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## Carve-Outs: The Efficacy of Reserving Judicial Remedies for Discreet Claims, While Requiring Arbitration for Others

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On its face, the United States Supreme Court's recent holding in *Vaden v. Discover Bank et al.*, 556 U.S. \_\_\_ (2009) is unremarkable: A federal court cannot exercise federal question jurisdiction over a petition to compel arbitration based on a counterclaim if the entire controversy would not otherwise provide a jurisdictional basis for federal court. The Court made clear that 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."<sup>1</sup> What makes *Vaden* significant is not the holding but the Court's seemingly gratuitous dicta regarding the merit of "slic[ing] off responsive proceedings for arbitration."<sup>2</sup> The Court's dicta coupled with decisions relating to the enforceability of arbitration provisions containing "carve-outs" may call into question the ability of a creditor who invokes the litigation process under a "carve-out" provision to then invoke arbitration if the debtor files a counterclaim. Essentially, one could read the Court's dicta as implicitly approving of decisions in which courts refused to enforce a carve-out that permits a creditor to use a judicial forum to recover a debt, reserving all other claims for an arbitration.

### I. *Vaden v. Discover Bank*

By way of background, the *Vaden* case began as a garden-variety action to collect a debt that was instituted in the State Court of Maryland by Discover Bank's servicing affiliate against a credit card holder.<sup>3</sup> The claims filed by Discover arose solely under state law. The credit card holder, Vaden, answered Discover's complaint and filed a counterclaim, alleging claims purportedly arising under state law.<sup>4</sup> Discover filed a petition in federal court to compel arbitration of Vaden's counterclaims, arguing that the federal court had federal question jurisdiction over the petition because Vaden's counterclaims were completely preempted by federal law.<sup>5</sup> Ultimately, the Court of

Appeals for the Fourth Circuit agreed, concluding that the complete preemption doctrine overrode the well-pleaded complaint rule and permitted a federal court to exercise jurisdiction if a state law counterclaim was completely preempted by federal law.<sup>6</sup> The Supreme Court disagreed, and held that a federal court may not entertain a petition filed pursuant to §4 of the Federal Arbitration Act based on the contents of a counterclaim if the court could not otherwise have exercised jurisdiction over the whole controversy.<sup>7</sup>

The Court's position on jurisdiction is unsurprising in light of previous precedent reiterating the well-pleaded complaint rule and expounding upon a party's ability to rely upon a counterclaim or affirmative defense as a basis to establish federal question jurisdiction. Troubling, however, was the Court's dicta and how that dicta may impact the ability of a party to effectively and efficiently utilize "carve-outs" contained in arbitration provisions that permit the party to file discrete types of cases in a judicial forum, while reserving arbitration for the remainder of any claims that may arise.

Specifically, the decision in *Vaden* could be read to question the merit of severing claims that are arbitrable under the parties' agreement from those that are not arbitrable if the non-arbitrable claims are already pending in court. In attacking the dissent, the majority in *Vaden* states:

As the dissent would have it, parties could commandeer a federal court to slice off responsive pleadings for arbitration while leaving the remainder of the parties' controversy pending in state court. That seems a bizarre way to proceed. In this case, Vaden's counterclaims would be sent to arbitration while the complaint to which they are addressed - Discover's state-law-grounded debt-collection action - would remain

pending in a Maryland court. When the controversy between the parties is not one over which a federal court would have jurisdiction, it makes scant sense to allow one of the parties to enlist a federal court to disturb the state-court proceedings by carving out issues for separate resolution.<sup>8</sup>

Although addressed to a very different situation, this language - standing alone - may be read by some as calling into question the ability of a creditor to utilize a carve-out to proceed in a judicial forum, while still retaining the right to require a debtor to arbitrate any counterclaims. Irrespective of the merit in doing so, creditors can expect the Court's dicta may be used by debtors to compound the already troubling case law relating to waiver and unconscionability with respect to carve-outs contained in arbitration provisions that reserve certain judicial remedies for the creditor that are not available to the debtor. If taken to the extreme, *Vaden*, coupled with other "carve-out" decisions, may erode the utility of carve-outs and may encourage specious counterclaims filed solely in an effort to apply pressure to creditors and complicate what should be a simple action to collect a valid debt.

## II. "Carve-Out" Cases

Even prior to *Vaden*, some courts have departed from the rule that parties are free to contract as they wish and equivocated on the enforceability of arbitration provisions containing carve-outs. Decisions from our own Alabama Supreme Court exemplify this equivocation. For example, in *Northcom, Ltd. v. James*,<sup>9</sup> the Alabama Supreme Court invalidated an arbitration provision containing a carve-out and took the position that:

[I]n a case involving a contract of adhesion, if it is not shown that the party in an inferior bargaining position had a meaningful choice of agreeing to arbitration or not, and **if the superior party has reserved to itself the choice of arbitration or litigation**, a court may deny the superior party's motion to compel arbitration based on the doctrines of mutuality of remedy and unconscionability.

*Northcom* was subsequently weakened by

the court's decision in *Ex parte McNaughton*,<sup>10</sup> in which the court openly disapproved of this analysis in *Northcom*.<sup>11</sup> However, *Northcom* was later revived by the court in its decision in *American General Finance, Inc. v. Branch*. The Court's decision in *Branch* is particularly troubling on the ability to include a carve-out in an arbitration provision. In *Branch*, one of the three factors present upon which the court relied in finding the provision unconscionable was the perception that the carve-out in that particular provision benefitted only the lender:

A third indicium [of unconscionability] is the provision *exempting* the *Lenders* from the duty to arbitrate and expressly reserving for *them* the right to try to a jury their claims against Branch up to \$10,000. Practically speaking, this provision *benefits only the Lenders*. In other words, American General reserved for itself the right to collect by *judicial action* the loan payments--the only species of claim it would ever realistically be expected to assert against Branch--while requiring Branch to settle by *arbitration* claims such as breach of contract and fraud--the species of claims she would most likely assert against the Lenders.

Since *Branch*, the court has been careful to underscore that mutuality of remedies (i.e., the existence of a carve-out) is not dispositive of an unconscionability argument, but has reiterated that mutuality of remedies is a factor to be considered in determining whether an arbitration provision is unconscionable.

The decisions relating to the carve-outs in the context of an unconscionability argument traditionally occur in circumstances in which a consumer files an action against a company, and the company attempts to invoke the arbitration provision. In the reverse situation, when a company files a judicial action pursuant to a carve-out and subsequent litigation occurs, the waiver doctrine or the Court's dicta in *Vaden* may erode the ability of the company to use the carve-out.

## III. Carve-Outs and Waiver

For example, in the waiver context, even if a court determines that an arbitration provision containing a carve-out is not unconscionable, certain courts have suggested that a party waives the right to compel arbitration if a party initiates a proceeding in a judicial forum pursuant to the carve-out. For example, the Third Circuit remanded a case to the district court to determine whether a party's initiation of a judicial action - an action which was primarily allowed under a carve-out - resulted in prejudice and thus a waiver of that party's right to compel arbitration of other claims.

#### IV. Conclusion

Given the Court's decision in *Vaden*, together with certain state and federal court decisions on waiver and unconscionability, a creditor seeking to recover a debt will want to carefully assess how any carve-outs contained in their existing arbitration provision may be perceived. Thus far, the courts have focused the unconscionability analysis on the perception that only the creditor benefitted from the carve-out. By crafting an arbitration provision to eliminate the perception that a particular carve-out benefits only a creditor, creditors will be able to have more confidence in the

enforceability of their arbitration provision.

Further, prior to filing an action to collect a debt, creditors should carefully assess how best to frame any claim they may have against a debtor, what forum the claims should be filed in initially and the existence of any potential counterclaims the debtor may have against the creditor. By carefully assessing these factors, every effort can be made to preserve a creditors right to compel arbitration and to utilize a federal court for the purpose of doing so.

#### End Notes

<sup>1</sup> *Vaden v. Discover Bank et al.*, No. 07-773 (March 9, 2009).

<sup>2</sup> *Id.* at 18.

<sup>3</sup> *Id.* at 1.

<sup>4</sup> *Id.* at 2.

<sup>5</sup> *Id.* Notably, on appeal, *Vaden* conceded that her counterclaims were preempted by federal law.

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

<sup>8</sup> *Vaden*, No. 07-773 at 18.

<sup>9</sup> 694 So. 2d 1329, 1338 (Ala. 1997) (emphasis added).

<sup>10</sup> 728 So.2d 592 (Ala.1998).

<sup>11</sup> See also, *Green Tree Fin. Corp. v. Wampler*, 749 So.2d 409, 416 (Ala.1999) ("while the agreement restricts the Wampplers to arbitration while reserving to Green Tree the option to litigate, this fact, standing alone, is not sufficient to warrant a finding of unconscionability").

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