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When Do Federal Courts Have Jurisdiction to Review Petitions to Compel Arbitration?

by Jay E. Grenig

PREVIEW of United States Supreme Court Cases, pages 37–41. © 2008 American Bar Association.

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ISSUE

Does a U.S. district court have subject-matter jurisdiction over a petition seeking to compel arbitration of a state-court defendant's counterclaims, when the counterclaims are completely preempted by federal banking law?

FACTS

In 1990, Betty Vaden, a Maryland resident, obtained a Discover credit card from Discover Bank, a Delaware-chartered, federally insured bank. According to a servicing agreement between Discover Financial Services (DFS) and Discover Bank, DFS performs functions such as marketing and servicing Discover Bank loan products and collecting on accounts pursuant to instructions from Discover Bank. In June 1999, Discover mailed Vaden a new Platinum Discover Card. Discover claimed Vaden's account was automatically converted to Platinum status at this time.

However, Vaden's credit card statements identified her as a regular card member until September 1999. In July 1999, Discover mailed Vaden a "Notice of Amendment to Discover Platinum Cardmember Agreement." This notice, which applied only to Platinum Card members, included a provision requiring arbitration of disputes.

In July 2003, DFS sued Vaden on behalf of Discover Bank in Maryland state court for nonpayment of a card balance in excess of \$10,000. Vaden then filed class-action counterclaims against DFS based solely on Maryland law. These counterclaims include a breach-of-contract claim and claims that certain fees and interest rates were charged in violation of applicable Maryland statutes regulating finance charges, late fees, and compounding of interest on consumer credit accounts. In that proceeding, DFS was identified as "Discover Financial Services, Inc. (Discover), SVC Affiliate of Discover Bank, F/K/A Greenwood Trust Co., a DE chartered state bank and issuer of the Discover Card."

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VADEN V. DISCOVER BANK
DOCKET NO. 07-773

ARGUMENT DATE:
OCTOBER 6, 2008
FROM: THE FOURTH CIRCUIT

Case at a Glance

Discover Financial Services, an affiliate of Discover Bank, sued Betty Vaden in state court for her unpaid credit card balance. She responded with class action counterclaims against Discover Financial Services that were based on state law, but preempted by federal law. Discover then filed suit in federal district court seeking to compel Vaden to submit her counterclaims to arbitration. The question now is whether the federal district court has subject-matter jurisdiction to hear Discover's petition to compel arbitration.

Shortly after Vaden filed her counterclaims, Discover filed a petition in federal court seeking to compel arbitration of Vaden's state-court counterclaims based on the arbitration provision in the Notice of Amendment. Discover had made no previous requests to Vaden for arbitration. The district court granted Discover's motion to compel arbitration.

Vaden appealed the district court's decision to the U.S. Court of Appeals for the Fourth Circuit. In January 2005, the Fourth Circuit considered the issue of whether the federal courts had subject-matter jurisdiction to decide this case. The court held that, "when a party comes to federal court seeking to compel arbitration, the presence of a federal question in the underlying dispute is sufficient to support subject-matter jurisdiction." *Discover Bank v. Vaden*, 396 F.3d 366, 367 (4th Cir. 2005). The court declined, however, to decide whether such an underlying federal question actually existed in this case. Instead, it directed the district court to determine whether a federal question existed and to examine whether Discover Bank was the "real party in interest" with respect to Vaden's state-court claims and whether these claims were completely preempted by the Federal Deposit Insurance Act.

The district court found that Discover Bank was the real party in interest and that Vaden's state-court usury claims were completely preempted by federal law. The district court also found that there was no issue of material fact regarding the existence of an arbitration agreement between Vaden and Discover Bank. Accordingly, it granted Discover's request for arbitration. *Discover Bank v. Vaden*, 409 F. Supp. 2d 632 (D. Md. 2006).

Vaden again appealed the district court's ruling to the Fourth Circuit. Vaden argued that DFS was the real party in interest, and thus that the Federal Deposit Insurance Act was not implicated and the federal court was without subject-matter jurisdiction over the dispute. Vaden also contended that compelling arbitration was improper for two reasons: (1) Discover lacked standing because it had failed to satisfy the relevant statutory requirements for compelling arbitration, and (2) there was no valid arbitration agreement between Vaden and Discover Bank.

Affirming the district court's decision, a majority of the three-judge Fourth Circuit panel held that (1) the bank, not the servicing affiliate, was the real party in interest on the counterclaims; (2) state-law usury claims against a state-chartered, federally insured bank are preempted by the Federal Deposit Insurance Act; (3) Vaden's claims for violation of state laws regulating finance charges, late fees, and interest involved usury charges under the Federal Deposit Insurance and thus were completely preempted; and (4) complete preemption of usury claims sufficed to provide a federal forum for proceeding to compel arbitration of all claims within the arbitration agreement.

Vaden argued that she had not refused to arbitrate because Discover did not request arbitration with her before it filed suit. The Fourth Circuit, however, found that Discover had "standing" to file a petition to compel arbitration because Vaden had counterclaimed in state court and taken two appeals "to avoid arbitration of her claims." *Discover Bank v. Vaden*, 489 F.3d 594 (4th Cir. 2007).

The dissenting judge asserted that the majority had inexplicably used

the removal doctrine of complete preemption to characterize a counterclaim in a state court civil action as "federal." The dissent contended that federal question jurisdiction cannot be predicated on federal issues that may arise later in an action by way of defense or counterclaim.

Vaden's request for review was granted by the U.S. Supreme Court. 128 S.Ct. 1651 (2008).

CASE ANALYSIS

Section 4 of the Federal Arbitration Act (FAA) provides that "[a] party aggrieved by the alleged failure, neglect, or refusal of another to arbitrate under a written agreement for arbitration may petition any United States district court which, save for such agreement, would have jurisdiction under title 28 ... for an order directing that such arbitration proceed in the manner provided for in such agreement." With respect to subject-matter jurisdiction, 28 U.S.C. § 1331 provides that "district courts shall have original jurisdiction of all civil actions arising under the Constitution, laws, or treaties of the United States."

According to Vaden, the Federal Arbitration Act does not allow a court to order arbitration simply because it finds one party in breach of an arbitration agreement. In this case, Vaden argues, the Fourth Circuit's analysis focused on the wrong statute. She notes that in finding it had jurisdiction based on language in Section 4 of the Federal Arbitration Act, the Fourth Circuit made little attempt to square its ruling with 28 U.S.C. § 1331 or decades of case law interpreting that provision. Vaden suggests that, under those precedents, an action seeking to enforce an ordinary arbitration provision does not arise under federal law, even if the Act might displace an otherwise avail-

able state-law defense. She claims the Fourth Circuit's decision impliedly repealed the "well-pleaded complaint" rule, which states that for a federal court to have jurisdiction over a case "arising under" federal law, it must be clear from the face of the complaint that there is a federal question.

Discover disagrees, claiming the language in Section 4 is plain and unambiguous. It is Discover's position that Section 4 grants federal courts jurisdiction to compel arbitration, but only if, after putting to one side the arbitration agreement, the court concludes that it would have jurisdiction over a suit arising out of the controversy between the parties. Because the underlying controversy over the legality of interest payments and other fees by Discover Bank was completely preempted and solely based on federal law, Vaden contends the district court properly exercised jurisdiction to compel arbitration.

Discover further claims that "the peculiar procedural posture of this case—that the parties' federal dispute first was revealed in a counterclaim filed in Maryland state court—should make no difference under Section 4...." Discover observes that Section 4 is designed to address the situation in which a party neglects or refuses to arbitrate a dispute, including cases in which no complaint has been filed at all. According to Discover, the fact that Vaden's refusal to arbitrate was reflected in counterclaims filed in state court does not deprive the district court of jurisdiction to address Discover's petition to compel arbitration.

Vaden argues that it makes no sense to assert that the well-pleaded complaint rule precludes a federal court from basing Section 1331 federal question jurisdiction on a federal

counterclaim, but permits jurisdiction based on a completely preempted state-law counterclaim.

Discover responds that, through Section 4, Congress provided a federal court vehicle for the effective enforcement of agreements to arbitrate, even when there is no pending litigation in the district court. Relying on cases involving complete preemption by federal law, Discover argues that the well-pleaded complaint rule did not preclude it from petitioning a United States district court to compel arbitration. As long as a party is "aggrieved by the alleged failure, neglect, or refusal of another to arbitrate" and the district court "would have jurisdiction" over a "suit arising out of the controversy between the parties," the district court has the power and duty to compel arbitration.

Discover asserts that an interpretation of Section 4 preventing the district court from "looking through" the petition to the parties' underlying dispute, would both violate the language of Section 4 and subvert Congress's goals under the Federal Arbitration Act. According to Discover, an examination required in looking through the petition to the underlying dispute is little different from the analysis required to assess whether the dispute falls within the scope of the Federal Arbitration Act and the parties' arbitration agreement. Discover argues that Vaden does not advance any basis for her position that district courts may "look through" to the underlying controversy in assessing the amount in controversy in diversity cases, but may not do so in federal question cases.

Vaden, however, argues that looking through the petition to the underlying dispute takes no account of what federal jurisdiction typically treats as central: the rightful inter-

est of states. She says Discover's theory would allow a federal court to assert jurisdiction based on a hypothetical lawsuit even when the parties were litigating an actual lawsuit in state court over which the federal court could not assert jurisdiction.

Discover also notes that federal question jurisdiction exists in a declaratory judgment action if the potential suit by the declaratory judgment defendant would arise under federal law. Vaden, however, rejects this analogy between Section 4 and the Declaratory Judgment Act. She contends that, unlike a declaratory judgment action, neither a Section 4 petition nor the response to it asks the court to resolve any federal question, and the court therefore cannot reach the merits of the underlying dispute in which any federal question is embedded. Discover responds that, in deciding a petition under Section 4, a court necessarily determines whether a party has been aggrieved by the alleged failure, neglect, or refusal of another to arbitrate under a written agreement for arbitration. Although the district court does not resolve the underlying dispute for which arbitration is sought, Discover says that is necessarily the case under Section 4, where the relief sought is enforcement of a federal right to compel arbitration.

Vaden also concludes that Discover's alleged lack of standing is an alternative ground for reversing the Fourth Circuit. Arguing that Discover filed its Section 4 petition in federal court when Vaden was not even arguably in breach of the alleged arbitration agreement, Vaden contends Discover did not establish an "injury in fact"—an indispensable prerequisite to having standing to file suit. Vaden points out that the contract allowed Discover to "elect to resolve [a cov-

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ered] claim or dispute by binding arbitration.” Claiming that arbitration was not mandatory under the agreement, Vaden reasons that litigating her claim could not itself constitute “neglect” of any legal obligation.

Disagreeing with Vaden, Discover argues that the Court need not and should not address the “new” issue of standing, which Discover asserts is procedurally improper and substantively meritless.

SIGNIFICANCE

Congress enacted the Federal Arbitration Act in 1925 to replace judicial indisposition to arbitration with a “national policy favoring it and placing arbitration agreements on equal footing with all other contracts.” *Buckeye Check Cashing, Inc. v. Cardegna*, 546 U.S. 440, 443 (2006). Section 2 of the Act makes written arbitration agreements “in any maritime transaction or a contract evidencing a transaction involving commerce ... valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.”

If no lawsuit is pending, a petition (rather than a motion) to compel arbitration is filed in order to commence the proceeding. The petition is filed in a court that would have jurisdiction over an action involving the dispute and that has personal jurisdiction over the parties. In a proceeding to compel arbitration under Section 4 of the Federal Arbitration Act, the court determines whether there is an arbitration agreement covered by the Federal Arbitration Act and if so, whether the respondent has failed, neglected, or refused to fulfill it. Once satisfied that an agreement for arbitration exists and has not been honored, the court must order arbi-

tration. See *Prima Paint Corp. v. Flood & Conklin Mfg.*, 388 U.S. 395, 400 (1967).

In this case, the Supreme Court must determine whether the federal courts had subject-matter jurisdiction to hear Discover’s Section 4 proceeding to compel arbitration of Vaden’s counterclaims. In earlier cases, the Supreme Court has held that the Federal Arbitration Act, standing alone, does not provide a basis for federal jurisdiction. See e.g., *Southland Corp. v. Keating*, 465 U.S. 1, 15-16 (1984) (stating the Court did not believe Congress intended to limit the Act to disputes subject only to federal court jurisdiction because that would frustrate congressional intent to place arbitration agreements upon the same footing as other contracts). Rather, the Supreme Court has said that “[a]s for jurisdiction over controversies touching arbitration, the Act does nothing, being ‘something of an anomaly in the field of federal-court jurisdiction’ in bestowing no federal jurisdiction but rather requiring an independent jurisdictional basis.” *Hall Street Associates, L.L.C. v. Mattel, Inc.*, 128 S. Ct. 1396, 1402 (2008), quoting *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 25 n.32 (1983) (holding federal courts’ jurisdiction to enforce Act is concurrent with that of state courts).

In *Hall*, the Supreme Court stated it was relying, in part, on 9 U.S.C. § 4, which provides for action by a federal district court, “which, save for such [arbitration agreement] would have jurisdiction under title 28.” The Court further explained that “[b]ecause the FAA is not jurisdictional, there is no merit in the argument that enforcing the arbitration agreement’s judicial review provision would create federal jurisdiction by private contract.”

The Court in *Moses H. Cone* stated: “Section 4 provides for an order compelling arbitration only when the federal district court would have jurisdiction over a suit on the underlying dispute; hence, there must be diversity of citizenship or some other independent basis for jurisdiction before the order can issue.” However, the Court also stated that, “although enforcement of the Act is left in large part to the state courts, it nevertheless represents federal policy to be vindicated by the federal courts where otherwise appropriate.”

Normally, for a federal court to have jurisdiction over a case “arising under” federal law (28 U.S.C. § 1331), it must be clear from the face of a well-pleaded complaint that there is a federal question. A federal right must be an essential element of the plaintiff’s claim; the controversy must be disclosed upon the face of the complaint, unaided by the answer or by the petition for removal. In a patent case, the Supreme Court held that the well-pleaded-complaint rule does not allow a counterclaim to serve as the basis for a district court’s “arising under” jurisdiction to hear all civil actions arising under the Constitution, laws, or treaties of the United States. Even when a complaint alleges only violations of state law, the Supreme Court has explained that the case may nevertheless center on a federal question and therefore be removable from state court to federal court if federal law completely preempts the state law claims. *Caterpillar Inc. v. Williams*, 482 U.S. 386, 393 (1987).

The courts of appeals disagree whether—in a proceeding to compel arbitration—a district court has subject-matter jurisdiction over a case when the underlying dispute between the parties raises a federal question. Compare *Westmoreland*

Capital Corp. v. Findlay, 100 F.3d 263 (2d Cir.1996) with *Tamiami Partners, Ltd. v. Miccosukee Tribe*, 177 F.3d 1212 (11th Cir.1999). The narrower view, known as the *Westmoreland* doctrine, echoes the well-pleaded complaint rule. This doctrine holds that, for a district court to have federal question jurisdiction over a suit compelling arbitration, the federal question must be evident on the face of the arbitration petition itself. Perhaps realizing that such a possibility is highly unlikely, the *Westmoreland* line of cases concludes that federal question jurisdiction will never form the basis for a court's subject-matter jurisdiction to hear a Section 4 petition. Under this view, jurisdiction will lie only when some other basis for federal jurisdiction exists, such as diversity of citizenship or assertion of a claim in admiralty, but will not lie simply because the underlying controversy between the parties raises a federal question.

The broader view, as set forth in *Tamiami*, permits a federal court to examine the underlying dispute between the parties to determine if a federal question is present. Under this view, a district court is permitted to "look through" the arbitration request to assess whether the overall controversy between the parties is grounded in federal law. Other circuits have disagreed with the Fourth Circuit and interpreted Section 4 to mean that a federal court does not have subject-matter jurisdiction over an action to compel or stay arbitration merely because the underlying claim raises a federal question.

The Supreme Court is called upon to resolve this disagreement among the circuits. A decision in Vaden's favor would reduce the number of petitions to compel arbitration filed in federal court. A ruling for Discover, would make it easier for

financial institutions and others seeking to compel arbitration to get into federal court.

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