LAURA A. KASTER

Getting to Federal Court Under the Federal Arbitration Act: *Vaden v. Discover Bank*

On March 9, 2009—84 years after the 1925 codification of the Federal Arbitration Act, 9 U.S.C. § 1, *et seq.* (FAA)—the U.S. Supreme Court, in *Vaden v. Discover Bank*, 556 U.S. ___, Slip. Op. 07-773 (March 9, 2009), settled a circuit conflict on what district courts should examine to determine whether there is federal subject matter jurisdiction over petitions to compel arbitration. The need for this ruling grew out of a peculiar circumstance: the FAA has been interpreted to be substantive law governing all contracts that can be said to fall within the broad definition of interstate commerce and indeed pre-empts state law as to those agreements, but the FAA contains no grant of jurisdiction. This is something of an anomaly: the FAA creates a body of federal substantive law governing arbitration without creating federal question jurisdiction. *See Moses H. Cone Mem'l Hosp. v. Mercury Const. Corp.*, 460 U.S. 1, 25 n.32 (1983). If no independent basis for federal jurisdiction can be established, the FAA must be enforced in state courts, which have concurrent jurisdiction.[1]

The questions presented in *Vaden v. Discover Bank* were the following: When one party files a petition to compel arbitration under § 4 of the FAA, must the court rely exclusively on the motion itself and the agreement between the parties? If not, and the court looks through or beyond the motion, what does the court examine?

Section 4 of the Federal Arbitration Act permits a party to petition for an order to compel arbitration without the prior filing of a lawsuit and provides an expedited process for a party "aggrieved by the alleged failure, neglect or refusal of another to arbitrate under a written agreement for arbitration." The statutory language dictates that there must be an independent basis for jurisdiction by providing that the aggrieved party "may petition any United States district court which, *save for such [written] agreement [to arbitrate]*, would have jurisdiction under Title 28, in a civil action or in admiralty of the subject matter of a suit arising out of the controversy between the parties. …" (Emphasis added.) Thus, there must be diversity, federal question, or admiralty jurisdiction over the underlying dispute for the federal court to resolve the petition.

Before *Vaden*, the majority of federal circuit courts that ruled on the issue—the Second, Fifth, Sixth, and Seventh Circuit Courts of Appeal—had held that the required underlying federal jurisdiction must be apparent on the face of the petition and the contract to arbitrate. *See* Slip Op. at 5–6. This view imposed severe limits on the scope of federal jurisdiction, because most contracts do not by themselves reflect a federal issue. In *Vaden*, the Fourth Circuit joined the Eleventh Circuit in the minority approach that held that the court must look through the petition to the underlying dispute. The U.S. Supreme Court unanimously affirmed the Fourth Circuit's determination that the statutory language "save for such written agreement" requires the court to examine the underlying dispute.

However, the Fourth Circuit also held that, when the district court looked through the FAA § 4 petition to the underlying state court litigation, it could rely on Vaden's state court counterclaims to justify federal jurisdiction. Because the Fourth Circuit viewed Vaden's counterclaims as completely pre-empted by federal statute, even though the counterclaims were couched in state law, the court determined that there was federal subject matter jurisdiction. On this point the Supreme Court majority of five justices rejected the Fourth Circuit's analysis and reversed the ruling. The Supreme Court held that this approach is a violation of the ordinary pleading rule that applies to both original and removal jurisdiction and demands reliance on the well-pleaded complaint. Under the well-pleaded complaint rule, defenses or counterclaims may not be relied upon to establish arising under jurisdiction based on 28 U.S.C. § 1331. Jurisdiction must be clear from the face of the well-pleaded complaint, and the federal right must be an essential element of the plaintiff's claim. Thus, *Vaden* holds that, even though a federal court may look through a § 4 petition to determine whether a controversy arises under federal law, it may not base jurisdiction on a counterclaim when the "whole controversy" between the parties does not qualify for federal jurisdiction. The Supreme Court ruled that there was no federal jurisdiction over Discover Bank's petition and required the bank to seek the aid of the state court.

Vaden resolves a circuit split and provides a practical answer that does not unduly narrow the scope of federal jurisdiction for cases in which a separate lawsuit is already on file. As Chief Justice Roberts noted in the dissent, the ruling leaves unresolved what federal courts should examine when the § 4 petition is the only court filing. Slip Op. at 16–17 and n.16. The ruling in *Vaden* grew out of very unusual facts and provides something of a cautionary tale for practitioners.

After nearly a decade of using a Discover Card, Betty Vaden was sent an upgraded Platinum Discover Card and, a month later, received an amendment to

the Platinum Card agreement that required arbitration of all disputes. The Discover Card's financing affiliate ignored the arbitration agreement and, in 2003, filed a case in Maryland state court demanding payment of charges of slightly more than $10,000 that were past due. Although the parties were diverse, this claim would not have satisfied the amount in controversy requirement for diversity jurisdiction; therefore, the initial lawsuit could not have been filed in federal court. Vaden counterclaimed, asserting a class action claim that Discover was violating Maryland law by charging fees and interest in violation of state law. Up to this point, neither party had sought arbitration.

Thus, this case is the unusual instance in which both parties had initially ignored the arbitration agreement. Given the counterclaims, Discover Bank determined that it wanted to avail itself of arbitration and the class action waiver provision in the arbitration clause. Instead of seeking a stay in the state court proceeding, however, Discover filed a separate petition under § 4 of the FAA in the U.S. District Court for the District of Maryland, seeking to compel arbitration of Vaden's counterclaims—and not including its own claim for the overdue payments.[2] Discover claimed that, even though Vaden had articulated her claims under state law, they were completely pre-empted by the federal law that prescribes interest rates for federally insured banks.

The case proceeded to appeal, remand, and a second appeal before the Fourth Circuit. Six years later, the U.S. Supreme Court determined that there was no federal jurisdiction and suggested that Discover Bank seek to enforce its arbitration agreement in the state court.

According to one view of this case, the decision is a straightforward application of the well-pleaded complaint rule. The majority opinion—authored by Justice Ginsburg, joined by Justices Scalia, Kennedy, Souter, and Thomas—points out that in *Homes Group Inc. v. Voronado Air Circulations Systems Inc.*, 535 U.S. 826 (2002), the Supreme Court squarely held that jurisdiction over federal questions cannot be based on counterclaims. Justice Ginsburg's decision therefore rejects as an attack on the well-pleaded complaint rule itself the concerns expressed in the dissent authored by Chief Justice Roberts (joined by Justices Stevens, Breyer, and Alito) that the majority's focus on the plaintiff's initial complaint yields arbitrary results that depend on who gets to the court first or how the complaint is styled.[3]

But *Vaden* presents an extremely unusual situation in which the party that initiated litigation instead of arbitrating the underlying dispute is the party that is seeking to compel arbitration. In most cases, the § 4 petition will not be preceded by a complaint at all—and rarely by a complaint filed by the party initiating the motion to compel. Under § 4, the court must examine whether "the making of the agreement for arbitration or the failure to comply therewith is not in issue. … If the making of the arbitration agreement or the failure, neglect, or refusal to perform the same be in issue, the court shall proceed summarily to the trial thereof." Discover Bank, which had filed a state court action rather than proceeding with arbitration initially, might not have satisfied this stay requirement with respect to its debt collection claims. That might have been a factor in the bank's election to seek arbitration of only the counterclaims.

In any case, Discover Bank's attempt to split its claims presented a problem for the *Vaden* majority: "The relevant question is whether the whole controversy between the parties—not just a piece broken off from that controversy—is one over which the federal courts would have jurisdiction." Slip Op. at 16–17. The majority disapproved of a result that would send the counterclaims to arbitration and leave the debt collection action in state court. *Id.* at 18.

The rule the *Vaden* decision establishes is fairly straightforward: When there is a pre-existing lawsuit, the ordinary well-pleaded complaint rule applies, and its application determines whether there is federal jurisdiction. What *Vaden* does not make clear is what happens in the much more typical case in which the § 4 petition is the only court filing. This is the issue the *Vaden* dissent examined.

The Chief Justice agreed that the federal court must look beyond the petition to see if the court "would have" jurisdiction over "the subject matter of a suit arising out of the controversy between the parties" (9 U.S.C. § 4), but he asked several questions: Look through to what? And how should "controversy" be defined? The dissent suggests that the controversy that the § 4 petitioner seeks to arbitrate is the one that should control and guide the district court to the specific controversy the other party is unwilling to arbitrate. The dissent seeks to use a consistent definition of "controversy" throughout the statute and identifies that issue as the specific dispute asserted in the § 4 petition to compel arbitration.

The dissent argues that, under the majority analysis, if Vaden had filed first, the debt collection suit brought to the state court would have been subject to an order to arbitrate and states that this is a problem with the majority approach. But this argument seems to lose sight of the fact that the issue is merely a question of which jurisdiction should order the parties to comply with their arbitration agreement. The FAA's statutory purpose of providing a means to expedite efficient arbitration of disputes controlled by an arbitration agreement is not forwarded by splitting actions (all of which are subject to arbitration) and by requiring arbitration of some but not others or requiring parties to ferret out different courts to enforce different contractual issues governed by their agreement to arbitrate their dispute. As the majority opinion recognizes, without alluding to any of the policies relating to arbitration, there is a policy reason for uniform treatment of the parties' agreement and for avoiding piecemeal litigation and arbitration.

But the dissenting opinion does outline the prob-

VADEN *continued on page 59*

MAGISTRATE *continued from page 47*

that have proceeded to trial and highlight the unpredictability of jury deliberations.

While cognizant of the sanctity of the attorney-client relationship, I am careful not to interfere with that relationship while meeting with the parties during Alternative Dispute Resolution sessions. However, the ADR judge can support an effective attorney-client relationship. For example, in a recent session, after I had explained to the plaintiff my understanding of how the employment-at-will rule and the antidiscrimination statutes would come into play in his lawsuit, the plaintiff's attorney reinforced the fact that she previously had given her client similar explanations regarding the burden of proof. Hearing similar information from a federal judge enhanced the credibility of the lawyer and may have been a factor in achieving settlement without trial.

As with any ADR process, each ADR session conducted by a judge will have unique dynamics, depending on the style of the ADR judge, the attorneys for the parties, the litigants, and the nature of the issues presented in the litigation. One criterion is paramount, however, and that is the confidentiality that attaches and the parties' trust that the ADR judge will not share information obtained during the ADR session with the trial judge assigned to the case. In addition, the ADR judge must be sensitive to and understand what issues are ripe or appropriate for resolution, depending on the timing of the ADR session and the interests that are driving the litigation at that point. Whether the ADR judge facilitates a full alternative to trial or otherwise assists the parties as they reach trial, judicially supervised Alternative Dispute Resolution sessions should remain integral to the ADR program for the District of Idaho. **TFL**

Candy Wagahoff Dale is the chief magistrate judge for the District of Idaho; her appointment as magistrate judge was effective March 30, 2008. She currently supervises the Pro Se and Capital Habeas Unit as well as the ADR coordinator for the District of Idaho; and she serves on the Ninth Circuit's Magistrate Judges' Executive Board. Judge Dale is an active participant and member of the FBA Idaho Chapter.

VADEN *continued from page 53*

lem of determining federal jurisdiction in the normal course of a § 4 petition that involves no filed lawsuit. The dissent's suggestion that the examination has to be hypothetical at least in part is surely correct, because there will be no complaint or counterclaim to examine. The dissent suggests examining whether a court would have jurisdiction of the subject matter of a suit arising out of the controversy. Added to that is the majority ruling that jurisdiction must exist over the entire dispute.

There are several practice points to be mined from this opinion for those who proceed to seek relief under a contract containing an arbitration provision. First, practitioners should try to anticipate potential counterclaims and articulate the nature of the entire potential controversy between the parties before ignoring the arbitration agreement. Having anticipated those counterclaims, practitioners should consider whether filing an arbitration demand with a § 4 petition that encompasses all the potential federal counterclaims will assure federal jurisdiction. Finally, the state court's remedies should not be ignored when assessing the best way to proceed. **TFL**

Laura A. Kaster is an arbitrator and mediator in Princeton, N.J., (www.AppropriateDisputeSolutions.com) and teaches Alternative Dispute Resolution at Seton Hall Law School. She was previously chief litigation counsel at AT&T and a partner in the law firm Jenner & Block.

Endnotes

[1]The exception is that the FAA grants federal jurisdiction over cases brought on the basis of Convention on the Recognition and Enforcement of Foreign Arbitral Awards, 9 U.S.C. § 201 et seq. *See* 9 U.S.C. § 203 (an action under the convention "shall be deemed to arise under the laws and treaties of the United States"); 9 U.S.C. § 205 (allowing removal from state to federal court notwithstanding the well-pleaded complaint rule: "the ground for removal provided in this section need not appear on the face of the complaint but may be shown in the petition for removal.").

[2]Discover Bank could have sought relief in state court. Section 2 of the FAA, which validates arbitration clauses and makes them enforceable, applies to the states, and by itself it dictates a state remedy even though the Supreme Court has not held that §§ 3 and 4 of the FAA apply to the states. *See* Slip Op. at 20 n.20. In any case, the Maryland Arbitration Act provides for a stay of the litigation: Md. Cts. & Jud. Proc. Code Ann. § 3-209 (Lexis 2006): "(a) A court shall stay any action or proceeding involving an issue subject to arbitration if: (1) A petition for order to arbitrate has been filed." Maryland law also affords a means to compel arbitration and does not provide for a pre-arbitration determination of compliance: Md. Cts. & Jud. Proc. Code Ann. § 3-207 (Lexis 2006): "(a) If a party to an arbitration agreement described in § 3-202 of this subtitle refuses to arbitrate, the other party may file a petition with a court to order arbitration; (b) If the opposing party denies existence of an arbitration agreement, the court shall proceed expeditiously to determine if the agreement exists; (c) If the court determines that the agreement exists, it shall order arbitration. Otherwise it shall deny the petition."

[3]The well-pleaded complaint rule does not enjoy universal approbation. However, Congress has not acted on commentators' repeated recommendations to consider responsive pleadings. *See* Slip Op at 10 n.11.