Vaden v. Discover Bank et al.[1]

I. INTRODUCTION

In *Vaden v. Discover Bank*, the Supreme Court clarified when federal courts have subject-matter jurisdiction to entertain petitions to compel arbitration brought under § 4 of the Federal Arbitration Act (FAA).[2] Through a § 4 petition, parties to an arbitration agreement can request a federal district court to enforce an agreement to arbitrate if they establish federal jurisdiction.[3] Specifically, § 4 of the FAA provides, in relevant part, that parties "may petition any United States district court which, save for such agreement, would have jurisdiction under Title 28 . . . . of the subject matter of a suit arising out of the controversy between the parties . . . ."[4] The Court granted certiorari to resolve a circuit split as to whether the federal character of the issue the parties seek to arbitrate can supply subject-matter jurisdiction over a § 4 petition.[5]

The Court considered two questions: First, whether a district court, "if asked to compel arbitration pursuant to § 4, [should] 'look through' the petition and grant the requested relief if the court would have federal-question jurisdiction over the underlying controversy," and second, if the Court should adopt the "look through" test, whether a district court may "exercise jurisdiction over a § 4 petition when the petitioner's complaint rests on state law but an actual or potential counterclaim rests on federal law."[6] Although the Court agreed with the Fourth Circuit's "look through" approach, it reversed and remanded, holding that Vaden's completely preempted state-law counterclaim could not serve as the basis for the district court's jurisdiction over Discover's § 4 petition.[7] The decision emphasized that Discover may petition a state court to enforce the arbitration agreement pursuant to § 2 of the FAA and state statutes similar to § 4.[8]

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[1] Vaden v. Discover Bank, 129 S. Ct. 1262 (2008).

[2] *Id.* at 1268. Although a federal statute, the FAA does not provide an independent basis for federal jurisdiction. *Id.*

[3] *See* Federal Arbitration Act, 9 U.S.C. § 4 (2000).

[4] *Id.*

[5] *Vaden*,129 S. Ct. at 1270.

[6] *Id.* at 1268.

[7] *Id.*

[8] *Id.* at 1269.

II. FACTS AND PROCEDURAL HISTORY

The case began as a simple breach of contract claim. In July 2005, Discover Bank and Discover Financial Services, Inc. ("Discover") sued Discover Card holder Betty Vaden in Maryland state court to recover an unpaid balance of $10,610.74 plus interest and litigation expenses.[9] In response, Vaden filed several class-action counterclaims alleging that the finance charges, interest, and late fees charged by Discover violated Maryland's credit laws.[10]

Instead of responding to Vaden's counterclaims in state court, Discover filed suit in the United States District Court for the District of Maryland under § 4 of the FAA seeking to compel arbitration of Vaden's counterclaims.[11] Discover alleged that pursuant to a 1999 amendment to Vaden's cardholder agreement, Vaden had agreed to arbitrate, at the request of either party, "any past, present, or future claim or dispute . . . . between you and us arising from or relating to your Account . . . ."[12] Discover further asserted that the district court had jurisdiction to entertain Discover's § 4 petition under 28 U.S.C. § 1331 because Vaden's state-law counterclaims were completely preempted by § 27(a) of the Federal Deposit Insurance Act ("FDIA").[13] The district court granted Discover's petition and ordered the parties to participate in arbitration.[14]

Vaden appealed the decision of the district court, arguing, in relevant part, that the district court lacked subject-matter jurisdiction to entertain the petition.[15] In *Vaden I*, the Fourth Circuit 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"

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[9] *Id.* at 1268.

[10] *Id.*

[11] *Vaden*, 129 S. Ct. at 1269.

[12] Joint Appendix at 34–35, Vaden v. Discover Bank, 128 S. Ct. 1651 (2008) (No. 07-773), 2008 WL 2309296.

[13] *Vaden*, 129 S. Ct. at 1269. Section 27(a) of the FDIA provides in part:

> In order to prevent discrimination against State-chartered insured depository institutions . . . with respect to interest rates . . . such State bank[s] . . . may, *notwithstanding any State constitution or statute which is hereby preempted for the purposes of this section*, take, receive, reserve, and charge on any loan or discount made, or upon any note, bill of exchange, or other evidence of debt, interest at a rate allowed by the laws of the State . . . where the bank is located.

12 U.S.C. § 1831d(a) (2000) (emphasis added).

[14] *Vaden*, 129 S. Ct. at 1269.

[15] *Id.*

and remanded to determine whether a federal question existed.[16] On remand, the district court again granted Discover's petition, finding that Vaden's state court counterclaims were completely preempted and that a federal question existed.[17]

Vaden again appealed, arguing, in part, that the district court was without subject-matter jurisdiction over the dispute.[18] In *Vaden II*, a divided panel of the Fourth Circuit affirmed the decision of the district court and held that the district court had subject-matter jurisdiction because "the FDIA completely preempts [Vaden's] state-court usury [counterclaims] against a state-chartered, federally insured bank . . . ."[19] The dissent concluded that the preemption doctrine relied on by the majority could not support jurisdiction because preemption does not override the rule that "[f]ederal question jurisdiction cannot be predicated on federal issues that may arise later in an action by way of defense or counterclaim."[20] The Supreme Court granted Vaden's petition for certiorari in March 2008.[21]

III. THE COURT'S HOLDINGS AND REASONING

In an opinion delivered by Justice Ginsburg, the Court unanimously held that a district court may "look through" a § 4 petition to determine whether or not it has subject-matter jurisdiction to entertain the petition.[22] The Court was, however, divided 5–4 as to whether Vaden's completely preempted counterclaim could be the basis for subject-matter jurisdiction.[23] The majority applied the rule that counterclaims cannot be the basis for jurisdiction and held that the district court did not have jurisdiction to entertain Discover's § 4 petition to compel arbitration.[24] The dissent disagreed, arguing that because the specific dispute that Discover had petitioned to arbitrate—namely the completely preempted counterclaims—

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[16] Discover Bank v. Vaden (*Vaden I*), 396 F.3d 366, 367 (4th Cir. 2005).

[17] *Vaden*, 129 S. Ct. at 1269.

[18] Discover Bank v. Vaden (*Vaden II*), 489 F.3d 594, 598 (4th Cir. 2007) (2-1 decision). Vaden also argued that Discover Financial Services was the real party in interest, not Discover Bank, and that compelling arbitration was improper because (1) Discover Bank lacked standing and (2) there was not a valid arbitration agreement between Vaden and Discover Bank. *Id.*

[19] *Id.* at 608.

[20] *Id.* at 609 (Goodwin J., dissenting).

[21] Petition for Writ of Certiorari, Vaden v. Discover Bank, 128 S. Ct. 1651 (2008).

[22] *Vaden*, 129 S. Ct. at 1273.

[23] *See id.* at 1279.

[24] *Id.* at 1276.

would be properly before the district court if considered independently, and the district court should thus have jurisdiction to compel arbitration.[25]

A. *Courts May "Look Through" § 4 Petitions to Find Jurisdiction*

The circuit split underlying the Supreme Court's decision to grant certiorari concerned whether the federal courts must find jurisdiction on the face of the petition to compel arbitration or whether district courts can "look through" the petition and find subject-matter jurisdiction based on the federal character of the underlying dispute.[26] The narrower approach adopted by the Second, Fifth, Sixth, and Seventh Circuits required the federal question to be "evident on the face of the arbitration petition itself" in order for a federal district court to have jurisdiction.[27] Under this approach, federal jurisdiction could not exist "simply because the underlying controversy between the parties 'raises a federal question.'"[28] The broader approach, employed by the Fourth and Eleventh Circuits, permits a federal court to "look through" the petition to assess whether a federal question is present in the underlying dispute.[29]

The Court adopted the "look through" approach used in the Fourth Circuit and held that "[a] federal court may 'look though' a § 4 petition to determine whether it is predicated on an action that 'arises under' federal law."[30] In analyzing the text of § 4, the Court found that the phrase "save for such agreement" is most naturally read to mean the underlying conflict between the parties.[31] Therefore, the Court determined that § 4 instructs district courts to assume the absence of an arbitration agreement and "determine whether [they] 'would have jurisdiction under title 28' without it."[32]

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[25] *Id.* at 1279 (Roberts, C.J., concurring in part and dissenting in part).

[26] *Id.* at 1270 (majority opinion).

[27] *Vaden I*, 396 F.3d at 368. *See* Westmoreland Capital Corp. v. Findlay, 100 F.3d 263, 267–69 (2d Cir. 1996); *see also* Wisconsin v. Ho-Chunk Nation, 463 F.3d 655, 659 (7th Cir. 2006) (in determining jurisdiction over a § 4 petition, the court may not "look through" the petition and focus on the underlying dispute); Smith Barney, Inc. v. Sarver, 108 F.3d 92, 94 (6th Cir. 1997) (same); Prudential-Bache Sec., Inc. v. Fitch, 966 F.2d 981, 986–89 (5th Cir. 1992) (same).

[28] *Vaden I*, 396 F.3d at 369.

[29] *Id.*; *see* Cmty. State Bank v. Strong, 485 F.3d 597, 605–06 (court may "look through" the petition), *vacated, reh'g en banc granted*, 508 F.3d 576 (11th Cir. 2007).

[30] *Vaden*, 129 S. Ct. at 1273.

[31] *Id.*

[32] *Id.* (quoting *Vaden I*, 396 F.3d at 372).

The Court was not persuaded by the "ouster" interpretation of the phrase "save for such agreement" promoted by Vaden and the circuits adopting the narrower approach to § 4 jurisdiction. Vaden argued that the "save for" clause was "designed to ensure that courts would no longer consider themselves ousted of jurisdiction and would therefore specifically enforce arbitration agreements."[33] The Court reasoned that this explanation was textually implausible because § 2 of the FAA directly addressed the problem of ouster and further that such a narrow approach "would not accommodate a § 4 petitioner who *could* file a federal-question suit in (or remove such a suit to) federal court, but who has not done so.".[34]

B. *Federal Jurisdiction Cannot be Invoked on the Basis of a Defense or Counterclaim*

The second question before the Court was "whether a 'completely preempted' state-law *counterclaim* in an underlying state-court dispute can supply subject matter jurisdiction."[35] The majority opinion, written by Justice Ginsburg and joined by Justices Scalia, Kennedy, Souter, and Thomas, held that because "federal-court jurisdiction cannot be invoked on the basis of a defense or counterclaim, the whole 'controversy between the parties' [did] not qualify for federal-court adjudication."[36] The majority found that § 4 requires courts to determine "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."[37] Finding that the whole controversy between the parties concerned Vaden's alleged debt to Discover—a completely state law cause of action—the Court dismissed Discover's § 4 petition for lack of jurisdiction.[38]

The split between the Court turned on the interpretation of the phrase "controversy between the parties" as used in § 4.[39] The majority held that the relevant controversy is the "whole controversy between the parties," while the dissent interpreted "the controversy between the parties" to refer to the controversy that the petitioner seeks to arbitrate.[40] The dissent reasoned that

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[33] *Vaden*, 129 S. Ct. at 1274; *see, e.g.*, *Westmoreland*, 100 F.3d at 267–68.

[34] *Vaden*, 129 S. Ct. at 1275 (emphasis in original).

[35] Petition for Writ of Certiorari at i, Vaden v. Discover Bank, 128 S. Ct. 1651 (2008) (No. 07–773), 2007 WL 4350779 (emphasis in original).

[36] *Vaden*, 129 S. Ct. at 1268.

[37] *Id.* at 1276.

[38] *Id.*

[39] *Id.*

[40] *Id.*

because a district court could have jurisdiction over the dispute Discover sought to arbitrate if it were brought independently in federal court, the district court should have jurisdiction to hear the petition to compel arbitration over the dispute.[41] The majority, however, rejected this approach, stating that it would be inconsistent with the federal rules of pleading to allow jurisdiction to rest on a hypothesis of how "one might imagine a federal-question suit involving the parties' disagreement" could have been styled to present a federal question.[42]

It is a fundamental rule of pleading that to satisfy the jurisdictional requirements of 28 U.S.C. § 1331, a plaintiff must present a well-pleaded complaint that demonstrates how the action "arises under" the Constitution, laws, or treaties of the United States.[43] The majority concluded that Discover's § 4 petition did not satisfy the "arising under" requirements of a well-pleaded complaint because federal jurisdiction cannot be predicated on an actual or anticipated defense or counterclaim.[44] In *Holmes Group v. Vornado Air Circulation Systems, Inc.*,[45] the Court unanimously held that "a federal counterclaim, even when compulsory, does not establish 'arising under' jurisdiction."[46]

The Court concluded that the Fourth Circuit misinterpreted the holding in *Holmes Group* when it held that the complete preemption doctrine overrides the well-pleaded complaint rule.[47] Even if Vaden's state law counterclaims were completely preempted, "under the well-pleaded complaint rule, a completely preempted counterclaim remains a counterclaim and thus does not provide a key capable of opening a federal court's door."[48] In sum, the rule adopted by the majority requires § 4 petitioners to establish that a district court has jurisdiction over the controversy as a whole using the same criteria that would be applied in standard federal pleading practice.[49] Accordingly, because the controversy as a whole between Discover and Vaden was based on state-law and the federal court's jurisdiction could not be based on a counterclaim, the Court dismissed Vaden's § 4 petition to compel arbitration for lack of jurisdiction.[50]

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[41] *Id.* at 1281 (Roberts, C.J., concurring in part and dissenting in part).

[42] *Vaden*, 129 S. Ct. at 1276 (majority opinion).

[43] *Id.* at 1272 n.9.

[44] *Id.* at 1272.

[45] Holmes Group v. Vornado Air Circulation Systems, Inc., 535 U.S. 826 (2002),

[46] *Vaden*, 129 S. Ct. at 1272.

[47] *Id.* at 1276.

[48] *Id.*

[49] *Id.* at 1276.

[50] *Id.* at 1279.

C. *Section 2 of the FAA Requires State Courts to Enforce Arbitration Agreements*

In addition to clarifying the requirements for jurisdiction to bring a § 4 petition in federal court, the Court confirmed that § 2 of the FAA requires state courts to enforce agreements to arbitrate. Section 2 provides that arbitration agreements in contracts "involving commerce" are "valid, irrevocable, and enforceable."[51] The Court advised Discover, and similarly-situated litigants, that because of § 2, federal court intervention is not necessary to enforce an arbitration agreement.[52] Parties may seek recourse by petitioning a state court to enforce the arbitration agreement pursuant to § 2 or a state statutory remedy similar to § 4.[53]

IV. THE IMPACT OF THE COURT'S DECISION

The *Vaden v. Discover Bank* decision may impact how parties who anticipate enforcing an arbitration agreement during the course of proceedings will style their complaints as well as the forum available to parties to enforce arbitration agreements.[54] The "look through" approach adopted by the Court expands access to the federal courts for litigants in circuits that previously only found federal jurisdiction when it was evident on the face of the § 4 petition.[55] The Court's second holding, that federal jurisdiction must be present in the controversy as a whole, will likely exclude some parties, such as credit card companies, that relied on the federal courts to enforce their arbitration agreements when a federal question appeared during proceedings in state court.[56]

What remains to be seen is whether the state courts that will now be receiving petitions to compel arbitration, similar to the one filed in federal court in this case, will be as diligent about enforcing arbitration agreements as the federal courts. During oral argument, Discover conceded that it could have petitioned the state court to enforce the arbitration agreement, but was concerned that it would not have its "[f]ederal rights protected as zealously

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[51] Federal Arbitration Act, 9 U.S.C. § 2 (2000); *Vaden*, 129 S. Ct. at 1271, 1278.

[52] *Vaden*, 129 S. Ct. at 1278.

[53] *Id.*

[54] *See id.* at 1272–73.

[55] *Id.* at 1275. The narrow approach would only "permit a federal court to entertain a § 4 petition when a federal-question suit is already before the court, when the parties satisfy the requirements for diversity-of-citizenship jurisdiction, or when the dispute over arbitrability involves a maritime contract." *Id.*

[56] *Id.* at 1277–78.

as [it] would in a Federal court."[57] If the state courts are not diligent in enforcing the rights granted under § 2 of the FAA, the Supreme Court may see another case in a few years clarifying the responsibilities of state courts to enforce arbitration agreements.[58]

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[57] Transcript of Oral Argument at 45, Vaden v. Discover Bank, 128 S. Ct. 1651 (2008) (No. 07-773), 2008 WL 4527978.

[58] *Id.* (Justice Stevens suggested that if Discover had difficulty having its arbitration agreement enforced in state court it could petition the Supreme Court).