

FEDERAL LAW TRUMPS STATE CLASS ACTION RULES

PERSPECTIVE

By Brian Kabateck and Evan Zucker

Last week, the U.S. Supreme Court issued its long awaited decision in *Shady Grove*, upholding the federal rules of procedure for certifying class actions in federal court. *Shady Grove Orthopedic Associates, P.A. v. Allstate Insurance Co.*, 08-1008.

The case began when a woman who was injured in a car accident assigned her insurance benefits to her medical provider, Shady Grove. The insurer, Allstate, paid the benefits but paid them late. That late payment incurred interest. And that statutory interest was the subject of *Shady Grove*.

Shady Grove alleged approximately \$500 of damage, but further argued that Allstate routinely failed to pay the statutory interest penalty due on late payments. As a result, Shady Grove filed its claim as a class action on behalf of a class of similarly injured plaintiffs. The plaintiff sued in federal district court on diversity grounds in New York for breach of contract under state law.

In New York, the state law analog to California Code of Civil Procedure Section 382 and Federal Rule of Civil Procedure 23 is New York Civil Practice Law Section 901. It outlines the requirements for maintaining a class action. Among other things, New York's Section 901 limits maintenance of class actions to cases that do not seek penalties. So, under the New York class action rules, Shady Grove cannot maintain a class action because the statutory interest they seek is a penalty. Yet under Federal Rule 23, there is no similar prohibition against class actions seeking to recover penalties.

In *Shady Grove*, the Supreme Court needed to decide which rule should apply in diversity cases, Federal Rule 23 or New York's Section 901? The court by way of a split decision decided that Rule 23 is applicable to the exclusion of New York's Section 901. Justice Antonin Scalia authored the majority opinion. But he was joined by a 5-4 majority only on the outcome, not on the rationale for that outcome. Justice John Paul Stevens joined the outcome but asserted a different rationale and Justice Ruth Bader Ginsburg penned the dissent on behalf of herself, Justice Anthony M. Kennedy, Justice Stephen G. Breyer and Justice Samuel A. Alito, Jr.

In order to determine whether a federal rule or a state rule should apply while a federal district court sits in diversity, the Court relied on a seemingly simple rule guided by the Rules Decision Act. That rule says that state laws are controlling on substantive issues but federal rules trump state laws on procedural issues. This distinction is cumbersome, ill defined and, as the court says, partially controlled by the "murky waters" of the Erie doctrine, which basically requires federal courts to apply the laws of the state in which they sit in diversity cases. *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938).

When both a federal rule and a state rule appear to govern a particular issue, courts must first look to see if the federal rule is in actual conflict with a state rule. This is where the majority and the dissent in *Shady Grove* differ. Led by Scalia, the majority read Rule 23 as defining the universe of situations where a class action could be maintained at the discretion of the plaintiff. It also said that New York's Section 901(b) presented a situation where a plaintiff could not maintain the class action, thereby finding the two rules in conflict. On the other hand, Ginsburg's dissent asserts that the two rules could co-exist because New York's Section 901(b) can be read as merely limiting the remedy available to a plaintiff.

When a conflict is found, the court must determine if the federal rule is a proper exercise of the court's Congressional mandate to create federal procedural rules found in the Rules Enabling Act. Stevens' analysis under the act looks at whether the federal rule abridges, enlarges or modifies any substantive right. If so, under this analysis, it oversteps the mandate provided to the Supreme Court by Congress. Scalia's presents a two-part analysis. First it must be determined whether the rule governs only the manner and means by which the litigants' rights are enforced, in which case the federal rule would be valid. Second, if the rule alters the procedures by which the court will adjudicate those rights, then the federal rule would fail.

While Stevens concurred on the outcome of the case, under his test it appears clear that other state statutes that are procedural in nature but function to define the scope of a state created right would not give way to federal procedural counterparts. Scalia opines that determining whether a seemingly procedural state rule is so intertwined with a state right or remedy is a complex, time consuming and inexact analysis that is unnecessary.

Under these differing formulations, both opinions find that Rule 23 is a proper exercise of procedural rule making authority granted to the Supreme Court by Congress. When the Supreme Court is put in charge of deciding which rules they themselves can promulgate, it should come as no surprise, as Scalia pointed out, that the Court has "rejected every statutory challenge to a Federal Rule that has come before [them]."

What does that mean for the litigants in this case? Given that *Shady Grove* has diversity under the Class Action Fairness Act and because they chose to file this case in federal district court, it is free to proceed as a class action seeking to recover penalties under Rule 23. This holds true despite the fact that the class would be barred from the same recovery had they filed their suit in New York state court. The Supreme Court notes that this approach may invite forum shopping. Indeed, if this case was in state court the plaintiff could individually seek a remedy of \$500. But in federal court, all the parties injured by Allstate's uniform practice can be aggregated as a class action and could seek damages up to \$5 million. While unlikely, individual plaintiffs are free to pursue claims for statutory penalties on their own in New York state court and each party injured by Allstate's practices could theoretically bring their own suit. With a federal forum available, *Shady Grove* provides a better and more efficient resolution of a large number of individual claims and a mechanism for holding the wrongdoer accountable.

What does this decision mean for litigants in the future? First, the underlying analysis to determine whether a federal rule or state rule applies in a diversity setting has not changed. The touchstone of whether or not the rule is procedural or substantive has not been altered and the specific formulation of how to determine if a rule is procedural or substantive is unmodified. Moreover, whether or not a federal rule goes beyond the Supreme Court's authority to issue that rule under the Rules Enabling Act has not been amended. In fact, the split of opinion here differed not on what the standards were in governing this case. Instead,

they differed on the application of those standards to the specific rules at issue. The district and appellate court applied Section 901(b) and held that no class action could be maintained due to the section's prohibition on classes seeking penalties. The majority in *Shady Grove* held that Federal Rule 23 was the proper procedural rule to govern the question of whether this case could be maintained as a class action.

In a footnote, the dissent warns that this decision may limit a state's ability and motivation to pass limitations on remedies in the future because litigants can merely forum shop their way into federal court and around state laws. This fear is most likely unfounded because, as the majority notes, Section 901(b) was not a limit on remedies. Instead, it went much further and limited the ability to maintain a class action at all. If the New York Legislature were to pass a new law limiting the remedies available to class action litigants, without limiting the procedural mechanism as a whole, they would likely not run afoul of the *Shady Grove* decision.

In the future, counsel must closely consider the effects of federal procedural rules in diversity cases with a particular eye on how state court limitations might be superseded in order to avoid being blindsided. For the time being, this case is unlikely to have an immediate effect in California because there is no analogous class action limitations in this state to New York's Section 901(b) and the majority in *Shady Grove* secured an outcome that was not directed at the heart of the analysis, which is found only in a plurality opinion.

Brian Kabateck is a consumer rights attorney and founder of Kabateck Brown Kellner in Los Angeles. He represents plaintiffs in mass torts litigation, class actions, insurance bad faith, insurance litigation, and commercial contingency litigation.

Evan Zucker is an associate at Kabateck Brown Kellner in Los Angeles, where he practices consumer litigation.