*First Options of Chicago, Inc. v. Kaplan**

In *First Options v. Kaplan*,[1] the Supreme Court examined two issues involving the standards of review for arbitration decisions. First, the Court revisited the issue of who should determine arbitrability of a dispute: the arbitrator or the courts. Second, the Court resolved the split among the Courts of Appeals as to what standard of review an appellate court should use in reviewing a district court's decisions on arbitrability issues.

In a unanimous decision, the Court held that the power to determine arbitrability is a contractual question. If the parties "clearly and unmistakably" agreed to arbitrate the arbitrability question, the court should defer to the arbitrator's decision. However, if the parties did not agree to allow the arbitrator to determine whether the case should be arbitrated, the court should review the question independently. Moreover, the Court sided with the majority of the circuits in holding that a district court's determination of the arbitrability question should be reviewed under the normal clearly erroneous/*de novo* standard of review.

The dispute in this case concerned whether the parties had agreed to arbitrate controversies arising out of a debt repayment plan. First Options of Chicago is the largest market maker clearinghouse on the Philadelphia Stock Exchange, and from 1984 until 1989, MK Investments, Inc. (MKI) was an options market maker customer of First Options.[2] On October 19, 1987, the stock market suffered the worst percentage drop in history. MKI lost over $12 million, and its accounts had a deficit of $2.1 million by the end of the trading day.[3] As the clearinghouse for MKI, First Options guaranteed the Exchange and all other traders that MKI's accounts would be covered, and thus, First Options was at risk on the $2.1 million deficit.[4]

First Options's "Market Maker" clearinghouse agreement gave it the right to liquidate MKI's positions "whenever in [First Options'] discretion [First Options] deemed it necessary," it therefore took over MKI's accounts and liquidated all of its questionable positions, thus increasing MKI's debt to $5.1 million.[5] First Options and MKI entered settlement negotiations

---

* 115 S. Ct. 1920 (1995).

[1] *Id.*

[2] *See* Kaplan v. First Options of Chicago, Inc., 19 F.3d 1503, 1506 n.3 (3d Cir. 1994) ("An 'options market maker' trades options for its own account," and "a clearinghouse guarantees a market maker's account to other traders."). Manuel Kaplan was the president, a director and sole shareholder of MKI. *See id.* at 1506.

[3] *See id.*

[4] *See id.*

[5] *Id.*

regarding this debt and MKI's continued operation.[6]

MKI and Manuel Kaplan disputed the amount and source of the debt, but by the end of 1987, they had drafted a Settlement/Workout Agreement consisting of four separate contracts.[7] Only one of the four contracts (the Subordinated Loan Agreement) contained an arbitration clause. The clause stated: "[A]ny controversy [between First Options and MKI] arising out of [MKI's business] or . . . this . . . Agreement . . . shall be submitted to and settled by arbitration . . . ."[8] The Subordinated Loan Agreement was signed by MKI but *not* by Mr. Kaplan in his individual capacity; the only document signed by Mr. Kaplan did *not* contain an arbitration clause.[9]

Following MKI's resumption of trading, it incurred further debt, and First Options closed its account, demanded accelerated payment under the workout agreement and filed for arbitration before the Philadelphia Stock Exchange Arbitration Panel.[10] MKI expressly submitted the dispute to arbitration, but the Kaplans submitted written objections to the arbitrators' jurisdiction over them.[11] However, the Kaplans were represented by counsel at a pre-hearing discovery conference held two years later.[12] The Kaplans' counsel participated in that hearing without renewing their objections to arbitral jurisdiction.[13]

The case lay dormant for the next twenty-two months.[14] However, in 1991, the Kaplans retained new counsel and, in 1992, filed a motion to dismiss for lack of jurisdiction.[15] The Exchange Arbitration Panel denied the motion and issued a decision in favor of First Options and against Mr. Kaplan and MKI for over $6 million.[16] The Kaplans and MKI filed a petition to vacate the award in the United States District Court for the

---

[6] *See id.* Under the Market Maker Agreement signed in 1984, Manuel Kaplan and the other principals were not to be held personally liable for MKI's debt to First Options; nevertheless, First Options sought to hold Mr. Kaplan personally liable. *See id.*

[7] *See id.* (These contracts consisted of the following: "(1) a Letter Agreement executed by First Options, MKI, Mr. Kaplan, Mrs. Kaplan, and certain other entities and individuals; (2) a Guaranty executed only by MKI; (3) a Subordinated Loan Agreement executed by First Options, MKI, and a separate entity; and (4) a Subordinated Promissory Note executed by MKI.").

[8] *Id.* at 1507 n.5.

[9] *See id.* at 1507.

[10] *See id.* at 1507-1508.

[11] *See id.* at 1508.

[12] *See id.*

[13] *See id.*

[14] *See id.*

[15] *See id.*

[16] *See id.*

Eastern District of Pennsylvania, and First Options filed a cross-petition to confirm the award.[17] In the district court, the parties stipulated to virtually all the relevant facts.

In an unpublished Memorandum and Order entered September 25, 1992, the district court confirmed the award.[18] The court held that the Kaplans had consented to jurisdiction by signing the arbitration clause in the Subordinated Loan Agreement signed by MKI, even though neither had ever signed that particular document.[19] In the alternative, the court held that the Kaplans had waived jurisdictional objections by their counsel's participating in the arbitration discovery conference.[20]

The Kaplans appealed the district court decision to the United States Court of Appeals for the Third Circuit.[21] The Third Circuit upheld the district court judgment as to MKI but reversed as to the Exchange Arbitration Panel's jurisdiction over the Kaplans. First, the Court of Appeals held that courts "should independently decide [i.e., a *de novo* standard of review] whether an arbitration panel has jurisdiction over the merits of any particular dispute," rather than applying the more deferential standard applicable to arbitrators' decisions on the merits.[22] The Third Circuit also applied the *de novo* standard of review to the district court's denial of a motion to vacate an arbitration award.[23] Applying these standards, the Third Circuit reversed the district court's decision and found that the Exchange Arbitration Panel had no jurisdiction over the Kaplans because they had not signed the Subordination Loan Agreement containing the arbitration clause.[24] Thus, the Kaplans had not submitted themselves to the jurisdiction of the Exchange Arbitration Panel. First Options's petition for a writ of certiorari was granted.[25]

---

[17] Confirmation is the procedure by which an arbitral award is converted into a court judgment, thereby making available the full power of a federal district court to enforce the award if the loser refuses to satisfy the arbitral award.

[18] *See* Kaplan v. First Options of Chicago, Inc., No. 92-MC-210, 1992 U.S. Dist. LEXIS 14961 (E.D. Pa. Sept. 25, 1992).

[19] *First Options*, 19 F.3d at 1508.

[20] *See id.*

[21] Kaplan v. First Options of Chicago, Inc., 19 F.3d 1503 (3d Cir. 1994).

[22] *Id.* at 1509.

[23] *See id.*

[24] *See id.* at 1515.

[25] First Options of Chicago, Inc. v. Kaplan, 115 S. Ct. 634 (1994) (granting certiorari). After the Third Circuit held that the arbitrators lacked jurisdiction over the Kaplans, First Options filed actions raising the same claims against Manuel Kaplan in the United States Bankruptcy Court for the Eastern District of Pennsylvania (Bankr. E.D. Pa. No. 94-0901) and against Carol Kaplan in the United States District Court for the Eastern District of

In a unanimous decision, the Supreme Court upheld the Third Circuit's decision regarding the appropriate standards of review for arbitral jurisdiction decisions and its finding that the Kaplans were not bound by the arbitration agreement.[26] The Court considered two questions regarding the review of arbitration decisions under the Federal Arbitration Act (FAA): first, how a district court should review an arbitrator's decision as to whether parties agreed to arbitrate a dispute; and second, how an appellate court should review a district court opinion affirming or vacating an arbitration award.

The Court first focused on the standard of review to be applied to the question of "who should have the primary power to decide . . . the arbitrability of the dispute."[27] The Court framed the issue in practical terms, noting that a party who is found to have submitted a dispute to arbitration essentially gives up his right to have a court independently decide on the merits of the dispute. This is because a court will only set aside an arbitrator's decision on the merits of a dispute in "very unusual circumstances," such as where the arbitrator exceeded his powers due to corruption, fraud, undue means or in "manifest disregard" of the law.[28]

The Court found that just as the arbitrability of the merits depends on the contractual agreement, so should the question of who has the power to

---

Pennsylvania (E.D. Pa. No. 94-5941).

[26] *See* First Options of Chicago, Inc. v. Kaplan, 115 S. Ct. 1920, 1926 (1995).

[27] *First Options*, 115 S. Ct. at 1923.

[28] *Id.* (citing 9 U.S.C. § 10 (1994); Wilko v. Swan, 346 U.S. 427, 436-437 (1953), *overruled on other grounds*, Rodriguez v. Shearson/American Express, Inc., 490 U.S. 477 (1989)); With regard to the grounds for vacatur of commercial arbitration awards, Section 10 of the FAA states:

> (a) In any of the following cases the United States court in and for the district wherein the award was made may make an order vacating the award upon the application of any party to the arbitration—(1) Where the award was procured by corruption, fraud or undue means; (2) Where there was evident partiality or corruption in the arbitrators, or either of them; (3) Where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced; (4) Where the arbitrators exceeded their powers or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made; (5) Where an award is vacated and the time within which the agreement required the award to be made has not expired the court may, in its discretion, direct a rehearing by the arbitrators.

9 U.S.C. § 10 (1994).

determine arbitrability.[29] If the parties agreed to submit arbitrability to an arbitrator, the more deferential standard should be applied to the arbitrator's decision. However, if the parties did not agree to submit arbitrability to an arbitrator, the district court should independently decide the issue. These holdings "flow inexorably from the fact that arbitration is simply a matter of contract . . . ."[30] As such, the Court held that district courts should apply ordinary state law principles of contract formation to the question of whether the parties agreed to submit the arbitrability question to arbitration.[31]

However, courts are not bound by an arbitrator's finding of arbitrability unless the contract has "clear and unmistakable" evidence that the parties intended to give the arbitrator the power to make that finding.[32] This evidentiary standard creates a presumption that the parties intended to have courts determine whether a case should be arbitrated.[33] The Court justified this difference as "understandable" because where "the parties are found to have a contract providing for arbitration of some issues . . . the parties likely gave at least some thought to the scope of arbitration."[34] However, when the agreement is unclear or silent as to arbitral jurisdiction,

---

[29] *See* First Options, 115 S. Ct. at 1923.

[30] *Id.* at 1924.

[31] *See id.* (citing Mastrobuono v. Shearson Lehman Hutton, Inc., 115 S. Ct. 1212 (1995)). In *Mastrobuono*, the Supreme Court held that common-law rules of contract interpretation, such as the construction of ambiguous contract language against its drafter and the reading of contract so as to give effect to and render internally consistent all provisions therein, should be used in interpreting arbitration agreements. *See Mastrobuono*, 115 S. Ct. at 1219.

[32] The Court imported this principle from collective bargaining law. *See First Options*, 115 S. Ct. at 1924 (citing Steelworkers v. Warrior & Gulf Navigation Co., 363 U.S. 574, 583 n.7 (1960) and AT&T Technologies, Inc. v. Communications Workers, 475 U.S. 643 (1986)).

[33] *See First Options*, 115 S. Ct. at 1924. *See also* AT&T Technologies, Inc. v. Communications Workers, 475 U.S. 643, 649 (1986) ("[T]he question of arbitrability . . . is undeniably an issue for judicial determination. Unless the parties clearly and unmistakably provide otherwise, the question of whether the parties agreed to arbitrate is to be decided by the court, not the arbitrator."). This is analogous to the result in *Mastrobuono*, *supra* note 31, wherein the Court implicitly suggested that the use of a choice-of-law provision in an arbitration agreement will be examined rigorously, and thus if parties wish to limit or exclude punitive damages awards, they must unequivocally indicate so in the terms of the agreement. *See* Henry G. Appel, Recent Development, *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 12 OHIO ST. J. ON DISP. RESOL. 233, 240 (1996).

[34] *First Options*, 115 S. Ct. at 1924.

the parties may not even have considered the possibility of arbitration, much less the scope, and forcing them into arbitration would be unfair.[35]

Here, the Court found that First Options failed to meet the "clear and unmistakable" evidentiary standard because "merely arguing the arbitrability issue to an arbitrator does not indicate a clear willingness to arbitrate that issue."[36] The Kaplan's objections to arbitral jurisdiction, combined with a reasonable explanation for their presence before the Exchange Arbitration Panel (i.e., that MKI was there) and Third Circuit case law suggesting that they could argue arbitrability without waiving their rights to independent court review,[37] was sufficient indication to the Court that the Kaplans were not willing to be bound by the arbitrator's decision on arbitrability.[38] Thus, the Kaplans were held not to have agreed to submit arbitrability to the arbitration panel, which supported the independent review of the panel's arbitrability decision by the district court.[39]

The Court next addressed the question of the appropriate standard of review to be applied to a district court decision confirming or reversing the vacatur of an arbitration award. The majority of the circuits have applied an ordinary *de novo*/clearly erroneous standard of review to district court decisions regarding arbitration awards.[40] First Options argued that the Court

---

[35] *See id.* at 1924-1925.

[36] *First Options*, 115 S. Ct. at 1925.

[37] *See id.* (citing Teamsters v. Western Pennsylvania Motor Carriers Ass'n, 574 F.2d 783, 786-788 (3d Cir. 1978)).

[38] Prior to the Court's decision in *First Options*, several courts of appeals had held that where a party had refused to sign a submission agreement and had unsuccessfully argued its jurisdictional objections to the arbitrator, *de novo* review of the arbitrator's jurisdictional decision was warranted. *See, e.g.*, Cargill Rice, Inc. v. Empresa Nicaraguense Dealimentos Basicos, 25 F.3d 223 (4th Cir. 1994); Alberici-Eby v. Local 520, Int'l Union of Operating Eng'rs, 992 F.2d 727 (7th Cir. 1993); Davis v. Chevy Chase Fin. Ltd., 667 F.2d 160 (D.C. Cir. 1981); Mobil Oil Corp. v. Local 8-766, Oil, Chem. & Atomic Workers Int'l Union, 600 F.2d 322 (1st Cir. 1979).

[39] *See First Options*, 115 S. Ct. at 1925.

[40] *See, e.g.*, Bowles Fin. Group, Inc. v. Stifel, Nicolaus & Co., 22 F.3d 1010 (10th Cir. 1994); McIlroy v. PaineWebber, Inc., 989 F.2d 817 (5th Cir. 1993); Employer Ins. of Wausau v. National Union Fire Ins. Co., 933 F.2d 1481 (9th Cir. 1991); Advest, Inc. v. McCarthy, 914 F.2d 6 (1st Cir. 1990); Anderman/Smith Operating Co. v. Tennessee Gas Pipeline Co., 918 F.2d 1215 n.2 (5th Cir. 1990), *In re* Arbitration No. AAA 13-161-0511-85, 867 F.2d 130 (2nd Cir. 1989); Parmac, Inc. v. I.A.M. Nat'l Pension Fund Benefit Plan A, 872 F.2d 1069 (D.C. Cir. 1989); Moseley, Hallgarten, Estabrook & Weeden v. Ellis, 849 F.2d 264 (7th Cir. 1988); Amerada Hess Corp. v. SS Athena, 1987 WL 37022, at *1 (4th Cir. Apr. 9, 1987).

should follow the Eleventh Circuit's "abuse of discretion" standard for review of district court decisions confirming arbitration awards.[41]

The Eleventh Circuit had employed a "hybrid standard" for reviewing a district court's decision to confirm or vacate an arbitrator's award. When a district court vacated an arbitration award, the court of appeals would engage in traditional *de novo* review of the decision. However, when the district court confirmed an arbitration award, the court of appeals applied a much lower "abuse of discretion" standard.[42] The Eleventh Circuit justified these disparate levels of review as better furthering the underlying goals of the FAA (i.e., "to relieve congestion in the courts and to provide parties with an alternative method for dispute resolution that would be speedier and less costly than litigation").[43] Under this view, the reversal of a denial of a motion to vacate an arbitration award only upon abuse of discretion would further the presumption that the award was proper, as would the *de novo* review of the denial of an award.[44]

This view relies on the "unique context" of arbitration, which requires "deferential judicial review" to promote arbitration's goals of "speed and finality."[45] The *de novo* review of arbitration vacatur allows the appellate court to assess whether sufficient deference was granted by the lower court, whereas review of arbitration confirmation under the abuse of discretion standard is appropriate because it presumes that proper deference was granted by the district court.[46] Thus, in the Eleventh Circuit's view, the "hybrid standard" of review would more strongly accord with the strong federal policy favoring arbitration than would the traditional *de novo*/clearly erroneous standard.[47]

The *First Options* Court declined to apply the Eleventh Circuit's "special" standard.[48] First, the Court stated that it is "undesirable" to proliferate review standards "without good reason."[49] Second, and in the Court's view more importantly, the standard of review should depend upon

---

[41] *See, e.g.*, Robbins v. Day, 954 F.2d 679, 681–682 (11th Cir. 1992); Schmidt v. Finberg, 942 F.2d 1571 (11th Cir. 1991).

[42] *See Robbins*, 954 F.2d at 681.

[43] *Id.* at 682 (citing Booth v. Hume Publishing, Inc., 902 F.2d 925 (11th Cir. 1990)).

[44] *See id.*

[45] *Id.*

[46] *See id.* (citing Stephen H. Kupperman & George C. Freeman III, *Selected Topics in Securities Arbitration: Rule 15c2-2, Fraud, Duress, Unconscionability, Waiver, Class Arbitration, Punitive Damages, Rights of Review, and Attorney's Fees and Costs*, 65 TUL. L. REV. 1547, 1602–1604 (1991)).

[47] *See* Kupperman & Freeman, *supra* note 46, at 1604.

[48] *See First Options*, 115 S. Ct. at 1926.

[49] *Id.*

"the respective institutional advantages of trial and appellate courts"[50] and should not be used instead to favor a certain substantive result such as confirmation of arbitration awards, even where a federal statute such as the FAA favors such confirmation.[51] Although First Options argued that Section 16 of the FAA allows special appellate review of district court rulings vacating arbitration awards, the Court found that to be an insufficient reason to apply a different standard of review for district court decisions regarding arbitrability.[52]

Finally, the Court declined to rule on whether the Third Circuit erred in concluding that the merits of the dispute were not arbitrable, as that issue was a factual question outside the narrow scope of the issues presented in the petition for writ of certiorari.[53]

The Supreme Court's decision in *First Options* goes to the heart of the essential tension between the alternative dispute resolution mechanism of arbitration and traditional judicial dispute resolution. One of the attractive features of arbitration as a dispute resolution mechanism is the promise of a fast, efficient and final resolution. The speed, efficiency and finality of arbitration are counterbalanced and complemented by the availability of judicial review of arbitration awards. Although judicial review presents the potential for drawing out the resolution of a dispute, it also serves to reassure the disputants that a fair result can be obtained.

Thus, as the Court in *First Options* recognized, the standard of review to be applied to judicial review of arbitral jurisdiction can have a significant practical impact on parties' decisions to contract for arbitral dispute resolution. The Court dismissed First Options' argument that permitting parties with objections to arbitral jurisdiction to seek independent judicial review of that issue after the conclusion of arbitration would cause delay and waste in dispute resolution.[54] Nevertheless, a claimant in a dispute will usually want a rapid determination of the arbitrability of the dispute (and a decision on the merits). The more deference courts give to arbitral decisions on jurisdiction and the merits, the more likely the claimant can obtain a speedy, less expensive resolution. In contrast, permitting parties to argue arbitrability to an arbitration tribunal without being bound by the result, then allowing them to seek *post hoc* independent judicial determinations as to arbitral jurisdiction, will inevitably lead to delays in the resolution of the dispute.

---

[50] *Id.* (citing Salve Regina College v. Russell, 499 U.S. 225, 231-233 (1991)).

[51] *See id.*

[52] *See id.*

[53] *See id.*

[54] *See id.* at 1925 (giving the reason that "factual circumstances vary too greatly to permit a confident conclusion").

On the other hand, requiring a party who objects to the jurisdiction of the arbitration tribunal to seek a stay of the arbitration at the outset in order to obtain an independent judicial decision as to arbitrability would also result in significant delays in the process. Forcing arbitral jurisdiction objectors to in essence refuse to participate in the arbitral process would seem to be in express contradiction to the goals of the FAA and arbitration in general.[55]

The Court's decision in *First Options* to permit *post hoc* independent judicial review of arbitral jurisdiction decisions would thus appear to be the choice that provides the best chance of avoiding delay. So long as the jurisdictional objector knows that *post hoc* independent judicial review is available to her in the event of an adverse decision, she will be more likely to enter into arbitration agreements and to participate in the arbitral process.[56] The *First Options* rule allowing arbitration to proceed while jurisdictional objections are preserved for independent judicial review will allow the entire controversy to be resolved by the relatively rapid and efficient arbitral process. There is the possibility that the jurisdictional objector may find the jurisdictional or merit-based decisions to her liking, and judicial review will be unnecessary.[57] In contrast, requiring her to seek pre-arbitration jurisdictional judicial review would always result in delays.

The Court's requirement that evidence of the parties' agreement to submit to arbitral jurisdiction be "clear and unmistakable" may not lead to the just and equitable results that the Court may have anticipated. Requiring unequivocal agreements as to arbitral jurisdiction may simply lead parties with powerful bargaining positions (like First Options) to include clearly

---

[55] *See, e.g.*, Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213, 220–221 (1985).

[56] *See, e.g.*, *AT&T Technologies*, 475 U.S. at 651 (1986) ("The willingness of parties to enter into agreements that provide for arbitration of specified disputes would be 'drastically reduced,' however, if [the] arbitrator had the 'power to determine his own jurisdiction . . . .'") (quoting Archibald Cox, *Reflections Upon Labor Arbitration*, 72 HARV. L. REV. 1482, 1509 (1959)).

[57] *See* David D. Siegel, *Appeals from Arbitrability Determinations Under the New § 15 of the U.S. Arbitration Act*, 126 F.R.D. 589, 594 (1989) ("It may well happen, of course, that the person opposing the arbitration has won it on the merits, either in full or at least in sufficient measure to accept the award, and that the victory will induce the abandonment of the objection to the arbitral forum. (Winning the battle always helps the winner forget who chose the battlefield.)"); *see also* International Ass'n of Machinists & Aerospace Workers, Lodge No. 1777 v. Fansteel, Inc., 900 F.2d 1005, 1009 (7th Cir. 1990) ("In permitting an arbitrator to attempt to address a dispute prior to a judicial arbitrability determination, parties may well be able to resolve their disputes without requiring the involvement of the judiciary.").

worded clauses conferring jurisdictional decision-making authority on the arbitral tribunal.

Finally, the *First Options* Court's affirmance of the ordinary, traditional *de novo* standard of review for appellate review of district court decisions on arbitration will have little effect in most jurisdictions. The Court's decision to reject the Eleventh Circuit's "hybrid" standard of review has been cited with approval by a majority of the circuits, including the Eleventh Circuit.[58] It will be interesting to follow, however, whether the Eleventh Circuit will take this new expanded power of review to heart and exercise truly plenary review power over district court decisions confirming arbitration awards or denying motions to vacate such awards.

Kevin Michael Flowers

[58] *See, e.g.*, Keebler Co. v. Milk Drivers and Dairy Emp. Union, 80 F.3d 284, 287 (8th Cir. 1996); International Telepassport Corp. v. USFI, Inc., 89 F.3d 82, 85 (2nd Cir. 1996); Prudential-Bache Securities, Inc. v. Tanner, 72 F.3d 234, 237 (1st Cir. 1995); Gateway Technologies, Inc. v. MCI Telecommunications Corp., 64 F.3d 993, 996 (5th Cir. 1995); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Jaros, 70 F.3d 418, 420 (6th Cir. 1995); Kelley v. Michaels, 59 F.3d 1050, 1053 (10th Cir. 1995); Lifecare Int'l, Inc. v. CD Medical, Inc., 68 F.3d 429, 433 (11th Cir. 1995).