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LEGAL ALERT

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Shady Grove: No Sanctuary for Federal Class Action Defendants

The Supreme Court's fractured decision on March 31, 2010 in *Shady Grove Orthopedic Associates, P.A. v. Allstate Ins. Co.*, 559 U.S. ___ (2010), appears to invalidate the enforcement in federal diversity class actions of many state law restrictions against proceeding on a class basis. Because numerous state statutes provide for civil actions to enforce state law rights but prohibit class actions, the decision has broad implications, particularly in view of the expansive federal jurisdiction over class actions conferred by the Class Action Fairness Act (CAFA).

Background

The litigation stemmed from Sonia Galvez's injury in an automobile accident. Her car was registered in New York, and she held a New York no-fault policy with Allstate Insurance that provided her with medical reimbursement rights. Ms. Galvez received treatment at Shady Grove Orthopedic Associates, to which she assigned her medical reimbursement rights. Shady Grove contended that Allstate failed to comply with Section 5106(a) of New York Insurance Law, which requires payment to be made within 30 days of receipt of the claim. Shady Grove sued Allstate for statutory interest penalties under Section 5106(a), alleging that Allstate routinely failed to pay its claims within the statute's mandated time frame and routinely failed to pay the statutory interest penalties when its claims were paid late. The interest penalties in Ms. Galvez's case alone were only $500, but Shady Grove alleged damages of more than $5 million on behalf of a putative class of all individuals who were owed interest payments under the New York law. Shady Grove brought its action in federal court based on diversity jurisdiction under CAFA. 28 U.S.C. § 1332(d)(2)(A). Allstate moved to dismiss the action, relying on New York Civil Practice Law and Rules ("CPLR") § 901(b), which prohibits class actions based on statutory penalties unless the underlying statute specifically allows class actions. Shady Grove argued that CPLR § 901(b) is inapplicable to class actions brought in federal court, because it is a state procedural rule that conflicts with Rule 23 of the Federal Rules of Civil Procedure.

Applying the doctrine of *Erie Railroad Co. v. Tompkins*, the district court agreed that Rule 23 would control a federal class action, but found that § 901(b) did not conflict with Rule 23. CPLR § 901(b) controlled the right to bring a class action in New York in the first place; once a class action was brought in federal court, Rule 23 would govern the class certification procedure. The court found that § 901(b) was not a procedural, but a substantive provision, and noted that "it would be patently unfair to allow a plaintiff an attempt at recovery in federal court for a state law claim that would be barred in state court."[1] The Second Circuit affirmed the district court's decision.[2]

In the Supreme Court, Allstate argued that if Shady Grove were to prevail, and the Court were to hold that states could not limit the types of state law claims that may be brought as class actions, then it would invalidate many other state laws that prohibit certain claims from being brought as class actions. This would limit the power of states to define how state-created rights of action may be enforced.[3] Allstate

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[1] *Shady Grove Orthopedic Assocs., P.A. v. Allstate Insurance Co.*, 466 F. Supp. 2d 467, 472 (E.D.N.Y. 2006) (quoting *Dorenberger v. Metropolitan Life Ins. Co.*, 182 F.R.D. 72, 84 (S.D.N.Y. 1998)).

[2] *Shady Grove Orthopedic Assocs., P.A. v. Allstate Insurance Co.*, 549 F.3d 137 (2d Cir. 2008).

[3] Brief for the Respondent, *Shady Grove Orthopedic Assocs., P.A. v. Allstate Insurance Co.*, 559 U.S. ___ (2010) (No. 08-1008) at Appendix B.

cited 59 representative state statutes that limit class actions as an enforcement mechanism, including the Georgia Fair Business Practices Act, O.C.G.A. § 10-1-399(a) and the Tennessee Consumer Protection Act, Tenn. Code. § 47-18-109(a).[4]

Supreme Court Decision

Five justices joined Justice Scalia's opinion holding that the case could proceed as a class action notwithstanding § 901(b)'s prohibition on class actions for statutory penalties. First, the majority held that since § 901(b) attempted to answer the same question as federal Rule 23— whether or not a suit may be maintained as a class action—"it cannot apply in diversity suits unless Rule 23 is ultra vires" under the Rules Enabling Act, 28 U.S.C. § 2072. (Slip op. at 4.)

Next, the majority rejected the distinction drawn by the Second Circuit between whether a class can be certified and whether a particular type of claim is eligible for class treatment in the first place, finding it to be "entirely artificial." (Slip op. at 5.) "There is no reason, in any event, to read Rule 23 as addressing only whether claims made eligible for class treatment by some *other* law should be certified as class actions." (*Id.*) The majority distinguished - but expressed no view on - laws that set ceilings on damages or restrict particular remedies in properly filed class actions, reasoning that § 901(b) "says nothing about what remedies the court may award; it prevents the class actions it covers from coming into existence at all." (*Id* at 7.)

The five-justice majority splintered when it dug more deeply into the rationale for the decision. Three justices (Chief Justice Roberts and Justices Thomas and Sotomayor) joined Justice Scalia's opinion that the *Erie* question in every case turns solely on the federal rule itself: "it is not the substantive or procedural nature or purpose of the affected state law that matters, but the substantive or procedural nature of the Federal Rule." (Slip op. at 16.) Rule 23's procedural nature mandates its application.

Justice Stevens disagreed, writing in his concurrence that some state rules which regulate procedure must be applied in diversity cases because the function as part of the state's definition of substantive rights and remedies. In Justice Stevens's view, however, § 901(b) is procedural in nature, and Rule 23 should therefore govern in diversity class actions asserting claims under New York law.

In dissent, Justice Ginsburg, joined by Justices Kennedy, Breyer and Alito, argued that New York's prohibition on class actions seeking penalties or statutory minimum damages is substantive and should be applied in federal court under *Erie* and the Rules Enabling Act. The dissent pointed out the "large irony" that the majority's decision coupled with CAFA "would make federal courts a mecca for suits of the kind Shady Grove has launched: class actions seeking state-created penalties for claims arising under state law—claims that would be barred from class treatment in the State's own courts." (Slip op. at 24.)

Shady Grove's outcome will surprise many observers. The unusual mix of justices in the majority and the dissent alone is noteworthy. That division may have originated more in alignments in the Court's past *Erie* cases than in contemporary class action wars. Justice Ginsburg authored the Court's *Erie* opinion in *Gasperini v. Center for Humanities, Inc.*, which held that a New York statute setting a standard for review of money damaged awards stricter than the federal standard should be applied in federal court, because

[4] *Id.*

it operates similarly to a cap on damages, which is a matter of substantive state law.[5] Justice Scalia dissented from that decision.

In future cases that apply *Shady Grove,* Justice Stevens's concurring opinion is likely to receive close scrutiny. That opinion implies that some prohibitions on class actions tied to a specific statute might still be applicable in federal court under the Rules Enabling Act, if the prohibitions are deemed substantive. The majority opinion also expressly leaves open whether state law restrictions on remedies in certified class actions apply in federal court. For the time being, though, at least one prediction in Justice Scalia's opinion seems unassailable. "We must acknowledge the reality that keeping the federal-court door open to class actions that cannot proceed in state court will produce forum shopping." (Slip op. at 22.)

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[5] *Gasperini v. Center for Humanities, Inc.*, 518 U.S. 415, 428-29 (1996).