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Can The Federal Courts Compel Arbitration?

Two recent rulings clarify key provisions of the FAA

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It is not an uncommon situation. Two parties have a straightforward contract dispute. One party wants to arbitrate; the other would rather be in court. The second party, despite a provision in the parties' agreement that calls for arbitration in the first party's backyard, commences a lawsuit, in a distant jurisdiction, for breach of contract. In response, the party desiring arbitration files a petition in federal court to compel arbitration. Will the federal court exercise jurisdiction over the petition?

Consider a related issue. Let's suppose, in the above hypothetical, that the second party, believing the arbitration provision does not apply to the parties' dispute, files suit against the first in federal court. The first party files a motion in the pending action to stay the litigation and compel arbitration. The court denies the motion, holding that the arbitration provision does not govern. Can the movant file an immediate interlocutory appeal of the district court's order?

The U.S. Supreme Court addressed both of those issues in two important decisions released earlier this term. In the earlier case, *Vaden v. Discover Bank,* 129 S. Ct. 1262 (March 9, 2009), the court resolved a split among lower courts, and held that federal courts have jurisdiction to entertain petitions to compel arbitration made under Section 4 of the Federal Arbitration Act (FAA) if a federal court would have had jurisdiction to adjudicate the parties' underlying dispute. In *Arthur Andersen LLP v. Carlisle,* 129 S. Ct. 1896 (May 4, 2009), the court held that a party who unsuccessfully moves to stay litigation in favor of arbitration under Section 3 of the FAA is entitled to appeal that denial immediately.

The court began its analysis by noting the long-settled policy favoring arbitration, but also observed the anomaly that the FAA bestows no federal jurisdiction itself.

Vaden v. Discover Bank

In *Vaden,* Discover Bank sued Betty Vaden in Maryland state court for an unpaid credit card balance of a little more than $10,000. Vaden filed an answer, affirmative defense and counterclaims, in which she alleged usury and violation of various state statutes. Upon receiving the counterclaims, Discover filed a petition in Maryland federal court to compel Vaden to arbitrate her state law claims pursuant to Section 4 of the FAA. The District Court granted Discover's petition, ordered arbitration, and stayed Vaden's counterclaims pending arbitration.

Vaden appealed to the U.S. Court of Appeals for the Fourth Circuit, arguing that federal jurisdiction was lacking. The Fourth Circuit remanded the case to the lower court, directing it to "look through" the petition, to the parties' substantive dispute, to determine whether a basis for federal jurisdiction existed. On remand, the district court determined that Vaden's state law counterclaims were pre-empted by federal law, specifically a provision of the Federal Deposit Insurance Act that prescribes the interest rates that certain federally insured banks can charge their customers. The court held that such pre-emption sufficiently presented a federal question over which it could exercise jurisdiction. The Fourth Circuit affirmed.

The Supreme Court granted certiorari, in part, to resolve a conflict among the lower courts as to whether a federal court, when faced with a petition to compel arbitration under Section 4 of the FAA, can "look through" the petition, to the parties' underlying dispute, to determine whether a basis exists to exercise jurisdiction. The court began its analysis by noting the long-settled policy favoring arbitration, but also observed the anomaly that the FAA — unlike many other federal statutes — bestows no federal jurisdiction itself. Instead, to pursue a claim under the FAA in federal court, the court must have an independent basis to exercise jurisdiction. The court then noted the tension between Discover's asserted basis for jurisdiction — Vaden's

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federally pre-empted counterclaims — and the well-pleaded complaint rule, which provides that federal jurisdiction exists when the plaintiff's complaint asserts a claim based on federal law. Under that rule, federal jurisdiction cannot be grounded on a defendant's counterclaim, actual or anticipated, as Discover was attempting to do. Ultimately, Justice Ruth Bader Ginsburg, writing for the court, held that a federal court may "look through" a petition filed under Section 4 of the FAA to determine if the parties' dispute arises under federal law, but cannot exercise jurisdiction if a party's actual or anticipated counterclaim — but not the plaintiff's initial complaint — presents the federal question.

In a separate opinion authored by Chief Justice John Roberts, four justices, concurring in part and dissenting in part, agreed that a federal court must "look through" the petition to determine if it can exercise jurisdiction. The justices, however, disagreed with the majority's conclusion that a district court is limited to a review of the complaint filed in an existing litigation to determine if jurisdiction exists. They noted that, frequently, a Section 4 petition is filed before any other litigation has commenced. They also interpreted more broadly the language of Section 4, which gives access to a federal forum if the court — but for the arbitration agreement — would have had jurisdiction over "the subject matter of a suit arising out of the [parties'] controversy."

Arthur Andersen LLP v. Carlisle

Two months later, in *Andersen*, the Supreme Court again addressed a jurisdictional question relating to the FAA. In that case, the court held that any litigant who unsuccessfully moves for a stay of litigation under Section 3 of the FAA is entitled to immediately appeal that denial to the U.S. Court of Appeals.

In *Andersen,* three individuals made certain investments through limited liability companies following the sale of their business. The companies entered into investment management agreements, containing arbitration provisions, with Bricolage Capital, which provided advice concerning the investments. The Internal Revenue Service later determined that the investments constituted illegal tax shelters. The individuals commenced a federal lawsuit against Bricolage and other professional advisors for malpractice, breach of fiduciary duty, and related claims.

The defendants moved to stay the action, arguing that Section 3 of the FAA — which entitles federal court litigants to a stay of any action referable to arbitration "under an agreement in writing" — and principles of equitable estoppel required the plaintiffs to arbitrate their claims under their agreements with Bricolage. The district court denied the motion, and the defendants filed an interlocutory appeal under Section 16(a)(1)(A) of the FAA. That statute allows an appeal from an order denying "a stay of any action under Section 3." The U.S. Court of Appeals for the Sixth Circuit dismissed the appeal for lack of jurisdiction, holding that the lower court's denial was not from an order denying a stay under Section 3 of the FAA, since the claimed right to arbitration was not based on an agreement in writing. The Supreme Court granted certiorari.

Justice Antonin Scalia, writing for a six-member majority, rejected the Sixth Circuit's reasoning. The court held that the clear and unambiguous language of Section 16(a)(1)(A) of the FAA entitles any litigant who unsuccessfully moves for a stay under Section 3 to an immediate appeal, regardless of the merits of the stay motion.

According to the majority's decision, the Sixth Circuit erroneously conflated the jurisdictional issue with the merits of the appeal. Even an utterly frivolous application for a Section 3 stay, once denied, is immediately appealable. In *dicta,* the court noted that the Sixth Circuit also erred in holding that non-signatories to an arbitration agreement cannot obtain a stay of litigation under Section 3 of the FAA, since such agreements can be enforceable by or against non-signatories based on a number of different theories (including assumption, piercing the corporate veil, waiver and estoppel).

The dissent stated that, in light of Congress' decision to substantially limit interlocutory appeals, the Section 6 requirement that the stay be denied "under Section 3" should be interpreted narrowly, only permitting an appeal when signatories to an arbitration agreement have moved unsuccessfully for a stay of litigation. The dissent pointed out that such an interpretation would prevent parties from "gaming the system" by incorrectly labeling their appeal as one made under Section 3, simply for purposes of delay.

Conclusion

Vaden and *Andersen* provide important guidance regarding a litigant's access to federal courts when seeking relief under the Federal Arbitration Act.

In both, the Supreme Court re-affirmed the strong public policy favoring arbitration of disputes. In *Vaden,* the Court ensured greater access to a federal forum by allowing courts to look through the petition to compel arbitration, to see if federal jurisdiction would otherwise exist. In *Andersen,* the court decreed that parties who are denied a stay of litigation in favor of arbitration can immediately appeal that denial. ■