follow state law carefully."

125. See also Bumb v. United States, 276 F.2d 729 (9th Cir. 1960), where a state bulk sales statute was found controlling despite the SBA's contention that federal law controlled. The Supreme Court approved this application of state law. See 86 Sup. Ct. 504 n.13. *But see* Note, 50 VA. L. REV. 1236 (1964), favoring the application of federal common law in *Yazell*.

cases[126] and for rejecting the Third Circuit's application of the inchoate lien doctrine to favor an SBA lien over prior state tax liens.[127] In *Lehigh* and in *United States v. Oswald & Hess Co.*[128] it was assumed by the Third Circuit without discussion that federal common law was appropriate.

b. *Inequitable Consequences of the Inchoate Lien Doctrine*

The court in the *Lehigh* and *Oswald & Hess* cases drew upon a federal tax lien case[129] to apply the "first in time" rule. However, because this "general equitable principle" would have given priority to the state and local tax liens, the court incorporated the inchoate lien doctrine to test the state and local liens.[130] In essence, the court declared that although the lien first in time would have priority, the liens competing against the federal lien must be choate in order for this test to be applied.

This pernicious combination of the "first in time" test and the inchoate lien doctrine has developed in cases involving the federal tax lien.[131] The SBA brief in *Lehigh* acknowledged this fact but argued that decisions by four different courts of appeals established the applicability of the doctrine to federal contractual liens.[132] Although the court accepted this contention without question,[133] the

126. Using federal common law to test the priority of federal tax liens appears appropriate under the *Yazell* considerations: (1) The underlying act of taxation appears to be the classic example of an act "emanating in a single form from a single source"; (2) the tax collection process is given uniformity by the federal statute creating a federal tax lien, INT. REV. CODE OF 1954, §§ 6321-25; (3) the conflict-of-laws consideration would be minimal; (4) as the tax lien arises by operation of federal law, there is no need to comply with state law in order to create it. Furthermore, Congress has stated the specific instances in which tax lien priority is dependent upon state law. See INT. REV. CODE OF 1954, § 6323(a), which declares that "the lien imposed by section 6321 shall not be valid as against any mortgagee, pledgee, purchaser, or judgment creditor until notice thereof has been filed . . . [in the designated office where the property is located]." Thus, three of the four considerations indicate a federal interest sufficient to pre-empt state law.

127. See notes 121-24 *supra*.

128. 345 F.2d 886 (3d Cir. 1965).

129. United States v. City of New Britain, 347 U.S. 81 (1954).

130. The limited *Clearfield* doctrine presents no greater obstacle to the application of the inchoate lien doctrine in tax lien cases than was encountered by the "first in time" test. However, the desirability of its use is of much greater doubt. See generally articles cited note 3 *supra*.

131. See, *e.g.*, United States v. City of New Britain, 347 U.S. 81 (1954). Although primarily used in tax lien cases, the inchoate lien doctrine has been applied infrequently in other contexts. See Rialto Publishing Co. v. Bass, 325 F.2d 527 (9th Cir. 1963); United States v. Latrobe Constr. Co., 246 F.2d 357 (8th Cir. 1957).

132. See Brief for the Small Business Administration, p. 31, *In re* Lehigh Valley Mills, Inc., 341 F.2d 398 (3d Cir. 1965), in which the SBA cited the following: United States v. County of Iowa, 295 F.2d 257 (7th Cir. 1961); United States v. Roessling, 280 F.2d 933 (5th Cir. 1960); Southwest Engine Co. v. United States, 275 F.2d 106 (10th Cir. 1960); United States v. Ringwood Iron Mines, Inc., 251 F.2d 145 (3d Cir.), *cert. denied*, 356 U.S. 974 (1958).

133. *In re* Lehigh Valley Mills, Inc., *supra* note 132, at 401. The district court

holdings in these four cases appear to offer little support for the SBA's argument. In each of the cited cases the Government, asserting a contractual security interest, prevailed over a competing lienor. However, each holding was predicated on a finding that the federal lien was prior in time;[134] thus, there was no need to rely on the inchoate lien test. The requirement of choateness was not mentioned in any of the cases.

However, the Third Circuit's rationale does have at least a tenuous basis in precedent. In *Southwest Engine Co. v. United States*,[135] the Tenth Circuit analogized the Small Business Administration's mortgage to a federal tax lien[136] and gave the SBA priority by applying the "first in time" principle. In a similar case considering the priority of a loan under the Emergency Relief Priority Act,[137] the Fifth Circuit applied the "first in time" test, saying, "That rule governing the priority of federal tax liens has been applied to federal mortgage liens as well."[138] From these decisions borrowing the "first in time" test from federal tax lien cases, the premise is arguable that the inchoate lien doctrine can also be borrowed for the same purpose.[139]

Upon closer examination, however, the justification by inference from precedent disappears. In the first place, the factors outlined in the *Yazell* opinion offer sound bases for distinguishing the foreclosure of an SBA lien from the foreclosure of a federal tax lien[140] and therefore suggest that the use of any federal common-law doctrine by the SBA cannot be predicated on an application of that doctrine in federal tax lien cases.[141] Second, the cases previously bor-

apparently rejected the application of the inchoate lien doctrine in favoring the city tax lien, 225 F. Supp. 494 (E.D. Pa. 1964), and commented as follows: "Even applying 'the first in time first in right' principle enunciated by United States v. City of New Britain, 347 U.S. 81 (1953), the same result would occur." *Id.* at 497.

134. See United States v. County of Iowa, 295 F.2d 257, 259 (7th Cir. 1961); United States v. Roessling, 280 F.2d 933, 936 (5th Cir. 1960); Southwest Engine Co. v. United States, 275 F.2d 106, 107 (10th Cir. 1960); United States v. Ringwood Iron Mines, Inc., 251 F.2d 145 (3d Cir. 1958).

135. 275 F.2d 106 (10th Cir. 1960).

136. *Id.* at 107.

137. United States v. Roessling, 280 F.2d 933 (5th Cir. 1960).

138. *Id.* at 936.

139. In *Lehigh* neither the Third Circuit nor the SBA revealed any policy arguments in favor of extending the use of the inchoate lien doctrine from federal tax liens to federal contractual security interests. The court's opinion is silent in this regard, and the SBA brief contains only a footnote citing the cases in note 134 *supra*. The court's lack of explanation suggests that the inchoate lien test was thought to be merely an aspect of the "first in time" test. As indicated in the text accompanying notes 141-43 *infra*, however, this is an erroneous suggestion.

140. *Compare* notes 121-24 *supra* and accompanying text *with* note 126 *supra*.

141. *But see* United States v. View Crest Garden Apts., Inc., 268 F.2d 380 (9th Cir. 1959), where the court separated federal security transactions into two phases—the "planning and working" phase and the "collecting" phase—and suggested the use of state law for the former and federal law for the latter, since commercial convenience

rowing the "first in time" test from tax lien cases did not in any way intimate that rules applicable to either federal tax liens or contractual security interests were necessarily interchangeable. In fact, interchangeability appears illogical, considering the contrast between the general commercial nature of a contractual security interest individually negotiated and consummated under the state law governing security transactions,[142] and the tax lien arising by operation of law for the purpose of securing tax obligations owed by members of the public. Third, "first in time" is an ancient rule developed for resolving disputes between rival private lienors[143] and has been applied broadly in all types of priority situations,[144] whereas the inchoate lien doctrine originated in a case involving competing tax claimants[145] and has been applied almost exclusively in tax claim disputes.[146]

The widespread condemnation by the commentators of the inchoate lien doctrine as applied in construing R.S. § 3466 and the federal tax lien law would seem to militate against its further expansion.[147] Among the many criticisms of the doctrine which have been advanced are that it leads to discrimination between "choate" and "inchoate" liens for no apparent reason,[148] introduces great uncertainty into security interests in general,[149] and has an adverse effect upon business and upon total Government revenue.[150] All of these criticisms are equally applicable to the inchoate lien doctrine as it pertains to contractual liens.

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is dominant in the former and federal policy is dominant in the latter. The Ninth Circuit seems since to have abandoned this line of reasoning. See Hendry v. United States, 305 F.2d 515 (9th Cir. 1962).

142. See notes 77-79 *supra* and accompanying text.

143. See Rankin v. Scott, 25 U.S. (12 Wheat.) 177 (1827).

144. See, *e.g.*, United States v. City of New Britain, 347 U.S. 81 (1954) (tax lien priority); Rankin v. Scott, *supra* note 143 (priority of judgment liens).

145. See County of Spokane v. United States, 279 U.S. 80 (1929); Kennedy, *The Relative Priority of the Federal Government: The Pernicious Career of the Inchoate and General Lien*, 63 YALE L.J. 905, 911-19 (1954).

146. See, *e.g.*, United States v. Vermont, 377 U.S. 351 (1964); United States v. Texas, 314 U.S. 480 (1941); New York v. Maclay, 288 U.S. 290 (1933). *But see* Rialto Publishing Co. v. Bass, 325 F.2d 527 (9th Cir. 1963), where a bankruptcy trustee used the inchoate lien doctrine to attack a lien on the bankrupt's property. However, this extension of the doctrine appears improper and is unlikely to be followed. See Kennedy, *The Inchoate Lien in Bankruptcy: Some Reflections on the Rialto Publishing Co. v. Bass*, 17 STAN. L. REV. 793 (1965). United States v. Latrobe Constr. Co., 246 F.2d 357 (8th Cir. 1957), is another isolated instance of an application of the inchoate lien doctrine outside the tax lien area.

147. See articles cited note 3 *supra; Report of the Special Committee on Federal Liens*, 84 A.B.A. REP. 645 (1959).

148. See Kennedy, *From Spokane County to Vermont: The Campaign of the Federal Government Against the Inchoate Lien*, 50 IOWA L. REV. 724, 750-51 (1965).

149. See Kennedy, *supra* note 146, at 820; Reeve, *The Relative Priority of Government and Private Liens*, 29 ROCKY MT. L. REV. 167 (1957).

150. See MacLachlan, *Improving the Law of Federal Liens and Priorities*, 1 B.C. IND. & COMM. L. REV. 73, 74-76 (1959).

A particularly objectionable aspect of the inchoate lien doctrine is its discriminatory application.[151] The federal contractual lien in *Lehigh* was as incapable of meeting the tests of choateness as were the state liens;[152] thus, no greater equity should exist in favor of the federal lien. Although the desire for uniformity may offer some basis for developing and enforcing federal common law, there appears to be no justification for the judiciary's overriding a state rule to "legislate" a priority for the federal government by testing *only* the nonfederal liens by the inchoate lien doctrine.

In summary, the Third Circuit's utilization of the inchoate lien doctrine on behalf of the SBA appears indefensible because the *Clearfield* doctrine as interpreted by *Yazell* militates against the use of any federal common-law doctrine in contests between SBA liens and the liens of competing creditors,[153] because the previous application of the doctrine in federal tax lien cases affords no proper foundation for its invocation by the SBA, and because the use of the doctrine to test only those liens competing against the federal liens produces unwarranted discrimination.

Another serious objection to the extended use of the inchoate lien doctrine is that it presents an opportunity for major abuse. If in the *Lehigh* case the private banks had been forced to seek recovery for their individual portions of the loan, the inchoate lien doctrine would have been unavailable to them in their competition with other private creditors. However, the application of the doctrine in *Lehigh* indirectly conferred federal priority on the banks' claims. This would appear to be in conflict with the categorical denial by the Supreme Court in *Nathanson* and *McClellan* of the extension to private creditors of priority under R.S. § 3466 and section 64(a)(5) of the Bankruptcy Act.[154] Furthermore, it would seem to be a perversion of the statutory purpose behind the federal priority provisions for the SBA, a public agency, to assert discriminately the questionable doctrine of the inchoate lien in favor of certain private creditors.

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151. The federal contractual security interest has not been subjected to the inchoate lien test. See Note, 43 TEXAS L. REV. 418, 420 (1965), criticizing the failure to apply the test to federal tax liens.

152. The state and local tax liens were found to be inchoate in *Lehigh* because the amount of the lien was uncertain. In order for the amount of the lien to be sufficiently certain, "the lienor must either have obtained judgment on the lien or it must be enforceable against the property by summary proceeding." *In re* Lehigh Valley Mills, Inc., 341 F.2d 398, 401 (3d Cir. 1965). Since the SBA did not have a judgment or a summarily enforceable lien, its lien was also uncertain and thus could not have met the test for choateness.

153. See notes 108-27 *supra* and accompanying text.

154. These denials were made when § 3466 priority was sought for private claims, but seem equally appropriate where the inchoate lien doctrine is being used to benefit certain private creditors to the detriment of others. See generally notes 98-103 *supra* and accompanying text.

Considering the past expansion of the doctrine,[155] its further growth within the sphere of the Small Business Act is not inconceivable. Recently, those liens Congress has designated for protected status when competing with unfiled federal tax liens have been required by the Supreme Court to attain choateness before being allowed to benefit from their preferred status.[156] Similarly, it is conceivable that this "judicial amendment" will also be extended to those liens which qualify for the special priority of section 17 of the Small Business Act.[157] Such an application of the inchoate lien test would emasculate section 17,[158] since it is doubtful whether any liens would be found choate.[159]

Other possible extensions of the doctrine are suggested by its past expansion. For instance, in the factual setting of *Lehigh* it would be as plausible for the SBA to attack the privately held first real estate mortgage as being inchoate as it was for the SBA to assert the inchoateness of the state tax liens, since both rely entirely upon state law for their vitality.[160] Thus, if the *Lehigh* rationale were to be utilized in this situation, the second mortgage of the SBA on real estate would be elevated above the privately held first mortgage on the same real estate, a result which appears totally unconscionable. The above illustrations clearly indicate that the present and potential unfairness resulting from the judiciary's recourse to R.S. § 3466 and the inchoate lien doctrine on behalf of the SBA demands forthright remedial action.

IV. Improving the Present Law

There are three possible approaches to the problem of improving the present law concerning the priority of the SBA—self-help by individual creditors, amendment of state law, and federal legislation. A satisfactory solution to this federal problem demands federal legislation, but the other means of improvement may provide some limited interim relief.

155. See note 6 *supra* and accompanying text.

156. Int. Rev. Code of 1954, § 6323 provides that the federal tax lien shall be ineffective against any mortgagee, pledgee, purchaser, or judgment creditor who had no notice of the tax lien. However, in United States v. Pioneer Am. Ins. Co., 374 U.S. 84 (1963), the Supreme Court significantly qualified the statutory protection accorded mortgagees (and pledgees and judgment creditors) by requiring them to have a choate lien before invoking § 6323. See generally Kennedy, *supra* note 148, at 730-35.

157. See notes 72-73 *supra* and accompanying text.

158. Even if § 17 had been enacted as first introduced, see note 53 *supra*, it would be ineffective if the liens were required to be choate before prevailing over the federal liens.

159. See note 42 *supra* and accompanying text.

160. *Cf.* United States v. Pioneer Am. Ins. Co., 374 U.S. 84 (1963), where the United States, claiming under a tax lien, successfully attacked a competing mortgage because the amount of the mortgage was uncertain. See generally Note, 43 Minn. L. Rev. 755 (1959).

There are several ways in which an individual creditor might try to protect himself, but all are too limited to be of real significance. For instance, the ancillary contracts between the participating banks and the SBA in the *Foodco* and *McClellan* cases represent means by which an individual creditor can "ride the coattails" of federal priority. The same type of contract might conceivably be demanded by all creditors who are aware of a previous loan to the debtor by the SBA. However, even if the SBA acceded to such a demand and the lender ultimately recouped some of his loss by receiving a share of the SBA's priority recovery, this "solution" would merely compound the difficulty by giving another nongovernmental creditor the benefit of federal priority.[161] Another means of self-help which could be utilized by purchase-money creditors aware of the debtor's financial problems would be the use of consignment. In *United States v. Menier Hardware No. 1, Inc.*,[162] a federal district court allowed a consignor to recover the consigned goods on the theory that since the goods were never the property of the debtor the federal security interest never attached to them.[163] The effectiveness of the consignment method is severely limited, however, by the difficulty of establishing a true consignment. In addition, the added risks necessarily carried by a true consignor[164] would frequently outweigh the risk of losing a debt collection because of federal priority. Still another means of self-help is to encourage a failing debtor to seek a Chapter XI arrangement under the Bankruptcy Act.[165] It has been held that the receiver appointed under Chapter XI is not a general receiver and that the appointment is therefore not an act of bankruptcy.[166] Thus, the SBA may be deprived of the use of R.S. § 3466 priority because the debtor's insolvency had not been manifested in any of the ways specified by that section.[167] At best, self-help can be considered no better than severely limited stopgap relief.

There may be situations where a change in state law would alleviate the unfairness inherent in the SBA's assertions of federal priority for its liens. It is highly doubtful, however, whether any change in state law would provide satisfactory permanent relief for private creditors competing with SBA liens. One possible measure at the state level would be legislation directed at the elements of choateness for liens created by state law. Such legislation would seem espe-

161. See notes 98-103 *supra* and accompanying text.

162. 219 F. Supp. 448 (W.D. Tex. 1963).

163. *Id.* at 459-68; *accord*, Aquilino v. United States, 363 U.S. 509 (1960); United States v. Bess, 357 U.S. 51 (1958), both of which develop the "no property" rule in the context of the tax lien.

164. See, *e.g.*, Simpson v. Union Oil Co., 377 U.S. 13 (1964).

165. 52 Stat. 905 (1938), 11 U.S.C. §§ 701-99 (1964).

166. See United States v. National Furniture Co., 348 F.2d 390 (8th Cir. 1965); United States v. Clover Spinning Mills Co., 244 F. Supp. 796 (W.D.S.C. 1965).

167. See note 8 *supra* and accompanying text.

cially appropriate for statutory liens such as those asserted by the state in the *Lehigh* case. By authorizing a summary proceeding for the enforcement of statutory liens against certain property, the state could eliminate one of the factors relied on in categorizing certain liens as inchoate.[168] Also, state legislatures could make property tax liens apply solely to the specific property taxed rather than to the debtor's entire property, thus enabling such liens to qualify under section 17 of the Small Business Act.[169] In addition to the many obvious and specific arguments against implementation of these suggestions,[170] there is the more basic objection that the creation of new obstacles to federal debt collection by states desiring to benefit their citizens against other citizens has a tendency to develop new problems and encourage disrespect for the federal government.[171] Thus, although the above means of self-help and changes in state laws might aid a debtor in a few specific circumstances, the improvement, if any, over the present situation would be minimal.

The best solution to the priority problem is congressional action. Many proposals intended to solve general federal priority problems have been submitted to Congress.[172] Since the more drastic proposals —those calling for the general elimination of R.S. § 3466 and the inchoate lien doctrine—have not met with success,[173] it seems desirable to suggest several less extensive reforms by which the unfairness of the SBA priority could be alleviated. A minimum provision which would go far in eliminating deception from SBA participation loans would be one imposing a notice-filing requirement for all private loans in which the SBA has an equitable interest.[174] Such a requirement would ensure that subsequent creditors were warned of possible competition from the federal government. Another relatively simple measure would be to prohibit the SBA from contracting away a portion of the preferred recovery afforded by R.S. § 3466. This would eliminate the unfairness, illustrated by *Foodco,* of indirectly allowing a certain private creditor the use of federal statutory priority.[175] Al-

168. In discussing the requirement of certainty of amount, the *Lehigh* court said that an amount would be certain if judgment was obtained or the lien was enforceable by summary proceedings. See *In re* Lehigh Valley Mills, Inc., 341 F.2d 398, 401 (3d Cir. 1965).

169. See notes 64-66 *supra* and accompanying text.

170. For instance, it is likely total collection risks will be less if a state's tax lien covers all of the taxpayer's property, even though the lien is thereby prevented from qualifying for the advantages of § 17.

171. See MacLachlan, *supra* note 150, at 82.

172. See, *e.g.*, H.R. 11256, 89th Cong., 2d Sess. (1966); H.R. 7915, 86th Cong., 1st Sess. (1959). See generally Kennedy, *supra* note 148, at 750-54; Kennedy, *supra* note 145, at 932-35; MacLachlan, *supra* note 150, at 82-85; The Wall Street Journal, March 2, 1966, p. 1, col. 5 (Midwest ed.).

173. See, *e.g.*, H.R. 4953, 88th Cong., 1st Sess. (1963). See generally Plumb, *What Ever Happened to the A.B.A. Federal Tax Lien Legislation?*, 18 Bus. Law. 1103 (1963).

174. *Cf.* Int. Rev. Code of 1954, § 6323(a).

175. If such legislation were enacted, the amount going to private entities would

though it is to be hoped that Congress will completely abolish the judicial doctrine of the inchoate lien, a minimum step would be the prohibition of its use by private creditors seeking priority for their portions of participation loans by assigning a debt to the SBA for collection "in return" for a portion of the preferred recovery.

A further means of improving federal law would be a clarification of the extent to which the SBA must respect state priority rules when seeking collection through a contractual security interest created by state law. As earlier suggested in this comment[176] and as recently intimated by the Supreme Court,[177] it seems most desirable to make state law controlling. This could be accomplished without disrupting general federal priority by prohibiting the SBA from invoking R.S. § 3466 and the inchoate lien doctrine to advance the priority of a state-created contractual security interest. Finally, it would not seem unreasonable to suggest that Congress extend the order of priorities prescribed by section 64(a) of the Bankruptcy Act to nonbankruptcy situations by amending R.S. § 3466.[178] Extending the simple fairness implicit in this ordered distribution would help to eliminate the major inequities discussed above.

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be increased by the amount claimed by the federal government on the portion of the note owned by the leading bank but assigned to the SBA for collection, since the bank would not assign its portion of the note unless the SBA promised to collect for the bank.

176. See notes 121-24 *supra* and accompanying text.

177. See United States v. Yazell, 86 Sup. Ct. 500 (1966).

178. This proposal was embodied in H.R. 4953, 88th Cong., 1st Sess. § 201 (1963). State and local taxes would be accorded equality with federal taxes, and all taxes would have lower priority than administrative and funeral expenses and wage claims. United States nontax claims would be given equal priority with rent claims, which follow taxes in the order of priority.