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ENFORCEMENT OF STATE ANNEXED-ARBITRATION RULES IN FEDERAL COURTS WITH DIVERSITY JURISDICTION:

*Towey v. Catling*¹

I. INTRODUCTION

Both state and federal court systems are swamped with litigants. This fact is so widely recognized, repeating it almost seems unnecessary. Courts experiment with a variety of approaches just to pump some of this litigious bilge into alternative forums for resolution. The state of Hawaii sought to lighten its overburdened docket with a Court Annexed Arbitration Program.² It provides for mandatory submission of certain tort claims to arbitration.³ It is non-binding and either party may obtain a trial de novo at its conclusion.⁴ However, to do so is not without risk. Pursuit of a trial de novo gambles not only with the possibility of a less favorable outcome, but also with payment of the opponent's attorney's fees should one fail to improve upon the arbitrators judgment by at least 15%.⁵ Disincentives such as this potential penalty are a common and integral element of an effective mandatory arbitration program.⁶ Without penalties there exists little, if any, reason for a dissatisfied party not to take a second bite at the apple.

The issue confronted in *Towey* was whether a federal court with diversity jurisdiction would eliminate this hazard for a party who removed to federal court after participating in the state arbitration proceeding.⁷ The court answered 'no', and the defendant faced the burden of absorbing \$5,000 of his opponent's attorney's fees plus another \$4,811.83 in costs after failing at trial.⁸ This is a laudable outcome. Failing to assess costs and fees according to the annexed arbitration program would eviscerate its effectiveness, promoting more, not less litigation. This Note will consider a further step: The possibility of a federal court with diversity jurisdiction, requiring federal litigants to go through mandatory arbitration, which is always required by the state court.

1. 743 F. Supp. 738 (D. Hawaii 1990).

2. HAW. ARB. R. 1.

3. HAW. ARB. R. 6(A).

4. HAW. ARB. R. 22.

5. HAW. ARB. R. 25, 26.

6. See *infra* notes 28-29 and accompanying text.

7. *Towey*, 743 F. Supp. at 740.

8. *Id.* at 741.

II. FACTS AND HOLDING

The island of Kauai is the oldest major island in the Hawaiian chain.⁹ The forces of erosion have acted on it for about five and a half million years,¹⁰ etching a particularly spectacular relief into the landscape. It is easy to imagine the attention of a tourist in a rented car being more absorbed in the scenery than potential obstacles in a narrowly winding coastal road. Thus, defendant, motorist, Thomas Catling struck plaintiff, bicyclist, John Towey on a Kauaian road.¹¹ Towey filed his complaint against Catling in Hawaii state court, alleging the defendant's negligence as the cause of the accident and the plaintiff's resulting injuries.¹² Pursuant to the Hawaii Court Annexed Arbitration Program, the Fifth Circuit Court assigned the action to an arbitrator.¹³ The arbitration proceeding resulted in an award for the plaintiff of \$18,471.49 in special damages, plus \$35,000 in general damages, totalling \$53,471.49.¹⁴ Defendant Catling then successfully removed the complaint to the federal district court in Hawaii, based on the parties' diversity of citizenship, and an amount in controversy in excess of \$50,000.¹⁵

The action proceeded to trial, where Towey won a jury verdict of \$23,907 in special damages, plus \$63,000 in general damages.¹⁶ The Court reduced the total in accordance with the jury's finding of plaintiff Towey's 25% negligence compared with defendant Catling's 75% negligence, arriving at a \$65,180.25 judgment for Towey.¹⁷

Towey then sought to recover costs and attorney's fees as provided for a "prevailing party" under Hawaii Arbitration Rules 25 and 26.¹⁸ The court found that the state law, even if only a rule of court, controlled the award of attorney's fees.¹⁹ Although Federal Rule of Civil Procedure 54(d) ordinarily governed the award of costs, the *Towey* court held that state law applies where the rules are an integral part of a substantive state policy, and do not conflict with federal rules, statutes or policies.²⁰

9. E. JOESTING, *KAUAI: THE SEPARATE KINGDOM* 13 (1984).

10. *Id.*

11. *Towey*, 743 F. Supp. at 739.

12. *Id.*

13. *Id.*

14. *Id.*

15. *Id.* at 740.

16. *Id.*

17. *Id.*

18. *Id.* For the text of Rules 25 and 26, see *infra* note 34.

19. *Towey*, 743 F. Supp. at 740.

20. *Id.*

III. BACKGROUND

A. Trend Toward Mandatory Arbitration

Since Pennsylvania implemented the nation's first mandatory arbitration program in 1952, over twenty states, the District of Columbia and ten federal district courts have followed suit.²¹ The vast majority of these programs have been implemented within the last fifteen years.²² Most programs are new enough that longevity is not certain; however, reports of general satisfaction on behalf of bench, bar and litigants alike indicate early success.²³ Some programs have already withstood a variety of constitutional attacks,²⁴ although their continuing validity will depend in part on their success.

Many programs apply broadly to civil actions of all sorts with specified exceptions, or include only money damage claims.²⁵ A few are limited to motor vehicle related claims.²⁶ Most programs contain a dollar amount limit on claims; those above the limit do not require arbitration.²⁷ Because the obvious intent of such programs is to reduce the number of actions carried through to trial, almost all provide some mechanism for discouraging appeals of the arbitrator's judgment.²⁸ Typically, this mechanism manifests itself as a provision for an appellant to post a bond for the arbitrator's fees or costs, or for a party who does

21. See Keilitz, Gallas & Hanson, *State Adoption of Alternative Dispute Resolution*, 12 STATE CT. J. 4, 6-8 (1988).

22. P. EBENER & D. BETANCOURT, COURT-ANNEXED ARBITRATION: THE NATIONAL PICTURE 5-6 (1985).

23. See Hensler, *What We Know and Don't Know About Court-Administered Arbitration*, 69 JUDICATURE 270, 270-72 (1986) (describing factors upon which eventual success or failure of such programs may turn, and some preliminary evaluations of their performance); see also Norris, *National Trends in Mandatory Arbitration*, 17 COLO. LAW. 1313, 1315-16 (1988).

24. See *Kimrough v. Holiday Inn*, 478 F. Supp. 566, 569-71 (E.D. Pa. 1979) (upholding compulsory arbitration in Pennsylvania); *In re Smith*, 381 Pa. 223, 235, 112 A.2d 625, 631 (1955); Redish, *Legislative Responses to the Medical Malpractice Insurance Crisis: Constitutional Implications*, 55 TEX. L. REV. 759, 796-99 (1978) (the medical malpractice insurance crisis of the 1970's spawned numerous state legislative responses in the form of mandatory pre-litigation dispute resolution which faced the same constitutional challenges annexed-arbitration faces now). For a more succinct state by state rundown of the contrasting results of constitutional attacks on medical malpractice ADR programs, see Allison, *The Context, Properties and Constitutionality of Nonconsensual Arbitration: A Study of Four Systems*, 1990 J. DISP. RESOL. 1, 23 n.110; see also *Firelock Inc. v. District Court*, 776 P.2d 1090, 1190 (Colo. 1989) (upholding Colorado's Annexed-Arbitration program).

25. See P. EBENER & D. BETANCOURT, *supra* note 22, at 5-6.

26. *Id.*

27. See Keilitz, Gallas & Hanson, *supra* note 21, at 6-7. The jurisdictional dollar limits in the state programs range from \$6,000 in New York to \$150,000 in Hawaii, with no limit in Florida, Michigan and New Hampshire. *Id.* The limits in federal court programs range from \$50,000 in the Eastern District of New York to \$150,000 in the Middle District of Ohio. See Walker, *Court-Ordered Arbitration Comes to North Carolina and the Nation*, 21 WAKE FOREST L. REV. 901, 914-17 (1986).

28. P. EBENER & D. BETANCOURT, *supra* note 22, at 5-6.

not improve upon the arbitrator's judgment at trial to pay the fees and costs of the opponent.²⁹

B. The Hawaii Program

Hawaii's Annexed Arbitration Program is mandatory for all tort cases with a "probable jury award value . . . not in excess of \$150,000."³⁰ The arbitration is non-binding,³¹ although the parties may agree to be bound at any time by the arbitrator's award,³² and any party may request a trial de novo within 20 days after the arbitrator's award is served on the parties.³³ In order to discourage an unsatisfied party from seeking a trial de novo, the Hawaii program provides for a "non-prevailing party," in a trial de novo, to pay the costs and attorney's fees to the opponent.³⁴

Because the proceeding is informal and the arbitrator's findings are inadmissible at a subsequent trial, no transcript or recording is to be made of the hearing.³⁵ For the same reasons, the arbitrator need not make any findings of fact or conclusions of law.³⁶ The extent to which discovery is permitted falls within the sole discretion of the arbitrator.³⁷

29. *Id.*

30. HAW. ARB. R. 6(A).

31. HAW. ARB. R. 1.

32. HAW. ARB. R. 6(C).

33. HAW. ARB. R. 22.

34. Hawaii arbitration rule 25 provides:

(A) The "Prevailing Party" in a trial de novo is the party who has (1) appealed and improved upon the arbitration award by 15% or more, or (2) has not appealed and the opposing party has appealed and failed to improve upon the arbitration award by 15% or more. For the purposes of this rule, "improve" or "improved" means to increase the award for a plaintiff or to decrease the award for the defendant.

(B) The "Prevailing Party" under these rules, as defined above, is deemed the prevailing party under any statute or rule of court, and such is entitled to costs of trial and all other remedies as provided by law.

HAW. ARB. R. 25.

Hawaii arbitration rule 26 provides the sanctions which the court may impose against a non-prevailing party: "(1) Reasonable costs and fees (other than attorneys' fees) actually incurred by the party but not otherwise taxable under the law; (2) Costs of jurors; (3) Attorneys' fees not to exceed \$5,000." HAW. ARB. R. 26.

35. HAW. ARB. R. 17.

36. HAW. ARB. R. 19(C).

37. HAW. ARB. R. 14.

C. Award of Fees and Costs in Diversity Cases

In diversity actions, it is well settled that the award of attorney's fees is determined in accordance with the applicable state law.³⁸ The state law need not be statutory. If an award of attorney's fees is authorized by a state rule of court, this will control in a diversity action.³⁹

An award of costs in federal courts with diversity jurisdiction is another matter. Federal courts are to apply state substantive law and federal procedural law.⁴⁰ Thus, Federal Rule of Civil Procedure 54(d) will ordinarily govern the award of costs.⁴¹ However, a rule of procedure is not always merely procedural. A procedural rule may create substantive liabilities. If so, it may rise above the status of a "mere procedural device" and warrant application in a diversity action.⁴² *Cohen v. Beneficial Industrial Loan Corp.*⁴³ involved a state statute requiring small stockholders in derivative suits to post security for expenses upon request by the defendant corporation. Although a procedural rule in some respects, the court found it to be an integral part of state policy.⁴⁴ Thus, for a state rule providing for an award of costs to govern in a diversity action, the rule must first play "an integral part [in] substantive state policy" and, second, not conflict with any federal rules, statutes, or policies.⁴⁵

IV. THE INSTANT DECISION

With respect to the plaintiff's request for attorney's fees, the instant court awarded them pursuant to Hawaii Arbitration Rules 25 and 26.⁴⁶ The court followed the well settled rule that state law regarding award of attorney's fees

38. *Sioux County v. National Surety Co.*, 276 U.S. 238, 243-44 (1928).

39. *Klopfenstein v. Pargeter*, 597 F.2d 150, 152 (9th Cir. 1979) (citing *Aleyeska Pipeline Co. v. Wilderness Society*, 421 U.S. 240, 259 n.31 (1975)).

40. *Hanna v. Plummer*, 380 U.S. 460, 465 (1965).

41. FED. R. CIV. P. 54(d).

42. *Cohen v. Beneficial Indust. Loan Corp.*, 337 U.S. 541, 556 (1949).

43. 337 U.S. 541.

44. *Id.* at 555-56. Thus the Court, in affirming the district court's application of the statute in a diversity action found:

Even if we were to agree that the New Jersey statute is procedural, it would not determine that it is not applicable. Rules which lawyers call procedural do not always exhaust their effect by regulating procedure. But this statute is not merely a regulation of procedure. With it or without it the main action takes the same course. However, it creates a new liability where none existed before . . . Such liability is not usual and it goes beyond payment of what we know as 'costs'.

Id. at 555.

45. *Byrd v. Blue Ridge Rural Elec. Coop.*, 356 U.S. 525, 538-40 (1958); *Hanna*, 380 U.S. at 460; *Walker v. Armco Steel Corp.*, 446 U.S. 740, 749-52 (1980).

46. *Towey*, 743 F. Supp. at 741.

controls in a diversity action.⁴⁷ That this law was a rule of court and not a statute posed no impediment to its application.⁴⁸

The *Towey* court was also willing to award costs pursuant to the same rules.⁴⁹ It found these rules to be "substantive and not procedural" because they are an "integral part of state policy, and [they] do not conflict with any federal policy, rule, or statute."⁵⁰ The court characterized the state policy promoted as "adherence to the result of arbitration by imposing liability upon those who chose a trial de novo on their action and who do not improve their arbitration position by 15% or more."⁵¹ Far from conflicting with any federal policy, rule, or statute, the *Towey* court recognized the congruence of these rules with federal policy, which "also supports the promotion of alternative dispute resolution wherever possible."⁵²

The *Towey* court also notes that it is "fundamentally unjust" to permit a party to evade the consequences of the state arbitration program, after participation, merely by removing to federal court.⁵³ "A federal court adjudicating a state created right solely because of the diversity of citizenship of the parties is . . . only another court of the state . . ."⁵⁴

V. COMMENT

In *Towey*, the court held that state law awarding attorney's fees and costs was controlling in a diversity action.⁵⁵ The *Towey* court noted that this was an issue of first impression, and proceeded to dispose of it in a cursory manner.⁵⁶ The court clearly and correctly applied state law to determine an award of attorney's fees and costs. Such a holding is worthy of note here only because the particular rules happened to be a part of those governing Hawaii's Annexed Arbitration Program. But why stop there? If a federal court in a diversity action is only another court of the state, why should it not, in the proper case, require the annexed arbitration procedure be complied with as a condition precedent to proceeding in federal court? The instant court had no reason to consider such a possibility. However, it is far from an outlandish proposition.

The crisis in the medical malpractice insurance arena of the 1970's led numerous states to enact alternative dispute resolution procedures for parties to go

47. *Id.* at 740.

48. *Id.*

49. *Id.* at 741.

50. *Id.*

51. *Id.* at 740-41.

52. *Id.* at 741 n.1.

53. *Id.* at 741.

54. *Guaranty Trust Co. v. York*, 326 U.S. 99, 108 (1945).

55. *Towey*, 743 F. Supp. at 740-41.

56. *Id.* at 740.

through prior to an action in state court.⁵⁷ Generally, these procedures consisted of screening panels or mandatory arbitration programs which were similar, in many respects, to the annexed arbitration program Hawaii has adopted.⁵⁸ A number of such state requirements are applicable in a federal court with diversity jurisdiction,⁵⁹ pursuant to *Erie Railroad v. Tompkins*.⁶⁰

There is considerable variation in the details of programs for screening malpractice claims as there is among various states' annexed arbitration procedures. However, there are prominent common threads to virtually all such programs. The programs are generally mandatory, non-binding, alternative forums for resolving a claim.⁶¹ They provide for a fairly complete hearing in an informal setting, generally following a relaxed application of the rules of procedure and evidence.⁶² They are designed to discourage trial by providing preliminary review of the merits so that parties may be better able to settle.⁶³ Almost all such programs, whether a screening panel for malpractice claims or a general annexed arbitration proceeding, include an appeal disincentive.⁶⁴

Of the decisions holding that a party in a diversity action must go through screening or arbitration of a malpractice claim, most rest on a holding that the procedure is a "condition precedent" to entry into state court.⁶⁵ Thus, a federal court in diversity cannot entertain a claim which would not be allowed in state court.⁶⁶ The result is that a plaintiff who attempts to bring a claim in federal

57. For a description of such programs see Comment, *An Analysis of State Legislative Responses to the Medical Malpractice Crisis*, 1975 DUKE L.J. 1417, 1455-63.

58. See *infra* notes 61-64 and accompanying text.

59. See, e.g., *Edelson v. Soricelli*, 610 F.2d 131, 134-35 (3d Cir. 1979) (Pennsylvania procedures); *Hines v. Elkhart Gen. Hosp.*, 603 F.2d 646, 647-49 (7th Cir. 1979) (Indiana procedures); *Woods v. Holy Cross Hosp.*, 591 F.2d 1164, 1168-70 (5th Cir. 1979) (Florida procedures); *DiAntonio v. Northampton-Accomack Memorial Hosp.*, 628 F.2d 287, 290 (4th Cir. 1980) (Virginia procedures); *Feinstein v. Massachusetts Gen. Hosp.*, 643 F.2d 880, 883-86 (1st Cir. 1981) (Massachusetts malpractice procedures). Although the Florida and Pennsylvania programs were subsequently invalidated by state courts on state constitutional grounds, see *Aldana v. Holub*, 381 So. 2d 231, 237-38 (Fla. 1980); *Mattos v. Thompson*, 491 Pa. 385, 396, 421 A.2d 190, 196 (1980), the rationale of these cases remains applicable.

60. 304 U.S. 64 (1938).

61. Comment, *supra* note 57, at 1455-63.

62. *Id.*

63. *Feinstein*, 643 F.2d at 881.

64. See Comment, *supra* note 57, at 1455-63; see also Norris, *supra* note 23, at 1314.

65. *Woods*, 591 F.2d at 1169 n.7. "Satisfaction of the mediation panel requirement is a condition precedent to the jurisdiction of any medical malpractice-based action." *Id.*

66. Such results rested on the reasoning of *Byrd* and *Hanna*, Supreme Court decisions fleshing out the *Erie* doctrine. *Byrd* allows for rejection of state law in light of "affirmative countervailing federal considerations" which outweigh strong and explicit state policy. 356 U.S. at 535. *Hanna* frames the decision in terms of the policies underlying *Erie*: prevention of forum shopping, and equitable administration of the laws. 380 U.S. at 467.

Edelson followed the *Byrd* analysis, finding the state interest in its malpractice ADR program outweighed any countervailing federal interests; in fact the majority found no such federal interests. 610 F.2d at 138-39.

court without having first jumped through the "screening hoop" has her complaint dismissed for having failed to meet the required condition precedent.⁶⁷

Most of these cases distinguish themselves from *Wheeler v. Shoemaker*,⁶⁸ in which a federal court refused to refer a claim to a state screening panel when the screening panel was found to be an "adjunct of the [Rhode Island] superior courts."⁶⁹ The distinction seemed to rest on when a complaint had to be submitted to the panel.⁷⁰ If a claim could not be filed without having first been reviewed by the panel, it was applied in diversity cases as a "condition precedent" to entry to the courts.⁷¹ In Rhode Island however, a case is referred to the panel after being filed.⁷² Thus, "a state-mandated referral to mediation after an action is filed clearly differs from a state statutory scheme wherein mediation is a jurisdictional prerequisite to any court action; it was recognized in *Wheeler* that Rhode Island's malpractice scheme differs significantly from that in Tennessee (or Florida)."⁷³ Clearly, the annexed arbitration program in Hawaii is more similar to the Rhode Island procedure in this regard. In *Towey* this is apparent where the claim was filed, and after a finding of eligibility for arbitration, was transferred into the program.⁷⁴

The *Wheeler* court would no doubt brand the Hawaii program "an adjunct of the court".⁷⁵ However, *Feinstein v. Massachusetts General Hospital* rejected this distinction.⁷⁶ In *Feinstein* the First Circuit held, with regard to a malpractice

Woods, on the other hand, relied more heavily on *Hanna*, finding that not requiring federal litigants to proceed through state ADR would encourage the worst kind of forum shopping. 591 F.2d at 1168.

67. Application of this requirement in federal court is not without its detractors. See Comment, *Mandatory State Malpractice Arbitration Boards and the Erie Problem: Edelson v. Soricelli*, 93 HARV. L. REV. 1562, 1566-73 (1980).

68. 78 F.R.D. 218 (D.C.R.I. 1978).

69. *Id.* at 219. "The purpose of diversity jurisdiction is to provide out-of-state suitors the option of an impartial forum." *Id.* In *Wheeler* it was held that reference of a medical malpractice case to a medical liability mediation panel established by state statute and appointed by the state court would be inconsistent with, and would defeat the purpose of, the congressional grant of diversity jurisdiction, because it would be "tantamount to vesting original jurisdiction in state court." *Id.* at 222-23. "The court concludes that reference to the panel so established amounts to little more than furnishing the state court an opportunity to pass upon the claim initially." *Id.* at 221.

70. See *D'Antonio*, 628 F.2d at 290. The seventh Circuit considered the more extensive and formal proceedings under the Rhode Island program a factor distinguishing Rhode Island's as an adjunct of the court. *Hines*, 603 F.2d at 648, n. 2. However, the fifth Circuit did not. In reviewing Florida's malpractice program, which provides for an unusually thorough hearing before the screening panel, the fifth Circuit found that program not to be an adjunct of the court based on the fact that the panel reviewed the claim before filing in court. *Woods*, 591 F.2d at 1167.

71. *Woods*, 591 F.2d at 1167.

72. *Wheeler*, 78 F.R.D. at 219.

73. *Woods*, 591 F.2d at 1169 n.7.

74. *Towey*, 743 F. Supp. at 739.

75. *Wheeler*, 78 F.R.D. at 219. The Hawaii program is undeniably an adjunct of the courts. After all, it was established, and is governed, by state rules of court, and is the "Court Annexed Arbitration Program." HAW. ARB. R. 1.

76. 643 F.2d 880.

program like that of Rhode Island (in that reference to the screening panel occurred after filing in court), that "we cannot accept plaintiff's contention that referring malpractice actions brought in federal court to a tribunal convened pursuant to rule 60(B)⁷⁷ is inherently unfair to out-of-state plaintiffs."⁷⁸ *Feinstein* stepped away from the prior decisions in two principle respects. It required participation in a program which it characterized as an "adjunct of the court",⁷⁹ and it granted the defendant's motion to refer the claim to the malpractice panel.⁸⁰ The court found that "failing to apply the requirements of rule 60(B) in malpractice actions brought in the federal court would encourage forum-shopping by out-of-state plaintiffs (or Massachusetts plaintiffs suing out-of-state defendants on Massachusetts malpractice claims) wishing to avoid the screening procedure".⁸¹ The court went on to say that not referring claims to the panel "would result in inequitable administration of the law by compelling a defendant sued in federal court to forego the procedural protection and substantive right to recovery of costs afforded by rule 60(B) 'solely because of the fortuity that there is diversity of citizenship between the litigants.'⁸²

A precisely analogous circumstance exists in Hawaii. In *Towey*, the fortuity of diversity should not deny the appellee protection of costs afforded by the arbitration rules. And in the proper case, avoidance of forum shopping and equitable administration of the laws should lead a federal court in a diversity action to refer a tort claim first to the annexed arbitration program.

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77. MASS. GEN. L. ch. 231, § 60(B) (1988) (includes the entire Massachusetts medical malpractice ADR program).

78. *Feinstein*, 643 F.2d at 890.

79. *Id.* at 888-90.

80. *Id.* at 890. All prior cases in which state malpractice ADR had been required of federal litigants had been disposed of by granting a motion to dismiss. This distinction was emphasized in *Woods*, 591 F.2d at 1169 n.7.

81. *Feinstein*, 643 F.2d at 886.

82. *Id.* at 886 (citing *Walker*, 446 U.S. at 753).

