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Federal Rule of Civil Procedure 23(b): Its Application under Erie R.R. v. Tompkins

virtually unlimited extent, and have developed a more restricted rule than is applied in basic tort law.[46] Since the architect's negligence would lead to property or personal harm, rather than intangible economic loss, it is quite obvious that architects are not performing "Ultramarian" services, and hence should be, like the contractors, subject to basic tort law. Of course, mere proof that his plans were defective and that the building collapsed, will not make the architect liable; it must also be shown that his plans were followed by the builder.[47] Similarly, the building contractor is justified in relying on plans and specifications provided him if they are not so obviously defective that he should be charged with notice of such a defect.[48] The effect of this limitation would be to make the architect solely liable to third parties where his plans are latently defective.

Conclusion

New York has finally carried the *MacPherson v. Buick* doctrine to its logical conclusion by removing the technical distinction between real and personal property. By destroying completely the initially irrational exception to tort law of non-liability for manufacturers, contractors, and architects, based on privity, the court has established that the foreseeability of the injury complained of should be the test and the classification of the object or tortfeasor should have no bearing on the plaintiff's right to recover. It points up the fact that the pendulum will soon swing to the point where courts will feel no need to pay lip service to the *MacPherson* rule (thereby obviating the apparent difficulty with respect to architects not dealing with a product), judging all tortfeasors on the same basis: where one undertakes to do a positive act, one has the duty to do it in such a way as not to create a probable danger to the person or property of those within the foreseeable scope of the risk.

FEDERAL RULE OF CIVIL PROCEDURE 23(b): ITS APPLICATION UNDER ERIE R.R. v. TOMPKINS

Since *Erie R.R. v. Tompkins*,[1] decided in 1938, federal courts in diversity cases have been required to apply state substantive law. While the *Erie* Court expressly relied upon statutory construction and constitutional grounds,[2] there

46. "If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences." Id. at 179-80, 174 N.E. at 444.

47. Bayne v. Everham, 197 Mich. 181, 163 N.W. 1002 (1917); Lake v. McElfatrick, 139 N.Y. 349, 34 N.E. 922 (1893).

48. Ryan v. Feeney & Sheehan Bldg. Co., 239 N.Y. 43, 145 N.E. 321 (1924).

1. 304 U.S. 64 (1938). This case overruled Swift v. Tyson, 41 U.S. (16 Pet.) 1 (1842), the doctrine of which was that of supremacy of federal general law over the general law of the states.

2. Id. at 72-73, 77-80.

is little doubt that the more compelling reason for its decision was the Court's belief that confusion and collusion were being served by having two courts in a single state hand down conflicting decisions.[3]

The Court indicated that federal substantive law was to be inapplicable in diversity cases, stating 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. There is no federal general common law. Congress has no power to declare substantive rules of common law applicable in a state. . . . And no clause in the Constitution purports to confer such a power upon the federal courts."[4]

HISTORY AND DEVELOPMENT OF FEDERAL RULE 23(b)

Rule 23(b) requires that a plaintiff in a derivative stockholder's action aver that he ". . . was a shareholder at the time of the transaction of which he complains or that his share thereafter devolved on him by operation of law. . . ."[5] This "contemporaneous-ownership" provision can be traced to *Hawes v. Oakland*,[6] decided by the Supreme Court in 1881. The *Hawes* Court suggested that rules were necessary to frustrate the collusive creation of diversity jurisdiction.[7] This reasoning gave rise to Equity Rule 94,[8] a predecessor of rule 23(b).

Shortly after the adoption of Equity Rule 94, the Court, by way of dictum in *Dimpfell v. Ohio & Md. R.R.*,[9] called it a matter of substantive law. Almost twenty-five years thereafter, but prior to the *Erie* case, *Venner v. Great Northern Ry.*,[10] rejected the argument that Equity Rule 94 had to be complied with to give the court jurisdiction. The Court said, "neither the rule nor the decision from which it was derived deals with the question of jurisdiction of the courts, but only prescribes the manner in which the jurisdiction shall be exercised."[11] Thus, ". . . if it appears that the plaintiff has not shown a case [within Equity Rule 94] . . . the bill should be dismissed for want of equity and not for want of jurisdiction."[12] The Court did not clarify what was meant by this distinction between "want of equity" and "want of jurisdiction."

3. Id. at 74-77. See Black & White Taxi Co. v. Brown & Yellow Taxi Co., 276 U.S. 518, 532 (1928), where Justice Holmes, in a dissenting opinion, pointed out some of the undesirable consequences of the doctrine of Swift v. Tyson. See also Shulman, The Demise of Swift v. Tyson, 47 Yale L.J. 1336, 1346-47 (1938); Keeffe, Gilhooley, Bailey and Day, Weary Erie, 34 Cornell L.Q. 494 (1949).

4. 304 U.S. at 78.

5. Fed. R. Civ. P. 23(b). See, generally, 3 Moore, Federal Practice, ¶¶ 23.15, 23.18 (2d ed. 1948).

6. 104 U.S. 450 (1881).

7. Id. at 453. The court in this case did not have an issue before it enabling it to promulgate the rule. The discussion by the court of collusion and of a rule to combat it is necessarily only dictum.

8. 104 U.S. ix (1882). Equity Rule 94 thereafter was enacted as Equity Rule 27, the predecessor of federal rule 23(b).

9. 110 U.S. 209, 210 (1884).

10. 209 U.S. 24 (1908).

11. Id. at 34.

12. Ibid.

The post-*Erie* decisions, beginning with *Summers v. Hearst*,[13] while reflecting confusion as to this distinction, have consistently characterized rule 23(b) as procedural.[14] In the *Summers* case the court was faced with a conflict between Equity Rule 27, the immediate predecessor of 23(b), and the case law of New York[15] which at that time had not yet adopted a state contemporaneous-ownership statute. The court conceded that "the federal cases that discuss this section of Rule 27 support the view that it states a principle of substantive law."[16] The distinction in the *Venner* case, then, was apparently considered to support a substantive characterization of rule 23(b). The court, however, applied the federal rule on the ground that it had been promulgated by the Supreme Court as a rule of procedure. In the absence of such a promulgation the court said it "might feel compelled," under *Erie*, to follow the New York law.[17] When the same question was presented a few years later in *Piccard v. Sperry Corp.*,[18] the court, while granting that ". . . there appears to be some doubt as to the applicability of the rule . . . ,"[19] relied largely upon the *Summers* case as authority for applying it. Ironically, the *Venner* case, which the *Summers* court impliedly viewed as indicative of the substantive nature of the rule, was cited as further authority. This case, the court said, made it "evident" that the Supreme Court considers the rule ". . . as being one personal to the plaintiff with no question of jurisdiction involved."[20]

Thus the cases, both antedating and subsequent to the *Erie* case, are by no means conclusive as to the nature of rule 23(b). The Supreme Court has said that a failure to satisfy the rule will result in a dismissal for "want of equity." If such a dismissal is res judicata as to the merits and the plaintiff has no further recourse to the state courts, then rule 23(b) is substantive. If, on the other hand, the rule is merely a procedural condition which must be met in order to proceed in the federal courts, then the distinction between "want of equity" and "want of jurisdiction" is of no practical effect. Thus, in *Perrott*

13. 23 F. Supp. 986 (S.D.N.Y. 1938).

14. York v. Guaranty Trust Co., 143 F.2d 503 (2d Cir. 1944), rev'd on other grounds, 326 U.S. 99 (1945); Benisch v. Cameron, 81 F. Supp. 882 (S.D.N.Y. 1948); Perrott v. United States Banking Corp., 53 F. Supp. 953 (D. Del. 1944); Piccard v. Sperry Corp., 36 F. Supp. 1006 (S.D.N.Y.), aff'd, 120 F.2d 328 (2d Cir. 1941); Lissauer v. Bertles, 37 F. Supp. 881 (S.D.N.Y. 1940). However, a strong post-Erie case for the proposition that rule 23(b) is substantive is Gallup v. Caldwell, 120 F.2d 90, 95 (3d Cir. 1941), where the state law was held applicable over rule 23(b). However, rule 23(b) was nevertheless applied on the grounds that it was the proper thing to do where the state law (New Jersey) was not clear upon the question. See also In re Western Tool & Mfg. Co., 142 F.2d 404, 408 (6th Cir. 1944), rev'd on other grounds, 324 U.S. 100 (1945), where the court said, "it may be that under the doctrine of Erie R. Co. v. Tompkins . . . the provisions of the rule . . . must yield to state law. . . ."

15. Pollitz v. Gould, 202 N.Y. 11, 94 N.E. 1088 (1911).

16. 23 F. Supp. at 992.

17. Ibid.

18. 36 F. Supp. 1006 (S.D.N.Y.), aff'd, 120 F.2d 328 (2d Cir. 1941).

19. Id. at 1009.

20. Id. at 1010.

v. United States Banking Corp.,[21] the court, in holding the rule procedural, ignored the so-called distinction and said simply, "the action is to recover for a wrong suffered by the corporation. Simply because a particular plaintiff cannot qualify as a proper party to maintain such an action does not destroy . . . the cause of action."[22] At this juncture it seemed clear enough that prior courts were not using the term "substantive" in the same sense that it was used in the *Erie* case. Although no court had said so, all that a dismissal for "want of equity" or a substantive characterization of the federal rule meant was that while the court had jurisdiction by reason of diversity of citizenship, the rule imposed a limitation on the *exercise* of that jurisdiction.

The Conflict Between Rule 23(b) and New York Law

The *Summers* and *Piccard* decisions, decided when rule 23(b) conflicted with New York law,[23] found no cause to ignore the rule in diversity actions. New York thereafter conformed to the federal law by the adoption of a contemporaneous-ownership statute substantially the same as rule 23(b).[24] It seemed then that the conflicts which rule 23(b) theretofore created were now academic.

However, in 1944, New York enacted the first "security-for-expenses" statute,[25] a law specifically designed to prevent "strike suits." A plaintiff in a stockholder's derivative action, who is not the holder of either 5 per cent in quantity of any class of stock outstanding or $50,000 in value of such stock of the corporation, must, under this statute, post security for the reasonable expenses which may be incurred by the corporation and other party defendants. If the plaintiff can effect the joinder of parties holding a sufficient number of shares to satisfy the 5 per cent or $50,000 requisites, the security requirement will be vacated.[26]

In *Noel Associates, Inc. v. Merrill*,[27] the New York Supreme Court held the security-for-expenses law to be substantive and independent of the contemporaneous-ownership law. Thus, a plaintiff who had joined shareholders who were not contemporaneous owners within section 61 of the General Corporation Law, was nevertheless held entitled to an order vacating the security requirement of section 61-b.

Thereafter, in *Cohen v. Beneficial Industrial Loan Corp.*,[28] the constitutionality of a New Jersey security-for-expenses statute, basically the same as section 61-b, was challenged and it was contended that, even if constitutional, the statute was merely procedural and the plaintiff's right to maintain suit therefore depended solely upon his satisfying rule 23(b). The United States Supreme Court, in an opinion by Justice Jackson, held the statute valid and called it a

21. 53 F. Supp. 953 (D. Del. 1944).

22. Id. at 956.

23. See p. 696 supra.

24. N.Y. Gen. Corp. Law § 61.

25. N.Y. Gen. Corp. Law § 61-b. Similar statutes have been adopted in other states. N.J. Stat. Ann. § 14:3-15 (Supp. 1956); Pa. Stat. Ann. tit. 12, § 1322 (1953).

26. Neuwirth v. Wyman, 119 N.Y.S.2d 266 (Sup. Ct. 1953).

27. 184 Misc. 646, 53 N.Y.S.2d 143 (Sup. Ct. 1944).

28. 337 U.S. 541 (1949).

matter of substantive law. Justice Douglas dissented in part, two other justices concurring in his dissent, arguing that the New Jersey statute ". . . regulates only the procedure for instituting a particular cause of action and hence need not be applied in this diversity suit in the federal court. Rule 23 of the Federal Rules of Civil Procedure defines that procedure for the federal courts."[29] Thus, the three dissenters who considered the New Jersey statute procedural were of the same opinion as to rule 23(b).

Two years later, in *Fuller v. American Mach. & Foundry Co.*,[30] a plaintiff in a derivative stockholder's suit, having joined others whose holdings aggregated $50,000, sought to have the order requiring the posting of security vacated. The defendant objected that the intervening stockholders were not contemporaneous owners as required by rule 23(b). The federal district court overruled the objection and held that the law of New York, which under the *Noel* case did not require contemporaneous ownership, was applicable. Previous decisions,[31] where rule 23(b) had been held procedural and enforced against all stockholders including intervenors, were said not to compel a different conclusion on the ground that they were decided before the *Cohen* and *Noel* cases and before the enactment of the pertinent New York statutes.[32]

In 1955, in *Kaufman v. Wolfson*[33] however, the same district court which had decided the *Fuller* case came to a contrary conclusion. As in the *Fuller* ruling, the plaintiff had sought to obviate the New York security requirement by joining stockholders whose holdings aggregated $50,000. The court held rule 23(b) applicable and required that all stockholders, including the intervenors, qualify as contemporaneous owners. In support of its decision the court argued that rule 23(b) had been consistently enforced previous to the *Fuller* case, and the mere fact that New York had subsequently construed its statute to permit the joinder of non-owners did not effect the federal rule. The court, having properly disposed of one basis of the *Fuller* decision, proceeded to reconcile its holding with the *Cohen* case. The court seized upon a dictum of Justice Jackson to the effect that, the provisions of rule 23(b) do not ". . . conflict with the statute in question [New Jersey security-for-expenses statute] and all may be observed by a federal court, even if not applicable in state court."[34] The *Kaufman* court concluded that rule 23(b) should be applied in the federal court "even if not applicable in state court."

29. Id. at 557.

30. 95 F. Supp. 764 (S.D.N.Y. 1951).

31. See note 21 supra.

32. The result of the Fuller case could be accomplished consistently with the Cohen dictum and with Piccard v. Sperry by permitting intervention for the limited purpose of determining whether the state security-for-expenses statute is satisfied. This, however, would lead to the awkward situation of having two types of plaintiffs—those who were such only for reference to the state security-for-expenses statute and those who were such in the proper sense, i.e., for pleading and arguing. The only virtue of such a classification would be its novelty and, it is submitted, there would be only a surface reconciliation with Piccard v. Sperry. When the court in the latter case spoke of intervenors it meant those who intervened as plaintiffs for all purposes.

33. 136 F. Supp. 939 (S.D.N.Y. 1955).

34. 337 U.S. at 556.

CONCLUSION

The *Fuller* court, while recognizing rule 23(b) to be procedural, considered it to be its duty under the *Erie* case to apply the state substantive law and to ignore any federal law, even though procedural, which conflicted with it. The *Fuller* decision would seem to be in error and properly disregarded in the *Kaufman* case. The Supreme Court, after the *Erie* decision, had promulgated rule 23(b) as one of *procedure*. The *Fuller* court conceded this, but apparently considered the *Cohen* case as indicative of a contrary intention. It would seem, however, that the procedural classification of rule 23(b), upheld in the *Kaufman* case, is more in accord with the *Cohen* decision. While the characterization of rule 23(b) was not in issue, the dictum of Justice Jackson speaking for the majority supports the procedural view. Moreover, all of the dissenters were of a like opinion.

A second possible ground for the *Fuller* decision, namely, that federal procedural law in conflict with state substantive law will be disregarded and the latter alone applied, is also inconsistent with the *Cohen* dictum. The plaintiff in a diversity action is actually confronted by a double hurdle, being required to satisfy both the state substantive law and the federal procedural law.[35] Thus, in the event that such laws are mutually inconsistent, as in the *Fuller* and *Kaufman* cases, the plaintiff is relegated to the state courts for relief. Since state courts have been the traditional and primary interpreters of state corporation laws, the *Kaufman* result has additional support from this very practical aspect.

35. See p. 698 supra.