

Schiff Hardin LLP Class Action Alert

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U.S. SUPREME COURT HOLDS THAT FEDERAL COURTS HAVE NO JURISDICTION TO COMPEL ARBITRATION OF STATE LAW CLASS ACTION COUNTERCLAIMS ORIGINALLY BROUGHT IN STATE COURT, ABSENT INDEPENDENT BASIS FOR FEDERAL JURISDICTION

SUMMARY

In a 5-4 decision, the United States Supreme Court held that federal courts have no jurisdiction under Section 4 of the Federal Arbitration Act (“FAA”) to compel arbitration of class action counterclaims brought under state law and filed originally in state courts — even if the state law counterclaims would be preempted by federal law — absent an independent basis for federal jurisdiction. *Vaden v. Discover Bank*, No. 07-773, ___ S. Ct. ___, 2009 WL 578636 (U.S. Mar. 9, 2009).

The Court resolved two key questions:

1. “Should a district court, if asked to compel arbitration pursuant to § 4, ‘look through’ the petition and grant the requested relief if the court would have federal-question jurisdiction over the underlying controversy?” *Id.* at *3.

Answer: Yes (resolving question against “the majority of Courts of Appeals to address the question,” *id.* at *8).

2. “And if the answer to that question is yes, may a district court 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?” *Id.* at *3.

Answer: No.

The Proceedings Below

Discover Bank’s servicing affiliate (“Discover”) filed suit in Maryland state court to collect past-due charges from Vaden, a cardholder. Discover’s complaint alleged only a state law claim. Vaden responded with class action counterclaims, contending that Discover’s finance charges and late fees violated Maryland credit laws. *Id.* at *4.

The parties’ cardholder agreement provided for arbitration of “any claim or dispute.” *Id.* Instead of moving to compel arbitration in state court, Discover filed a petition in federal district court to compel arbitration of Vaden’s counterclaims pursuant to Section 4 of the FAA, 9 U.S.C. § 4, which authorizes a federal district court to entertain a petition to compel arbitration — but only if the court would have federal jurisdiction, “save for [the arbitration] agreement,” over “a suit arising out of the controversy between the parties.”

The district court ordered arbitration, but the Fourth Circuit vacated and remanded, holding that the district court must first decide the issue of federal question jurisdiction under 28 U.S.C. § 1331, which grants federal courts jurisdiction over cases “arising under” federal law. *See* 2009 WL 578636 at *4.

The Fourth Circuit instructed the district court to “look[] through” the arbitration petition to the substantive controversy between the parties to determine whether that controversy presented a “properly invoked federal question.” On remand, Vaden conceded that her state law counterclaims were “completely preempted” by federal banking laws. The district court therefore held that it had federal question

jurisdiction over Discover's arbitration petition, and the Fourth Circuit affirmed. *See id.* Although the Fourth Circuit recognized that federal question jurisdiction must be determined from the "contents of a well-pleaded complaint, and may not be predicated on counterclaims," it concluded that "the complete preemption doctrine is paramount, overrid[ing] such fundamental cornerstones of federal subject-matter jurisdiction as the well-pleaded complaint rule." *Id.* (internal quotations and citations omitted).

The Supreme Court's Decision

The Supreme Court reversed. Justice Ginsburg delivered the opinion of the Court (joined by Justices Scalia, Kennedy, Souter, and Thomas), and Chief Justice Roberts filed an opinion (joined by Justices Stevens, Breyer, and Alito) concurring in part and dissenting in part.

- **The FAA and Federal Subject Matter Jurisdiction**

The Court reiterated that the FAA does not grant federal subject matter jurisdiction, but instead requires an independent federal jurisdictional basis over the dispute. *Id.* at *6.

- **The Well-Pleaded Complaint Rule and the "Complete Preemption" Doctrine**

For its "independent jurisdictional basis" over the arbitration petition, Discover relied on 28 U.S.C. § 1331, providing for federal jurisdiction over "all civil actions arising under" federal law.

The Court observed that under the "well-pleaded complaint rule," a suit "arises under" federal law "only when the plaintiff's statement of his own cause of action shows that it is based on" federal law. 2009 WL 578636, at *6 (internal quotations and citations omitted). Federal question jurisdiction cannot be predicated on an actual or anticipated defense or counterclaim. *Id.* at *6-7.

Moreover, although a *complaint* purporting to rest on state law may be recharacterized under the "complete preemption" doctrine as one "arising under" federal law when the law governing the complaint is exclusively federal, a state law *counterclaim*, even one "similarly susceptible to recharacterization," remains nonremovable. *Id.* at *7.

- **Section 4 of the FAA**

The Court next held that under Section 4 of the FAA, a federal court should "look through" a petition to compel arbitration to the parties' underlying substantive controversy "to determine whether it is predicated on an action that 'arises under' federal law." *Id.* at *8.

The Court concluded that under Section 4, federal jurisdiction exists only if the court would have federal jurisdiction over "the controversy between the parties" *in the absence of* the arbitration agreement. The "controversy between the parties," the Court held, "is most straightforwardly read to mean the 'substantive conflict between the parties' " — *not* their dispute regarding arbitrability of the claims. *Id.* at *8.

- **The "Complete Preemption" Issue as Applied to this Case**

Having determined that a federal court should "look through" the arbitration petition to assess federal question jurisdiction, the Court concluded that there was no federal question jurisdiction over the parties' underlying dispute in this case. *Id.* at *10. The controversy between the parties

arose from Vaden's alleged debt, a claim "that plainly did not 'arise under' federal law," and there was no other independent basis for federal jurisdiction. *Id.*

The Court rejected the Fourth Circuit's attempt to predicate federal question jurisdiction on the grounds that the state law counterclaims were "completely preempted" by federal law: "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." *Id.*

The Court also rejected the dissent's argument there was federal question jurisdiction over "the controversy Discover seeks to arbitrate" — namely, "whether 'Discover Bank charged illegal finance charges, interest and late fees.'" *Id.* The dissent found that two federal suits might arise out of this controversy: "an action by Vaden asserting that the charges violate [federal banking laws], or one by Discover seeking a declaratory judgment that they do not." *Id.*

The majority found a "fundamental flaw" in this analysis:

In lieu of focusing on the whole controversy as framed by the parties, the dissent hypothesizes discrete controversies of its own design. . . . [T]he originating controversy here concerns Vaden's alleged debt to Discover. Vaden's responsive counterclaims challenging the legality of Discover's charges are a discrete aspect of the whole controversy Discover and Vaden brought to state court. Whether one might imagine a federal-question suit involving the parties' disagreement over Discover's charges is beside the point. 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.

Id.

- **Discover's Remedy: Seek to Compel Arbitration in State Court**

Finally, the Court noted that Discover was "not left without recourse," for it could "petition a Maryland court for aid in enforcing the arbitration clause of its contracts with Maryland cardholders." *Id.* at *12.

SECOND CIRCUIT INVALIDATES “NO CLASS ACTION” ARBITRATION PROVISION IN AMERICAN EXPRESS MERCHANTS LITIGATION

SUMMARY

In a case of first impression for the Second Circuit, the Court addressed the enforceability of “class action waiver” (or “no class action”) provisions in arbitration clauses in a challenge brought by American Express merchants to the fees charged them by American Express. *In re American Express Merchants’ Litig.*, 554 F.3d 300 (2d Cir. 2009).

Without taking a position on whether “no class action” arbitration clauses are *per se* valid or invalid, the Court held that the provision in *this* case was not enforceable because, based on the extensive factual record developed by the plaintiffs regarding the prohibitive costs of individual arbitration, “enforcement of the clause would effectively preclude any action seeking to vindicate the statutory rights [here, federal antitrust laws] asserted by the plaintiffs,” and would grant the defendant “de facto immunity from antitrust liability by removing the plaintiffs’ only reasonably feasible means of recovery.” *Id.* at 304, 320.

This decision is by no means the first to address the intersection of arbitration and class action law. In recent years, the United States Supreme Court, the federal circuits, and many other federal and state courts have wrestled with one or more aspects of this issue. But it does mark the first time the Second Circuit has squarely addressed the validity of an arbitration provision that purports to prohibit classwide litigation and arbitration.¹

The decision is also significant because, among other things,

- (1) the Court addresses the validity of such arbitration provisions in the *commercial* context — in which the plaintiffs were merchants, not consumers — and still found the arbitration provision unenforceable;
- (2) the decision demonstrates the importance of developing a detailed factual record to support or defeat a claim that individual arbitration would be prohibitively expensive; and
- (3) the Court declined to apply state law unconscionability principles to evaluate the validity of the arbitration provision, and instead held that requiring individual arbitration of the plaintiffs’ federal statutory claims “would be incompatible with the *federal* substantive law of arbitrability.”

The District Court Proceedings

The case involved a federal antitrust challenge by American Express merchants to the merchant fees for “charge” and “credit” cards. The plaintiffs claimed that by leveraging its market power in corporate and personal charge cards, American Express was able to compel merchants to accept its newer credit card products and pay supracompetitive fees. The plaintiffs claimed that this practice amounted to an illegal “tying arrangement,” in violation of Section 1 of the Sherman Act, 15 U.S.C. § 1. 554 F.3d at 305-09.

¹ The Second Circuit appeared previously to have rejected, albeit in dicta, the argument that “class claims should serve as a bar or deterrent to” individual arbitration. *JLM Indus., Inc. v. Stolt-Nielsen SA*, 387 F.3d 163, 180 n.9 (2d Cir. 2004) (“We would likely view such an argument skeptically . . .”).

American Express moved to compel individual arbitration of the named plaintiff's claims pursuant to the FAA and the terms of the merchants' contracts, which provided, in relevant part:

IF ARBITRATION IS CHOSEN BY ANY PARTY WITH RESPECT TO A CLAIM, NEITHER YOU NOR WE WILL HAVE THE RIGHT TO LITIGATE THAT CLAIM IN COURT OR HAVE A JURY TRIAL ON THAT CLAIM. . . . FURTHER, YOU WILL NOT HAVE THE RIGHT TO PARTICIPATE IN A REPRESENTATIVE CAPACITY OR AS A MEMBER OF ANY CLASS OF CLAIMANTS PERTAINING TO ANY CLAIM SUBJECT TO ARBITRATION.

Id. at 306.

The district court granted American Express' motion to compel individual arbitration. The court "expressed skepticism" of the plaintiffs' contention that "enforcement of the class action waiver would effectively strip them of the ability to assert their claims because 'each individual plaintiff would have to incur discovery costs amounting to hundreds of thousands of dollars, despite seeking average damages of only \$5000.'" *Id.* at 308. But the court ultimately concluded that the enforceability of the clause was an issue for the arbitrator — not the court — to resolve. *Id.* at 309.

The Second Circuit's Decision

The Second Circuit reversed, finding the arbitration provision unenforceable under the particular circumstances of the case.

- **Who Decides the Validity of the Arbitration Clause, the Court or the Arbitrator?**

The Second Court concluded that the question of the enforceability of the class action waiver provision is a "gateway" issue for the *court*, not the arbitrator, because the plaintiffs were challenging the validity of the arbitration clause itself — not the contract generally:

The plaintiffs are plainly challenging the Card Acceptance Agreement's arbitration clause insofar as they dispute the enforceability of its class action waiver and, by extension, the validity of the parties' agreement to arbitrate. Their challenge is to the arbitration clause itself, . . . rather than to the entirety of the Card Acceptance Agreement.

Id. at 311 (internal quotations omitted).

- **Does Federal or State Law Apply to Determine the Validity of the Clause?**

The Court proceeded to evaluate the enforceability of the class action waiver under "the federal substantive law of arbitrability," not state law unconscionability standards applied by some courts. *Id.* at 312. In so doing, the Court repeatedly emphasized that the claims involved in this case were federal *statutory* claims.²

Indeed, in a "caveat" at the end of the opinion, the Court emphasized that the decision "in no way rests upon the status of the plaintiffs as 'small' merchants," *id.* at 320, and rejected the plaintiffs' attempt to rely on cases applying state law unconscionability principles to claims involving

² For support, the Court cited the Third Circuit's decision in *Gay v. CreditInform*, 511 F.3d 369, 394-95 (3d Cir. 2007), which the Third Circuit recently distinguished in *Homa*, discussed *infra*.

consumers “of unequal bargaining power.” *Id.*; *see id.* (“We do not follow these cases because they all rely on findings of unconscionability under state law, while we have relied here on a vindication of statutory rights analysis, which is part of the federal substantive law of arbitrability.”).

- **Individual Arbitration Would Not Be “Economically Rational” in This Case.**

Turning to the merits of the plaintiff’s arguments, the Court began by “recognizing that insofar as a plaintiff may be said to possess a ‘right’ to litigate an action in federal court as a class action under Rule 23 . . . , the right ‘is a procedural right only, ancillary to the litigation of substantive claims.’ ” *Id.* at 312 (internal quotations omitted). Nevertheless, the Court proceeded to affirm “the utility of the class action as a vehicle for vindicating statutory rights,” particularly because “the class action device is the only economically rational alternative when a large group of individuals or entities has suffered an alleged wrong, but the damages due to any single individual or entity are too small to justify bringing an individual action.” *Id.*

The Court acknowledged that when “ ‘a party seeks to invalidate an arbitration agreement on the ground that arbitration would be prohibitively expensive, that party bears the burden of showing the likelihood of incurring such costs.’ ” *Id.* at 315 (quoting *Green Tree Fin. Corp. v. Randolph*, 531 U.S. 79, 92 (2000)). The Court emphasized that the validity of such arbitration provisions must be evaluated “on a case-by-case basis, considering the totality of the facts and circumstances,” including “the fairness of the provisions, the cost to an individual plaintiff of vindicating the claim when compared to the plaintiff’s potential recovery, the ability to recover attorneys’ fees and other costs and thus obtain legal representation to prosecute the underlying claim, the practical [e]ffect the waiver will have on a company’s ability to engage in unchecked market behavior, and related public policy concerns.” *Id.* at 321 (internal quotations omitted).

The Court concluded that the record developed by the plaintiffs “abundantly supports” their argument that “arbitration would be prohibitively expensive” and that “an inability to pursue arbitration on a class basis would be tantamount to an inability to assert their claims at all.” *Id.* at 302 n.1, 315.

The Court found the plaintiffs’ argument to be “compellingly set forth” by an economist the plaintiffs retained as an expert. He compared the “likely costs” required to arbitrate the plaintiffs’ complex antitrust claims on an individual basis (including the costs of necessary expert witness fees) with the “potential recovery of damages.” *Id.* at 316. The expert concluded that, given the costs involved, it would not be “economically rational” for a merchant to pursue an individual claim in arbitration. *Id.*

Based on this record, the Court concluded that the plaintiffs had demonstrated that “their antitrust claims against Amex can, for all intents and purposes, only be pursued through the aggregation of individual claims, either in class action litigation or in class arbitration.” *Id.* The Court also rejected the district court’s conclusion that the Clayton Act provisions allowing for treble damages and an award of attorneys’ fees adequately protected the merchants, because these provisions would not necessarily pay for the expert fees required. *See id.* at 317-18

- **The Risk of Classwide Arbitration When Moving to Compel Individual Arbitration**

Because the plaintiffs had “declared themselves amenable to proceeding to arbitration,” *id.* at 321, the Court did not need to address the issue whether the “no class action” clause was severable from the rest of the arbitration clause.

At oral argument, counsel for American Express represented that if the “no class action” provision were declared unenforceable, American Express would “reconsider” its intent to arbitrate. *Id.* The Second Circuit remanded the matter to the district court “to allow Amex the opportunity to withdraw its motion to compel arbitration.” *Id.*

The Court thus gave American Express the opportunity to avoid one of the hazards of moving to compel individual arbitration in a putative class action: a court ruling compelling arbitration, but allowing the *arbitrator* to decide (1) whether an arbitration clause permits classwide arbitration, and (2) whether class certification in arbitration is appropriate. *Cf. Green Tree Fin. Corp. v. Bazzle*, 539 U.S. 444 (2003) (certain arbitration clauses may be interpreted by arbitrator to provide for classwide arbitration). Under *Bazzle*, arbitration clauses that do not expressly prohibit classwide arbitration, or that are silent on the issue, may be interpreted to *permit* classwide arbitration.

Given the limited judicial review of arbitral awards (including class certification decisions rendered in arbitration), defendants moving to compel arbitration can thus win the (arbitration) battle, but lose the war: a contractual provision intended to require *individual* arbitration becomes a vehicle for classwide arbitration. Before moving to compel individual arbitration in a putative class action, companies therefore should carefully consider the pros and cons of such a motion, and whether they will be permitted to withdraw the motion if classwide arbitration is ordered.

THIRD CIRCUIT INVALIDATES “NO CLASS ACTION” PROVISION IN AMERICAN EXPRESS CONSUMER CLASS ACTION

SUMMARY

Less than one month after the Second Circuit invalidated American Express’ “no class action” arbitration provision in its commercial contracts with merchants, the Third Circuit invalidated a “no class action” arbitration provision in American Express’ contracts with its individual cardholders. *Homa v. American Express Co.*, No. 07-2921, ___ F.3d ___, 2009 WL 440912 (3d Cir. Feb. 24, 2009).

In contrast to the Second Circuit, which applied the “federal substantive law of arbitrability” in analyzing the validity of such a provision in a federal antitrust class action, the Third Circuit looked to state law (New Jersey) unconscionability principles to analyze the validity of the provision in a consumer class action.

Moreover, notwithstanding the contract’s choice of Utah law (which permits “no class action” arbitration provisions in consumer credit agreements), the Third Circuit held that, at least in “small sum” consumer class actions, such a provision would violate the public policy of New Jersey and, therefore, was not enforceable.

The District Court’s Decision

The named plaintiff, an American Express consumer cardholder, filed a class action in the District of New Jersey on behalf of a New Jersey class, and alleged that American Express had violated New Jersey’s consumer fraud statute by misrepresenting the terms of its “rewards” programs. *Id.* at *1.

The plaintiff’s agreement with American Express contained an arbitration provision which provided, in relevant part, that all claims must “be arbitrated on an individual basis . . . [with] no right or authority for any Claims to be arbitrated [as] a class action.” *Id.* Significantly, the agreement also included a choice-of-law provision requiring that any disputes arising out of the agreement be governed by Utah state law. *Id.*

The district court granted the defendants’ motion to compel arbitration of the named plaintiff’s individual claims, noting particularly that Utah law permits class action arbitration waivers in consumer credit agreements. *Id.* The district court rejected the plaintiff’s argument that the application of Utah law would violate the public policy of New Jersey, which (according to the plaintiff) would prohibit enforcement of such an arbitration clause. *Id.*

The Third Circuit’s Decision

The Third Circuit reversed.

- **Does Federal or State Law Apply to Determine the Validity of the Clause?**

The Court first held that the Federal Arbitration Act did not preclude application of state law unconscionability principles to determine the validity of a “no class action” arbitration provision.

The Court cited Section 2 of the FAA, 9 U.S.C. § 2, which provides that “an agreement . . . to submit to arbitration an existing controversy . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist in law or in equity for the revocation of any contract.” The Court

concluded that this provision “requires federal courts to look first to the relevant state law of contracts . . . in deciding whether a provision is valid under the FAA.” 2009 WL 440912 at *3 (internal quotations omitted). The Court distinguished as “dicta” statements in its earlier decision in *Gay v. CreditInform*, 511 F.3d 369 (3d Cir. 2007), and rejected the attempt to read *Gay* as a “blanket prohibition on unconscionability challenges to class-arbitration provisions.” 2009 WL 440912 at *5.

- **The “No Class Action” Arbitration Provision Is Unconscionable Under New Jersey Law.**

Having concluded that the FAA did not preclude application of New Jersey law, the Court analyzed whether Utah or New Jersey law would govern the dispute. If New Jersey law applied, the Court concluded, the arbitration provision must be invalidated, because “the class action waiver violates fundamental New Jersey public policy as applied to small-sum cases.” *Id.* at *6.

- **New Jersey’s Public Policy Requires Application of New Jersey Law.**

Having decided that the “no class action” provision violated New Jersey’s public policy “as applied to small-sum cases,” the Court held that New Jersey law should apply here as a matter of conflicts law.

The Court observed that Utah appears to be the only state to have enacted legislation favoring enforcement of “no class action” arbitration provisions in consumer credit agreements — presumably because the Utah legislature wanted to “honor[] freedom-of-contract principles and . . . protect Utah banks from unwarranted class-action suits.” *Id.* Nevertheless, the Court concluded that New Jersey had a “materially greater interest than Utah in the enforceability of a class-arbitration waiver that would operate the preclude a New Jersey consumer from relief under” New Jersey’s consumer fraud laws. *Id.* at *7.



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Schiff Hardin LLP has an active and experienced team of litigators who concentrate their practice in defending corporations against class actions and other complex civil litigation. Our attorneys have defended our corporate clients in class action cases in both state and federal courts throughout the United States.

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