2004

Statutes of Limitations in Securities Arbitrations: Who Decides?

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STATUTES OF LIMITATION IN SECURITIES ARBITRATIONS: WHO DECIDES?

By Barry R. Temkin [1]

Since the 1987 decision of the United States Supreme Court in *Shearson/American Express Inc. v. McMahon,*[2] upholding the enforceability of an arbitration agreement in a securities fraud claim, the overwhelming majority of securities industry customer disputes have been adjudicated before arbitration panels at Self-Regulatory Organizations (SROs) such as NASD Dispute Resolution Inc. (NASD) and the New York Stock Exchange (NYSE). These arbitration forums have six-year "eligibility rules" which bar the adjudication of stale claims. The eligibility rules are, in turn, subject to substantive state and federal statutes of limitations. The question of who decides whether a particular dispute is time barred - - the arbitrator or a court - - is a thorny one, and calls into play a potential conflict between the Federal Arbitration Act,[3] and New York's own injunction statute, CPLR 7502. Although, as detailed below, it is now settled that a Self-Regulatory Organization must interpret its own eligibility rules, it is less clear whether it is for a judge or an arbitrator to decide whether an arbitration is time barred under New York's CPLR 7502.

The Six-Year Eligibility Rule

The NASD Code of Arbitration Procedure precludes arbitration of claims which arose six years or more before the filing of the statement of claim:

> No dispute, claim or controversy shall be eligible for submission to arbitration under this Code where six (6) years have elapsed from the occurrence or event giving rise to the act or dispute, claim or controversy. This Rule shall not extend applicable statutes of limitations, nor shall it apply to any case which is directed to arbitration by a court of

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[2] 482 U.S. 220 (1987).

[3] 9 U.S.C. § 1 *et seq* (1947).

competent jurisdiction.[4]

The NYSE eligibility rule is virtually identical.[5] Both SROs provide for tolling of the eligibility rule pending litigation of the matter before a court of competent jurisdiction.[6] The American Arbitration Association, interestingly, has no such eligibility rule and is not a routinely selected forum in security industry arbitration agreements.[7]

The United States Supreme Court, in *Howsam v. DeanWitter Reynolds, Inc.,*[8] held that while a court may play a threshold role in deciding whether or not the parties are bound by an arbitration agreement, is for the arbitrators and not the court to adjudicate the timeliness of arbitration claims under the NASD Code. This decision, which was based in part on the presumed expertise of an NASD arbitrator to interpret that organization's own code, was anticipated by both the Second Circuit[9] and the New York Court of Appeals.[10]

Substantive Statutes of Limitation

Since both NYSE and NASD eligibility rules provide that they "shall not extend applicable statutes of limitations,"[11] a claim which is timely under an SRO eligibility rule may nonetheless be time-barred by application of a state or federal substantive statute of limitations. SRO arbitrators, in interpreting the eligibility rules, have recognized that they do not override or extend applicable statutes of limitation.[12] As an NASD arbitration panel has explained:

> [E]ven if the applicable statute of limitations allowed a claim to be filed more than six years after the act or event giving rise to the claim, such a claim could not be submitted to NASD arbitration; but if a claim is filed for NASD arbitration within

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[4] NASD Code of Arbitration Procedure (NASD Code) (1984) § 10304.
[5] New York Stock Exchange Arbitration Rule 603. (The only difference is that NYSE Rule 603 substitutes the word "section" for the word "rule".)
[6] NASD Code § 10307; NYSE Arbitration Rule 606.
[7] Constantine N. Katsoris, *The Six Year Rule: "To Be or Not to Be"?,* Securities Arbitration Commentator, Vol. 2003, No. 5 (Sept. 2003) at 4.
[8] 537 U.S. 79 (2002).
[9] *PaineWebber, Inc. v. Bybyk*, 81 F.3d 1193 (2d Cir. 1996).
[10] *Smith Barney Shearson v. Sacharow*, 91 N.Y.2d 39, 666 N.Y.S.2d 990 (1997).
[11] NASD Rule 10304; NYSE Rule 603.
[12] *See* David E. Robbins, *Securities Arbitration Procedure Manual* (5th Ed. 2002), Section 8-6 at 8-20.

> six years of the act or event, the submission will be accepted and the claim will be assigned to an arbitration panel for further consideration of the issues, including the timeliness of the claim. If the claim was not filed within the applicable statutory period of limitations, even though it may have been filed within the NASD time limit, the arbitrators can and should dismiss it.[13]

Arbitration panels applying the NASD Code have shown a willingness to dismiss eligible claims which are time-barred by shorter substantive statutes of limitations. For example, in *Ancona v. Dean Witter Reynolds*,[14] a Florida claimant filed an arbitration in May 2002, alleging that her stockbroker failed to execute an order to sell stock in April 2000. Although that aspect of the claim was eligible under the NASD Code, the arbitration panel dismissed it for failure to comply with Florida's two-year statute of limitations for securities fraud.[15]

Who Decides: Court or Arbitrator?

Although it is clear that an arbitration must be dismissed if it is barred by a substantive statute of limitations, it is less than clear whether this should be a threshold determination by a court or, rather, submitted to arbitration, like the eligibility issue under *Howsam.* In New York, CPLR 7502 (b) explicitly empowers a state court to enjoin an arbitration on statute of limitations grounds:

> If, at the time that a demand for arbitration was made and a notice of intention to arbitrate was served, the claim sought to be arbitrated would have been barred by limitation of time had it been asserted in a court of this state, a party may assert the limitation as a bar to the arbitration on an application to the court as provided in section 7503 or subdivision (b) of section 7511.[16]

The New York Court of Appeals, in *Smith Barney, Harris Upham & Co. v. Luckie,*[17] held that a court may enjoin an arbitration which is time barred under New York law, and where the

[13] *Stordahl v. SunAmerica Securities Inc*, 1997 WL 282295 (NASD 1997) at *4.
[14] 2003 WL 22047683 (NASD 2003).
[15] See also *Magoon v. The Ohio Co.,* 1997 WL 459387 (NASD 1997) (Two year state statute of limitations bars otherwise eligible claim).
[16] NY CPLR 7502 (b).

parties signed an arbitration agreement choosing New York law. "Clearly," wrote the court, "under New York law, *statutory* time limitation questions such as those presented on these two appeals - - as opposed to *contractual* time limitations agreed upon by the parties - - are for the courts, not the arbitrators."[18] By choosing New York law in their arbitration agreement, the parties in *Luckie* agreed to the New York rule "that threshold Statute of Limitations questions are for the courts."[19] Some courts – state and federal -- have followed *Luckie* to uphold the power of a judge to determine the applicability of a substantive statute of limitations to an arbitration under New York law.[20] On the other hand, most federal courts – and some state courts -- have rejected motions to stay arbitration on statute of limitations grounds, reasoning that this is the province of the arbitrators under the Federal Arbitration Act (FAA).[21]

Generally speaking, the FAA permits a party to an arbitration agreement to petition a federal court to compel arbitration in accordance with its terms.[22] The United States Supreme Court has held, in a variety of contexts, that the FAA preempts inconsistent state laws which are inimical to its purpose of enforcing contractual arbitration agreements. For example, in *Mastrobuono v. Shearson Lehman Hutton*,[23] the Court interpreted an arbitration agreement which selected New York law. At the time, New York law authorized a court but not an arbitrator to award punitive damages. The Supreme Court interpreted the arbitration agreement "to encompass substantive principles that New York courts would apply, but not to include

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[17] 85 N.Y.2d 193, 623 N.Y.S.2d 800 (1995)
[18] 85 N.Y.2d at 202.
[19] 85 N.Y.2d at 202.
[20] *See Coleman & Co v. Giaquinto*, 236 F.Supp.2d 288 (S.D.N.Y. 2002); *Kidder Peabody & Co., Inc. v. Henehan*, 267 A.D. 2d 120, 699 N.Y.S.2d 689 (1st Dep't 1999); *Investec Inc. v. Baron,* NYLJ 9/04/2004 page 18 (col.1) (Sup. Ct. N.Y. Co. 3/4/04).
[21] 9 U.S.C. § 1 *et seq.*
[22] 9 U.S.C § 4.
[23] 514 U.S. 52, 115 S. Ct. 1212 (1995).

special rules limiting the authority of arbitrators."[24] Accordingly, the power of the arbitrator to award punitive damages could not be circumscribed, by contract or by statute.

Volt Information Sciences, Inc., v. Board of Trustees of the Leland Stanford Junior University, [25] concerned a California statue which permitted a judge to enjoin arbitration pending disposition of pending litigation. The court's power to enjoin arbitration temporarily was upheld because: "There is no federal policy favoring arbitration under a certain set of procedural rules; the federal policy is simply to ensure the enforceability, according to their terms, of private agreements to arbitrate."[26]

The Supreme Court more recently addressed the preemption of state law under the FAA in *Green Tree Financial Corp. v. Bazzle*, [27] which concerned the interpretation of an arbitration clause in a home improvement loan agreement. The Court held that it was for an arbitrator and not a court to determine whether the arbitration agreement called for class action treatment of the claims.

The Second Circuit Court of Appeals has ruled that statute of limitations issues are generally for arbitrators and not the courts to decide. For example, in *Shearson Lehman Hutton, Inc. v. Wagoner,* [28] the district court had enjoined an arbitration brought by a customer's bankruptcy trustee on the grounds that it was barred by Connecticut's three year statute of limitations for tort claims. The Second Circuit reversed, noting that "it is up to the arbitrators, not the court, to decide the validity of time-bar defenses."[29]

PaineWebber Incorporated v. Bybyk[30] presaged *Howsam* by holding that an arbitrator and not a judge should decide the six-year eligibility provision of the NASD Code. The arbitration

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[24] 514 U.S. at 64.
[25] 489 U.S. 468 (1989).
[26] 489 U.S. at 476.
[27] 123 S.Ct. 2402 (2003).
[28] 944 F.2d 114 (2d Cir. 1991).
[29] 944 F.2d at 121.
[30] 81 F.3d 1193 (2nd Cir. 1996).

agreement in *Bybyk,* which chose New York law, provided for arbitration of "any and all controversies which may arise" concerning the account.[31] The Second Circuit reasoned that this broad language evinced an intent to arbitrate issues of arbitrability, including the eligibility of the claim for arbitration under the NASD Code. Subsequent federal decisions have been divided on the question of whether a court or an arbitrator should decide statute of limitations issues.[32] A recent state court decision[33] has followed *Howsam* to hold that a broad arbitration clause selecting New York law requires statute of limitations issues to be decided by the arbitrators, not the court. Yet another recent decision has followed *Luckie* to enjoin an arbitration under CPLR 7502.[34]

Conclusion

Application of CPLR 7502 has largely been determined on a case-by-case and agreement-by-agreement basis. The analysis has been complicated by delicate considerations of federal preemption under the FAA and interpretation of the language of individual arbitration agreements. Based on these factors, it appears that federal and state courts on opposite sides of Foley Square will continue to disagree or at least equivocate about resolving the tension between the FAA and the CPLR, with the federal courts favoring the former and the state courts favoring the latter—and with some exceptions on both sides of the square. As a practical matter, a party seeking to enjoin an arbitration would be well advised to commence a petition in New York State Supreme Court, while the party seeking to compel arbitration would be equally well-advised to consider removing that same petition to federal court.

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[31] 81 F.3d at 1195.

[32] Compare *Prudential Securities Inc. v. Laurita*, 1997 WL 109438 (S.D.N.Y.1997) (arbitrator decides statutes of limitation issues); with *Coleman & Co., v. The Giaquinto Family Trust*, 236 F. Supp. 288 (S.D.N.Y. 2002) (judge decides).

[33] *Von Steen v. Musch,* NYLJ (Feb. 10, 2004) at 18 (col. 1) (S. Ct. N.Y. Co.) (Kornreich, J.).

[34] *Investec Inc. v. Baron,* NYLJ (March 4,2004) at 18 (col.1) (S. Ct. N.Y. Co. 3/4/04) (Payne J.).