UNPUBLISHED

IN THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF VIRGINIA
ABINGDON DIVISION

RUSSELL COUNTY SCHOOL BOARD,	)	
	)	
Plaintiff,	)	Case No. 1:01CV00131
	)	
v.	)	**OPINION AND ORDER**
	)	
CONSECO LIFE INSURANCE COMPANY,	)	By: James P. Jones
	)	United States District Judge
	)	
Defendant.	)	

Frank Kilgore, Kilgore and Kilgore, St. Paul, Virginia, for Plaintiff; Monica L. Taylor, Gentry Locke Rakes & Moore, Roanoke, Virginia, for Defendant.

The question in this case is whether a provision in an insurance contract between a Virginia school board and an insurance company, providing for arbitration in Chicago, is enforceable. I hold that the arbitration clause is enforceable even though its results are nonbinding and I will stay the proceedings in this court and order arbitration.

I

On January 10, 2000, the defendant, Conseco Life Insurance Company ("the Insurance Company"), issued a insurance policy to the plaintiff, Russell County School Board ("the School Board") under which it agreed to reimburse medical expenses of the School Board's employees to the extent that the expenses exceeded $65,000. The insurance policy, entitled "Excess Loss Reinsurance Treaty," states that Virginia law governs its terms. One of the clauses of the policy provides that all disputes between the parties "upon which an amicable understanding cannot be reached are to be decided by arbitration." Arbitration is to take place in Chicago, Illinois, with three arbitrators, one picked by each party and the third by the arbitrators, and the costs of the arbitration are to be paid by the losing party, unless the arbitrators decide otherwise.

The School Board filed suit in the Circuit Court of Russell County, Virginia, alleging that the Insurance Company did not reimburse certain medical expenses in the amount of $152,225.82, as promised in the policy. The Insurance Company removed the case to this court on the ground of diversity jurisdiction. *See* 28 U.S.C.A. § 1332(a) (West 1993 & Supp. 2001).

The Insurance Company thereafter filed a motion to dismiss pursuant to Federal Rules of Civil Procedure 12(b)(1) and 12(b)(6). The Insurance Company argues that the case should be dismissed because arbitration is required under the agreement

between the parties. The Insurance Company thus contends that the School Board has failed to state a claim upon which relief may be granted and the court lacks subject matter jurisdiction over the case. The Insurance Company has also filed a motion to compel arbitration.

The School Board contends that according to *W. M. Schlosser Co. v. Sch. Bd. of Fairfax County*, 980 F.2d 253 (4th Cir. 1992), a Fourth Circuit case interpreting Virginia law, a school board cannot validly enter into an arbitration agreement because it would be an ultra vires act. In the alternative, the School Board argues that the arbitration provision is unconscionable and thus unenforceable because arbitration in Chicago would be prohibitively expensive to it.

The Insurance Company counters that the School Board could validly enter into an arbitration agreement and the arbitration would not be prohibitively expensive. In support of its first argument, the Insurance Company cites a change in Virginia law since the decision in *W. M. Schlosser Co.* In 1995, Virginia enacted a statute allowing public bodies, including school boards, to enter into arbitration agreements. *See* Va. Code Ann. § 2.2-4366 (Michie 2000).[1] However, the statute provides that "such procedures entered into by school boards shall be nonbinding." *Id.*

[1] This statute was originally codified at Va. Code. Ann. § 11-71.1 and was later repealed and recodified at Va. Code Ann. § 2.2-4366.

The Insurance Company also argues that the School Board has not met its burden under *Green Tree Financial Corp.-Alabama v. Randolph*, 531 U.S. 79, 92 (2000), to show that arbitration would be prohibitively expensive.

The parties have briefed the issues and presented oral argument. The motions are now ripe for decision.

II

A federal court exercising diversity jurisdiction must apply the substantive law of the state in which it sits. *See Erie R.R. v. Tompkins*, 304 U.S. 64, 78-79 (1938). However, in *Prima Paint Corp. v. Flood & Conklin Manufacturing Co.*, 388 U.S. 395, 405 (1967), the Supreme Court held that although provisions of the Federal Arbitration Act, 9 U.S.C.A. §§ 1-16 (West 1999) ("FAA"), are substantive rather than procedural, a federal court sitting in diversity should still apply the FAA. The Court reasoned that Congress intended for the FAA to apply in diversity cases. *See id.* at 405. In *Southland Corp. v. Keating*, 465 U.S. 1, 16 (1984), the Court held that state laws that attempt to "undercut the enforceability of arbitration agreements" are preempted by the FAA.

The Supreme Court ruled in *Allied-Bruce Terminix Companies, Inc. v. Dobson*, 513 U.S. 265, 277 (1995), that Congress intended to exercise its commerce power "to

the full" when it enacted the FAA. In that case, the Court adopted the "commerce in fact" test to determine if the FAA applies. *Id.* at 281. This test requires that the transaction actually involve interstate commerce but does not require that the parties actually contemplate that interstate commerce will be involved at the time the contract is formed. *See id.*

Interstate commerce is involved in this case. Under the policy, the Insurance Company must supply services and funds from Illinois to the School Board in Virginia in exchange for the School Board's payment of premiums. *See Maxum Found.'s, Inc. v. Salus Corp.*, 779 F.2d 974, 978 n.4 (4th Cir. 1985). Because interstate commerce is involved, federal law determines the question of arbitrability. *Id.* at 978.

The FAA provides that "[a] written provision in any . . . contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C.A. § 2. The FAA reflects a strong federal policy in favor of arbitration such that any questions involving arbitrability should be resolved in favor of arbitration. *See Moses H. Cone Mem'l Hosp. v. Mercury Const. Corp.*, 460 U.S. 1, 24 (1983).

As an initial matter, I hold that the enforceability of the arbitration agreement is not affected by the fact that Virginia law requires the arbitration to be nonbinding. The

School Board in this case is a school board. Under Virginia law, a school board may enter into an arbitration agreement, but the arbitration must be nonbinding. *See* Va. Code. Ann. § 2.2-4366.

In a recent Fourth Circuit case, *United States v. Bankers Ins. Co.*, 245 F.3d 315 (4th Cir. 2001), the government argued that agreements for nonbinding arbitration are unenforceable under the FAA. The Fourth Circuit held that the fact that arbitration is nonbinding would not preclude enforcement of the agreement. *See id.* at 322. The court placed some emphasis on the fact that under the applicable statute, arbitration was nonbinding to the government, but was binding on the opposing party. *See id.* at 322 n.8. The court reasoned that it could not conclude that the arbitration would be futile because the government "would presumably act reasonably and rationally" in accepting a favorable arbitration decision. *Id.* at 323.

In reaching its conclusion, the Fourth Circuit relied on cases from other circuits to establish a framework for what constitutes "arbitration" under the FAA. In *Wolsey, Ltd. v. Foodmaker, Inc.*, 144 F.3d 1205, 1209 (9th Cir. 1989), the court held that a nonbinding arbitration clause was enforceable under the FAA when the arbitration agreement required the parties to submit a dispute to a third party and neither party could "seek recourse from the courts" until the arbitration was complete.

The arbitration clause here meets these requirements. The parties must submit disputes to arbitrators in Chicago and nothing in the provision allows the parties to go outside the arbitration process for recourse from the courts. *Cf. Harrison v. Nissan Motor Corp.*, 111 F.3d 343, 350 (3rd Cir. 1997) (where the applicable statute provided for application to a court before the arbitration had ended).

In addition, the argument that nonbinding arbitration is futile is flawed. That argument assumes that simply because arbitration is nonbinding, the conflict will not be resolved and arbitration would merely prolong the matter unnecessarily. This argument ignores the purposes of alternative dispute resolution, such as to reorient the parties toward settlement in a less costly and less confrontational setting than litigation. In addition, it ignores the fact that disputes, even hotly contested ones, are often resolved as a result of this process. *See* Lucy v. Katz, *Enforcing an ADR Clause–Are Good Intentions All You Have?*, 26 Am. Bus. L.J. 575, 584-85 (1988).

Therefore, the arbitration agreement is enforceable, unless the School Board can show a valid defense. Under the FAA, arbitration agreements may be held to be unenforceable as any other contract if a valid defense is proved. 9 U.S.C.A. § 2.[2] The

[2] *Southland Corp.* does not change the application of state contract defenses to arbitration clauses. Rather, the holding only reaches defenses that merely and solely defeat arbitration agreements. *See Southland Corp.*, 465 U.S. at 16 n.11.

School Board asserts two defenses to the contract: First, that the agreement was ultra vires and in the alternative that the agreement is unconscionable.

The School Board's argument that the arbitration agreement is an unenforceable, ultra vires act by the School Board is without merit. Va. Code Ann. § 2.2-4366 clearly provides that school boards may properly enter into arbitration agreements.

Next, the School Board argues that the arbitration clause is unconscionable. Unconscionability is a defense that requires a contract to be "one which no reasonable person would enter into, and the 'inequality must be so gross as to shock the conscience.'" *Syndor v. Conseco Fin. Servicing Corp.*, 252 F.2d 302, 305 (4th Cir. 2001) (quoting *L & E Corp. v. Days Inns of Am., Inc.*, 992 F.2d 55, 59 (4th Cir. 1993)).

It is the burden of the party arguing that the agreement is unconscionable to show the likelihood of incurring prohibitively expensive costs in arbitration. *See Green Tree Fin. Corp.-Ala. v. Randolph*, 531 U.S. 79, 92 (2000). The Supreme Court has not delineated the precise evidence that must be shown, but showing a mere risk of prohibitive costs is not enough. *See id.* at 91.

In *Camacho v. Holiday Homes, Inc.*, 167 F. Supp. 2d 892 (W.D. Va. 2001), the court held that the plaintiff had met her burden of showing that the arbitration fees were prohibitively expensive. In that case, the agreement required the plaintiff, who was

proceeding in forma pauperis, to pay an initial fee of $1250 and another fee of $750 thereafter, both of which were not recoverable regardless of the outcome of the arbitration. *See id.* at 897. In addition, the plaintiff would have had to pay one-half of the arbitration expenses, which could be up to $4100. *Id.* Because of these costs as well as the plaintiff's indigent status, the court held that the arbitration clause was unenforceable.[3] *See id.*

The School Board argues that the costs of arbitration in Chicago would be prohibitively expensive, considering the School Board's present financial status. In a supporting affidavit, the procurement officer for the School Board elaborates that because of financial difficulties the School Board was recently required to borrow funds and its central office staff has been reduced by fifty percent. The Insurance Company argues that the School Board has not met its burden under *Randolph.*

I hold that the School Board has not shown that arbitration would be prohibitively expensive. Although the School Board has submitted an affidavit evidencing that the School Board has had some financial difficulty, unlike the plaintiff in *Camacho,* it has not shown that it would be unable to pay the costs associated with arbitration. While, as the School Board argues in his response, arbitration in Virginia

[3] The court declined to decide whether the agreement was unconscionable. *See id.* at 896 n.2.

might be less expensive to it, the School Board agreed to arbitrate in Chicago and the mere existence of a less expensive forum does not show that the agreed upon arbitration would be prohibitively expensive.

In addition, the agreement provides that subject to the arbitrators' decision, the losing party is responsible for the costs of arbitration. At this point, the assertions of the School Board that it will be responsible for any costs at all evidences merely a risk of costs. Under *Randolph*, an arbitration clause should not be invalidated on these grounds.

Therefore, I find that the arbitration agreement is valid. "When a valid agreement to arbitrate exists between the parties and covers the matter in dispute, the FAA commands the federal courts to stay any ongoing judicial proceedings and to compel arbitration." *Hooters of Am., Inc. v. Phillips*, 173 F.3d 933, 937 (4th Cir. 1999) (internal citations omitted). If the court finds that the parties have entered into a valid arbitration agreement, and no applicable formation or compliance issues exist, the court must issue an order directing the parties to arbitrate. *See* 9 U.S.C.A. § 4.

While the Insurance Company has filed a motion to dismiss, under the FAA "the appropriate procedural mechanism to enforce an arbitration agreement is a motion to compel, not a motion to dismiss." *West v. Merillat Indus., Inc.*, 92 F. Supp. 2d 558, 561 (W.D. Va. 2000) . Accordingly, I will deny the Insurance Company's motion to

dismiss, stay the proceedings pursuant to 9 U.S.C.A. § 3, and order the parties to arbitrate according to their agreement, pursuant to 9 U.S.C.A. § 4.

III

For the aforementioned reasons, it is **ORDERED** as follows:

1. The Insurance Company's motion to dismiss (Doc. No. 2) is denied;

2. The Insurance Company's motion to compel arbitration (Doc. No. 12) is granted;

3. The parties are directed to proceed to arbitration in accordance with their agreement and this action is stayed pending that arbitration; and

4. The parties must advise the court in writing when the arbitration is completed, and in any event the parties must advise the court in writing in ninety days of the status of the arbitration, and each ninety days thereafter until the arbitration is completed.

ENTER: December 12, 2001

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United States District Judge