The Erie Doctrine in Equity

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*Guaranty Trust Co. v. York* is best known as the Supreme Court’s first attempt to demarcate the line between “substance” and “procedure” for purposes of applying the rule in *Erie R. Co. v. Tompkins.* York held that because a state statute of limitations was a matter of substance, a federal court adjudicating a claim arising under the law of that state must apply state law rather than federal law. Recognizing that the terms substance and procedure are mere labels, the *York* Court analyzed the question in light of the purpose of *Erie,* which was to ensure uniformity in result between federal and state courts. York’s “outcome determinative” test, as refined by the Court over the past fifty years, remains a cornerstone of the *Erie* doctrine.

But there is another facet of the *York* opinion that although largely overlooked, is of equal importance. Notwithstanding its constitutional overtones, *Erie* can be understood as a reinterpretation of the Rules of Decision Act, rejecting the narrow reading of that Act set out in *Swift v. Tyson.* Until 1948, application of the Act was explicitly confined to “trials at common law.” York, however, was an action in equity. Therefore, if *Erie* is based solely on the Rules of Decision Act, the rule announced by the Court would not apply to the state law at issue in *York.* Although it recognized the limiting language of the Rules of Decision Act, the *York* majority declared that the statute did not create new law. Rather, its command to follow state law was “merely declaratory of what would in any event have governed the federal courts and therefore was equally applicable to equity suits.” It was this basic principle, not merely the Rules of Decision Act, that required federal courts to honor state-law substantive rights. *York* therefore strongly reinforced the intimation in *Erie* that the rule is constitutionally compelled.

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* Professor of Law and Brown, Todd & Heyburn Fellow, University of Louisville School of Law.

2. 304 U.S. 64, 58 S. Ct. 817 (1938).
4. *Id.*
8. The suit involved a claim by the beneficiary of a trust against the trustee, a matter within the traditional jurisdiction of equity. *York,* 326 U.S. at 100-01, 65 S. Ct. at 1465-66.
9. *Id.* at 103-04, 65 S. Ct. at 1467.
10. The *Erie* Court itself indicated that the decision was based at least in part upon the Constitution. 304 U.S. at 77-78, 58 S. Ct. at 822.
Yet, although York extended Erie to equity, Justice Frankfurter’s majority opinion did not entirely dismiss the notion that equity is different. In dictum, he suggested that federal courts could often diverge from state law in equity, especially on questions of remedy.11 His opinion listed in detail the scope of, and limitations on, the federal law of equity.12 Because Justice Frankfurter never clearly explained where the federal courts derive this special prerogative in equity, this part of the York opinion is difficult to square with the basic principle of limited federal judicial authority set out in the remainder of the opinion.

As analysis of the Erie doctrine has matured over the years, courts and commentators have quite naturally questioned whether York’s dictum concerning federal equity is good law. After all, the remedy that a court grants is the “outcome” of a case. Therefore, if a federal court may provide different remedies than a state court hearing the same claim, the difference in laws would clearly be outcome-determinative, and would inevitably lead to forum-shopping. Several courts and commentators have accordingly concluded that a federal court adjudicating a state-law claim must defer to state law on all issues of remedy, even if the underlying claim is equitable.13

This article explores this largely overlooked side of the Erie doctrine. The central thesis is that the York majority was correct when it suggested an equity exception to Erie. In fact, there are two distinct equity exceptions. First, when the underlying substantive right is created by Congress, federal courts will ordinarily apply a uniform federal judge-made rule governing remedies and other equitable issues. This first exception is merely a variation on a well-recognized exception to Erie, and is therefore largely non-controversial.

Second, federal courts hearing claims arising under either state or federal law have considerable discretion to diverge from state rules dealing with issues of equitable procedure, remedies, and defenses, regardless of whether applying a different rule would change the outcome of the case. This second conclusion is considerably more controversial. It is certainly at odds with the leading commentators, who have rejected a general equity exception to Erie in cases arising under state law.14 These commentators argue that equitable remedies cannot qualify as rules of procedure under the current test used to evaluate procedural rules. Although that conclusion is undeniably correct, it does not resolve the matter. The procedural rules discussed in Hanna v. Plumer15 are but one of several types of valid federal judge-made law. A complete analysis of whether federal judge-made rules of equity are valid should also ask whether equity falls into one of these other categories.

Part II of the article explores the realm of substantive federal judge-made law. That analysis provides a firm footing for the first equity exception, under which a federal court may craft equity rules when adjudicating a primary right created by

12. Id.
13. See infra cases and commentary cited in notes 127 to 137.
14. See infra text accompanying notes 134 to 138.
However, none of the existing categories of substantive federal judge-made law applies to equity cases involving state-law claims. Each of those categories involves considerations of federalism that will ordinarily not be present when a federal court in equity hears a state-law claim or defense.

Nevertheless, the analysis of substantive federal judge-made law in Part II ultimately reveals a new way to deal with the basic problem. Reasoning from the insights gleaned from a general analysis of federal judge-made law, Part III demonstrates that equity is a separate, *sui generis* area in which federal courts have the power to make law. The federal courts derive the authority to craft a separate body of federal equity law from the Constitution itself. More specifically, the Article III judicial power includes the authority to exercise the type of discretion practiced by courts of equity in the late eighteenth century. As long as that exercise of discretion does not result in the creation of new substantive rights or the abolition of existing rights, it falls within a federal court’s inherent constitutional authority. Therefore, all federal judge-made rules that deal with how a court should exercise its equitable discretion in enforcing a right are valid, and may be applied by a federal court in lieu of state law.

Part IV of the Article briefly fleshes out some of the details of the two “equity exceptions” to *Erie*. The only limits on the first exception are the Constitution and the will of Congress. Although federal judicial authority is narrower under the second exception, it is still much more expansive than the current commentary would suggest. Most significantly, a federal court’s lawmaking power is not limited to the question of equitable remedies. Equity involves not only remedies, but also unique causes of action and defenses. Part IV explores the extent to which *Erie* requires a federal court to follow state law governing this myriad of matters. It concludes that although federal courts hearing state-law claims do retain considerable power to employ equitable procedural devices and defenses, they must generally follow state-law rules defining equitable causes of action.

Before embarking on the analysis, however, a few notes on terminology are in order. *Erie* analysis quite often uses the term “federal common law.” The meaning of “common law” has changed over the past century. Today, the term is a shorthand way of referring to all law that stems from judicial precedent rather than legislatures. But historically that term had a more precise meaning, denoting one particular court in the multi-court English system. Because the historical distinctions between common law and equity are crucial to the analysis that follows, this article will use the term common law in its historical sense to refer both to the common-law court system and to the body of rules applied in those courts. The less common, but more accurate term “judge-made law” will refer to all rules established by precedent, whether in common law or equity. On the other hand, “law” and “legal” are not used for their historical meanings, in which they

16. *See infra* text accompanying notes 167 to 177.
referred only to common law, but instead mean all binding rules, regardless of the court system in which that rule is applied. Although this convention may prove clumsy at times, it prevents the ambiguities that can arise from imprecise terminology.

I. A BRIEF HISTORY OF STATE LAW IN FEDERAL EQUITY CASES

A. Pre-Erie

Federal equity is as old as the federal courts themselves. The Judiciary Act of 1789 created a set of federal trial courts and gave them jurisdiction over “all suits of a civil nature at common law or in equity” involving diverse parties and an amount in controversy in excess of $500. Unlike the judicial systems of England and several of the states, however, the federal judiciary was not divided into separate courts of common law and equity, but was instead a single system with law and equity sides. Even within this unitary system, however, Congress retained the traditional preeminence of common law over equity, explicitly barring suits on the equity side where a “plain, adequate and complete remedy” was available at common law. Additional provisions of the Judiciary Act preserved the traditional customs of the equity courts.

The 1789 Judiciary Act also contained the original Rules of Decision Act. That provision, however, explicitly controlled only “trials at common law.” The 1789 Act failed to specify what rules of decision were to apply in either equity or admiralty/maritime cases.

One week after passing the original Judiciary Act, Congress enacted a companion statute regulating procedure in the new federal courts. This statute also distinguished the common-law and equity sides of the federal courts. Paralleling the Rules of Decision Act, the 1789 Process Act required that the modes of proceeding in common law cases “be the same in each state respectively as are now used or allowed in the supreme courts of the same.” In equity, however, the courts were to adopt the modes and proceedings of the civil law.

The 1789 Process Act was intended to be a temporary solution, and was accordingly replaced in 1792. The 1792 Process Act remained in force for all of

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19. Section 19 of the Judiciary Act of 1789, for example, required judges both in equity and in admiralty and maritime law to state their factual findings in detail. Judiciary Act of 1789, § 19, ch. 20, 1 Stat. 83 (1789).
24. The 1789 Act expired by its terms in 1790, at the end of the second term of the first Congress. Congress extended the provision for one additional session in both 1790, “An Act to continue in force an act passed at the last session of Congress, entitled [sic] ‘An act to regulate processes in the Courts of the United States,’” ch. 23, 1 Stat. 123 (1790), and 1791, “An Act to continue in force, for a limited
the nineteenth century and almost half of the twentieth.³⁵ It therefore played a significant role in the development of federal equity prior to \textit{Erie}. Like its 1789 counterpart, the 1792 Act generally required federal courts in common-law actions to conform their modes of proceeding to state practice.²⁶ However, Congress changed the rules governing proceedings in equity. Instead of the civil law, Congress required equity proceedings to conform to “the principles, rules and usages which belong to courts of equity... as contradistinguished from courts of common law...”²⁷

Viewed from our post-\textit{Erie} vantage point, that reference to “courts of equity” may seem ambiguous because Congress failed to specify which of the several systems of equity courts it intended the federal courts to mirror. To the Supreme Court of the era, however, Congress’s intent was clear. In \textit{Robinson v. Campbell},²⁸ the Court considered whether a defendant could interpose an equitable defense in a common-law action in federal court.²⁹ The defendant claimed that state law allowed it to assert that defense at common law. Because \textit{Robinson} was a common-law action, that state law would arguably apply in federal court because of the Rules of Decision Act. Nevertheless, the Supreme Court held that the defense was not available in federal court, relying on the 1792 Process Act.³⁰

²⁵. The provision was commonly called the “Conformity Act,” and was eventually codified at 28 U.S.C. § 723 (1948). That provision was dropped when the Judicial Code was revised and recodified in 1948. “‘An Act to revise, codify, and enact into law title 28 of the United States Code entitled ‘Judicial Code and Judiciary,’” ch. 646, 62 Stat. 869 (1948); 1B Bernard D. Reams, Jr. & Charles R. Haworth, Congress and the Courts: A Legislative History 1787-1977 1551 table 2 (1978). However, Congress did not specifically abolish the provision. Rather, the Reviser apparently decided that the provision was no longer relevant given the new Federal Rules of Civil Procedure. The legislative history in the 1948 Annotated States—the last volume in which § 723 appeared—contains the following notation by the Reviser: “The Federal Rules of Civil Procedure... supplant the Equity Rules since in general they cover the field now covered by the Equity Rules and the Conformity Act.”

²⁶. Conformity Act, § 2, ch. 36, 1 Stat. 276 (1792).
²⁷. \textit{id. This provision also applied to admiralty. The requirement to follow the rules of equity and admiralty was not absolute, but was subject “to such alterations and additions as the said courts respectively shall in their discretion deem expedient, or to such regulations as the supreme court of the United States shall think proper from time to time by rule to prescribe to any circuit or district court concerning the same...” \textit{id. Thus, federal courts had a power to regulate their own procedure well before the Rules Enabling Act, 28 U.S.C. § 1652 (1994), was enacted in 1938.

²⁸. 16 U.S. (3 Wheat.) 212 (1818).
²⁹. Plaintiff had sued for ejectment, claiming that defendant wrongfully occupied plaintiff’s land in Tennessee. \textit{id. at 213. Defendant responded by claiming that it had equitable title to the property. \textit{id. at 218.

³⁰. \textit{id. at 220.
Although the Court's lengthy discussion of the Process Act is arguably dictum, it illustrates the Court's view of the nature of federal equity.

To the Court, the language in the 1792 Act directing federal courts in equity to apply the "principles, rules, and usages which belong to the courts of equity" referred to the rules prevailing in English Chancery, not those in any particular state. Traditionally, a defendant could assert the equitable defense involved in Robinson only in equity, not in a common-law action. Moreover, the Court treated the 1792 Process Act as a statute defining the subject-matter jurisdiction of the federal courts, giving those courts the authority to hear the particular defense only when they sat in equity. States, of course, cannot regulate the subject-matter jurisdiction of the federal courts. Therefore, notwithstanding the Rules of Decision Act's mandate to follow state law in suits at common law, a state law like that in Robinson, which expanded common-law jurisdiction at the expense of equity, could not apply in the federal courts.

On the other hand, the Robinson Court indicated that states were not completely powerless to alter the traditional division between law and equity. Because states retain the authority to regulate property ownership, the Court recognized that a state statute might change the result. If a state legislature had codified the defense asserted in Robinson, that defense would be part of the legal title and would therefore be available even in a common-law action.

The basic principles established in Robinson continued to guide the courts over the next hundred years. Several Supreme Court cases applied those principles in deciding whether a federal court of equity was precluded from hearing a case because an adequate remedy existed at common law. Analogizing to Robinson, these cases concluded that because an adequate legal remedy deprives a court of its equity jurisdiction, a federal court should consider only federal, not state, remedies in determining adequacy of the remedy at law. The Court used similar jurisdiction-based arguments in holding that a federal court could ignore other state rules, such as limits on the scope of an injunction, requirements that a party first

31. Earlier in the opinion, the Court found that because title to the land had originally been acquired from Virginia, defendant could not avail itself of an equitable title based on Tennessee law. Id. at 220.
32. Id. at 222.
33. Id. at 222.
34. Id. at 220.
35. Id. at 222.
proceed before a probate court, and even the complete absence of any state courts of equity.

However, the Court did not forget its suggestion in Robinson that state legislatures could affect cases in equity by either enlarging or constricting the basic substantive rights of the litigants. The seminal case was Clark v. Smith. In this case, Clark (a descendant of George Rogers Clark) brought what would today be called a suit to remove a cloud on title to land in Kentucky. He filed suit in federal equity, requesting an order requiring Smith to deliver a quitclaim deed. Although such an action would apparently not have been available in English Chancery, the Kentucky legislature had explicitly granted the right to such a conveyance to senior claimants such as Clark.

The Court held that Clark was entitled to the relief he had requested even though he had sued in federal equity. In reaching that conclusion, the Court distinguished between the underlying substantive right and the remedy:

Kentucky has the undoubted power to regulate and protect individual rights to her soil, and to declare what shall form a cloud on titles; and having so declared, the Courts of the United States, by removing such clouds, are only applying an old practice to a new equity created by the legislature, having its origin in the peculiar condition of the country. . . . Kentucky may prescribe any policy for the protection of the agriculture of the country that she may deem wise and proper; she has in effect declared, that junior patents, issued for previously granted lands, shall be delivered up and cancelled; with the addition, that a release of the title shall be executed: and it is the duty of the Courts to execute the policy.

In essence, then, the Kentucky law created a new substantive right. That substantive right could be enforced at common law, or if the common-law remedy were inadequate, in equity. Interestingly, the Court apparently assumed that federal courts in equity would enforce the state-law right even though the Rules of Decision Act did not apply in equity.

The Court next turned to the question of remedy. In addition to creating the new right, the Kentucky legislature had also specified how that right was to be effectuated; namely, by an order requiring the defendant to execute and deliver a deed conveying his interest to the plaintiff. As a general proposition, the Court

39. Livingston v. Story, 34 U.S. (9 Pet.) 632, 657 (1835). This result had been foreshadowed by Robinson and Howland.
41. Id. at 202.
42. The Court never explicitly says that the plaintiff could not have sued in Chancery, but that premise is implicit in its logic.
43. Clark, 38 U.S. at 202.
44. Id. at 203.
45. The Kentucky statute explicitly stated, "[I]f the complainant shall be able to establish his title to such land, the defendant shall be decreed to release his claim thereto . . . ." Id. at 202.
noted, states do not have the authority to regulate the procedure in federal courts. However, where the legislature had provided a remedy that was "substantially consistent" with the traditional modes of proceeding in equity, the Court saw no reason why the federal court should not afford the statutory remedy.

The Court then went one step further, strongly suggesting that in a case like Clark the federal court was actually obligated to provide the statutory remedy. It found that the underlying right created by the Kentucky legislature—the right to clear the title of adverse claims—would be fully effective only if the defendant were to convey its interest. Therefore, the Court reasoned, "had the form of the remedy been rejected by the Courts of the United States, the right to have such record conveyance would have fallen with it, as they could not be separated." This passage represents the birth of the idea of a "right/remedy merger," which was to become increasingly important in the years following Erie.

After Clark, the relevance of state law in federal equity differed depending on whether the issue was one of right or remedy. In both cases, however, the default rules were those applied in English Chancery. With respect to matters of right, the Court applied the traditional rules unless those rules had been modified by a state legislature. A state legislature could provide additional substantive rights, which the federal courts in equity would enforce even if no analogous action existed in English Chancery.

Conversely, if a state legislature abolished or limited a right traditionally available in equity, federal courts would similarly defer to the legislature's power to define legal relationships and dismiss the claim or defense.

46. Id. at 203.
47. Id.
48. Id.
49. Id. at 204. The Court stated that "had the form of the remedy been rejected by the Courts of the United States, the right to have such record conveyance would have fallen with it, as they could not be separated." Id.

Language in an 1851 Supreme Court opinion suggests that a federal court in equity would be free to grant relief even if the state had limited the underlying right. Neves v. Scott, 54 U.S. (13 How.) 268, 272 (1851). However, in that case the limitation on the right had been imposed by the state supreme court, not the legislature. Id. at 271. Moreover, the language suggesting that the federal court could ignore the state-imposed restriction is dictum. Later in the opinion, the Court concluded that the state court decision did not actually impose the limit that the party had claimed. Id. at 272-73.

Similarly, Pennsylvania v. The Wheeling & Belmont Bridge Co., 54 U.S. (13 How.) 518 (1851) is not inconsistent with the right-remedy rule. The Court in that case admittedly held that a federal court of equity should grant relief notwithstanding a state statute that arguably provided a substantive defense to the underlying nuisance claim. Id. at 563. However, the Court held that the state-law defense could not apply to an interstate river because of preemption. Id. at 565.
When questions of procedure and remedy were involved, by contrast, state legislation rarely controlled. Federal courts could grant a traditional equitable remedy even if the state legislature had limited or abolished it, and was not bound to grant new remedies created by the state unless a particular remedy was essential to the underlying right. Aside from a few questionable applications, this rule proved fairly workable in practice.

B. The Impact of Erie

Erie R. Co. v. Tompkins threatened to undermine this neat framework. Read broadly, the decision bars the federal courts from operating a separate and independent system of legal rules. The rules that federal courts were applying in equity constituted just such a body of judge-made law. If the federal courts could not create their own rules governing equitable rights and remedies, they would by default be obligated to apply governing state law.

Had the Erie Court confined its discussion to the Rules of Decision Act, the case probably would have had little impact in equity, as the Rules of Decision Act still applied only to actions at common law. But the majority made it clear that the new paradigm was also mandated by the Constitution. Allowing federal courts to make binding rules of law would give the federal government a de facto legislative jurisdiction in areas that Article I reserved to the states. That threat to state sovereignty exists regardless of whether the federal court crafting rules of law sits in common law or equity.

52. Guffey v. Smith, 237 U.S. 101, 35 S. Ct. 526 (1915) (federal court could issue injunction even though party could obtain only damages in state court).


54. How the Supreme Court labeled certain issues was at times somewhat questionable. For example, in Pusey & Jones v. Hansen, 261 U.S. 491, 43 S. Ct. 454 (1923), the Court held that a state statute that gave an unsecured creditor the right to have a receiver take over the debtor’s assets was an issue of remedy that did not apply in a federal court in equity. The opinion acknowledges that without the statute, an unsecured creditor had no property interest in the debtor’s assets. Id. at 497. The only way for an unsecured creditor to gain a right to those assets would be by executing on a money judgment. The Court nevertheless reasoned that the receivership was merely a way to preserve assets so that those assets would be available to satisfy a later money judgment. Id. Because the creditor still needed the later money judgment actually to reach the assets, the receivership itself was not a “substantive” right.

Of course, the Court could just as easily have concluded that the creditor’s power to prevent transfer of the debtor’s assets was itself a new substantive right, especially given some the Court’s earlier precedent. In Clark, Holland, and Reynolds, the Court had held that state laws defining what constituted a cloud on a title were matters of right. The Court’s attempt to distinguish these cases in Pusey is not at all convincing. Like Clark and Holland, the state law at issue in Pusey extended a new right to a party who historically could not bring such an action.

55. 304 U.S. 64, 58 S. Ct. 817 (1938).

56. Id. at 78, 58 S. Ct. at 822 (“There is no federal general common law.”).

57. Id. at 77-78, 58 S. Ct. at 822 (“If only a question of statutory construction were involved, we should not be prepared to abandon a doctrine so widely applied throughout nearly a century. But the unconstitutionality of the course pursued has now been made clear, and compels us to do so.”).
The Court took only one week to confirm that Erie applied to equity. *Ruhlin v. New York Life Insurance Co.* 58 was a suit in which an insurance company sought cancellation 59 of life insurance policies because of misrepresentations made by the insured. 60 Although the policy had an incontestability clause barring any such challenge, some pre-Erie federal cases, applying general commercial law, had held those incontestability clauses inapplicable to the specific policy provisions at issue in *Ruhlin.* 61 Both the trial and appellate courts had applied this general rule. 62 The Supreme Court remanded the case with instructions to apply state law. 63 Discussing Erie, the Court stated, "'[t]he doctrine applies though the question of construction arises not in an action at law, but in a suit in equity.'" 64

Actually, *Ruhlin* was not that dramatic a departure from the pre-Erie approach. As noted above, federal courts in equity already applied state law on questions of right. 65 The underlying issue in *Ruhlin,* whether a contract provision would be enforced, was clearly a matter of right, not remedy. Had the state law been set out in a statute, a federal equity court would have applied it even before Erie. The twist in *Ruhlin* was that the state law was contained in judicial decisions, not a statute. Thus, the "doctrine" that *Ruhlin* borrows from *Erie* is the notion that state law includes state-court precedent. After Erie, a federal court must look to both statute and case law to determine the litigants' respective rights.

*Ruhlin* left unanswered the more important question of whether Erie also required use of state laws governing remedy. That issue came before the Court almost exactly one year later. Like *Ruhlin,* *Atlas Life Insurance Co. v. W.I. Southern, Inc.* 66 was a suit to cancel life insurance policies based on misrepresentations by the insured. The trial court dismissed the action for cancellation because it found the insurance company's common-law remedy to be adequate. 67 Oklahoma law allowed an insurance company sued in common law to assert the fraud as a defense to a claim under the policy and to bring a counterclaim to cancel the policy. 68 In fact, a common-law action on the policy was already pending in state court. 69 If that state-court action was an adequate remedy at law, the trial court's decision was correct.

58. 304 U.S. 202, 58 S. Ct. 860 (1938).
59. This article will use the technical term "cancellation" instead of the more commonplace term "rescission" for the sake of precision. Historically, there were two separate remedies of rescission, one available in equity and the other at common-law. The common-law remedy was unilateral, while the remedy in equity required court intervention. *See generally* Dan B. Dobbs, Law of Remedies 415 (2d ed. 1993).
60. 304 U.S. at 203, 58 S. Ct. at 860.
61. *Id.* at 204-05, 58 S. Ct. at 860-61.
62. *Id.*
63. *Id.* at 206, 58 S. Ct. at 861.
64. *Id.* at 205, 58 S. Ct. at 861.
65. *See supra* text accompanying notes 50 to 51.
67. *Id.* at 567, 59 S. Ct. at 659.
68. *Id.*
69. *Id.* at 566, 59 S. Ct. at 659.
However, the Court was faced with the long-established rule, discussed above, that a federal court of equity was ousted of jurisdiction only by legal remedies available in federal court. The Court could have disposed of the case simply by holding that because Erie required the federal court to apply the state-law legal remedy, that remedy was now available in federal court. It opted instead for a more oblique approach. In a somewhat tortured argument, the Court concluded that although the state legal action did not deprive the federal court of equitable jurisdiction, it undermined the plaintiff's case for equitable relief. Cancellation is available, the Court reasoned, only when the party would otherwise suffer irreparable injury. If the insurance company could interpose fraud as a defense in the pending state-court case, it faced no risk of irreparable injury. The Court therefore remanded to allow the lower court to determine if any special circumstances might prevent the insurance company from making full use of the fraud defense in the state-court action. Assuming no such circumstances, the federal court's initial decision to deny equitable relief would be upheld.

Atlas Life, then, did not completely reject the pre-Erie rule that adequacy of legal remedy was to be determined only by reference to the legal remedies available in federal court. Although a federal court now had to consider how the case would be treated in the state system, the outcome in state court was a factor only in determining whether the federal court should grant a particular remedy, not on the more fundamental issue of whether the federal court could sit in equity. More significantly, the Court indicated in dictum that federal equity jurisdiction remained a purely federal matter controlled by federal statute:

The "jurisdiction" thus conferred on the federal courts to entertain suits in equity is an authority to administer in equity suits the principles of the system of judicial remedies which had been devised and was being administered by the English Court of Chancery at the time of the separation of the two countries. This clause of the statute does not define the jurisdiction of the district courts as federal courts, in the sense of their power or authority to hear and decide, but prescribes the body of doctrine which is to guide their decisions and enable them to determine whether in any given instance a suit of which a district court has jurisdiction as a federal court is an appropriate one for the exercise of the extraordinary powers of a court of equity.

That language suggests that national equitable rules determine not only whether a federal court can sit in equity, but also how it disposes of a given case.

70. See supra note 36 and accompanying text.
71. Taking this task would have required the federal court to modify its procedure to the extent necessary to allow at least the defense of fraud to be asserted in the common-law action.
72. 306 U.S. at 570, 59 S. Ct. at 660 (citations omitted).
73. Id. at 572, 59 S. Ct. at 661.
74. Id. at 568, 59 S. Ct. at 651-60 (emphasis added).
Three other decisions rendered in the immediate wake of Erie confirm this reading of Atlas. In Sprague v. Ticonic National Bank, the Court upheld a federal court’s award of attorney’s fees and costs to a litigant in equity. The Court supported the ruling by reference to the “recognized power of equity” to grant such remedies, without even considering whether state law would allow recovery of fees. Shortly thereafter, Russell v. Todd upheld a lower court’s use of laches in a case seeking equitable relief, even though the state statute of limitations had expired. Although Sprague and Russell involved claims arising under a federal statute, both cases support the general notion that there exists a uniform body of federal equity rules.

Kelleam v. Maryland Casualty Co. applied that reasoning to a suit arising under state law. In this case a surety under a bond brought a diversity action in federal court against its principal, the administrator of an estate. Distribution of that estate had already been challenged in state court. The surety had come to federal court seeking appointment of a receiver for the estate assets pending resolution of the state-court proceeding. The Supreme Court held that receiverships were unavailable in this sort of situation, citing a series of federal court cases. The Court found it irrelevant that state law allowed for a receiver. Quoting from a pre-Erie decision, the Court merely noted that “a remedial right to proceed in a federal court sitting in equity cannot be enlarged by a state statute.”

One other decision from this period warrants a brief mention. Although it is not cast in terms of a clash between state and federal law, Meredith v. City of Winter Haven affords considerable insight into the Court’s views concerning the unique powers of federal equity. Meredith dealt with abstention. It held that a federal court may not abstain in a diversity case merely because state law is unclear. The Court distinguished a number of its earlier decisions allowing abstention by noting that those cases involved “the discretionary powers of courts

76. Id. at 166, 59 S. Ct. at 779-80.
77. 309 U.S. 280, 60 S. Ct. 527 (1940).
78. 312 U.S. 377, 61 S. Ct. 595 (1941).
79. Id. at 378, 61 S. Ct. at 596-97.
80. Id.
81. Id. at 379, 61 S. Ct. at 597.
82. Id. at 381, 61 S. Ct. at 598. These decisions were based on the rationale that a receivership is a remedy that is ancillary to another remedy, not an end in itself.

The surety had also requested an order exonerating it from liability on the bond, based on alleged fraudulent acts committed by the administrator. The Supreme Court’s order of reversal also applied to the trial court’s order of exoneration. Id. at 379, 61 S. Ct. at 597. The Court disposed of the exoneration question in short order. It noted that the right to exoneration is contingent, becoming available only if the state court were to determine that the estate had been distributed to the wrong people. Id. at 380, 61 S. Ct. at 597-98. Because exoneration was not yet available, the Court treated the receivership as the “essential purpose” of the case. Id.

83. Id. at 381-82, 61 S. Ct. at 598-99.
84. Id.
85. 320 U.S. 228, 64 S. Ct. 7 (1943).
86. Id. at 236, 64 S. Ct. at 11-12.
of equity." Unlike Meredith, all of those earlier cases involved considerations of federalism that made the federal courts hesitant to exercise their broad authority in equity. It is interesting to note, however, that those federalism concerns would not have caused most state courts of equity to dismiss the case. Therefore, Meredith tacitly established that a federal court of equity may dismiss a case—effectively refusing to grant any relief—notwithstanding that state tribunals would hear the case and afford relief to the claimant.

On the eve of York, then, Erie had caused only a minor disruption in federal equity. Notwithstanding Erie's bold statements about the federal courts' lack of any general lawmaking authority, and the extension of that principle to equity in Ruhlin, the Court still indicated that federal courts in equity retained independent authority in questions of remedy. In deciding what remedy to grant in a particular case, courts were to apply a uniform body of federal rules, not state law.

C. York

Guaranty Trust Co. v. York was a diversity action brought by the beneficiary of a trust against the trustee. An action to enforce a duty arising from a trust was within traditional equity jurisdiction. The plaintiff asked the court to order an accounting, a traditional equitable remedy. The trial court granted summary judgment for the defendant, concluding that because the particular arrangement did not constitute a trust, the plaintiff was not entitled to any relief. The Second Circuit reversed. It first found that the arrangement did constitute a trust. The appellate court then rejected the defendant's alternate contention that the action was barred by the New York statute of limitations. Although acknowledging the New York statute, the Court of Appeals held that the limitations period should be extended because of the defendant's inequitable conduct. In answer to the defendant's argument that Erie required the federal court to apply the New York statute as written, the Court held that because laches was a question of

87. Id. at 235-36, 64 S. Ct. at 11-12.
88. Id. Although Meredith itself was also a case in equity, the only reason the district court gave for abstaining was the ambiguity in state law, not any of the policy reasons cited with approval by the Court.
90. The underlying dispute was highly complicated, and is described in great detail in the appellate court's opinion. York v. Guaranty Trust Co., 143 F.2d 503, 505-12 (2d Cir. 1944), rev'd, 326 U.S. 99, 65 S. Ct. 1464 (1945).
91. Id. at 525. See generally Henry L. McClintock, Handbook of the Principles of Equity 102 (2d ed. 1948).
92. 143 F.2d at 512.
93. Id.
94. Id. at 528.
95. Id. at 521. New York had two potentially applicable statutes of limitations. In a state court, the action against the trustee could be brought in common-law, in which case it would be governed by a six-year limitations period. Id. New York also had a ten-year statute of limitations that applied to actions exclusively within equity jurisdiction. Id. Both limitations periods had expired before plaintiff brought the action.
remedy, not right, *Russell v. Todd*\(^6\) required the federal court to apply national law.\(^7\)

The Supreme Court reversed, relying solely upon the statute of limitations. The Court first confirmed that *Erie* applied in equity notwithstanding that the Rules of Decision Act referred only to common law.\(^8\) The Court then turned to the narrower question of whether a federal court in equity was bound to honor a state statute of limitations. It began by reaffirming the basic distinction between right and remedy, restating the argument it had used in *Atlas Life*.\(^9\) Equity is different than common-law, the Court reasoned, even in the context of *Erie*. When it gave federal courts jurisdiction over equity in the Judiciary Act of 1789, Congress intended to create a system much like traditional English Chancery. The essence of that system was the freedom of the courts to exercise discretion in determining appropriate relief for a wrong. In addition to copying the basic structure of equity, Congress also transplanted to the United States the set of rules and principles that applied in the English Court of Chancery.\(^10\) Accordingly, a federal court in equity was not bound by state law governing equitable remedies:

This does not mean that whatever equitable remedy is available in a State court must be available in a diversity suit in a federal court, or conversely, that a federal court may not afford an equitable remedy not available in a State court. Equitable relief in a federal court is of course subject to restrictions: the suit must be within the traditional scope of equity as historically evolved in the English Court of Chancery, a plain, adequate and complete remedy at law must be wanting, explicit Congressional curtailment of equity powers must be respected, the constitutional right to trial by jury cannot be evaded. That a State may authorize its court to give equitable relief unhampered by any or all such restrictions cannot remove these fetters from the federal courts. State law cannot define the remedies which a federal court must give simply because a federal court in diversity jurisdiction is available as an alternative tribunal to the State's courts. Contrariwise, a federal court may afford an equitable remedy for a substantive right recognized by a State even though a State court cannot give it.\(^11\)

At the same time, however, the Court indicated that state law still controlled the parties’ basic rights:

In giving federal courts “cognizance” of equity suits in cases of diversity jurisdiction, Congress never gave, nor did the federal courts ever claim,

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96. 309 U.S. 280, 60 S. Ct. 527 (1940). *Russell* is discussed *supra* at text accompanying note 77.
97. 143 F.2d at 522-23.
98. 326 U.S. at 102-05, 65 S. Ct. at 1466-68.
99. *Atlas Life* is discussed *supra* at text accompanying notes 66 to 74.
100. 326 U.S. at 105, 65 S. Ct. at 1467-68.
101. *Id.* at 105-06, 65 S. Ct. at 1468-69 (citations omitted).
the power to deny substantive rights created by State law or to create substantive rights denied by State law.\textsuperscript{102}

In essence, the Court confirmed that the right/remedy approach employed in the early cases was the proper measure of federal judicial authority in equity.

However, York presented a twist on the right-remedy problem. State law clearly gave beneficiaries of a trust the right to sue their trustee. However, that right was subject to the statute of limitations. Once the limitations period expired, the beneficiaries could no longer obtain relief in any state court, including a state court of equity.\textsuperscript{103} If a federal court ignored the limitations period and granted any relief, it would effectively create a new substantive right for the plaintiff, enforceable only in federal court. By that measure, the New York statute of limitations was undeniably a matter of right instead of remedy.

However, the Court was also faced with a considerable volume of precedent holding that statutes of limitation were “remedial” or “procedural.” Noting that these cases involved issues such as retroactivity and choice of law,\textsuperscript{104} the Court found them easily distinguishable. It reasoned that the policies underlying retroactivity and choice of law were quite different than the federalism concerns involved in \textit{Erie}. This discussion of the goals of \textit{Erie} led to the Court’s well-known “outcome determinative” test. Because one of the purposes of \textit{Erie} was to ensure that the outcome of a given suit be substantially the same regardless of whether it was litigated in federal or state court,\textsuperscript{105} a rule would be considered procedural—and therefore governed by a uniform federal rule—only if it would not materially affect the outcome. According to that logic, the New York statute of limitations that barred the action was clearly substantive.\textsuperscript{106}

Although the \textit{York} Court did require the lower court to apply the particular state law in question, the language of the opinion generally ratifies the approach used in equity both before and immediately after \textit{Erie}.\textsuperscript{107} The main impact was the

\textsuperscript{102} Id. at 105, 65 S. Ct. at 1468. Later in the opinion, the Court restated this basic premise: [T]he body of adjudications concerning equitable relief in diversity cases leaves no doubt, that the federal courts enforced State-created rights if the mode of proceeding and remedy were consonant with the traditional body of equitable remedies, practice, and procedure, and in so doing they were enforcing rights created by the States and not arising under any inherent or statutory federal law.

\textsuperscript{103} Id. at 108, 65 S. Ct. at 1468. The Supreme Court did not decide whether the New York courts would actually invoke the statute to bar the action, id. at 101, 65 S. Ct. at 1465, but remanded to the appellate court for that determination.

\textsuperscript{104} Id. at 107-08, 65 S. Ct. at 1470.

\textsuperscript{105} Id. at 109, 65 S. Ct. at 1472.

\textsuperscript{106} As indicated in \textit{supra} note 95, New York had two potentially applicable limitations periods—a six-year period for common-law actions, and a ten-year period for actions in equity. The Court never indicates which limitations period applied. Therefore, the decision does not answer the question of whether a state’s classification of an action as common-law or equitable binds a federal court for purposes of selecting an appropriate statute of limitations.

\textsuperscript{107} Although the majority opinion questions the language of some of the earlier equity cases, it indicates that the holdings in those cases were sound, with the possible exception of \textit{Kirby v. Lake}}
Court’s new definition of procedure. Regardless of how mundane its topic, a state rule that would completely bar recovery on a claim in all state courts must be applied by a federal court that is adjudicating that same claim. Even if that state rule looks procedural, *Erie* requires a federal court to follow it if has the effect of terminating a substantive right. On the other hand, as long as a state court would afford some relief on a claim, a federal court in equity can enforce that claim in accordance with its own set of national equity practices.

D. Holmberg v. Armbrrecht

The Court revisited *Erie*’s effect on equity during its next term. *Holmberg v. Armbrrecht*\(^ {108} \) also dealt with the extent to which state statutes of limitations applied in federal equity. As in *York*, the statutory period established by state law had already expired.\(^ {109} \) Unlike *York*, however, the underlying claim in *Holmberg* arose under a federal statute.\(^ {110} \) The Court found that difference crucial. In a case such as *York* where the claim arose under state law, the state statute of limitations forms a crucial element of the underlying right. Applying the state statute of limitations was necessary to ensure that the federal court reached the same outcome as the state courts. The Court declared that these considerations were “hardly relevant” when the underlying right was one provided by Congress.\(^ {111} \) In federal statutory cases, Congress had left to the federal courts the task of ascertaining an appropriate limitations period, which might or might not mirror the state statute of limitations.\(^ {112} \)

However, the Court again had to deal with adverse precedent. In several of its earlier decisions, the Court had required lower federal courts to apply state limitations periods even when dealing with claims arising under federal statutes.\(^ {113} \) The Court distinguished that precedent by noting that unlike those cases, the case before it was in equity.\(^ {114} \) Determining the limitations period for a federal statutory claim was, the Court reasoned, really a question of Congress’s intent. In statutory actions heard in common-law courts, congressional silence was normally interpreted as a command to borrow the closest state limitations period.\(^ {115} \) However, when Congress chose to create a right that could be enforced in equity, the considerations were completely different. By sending its newly-created right

\(^ {109} \) Id. at 393-94, 66 S. Ct. at 583.
\(^ {110} \) Id. at 395, 66 S. Ct. at 584.
\(^ {111} \) Id. at 395, 66 S. Ct. at 584.
\(^ {112} \) Id. at 395, 66 S. Ct. at 584.
\(^ {113} \) Id.
\(^ {114} \) Id.
\(^ {115} \) Id.
to equity, Congress must have intended that it be enforced with the flexibility and judicial discretion that are the hallmark of equity, not by "mechanical rules" that may have been established by the states. Therefore, Congress must have meant for courts adjudicating these new statutory equitable rights to apply the flexible doctrine of laches. The Court accordingly remanded the case with instructions to determine whether the claim was barred by laches.

Taken together, York and Holmberg suggest a broad equity exception to Erie. There is a uniform national law of equity, made up of the traditional rules that governed English Chancery. In a federal question case like Holmberg, these traditional principles apply instead of state law on most issues that may arise. Even when the underlying substantive right arises under state law, York suggests that the traditional principles apply in lieu of state law as long as the federal court does not create new substantive rights or fundamentally alter existing rights.

E. Interpreting York and Holmberg

York and Holmberg are the last Supreme Court opinions that deal directly with how Erie applies in equity. However, the Erie doctrine has changed in certain significant ways over the past half-century. Whether the Court's broad statements about federal equity survive these new developments is a difficult question. Because of the dearth of Supreme Court precedent directly on point, the burden of answering that question has fallen upon the lower courts and the commentators.

The court decisions that involve an actual conflict between state and federal law are split. Most federal courts, including the Second, are split. Most federal courts, including the Second, 121

116. Id. at 396, 66 S. Ct. at 585.
117. Id. at 395-96, 66 S. Ct. at 585.
118. Id. at 397-98, 66 S. Ct. at 587.
119. On the other hand, just three years after reshaping Erie in Hanna, the Court indicated in dictum that the question was still open. Stern v. South Chester Tube Co., 390 U.S. 606, 88 S. Ct. 1332 (1968), was a shareholder's derivative action litigated in federal court on the basis of diversity. The plaintiff sought an order requiring the corporation to open its books for inspection. The lower court denied this request based on federal precedent indicating that courts would not grant these orders when they were the only relief sought by the plaintiff. The Supreme Court reversed because it found a clear right to such an order in state law. The Court expressly indicated that it was not facing the question of whether the federal court could grant such an order if state law did not allow it. Id. at 609-10, 88 S. Ct. at 1334.
120. Absent a conflict between state and federal law, Erie is for all practical purposes a moot point. For this reason, one can immediately disregard the several cases that "select" state or federal law in equity, even though both rules would produce the same outcome. See, e.g., Bogosian v. Woollohojian Realty Corp., 923 F.2d 898 (1st Cir. 1991) (allows federal court to order a buyout in a corporate dissolution case; court assumes "for the sake of argument" that state law controlled); Friends for All Children, Inc. v. Lockheed Aircraft Corp., 746 F.2d 816, 828 n.18 (D.C. Cir. 1984) (applies District of Columbia law, but predicts that law would employ the same general principles that federal equity courts use); Franke v. Wiltschek, 209 F.2d 493 (2d Cir. 1953) (applies state law to determine whether injunction should issue, but calls the question "academic" because of the absence of any conflict); Paramount Pictures Corp. v. Holden, 166 F. Supp. 684 (S.D. Cal. 1958) (specific performance).
121. Perfect Fit Indus., Inc. v. Acme Quilting Co., 646 F.2d 800 (2d Cir. 1981) (federal court may issue a recall order even if state courts cannot).
Fifth, and Seventh circuits, as well as several district courts, have relied on York to hold that a federal court in equity is not bound by state rules dealing with equitable procedure and remedies. The Third Circuit has agreed with this conclusion in dictum. On the other hand, virtually all courts look to state law for the rules governing the equitable defenses of laches and unclean hands.

The Ninth Circuit and a few district courts go even further, requiring the use of state law even on matters of remedy. Some of these courts give no reason for

122. Clark Equip. Co. v. Armstrong Equip. Co., 431 F.2d 54 (5th Cir. 1970), reh'g denied, 434 F.2d 1039, cert. denied, 402 U.S. 99, 91 S. Ct. 1319 (1971) (federal court may order a debtor to assemble equipment covered by a security interest even though a state court would require a creditor to seek such relief in detinue); Humble Oil & Ref. Co. v. Sun Oil Co., 191 F.2d 705 (5th Cir. 1951), cert. denied, 342 U.S. 920, 72 S. Ct. 368 (1952) (state statute establishing a new action at law does not preclude a federal court from enforcing the underlying right in equity).

123. General Elec. Co. v. American Wholesale Co., 235 F.2d 606 (7th Cir. 1956) (preliminary injunction governed by federal law). The Seventh Circuit's more recent opinion in Hayes v. Allstate Ins. Co., 722 F.2d 1332 (7th Cir. 1983) does not overturn General Electric. Although the court in Hayes did deny relief to the plaintiff based upon state law, the state law in question dealt with not with the remedy, but with the underlying substantive right. Even before Erie federal courts in equity looked to state law to determine the relative legal rights of the litigants.


125. Zippertubing Co. v. Teleflex, Inc., 757 F.2d 1401 (3d Cir. 1985) (state rule providing that an order of accounting is available only in cases where the party also seeks an injunction does not prevent a federal court from granting an order of accounting even where no injunction is sought; discussion is dictum as the court expresses doubt as to whether such a state-law limitation on accounting orders actually exists).

126. The decisions dealing with equitable defenses are legion. For a small sample of the more recent decisions dealing with laches, see Steiner Corp. v. Johnson & Higgins of Cal., 135 F.3d 684 (10th Cir. 1998); Rogers v. Office of Personnel Management, 87 F.3d 471 (Fed. Cir. 1996), reh'g denied; Goodman v. Lee, 78 F.3d 1007 (5th Cir. 1996), cert. denied, 519 U.S. 861, 117 S. Ct. 166 (1996); Landreth v. First Nat'l Bank of Cleburne County, 45 F.3d 267 (8th Cir. 1995); Maksym v. Loesch, 937 F.2d 1237 (7th Cir. 1991), reh'g denied; Johns v. Rozet, 141 F.R.D. 211 (D.D.C. 1992); for cases dealing with unclean hands, see In re Omegas Group, Inc., 16 F.3d 1443 (6th Cir. 1994); Foy v. Klapmeier, 992 F.2d 774 (8th Cir. 1993); Stephens, Inc. v. Gedermann, Inc., 962 F.2d 808 (8th Cir. 1992). Most of these decisions apply state law without even considering whether that law differs from the federal rule.

resorting to state law. Most of the other decisions conclude that because differences in remedy directly affect the outcome of litigation, the Supreme Court's later *Erie* cases mandate use of state law.

Two cases take a middle ground. Although citing the language in *York* suggesting that *Erie* does not apply to most questions of equitable remedies, these courts nevertheless apply state law governing a preliminary injunction. Both courts conclude that because a preliminary injunction is inextricably intertwined with the substantive right, denying the remedy would be akin to refusing to recognize the right. This reasoning mirrors the "right-remedy merger" concept first established in the 1851 *Clark v. Smith* case.

Two leading commentaries conclude that when the underlying right arises under state law, state law controls even on questions of equitable remedy. In an article dealing mainly with preliminary injunctions, Professor Crump argues that federal courts should ordinarily turn to state law to determine when relief should be granted. Professors Wright, Miller, and Cooper devote a section of their Treatise to the more general question of equitable remedies. They too reject the dictum in *York*, concluding that more recent Supreme Court cases require a federal court to apply state rules governing equitable remedies. In their opinion, federal courts can apply a federal law of remedies only when hearing a claim arising under a federal statute or when the remedy is contained in a rule promulgated under the Rules Enabling Act. Like Professor Crump, however, they concede that there might be "exceptional cases" in which a federal court sitting in diversity could

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128. Genovese, 563 F. Supp. at 1304 (court merely cites *Perfect Fit*, which actually held to the contrary, and *Franke*, in which the discussion was dictum as there was no conflict); *Anglo-American Investment*, 294 F. Supp. at 1153 (court cites *Goldman v. Henry's Drive In, Inc.*., 314 F.2d 162 (7th Cir. 1963), where the parties had agreed that state law controlled).

129. Sims, 863 F.2d at 646-47; *Halchak*, 71 F. Supp. at 226; *Standard Brands*, 264 F. Supp. at 263 n.16.


133. David Crump, *The Twilight Zone of the Erie Doctrine: Is There Really a Different Choice of Equitable Remedies in the "Court a Block Away?"* 1991 Wis. L. Rev. 1233, 1272-73. He cites Federal Rule of Civil Procedure Rule 65, which governs temporary restraining orders and preliminary injunctions, as the main exception. Because that rule was promulgated under the Rules Enabling Act, 28 U.S.C. § 2072 (1990), it is subject to a different standard than would apply to most federal judge-made law in equity. Therefore, Professor Crump may not be willing to concede that a federal court's inherent power to fashion rules in equity is limited to those few rules that would not cause forum-shopping.


135. *Id.* at 446.

136. *Id.* at 442-46.
apply different equity rules than a state court, as long as the final result was "consistent with the state-created rights of the parties."\(^{137}\)

The remainder of this article will argue that *York* and *Holmberg* are good law. Federal courts have an inherent power to create their own rules for equity cases, even if those rules differ from state law. Although the breadth of federal judge-made law in equity is much greater in a federal question case like *Holmberg* than in a state-law case like *York*, federal courts in both instances may apply their own rules even if it would directly change the ultimate outcome of the case.

The problem with the arguments against a special federal power in equity is that the analysis tends to be incomplete. More specifically, these courts and commentators assume that a judge-made federal rule of equity is valid only to the extent that it can be traced to a federal court's inherent power to regulate its own "procedure." By limiting the discussion to procedure, they have failed to consider other possible sources for an independent federal equity. Once these other possibilities are taken into account, it becomes apparent that there is a valid federal judge-made body of law in equity.

## II. RECONCILING FEDERAL EQUITY WITH ERIE

The Supreme Court's discussions of a separate and independent body of federal equity law in *York* and *Holmberg* seem difficult to square with the basic axiom of *Erie*. Under *Erie*’s "new way of looking at law,"\(^ {138}\) no legal rule is valid unless it can be traced to a sovereign with legislative jurisdiction over the subject of the rule. Unlike state courts, federal courts have no general lawmaking power. Accordingly, in most cases federal courts have no choice but to use state law or a federal statute.

Of course, *Erie* did not completely strip the federal courts of lawmaking authority. *York* itself recognizes that the federal courts may create a body of federal procedural law.\(^ {139}\) Later Supreme Court cases have refined *York*’s test for determining whether a particular federal judge-made rule qualifies as a rule of procedure.\(^ {140}\) In addition, in certain areas federal courts have the power to craft even the rules that define the basic rights and obligations of the litigants.\(^ {141}\) If federal equity rules fall within either the procedural or substantive categories of

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139.  Read literally, *York* actually suggests that federal courts may craft procedural rules only when they sit in equity. The portion of the opinion discussing procedural rules, *Id.* at 108-09, 65 S. Ct. at 1469-70, follows the section dealing with the special powers of a court of equity, *Id.* at 104-07, 65 S. Ct. at 1467-69. The Court never clearly states that federal courts have the power to craft rules of procedure when they sit in common law. Nevertheless, later Supreme Court cases make it clear that a federal court also has the authority to govern its own procedure in common-law cases. See, e.g., Hanna v. Plumer, 380 U.S. 460, 85 S. Ct. 1136 (1965) (tort damages action).

140.  See *infra* discussion at text accompanying notes 142 to 144.

141.  See *infra* discussion at text accompanying notes 152 to 164.
federal judge-made law, a federal court may apply them notwithstanding a contrary state rule.

A. Procedural Federal Judge-Made Law

1. Basic Principles

The great majority of the Supreme Court’s *Erie* decisions deal with the issue of procedure. Of these, the most significant is *Hanna v. Plumer*, which established a framework for analyzing all questions of procedure. *Hanna*’s most notable feature is its recognition that there are actually two separate bodies of federal procedural judge-made law. The first category, exemplified by *Erie*, *York*, and most of the other pre-*Hanna* cases, is where a court simply crafts the rule of its own volition. *Hanna* not only reaffirmed *York*’s unstated assumption that federal courts have the inherent authority to regulate their own procedure, but also reshaped the analysis used to measure the validity of these “inherent” procedural rules. Realizing that *York*’s crude outcome determinative test was unworkable, the *Hanna* Court incorporated the concept of forum-shopping, resulting in the “twin aims/likely to cause forum shopping” test that remains the mainstay of the analysis today. Under this test, a federal judge-made rule is truly procedural, and therefore valid, if it is not likely to cause the litigants to choose their forum based on the effect that differing state and federal rules would have on the outcome of the case.

The Court did not, however, apply that test to the federal rule at issue in *Hanna*. The rule in that case actually fell into the second category of valid judge-made procedural law. The Federal Rules stem from the Rules Enabling Act, by which Congress delegated lawmaking authority to the Supreme Court. If that delegation was proper, and the rule in question fell within the scope of the delegation, the rule would constitute a valid federal law that would control in federal litigation.

The Court upheld the federal service rule at issue in *Hanna*. In so doing, the Court established three important principles. First, it held that Congress has the constitutional authority to regulate procedure in the federal courts. Second, it confirmed its earlier holding in *Lincoln Mills* that Congress can delegate some of...
its legislative powers to the federal courts. Third, it indicated that the test for the validity of a rule promulgated pursuant to a congressional delegation is not the restrictive "likely to cause forum shopping" analysis that applies to the court's inherent power to promulgate procedural rules, but instead whether the promulgated rule fits within the scope of the delegation. In the case of the Rules Enabling Act, the Court concluded that the rule is valid as long as it truly regulates practice and procedure, and does not "abridge, enlarge, or modify" a substantive right. Whether that rule might change the outcome, and thereby induce forum shopping, is irrelevant.

2. Applying These Principles to Equity

Most discussions of Erie and equity focus on whether rules of equity fit within the federal courts' inherent power to govern their own procedure. Clearly, the expansive federal judge-made law of equity envisioned by York and Holmberg cannot survive Hanna's test for inherent procedural rules. Differences in the remedies available in state and federal courts would unquestionably lead to forum shopping, as the desire for certain relief is the main reason people go to court.

The leading commentators also consider the extent to which rules of equity might be justified as an exercise of delegated lawmaking power. The few Rules Enabling Act rules that deal with equitable matters, such as Federal Rules of Civil Procedure 62 and 65, are valid exercises of the Supreme Court's delegated authority. But the vast majority of the corpus of federal equity law was not—and probably could not be—promulgated by the Supreme Court under that Act. Therefore, the Rules Enabling Act cannot support a system of federal equity law as wide-ranging as that suggested in York and Holmberg.

Thus, the judges and commentators who conclude that the rules that comprise federal equity go far beyond the federal courts' power to regulate procedure are undoubtedly correct. But that conclusion does not end the matter. The Supreme Court has on many occasions sustained judge-made federal laws that were unquestionably substantive under either of Hanna's tests. A complete analysis should also consider whether the broad scope of federal equity envisioned by York qualifies as substantive federal judge-made law. As none of the discussions to date


This delegation theory also provides a satisfactory answer to the separation of powers issues raised by Erie. Federal judge-made law is not necessarily valid even when it regulates a matter within Congress's Article I powers. Instead, Erie strongly reaffirms the notion that the Constitution vests the federal legislative power exclusively in Congress, not the courts. On the other hand, if Congress delegates that power to the courts, any law crafted pursuant to that delegation presents no separation of powers problems.


149. Sims Snowboards, Inc. v. Kelly, 863 F.2d 643, 646-47 (9th Cir. 1988); Wright et al., supra note 134, at 446.

150. Wright et al., supra note 134, at 442-44; Crump, supra note 133, at 1266-67.
even considers that possibility, it is necessary to explore this uncharted territory in some detail.

B. Substantive Federal Judge-Made Law

1. Basic Principles

On the same day it released *Erie*, the Supreme Court delivered its opinion in *Hinderlider v. La Plata River & Cherry Creek Ditch Co.* In a unanimous opinion written by Justice Brandeis (who also wrote *Erie*), the Court held that federal precedent, not state, controlled how water in an interstate stream should be apportioned. Although the opinion never uses the magic label "federal common law," it clearly proceeds from the premise that the federal courts may define and apply a uniform national law that differs from state law. *Hinderlider* was merely the first in a long string of Supreme Court decisions that have applied federal judge-made rules on issues that are clearly substantive.

An analysis of substantive federal judge-made law can proceed along the same basic lines as an analysis of procedural rules. On certain issues, federal courts have an inherent power to define the substantive law. Moreover, Congress may delegate portions of its lawmaking authority to the federal judiciary. Regardless of whether it stems from a court's inherent power or from a delegation by Congress, federal substantive judge-made law overrides state law and governs the rights of the parties.

151. Admittedly, it is easy to understand why the discussion of how *Erie* applies in equity has focused entirely on the question of procedure. Many of the rules of equity appear procedural. In addition, even *York* itself seems to imply a connection between equitable remedies and federal procedure, see *supra* note 139. The natural implication is that equitable remedies are somehow procedural in nature.

152. 304 U.S. 92, 58 S. Ct. 803 (1938).

153. Justice Cardozo did not participate.

154. *Hinderlider*, 304 U.S. at 101-02, 58 S. Ct. at 806. The state law in question was a Colorado decree that applied a contrary rule.


156. All of the cases cited in the prior footnote except for *Illinois* are examples of the federal courts' inherent power.


In this respect, substantive federal judge-made law is quite different from the federal procedural rules discussed above. Federal procedural rules ordinarily apply only to litigation in the federal courts. The only situation in which state courts must follow federal procedure is when that procedure is an integral part of a federal substantive right, see, e.g., *Dive v. Akron, Canton & Youngstown R. Co.*, 342 U.S. 359, 72 S. Ct. 312 (1952) (even though the seventh amendment to the Constitution does not apply to the states, a state court hearing a claim under the Federal Employers' Liability Act must provide a jury).
Congress may delegate lawmaking authority to the courts in various ways. Although an express delegation analogous to the Rules Enabling Act is the most obvious possibility, Congress rarely expressly delegates to the courts the power to enact substantive law. Much more common is the implied delegation. Several courts have interpreted a federal statute as containing an unexpressed delegation of authority to enact those rules necessary to effectuate Congress's intent.

The typical implied delegation case involves a federal statute that contains no specific provision dealing with a key issue, thereby requiring the court to find some rule to fill the gap. Quite often, federal courts fill these gaps by grafting onto the statutory rights and duties certain traditional principles of judge-made law. In *American Society of Mechanical Engineers v. Hydrolevel Corp.*, for example, the Supreme Court held that an organization could be held vicariously liable for antitrust violations committed by its agent notwithstanding any language in the antitrust statute mentioning vicarious liability. Recognizing that Congress enacts legislation against the backdrop of judicial precedent, the Court concluded that absent some indication to the contrary, Congress intended for the federal courts to apply general legal concepts, such as secondary liability, when enforcing statutory rights. Although *Erie* declares that federal courts have no inherent power to create such a body of general rules, the federal courts may nevertheless look to the general body of law established by the English courts and the states as evidence of how Congress intended a particular statutory right to be enforced.

On the other hand, delegation need not always be directly linked to a substantive right created by Congress. The Supreme Court's most notorious—and potentially most expansive—delegation decision is *Textile Workers v. Lincoln Mills*. The particular federal statute in *Lincoln Mills* merely gave the federal courts jurisdiction over certain labor contracts. The Supreme Court nevertheless concluded that when it granted jurisdiction, Congress also delegated to the courts the power to create a body of federal substantive law to be used in cases decided

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159. *id.* at 569, 102 S. Ct. at 1944. In two other cases decided during the same period, Texas Indus. v. Radcliff Materials, Inc., 451 U.S. 630, 101 S. Ct. 2061 (1981), and Northwest Airlines, Inc. v. Transport Workers Union, 451 U.S. 77, 101 S. Ct. 1571 (1981), the Court refused to impose secondary liability. The Court distinguished those cases from *American Society* in a way that is directly pertinent to the thesis of this article. In both *Texas Industries and Northwest Airlines*, Congress had created an entirely new cause of action that had no close historical analogue. Because of the *sui generis* nature of the new substantive right, the Court refused to assume that Congress meant for the courts to augment the right by applying traditional principles of secondary liability. The Court was willing to make that assumption, however, in a case like *American Society*, where Congress created a cause of action similar to those that existed at common-law.
160. Federal courts will not always borrow from the general law when interpreting federal statutes. In *Desyvna v. Ballentine*, 351 U.S. 570, 76 S. Ct. 974 (1956), the Court had to determine the meaning of the term "children" in the federal copyright laws. The Court turned to state law for that definition. Because the states bear primary responsibility for laws regulating the family, the Court held that federal courts should use those state definitions rather than develop their own rule.
under that jurisdiction. Thus, the federal court did not have to rely on state law. Although no other case has gone quite this far, neither the holding nor the rationale of Lincoln Mills has ever been denounced by the Court.

2. Applying These Principles to Equity

a. Delegation

Given that no federal statute currently in force contains language that even remotely resembles an explicit delegation of authority to create a general body of federal equitable law, implied delegation is the only possibility. The first step in the search for an implied delegation is to pinpoint the federal statute that serves as Congress's vehicle for delegation. When Congress has created a new substantive right enforceable in a federal court of equity, the statute creating that right is the obvious candidate. But as Lincoln Mills demonstrates, courts will sometimes imply a delegation from a statute that does not create new rights. Because these two situations involve significantly different considerations, each will be addressed separately.

i. Claims Based on a Federal Statute

As discussed above, the Supreme Court held in Holmberg v. Armbrecht that federal courts need not apply state equity law to claims arising under a federal statute. The rationale of York, the Court reasoned, was inapposite when Congress

164. Id.
165. The Conformity Act, discussed supra at text accompanying notes 24 to 27, arguably gave the federal courts lawmaking authority in equity. That statute remained in force until 1948. At the time of the 1945 York decision, it read:

The forms of mesne process and the forms and modes of proceedings in equity and of admiralty jurisdiction in the district courts shall be according to the principles, rules, and usages which belong to courts of equity and of admiralty, respectively, except when it is otherwise provided by statute or by rules of court made in pursuance thereof; but the same shall be subject to alteration and addition by the said courts, respectively, and to regulation by the Supreme Court, by rules prescribed, from time to time, to any district court, not inconsistent with the laws of the United States.


Of course, as that statute is no longer in force, it is of little use in supporting a federal common law of equity today. Moreover, even if it were still in force, the Conformity Act could not serve as the foundation of a broad law of equity. The statute dealt only with the "process and the forms and modes of proceedings." Although this might support equitable procedural rules, it would not justify a separate federal set of remedies or equitable causes of action.

166. Of course, many federal statutes explicitly authorize equitable remedies such as injunctions in connection with particular causes of action. However, there is no general federal statute that explicitly gives the federal courts the power to grant equitable remedies in all cases within their jurisdiction.

created the substantive right. Notwithstanding the significant development in *Erie* jurisprudence since *Holmberg*, the holding of that case has remained largely unchallenged. Lower federal courts have applied federal equity rules to claims based on a federal statute with little concern for any *Erie* implications. Federal law clearly governs remedies. However, it may also apply to other matters. For example, federal courts routinely invoke the equitable defenses of laches and unclean hands when deciding whether equitable relief is available for a federal statutory claim, unless that defense interferes with Congress's purpose. The Supreme Court has also held that federal courts may graft ancillary, traditionally equitable, substantive rights such as contribution and indemnity onto federal statutory rights, as long as doing so would not undermine Congress's intent.

These cases are entirely consistent with *Erie*. *Erie* does not require a federal court to apply state law when there is valid federal law on point. The body of uniform equity rules that federal courts use in connection with federal statutory rights is legitimate federal law because it is created either by Congress itself or by the federal courts acting pursuant to a delegation of Congress's power.

To illustrate, consider what occurs when a new federal statutory right comes into being. Congress's power to create that substantive right includes the power to specify how that right will be enforced. However, Congress rarely drafts detailed rules governing every step of the enforcement process. Instead, it typically builds upon existing concepts, including the well-developed body of equity law.

Suppose, for example, that Congress creates a new statutory right, and specifies that a party who proves a violation of that right may obtain an injunction. Notwithstanding that straightforward language, courts will not grant an injunction merely upon a showing that the right has been violated. Instead, they will analyze several additional factors, such as public policy, adequacy of alternate common-law relief, and whether the defendant is guilty of laches or unclean hands, even though the statute makes no mention of these factors. When it included a term of art like "injunction" in its statute, the courts reason, Congress intended that the courts would interpret that term in light of well-established principles of equity.

168. *Id. at 395, 66 S. Ct. at 584.*
170. *In McKennon v. Nashville Banner Publ'g Co.*, 513 U.S. 352, 115 S. Ct. 879 (1995), the Court refused to allow an unclean hands defense because it found that the private right created by the federal statute served an important federal policy. Absent such considerations, however, federal courts typically do apply the doctrines of laches and unclean hands in federal question cases where the plaintiff seeks equitable relief. *See, e.g.*, *Saxon v. Blann*, 968 F.2d 676 (8th Cir. 1992) (copyright infringement); *Atari Games Corp. v. Nintendo of Am., Inc.*, 975 F.2d 832 (Fed. Cir. 1992), *reh'd denied*, 1992 U.S. App. LEXIS 30957 (counterclaim of copyright misuse); *Levi Strauss & Co. v. Shilon*, 121 F.3d 1309 (9th Cir. 1997) (trademark infringement); *Conopco, Inc. v. Campbell Soup Co.*, 95 F.3d 187, 191 (2d Cir. 1996) (false advertising and misrepresentation under 15 U.S.C. § 1125(a) (1994)).
172. Many statutes make this clear, *e.g.*, by expressly providing for an injunction or accounting "subject to the principles of equity," or with similar limiting language. *See, e.g.*, 15 U.S.C. § 1116.
Supreme Court stated in *Holmberg*, "When Congress leaves to the federal courts the formulation of remedial details, it can hardly expect them to break with historic principles of equity in the enforcement of federally-created rights." 173

Of course, all states have their own established principles of equity, which often differ in their particulars. But Congress did not intend for its new statutory right to incorporate the idiosyncracies of any single state’s law. Borrowing individual state rules of equity would lead to unequal enforcement of the federal right across the nation, which would usually frustrate Congress’s intent. 174 Instead, the equitable principles that Congress had in mind when it enacted the legislation are those traditional principles inherited from England. Those traditional principles constitute a separate federal judge-made law of equity that applies in lieu of an individual state’s laws in cases involving the federal statutory right. 175

If a federal court were simply divining the meaning of a particular word or phrase in a statute, the conclusion that state law does not control is hardly controversial. Even though it produces binding precedent, statutory interpretation is not the same as true judicial lawmaking. 176 However, a federal court’s power in equity may go well beyond interpretation. Supplementing a statutory cause of action with an ancillary right such as contribution, for example, clearly involves more than interpreting Congress’s wording. As Congress likely never considered these questions, the courts in these cases are actually making law.
This judge-made federal law is valid because it is promulgated pursuant to authority delegated by Congress. Rather than deciding for itself how the statute should be enforced, Congress left that issue to the courts. However, the courts do not have free rein to enforce the right however they might see fit. First, they are obligated to enforce it in a way that best carries out Congress’s intent. Second, as in the case of statutory interpretation, the courts are bound by the “backdrop” of the historic rules and limits of equity. Congress was willing to let the federal courts work out the details of how a right would be enforced only if the courts worked within well-established principles already familiar to Congress. As in statutory interpretation, these guiding principles are the general rules inherited from English Chancery, not the modern variants in force in a state that happens to have some connection to the case.

A federal statute may delegate the power to create rules of equity even when it does not explicitly authorize equitable relief. Many federal statutes create obligations, but do not provide details on how that obligation should be enforced. In these cases, a federal court may assume that Congress has delegated the task of determining what remedies are appropriate to enforce the new right. Those remedies often include equitable relief. As long as the federal court acts within the historic limits of equity, it is irrelevant whether the remedy it chooses is available under state law. Congress’s decision to allow its new right to be adjudicated in federal courts is an implied delegation of authority for that court to invoke its traditional equitable discretion.

Overall, then, there is a considerable body of federal equity law that applies in cases involving federal statutory rights. Federal statutes are enacted against a backdrop of case law, including the historic principles that governed equity. In addition to guiding a court when it interprets a statute, those principles define a court’s power to make rules to “fill the gaps” in the federal statute. As long as the court observes these guidelines, its gap-filling rules are valid, binding federal law, and are accordingly immune from Erie.

ii. Other Cases

Although it works quite well for federal statutory claims, the implied delegation argument is much weaker in cases where Congress did not create the substantive right. Congress delegates its legislative powers by statute. Had Congress intended to give the federal courts general lawmaking powers in equity,

it would have enacted a statute that applies to all equity cases that could be heard in federal court. The only statutes that come even close to meeting this requirement are the provisions granting the federal courts jurisdiction in equity. Therefore, the argument for an implied delegation in cases that do not involve a federal statutory right turns on whether the Lincoln Mills theory, under which a grant of jurisdiction includes a delegation of lawmaking power, can be applied to equity.

Extending Lincoln Mills to federal equity would clearly extend that theory beyond its breaking point. The jurisdictional statute involved in that case was a far cry from the broad grant of jurisdiction that Congress has given to the federal courts in equity. The statute in Lincoln Mills specifically applied only to labor contracts. Because labor contracts unquestionably affect interstate commerce, Congress itself would have had the authority to enact any of the substantive rules of contract law that a court might create when hearing a case under that jurisdictional statute. Equally important, Congress could also overturn by statute any judge-made rule with which it disagreed.

The situation in equity is fundamentally different. Even assuming that Congress did intend the grant of diversity jurisdiction to include a delegation of lawmaking power in equity, that delegation would face serious constitutional problems. Congress cannot delegate authority it does not have. None of Congress’s enumerated powers, even when augmented by the Necessary and Proper Clause, are broad enough to cover the entire set of substantive rules that comprise the law of equity. Congress certainly has no general power to regulate what remedies are available in cases arising under state law, even when those remedies are heard in federal court. Although a delegation pursuant to the

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179. Lincoln Mills is discussed supra at text accompanying notes 161 to 164.
181. U.S. Const. art. I, § 8, cl. 3 gives Congress the power to regulate interstate commerce. Although performance under a labor contract may be entirely within the confines of one state, that contract undoubtedly has a sufficient effect on interstate commerce to fit within the commerce clause.
182. Even that basic assumption is unrealistic. The idea that Congress meant for its grant of jurisdiction in equity to include a delegation of lawmaking power is inconsistent with the language of the statutes it enacted. Section 1332, the general diversity statute, does give the federal courts a general equity jurisdiction over non-federal claims. However, that statute applies to all “civil actions,” including actions at common law. Therefore, if Congress meant for the general diversity statute to delegate lawmaking authority, the natural conclusion is that it did so in both common law and equity. That conclusion is clearly undermined by Erie.
183. Admittedly, Congress may allocate the federal judicial power—a power that Congress itself cannot exercise—to the lower federal courts. However, there is a difference between delegation and Congress’s unique power to control the situations in which the lower federal courts may exercise their constitutional authority.
185. In the case of a state-law cause of action, it is theoretically possible that the state legislature may have intended to delegate its legislative authority. At present, it is unclear whether a state could delegate lawmaking authority to the federal courts. But even if it could, such a delegation would not avoid the Erie problem. If a state legislature delegated to the courts the authority to fill gaps in its statutes, its intent would undoubtedly be to have those gaps filled with the judge-made law of that state,
jurisdiction statutes would give the federal courts in equity the power to create any law that Congress itself could have enacted, including rules governing procedure,\textsuperscript{186} such delegation could not sustain most of the federal judge-made rules dealing with equitable remedies and defenses.

In short, then, delegation does support some federal judge-made law in equity. The Rules Enabling Act applies to equity as well as common-law, and can support procedural rules like Federal Rules of Civil Procedure 62 and 65. Moreover, there is an implied delegation of legislative power to apply a federal judge-made law of equity in connection with rights created by Congress. In the typical diversity case, however, the delegation argument is of no avail. Not only is there no evidence that Congress meant to delegate lawmaking authority,\textsuperscript{187} but any such delegation would be limited to rules that Congress itself could enact. If a federal court has the authority to craft a general body of independent federal equity rules for non-statutory cases, it must be because equity fits into the other category of substantive federal judge-made law: where the federal court has the inherent authority to create law.

\textit{b. Inherent Authority}

Most of the Supreme Court cases recognizing substantive federal judge-made law involve no delegation from Congress. These cases proceed from the premise not an independent federal law.

\textsuperscript{186} The Supreme Court's decision in \textit{Hanna v. Plumer}, 380 U.S. 460, 85 S. Ct. 1136 (1965), holds that Congress's power to regulate federal procedure is greater than a federal court's inherent power. Under \textit{Hanna}, a federal judge-made rule of procedure is invalid if it leads to forum-shopping for a different outcome. \textit{Id.} at 468, 85 S. Ct. at 1142. If the court acts pursuant to a delegation from Congress, however, its rule is valid as long as it fits within the scope of the delegation, even if it might lead to forum-shopping. \textit{Id.} at 471, 85 S. Ct. at 1144. As Congress can delegate only those powers that it itself could exercise, Congress itself must have the power to enact "procedural" rules that might change the result and lead to forum shopping.

\textsuperscript{187} In hindsight, it is not surprising that there is no real evidence of an implied delegation. The Judiciary Act of 1789 was enacted almost exactly 150 years before \textit{Erie}. At that time, it would have been nonsensical to speak of equitable rules as a body of "judge-made law." The notion that rules set out in precedent are merely another form of positive law is the product of a paradigm shift that began in the last half of the nineteenth century, and culminated in \textit{Erie}.

In 1789, courts of both common law and equity believed in a transcendental "superlaw" that existed in all common-law nations. Court decisions did not create this law, but rather merely provided evidence of those unwritten rules. That transcendental, almost platonic Form of law evolved in England, was transplanted to the colonies, and was inherited upon independence of the new United States. Therefore, differences in the way an individual state court interpreted that law would be an aberration, not binding upon any court except those inferior to that state court.

It is clear from the very first Judiciary Act that Congress meant to have this universal law apply in federal cases. Section 11 of the Judiciary Act of 1789 gave the trial courts jurisdiction in "Law and Equity" over cases involving parties of diverse citizenship. The very generality of this language reflects the common view of a single body of equity law. Therefore, as reflected in \textit{Swift v. Tyson}, 41 U.S. (16 Pet.) 1 (1842), federal courts did not consider themselves bound to follow individual state variations in the universal law.
that notwithstanding *Erie's* condemnation of a federal general judge-made law,\(^{188}\) there are certain specific areas in which federal courts do have the inherent authority to create binding substantive law. If equity is one of these areas, federal courts could apply a national law of equity even though some of the rules would change the outcome of litigation.

At first glance, equity seems a far cry from the typical case in which the Supreme Court has recognized federal substantive judge-made law. Although the cases defy easy categorization, the vast majority involved, at least in the eyes of the Court, a strong federal interest in the dispute. Accordingly, federal judge-made law may apply when the United States is a party,\(^{189}\) two states ask the Supreme Court to settle a dispute,\(^{190}\) a party sues directly under the Constitution,\(^{191}\) or when the litigation threatens international relations\(^ {192}\) or some other significant federal policy or project.\(^ {193}\) There is no comparable federal interest in equity cases that involve state-law substantive rights. The federal government has no overwhelming concern with what one private party must show to obtain an accounting of another private party's profits, or whether a claimant has unclean hands. Given that Congress would not even have the power to codify all of the rules of equity, it is difficult to see how the federal government could claim any real interest in those rules. Therefore, unless a given case involves some other federal interest, the mere fact that a party seeks equitable relief instead of damages is not itself sufficient to support the use of federal judge-made equitable rules.

There is, however, one category of substantive federal judge-made law that does not fit the standard mold. The substantive law of admiralty and maritime is federal judge-made law.\(^ {194}\) Where federal courts derive their authority to develop that law is less clear. Although there is an ostensible federal interest in navigation, the Court has not invoked that interest in sustaining federal judicial authority. Instead, the Court has indicated that the courts' lawmaking authority stems directly from the admiralty and maritime jurisdiction of Article III. In 1874, the Supreme Court held that Article III's reference to admiralty and maritime cases not only authorized federal judicial jurisdiction, but also provided a body of substantive law for the courts to apply:

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That we have a maritime law of our own, operative throughout the United States, cannot be doubted. The general system of maritime law which was familiar to the lawyers and statesmen of the country when the Constitution was adopted, was most certainly intended and referred to when it was declared in that instrument that the judicial power of the United States shall extend to "all cases of admiralty and maritime jurisdiction." Federal courts in admiralty and maritime were to apply the basic rules of admiralty and maritime law shared by commercial nations. Moreover, the Court indicated that this national law applied in lieu of state law whenever the two differed.

The Court has reaffirmed this basic principle several times, both before and after Erie. In 1959, for example, the Court in _Romero v. International Terminal Operating Co._ explained in more modern parlance how Article III affected the substantive law in admiralty and maritime:

Article III impliedly contained three grants. (1) It empowered Congress to confer admiralty and maritime jurisdiction on the "Tribunals inferior to the Supreme Court" which were authorized by Art. I, §8, cl. 9. (2) It empowered the federal courts in their exercise of the admiralty and maritime jurisdiction which had been conferred upon them, to draw upon the substantive law "inherent in the admiralty jurisdiction," _Crowell v. Benson_, and to continue the development of this law within constitutional limits. (3) It empowered Congress to revise and supplement the maritime law within the limits of the Constitution.

In essence, Article III incorporated a basic set of legal principles for courts to use in admiralty and maritime cases.

The quoted passage from _Romero_ bears a striking resemblance to the nineteenth century equity cases discussed in Part I.A. Those cases indicate that

196. _The Lottawanna_ indicated that the courts were not necessarily to apply the specific rules used in the English courts, but were instead to apply the basic principles of admiralty law shared by all western nations. Those basic principles, not the specific rules of English law, were adopted by the United States upon independence. _Id._ at 576.
197. "One thing . . . is unquestionable; the Constitution must have referred to a system of law coextensive with, and operating uniformly in, the whole country. It certainly could not have been the intention to place the rules and limits of maritime law under the disposal and regulation of the several states . . . .

_Id._ at 575.
201. The reference to "Constitutional limits" in the quoted passage is unclear. That term could refer to other limits that the Constitution places on the federal government, such as those set out in the Bill of Rights. On the other hand, it could refer to the historic parameters of admiralty, which define the areas in which the federal court has the constitutional authority to make law.
federal courts in equity apply those "historic principles established in English Chancery." This similarity between the admiralty and equity cases makes it tempting to conclude that federal courts also have an inherent power to decide equity cases using a national body of law borrowed from England. In other words, just as the grant of admiralty and maritime jurisdiction in Article III empowers federal courts to "draw upon the substantive law inherent in" that jurisdiction, the grant of equity jurisdiction in the same Article might empower them to draw upon the substantive law inherent in equity when deciding equity cases.

Upon closer scrutiny, however, a direct analogy to admiralty fails. The argument that a federal court can apply federal substantive law whenever it sits in equity is fundamentally inconsistent with the basic premise of Erie. After all, the provision of Article III that allows federal courts to sit in equity also grants jurisdiction over common-law cases. Erie and the later cases make it clear that notwithstanding Article III's reference to common law, there is no general common law for the federal courts to apply in diversity cases.

The situation in admiralty and maritime is quite different. First, that is a discrete and narrow pocket of law. Even if federal courts may ignore state law in admiralty and maritime cases, they remain bound to defer to state authority in the more common diversity case. Second, and more importantly, the Article III reference to admiralty and maritime essentially "federalized" that discrete area of the law by augmenting both the judicial and the legislative powers of the federal government. The above-quoted passage from Romero interpreted Article III's admiralty and maritime clause not only as a grant of jurisdiction, but also as a grant of legislative power to Congress. Article III's grant of common-law and equity jurisdiction, by contrast, has never been interpreted to contain an ancillary grant of legislative power to Congress. Nor will that clause ever be interpreted to include lawmaking power, for if Congress could enact substantive law for all common-law and equity cases, the Article I restrictions on Congress's power would be effectively eviscerated. This difference between the admiralty/maritime and diversity provisions in Article III is crucial in a post-Erie world, where both legislation and precedent are treated as positive law, and accordingly are valid only if the sovereign has legislative power over the subject of the law. It would


203. That Article III gives the federal courts potential jurisdiction over all admiralty and maritime cases, while limiting jurisdiction in equity to cases that fall within one of Article III's other categories, is of no significance. Even if federal courts may hear only some equity cases, they could still apply a body of federal equitable rules to decide those cases. U.S. Const. art. III.

204. See supra text accompanying note 200.
therefore be a serious blunder to conclude that the logic of the admiralty and maritime cases applies to equity.

Under a standard analysis of federal judge-made law, then, it would seem that federal courts have a very limited power to make rules of law in equity cases. First, a federal court may always control its own procedure. Because most of the rules of equity would lead to forum shopping, however, they are not procedural for purposes of *Erie*. Second, when Congress creates a substantive right enforceable in equity, it ordinarily delegates to the courts the authority to apply traditional principles of equity in cases involving that right. No implied delegation, however, exists in the typical diversity case. Absent any basis for a substantive judge-made law of equity, it may seem that *Erie* applies in equity to the same extent as it does at common law, and requires federal courts hearing state-law claims to borrow state equitable rules.

However, there is one more path to be explored. Although a direct analogy to admiralty and maritime ultimately proves to be a dead end, that analysis reveals a new source for federal judicial lawmaking power. The notion that federal judge-made law can stem directly from Article III is actually quite useful. That concept not only helps explain other aspects of federal judge-made law, most notably the court’s inherent power to regulate procedure, but also provides a new rationale for judge-made rules in equity. The next section explores this line of reasoning.

III. ARTICLE III AS A SOURCE OF FEDERAL JUDGE-MADE LAW

As discussed in Part II.A. of this article, a federal court’s inherent authority to create rules of procedure is clearly established. Yet, although the Supreme Court has devoted considerable attention to defining procedure, it has never disclosed the source of the federal courts’ authority to make procedural law. Read literally, *Erie* indicates that federal courts have no lawmaking powers whatsoever. Therefore, there must be something special about procedural rules to justify exempting them from this general rule.

The simplest explanation is that a federal court’s power to regulate judicial procedure comes from the simple fact that it is a court. In the Anglo-American tradition, a court is an organ of government with the power to decide disputes in an organized fashion. To ensure that it can decide disputes fairly, a court has the inherent power to control its own procedures. As the Supreme Court recently stated in a case dealing with a court’s inherent power to discipline attorneys:

> It has long been understood that “certain implied powers must necessarily result to our Courts of Justice from the nature of their institution,” powers “which cannot be dispensed with in a Court, because they are necessary to the exercise of all others.” . . . These powers are “governed not by rule or statute but by the control necessarily vested in courts to manage their own affairs so as to achieve the orderly and expeditious disposition of cases.”

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The Constitution itself makes it clear that federal courts are an integral part of the federal government, and that they exercise part of the federal sovereign authority. Article III deals with the "judicial Power of the United States," a counterpart to the legislative and executive powers discussed in the first two articles. Because the judicial power is a sovereign power, the actions of a court are legally binding on individual litigants. The judicial power also includes a limited authority to make rules of law governing how rights are to be adjudicated in the federal courts.

The question, of course, is not whether a federal court has an innate lawmaking authority, but the extent of that authority. To answer that question, it is necessary to determine exactly how much lawmaking authority is contained in the Article III judicial power. Unfortunately, there is little guidance on what "judicial power" actually means. Although Article III goes into great detail about the areas in which the federal courts may exercise the judicial power, it nowhere defines that crucial phrase. Nor has the Supreme Court ever provided a precise definition.206

History, however, provides certain clues as to what the framers meant by judicial power. The framers did not create federal court system out of whole cloth. Instead, they borrowed many basic features from the English judicial system. Although the federal courts were to enjoy a much higher degree of independence from the legislative branch than their English counterparts, the basic way in which rights were to be adjudicated was intended to be roughly the same. Therefore, one can glean hints to what Article III means by judicial power by reviewing the English practice.207

A. The English System: Different Courts with Different Roles

Obviously, an article of this scope cannot begin to explore the nuances of a system as complicated as the English judicial system of the late eighteenth century. Fortunately, an exhaustive analysis is not necessary. Although the framers of the United States Constitution envisioned a federal court system constructed along the same basic lines as the English, they did not necessarily intend to adopt all of the particulars of that system. All this article need discuss, then, is the basic structure of the English system.


A central feature of the English system was the division of caseload among several different courts, including the courts of common law, equity, and admiralty. However, the subject-matter jurisdiction of these courts was not mutually exclusive, as the same dispute could sometimes be presented to more than one court. The overlap in jurisdiction was especially great between common law and equity. Although at first this overlap gave claimants the ability to shop for the most favorable result, the notorious Coke-Ellesmere controversy led to a royal decree in 1616 that gave precedence to law. From that point on, a party could proceed in equity only by demonstrating that its remedy at common law was somehow deficient.

Subject-matter jurisdiction was not the only matter that separated the English courts of common law, equity, and admiralty. Each court also had its own procedure. These differences in procedure became especially important after equity became a fallback to common law. Equity’s mode of adjudicating cases would later give that system a unique role, and ultimately define the very nature of equity.

The common-law courts employed an extremely formalistic procedure, marked by difficult rules of pleading and the rigidity of the writs. A party who failed to follow the strict procedure often found his case dismissed on technical grounds. On the other hand, the common-law courts had considerable flexibility in defining the underlying rights of the litigants. As long as the legislature had not spoken, a common-law court could, when presented with a new type of case, define the rule that determined if one party ought to be liable to the other.

In some ways the situation in equity was exactly the opposite. The main feature of equity procedure was its flexibility. Pleading was not formalistic, but was instead intended to provide notice to the other side. Equity also employed a number of procedural tools, such as discovery and the class action, which were not available in common-law courts. This flexibility in procedure often helped parties who were hamstrung by the rigidity of common-law procedure. A party could ordinarily proceed in equity merely by showing that procedural limitations made the relief available at common law inadequate. Over time, procedural flexibility and judicial discretion naturally became a defining feature of the equity courts.

On the other hand, a court of equity had considerably less authority than its common-law counterpart to mold the substantive law. Admittedly, equity did develop a number of important substantive rights that did not exist at law, such as

211. Id. at 88.
212. See generally McClintock, supra note 91, at 20-45, 110. Equity’s relegation to a “fallback” role in 1616 hastened the development of these procedural tools. One way for equity to ensure itself a continuing role was to make itself available when a party could not meet the inflexible requirements of common law. Baker, supra note 208, at 88.
the use, the trust, and the right to redeem collateral from a mortgagee.\textsuperscript{213} Aside from these rights, however, equity typically looked to the legislature and the precedent of the common-law courts for the rules that established the relative legal position of the litigants.\textsuperscript{214} Equity instead used its discretion mainly to determine whether it was just to enforce those legal rights in the circumstances of the actual dispute.\textsuperscript{215}

But even though equity did not generally create rights, its unique mode of adjudicating cases often had the effect of strengthening or weakening existing substantive rights. Equity could augment existing rights in several ways. For example, a party whose legal rights had been violated might nevertheless find that the facts of the case did not precisely fit any of the common-law writs. Even though that party could not obtain relief at common law, he might in equity.\textsuperscript{216} Similarly, equity could often strengthen a legal right by providing a more effective remedy, such as specific performance instead of damages for breach of a contract.\textsuperscript{217}

On the other hand, equity’s flexibility could also serve to weaken a party’s legal position. Even when equity relied on substantive rules established by a legislature or in common law, it retained considerable discretion in deciding whether that legal right should be enforced in the given case. Because equitable relief was special, equity developed the “defenses” of laches and unclean hands, which would lead courts of equity to deny relief even when faced with a clear violation of a substantive right. A party who was denied access to equity because of laches or unclean hands could still sue in common law.\textsuperscript{218} However, as claimants sought relief in equity only when the relief available in common law was in some way inadequate, use of an equitable defense significantly reduced the effectiveness of the claimant’s legal right.

At the risk of oversimplification, then, the “power” of the English judiciary in equity comprised three separate elements. Like the common-law courts, courts of equity could develop substantive rights and devise procedures to enforce those rights. Courts of equity, however, had an extra power, the ability to exercise discretion in determining whether and how to enforce a legal right. As common-

\begin{itemize}
  \item \textsuperscript{213} McClintock, \textit{supra} note 91, at 5-9.
  \item \textsuperscript{214} Dobbs, \textit{supra} note 59, at 84 (“Equity courts never claimed the power to deny a plaintiff’s legal rights except by substantive defenses such as estoppel.”); McClintock, \textit{supra} note 91, at 53; Baker, \textit{supra} note 208, at 94.
  \item \textsuperscript{215} \textit{id.}
  \item \textsuperscript{216} McClintock, \textit{supra} note 91, at 110.
  \item \textsuperscript{217} \textit{id.} at 112-13.
  \item \textsuperscript{218} Dobbs, \textit{supra} note 59, at 68 (unclean hands), 76 (laches); Restatement (Second) of Judgments, § 25 (1980), comment i(1) (indicates that a plaintiff whose common-law action was dismissed could sue again in equity, stating, “This was true, for example, where the suit in equity was dismissed because the plaintiff had an adequate remedy at law, or on the ground of such delay or hardship or impropriety of the plaintiff’s conduct as barred a suit in equity but not an action at law.”)

Of course, plaintiff’s right to sue again at common law was dependent on whether the statute of limitations had expired.
law courts had only a very limited discretion, discretion became a hallmark of the separate system of equity.

B. Incorporating the English System into the United States Constitution

This basic model of separate courts traveled across the Atlantic Ocean to England's North American colonies. Although thirteen of these colonies threw off the yoke of English sovereignty, they did not discard all English ways. When the framers of the Constitution began to design a system of national courts, they naturally used the English model. The federal courts were to be units of government that exercised "judicial Power," one of the component parts of sovereign authority. They could exercise that power in common law, equity, and admiralty/maritime. When they divided the federal courts along the same lines as the English system, the framers undoubtedly envisioned that each of the national courts would function in the same basic way as the English counterpart. Federal courts sitting in common law would continue, in the absence of legislation, to define substantive rights. When sitting in equity, by contrast, the courts would serve primarily as a fallback to common-law. Although generally deferring to common law's interpretation of substantive rights, federal equity would, like its English

219. Not all of the colonies maintained separate courts of equity. Robinson v. Campbell, 16 U.S. (3 Wheat.) 212, 222 (1818). But all of the colonies allowed some court to issue injunctions and adjudicate historically equitable rights and remedies. The addition of Louisiana, with its civil law tradition, raised the additional problem of how the federal courts should deal with the absence of even a law of equity, which was resolved in Livingston v. Story, 34 U.S. (9 Pet.) 632, 655 (1835). However, as both the Louisiana Purchase and the admission of Louisiana as a state occurred well after the Constitution was enacted, the state of the law in Louisiana should not affect how the Constitution is interpreted. However, there is an additional problem with the wording. As finally enacted, Article III, section 2 specifically mentions "equity" only in connection with so-called "federal question" suits: "all Cases, in Law and Equity, arising under this Constitution, the Laws of the United States, and treaties made, or which shall be made, under their Authority." In the other eight categories, by contrast, Article III does not mention equity. This phrasing could be interpreted to mean that federal courts may exercise equitable discretion only in federal question cases. That literal interpretation is hardly tenable. In fact, the remaining eight Article III categories mention neither law nor equity; relying instead on the terms "all Cases" and "Controversies." Although this omission makes sense in two of the categories, suits against the United States and admiralty and maritime cases, which would in England have been litigated in neither courts of equity nor common-law, it is difficult to imagine cases within some of the other categories, such as citizen-citizen diversity, that would not fall into law or equity. Therefore, the most logical interpretation is that the omission of "equity" does not preclude the federal courts from acting as courts of equity in the other categories. The federal courts have never doubted their power to act in equity when sitting in diversity. Why the framers chose to include the reference to law and equity for federal question suits but not the others may remain a mystery forever.
predecessor, provide relief from the rigidity of common law by exercising discretion in procedure and remedies.

Of course, the Article III judicial power does not automatically vest in the lower federal courts, but is allocated by Congress. The first Congress certainly revised the English model. Instead of separate courts, the Judiciary Act of 1789 created a unitary court with separate heads of jurisdiction. Congress also restricted common-law's powers by the Rules of Decision Act,\(^{221}\) which required those courts to look to state law for substantive rules.

However, the first Congress did little to affect the basic role of equity. It gave the federal courts expansive jurisdiction over diversity cases in both common law and equity.\(^{222}\) Aside from the procedure acts discussed above\(^ {223}\) and other incidental restrictions on the judicial power in equity, Congress has maintained a broad federal equity jurisdiction to this day.\(^{224}\) The fact that equity jurisdiction has continued for so long a period is a clear indication that Congress is comfortable with the current system, in which federal courts perform the same functions as the English equity system.

History continues to play an important part in defining the role of the federal courts in equity. Although a federal court may exercise discretion in determining how to enforce a substantive right, its discretionary power exists only with respect to matters that traditionally could have been heard in a court of equity. For a federal court to exercise similar discretion in either a common-law or admiralty matter would exceed not only the authority delegated by Congress, but also the judicial power authorized by Article III. Thus, unless Congress sets up a different system, history continues both to define the powers of the federal courts and to limit the cases in which they may exercise those powers.

C. **Erie and the Article III Judicial Power**

If Article III itself gives federal courts certain lawmaking powers in equity, it is tempting to conclude that *Erie* simply does not apply. *Erie* requires the federal courts to follow state law whenever that law deals with a matter outside the limited sovereignty of the federal government. However, those federalism concerns do not exist if the Constitution extends federal sovereignty to a certain matter. When the states ratified the Constitution, they conveyed some of their authority to the federal government. Part of the authority they conveyed was a judicial power in equity. Therefore, the argument continues, any federal judge-made law promulgated

\(^{221}\) Judiciary Act of 1789, § 34, ch. 20, 1 Stat. 92 (1789).

\(^{222}\) Judiciary Act of 1789, § 11, ch. 20, 1 Stat. 78 (1789).

\(^{223}\) See *supra* text accompanying notes 21 to 27.

pursuant to the judicial power is valid, and can be applied in lieu of state law. If the states ceded lawmaking power to the federal courts, they cannot later insist that the federal courts refrain from exercising it.

The problem with this argument is that it proves too much. Article III gives the federal courts judicial power in both equity and common law. Among the historic powers of the English judiciary, in both common law and equity, was the ability to declare the content of the substantive law in the absence of legislation. *Erie* clearly takes that power away from the federal courts when they sit in common law. There is no reason to think that the effect of *Erie* should be any different in equity.

Viewed in this light, one important, but generally overlooked effect of *Erie* is that it reinterprets Article III. At *Erie*’s core is the notion that what we commonly call judicial interpretation is in truth “lawmaking.” Even though such lawmaking was a traditional function of English and colonial courts, federalism and separation of powers concerns prevent federal courts from making substantive law, except on matters uniquely federal. Thus, *Erie* diminishes the scope of the federal judicial power. Today, the judicial power does not include the traditional power of Anglo-American courts to define substantive rights.

However, *Erie* does not entirely strip the federal courts of their power to make law. A federal court’s inherent authority to regulate its own procedure, recognized in *York* and the later cases, remains an important incident of the judicial power. As a result, the only lawmaking power that *Erie* took away from the federal courts was the ability to define the substantive rights and duties of the litigants. Those courts retain all other traditionally judicial powers granted by Article III.

From this perspective, *Erie*’s impact is much greater in common law than in equity. The most important discretionary power of the common-law court was its ability to define the content of law. Although those courts often controlled their own procedure, the rigid common-law procedural system left a judge little room for discretion. Once *Erie* took away the power to define legal rights, the discretionary power of the federal courts in purely common-law matters was diminished significantly.

*Erie*’s impact in equity is not nearly as pervasive. Like common law, federal courts in equity lost the power to define substantive rights, but retained the power to regulate procedure. However, as equity typically already looked to other sources for the substantive rules, the loss of the power to make substantive law is not as significant.

But there was a third element to equity—the power to exercise discretion in enforcing substantive rights. The rules that define this discretion are neither procedural nor substantive, but fall somewhere between the two. Like procedural rules, the rules governing equitable discretion take the basic legal relationship of the parties as a given. The court limits its discretion to the question of how best to enforce those underlying substantive rights. As long as it does not restructure the basic legal relationship, a federal court employing traditional equitable discretion
does not raise the constitutional issues that underlie the *Erie* decision. The exercise of discretion in determining how a right should be enforced in a given context is an inherently *judicial* function, not a legislative one. In that respect, it fits well with the actual language used in Article III. Moreover, this exercise of discretion raises none of the federalism concerns underlying *Erie*. Allowing federal courts to exercise independent judgement when they perform this judicial function in no way disrupts the Constitution's allocation of legislative power between the federal and state governments.226 Because *Erie* does not deprive a federal court of its traditional power to exercise discretion in matters involving whether and how a substantive right should be enforced, federal judge-made rules governing equitable discretion are exempt from *Erie*.

In fact, a 1996 Supreme Court decision clearly indicates that a federal court in equity may invoke historical equitable discretion in deciding whether to enforce a state-law substantive right. *Quackenbush v. Allstate Insurance Co.*227 involved a suit by the California insurance commissioner against Allstate to recover insurance proceeds. After the case was removed to federal court, the district court invoked *Burford* abstention228 and remanded the action to the state court.

The Supreme Court held that abstention was improper. Rather than focusing on the elements of *Burford* abstention, however, the Court's reasoning focused on the fact that the commissioner had sued for damages. Abstention, the Court held, was available only when the plaintiff sought equitable or other discretionary relief. The crucial portion of the Court's opinion relies heavily on the special powers of courts in equity:

> Our longstanding application of [the abstention] doctrines reflects "the common-law background against which the statutes conferring jurisdiction were enacted," . . . . It has long been established that a federal court has the authority to decline to exercise its jurisdiction when it "is asked to employ its historic powers as a court of equity." This tradition informs

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226. In addition to the obvious federalism issues, there are also separation of powers concerns underlying *Erie*. After all, federal judge-made law is invalid even if it involves a topic within Congress's Article I powers. According to the *Erie* Court, choosing a rule to decide a case in the absence of a controlling statute was merely another form of law-making. Because the Constitution vests the legislative power in Congress, not the courts, federal judge-made law also ran afoul of the Constitution's separation of sovereign powers among the three branches. That violation of separation of powers was of concern not only to Congress, but also to the states. Although the states may have been willing to hand over some of their lawmaking power to an elected Congress, they did not agree to let federal judges, who are appointed rather than elected, exercise that power.

The "judicial power" theory of this article also provides an adequate answer to these separation of powers concerns. The crux of the theory is that when the Constitution was enacted, courts of equity had certain limited powers to make binding rules. This rule-making authority was a widely recognized facet of equity. Therefore, when the states agreed to a federal court system with jurisdiction in equity, they could anticipate that the judicial power of those federal courts would encompass the same sorts of judge-made equitable rules.


228. *Burford* abstention, named after *Burford v. Sun Oil Co.*, 319 U.S. 315, 63 S. Ct. 1098 (1943), is where a federal court abstains because the state had established complex administrative procedures to deal with the same dispute.
our understanding of the jurisdiction Congress has conferred upon the federal courts, and explains the development of our abstention doctrines. In *Pullman*, for example, we explained the principle underlying our abstention doctrines as follows:

The history of equity jurisdiction is the history of regard for public consequences in employing the extraordinary remedy of the injunction. . . . These cases reflect a doctrine of abstention appropriate to our federal system, whereby the federal courts, "exercising a wide discretion," restrain their authority. . . .

Cases like *Quackenbush* confirm that there is indeed an "equity exception" to *Erie*. As in common law, courts of equity must defer to Congress and the states in determining whether a legal right exists. When a party seeks to enforce that right in federal equity, however, the court has considerable discretion in determining how that right can best be effectuated. That discretion is part of the judicial power assigned to the federal courts by Article III of the Constitution. Because the authority stems from the Constitution, a federal court's use of equitable discretion is governed not by state law, but by uniform national rules that originated in England and are fleshed out in federal precedent. That federal precedent makes up the federal judge-made law of equity.

IV. THE SCOPE OF THE EQUITY EXCEPTION TO *ERIE*

Although history and the language of the Constitution support a general equity exception to *Erie*, neither provides many details about how that exception applies to particular rules of equity. Equity is, after all, a multifaceted area of law. Among other things, equity has rules governing joinder, pleading, remedies, special defenses, and causes of action. Because some of these rules may create or destroy substantive rights, some may be invalid after *Erie*. Lower courts will face the task of determining which of equity's many rules fall within the exception, and which must give way to state law because of *Erie*. Nevertheless, while an article of this

229. *Quackenbush*, 517 U.S. at 717-18, 116 S. Ct. at 1721. The Court went on to explain that abstention would be available not only in cases seeking equitable remedies, but also in other cases where the court was called upon to exercise broad discretion. *Id.* at 718, 116 S. Ct. at 1721-22. Whether discretionary legal remedies like mandamus are also exempt from *Erie* is beyond the scope of this article.

230. Because equitable rules stem from the judicial power, it is irrelevant whether Congress would also have the constitutional power to enact such rules. Notwithstanding Justice Marshall's bold dictum in *Osborn v. Bank of the United States*, 22 U.S. (9 Wheat.) 738, 818 (1824), that "the legislative, executive, and judicial powers, of every well constructed government, are coextensive with each other," the judicial and legislative powers of the federal government are not coextensive. Although Congress has no authority to pass a general code of laws that covers every possible dispute that might arise between people of diverse citizenship, the federal courts have undisputed jurisdiction to adjudicate all of these disputes. Therefore, a federal court may perform a judicial function regardless of whether Congress could itself perform the same function. All that matters is that the action fits within the Article III judicial power, and that Congress allocated that portion of the judicial power to the federal courts.
scope cannot cover all of the particulars, it can provide some observations about the scope of the equity exception.

As an initial matter, it is important to note that acknowledging the existence of an equity exception has very little effect on Supreme Court precedent. Those cases discussing a federal court's power to regulate its own procedure remain valid, and continue to apply both in common law and equity. Likewise, the equity exception affects neither a federal court's power to craft substantive law in certain narrow areas nor Congress's ability to delegate legislative powers to the judiciary. The equity exception is a separate and distinct area in which federal courts may diverge from state law.

Like the other areas of federal judge-made law, the equity exception has limits. First, it is, of course, confined to equity. That limitation is not as straightforward as it may seem. A matter can be deemed "equitable" for a number of different reasons, not all of which involve the remedy sought by the claimant. Moreover, the domain of equity is not static, but has changed considerably over time. As demonstrated above, applying the equity exception requires a court to consult history in an attempt to ascertain equity's domain in the late eighteenth century.

A second, equally important limit on the equity exception is that it does not allow a court to reshape to any significant extent the substantive rights of the litigants. This limitation is not historical, but is a direct result of Erie. Therefore, even when it applies an historic rule of equity, a federal court exceeds its constitutional authority if it creates new substantive rights or negates basic rights created by either Congress or the states.

The remainder of this article attempts to apply these guidelines and thereby clarify the scope of the equity exception. Part A explores the external limitations on a federal court's power that are imposed by both history and Congress. Part B explores where the line lies between permissible use of equitable discretion and impermissible restructuring of substantive rights. Resolving these major issues should help the lower courts in their inevitable task of fleshing out the equity exception.

A. Limitations on the Exception

The equity exception was first recognized in the majority opinion in Guaranty Trust Co. v. York. That opinion actually provides certain clues as to how far the exception extends. In the key passage quoted earlier, the majority suggested that a federal court's power to create a uniform national law of equity was bound by the


232. A federal court's inherent power to create substantive law is discussed supra at text accompanying notes 188 to 201.

233. Delegation is discussed supra at text accompanying notes 145 to 148, and 158 to 164.


235. See supra text accompanying note 101.
Constitution, the historical limits on equity, and any additional limits imposed by Congress.

The first limit is obvious. A federal court's power to enjoin speech, for example, may be restricted by the first amendment. Likewise, as the seventh amendment requirement of a jury in suits at common law has been interpreted to extend to cases involving a mixture of legal and equitable claims and even some cases that would historically have been purely equitable, a federal court must provide a jury notwithstanding that historically the judge would have served as factfinder. Even though the judicial power of Article III provides the federal judiciary some of the powers of a court of equity, these later and more specific limits on the federal courts take precedence over the general delegation of judicial power.

The other two limitations suggested in York are not as immediately obvious. English practice normally carries little weight in interpreting the United States Constitution. Similarly, because of the well-developed idea of separation of powers, it is not immediately clear how Congress can regulate the exercise of judicial power. Nevertheless, the suggestion in York that a federal court's power in equity is subject to history and Congress is completely consistent with the notion that the equity exception originates in Article III.

1. The Relevance of History

History is important not because it somehow overrides the Constitution, but because it helps clarify the meaning of Article III. It has already been demonstrated how the framers intended to structure the federal courts along the same lines as the English court system. Article III's grant of "judicial power" included, among other things, the special power of a court of equity to exercise discretion when adjudicating substantive legal rights. By ratifying a provision that gave the federal judiciary equity jurisdiction in diversity cases, the states agreed that federal courts would have this discretion even when they dealt with cases arising under state law.

The states may have agreed to this provision because the system of equity that they had in mind had certain historical limits. In English practice, equity's discretion was limited in two basic ways. The first was jurisdictional. Many cases, including those in which effective relief could be obtained in common law, could not be heard in a court of equity. Of course, if a court of equity could not even hear the case, it would have no opportunity to exercise its discretion. Second, even when equity had jurisdiction, it could exercise its discretion only in certain

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238. See supra text accompanying notes 219 to 224.
239. "Equity jurisdiction" is more than merely a sub-class of subject-matter jurisdiction. As the passage from Atlas Life quoted supra at text accompanying note 74, "equity jurisdiction" includes not only the raw power to hear a dispute, but also defined the sorts of cases in which the courts could exercise their discretion in deciding that case. See also McClintock, supra note 91, at 97-99.
ways. Because "equity follows the law," courts of equity generally could not ignore the existence or non-existence of the legal rights claimed by the plaintiff. Its discretion was generally limited to the issue of how that right should best be enforced.

Those same historic principles limit the equity exception. For example, because a suit seeking damages for breach of contract could not have been heard in English Chancery, a federal court has no discretion to ignore state law governing damages. If the plaintiff in that case instead sought specific performance, the suit would be in equity, but the federal court's discretion would extend only to matters involving enforcement, not to the core issues of whether a contract existed and was breached. These core issues continue to be governed by state law.

Of course, it can be difficult for the modern court or attorney to ascertain the historic scope of equity. The American judicial system has experienced monumental changes since 1800; changes that have erased many of the differences between the two systems.242 As a result, the traditional distinctions between common law and equity are to most people a dim and distant memory. Nevertheless, because these historic differences determine the scope of the federal court's power to apply a uniform national rule of equity, a review of the historic situation remains important whenever a federal court in equity is asked to apply state law.

This need to consult the historic distinctions between common law and equity is not unique to the Erie question. In many ways, the problem here is similar to that which courts face under the seventh amendment to the Constitution. That amendment "preserves" a right to a jury in "suits at common law." The same changes in federal procedure, together with the creation of new rights, have made

240. McClintock, supra note 91, at 52.
241. The hypothesized case could have been heard in equity if it involved the use of an equitable procedural device such as the class action. In that case, however, the court's discretion would have extended only to the joinder issues, not to the amount of damages.
242. The main impetus for this standardization has been the merger of common-law and equity in most United States jurisdictions. See, e.g., Fed. R. Civ. P. 1. In the majority of systems that have merged law and equity, a single court may hear all claims and defenses that each party has against the other, regardless of whether those claims were historically relegated to common law or equity. There is accordingly little need today to differentiate between the legal and equitable causes of actions, as both may be presented to the court in the unitary civil action.

Other changes have reduced the importance of the equitable procedural devices. Comprehensive court rules like the Federal Rules of Civil Procedure and their state-law cousins have codified many of the procedures that were historically available only in equity, and made them applicable to the unitary civil action. Discovery is now widely available in all types of actions. Similarly, rules governing joinder devices such as class action, Fed. R. Civ. P. 23, and interpleader, Fed. R. Civ. P. 22, are codified in written form.

These changes have had less of an impact on equitable remedies. Of course, legislatures have been busy in this area too, enacting detailed statutes regulating matters like injunctions and accounting. Absent such a statute, however, courts still differentiate between legal and equitable relief in deciding what remedy to provide. Even in a unitary civil action, a party seeking an equitable remedy must demonstrate that its legal remedy is inadequate. Courts likewise retain considerable discretion in determining whether to grant injunctions or receiverships. That courts still cling to these distinctions between legal and equitable actions may explain why most modern efforts to distinguish law from equity focus primarily on the remedy.
possible suits that traditionally could have been prosecuted in neither common law nor equity. Courts have struggled with finding the closest historic analogue and carving up hybrid actions into their legal and equitable parts.

In the jury trial cases, the courts have erred in favor of concluding that questions involve common-law issues, which results in the grant of a jury. A similar bias towards common law should apply to the equity exception to Erie. A federal court hearing a state-law right must follow non-procedural state law except on matters within the historic scope of equity. When a court is presented with a modern hybrid case that includes both legal and equitable components, its first task should be to separate the case into individual claims based on substantive law. If a claim is historically equitable or highly analogous to something equity would hear, it fits within the equity exception to Erie. If it is purely common law, of course, the court should apply state law. Issues that fall into the historic domains of neither common law nor equity should also be governed by state law. Because Article III is a cession of power from the states to the federal judiciary, it should be interpreted in light of what the states knowingly relinquished.

2. Congress's Power to Limit Federal Equity.

Congress exercises the legislative power, not the judicial. On the other hand, Congress does have a unique role with respect to the judicial power of Article III. Congress's explicit constitutional authority to create lower federal courts includes the authority to parcel out to those courts all or only part of the judicial power contained in Article III. Therefore, unlike the legislative and executive powers, the judicial power of the lower federal courts is a potential, not an actual, power.

Congress's control over the judicial power has significant implications for the equity exception. It means, for example, that Congress may limit a federal court's discretion in equity, either by imposing additional requirements on the availability of remedies or by preventing altogether the use of a given remedy. No one doubts that Congress has the power to control remedies in connection with rights that it creates. Through its control of the judicial power, however, Congress may also control what remedies a federal court can grant in a state-law case, even if the underlying substantive right falls outside Congress's legislative power. As long

243. See, e.g., Chauffers, Local 391 v. Terry, 494 U.S. 558, 110 S. Ct. 1339 (1990), in which the Court labored to find an historic analogue to a thoroughly modern federal statutory claim, a suit against a labor union for breach of the duty of fair representation.


245. Id. at 501, 79 S. Ct. at 948; Dairy Queen v. Wood, 369 U.S. 469, 473, 82 S. Ct. 894 (1962) (jury trial even if equitable issues predominate).


247. For examples of such limiting statutes, see supra note 224.


249. In Lauf v. E.G. Shinner & Co., the Supreme Court specifically upheld the Norris-LaGuardia Act, currently codified at 29 U.S.C. § 105 (1994), which limits a federal court's ability to enjoin labor
as Congress does not attempt to control the discretion that state courts may exercise in those state-law cases, it has not exceeded its constitutional authority.

Conceivably, Congress could entirely prohibit a federal court from sitting in equity in all cases arising under state law. Of course, the situation currently is just the opposite, as federal courts have always enjoyed a broad equity jurisdiction in diversity cases.\textsuperscript{250} Were Congress to change its mind, however, it could bar the use of equitable discretion over state law claims by the simple expedient of taking equity jurisdiction away from the lower federal courts. Withdrawing equity jurisdiction would violate no constitutional norms. Although Congress cannot tell the courts how to exercise judicial power in a given case,\textsuperscript{251} it need not give the courts all the judicial power authorized by Article III. Congress could in theory keep state-law cases completely out of the lower federal courts. If Congress can remove state-law cases in their entirety, it certainly can confine the lower federal courts to common-law jurisdiction. Moreover, although some have suggested that there are unstated separation-of-powers limits on Congress's power to deny some aspects of the judicial power to federal courts,\textsuperscript{252} removing equity jurisdiction with respect to state-law claims does not raise any serious separation of powers concerns. Therefore, a federal court hearing either a federal statutory claim or a state-law claim is obliged to heed any restrictions on its equitable discretion imposed by Congress.\textsuperscript{253}

B. Applying the Exception to Specific Rules of Equity in Cases Involving Non-Federal Claims

Part III of this article demonstrated that there are actually two distinct equity exceptions to \textit{Erie}. First, in cases arising under a federal statute a federal court has a delegated authority to fill in any gaps in the statute with judge-made rules. Determining whether a gap-filling rule is valid is entirely a question of Congress's intent, which may vary depending on the federal statute involved. Second, in all cases a federal court that has been presented with a claim in equity has the inherent authority to apply the historic rules of equity, provided it respects the underlying

\textsuperscript{250} Diversity jurisdiction in equity was granted in Section 11 of the Judiciary Act of 1789, and has continued to this day, 28 U.S.C. § 1332 (Supp. 1999).


\textsuperscript{253} Of course, those restrictions must not violate any other constitutional limitations. A restriction on equity jurisdiction that applied only to one religion, for example, might well violate the equal protection requirement.
substantive right. Determining the validity of judge-made law under this second, and more controversial, exception is a trickier matter.

The notion that federal rules of equity cannot encroach on substantive rights sounds much like the language used in the Supreme Court cases dealing with a federal court's power to regulate procedure. And in fact both areas of federal judge-made law stem from the Article III judicial power. Notwithstanding this common origin, however, equity rules and procedural rules should not be measured by the same yardstick. Equity is a separate exception to \textit{Erie}, not a subset of the procedural exception. The considerations underlying each differ significantly. Rules of procedure should focus on fair and efficient adjudication, not on the ultimate outcome of the case. Equity, by contrast, focuses primarily on how rights are enforced. Given that the essence of equity is flexibility in remedy, it is highly likely that two courts exercising their discretion could reach different outcomes. That difference in outcome may well cause forum shopping by a plaintiff who desires a certain outcome, or by a defendant who especially wants to avoid that outcome.\textsuperscript{24} Because a federal court can honor a state-law right even if it enforces it with a different remedy than state law would allow, the validity of an equity rule should not be gauged by the outcome/forum shopping test developed by the Supreme Court in \textit{York, Hanna}, and other cases.

A better test for equitable rules is the right/remedy distinction formulated in the early Supreme Court cases. That rule requires a federal court in equity to defer to other sovereign authority with respect to the basic legal rights and duties of the parties. A federal court cannot enforce rights that do not exist in any state court, even if that right would have been recognized in historic equity. Conversely, any application of federal judge-made law that leads a federal court to destroy a state-law right exceeds the court’s authority. As long as it does not completely terminate the right, however, the federal court has considerable discretion, subject only to Congress and federal-court precedent, to determine how best to enforce that existing state-law right.\textsuperscript{25}

Logically, providing a remedy where no substantive right exists and refusing to grant a remedy for a clearly-established right are opposite sides of the same coin. However, because of the procedural rules used in federal court practice, the analysis of the two situations turns out to be very different. It is therefore useful to deal with each situation separately.

\textsuperscript{24} Because they make the initial choice of forum, plaintiffs have a much greater ability to shop for a forum than defendants. Defendants who are sued in federal court cannot transfer the case to state court, although a few may be able to convince the federal court to abstain. And although 28 U.S.C. § 1441 (1948) allows defendants sued in state court to remove the case to federal court, that provision contains certain restrictions, such as the § 1441(b) limitation on “home state” removal in diversity cases, that limits its use.

\textsuperscript{25} Actually, the proposed test for federal rules of equity is conceptually similar to the analysis set forth in \textit{Hanna v. Plumer}, 380 U.S. 460, 85 S. Ct. 1136 (1965) for evaluating rules of procedure promulgated in accordance with the Rules Enabling Act, 28 U.S.C. § 2072 (1990). The Rules Enabling Act authorizes only those rules that do “not abridge, enlarge or modify a substantive right.” In the same vein, a rule of equity cannot create or abolish the underlying right, but can make existing rights more or less effective by providing different means of enforcement.
1. Federal Equity's Power to Grant Relief When a State Court Would Deny It

Guaranty Trust Co. v. York\textsuperscript{256} itself falls into this category. In York, a federal court invoked its special powers of equity to grant relief on a claim that the state court, relying on the state statute of limitations, would have dismissed outright. Even though the Supreme Court discussed an equity exception to Erie at length, its actual holding ordered the lower federal court to apply the state statute.\textsuperscript{257} Were it to ignore that state-law limitations period, the federal court would in essence have created a right where none existed under state law.

However, the holding in York does not always bar a federal court in equity from granting a remedy that a party could not obtain in state court. York was a special case. The state statute of limitations in that case did not simply bar a particular remedy, but purported to foreclose all relief, legal or equitable, in any court.\textsuperscript{258} In essence, expiration of the limitations period effectively terminated all underlying rights that may have existed.

a. State Law Precludes All Relief

Therefore, York stands only for a narrow, and, under the analysis set forth in this article, a somewhat obvious proposition: a federal court's discretion in equity does not include the power to create new substantive rights. There are two basic types of cases in which a federal equity rule will have this effect. The first comprises situations similar to York, where a state court would have recognized a right, but has for some reason declared that that right does not exist in this sort of case. In addition to statutes of limitations, state-law rules such as immunities must be applied in federal equity.\textsuperscript{259}

The second situation is a case where a party asserts a substantive right recognizable only in equity. If the state, either through its legislature or its courts, has modified or abandoned an historically equitable substantive right, the federal court must dismiss any claim or defense based upon that right. Although the English system afforded equity the discretion to create such rights, federal courts after Erie do not have that substantive lawmaking authority. Therefore, the federal court must look to state law to ascertain whether these substantive rights exist.

\textsuperscript{256} 326 U.S. 99, 65 S. Ct. 1464 (1945).
\textsuperscript{257} Id. at 112, 65 S. Ct. at 1471.
\textsuperscript{258} The Supreme Court did not decide whether the state statute actually applied in equity. Id. at 101, 65 S. Ct. at 1465. After determining that state law governed, the Court remanded the case for the lower court to interpret state law. Id. at 112, 65 S. Ct. at 1471.
\textsuperscript{259} The reference to immunities in the text is meant to include only substantive state-law immunities. If a state limits certain actions to a specific state court, thereby proving a defendant a sort of jurisdictional immunity in any other court, that rule would be a matter of jurisdiction that would not bind the federal courts, regardless of whether the federal court sat in law or equity.
b. State Law Precludes All Equitable Remedies, But Allows Other Relief

In many cases a party with a clearly-established legal right will nevertheless be precluded from obtaining equitable relief in state court. Equity may shut its doors because of the claimant's own acts or omissions, or because equity cannot hear cases in which there is an adequate remedy at common law. In either situation, the state has limited, but not entirely rejected, the underlying substantive right. Because the substantive right still exists, a federal court in equity has the discretion to enforce it as it sees fit in all but a handful of cases.

i. Equitable Defenses

Courts of equity have traditionally refused to aid claimants who were guilty of improper behavior. This basic principle is reflected in the equitable defenses of laches and unclean hands. As an important part of the English tradition, these equitable defenses were preserved in the North American colonies. Over the years, however, several states have modified some of the rules governing equitable defenses, raising potential Erie concerns.

For purposes of Erie, most defenses are part and parcel of a substantive right. For example, if a defendant in a breach of contract case proves that the statute of frauds is not satisfied, the court will dismiss the plaintiff's breach of contract claim. In essence, successful imposition of the defense negates the substantive right to recover under that contract. Therefore, a federal court hearing that contract case would be Erie-bound to follow the state rule governing the statute of frauds.

Most courts apparently assume that the same logic applies to equitable defenses. As noted above, a clear majority of federal courts hearing a state-law claim look to state law to determine whether the defendant can prevail on a laches or unclean hands defense. If state law defines the basic right, the argument goes, it should also define when that right is lost because of the conduct of the plaintiff.

But that reasoning is too simplistic. Laches and unclean hands are fundamentally different than other defenses. Unlike the statute of frauds defense, a defendant may assert laches or unclean hands as a defense only when the plaintiff seeks equitable relief. More importantly, a finding of laches or unclean hands negates only the plaintiff's right to equitable relief. That plaintiff may still

260. Of course, laches and unclean hands are not the only defenses available to a defendant in equity. However, these defenses are the only two that are unique to equitable claims. Other defenses based on the conduct of the claimant, such as waiver, contributory negligence, and election of remedies, were historically available in both common law and equity.

Estoppel is a more complex case. Although common law and equity would both bar claims based on estoppel, the doctrines in the two systems originally differed in significant ways. Today, however, common-law estoppel is largely indistinguishable from equitable. McClintock, supra note 91, at 80.

261. See supra note 126.

262. The rule that equitable defenses bar only equitable claims is not universally followed. For example, federal courts have for many years allowed the defense of laches in suits seeking damages under the patent and trademark acts. A.C. Aukerman Co. v. R.L. Chaides Constr. Co., 960 F.2d 1020
recovery will be limited to damages. Because the plaintiff may still recover, the equitable defense does not take away the underlying substantive contract right. An equitable defense, then, is more akin to a bar to certain types of relief than it is to a true defense.

This difference between true defenses and laches and unclean hands is crucial for purposes of the equity exception to Erie. The majority of federal courts that look to state law dealing with laches and unclean hands are in most cases deferring unnecessarily to state law. Unlike true defenses, the existence of a state-law equitable defense will rarely prevent a federal court from granting equitable relief in a case. As long as the state would still provide some relief on the substantive right, the federal court is free to apply federal precedent in determining whether it is appropriate to grant equitable relief.


263. Although laches itself was available only with respect to claims for equitable relief, the same behavior might also give rise to a common-law defense such as estoppel or waiver. Dobbs, supra note 59, at 76. Therefore, a party guilty of laches will not necessarily be able to recover damages.

264. A federal court adjudicating a state-law claim must make an initial reference to state law to determine if laches and unclean hands are "complete" defenses that may be used against both legal and...
the defense is available, even if the result is to allow the claimant to proceed in equity. Although the outcome may differ, that difference is well within the flexibility that Article III and Congress granted to the federal courts in equity.

The only situation in which a state equitable bar would apply is when the state courts would allow only equitable relief on that claim. This situation could arise, for example, in connection with a cause of action that could traditionally be heard only in equity, such as a suit against a trustee for breach of fiduciary duty. If the state would dismiss the suit because of an equitable bar, it has for all practical purposes declared that the party has no judicially-enforceable substantive right. Therefore, if the federal court were to ignore the state-law bar and grant any relief whatsoever, it would exceed its judicial power by creating a new cause of action. Aside from that rare case, however, a federal court need not apply unusual state-law rules governing equitable defenses.

ii. Adequacy of the Remedy at Common Law

The historic notion that a court of equity would refuse to hear a case in which the claimant could obtain full and complete relief at common law was explicitly preserved in the first Judiciary Act. Vagaries in state practice, however, caused problems for the federal courts from a very early date. Some states maintained no courts of equity. Others allocated cases between law and equity in ways different than the English courts. Faced with these problems, the Supreme Court quickly established that adequacy in federal courts of equity was a purely federal issue. In determining whether it could proceed, a federal court of equity was required to consider only those common-law claims recognized by the federal courts, not state law. Thus, a federal court could proceed in equity notwithstanding that the state had created a new remedy or procedure that was available in its common-law courts, or even if the state did not maintain courts of equity. Conversely, a federal court was supposed to deny a remedy if an adequate remedy existed in

equitable claims. If the state law treats it as a complete bar, and the federal standard for laches or unclean hands is the same as the state, a federal court that ignored the defense would in effect be creating a substantive right.

federal common law, even if the state courts would allow the party to proceed in equity. 269

This complete disregard of state practice must be tempered in light of *Erie*. The problem with the approach of these early cases is not that *Erie* somehow limits the discretion that Article III allows a federal court in equity. Rather, the problem is that *Erie* effectively destroys that body of federal common law to which the federal courts in equity had looked for an adequate legal remedy. Today, unless the issue is governed by a federal statute or treaty, the Constitution, or one of the narrow categories of federal substantive judge-made law, state law alone defines whether one party has a legal claim against another. If a party presents that claim to a federal court, *Erie* requires the federal court to administer the state-law right in the same way a state court would administer it. Therefore, a federal court today must survey state law to determine what sorts of claims are alternatives to the equitable remedy sought by the claimant. 270

But *Erie* does not require a wholesale adoption of state rules governing adequacy of the legal remedy. First, although state law provides the list of available actions, whether the state labels those actions as common-law or equitable is not binding on the federal court. Because equity will enforce newly-created substantive rights, a federal court could well deem a novel state-law cause of action equitable notwithstanding that the state labeled it a common-law action. Second, even if a federal court considers a particular state-law action to be at common law, federal law rather than state determines whether that remedy is a complete and adequate alternative to the equitable relief. If a federal court ascertains that a state common-law legal remedy is deficient in one or more respects, it should be free to exercise its judicial power to craft a more suitable remedy, even if the state considers its common-law remedy fully adequate. Thus, although a federal court must look to state law for the common-law alternatives, whether a particular alternative is adequate is a federal issue.

**c. State Law Precludes One, But Not All, Equitable Remedies**

If a federal court may grant an injunction when a state court would give only damages, it stands to reason that a federal court could also grant that injunction when a state court would afford only another type of equitable relief. After all, in this situation the state agrees that the case is appropriate for use of the discretionary powers of equity. Nevertheless, as the rules that bar particular equitable remedies are different than those used to bar all equitable relief, a brief analysis of this situation is useful.


270. Of course, not all state-law remedies are available in a federal court. For example, if a state gives an administrative agency the authority to oversee certain matters, that administrative remedy can be obtained only from the state. If a federal court has no power to provide a state-law remedy, the existence of that remedy ought not preclude a federal court from affording equitable relief.
i. Choice of Remedy

A state court might refuse a certain remedy in a particular case because it finds another equitable remedy better suited to the facts of that case. That decision could simply be an ad hoc determination by a judge, or could be guided by state-court precedent that declares that certain remedies are never available in given cases, such as the commonplace rule that a court will not issue a mandatory injunction to enforce a personal services contract. In either situation, the federal court is free to ignore state practice and grant the remedy. The state clearly recognizes the substantive right. As the federal judicial power in equity includes the authority to select the most appropriate remedy to enforce that right, a federal court may exercise that discretion without considering the state’s opinion as to how a case should be resolved.271

ii. Elements of a Particular Remedy

A state may also refuse to grant a particular remedy because it has established certain standards for use of that remedy. Such state-law limitations on a remedy should rarely, if ever, be binding on a federal court. Regardless of whether the limit is imposed by case law, the state legislature, or even the state constitution, that limit simply represents the state’s view as to whether that particular remedy is appropriate. The Article III judicial power, however, gives the federal courts an independent authority to make that same determination. If a federal court decides that the remedy is appropriate, whether that decision is based on federal precedent or upon the court’s evaluation of the facts of the case, it is not bound by the state law to the contrary.

The only situation in which Erie might require a federal court to honor state-created elements for a particular remedy is where that remedy is inextricably intertwined with the underlying substantive right. It is possible, for example, that a right could be effective only if it is enforced by injunction. If a federal court would grant an injunction in a case where a state court would deny it, the federal court would in effect be creating a new right. However, true right/remedy mergers are exceedingly rare. Accordingly, a federal court in the vast majority of cases will be able to grant equitable remedies even if state law limits the availability of that remedy in state court.

271. Conceivably, however, a state might limit the remedies available for given claim so significantly that it has for all intents and purposes abolished the underlying right. For example, if a state allowed only the imposition of a constructive trust in defamation cases, the right to sue for defamation would be largely illusory. When the state has effectively abolished the underlying right, a federal court is bound to deny all remedies that would honor that right in any way.

272. For example, a state might prohibit its courts from enjoining speech based upon a provision in the state constitution.
iii. Limits on a Remedy Imposed by a State Legislature

At times, state legislatures will limit equitable relief. Many states, for example, will not enjoin violations of covenants not to compete. These legislative limitations should rarely apply in federal litigation. Of course, the limits reflect important state policy concerns involving the underlying right. A federal court should certainly acknowledge these concerns, and consider them when deciding whether to grant the requested remedy. Nevertheless, the federal court is not bound by the state determination, and may grant the remedy if it finds it appropriate.

Another way in which a state legislature may limit equity is to create a new right, but authorize only one or two remedies for enforcing that right. A state legislature does, of course, retain the sole authority to define substantive rights as it sees fit. Any restrictions on the right itself must be honored by the federal court, including who may bring an action to enforce the right, the damages that may be recovered, and how long the right lasts. But a federal court is usually not bound by a state legislature’s attempt to cut off certain available remedies. If a federal court considers an accounting to be the most effective way to enforce that right, it may grant that remedy even though the state legislature limited the remedy to damages. Once again, the only exception is where the legislature has limited the remedy so greatly that it has in effect rendered the underlying right a nullity or fundamentally changed its character. Although these situations involving a right-remedy merger may be more common in the case of legislatively-imposed limits, they still make up only a small percentage of cases.

In short, then, Erie requires a federal court in equity to apply a state law denying recovery only when the state either does not recognize the right at all, or when it has foreclosed all effective remedies for that right. In these situations, for a federal court to grant any remedy would create a new substantive right enforceable only in federal court, an act that falls without the judicial power of Article III. However, as long as the state allows any effective remedy, legal or equitable, for a substantive right, the federal court may grant whatever equitable remedy it chooses.

2. Federal Equity's Power to Deny Relief When a State Court Would Grant It

Although this situation appears to be merely the converse of that discussed in the prior section, subtle differences in court procedure require a separate analysis. Procedural rules were not a great concern in the earlier discussion. A federal court that grants equitable relief where a state court would deny all relief has certainly “created” a new substantive right. A federal court that denies relief when a state

273. See, e.g., Sims Snowboards, Inc. v. Kelly, 863 F.2d 643 (9th Cir. 1988) (California statute prevented a preliminary injunction).
court would grant it, however, has not necessarily refused to recognize the substantive right. As long as the claimant may still enforce the right in some other way, the federal court's refusal to grant the remedy does not destroy the underlying legal relationship created by the state.

a. Federal Limits on Particular Remedies

Federal rules dealing with specific equitable remedies are the easiest case. For example, a federal court's decision not to grant an injunction where such relief would be against the public interest is clearly within the Article III judicial power. Although the court might deny the injunction, it would still grant damages or other appropriate common-law relief. Therefore, as the federal court has in fact enforced the underlying legal right, albeit not as fully or effectively as the plaintiff had hoped, it has not engaged in the sort of substantive lawmaking condemned by *Erie*.

As before, a few cases may involve a right/remedy merger, where the underlying right can be effectively enforced in only one particular way. Denying that remedy would be akin to rejecting the underlying right, which the federal court cannot do. Although several federal courts have found a right/remedy merger in cases of this sort, all involved a request for a preliminary injunction, which as discussed above is a unique situation. The only other case in which a federal court might find a merger is where the state recognizes a novel remedy such as an apology or a declaratory judgment, and no other relief effectively vindicates the right.

b. Federal Rules Barring All Equitable Relief

The Supreme Court's *Quackenbush* decision, discussed above, establishes that a federal court in equity may invoke policy considerations to refuse to hear state-law rights, regardless of whether those policy considerations would matter to a state court. That decision is entirely consistent with the thesis of this article. A grant of equity jurisdiction is a grant of discretion to determine how rights should be enforced. Historically, that discretion included the right to deny any equitable remedy if the circumstances so warranted. The English courts reduced some of these discretionary factors to rules, which today constitute the equitable defenses.

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275. Courts grant preliminary injunctions in order to reduce or prevent the harm that litigants may suffer before the lawsuit can be resolved. In essence, then, the preliminary injunction creates a substantive right to preserve the status quo for the pendency of the lawsuit. Because no other remedy really accomplishes that goal, the preliminary injunction may be one of those rare cases in which the right and remedy merge.

Regardless of whether it is based on case-by-case discretion or an established equitable defense, however, a federal court's refusal to grant equitable relief does not mean that the court has rejected the claimant's substantive right, but merely limits the claimant to a common-law remedy.\footnote{277}

\subsection*{Equitable Defenses}

Contrary to the clear majority rule,\footnote{278} a federal court should be free to deny equitable relief based upon laches or unclean hands regardless of whether that defense would apply in a state proceeding. Equitable defenses focus on whether it is fair to allow a party who has misbehaved to invoke the extraordinary powers of equity. The penalty for misbehavior is not loss of the substantive right, but only the denial of any equitable relief.\footnote{279} Therefore, except in the rare case of a right/remedy merger, \textit{Erie} does not apply to federal equitable defenses.

The result is the same even if the state legislature abrogates one of the defenses. A statute of limitations, for example, is often interpreted as supplanting the equitable defense of laches.\footnote{280} Nevertheless, a federal court is free to deny equitable relief based on laches even if the applicable state statute of limitations has not yet expired. Because a decision to apply laches is a decision to refuse the plaintiff access to equitable discretion, it is a jurisdictional matter governed by federal instead of state law.\footnote{281}

\subsection*{Adequacy}

Federal instead of state law likewise controls whether the common-law relief is full and adequate. As with equitable defenses, a determination of adequacy

\footnote{277. In systems that operate separate common-law and equity courts, a court of equity would dismiss the case if it found unclean hands or laches. As discussed \textit{supra} in note 218, that dismissal did not preclude the plaintiff from filing again in common law. In a modern unified system like the modern federal courts, a court that finds laches or unclean hands will not dismiss the action, but will instead deny all equitable relief. Even if the plaintiff has requested only equitable remedies, Federal Rule of Civil Procedure 54(c) allows the court to grant whatever relief it deems appropriate.

Of course, a federal court invoking an equitable defense must still provide some form of relief. Even abstention does not necessarily deprive the claimant of a forum. \textit{Quackenbush} allows a federal court to abstain only when presented with a claim for discretionary relief. Thus, if a party has suffered an injury compensable by damages, a federal court may nevertheless be required to hear the case.

\footnote{278. \textit{See supra} note 126.}

\footnote{279. As discussed \textit{supra} in note 262, some states allow laches and unclean hands to be asserted in all cases, not just in equity. \textit{Supra} note 264 discusses how a federal court should deal with a case under the law of one of those states.}

\footnote{280. Dobbs, \textit{supra} note 59, at 77-78.}

\footnote{281. In fact, federal courts will typically not dismiss an equitable claim based on laches if that claim is governed by a statute of limitations that has not expired. Ashley v. Boyle's Famous Corned Beef Co., 66 F.3d 164, 169 (8th Cir. 1995) (federal law); FDIC v. Fuller, 994 F.2d 223, 224 (5th Cir. 1993) (state law); Miller v. Maxwell's Int'l, Inc., 991 F.2d 583, 586 (9th Cir. 1993), \textit{cert. denied}, 510 U.S. 1109, 114 S. Ct. 1049 (1994). The argument in the text merely demonstrates that they would be free to invoke the equitable defense in such a case.}
merely limits the claimant to damages or other common-law relief. Moreover, unlike many of the other rules discussed in this section, there will never be a case where a federal court's determination of adequacy runs afoul of the problem with right/remedy merger. If the federal court has determined that damages or other common-law relief is adequate, then the underlying substantive right is being fully vindicated.

c. Federal Law Precludes All Relief

Just as a federal court in equity cannot create new substantive rights, it is powerless to destroy rights that a state has created. However, a federal court does not necessarily destroy a right merely because it refuses to provide any relief to a claimant. For example, consider a federal court faced with a new and unique state-law cause of action that is equitable in nature. Because that cause of action was not one historically recognized by equity, a federal court applying federal precedent might be inclined not to recognize it. The court would probably dispose of the case by granting a dismissal under Federal Rule of Procedure 12(b)(b). Whether that dismissal terminates the substantive right turns on whether the claimant is barred by res judicata from presenting the same claim to another court. Although a 12(b)(6) dismissal ordinarily does bar relitigation, the court can specify that the dismissal is "without prejudice." Therefore, a federal court conceivably could refuse to provide any relief on a claim without actually affecting the claimant's substantive rights.

However, a federal court should not be able to shirk its duties under Erie in this fashion. The essence of Erie is that federal courts must defer to Congress and the state for the substantive law. Congress has further made the federal courts

282. The argument in favor of applying federal law on the question of adequacy may actually be even more compelling than the argument for equitable defenses. There is a strong jurisdictional flavor to the issue of adequacy. Traditionally, the adequacy determination controlled whether the equity courts could even hear the case. Although there were no separate federal equity courts, Congress also specifically drew the line between the common-law and equity sides of the federal courts based upon the standard used in the English courts. Judiciary Act of 1789, § 16, ch. 20, 1 Stat. 82 (1789). Because Congress has exclusive control over federal jurisdiction, where a state happens to draw the line between common-law and equity is irrelevant.

283. Fed. R. Civ. P. 41(b). The Supreme Court has interpreted 41(b) literally, holding that 12(b)(6) dismissals are with prejudice unless the judge specifies otherwise. Federated Dep't Stores, Inc. v. Moitie, 452 U.S. 394, 399 n.3, 101 S. Ct. 2424, 2428 n.3 (1981).

284. Not all equitable causes of action involve substantive rights. Equity also recognized several auxiliary causes of action, such as the bill of discovery, a creditor's suit to help collect a judgment, receivership, and the suit to reopen a judgment for fraud upon the court. See generally McClintock, supra note 91, at 547-60. Most of these auxiliary actions have been supplanted by statute or court rules, and therefore are no longer a real issue. A few, however, remain in force in some states, especially the independent action to set aside a judgment. Cf. Fed. R. Civ. P. 60(b), which recognizes the possible existence of the action to set aside a judgment.

Federal courts should not be required to hear a case in which a party asserts an auxiliary equitable right that is not otherwise available in federal court, even if it results in the federal court dismissing the proceeding. Although these equitable actions create new legal rights, those rights exist only as an adjunct to an existing cause of action that involves a substantive legal rule. Therefore, the only right
available for hearing state-law claims between diverse parties. For a federal court
to dismiss a case without prejudice based on the fact that the underlying substantive
right did not exist in English equity, thereby forcing the claimant to protect her
rights in state court, violates the essence of Erie and the explicit command of
Congress.\(^{285}\) Congress did not intend for its grant of equitable discretion in the
diversity statute to include the discretion to refuse all enforcement of valid state-
law rights. Therefore, a federal court must grant some effective remedy, although
not necessarily an equitable remedy, for all state-law equitable causes of action.\(^{286}\)

In conclusion, although the two situations arise in different contexts and
involve different considerations, a federal court's power to deny relief when sitting
in equity is roughly the mirror image of its power to grant relief. A federal court
must defer to the state on the issue of whether a substantive right exists.\(^{287}\) If no
right exists, the federal court cannot grant any relief whatsoever. If a right does
exist, however, a federal court asked to provide equitable relief has broad authority
to enforce that right by applying federal judge-made law. As long as the court
affords some effective remedy, it has satisfied the requirements of Erie. Because
the Constitution gives the federal courts considerable discretion when acting in
equity, they have the authority to reach an outcome different from the likely result
in state court.

V. CONCLUSION

The actual holding of Guaranty Trust Co. v. York does not immediately square
with some of the language found in the majority opinion. Although the Court held
that Erie required a federal court to apply the particular state law in question, the
majority argued that Erie applied differently in equity than it did in common law.
Because the Court did not explain why equity enjoyed this special status, that
dictum has led to some confusion in the lower courts.

This article has demonstrated that the basic premise of the York dictum is
correct. There are, in fact, two distinct "equity exceptions" to Erie. The first is
that a federal court's power to "fill in the gaps" in a federal statute by creating a
body of auxiliary rules includes the authority to apply a federal law of equity,

\(285\) A federal court in this situation may still refuse to hear a case for reasons other than the nature
of the underlying claim, such as *forum non conveniens* or abstention.

\(286\) Of course, there may be other reasons why a federal court is precluded from hearing the claim.
The eleventh amendment to the Constitution, for example, prevents a federal court from hearing state-
law claims against state defendants.

\(287\) If Congress, acting within its constitutional authority, either creates a new right or abolishes
a state-law right, the federal court must of course defer to Congress.
derived from historical principles of equity. As a federal court's general gap-filling power is already widely recognized, this first exception is largely undisputed.

The second exception is both broader in scope and more controversial. A federal court in equity has considerable power to diverge from state law on matters pertaining to how a right should be enforced. The federal courts derive that authority from the Article III judicial power. By extending the judicial power to include cases in equity, the framers contemplated that federal courts would continue to exercise the sorts of discretion that characterized English Chancery. Although that discretion does not allow the federal courts to create or destroy substantive rights, it does give them considerable flexibility when dealing with rights created by either Congress or the states. In most instances, federal courts have the authority to apply their own rules governing remedies, equitable defenses, and whether the remedy at common law is adequate.

Of course, this article is not intended to be the last word on the equity exception to *Erie*. Equity is largely an historical accident, which produced a system that includes many widely-varying rules. Courts and commentators must continue to explore how *Erie* applies to each of the myriad rules that form up this law of equity. Although this article merely scratches the surface, use of the general principles set out above should help guide the courts and commentators in their task.