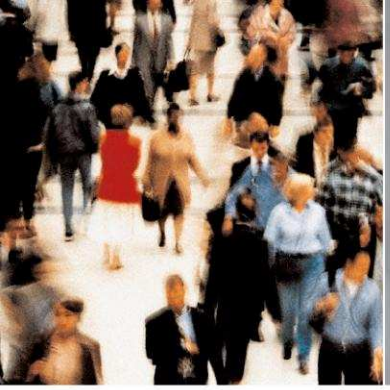

Class Action Alert
Recent developments in class action law

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# Update on the Kilgore Ninth Circuit appeal: California's public injunction exception escapes for another day, but the en banc court reads the exception to arbitration narrowly and rejects plaintiffs' attempt at artful pleading

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In a prior alert (see Ninth Circuit applies Concepcion to invalidate California's "public injunction" exception to arbitration and further upholds KeyBank's "opt-out" clause, March 12, 2012), we reported on a three-judge panel decision of the Ninth Circuit, which ruled in favor of KeyBank and held that the Federal Arbitration Act ("FAA") trumps California's court-made rule that actions seeking relief on behalf of the public may only be adjudicated in court and not in arbitration.[1] That panel had concluded that the Supreme Court's rulings in *AT&T Mobility LLC v. Concepcion*, 131 S. Ct. 1740, 179 L. Ed. 2d 742 (2011), and *Marmet Health Care Center, Inc. v. Brown*, 132 S. Ct. 1201, 182 L. Ed. 2d 42 (Feb. 21, 2012) (per curiam) made clear that any state law rules that "prohibit[] outright the arbitration of a particular type of claim" are displaced by the FAA. The en banc Ninth Circuit reconsidered that decision and, after further briefing and arguments before a ten-judge panel, issued a decision on April 11, 2013. *See Kilgore v. KeyBank, National Association*, No. 09-16703, 2013 U.S. App. LEXIS 7312 (9th Cir. en banc Apr. 11, 2013). While the en banc Court declined to go as far as the original panel to declare the outright demise of the public injunction rule, it applied a narrow definition of what it means to bring a public injunction action. Digging below the surface of plaintiffs' claims, the en banc Court rejected the plaintiffs' avowals that they sought relief on behalf of the general public, and concluded that arbitration is a proper forum for their claims.

The *Kilgore* lawsuit was brought by two aspiring helicopter pilots who had enrolled in Silver State Helicopters, LLC, a national aviation school, before it declared bankruptcy in February 2008. KeyBank had been one of Silver State's preferred lenders. Dissatisfied with the training they received from Silver State, the plaintiffs brought a preemptive class action in May 2008 alleging that Silver State was a sham school for which the students should not be required to pay. Because the school was insolvent, the plaintiffs sought loan forgiveness from the lender. On behalf of themselves, and a putative class of about 120 other former California-based Silver State borrowers, plaintiffs filed suit

[1] *See Kilgore v. KeyBank, National Association* 673 F.3d 947 (9th Cir. 2012), *vacated and rehearing en banc granted by Kilgore v. KeyBank Nat'l Assoc.*, 697 F.3d 1191 (9th Cir. Sept. 21, 2012).

in California state court. KeyBank removed the lawsuit to the U.S. District Court for the Northern District of California.

Plaintiffs claimed that KeyBank should be held derivatively liable for the flight schools' failures because KeyBank had allegedly violated California's Unfair Competition Law ("UCL"), Cal. Bus. & Prof. Code § 17200, by failing to include the "holder in due course" notice required by the Federal Trade Commission's "holder rule." Had the holder notice been included in the promissory notes, plaintiffs would have been entitled to assert any claims or defenses against KeyBank arising from Silver State's misconduct. The plaintiffs argued that pursuant to the UCL, the FTC's holder notice should be read into the promissory notes despite KeyBank's omission of it. For relief, the plaintiffs sought an order enjoining KeyBank from (1) enforcing collection under the promissory notes; (2) making adverse reports concerning class members to the credit reporting agencies; and (3) engaging in false and deceptive acts and practices with respect to consumer credit transactions (namely, disbursing loan proceeds to any seller without including the holder rule language in the consumer credit contract).

The promissory note for each Silver State student in the class contained an identical arbitration clause, which provided that any disputes between the lender and the borrower would be subject to binding bi-lateral arbitration upon election of either party, and that if arbitration is elected, the borrower waives any right to participate as a representative or member in a class action. But the clause also provided that any borrower could "opt out" of the arbitration provision (and the class action waiver) simply by providing written notice of such election to KeyBank within 60 days of signing the promissory note. The promissory note did not tie disbursement of the loan funds to the passage of this 60-day opt-out period, and therefore borrowers were not penalized for making that election.

Because neither of the *Kilgore* plaintiffs had elected to opt out of the arbitration clause, KeyBank sought to remove the case to arbitration. But the district court denied KeyBank's motion to compel arbitration based on California's policy against arbitrating public injunction claims. In California, this rule is commonly called the "*Broughton/Cruz*" rule, after the two California Supreme Court cases that established it.[2] KeyBank immediately filed for interlocutory appeal pursuant to the FAA. In the meantime, the district court retained jurisdiction and then granted KeyBank's motion to dismiss on all grounds, ruling that plaintiffs' various claims either failed to state a claim or were preempted by the National Bank Act. Plaintiffs appealed the district court's dismissal order and that appeal was consolidated with KeyBank's arbitration appeal.

In March 2012, a three-judge panel of the Ninth Circuit ruled in favor of KeyBank on its arbitration appeal and vacated the district court's dismissal order as moot. Applying *Concepcion* and the body of Supreme Court case law before and since, the Ninth Circuit panel ruled that California's public injunction rule must yield to the FAA. The panel ruled that the public injunction rule could not survive *Concepcion* because the FAA expressly displaces state rules that amount to a categorical ban against arbitration. Congresses' national policy that all valid agreements to arbitrate should be

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[2] *Broughton v. Cigna Health-plans of California*, 988 P.2d 67 (Cal. 1999) (public injunction claims brought under the Consumer Legal Remedies Act not arbitrable); *Cruz v. Pacificare Health Systems, Inc.*, 66 P.3d 1157 (Cal. 2003) (public injunction claims brought under the UCL not arbitrable). *See also Davis v. O'Melveny & Myers*, 485 F.3d 1066, 1082 (9th Cir. 2007) (applying California rule against arbitrating actions seeking public injunctions to federal case).

enforced, trumps any state law-making body's conclusion that arbitration is unsuitable in some cases. The panel remanded to the district court with instructions to compel arbitration.

The plaintiffs thereafter petitioned the en banc Ninth Circuit for rehearing. Underscoring the stakes involved, plaintiffs' petition was supported by several amicus briefs filed by organizations aligned with the plaintiffs' bar, including, among others, the National Association of Consumer Advocates, National Consumer Law Center, the National Employment Lawyers Association, and an alliance of law professors from across the country. KeyBank opposed the petition for rehearing and was joined by its own amicus ally, the United States Chamber of Commerce. The Ninth Circuit granted the plaintiffs' petition for rehearing and an argument before the ten-judge en banc panel was conducted on December 11, 2012.

Plaintiffs' focused their argument on the so-called "vindication of rights" exception to arbitration. In a number of cases, the Supreme Court has recognized an exception to the FAA in addition to the savings clause—namely, that the FAA cannot compel enforcement of an arbitration clause where enforcement would prevent a party from effectively vindicating its substantive statutory rights. *See*, *e.g.*, *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614 (1985). Plaintiffs argued that while a party may waive procedural rights by arbitration agreement, they cannot waive substantive rights, and the right to seek a public injunction is a substantive right that cannot be adequately vindicated in arbitration. KeyBank and the Chamber of Commerce responded by pointing out that all of the Supreme Court's "vindication of rights" cases concerned the vindication of *federal* statutory rights. Contrary to cases involving state law exceptions to arbitration, cases involving federal statutes do not implicate the Supremacy Clause. The Supremacy Clause prevents state courts and state legislatures from carving their own exceptions out of federal law, however well intentioned; that prerogative is left solely to Congress. KeyBank also argued that plaintiffs were seeking a public injunction in name only, not in substance, and thus the vindication of rights argument was inapplicable.

Judge Andrew D. Hurwitz, writing for the nine-judge majority, seized the latter argument as a vehicle for resolving the case without reaching the broader question of the vitality of California's public injunction rule. The majority opinion analyzed the definition of a "public injunction": "Whatever the subjective motivation behind a party's purported public injunction suit, the *Broughton* rule applies only when 'the benefits of granting injunctive relief by and large do not accrue to that party, but to the general public in danger of being victimized by the same deceptive practices as the plaintiff suffered.'" *Kilgore*, 2013 U.S. App. LEXIS 7312, at *18-19 (quoting *Broughton*, 988 P.2d at 76). Breaking down the *Kilgore* plaintiffs' individual claims for relief, the majority concluded that they do not fall within the "narrow exception to the rule that the FAA requires state courts to honor arbitration agreements." *Id.* at *19 (quoting *Cruz*, 66 P.3d at 1162). The first two claims for relief—seeking to enjoin KeyBank from enforcing the promissory notes and from reporting defaults to the credit agencies—would only benefit the 120 putative class members. While the third requested injunction—barring future loan disbursements to sellers without the holder rule language—could potentially amount to a claim for public relief, it was not such a claim on the undisputed facts of this case. As the plaintiffs' third amended complaint conceded, KeyBank had completely withdrawn from the private school lending business and there was no allegation that KeyBank was still making similar loans. The majority rejected the notion that arbitration of plaintiffs' claims would be inadequate in this case, "where Defendants' alleged statutory violations have, by Plaintiffs' own admission, already ceased, where the class affected by the alleged practices is small, and where there is no real

prospective benefit to the public at large from the relief sought." In other words, the Ninth Circuit looked past plaintiffs' conclusory assertion of a claim for public injunctive relief, and found that plaintiffs merely sought run-of-the mill individual debt relief—exactly the type of claim well suited to arbitration.

The majority also ruled that the arbitration agreement was not unconscionable. Under California law, a contractual provision is unenforceable only if it is both procedurally and substantively unconscionable. The majority found that KeyBank's arbitration provision was neither. The arguments that the class waiver provision or the costs of arbitration could make the arbitration clause substantively unconscionable are both foreclosed by Supreme Court precedent. *See id.* at *13 (citing *Concepcion*, 131 S. Ct. at 1753, and G*reen Tree Fin. Corp.-Ala. v. Randolph*, 531 U.S. 79, 90-91 (2000)). Moreover, the majority had little trouble finding that the arbitration provision was not procedurally unconscionable inasmuch as the arbitration clause was not buried in fine print, was clearly labeled in bold and set forth in its own section of the promissory note, and provided all borrowers with an opportunity to opt out of arbitration within 60 days of signing the note. *See id.* at *14. Accordingly, the Court reversed the denial of the motion to compel arbitration and remanded to the district court with instructions to compel arbitration.

Judge Pregerson wrote the lonely dissent. The dissent did not engage the public injunction argument, but instead rested on Judge Pregerson's belief that the arbitration clause is unconscionable.

The end result of the en banc rehearing is a modest ratcheting back of the initial panel's opinion, which had relegated California's public injunction exception to the scrap heap of California rules preempted by the FAA. While the en banc decision preserves that question for another day (and the public injunction rule survives on life support), the decision significantly limits the exception by defining it narrowly.

The Ninth Circuit's ruling sends a strong signal to the plaintiffs' bar that they will not be successful in circumventing the preemptive effect of the FAA through artful pleading. The ruling should discourage tactical pleading of "public injunction" claims solely for the purpose of gaining settlement leverage. Additionally, the majority opinion's unconscionability analysis provides a roadmap for businesses seeking to craft arbitration clauses that will withstand judicial scrutiny. And it is not just consumer-facing businesses that should take note, as the impact of the decision is likely to reverberate in other areas. For example, many employers now require their employees to sign agreements mandating arbitration of any disputes. The *Kilgore* decision further affirms the national policy that arbitration is a preferred method of dispute resolution and that unsubstantiated unconscionability challenges will not be given credence.

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