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COURTS—State Substantive Law Applies in Non-Diversity Actions When Local Interests Predominate—*United States v. Yazell**

Respondent and her husband received an authorization for a Small Business Administration (SBA) disaster loan and were referred by the SBA Disaster Loan Office to a local counsel employed by the SBA to aid them in complying with the terms of the loan. After personal negotiations with the counsel, a promissory note was signed by the couple on SBA forms specifically tailored to conform to the requirements of state law. This contract was then submitted to the SBA along with a signed chattel mortgage on the Yazell's store fixtures and inventory and a certification by the local counsel that all state law requirements necessary to insure enforceability had been met.[1] However, under the Texas law of coverture, respondent was unable to bind her separate property by contract without first having obtained a court decree removing the disability.[2] She had satisfied the statutory requirement with respect to the chattel mortgage, attaching a notarized acknowledgment to this effect to the transferred security instrument, but had failed to remove the disability to negotiate the note. In an action by the United States upon the respondent's default in payment of the loan, both the federal district court and the Fifth Circuit Court of Appeals held that the state law limiting the respondent's capacity to enter binding agreements barred recovery against her on the note.[3] On appeal to the Supreme Court, *held*, affirmed, three justices dissenting. Absent a sufficient federal interest to the contrary, the United States' rights under contracts which contain specific reference to state law and which are "custom-tailored" through personal negotiations to the particular circumstances involved are subject to state laws dealing with familial-property rights.

The Government's contention in the principal case was that the substantive law to be applied in determining its rights under the note was not state law, but rather "federal common law." This contention was based on the decision in *Clearfield Trust Co. v. United States*,[4] where the Court acknowledged that *Erie R.R. v.*

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* 382 U.S. 341 (1966) [hereinafter cited as principal case].

1. See principal case at 344-45.

2. Tex. Acts 1937, ch. 499, § 2. This medieval limitation was subsequently removed. Tex. Rev. Civ. Stat. art. 4626 (Supp. 1965). It now exists only in Michigan, and there in modified form. Mich. Comp. Laws §§ 557.1–.55 (1948).

3. Yazell v. United States, 334 F.2d 454 (5th Cir. 1964), 16 Baylor L. Rev. 412, 1965 Duke L.J. 386, 50 Va. L. Rev. 1236. The District Court decision was not reported. A judgment against the husband was not appealed.

4. 318 U.S. 363 (1943). This case involved the rights of the United States on forged federal commercial paper. See generally Wright, Federal Courts §§ 58-60 (1963); Hart, *The Relations Between State and Federal Law*, 54 Colum. L. Rev. 489, 509-15, 525-35 (1954).

Tompkins[5] had abolished federal common law for diversity actions, but, nonetheless, held that when a case involved the governmental exercise of a constitutional function or power, such as the disbursement of its funds, a sufficient "federal interest" exists to justify permitting the federal courts to fashion their own rules to govern the relations between the parties—a use of federal common law.[6] Subsequently, this federal common law was applied in cases dealing with contracts involving such functions or powers,[7] and in tort actions in which the government was a plaintiff.[8]

However, *Clearfield* also indicated that in the absence of a federal statute or regulation, state law could, in an appropriate situation, be adopted by a court as the applicable federal common law.[9] But it was not until the decision in *United States v. Standard Oil Co.*[10] that the Court established guidelines as to when such adoption should occur. There the Court said that state law was to be used when it provided a "fair and convenient mode of disposition" and was either "inescapable" or would not result in "substantially diversified treatment where uniformity is indicated as more appropriate."[11] Under these guidelines an increased judicial adoption of state law as the federal common law has begun. Indeed, the Supreme Court has promoted such a tendency by two statements in its more recent discussions of the area. In *Commissioner v. Stern*, the Court stated that since federal common law as a separate entity had been greatly stifled by its elimination from diversity cases, the more flexible state law should be adopted whenever possible,[12] and in *United States v. Brosnan*, it noted that when the Government entered areas already subject to complex state law, it should be prepared to deal within such laws.[13]

5. 304 U.S. 64 (1938). See generally WRIGHT, FEDERAL COURTS §§ 54-57 (1963).

6. Interim Supreme Court opinions had indicated that federal common law still existed for non-diversity actions. D'Oench, Duhume & Co. v. FDIC, 315 U.S. 447 (1942); Royal Indem. Co. v. United States, 313 U.S. 289 (1941); Deitrick v. Greaney, 309 U.S. 190 (1940); Board of Comm'rs v. United States, 308 U.S. 343 (1939). However, Mr. Justice Brandeis' statement in *Erie* that "there is no federal general common law," 304 U.S. at 78, had seemingly confused some lower federal courts. *Compare* Kolker v. United States, 40 F. Supp. 972 (D. Md. 1941), *and* Byron Jackson Co. v. United States, 35 F. Supp. 665 (S.D. Cal. 1940), *with* Alameda Co. v. United States, 124 F.2d 611 (9th Cir. 1941), *and* United States v. Brookridge Farms, Inc., 111 F.2d 461 (10th Cir. 1940). *Clearfield* clarified this, stating:

> We . . . agree that the rule of Erie R.R. v. Tompkins . . . does not apply to this action. The rights and duties of the United States on commercial papers which it issues are governed by federal law rather than local law.

318 U.S. at 366.

7. United States v. Allegheny County, 322 U.S. 174 (1944).

8. United States v. Standard Oil Co., 332 U.S. 301 (1947).

9. "In our choice of the applicable federal rule, we have occasionally selected state law." 318 U.S. at 367.

10. 332 U.S. 301 (1947).

11. *Id.* at 309.

12. 357 U.S. 39, 45 (1958).

13. 363 U.S. 237, 242 (1960). See also Wheeldin v. Wheeler, 373 U.S. 647 (1963),

The decision in the principal case to apply state law is sound as a natural progression in this trend toward greater adoption, particularly in light of the factors upon which the Court based its decision: (1) that there was no federal statute or regulation dictating the use of federal law; (2) that the question involved familial relationships; and (3) that the contract was made with specific reference to state law and was personally negotiated between the SBA and the Yazells. With respect to the first factor, the existence of a federal statute or regulation would have made the use of federal law mandatory[14] and, while the converse of this (that is, the absence of federal law would compel the use of state law) does not necessarily follow, the recent Court decisions indicating that state law should be used whenever appropriate certainly encourage this result.[15]

The existence of the second factor—the involvement with familial-property relationships—would not seem to compel the use of state law, for, as the Court noted in *Standard Oil*,[16] the test in determining whether to apply a uniform federal law or to adopt state law is to balance the relative federal and state interests. Federal interests were certainly present in the principal case, for it dealt with a government contract and the disbursal of federal funds, both of which have been held to be governed by federal law.[17] Other federal interests included the uniform administration of the disaster loan program and, naturally, the repayment of the loan.[18] However, in the light of previous Court decisions concerning familial-property relationships, and the peculiar circumstances of this case, the Court seems to have properly applied state law. In *Fink v. O'Neil*, state homestead laws prevented the United States from levying on the protected property.[19] Homestead laws, like the law in question in the principal case, were established to protect from the reach of *any* creditor certain familial properties which the state thought were essential to the maintenance of proper domestic relations. As more recent Court decisions have apparently strengthened this hands-off

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where Mr. Justice Douglas stated that *Clearfield* had been limited to suits in which the Government was a party by Bank of America v. Parnell, 352 U.S. 29, 35 (1956). The *Parnell* case is of little significance here, however; first, because the Government *is* a party; and second, because the Court in *Parnell* did not eliminate the possibility of using the *Clearfield* doctrine, it simply failed to find a sufficient federal interest involved to require its invocation.

14. See, *e.g.*, United States v. Bess, 357 U.S. 51 (1958) (statute); United States v. Shimer, 367 U.S. 374 (1961) (regulation).

15. See notes 12 and 13 *supra* and accompanying text.

16. See note 11 *supra* and accompanying text.

17. See notes 4 and 7 *supra* and accompanying text.

18. These two interests were the ones relied upon by Mr. Justice Black in his dissent. See principal case at 359-60.

19. 106 U.S. 272 (1882).

policy toward state treatment of domestic relations,[20] it appears that more compelling federal interests than those enumerated above should be present before such relations are tampered with. The government has a strong interest in the repayment of its loans, but in the principal case adequate provisions were available to secure repayment had the government made the effort to meet the appropriate requirements. Also, had Congress felt that in cases like the principal case an overriding federal interest did exist, which interest should take precedence over the state law, it could have easily provided that federal law was to be applied in loan situations. Moreover, it appears that the most relevant evidence of congressional intent is actually to the contrary. Rule 69 of the Federal Rules of Civil Procedure permits execution of a judgment only in a manner prescribed by state law unless federal law dictates otherwise. Similarly, Rule 64 requires that remedies calling for seizure of a person or property must be consistent with state law, again excepting cases in which a specific federal statute is applicable. While it may well be that a contrary decision on the facts of the principal case would not have had any serious effects on Texas property law since the Texas legislature repealed the coverture statute subsequent to the execution of the note in question,[21] the Court noted that eleven other states still have statutory provisions restricting the capacity of a wife to bind her property by contract.[22] Certainly, when the government has alternative means of securing repayment of loans, as it did in the principal case, there would not seem to be any compelling reasons why state property law should not apply.

Although the Court admits the novelty of its reliance on the personal negotiation and local law orientation aspects of the loan,[23] these considerations would also seem to justify the Court's decision to apply state law. The SBA consciously attempted to adapt the loan to the requirements of state law and even employed a local law firm to aid respondent and her husband in complying with the terms of the loan. Both the SBA Regional Office and the local counsel certified that all necessary steps had been taken to

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20. See, *e.g.*, DeSylva v. Ballentine, 351 U.S. 570 (1955), holding that state law should be used to interpret the word "children" in § 24 of the Copyright Act, and Commissioner v. Stern, 357 U.S. 39 (1958), where state law limited a widow's liabilities for her husband's tax deficiencies. In *Ballentine* the Court specifically stated that there was no federal law of domestic relations. 351 U.S. at 580.

21. See note 2 *supra*.

22. Principal case at 351 n.23. The eleven states are Alabama, Arizona, California, Florida, Georgia, Idaho, Indiana, Kentucky, Michigan, Nevada, and North Carolina.

23. After discussing at length the reference to state law and the personal negotiations, the Court noted:

> None of the prior cases decided by this Court in which the federal interest has been held to override state laws resembles this case in those respects . . . .

382 U.S. at 346.

insure the enforceability of the note.[24] These factors, both individually and collectively, strongly indicate: (1) that the SBA must have been aware of the state limitation on respondent's ability to contract; (2) that the SBA had every intention of dealing within the provisions of the state law; and (3) that despite this knowledge and intent, the SBA, although it was aware that the respondent had removed her disability to negotiate the chattel mortgage, made no effort to have her remove the disability to negotiate the loan. To allow the SBA to reach this property—property known to be subject to restrictions of state law, which restrictions the SBA failed to have removed—would certainly be unfortunate, for it would subject the respondent to obligations and liabilities which she did not and could not undertake.

Despite the soundness of result in the principal case, two aspects of the decision seem likely to breed future problems. The first of these is that the Court hinted that two courts of appeals cases involving the Federal Housing Administration[25] (FHA) are distinguishable from the principal case because although FHA transactions are made on forms adapted to state law, they are not personally negotiated.[26] This differentiation is apparently made because the FHA merely insures loans made by private financial institutions, rather than dealing directly with the borrower as does the SBA. However, these cases clearly indicate that personal negotiation is still an important aspect of FHA loans, even though the negotiations are between the borrower and the lender and the lender and the FHA, rather than directly between the borrower and the FHA.[27] Indeed, in one case, a modification agreement was negotiated directly between the debtor and the agency.[28] Moreover, since the Veteran's Administration[29] operates in a manner similar to that of the FHA,[30] this tenuous legalistic distinction could insulate two of the Government's largest lending institutions from the scope of the decision in the principal case, and openly invites the SBA to adopt a similar "middle-institution" system to avoid the pitfalls of state law.[31] Such a result would be undesirable, for

24. See note 1 *supra* and accompanying text. For further discussion of these factors, see principal case at 344-47.

25. See National Housing Act, 48 Stat. 1246 (1934), as amended, 12 U.S.C. ch. 13, §§ 1701-50 (1964).

26. 382 U.S. at 348 n.15.

27. United States v. Helz, 314 F.2d 301 (6th Cir. 1963); United States v. View Crest Garden Apartments, Inc., 268 F.2d 380 (9th Cir. 1959), *cert. denied*, 361 U.S. 884 (1960).

28. United States v. View Crest Garden Apartments, Inc., *supra* note 27, at 381.

29. 38 U.S.C. § 1801-25 (1964).

30. See, *e.g.*, United States v. Shimer, 367 U.S. 374 (1961).

31. The Small Business Act, 72 Stat. 384 (1958), as amended, 15 U.S.C. §§ 631-51 (1964), seems to give the SBA definite authority to operate in this manner if they desire. 15 U.S.C. § 634(a)(9) states: "[T]he Administrator may accept the services and facilities of Federal, State, and local agencies and groups, both public and private."

the explicit purpose underlying the SBA's power to make disaster loans is to insure that the victims of natural catastrophes are given the necessary assistance,[32] and obviously the faster the loans can be made and the less expensive they are to the borrower, the more readily this goal will be achieved. If the loans were made through private institutions and were merely insured by the SBA, the interest rate would undoubtedly go up, and the multiple negotiation among agency, creditor, and debtor would probably substantially inhibit the expediency which the Court found so commendable in the principal case.[33] Hopefully, therefore, the SBA will decline the Court's invitation to circumvent the decision in the principal case by adopting procedures which are incompatible with the program's underlying policy considerations.

The second problem is created by the Court's explicit refusal to clarify its reasons for applying state law—whether state law was adopted to give content to the federal common law or whether it was applied *ex proprio vigore*, that is, of its own force in lieu of federal common law.[34] *Clearfield* had held that cases involving disbursal of federal funds were to be governed by federal law,[35] and *United States v. Allegheny County* had held that all government contracts involving the exercise of constitutional functions and powers were to be governed by federal law.[36] The principal case seems to be an obvious retreat from the broad generalizations found in these two cases, but in so retreating, the Court has said that state law may be applied in some cases, without indicating how to determine when it may be so applied. Thus, as an example, a court in a government lease case, looking at the personal negotiation and real property aspects of such a case,[37] cannot be certain, in light of the decision in the principal case, that state law is not to be applied, even though numerous lower court cases have held that rights

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Also, §§ 636(a) and (b), which empower the SBA to make small business and disaster loans respectively, both contain the clause: "[A]nd such loans may be made or effected either directly or in cooperation with banks or other lending institutions through agreements to participate on an immediate or deferred basis."

32. See Small Business Act, 72 Stat. 384 (1958), 15 U.S.C. § 631(b) (1964).

33. Principal case at 344. The loan was for $12,000, repayable at $120 per month and 3% interest. The authorization for the loan was received within ten days after application, and though not specifically indicated, it appears that the entire transaction was consummated in two weeks.

34. Principal case at 357. This is an important doctrinal distinction which has at times been confused by lower federal courts. See Mishkin, *The Variousness of "Federal Law": Competence and Discretion in the Choice of National and State Rules for Decisions*, 105 U. PA. L. REV. 797, 803 n.25 (1957).

35. See notes 4-6 *supra* and accompanying text.

36. 322 U.S. 174 (1944).

37. Rights in real property are normally governed by state law. See United States v. Brosnan, 363 U.S. 237 (1960); Reconstruction Fin. Corp. v. Beaver County, 328 U.S. 204 (1946).

under government leases are to be governed solely by federal law.[38] If the court decides that state law may be applicable, it now must decide whether that law applies of its own force—a possibility which the Court in the principal case refused to preclude—or, if it does not apply of its own force, whether it should be adopted to give content to the federal common law or be rejected in favor of a uniform federal standard. On neither of the latter questions did the Court in the principal case offer any help.

For two reasons the better view would be that state law should be treated as having been adopted as the appropriate federal common law. First, adoption clearly gives greater judicial flexibility by allowing rejection of state law when it does not provide a "fair and convenient mode of disposition."[39] Second and more important, adoption permits the court to recognize the federal interests involved and where necessary to apply federal as opposed to state law. For the Court now to refuse to preclude the possibility that state law can be applied of its own force in a case involving a disbursal of federal funds or a government contract raises the question whether the decisions in *Clearfield* and *Allegheny County* are still good law, for they did not leave any room for the application of state law of its own force. Thus, the courts should resist any temptation to apply state law *ex proprio vigore*, so that they may continue to work within the framework of authority which gives the courts the right to adopt state law as the federal common law in appropriate situations and therefore the ability to weigh the competing federal and state interests.[40]

38. United States v. Starks, 239 F.2d 544 (7th Cir. 1956); American Houses v. Scheider, 211 F.2d 881 (3d Cir. 1954); Girard Trust Co. v. United States, 149 F.2d 872 (3d Cir. 1945); United States v. Morgan, 196 F. Supp. 345 (D. Md. 1961); Sands v. United States, 198 F. Supp. 880 (W.D. Wash. 1960), *aff'd*, 295 F.2d 481 (9th Cir. 1961). In all of these cases, federal law was applied under the rationale of *Clearfield*: "A federal court proceeds to such adjudication without obligation to the landlord-tenant law of any state or any limitations which a state may impose on its courts . . . ." American Houses v. Scheider, *supra* at 882.

39. See note 11 *supra* and accompanying text.

40. Besides possibly bringing about a re-evaluation of the choice of law previously made in certain types of cases, such as government leases, see note 38 *supra* and accompanying text, the idea of state law applying *ex proprio vigore* would also supersede two general approaches lower federal courts have used in determining what state law should be applied. One approach has been that if the source of the relationship between the parties was federal, federal law should be applied. United States v. View Crest Garden Apartments, Inc., 268 F.2d 380 (9th Cir. 1959), *cert. denied*, 361 U.S. 884 (1960); United States v. Independent School Dist. No. 1, 209 F.2d 578 (10th Cir. 1954). An even more common rationale is that if the United States is a party to a contract, federal law must be applied to interpret it. Cargill, Inc. v. Commodity Credit Corp., 275 F.2d 745 (2d Cir. 1960); United States v. Starks, 239 F.2d 544 (7th Cir. 1957); United States v. Lemmox Metal Mfg. Co., 225 F.2d 302 (2d Cir. 1955); Sealbrook Farms, Inc. v. Commodity Credit Corp., 206 F.2d 93 (3d Cir. 1953); Ingraham v. Williams, 173 F. Supp. 1 (N.D. Cal. 1959); United States v. United States Foreign Corp., 151 F. Supp. 658 (S.D.N.Y. 1957); Terminal Warehouse v. United States, 101 F. Supp. 937 (D.N.J. 1952).