SIMPSON THACHER

REPORT FROM WASHINGTON

The Supreme Court Adopts Broader View of Federal Jurisdiction to Hear Motions to Compel Arbitration under the Federal Arbitration Act

March 10, 2009

TO READ THE DECISION IN *VADEN V. DISCOVER BANK, ET AL.*, PLEASE CLICK HERE.

The *Report From Washington* is published by the Washington, DC office of Simpson Thacher & Bartlett LLP.

Celebrating 125 YEARS 1884-2009

Yesterday, in *Vaden v. Discover Bank, et al.*, No. 07-773, the Supreme Court found that federal jurisdiction exists to compel arbitration of substantive controversies under the Federal Arbitration Act ("FAA") if the federal courts otherwise would have had jurisdiction over the controversy absent the arbitration agreement. Specifically, the Court expressly held that federal courts may "look through" the petition for arbitration to the underlying substantive controversy in order to determine whether it is predicated on an action that "arises under" federal law. The Court recognized and rejected the view adopted by the majority of the circuits that have declined to follow the "look through" approach.[1]

BACKGROUND

The *Vaden* appeal relates to a state court action in which Discover Financial Services, Inc. ("DFS"), a servicing company affiliated with Discover Bank, sued Betty Vaden, a Discover card holder, in Maryland state court for failing to pay a $10,000 credit card balance. Vaden counterclaimed with a number of state class action claims, which were primarily breach of contract claims concerning increased interest rates and late fees.

Discover Bank, the lender, and DFS (together, "Discover Bank") filed suit in federal court to compel Vaden to submit her counterclaims to arbitration, arguing that federal jurisdiction existed because the state law claims were completely preempted by the Federal Deposit Insurance Act ("FDIA"). The district court sided in favor of Discover Bank, finding: (1) Vaden had entered into a binding arbitration agreement; and (2) Discover Bank had standing to sue for arbitration

[1] The question before the Court was not directly relevant to international arbitrations. The FAA already provides an express independent basis for federal subject matter jurisdiction for cases involving international commerce and governed by the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards. *See* 9 U.S.C. § 203.

notwithstanding the fact that Vaden's state-law claims were filed against DFS.

On appeal, the Fourth Circuit Court of Appeals addressed whether the district court properly had subject matter jurisdiction. The issue turned on the court's interpretation of section 4 of the FAA, which provides that a petition to compel arbitration may be filed in "any United States district court which, save for such agreement, 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 . . . ."

Vaden argued that the "save for" provision required courts to determine whether they would have jurisdiction to enforce specific performance of the arbitration agreement assuming that agreement did not oust their jurisdiction. She maintained that Congress included the "save for" provision to overcome the common law principle of ouster. Under the doctrine of ouster, long since rejected, courts refused to enforce specific performance of an arbitration agreement because it would "oust" the court of its jurisdiction.

The Fourth Circuit rejected Vaden's argument and held that federal courts must examine the underlying dispute, not the petition to arbitrate, to determine whether a federal question is presented. The Court of Appeals provided three grounds for its decision. First, interpreting "save for" as "but for" or "notwithstanding," the Court reasoned that the statute instructed federal courts to examine whether they would have jurisdiction absent the agreement. Second, section 4's reference to Title 28 evidences Congress' intent to grant jurisdiction if a district court were to have jurisdiction under any section within Title 28, and thus interpreting the FAA to prevent a petition based on federal question jurisdiction would effectively rewrite the statute. Third, the phrase "controversy between the parties" refers to the substantive conflict between the parties, not merely the dispute over arbitration. The Fourth Circuit remanded the case to the district court to determine whether federal question jurisdiction existed in the underlying dispute.

On remand, the district court found that Vaden's state-law counterclaims were completely preempted by the FDIA because the Act limits states' abilities to regulate interest rates imposed by out-of-state banks, such as Discover Bank. The court further found the FDIA's language mirrors language in the National Bank Act, which the Supreme Court has found completely preempts state law usury claims against national banks. The complete preemption of Vaden's state law counterclaims, the court reasoned, converted the counterclaims into federal claims and created federal question jurisdiction in the underlying dispute.

On appeal, the Fourth Circuit agreed with the district court, finding that: (1) Vaden's state law counterclaims were completely preempted; and (2) the preemption created subject matter jurisdiction in the district court to hear the petition to compel arbitration.

Before the Supreme Court on October 6, 2008, Petitioner Vaden argued that the "save for such agreement" provision of section 4 of the FAA was necessary to overcome the doctrine of ouster. Section 4's language, Vaden claimed, directs federal courts to determine whether they have jurisdiction over the petition to arbitrate absent the ouster doctrine. Respondent Discover Bank, on the other hand, argued that the Court should accept the simplest construction of section 4 and interpret the "save for"

provision as an instruction to look at the underlying controversy to determine federal question subject matter jurisdiction.

SUMMARY OF DECISION

The Supreme Court, in an opinion written by Justice Ginsburg and joined by Justices Scalia, Kennedy, Souter, and Thomas, held that federal courts may "look through" the motion to compel arbitration to the substance of the parties' underlying controversy. Federal court jurisdiction to hear motions to compel arbitration, therefore, does not require some independent basis separate from the controversy sought to be arbitrated. The Court nevertheless found that there was no federal subject matter jurisdiction in the dispute between Vaden and Discover Bank, reversing the judgment of the Court of Appeals and remanding the case for further proceedings consistent with its opinion.

"['The controversy between the parties'] is most straightforwardly read to mean the 'substantive conflict between the parties.'"

OPINION OF THE COURT

In approving the "look through" approach advanced by Discover Bank, the Court reasoned that the phrase "controversy between the parties," as used in section 4 of the FAA, "is most straightforwardly read to mean the 'substantive conflict between the parties.'" In so holding, the Court expressly rejected Vaden's argument—and the position of the majority of the Courts of Appeals—that the statute simply refers to the parties' dispute concerning the arbitrability of their claims. The Court questioned how the term "controversy between the parties" could refer to the existence or applicability of the arbitration agreement when the statute expressly asks the Court to determine its jurisdiction "save for [the arbitration] agreement."

"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."

OPINION OF THE COURT

The Court also observed several "curious practical consequences" of Vaden's proposed interpretation. Most significantly, the Court noted that such an interpretation would permit federal courts to hear motions to compel only when: (1) a federal-question suit already is pending before the court; (2) the parties satisfy diversity requirements; or (3) the dispute over arbitrability involves a maritime contract. On the other hand, the "look through" approach adopted by the Court would allow a petitioner to ask a court to compel arbitration of a federal-question dispute, regardless of whether a federal-question suit had been filed.

The Court then addressed the scope of the controversy that courts must "look through" in order to determine subject matter jurisdiction. The majority rejected framing the scope of the dispute solely by reference to the motion to compel arbitration because, otherwise, the petitioner could recharacterize an existing controversy or manufacture a new one in an effort to gain access to federal court. Instead, the Court held that "[t]he 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." The Court concluded that, when litigation has defined the parties' controversy, it is not enough to show that a federal question lurks somewhere inside such controversy; federal jurisdiction instead must exist over the litigation as presented.

In examining the case before it, the Supreme Court found that Discover's dispute against Vaden was not subject to

federal jurisdiction. Pursuant to its decision in *Holmes Group, Inc. v. Vornado Air Circulation Systems, Inc.*, 535 U.S. 826 (2002), the Court explained that, "[u]nder 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." As a result, Vaden's completely preempted counterclaim was insufficient to establish federal subject matter jurisdiction. The Court nevertheless noted that state courts also are obligated to enforce agreements to arbitrate, and that Maryland (the state in which the claims are pending) includes a statutory remedy nearly identical to section 4.

Chief Justice Roberts, joined by Justices Stevens, Breyer, and Alito, wrote separately, concurring in part and dissenting in part. Although the Chief Justice agreed with the "look through" approach adopted by the Court, he disagreed with the majority's conclusion that dispute between Discover Bank and Vaden was not subject to federal jurisdiction. According to Chief Justice Roberts, "[r]ather than ask whether a court 'would have' jurisdiction over the 'subject matter' of 'a' suit arising out of the 'controversy,' the majority asks only whether the court *does* have jurisdiction over the subject matter of a *particular* complaint." He noted that the majority's standard artificially limits the scope of section 4 to particular suits filed, and instead would have focused the inquiry on the dispute as framed by the parties in the motion to compel.

"Rather than ask whether a court 'would have' jurisdiction over the 'subject matter' of 'a' suit arising out of the 'controversy,' the majority asks only whether the court does have jurisdiction over the subject matter of a particular complaint."

CHIEF JUSTICE ROBERTS, CONCURRING IN PART AND DISSENTING IN PART

IMPLICATIONS

In its decision, the Supreme Court held that federal courts may "look through" a petition to compel arbitration to determine whether the underlying dispute between the parties is subject to federal subject matter jurisdiction. The Court resolved a circuit split concerning the proper scope of jurisdiction under section 4 of the FAA, rejecting the narrow interpretation of jurisdiction adopted by the majority of circuits to address the question, which required an independent basis of federal jurisdiction (*e.g.*, diversity or arbitrability of an admiralty law contract) separate and apart from a federal question in the underlying dispute. *See*, *e.g.*, *Westmoreland Capital Corp. v. Findlay*, 100 F.3d 263 (2d Cir. 1996); *Blue Cross v. Anesthesia Care Associations Medical Group*, 187 F.3d 1045 (9th Cir. 1999). The Court expanded federal court jurisdiction to hear motions to compel arbitration by instructing lower courts to examine the "whole controversy" between the parties, requiring courts to analyze any previous pleadings filed by the parties to determine whether such dispute could have been brought in federal court. As the Chief Justice explained in his separate opinion concurring in part and dissenting in part, however, the majority's approach allows for the procedural posture of the dispute to influence the determination of whether or not such dispute provides federal subject matter jurisdiction.

For further information about this decision, please feel free to contact members of the Firm's Litigation Department, including:

New York City:

Barry Ostrager
212-455-2655
bostrager@stblaw.com
John Kerr
212-455-2526
jkerr@stblaw.com
Mary Kay Vyskocil
212-455-3093
mvyskocil@stblaw.com
Mary Beth Forshaw
212-455-2846
mforshaw@stblaw.com
Andy Amer
212-455-2953
aamer@stblaw.com
Robert Smit
212-455-7325
rsmit@stblaw.com

Washington DC:

Peter Thomas
202-220-7735
pthomas@stblaw.com
Arman Oruc
202-220-7799
aoruc@stblaw.com

London:

Tyler Robinson
+44-20-7275-6118
trobinson@stblaw.com

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017-3954
212-455-2000

Washington, D.C.
601 Pennsylvania Avenue, N.W.
North Building
Washington, D.C. 20004
202-220-7700

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
310-407-7500

Palo Alto
2550 Hanover Street
Palo Alto, CA 94304
650-251-5000

EUROPE

London
Citypoint
One Ropemaker St.
London EC2Y 9HU England
+44-20-7275-6500

ASIA

Beijing
29/F China Merchants Tower
No. 118, Jianguo Road
Chaoyang District, Beijing 100022, China
+86-10-8567-2999

Hong Kong
ICBC Tower
3 Garden Road
Hong Kong
+852-2514-7600

Tokyo
Ark Mori Building
12-32, Akasaka 1-Chome
Minato-Ku, Tokyo 107-6037, Japan
+81-3-5562-6200