FEDERAL "PROCEDURAL" RULES UNDERMINE IMPORTANT STATE INTERESTS IN *SHADY GROVE ORTHOPEDIC ASSOCIATES, P.A. V. ALLSTATE INSURANCE CO.*, 130 S. CT. 1431 (2010)

Since the Supreme Court's decision in *Erie Railroad Co. v. Tompkins*,[1] federal courts have attempted to apply state "substantive" law and federal "procedural" law when sitting in diversity.[2] Courts draw this distinction differently depending on whether a Federal Rule of Civil Procedure (Federal Rule) "directly conflicts" with the state law.[3] When a court determines that a Federal Rule does not govern a question, it then applies the "twin aims of *Erie*" test to determine whether state law should apply.[4] This test asks if applying state law is necessary to (1) avoid inequity between in-state and out-of-state litigants, and (2) avoid incentives for forum-shopping.[5] Courts often read a Federal Rule quite narrowly to avoid a conflict with "substantive" state law.[6] In *Sibbach v. Wilson & Co.*,[7] however, the Court held that when a Federal Rule directly conflicts with

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1. 304 U.S. 64 (1938).

2. Gasperini v. Center for Humanities, Inc., 518 U.S. 415, 427 (1996).

3. *See* Shady Grove Orthopedic Assocs., P.A. v. Allstate Ins. Co., 130 S. Ct. 1431, 1461 (2010) (Ginsburg, J., dissenting).

4. Walker v. Armco Steel Corp., 446 U.S. 740, 747 (1980).

5. Hanna v. Plumer, 380 U.S. 460, 467–68 (1965).

6. The Court has said that "Federal Rules should be given their plain meaning." *Walker*, 446 U.S. at 750 n.9 ("This is not to suggest that the Federal Rules of Civil Procedure are to be narrowly construed in order to avoid a 'direct collision' with state law."). Nevertheless, in practice the Court has actively narrowed the scope of federal rules to avoid conflict with substantive state interests. *See, e.g.*, *id.* 750–52 (holding that state law controls tolling for statute of limitations, notwithstanding Rule 3); Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 556 (1949) (enforcing state requirement that plaintiffs in stockholder derivative suit post a security bond, notwithstanding another Federal Rule listing different prerequisites); Ragan v. Merchants Transfer & Warehouse Co., 337 U.S. 530, 531–33 (1949) (holding that state law controls tolling for statute of limitations, notwithstanding Rule 3); Palmer v. Hoffman, 318 U.S. 109, 117 (1943) (limiting Rule 8(c) to avoid conflict with pleadings standards). Even Justice Scalia, writing for the Court in *Shady Grove*, agreed with the dissent that the Court "should read an ambiguous Federal Rule to avoid substantial variations in outcomes between state and federal litigation." 130 S. Ct. at 1441 n.7 (internal quotations, citation, and alteration omitted).

7. 312 U.S. 1 (1941).

state law, the Federal Rule must govern unless it is facially invalid for conflicting with the Rules Enabling Act.[8] The Act authorizes the Supreme Court to promulgate rules of procedure for federal courts, with the proviso that such rules not "abridge, enlarge or modify any substantive right."[9] This limitation has been construed as authorizing any federal rule that is "arguably procedural"[10] without regard for the nature of the substantive rights that may be modified by application of the rule in particular cases. Last Term, in *Shady Grove Orthopedic Associates, P.A. v. Allstate Insurance Co.*,[11] the Supreme Court held that the Federal Rules permit a class action suit to go forward in federal court even though it would have been barred in state court. This ruling frustrates important state legislative objectives and exposes defendants to massive liability in diversity suits. The "arguably procedural" approach is at odds with the plain meaning of the statute and should be retired. In its place, the Court should adopt an "as applied" test for determining how Federal Rules apply in diversity suits.

Petitioner Shady Grove, a healthcare provider, alleged that Allstate Insurance was routinely late in paying out benefits and refused to pay the two-percent monthly interest penalty required by New York law.[12] Shady Grove filed a diversity suit in the Eastern District of New York "on behalf of itself and a class of all others to whom Allstate owes interest."[13] Under New York Civil Practice Law Section 901(b) (Section 901(b)), a class action "may not be maintained" to recover a "penalty" or statutory minimum damages,[14] thus limiting class certification to plaintiffs seeking only actual damages. There is no comparable prohibition in Federal Rule 23, which contains its own, apparently exclusive, criteria for class certification.[15] New York enacted its prohibition out of concern that combining statutory minimum penalties with the

8. 28 U.S.C. § 2072(b) (2006).

9. *Id.*

10. *Hanna*, 380 U.S. at 476 (Harlan, J., concurring).

11. 130 S. Ct. 1431 (2010).

12. *Id.* at 1436 (citing N.Y. INS. LAW § 5106(a) (McKinney 2009)).

13. *Id.* at 1436–37.

14. N.Y. C.P.L.R. § 901(b) (McKinney 2010).

15. The criteria are: numerosity, commonality, typicality, and adequacy of representation. FED. R. CIV. P. 23(a).

class action device could lead to "annihilating punishment."[16] A common purpose of both statutory penalties and the class action device is to incentivize lawsuits that might not otherwise be worth the time, effort, or cost; so combining the two devices would greatly magnify incentives to sue.

Both the Eastern District of New York and the Second Circuit held that Rule 23 and section 901(b) could be applied simultaneously. According to the Second Circuit, the New York statute creates a threshold inquiry—whether certain causes of action are even eligible for class treatment—that must be answered before the procedural criteria of Rule 23 can be applied.[17] Because the court found no conflict between the Federal Rule and the state statute, the court analyzed Section 901(b) under the "twin aims of *Erie*" test. The obvious conclusion was that a failure to apply the New York prohibition on class actions seeking penalties would create an enormous incentive for plaintiffs to choose the federal forum.[18] In so ruling, the Second Circuit followed "the overwhelming majority of district courts that have concluded that section 901(b) is a substantive law that must be applied in the federal forum, just as it is in state court."[19]

In an opinion by Justice Scalia,[20] the Supreme Court reversed. The Court held that Rule 23 and section 901(b) could not apply simultaneously.[21] The Court rejected the Second Circuit's attempt to draw a distinction between class "eligibility" and class "certifiability,"[22] concluding that the two concepts are functionally identical. Although the language of Rule 23 prescribes preconditions that determine when a class action "*may* be

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16. *Shady Grove*, 130 S. Ct. at 1440 (citing Vincent Alexander, *Practice Commentaries*, *in* N.Y. C.P.L.R. § 901, at 104 (McKinney 2010)). Although the majority and the concurrence reject this legislative history as too flimsy to support a conclusion about the purpose of the statute, they offer no plausible alternative. *See id.* ("This evidence of the New York Legislature's purpose is pretty sparse."); *id.* at 1458 (Stevens, J., concurring) (suggesting, without offering examples, that there are "any number of reasons" the statute might have been enacted).

17. Shady Grove Orthopedic Assocs., P.A. v. Allstate Ins. Co., 549 F.3d 137, 143 (2d Cir. 2008), *rev'd*, 130 S. Ct. 1431 (2010).

18. *Id.* at 145.

19. *Id.* (collecting cases).

20. Justice Scalia announced the opinion of the Court in Parts I and II-A, in which Chief Justice Roberts and Justices Stevens, Thomas, and Sotomayor joined.

21. *Id.* at 1438.

22. *Id.*

maintained,"[23] the Court explained that the "discretion suggested by [the word] 'may' is discretion residing in the plaintiff"[24] rather than the court. Thus, "Rule 23 provides a one-size-fits-all formula for deciding the class-action question. Because § 901(b) attempts to answer the same question . . . it cannot apply in diversity suits unless Rule 23 is ultra vires."[25]

Having concluded that direct conflict was unavoidable, the Court's second inquiry was whether Rule 23 is consistent with the Rules Enabling Act.[26] Justice Stevens did not join this part of the opinion, so it commanded only a four-Justice plurality. Justice Scalia quoted the language of the Act, which states that Federal Rules "shall not abridge, enlarge or modify any substantive right,"[27] but he never actually applied that statutory language to the case. Instead, he turned directly to prior cases interpreting the Rules Enabling Act.[28] Under these cases, Federal Rules are valid if they are "rationally capable of classification as procedure"[29] or if they "really regulate procedure."[30] According to this approach, a Federal Rule is either facially invalid in all jurisdictions or it applies everywhere, and the validity of a rule is determined by looking at the rule alone, without reference to state law. If the Federal Rule is at least somewhat procedural, it will apply notwithstanding any state law to the contrary.[31] Applying this test, the plurality concluded that Rule 23 was a valid exercise of the Supreme Court's rulemaking authority.

Justice Stevens wrote separately to dispute the contention that state law is irrelevant to the question of whether a Federal Rule must apply. Although he agreed that in this case Rule 23 must apply instead of section 901(b), he argued that the Rules Enabling Act inquiry requires a court to examine the state law being displaced. Unlike Justice Scalia, Justice Stevens emphasized the plain language of the Rules Enabling Act, concluding that the words "*shall not* alter *any* substantive right" instruct

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23. FED. R. CIV. P. 23(b) (emphasis added).
24. *Shady Grove*, 130 S. Ct. at 1438.
25. *Id.* at 1437.
26. *Id.* at 1492.
27. 28 U.S.C. § 2072(b) (2006).
28. *Shady Grove*, 130 S. Ct. at 1437, 1442.
29. *Id.* (citing Hanna v. Plumer, 380 U.S. 460, 472 (1965)) (internal quotations omitted).
30. *Id.* (citing Sibbach v. Wilson Co., 312 U.S. 1, 14 (1941)) (alteration omitted).
31. *See id*. at 1444.

courts to review the validity of Federal Rules *as applied*.[32] Justice Stevens suggested that a state law may be "procedural in the ordinary use of the term but [be] so intertwined with a state right or remedy that it functions to define the scope of the state-created right."[33] He recognized that Justice Scalia's "arguably procedural" approach essentially ignores the language of the Enabling Act.[34] Nevertheless, Justice Stevens concurred in the result because he found that section 901(b) did not clear the "[high] bar for finding an Enabling Act problem."[35] Justice Stevens articulated two principal grounds for this conclusion: First, the text of the New York statute is not expressly limited to New York penalties. Because the prohibition on class actions apparently applied to penalties under the laws of other states as well as federal penalties, it was not clear that this rule "serves the function of defining New York's rights or remedies."[36] Second, Justice Stevens concluded that the nature of the class action device is essentially procedural—each individual class member must have a valid claim, so there is no difference in the total liability to which the defendant is exposed.[37] The only difference, according to Stevens, is the efficiency of the litigation.[38]

Justice Ginsburg dissented, concluding that Rule 23 and section 901(b) do not directly conflict.[39] Instead of a neutral, plain-meaning interpretation of the Federal Rule in question, the dissent endorsed a "vigilant[] read[ing of] the Federal Rules to avoid conflict with state laws,"[40] and argued that Federal Rules should be interpreted "with sensitivity to important state interests."[41] Such an approach requires a more probing inquiry into

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32. *Id.* at 1452 (Stevens, J., concurring) (first emphasis added) (internal quotations omitted).

33. *Id*.

34. Justice Scalia, joined by Chief Justice Roberts and Justice Thomas, responded to Justice Stevens's approach by essentially conceding that it is the stronger reading of the statute. Justice Scalia contended, however, that his own approach is compelled by stare decisis and by the lack of briefing on whether *Sibbach* should be overturned. *See infra* note 47.

35. *Shady Grove*, 130 S. Ct. at 1457.

36. *Id.*

37. *See id.* at 1459 n.18.

38. *See id.* at 1459.

39. Justices Kennedy, Breyer, and Alito joined Justice Ginsburg.

40. *Id.* at 1462 (Ginsburg, J., dissenting).

41. *Id.* at 1463 (citing Gasperini v. Center for Humanities, Inc., 518 U.S. 415, 427 n.7 (1996)). Justice Scalia essentially dismisses this aspect of *Gasperini*, arguing that

the purpose of the relevant state law. The dissent argued that it would be "very hard . . . to ascribe to § 901(b) *any* purpose"[42] not related to the availability of remedies—a classically substantive area of law. Because availability of remedies is an "important state interest," the dissent would have affirmed the Second Circuit and ruled that section 901(b) limits the availability of penalties when class actions suits are pursued, even though Rule 23 continues to define the standards for class certification.[43] To the dissenters, New York's objective was crystal clear: The state could have achieved its objective simply by writing the statute so that "[i]n any class action seeking statutory damages, relief is limited to the amount the named plaintiff would have recovered in an individual suit."[44] Under these circumstances, the dissent argued, there was no cause to read Rule 23 "relentlessly" so as to defeat a state interest that was clearly within the state's power to achieve if it had merely worded the statute differently.[45]

In *Shady Grove*, the Court missed an opportunity to correct a persistent error in its *Erie* jurisprudence as applied to Federal Rules. The Court should return to the text of the Rules Enabling Act and review Federal Rules that directly conflict with state law for validity as applied. The alternative approach advocated by Justice Scalia, whereby an "arguably procedural" rule must always trump conflicting state law, would be a convincing reading of the Rules Enabling Act only if the text stopped after section 2072(a), which directs the Court "to prescribe general rules of practice and procedure . . . for cases in the United States . . . courts."[46] Any rule that is not "arguably procedural" would clearly exceed the authority granted by this subsection. Justice Scalia's approach, therefore, renders section 2072(b), which states that "rules shall not abridge, enlarge or modify any substantive right," entirely superfluous.[47] Yet, giving the text of subsection "b" its ordinary meaning, it is hard to imagine how it

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"[t]he search for state interests and policies that are 'important' is just as standardless as the 'important or substantial' criterion we rejected in *Sibbach*." *Id.* at 1441 n.7 (majority opinion) (citation omitted).

42. *Id.* at 1466 n.6 (Ginsburg, J., dissenting).

43. *Id.* at 1465–66.

44. *Id.* at 1472 (internal quotation marks omitted).

45. *Id.* at 1460.

46. 28 U.S.C. § 2072 (2006).

47. *Id.* § 2072(b).

does not require a distinct inquiry into the effect of applying a Federal Rule on substantive rights rooted in state law.

Justice Scalia essentially conceded that the "arguably procedural" approach is at odds with the text of the statute, but concluded that stare decisis compelled the Court's decision.[48] This is an odd approach for an avowed textualist, particularly because the key precedents supporting his approach are factually distinguishable from the situation in *Shady Grove*.

In *Sibbach v. Wilson & Co.*, the Court only addressed the test for whether a Federal Rule was *facially* invalid.[49] The Court in *Sibbach* did not even consider the question of whether a rule could be invalid as applied.[50] Then, in *Hanna v. Plumer*, although the Court did describe the domain of the Federal Rules as encompassing matters "rationally capable of classification as [procedure],"[51] the Court also said that it "need not wholly blind itself to the degree to which the Rule makes the character and result of the federal litigation stray from the course it would follow in state courts."[52] Justice Scalia referred to the latter statement as "obiter dictum"—an "unfortunate utterance"[53] that has laid dormant for decades. This statement may be dicta, but it nevertheless serves as a warning not to apply the holding too aggressively, especially because the result in *Hanna* was such an easy call. In *Hanna*, the Court examined the validity of Rule 4's notice requirements for service of process.[54] These requirements clearly do not implicate substantive rights and remedies. "[I]t is doubtful that, even if there were no Federal

48. *Shady Grove*, 130 S. Ct. at 1445–46 (plurality opinion) ("[*Sibbach*'s] approach, the concurrence insists, gives short shrift to the statutory text forbidding the Federal Rules from 'abridg[ing], enlarg[ing], or modify[ing] any substantive right.' There is something to that. . . . [I]t is hard to understand how it can be determined whether a Federal Rule 'abridges' or 'modifies' substantive rights without knowing what state-created rights would obtain if the Federal Rule did not exist. . . . *Sibbach* has been settled law, however, for nearly seven decades.") (citations omitted).

49. 312 U.S. 1, 6 (1941) ("This case calls for decision as to the *validity* of Rules 35 and 37 of the Rules of Civil Procedure for District Courts of the United States.") (emphasis added).

50. *See id*. at 11 ("[Appellant] insists, nevertheless, that by the prohibition against abridging substantive rights, Congress has *banned* the rules here challenged.") (emphasis added).

51. 380 U.S. 460, 472 (1965).

52. *Id.* at 473.

53. *Shady Grove*, 130 S. Ct. at 1446 n.12.

54. *Hanna*, 380 U.S. at 461.

Rule making it clear that in-hand service is not required in diversity actions, the *Erie* rule would have obligated the District Court to follow the Massachusetts procedure."[55] Because the service requirements at issue in *Hanna* had only the most incidental effect on substantive rights, an "as applied" inquiry would have been entirely superfluous. Because the Court has never squarely confronted the appropriateness of an "as applied" inquiry, it is interpretively unsound to invoke stare decisis as the sole justification for rejecting the plain text of the Rules Enabling Act.

An as-applied Enabling Act inquiry would also be superior to the approach advocated by Justice Ginsburg, whereby courts construe Federal Rules narrowly to avoid conflict with important state interests.[56] In applying this approach, the Court has occasionally adopted truly strained readings of Federal Rules. For example, in *Walker v. Armco Steel Corp.*, the Court read Rule 3, which states that an action is "commenced" in federal court when it is filed, as applying only to internal filing deadlines but not to a state's statute of limitations.[57] The Court made this ruling despite the fact that Rule 3 does toll statutes of limitations in federal question cases.[58] Such inconsistent application of federal law is hard to square with an approach requiring any arguably procedural Federal Rule, given its "plain meaning,"[59] to supersede all state law to the contrary. The Tenth Circuit in *Walker* correctly recognized that the state statute in question "was in direct conflict with Rule 3."[60] Even in *Shady Grove*, the dissent advanced a barely credible interpretation of Rule 23 because it recognized that substantive state interests were at risk. The Court's reading of Rule 23 required drawing a distinction "between [class] eligibility and certifiability" that was, as Justice Scalia noted, "entirely artificial."[61] As a functional matter, Rule 23 and section 901 answer the exact same question:

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55. *Id.* at 466.

56. *Shady Grove*, 130 S. Ct. at 1462 (Ginsburg, J., dissenting).

57. 446 U.S. 740, 751 (1980) ("In our view, in diversity actions Rule 3 governs the date from which various timing requirements of the Federal Rules begin to run, but does not affect state statutes of limitations.") (internal citations omitted).

58. *See* West v. Conrail, 481 U.S. 35, 39 (1987).

59. *Walker*, 446 U.S. at 750 n.9.

60. *Id.* at 744 (citing Walker v. Armco Steel Corp., 592 F.2d 1133, 1135 (10th Cir. 1979)).

61. *Shady Grove*, 130 S. Ct. at 1438 (majority opinion).

When may a class be certified? Only by truly inventive interpretation was the dissent able to avoid a conflict between state and federal law.

Such strained statutory interpretations should of course be avoided because they undermine the credibility of the judiciary. But a bigger problem with Justice Ginsburg's "narrow reading" approach is that it is simply inadequate to protect substantive rights created by state law. The outcome of an *Erie-Hanna* case should not depend on how far the language of a statute can be stretched. Inventive interpretation is unnecessary when the plain text of the Enabling Act instructs courts to look to potentially affected state law and to protect substantive rights created by that law.

The only Justice to advocate a decisional framework roughly consistent with the statute was Justice Stevens. Unfortunately, he failed to appreciate the substantive nature of the New York statute, considering it a "classically procedural calibration of making it easier to litigate claims in New York courts . . . only when it is necessary to do so, . . . the same sort of calculation that might go into setting filing fees or deadlines for briefs."[62] His conclusion ignores the realities of civil litigation, where the question of class certification is frequently more important than the merits of a claim, because certification puts defendants "under intense pressure to settle."[63] Indeed, in some cases class certification "is, in effect, the whole case."[64] Granted, as a formal matter, the class action device allows mass aggregation of claims that should otherwise be individually valid. As a practical matter, however, the availability of class certification for statutory penalties exposes parties to far greater liability in federal court than they would face in state court, upsetting the state legislature's careful determination about the proper scope

62. *Id.* at 1459 (Stevens, J., dissenting).

63. *In re* Rhone-Poulenc Rorer, Inc., 51 F.3d 1293, 1298 (7th Cir. 1995); *see also* Robert G. Bone & David S. Evans, *Class Certification and the Substantive Merits*, 51 DUKE L.J. 1251, 1327–28 (2002) ("[T]he mere certification of a class action makes settlement likely by shifting a tremendous amount of bargaining power to the plaintiffs. [There is a] stark difference [between] the exposure that defendants face when a case is certified and when it is not.").

64. Diane Wood, Circuit Judge, Remarks at the FTC Workshop: Protecting Consumer Interests in Class Actions (Sept. 13–14, 2004), *in Panel 2: Tools for Ensuring that Settlements are "Fair, Reasonable, and Adequate,"* 18 GEO. J. LEGAL ETHICS 1197, 1213 (2005).

of deterrence. By magnifying the deterrent effect of a cause of action, the Court takes away the state's power to regulate the behavior of its own citizens and to create rights under state law. Sensibly read, the Rules Enabling Act prohibits such a result.

Although Justice Stevens has set the bar for finding an Enabling Act problem too high,[65] that does not mean that a proper "as applied" Enabling Act inquiry should merely duplicate the "twin aims of *Erie*" test. A facially valid Federal Rule should presumptively apply, but this presumption should be rebuttable.[66] Courts should not refuse to apply a Federal Rule based on nothing more than unguided speculation about the possibility of affecting a litigant's substantive rights. A litigant who asks a court not to apply a valid Federal Rule should at least have to convince the court that it is more likely than not that the application of the rule would "abridge, enlarge or modify [a] substantive right."[67]

For purposes of the Enabling Act inquiry, the Court should also adopt Justice Harlan's definition of substantive laws: those that affect "primary activity," outside the context of litigation.[68] This standard would still set a significantly higher bar for finding an Enabling Act conflict than finding conflict under the unguided *Erie* inquiry, because it is much easier to implicate the "twin aims" than it is to influence behavior outside of litigation. Indeed, it would be quite rare for potential litigants to alter their behavior outside of litigation merely because they fear the application of a Federal Rule. This high bar would prevent the new Enabling Act inquiry from draining judicial resources because litigants would understand that it would be difficult to prevail on such a challenge; yet, it would also prevent courts from destroying important substantive rights that are bound up in procedural devices.

The Supreme Court should have taken *Shady Grove* as an opportunity to correct an old but serious error in its *Erie* jurisprudence. Although stare decisis "counsel[s] that [the Court] use

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65. *See supra* note 35 and accompanying text.

66. The logical presumption that Federal Rules should apply in diversity was the original basis for adopting a "two track" system of *Erie* analysis. *See* Hanna v. Plumer, 380 U.S. 460, 471 (1965).

67. 28 U.S.C. § 2072(b) (2006).

68. *See Hanna*, 380 U.S. at 477 (Harlan, J., concurring). Although this standard has never been adopted, it remains a useful touchstone.

caution in rejecting established law,"[69] the *Sibbach* rule is so plainly contrary to the text of section 2072(b) that its reaffirmation cannot be justified. Nor is it particularly relevant in this case that "Congress remains free to correct" *Sibbach*'s errant statutory interpretation.[70] Congress is most likely to respond to perverse results, and the Court has generally avoided perverse results by adopting narrow and occasionally strained readings of Federal Rules.[71] Therefore, Congress lacked motivation to correct the *Sibbach* rule because the judiciary itself was the institution that bore the cost: a loss in credibility for adopting strained readings of Federal Rules and ignoring the plain text of a duly enacted statute. Nevertheless, in this case the Court has reached a perverse result, which will have the very substantive consequence of exposing defendants to far greater liability in federal courts than was ever intended by the state legislature that created the cause of action in the first place. A Federal Rule should not be applied in a case where it interferes with a state's legitimate ability to regulate the conduct of its own citizens.

Jeffrey Redfern

69. Walker v. Armco Steel Corp., 446 U.S. 740, 749 (1980).

70. Shady Grove Orthopedic Assocs., P.A. v. Allstate Ins. Co., 130 S. Ct. 1431, 1446 (2010) (plurality opinion).

71. *See supra* note 6.