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# Conflict of Laws -- Application of State Security Statute in Federal Court in Diversity Cases

# CASES NOTED

## CONFLICT OF LAWS—APPLICATION OF STATE SECURITY STATUTE IN FEDERAL COURT IN DIVERSITY CASES

Plaintiff stockholders, owning less than $50,000 or five percent of the total capital stock of the corporation, brought a derivative action in the Federal District Court of New Jersey against defendant, a Delaware corporation. Defendant's motion to require security under a New Jersey statute,[1] which gives a defendant corporation in a shareholder's suit the right to require security for the reasonable expenses, including attorney's fees of the corporation [2] for which the plaintiff is liable should he lose the suit, was denied.[3] *Held*, on certiorari, that although the security provision related to procedure, the statute so conditioned the cause of action that it was applicable in a case where the federal court had jurisdiction solely by diversity of citizenship.[4] *Cohen v. Beneficial Industrial Loan Corporation*, 337 U.S. 541 (1949).

The instant case illustrates a trend which had developed after *Erie Railroad Co. v. Tompkins*,[5] concerning the resolution of the substance-procedure problem in the federal court. The *Erie* decision demands intrastate uniformity of decisions between federal and state courts, when federal jurisdiction is based on diversity.[6] Following this policy, generalizations as to the category of the substance-procedure dichotomy into which a subject fell, were disregarded by federal courts, and state rules dealing with burden of proof,[7] proving contributory negligence,[8] conflict of laws,[9] and parole evidence [10] were applied in cases where jurisdiction was founded on the ". . . accident of diversity of citizenship." [11] To add reality to the spirit of

1. N.J. STAT. ANN. § 14:3-15 (Cum. Supp. 1947).
2. *Ibid.* This act is applicable only if plaintiff owns less than $50,000 or five percent of the stock of defendant corporation.
3. Three other states have passed similar statutes aimed at eliminating the "strike suit," N.Y. GEN. CORP. LAW § 61-b (1944); PA. STAT. ANN. TIT. 12 § 1322 (1949); MD. ANN. CODE GEN. LAWS art. 16 § 195 (Cum. Supp. 1947). For the theory and criticism of it see Hornstein, *The Death Knell of Stockholders' Derivative Suits in New York*, 32 CALIF. L. REV. 123 (1944) and Zlinkoff, *The American Investor and the Constitutionality of § 61-b* of the New York General Corporation Law, 54 YALE L. J. 352 (1945). In the present decision the Court also affirmed the constitutionality of the statute.
4. ". . . in diversity cases the federal court administers the state system of law in all except details related to its own conduct of business." Cohen v. Beneficial Industrial Loan Corporation, 69 Sup. Ct. 1221, 1230 (1949).
5. 304 U.S. 64 (1938).
6. *Id.* at 75.
7. Cities Service Oil Co. v. Dunlap, 308 U.S. 208 (1939).
8. Palmer v. Hoffman, 318 U.S. 109, 117 (1943).
9. Klaxon Co. v. Stentor Electric Mfg. Co., 313 U.S. 487 (1941).
10. Long v. Morris, 128 F.2d 653 (3d Cir. 1942).
11. Klaxon Co. v. Stentor Electric Mfg. Co., *supra* at 496.

the *Erie* case, a new test for determining application of state law in the federal courts was announced in *Guaranty Trust Co. v. York*.[12] Henceforth the question was no longer one depending on classical terminology of substance or procedure, but ". . . does it significantly affect the result . . ." of a suit to apply the rule in the federal court?[13] Under this rule, the Supreme Court held that in diversity cases the federal court was regarded as a state tribunal, and if the state court has declined jurisdiction under a statute termed "procedural," then the federal courts were also closed to such litigation.[14]

The apparent difficulty presented in the principal case is with that portion of the state statute requiring security, which "prescribed a procedure."[15] Dissent[16] argued that the statute was procedural and not within the intent of the *Guaranty* decision, and it followed that the federal courts were free to apply the federal procedure dealing with shareholder's suits.[17] However, the majority reasoned that a judgment for costs without a bond would not achieve the result desired by state policy as embodied in the statute, *i.e.* prevention of certain minority stockholders from prosecuting derivative actions.[18] Since it would affect the result, although not the merits, the *Guaranty* rationale demands its use in the federal courts.[19]

An obvious question to arise from the result of the principal case is how far will the *Erie* policy allow states to dictate their procedure to the federal courts? Since remedial regulations quite often influence the outcome of a suit,[20] the decision here, where a statute so "close to controlling

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12. 326 U.S. 99 (1945).

13. *Id.* at 108. Indications had been previously manifested that state categorizations were outmoded for diversity use and that classification should depend upon the purpose for which the classification is made. *See* Sampson v. Channell, 110 F.2d 754, 756 (1st Cir. 1940), *cert. denied*, 310 U.S. 650 (1940) (for purpose of Conflict of Laws, burden of proof was procedural, and the law of the state where the suit was brought governed; but for diversity purposes the state law had to be applied in the federal court). *But cf.* Shielcrawt v. Moffett, 184 Misc. 1074, 56 N.Y.S.2d 134 (Sup. Ct. 1945) (the act involved in the principal case was declared to be procedural for Conflict of Laws purposes.) The problem is more fully developed in *Tunks, Categorization and Federalism: "Substance" and "Procedure" after Erie Railroad Co. v. Tompkins*, 34 ILL. L. REV. 271 (1942).

14. Angel v. Bullington, 330 U.S. 183 (1947).

15. District courts often invoke statutes requiring security for costs, but do so on the basis that they have adopted the procedure so far as it is consistent with federal rules. Schuldt v. Schuman, 26 F. Supp. 358 (W.D. Wash. 1938).

16. See the language in the majority opinion by Justice Frankfurter in Guaranty Trust Co. v. York, *supra* and Angel v. Bullington, *supra*. His position is difficult to reconcile with the broad language of the previous decisions. *Cf.* Houseware Sales Corporation v. Quaker Stretcher Co., 70 F. Supp. 747, 749-750 (E.D. Wis. 1947); Cohen v. Beneficial Industrial Loan Corporation, 170 F.2d 44, 55 (3d Cir. 1948).

17. FED. R. CIV. P. 23(b).

18. Elimination of the "strike suit," where small shareholders attempt to embarrass directors of corporations into settling outside of court, rather than assume the financial burden of contesting unfounded claims, is the purpose of the statute.

19. "Rules which lawyers call procedural do not always exhaust their effect by regulating procedure." Cohen v. Beneficial Industrial Loan Corporation, *supra* at 1230.

20. Statements that rules dealing with the form are often closely related to the rights of parties are common. *See* Shielcrawt v. Moffett, 294 N.Y. 180, 61 N.E.2d 435, 439 (1945); Cohen v. Beneficial Industrial Loan Corporation, 170 F.2d 44, 55 (3d Cir. 1948)

the incidents of the litigation" was applied, may also severely limit the power of Congress to regulate procedure in federal courts in diversity cases.[21] For if a procedural regulation in force in the federal courts was interpreted to affect the outcome of a suit, and such rule did not also exist in the state court, to apply the rule in the federal court in a diversity case would lead to a different result than if the suit were tried by a state tribunal.[22] This would seem to fall within the *Guaranty* principle as clearly as the situation where a state act was interpreted to affect the outcome of a suit so as to make it applicable in the federal court.

## CONSTITUTIONAL LAW—SOVEREIGN IMMUNITY FROM SUIT—WAIVER BY APPEARANCE—ANCILLARY JURISDICTION OF FEDERAL COURT

Complainant sought to enforce the injunction, in a previous decree by this same federal court, restraining the assessment or collection of any taxes contrary to the terms of a valid tax exemption granted by its legislative charter from the state.[1] In the prior case, brought by this complainant, the defendant of record was the person whose duty as a state official consisted of assessing and collecting taxes, and his counsel was the Attorney General of the state. Whether each one was named and appeared as an individual citizen or in his official capacity was not clearly shown, due to the lack of uniform designation of the defendant and of counsel, in the process and the pleadings and in the opinion by the court. The present suit named as defendant the state official charged with the same duty to levy taxes, who also was represented by the Attorney General. *Held,* complaint dismissed for lack of jurisdiction of a federal court, this ancillary proceeding being one against the state[2] within the immunity from suit

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(". . . substance and procedure will become in law, as in fact, one.") 1 CHAMBERLAYNE, MODERN LAW OF EVIDENCE § 171 (1911).

21. See Justice Holmes' dissent in Black & White Taxi Co. v. Brown & Yellow Taxi Co., 276 U.S. 518, 533 (1928) (there had been an "unconstitutional assumption of powers" by the courts of the U.S.); Erie Railroad Co. v. Tompkins, *supra* at 78 "Congress has no power to declare substantive rules of common law applicable in a state whether they be local in nature or 'general'. . . ."

22. Fed. R. Civ. P. 23 (b) is a limitation on bringing shareholder's derivative actions. It would appear to affect a litigation as much as, if not more than the security statute involved in the instant case. Under the present decision, if the above premise is valid, it could no longer be applied by district courts unless the same rule existed in the state. *Contra:* Piccard v. Sperry Corporation, 36 F. Supp. 1006 (S.D.N.Y. 1941), *aff'd,* 120 F.2d 328 (2d Cir. 1941), *cert. denied,* 328 U.S. 845 (1946). Perrot v. United States Banking Corp., 53 F. Supp. 953 (D. Del. 1944) [23(b) is procedural, using the same reasoning of the district court opinion in the principal case, 7 F.R.D. 352 (D.N.J. 1947)].

1. Georgia Railroad & Banking Co. v. Wright, 132 Fed. 912 (C.C.N.D.Ga. 1904); *aff'd,* 216 U.S. 420 (1910).

2. The court relied on Musgrove v. Georgia Railroad & Banking Co., 204 Ga. 139, 49 S.E.2d 26 (1948) (*held,* whether defendant is named as an individual or in his