



Hon. Fern M. Smith (Ret.)
JAMS
Two Embarcadero Center, Suite 1500
San Francisco, CA 94111
Telephone: (415) 982-5267
Fax: (415) 982-5287

ARBITRATOR

ARBITRATION

In the 2003 NPM Adjustment
Proceedings

JAMS Ref No. 1100053390

**FINAL AWARD RE:
STATE OF WASHINGTON**

CHAPTER I: THE PARTIES TO A SPECIFIC STATE AWARD

Petitioners are manufacturers of tobacco products that have joined the MSA (“Master Settlement Agreement”), entered into in 1998, and agreed to be bound by its terms. The MSA refers to such manufacturers as “Participating Manufacturers” or “PMs.” *See* MSA § II(jj). The PMs fall into two categories. The “Original Participating Manufacturers,” or “OPMs,” are those manufacturers that were original parties to the MSA: Philip Morris USA Inc., R.J. Reynolds Tobacco Company, and Lorillard Tobacco Company. *See* MSA § II(hh). (A fourth OPM, Brown & Williamson Tobacco Corporation, combined with R.J. Reynolds Tobacco Company in 2004.) The “Subsequent Participating Manufacturers,” or “SPMs,” are smaller manufacturers, most of which were never sued by the States, but joined the MSA thereafter. *See* MSA § II(tt). The following SPMs claim entitlement to an NPM Adjustment for 2003 and are petitioners in these proceedings: Commonwealth Brands, Inc., Compania Industrial de Tabacos Monte Paz, S.A., Daughters & Ryan, Inc., House of Prince A/S, Japan Tobacco International U.S.A. Inc., King Maker Marketing, Inc., Kretek International, Liggett Group LLC, Peter Stokkebye

1 Tobaksfabrik A/S, P.T. Djarum, Santa Fe Natural Tobacco Company, Inc., Sherman 1400
2 Broadway N.Y.C., Inc., Top Tobacco LP, and Von Eicken Group. All Petitioners are
3 collectively referred to as PMs for purposes of this Award, and a finding as to one PM is a
4 finding as to all, unless specifically noted.

5 Respondents in the Petitioners' claim were initially listed as the 52 States and Territories
6 that are parties to the MSA. The MSA refers to these States and Territories as "Settling States."

7 The Settling States originally consisted of Alabama, Alaska, American Samoa, Arizona,
8 Arkansas, California, Colorado, Connecticut, Delaware, District of Columbia, Georgia, Guam,
9 Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland,
10 Massachusetts, Michigan, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey,
11 New Mexico, New York, North Carolina, North Dakota, the Northern Marianas Islands, Ohio,
12 Oklahoma, Oregon, Pennsylvania, Puerto Rico, Rhode Island, South Carolina, South Dakota,
13 Tennessee, U.S. Virgin Islands, Utah, Vermont, Virginia, Washington, West Virginia,
14 Wisconsin, and Wyoming. (Four States—Florida, Minnesota, Mississippi, and Texas—had entered
15 into separate settlements with certain PMs prior to the MSA and, therefore, are not parties to the
16 MSA.) Since this proceeding began, the PMs have dismissed their allegations against several
17 states (Alaska, Delaware, Hawaii, Idaho, Massachusetts, New Jersey, Rhode Island, South
18 Dakota, Utah, Vermont, Wisconsin, Wyoming, Guam, the Northern Mariana Islands, American
19 Samoa, and the U.S. Virgin Islands; *see* Participating Manufacturers' Notice of Contest as to
20 Certain States' Claims of Diligent Enforcement, filed November 3, 2011). Further, numerous
21 other states entered into a Settlement Agreement with the PMs, dated March 12, 2013, leaving 15
22 States who remain in this proceeding for whom Awards are now addressed by this Arbitration
23 Panel (the "Panel"). Numerous issues ("Global Issues") are decided and applicable to all
24 remaining Parties; however, because each remaining Settling State may have recourse to its own
25 MSA Court, the Panel will issue a separate Award for each specific state, including therein both
26 the Global Issues and also determinations that are specific to that state only.

27 Although numerous references may be made to the National Association of Attorneys
28 General ("NAAG") and the "NAAG Tobacco Project," which assist the states in implementing

1 the MSA and through which the states often act with respect to NPM Adjustment issues and
2 enforcement of the Escrow Statutes, NAAG was never made a party to this Arbitration
3 proceeding. NAAG is defined in the Definitions section of the MSA as “the National
4 Association of Attorneys General, or its successor organization that is directed by the Attorneys
5 General to perform certain functions under this Agreement.” MSA § II(bb). It is undisputed that
6 NAAG served as an advisory and legal resource to the Settling States, including interpreting the
7 MSA and opining on potential requirements for “diligent enforcement.” These Awards may also
8 refer to determinations made by the MSA’s “Independent Auditor,” which since 1998 has been
9 PricewaterhouseCoopers LLP (“PwC”). The MSA provides that the “Independent Auditor” is
10 responsible for “calculat[ing] and determin[ing] all payments” under the MSA, applying the
11 MSA’s various “adjustments, reductions and offsets” (including the NPM Adjustment) to those
12 payments, and determining “the allocation of such payments, reductions, offsets . . . among the
13 Settling States.” MSA § XI(a)(1). Although the Independent Auditor plays a major role in the
14 implementation of the MSA, it is not a party to this Arbitration, and the Panel has no jurisdiction
15 over its actions or determinations.

16 **CHAPTER II: THE BACKGROUND**

17 **A. Origin of the Dispute.**

18 This section is set forth as a summary and does not constitute either findings of fact or
19 conclusions of law by the Panel.

20 Both the Supreme Court and the Settling States have referred to the MSA as a
21 “landmark” public health agreement. *Lorillard Tobacco Co. v. Reilly*, 533 U.S. 525, 533 (2001);
22 NAAG March 8, 2006 News Release. The MSA settled and released past and future claims by
23 the Settling States for, among other things, recovery of health-care costs attributed to smoking-
24 related illnesses. In exchange, the PMs agreed to make substantial annual payments in perpetuity
25 based upon their annual nationwide cigarette sales and to be subject to an array of advertising,
26 marketing, and other restrictions. Since the MSA was first signed in November 1998, over 50
27 tobacco companies have agreed to be bound by its terms. Tobacco product manufacturers who
28 have not joined the MSA and agreed to its terms are referred to as Non-Participating

1 Manufacturers (“NPMs”).

2 Pursuant to the MSA, each PM makes a single annual payment based on its nationwide
3 cigarette sales volume during each calendar year. The annual payment on a year’s volume is due
4 on April 15 of the following year. It is alleged, and not disputed, that these annual payments
5 total in the billions of dollars each year. For example, the OPMs’ aggregate base payment
6 obligation was approximately \$8 billion for 2003 (the year in question here). *See* MSA §§
7 IX(c)(1)-(2). The SPMs make separate annual payments also based on their sales volume during
8 the year. *See* MSA § IX(i). The PMs’ annual payments are calculated by an “Independent
9 Auditor” agreed to by the parties. *See* MSA § XI(a)(1).

10 The MSA’s annual base payment amounts are subject to various adjustments, including
11 an Inflation Adjustment and a Volume Adjustment (under which the base payments are increased
12 or decreased in proportion to changes in the OPMs’ nationwide volume of sales). *See* MSA §§
13 IX(c), XI(a). According to the PMs, and not disputed, the OPMs’ aggregate annual payments
14 after these and other adjustments (other than the NPM Adjustment) since the MSA was entered
15 into have been as follows: 1999–\$3.545 billion; 2000–\$4.022 billion; 2001–\$5.066 billion;
16 2002–\$4.967 billion; 2003–\$5.950 billion; 2004–\$6.048 billion; 2005–\$6.128 billion; 2006–
17 \$6.221 billion; 2007–\$7.076 billion; 2008–\$7.011 billion; and 2009–\$6.497 billion. These
18 payments are split among the OPMs in proportion to their relative market shares. *See* MSA §§
19 IX(c)(1)-(2).

20 Each SPM makes annual payments that, on a per-cigarette basis, approximate the OPMs’
21 annual payments and that are likewise based on the SPMs’ sales volume during the year in
22 question. *See* MSA § IX(i). The SPMs’ aggregate annual payments for each year have been
23 claimed as follows: 1999–\$46.4 million; 2000–\$98.5 million; 2001–\$200.4 million; 2002–
24 \$319.0 million; 2003–\$484.5 million; 2004–\$433.7 million; 2005–\$441.5 million; 2006–\$517.7
25 million; 2007–\$475.0 million; 2008–\$569.5 million; and 2009–\$571.5 million.

26 These annual payments continue each year into perpetuity. The PMs’ total MSA
27 payments to the Settling States to date exceed \$70 billion, including the annual payments listed
28 above and additional “initial” payments made by the OPMs.

1 The PMs do not make these payments to individual States. Instead, each PM makes a
2 single, nationwide payment in the overall amount calculated and determined by the Independent
3 Auditor. The Independent Auditor then allocates those nationwide payments among the States
4 by applying pre-set “Allocable Share” percentages previously negotiated by the States (and set
5 forth in Exhibit A to the MSA), which represent each State’s percentage share of the PMs’
6 nationwide payments. *See* MSA §§ II(f)-(g); IX(b)-(c); IX(j), clause thirteenth; MSA Ex. A.

7 The MSA’s payment obligations impose substantial costs on the PMs. The NPMs, by
8 contrast, do not bear these MSA costs and thus do not reflect them in their pricing. Absent
9 enforcement of statutes imposing similar costs on NPMs, that differential cost between the PMs
10 and the NPMs could be harmful to both the PMs and to the States, as well as to the public, by
11 undermining the goals and purpose of the MSA.

12 In an attempt to minimize that disadvantage, the MSA included the prospect of reduced
13 payments to supply an incentive for each Settling State to enact and enforce a statute that
14 imposes similar payment obligations on NPMs and thereby neutralizes the MSA-related cost
15 disadvantage imposed on PMs. Moreover, if Settling States nevertheless failed to enact and
16 enforce such a statute, the payment reduction would compensate the PMs for their MSA-related
17 loss of sales.

18 The NPM Adjustment was made a part of the MSA to address that cost differential or, as
19 the PMs describe it, to “level the playing field.” The MSA provides that “[t]o protect the public
20 health gains achieved by this Agreement,” the PMs’ annual MSA payments “shall” be subject to
21 an NPM Adjustment. *See* MSA § IX(d)(1)(A). The Adjustment provides for a potential
22 reduction in the PMs’ MSA payments in event of an MSA-related market-share shift to NPMs
23 above a specified threshold. It is designed to give the States an incentive to eliminate the MSA
24 cost disadvantage faced by PMs, and with it the threat to the MSA’s public health gains—and to
25 provide compensation to the PMs in the event such a market-share shift nevertheless occurs. The
26 NAAG Tobacco Project has thus described the NPM Adjustment as follows:

27
28 [The] NPM Adjustment provides [an] incentive to ameliorate these adverse
 effects [*i.e.*, “undermin[ing] the MSA’s public health goals” and “unfairly

1 disadvantag[ing] companies that had chosen to” join the MSA. It provides that if,
2 because of the disadvantages imposed on them by the MSA, the PMs lose
3 “Market Share” to NPMs, the PMs’ payments to the States can be reduced.

4 NAAG Tobacco Project, *Understanding and Enforcing the NPM Statute*, MSA Issues Seminar
(Oct. 15-16, 2001).

5 The NPM Adjustment is set forth in Section IX(d) of the MSA (beginning at page 58 of
6 the Agreement). The first subsection, Section IX(d)(1), governs when the NPM Adjustment
7 applies. It provides that the Adjustment “shall apply” to the PMs’ annual payment for the year in
8 question if two conditions are met. MSA § IX(d)(1)(C).

9 First, the PMs must have suffered a “Market Share Loss,” which is defined to mean that
10 the PMs’ collective market share during that year decreased by more than two percentage points
11 compared to their collective market share in 1997, the last full year before the MSA was signed.
12 MSA §§ IX(d)(1)(A); IX(d)(1)(B).

13 Second, a nationally recognized firm of economic consultants jointly selected and
14 retained by the OPMs and the States (the “Firm”) must have determined that the disadvantages
15 experienced by the PMs as a result of the provisions of the MSA were a “significant factor”
16 contributing to the Market Share Loss for the year in question. *See* MSA § IX(d)(1)(C).

17 The only exception is where a State demonstrates that it has enacted and “diligently
18 enforced” a “Qualifying Statute.” MSA § IX(d)(2)(B). A “Qualifying Statute” is defined as a
19 statute that “effectively and fully neutralizes the cost disadvantages that the Participating
20 Manufacturers experience vis-à-vis Non-Participating Manufacturers within such Settling State
21 as a result of [the MSA].” MSA § IX(d)(2)(E). States are thus not required either to enact or
22 enforce such a statute, but if they want the benefit of the contractual exemption from the NPM
23 Adjustment, they must do both.

24 If an individual Settling State demonstrates that it diligently enforced such a statute
25 during the year in question, the NPM Adjustment still applies to the PMs’ MSA payments for
26 that year, but none of it is allocated to that Settling State’s share of those payments. *See* MSA §
27 IX(d)(2)(B). It is of critical import that nowhere in the MSA or any of the supporting exhibits, is
28 the term “diligent enforcement” defined. The MSA merely states that an exception to the NPM

1 Adjustment shall be available “. . . if such Settling State continuously had a Qualifying Statute
2 (as defined in subsection (2)(E) below) in full force and effect during the entire calendar year
3 immediately preceding the year in which the payment in question is due and diligently enforced
4 the provisions of such statute during such entire calendar year . . .” *Id.* Thus, defining what
5 standard is required before a State qualifies for this critical exception is left for this Panel to
6 decide.

7 Where an individual Settling State qualifies for this exception, the MSA provides that its
8 share of the NPM Adjustment will be reallocated to all other States that do not qualify for the
9 exception because they have not demonstrated diligent enforcement of their own Qualifying
10 Statute. Section IX(d)(2)(C) of the MSA thus provides that the “aggregate amount of the NPM
11 Adjustments that would have applied” to Settling States that prove they fall within the diligent
12 enforcement exception “shall be reallocated among all other Settling States pro rata in proportion
13 to their respective [payment shares],” and that those States’ MSA payments “shall be further
14 reduced” up to the full amount of their MSA payments for that year. MSA § IX(d)(2)(C); *see*
15 *also id.* § IX(d)(2)(D). As a result of this reallocation provision, the greater the number of
16 Settling States that did not diligently enforce a Qualifying Statute, the more widely the NPM
17 Adjustment is spread and the less the share of the Adjustment that each such State bears.
18 Conversely, if only a few Settling States fail to prove diligent enforcement, those Settling States
19 face a more concentrated application of the NPM Adjustment – and hence a greater reduction of
20 their payments, subject only to the limitation that the Adjustment applied to a Settling State can
21 be no greater than the total MSA payment it received for that year. The diligent enforcement and
22 reallocation provisions thus create a dual incentive for individual Settling States to enact and
23 enforce a Qualifying Statute.

24 The MSA defines a “Qualifying Statute” as one that, among other things, “effectively and
25 fully neutralizes the cost disadvantages that the [PMs] experience vis-à-vis [NPMs] within such
26 Settling State as a result of” the MSA. MSA § IX(d)(2)(E). Exhibit T to the MSA provides a
27 model for such a statute: a “model” Escrow Statute. The MSA provides that this “model”
28 Escrow Statute, if enacted with those modifications necessary to reflect “particularized state

1 procedural or technical requirements” will “constitute a Qualifying Statute.” *Id.*

2 The “model” Escrow Statute provides for each NPM to make escrow deposits on the
3 cigarettes it sells in the enacting Settling State in the year in question. The escrow deposits are to
4 be made into a “[q]ualified escrow fund,” which is defined as an escrow arrangement with a
5 qualifying financial institution in which the deposits are held for the benefit of the State. *See*
6 MSA, Ex. T, at T-2 (§ (f)). The deposits are to remain in escrow for 25 years except insofar as
7 they are used to pay a judgment to or settlement with the State for liability on claims like those
8 the Settling States settled against the PMs in the MSA. *See* MSA, Ex. T, at T-4 & T-5
9 (§ (b)(2)(A)-(C)). The escrow deposits thus guarantee the State a source of recovery should it
10 subsequently sue or settle with that NPM on claims like those the State settled against the PMs in
11 the MSA, and avoid the risk that NPMs would otherwise use their MSA-related “cost advantage
12 to derive large, short-term profits . . . and then becom[e] judgment-proof before liability [to the
13 State] may arise.” MSA Ex. T, at T-1 (§§ (a), (f)).

14 The Settling States all enacted Escrow Statutes following the MSA. But following the
15 signing of the MSA in 1998, and despite the Settling States’ universal enactment of Escrow
16 Statutes imposing payment obligations on NPMs, the NPMs’ market share increased at
17 significant rates.

18 This shift of market share from PMs to NPMs has triggered the NPM Adjustment
19 provision of the MSA for multiple years. The PMs and the States settled the NPM Adjustments
20 through 2002. The NPM Adjustments for 2003 and subsequent years, however, were not
21 resolved, and the dispute over the Adjustment for the first of these years—2003—has culminated in
22 the proceedings before this Panel.

23 As a beginning and necessary step leading to this Arbitration, in connection with its April
24 2004 calculation of the PMs’ MSA payment for 2003, the Independent Auditor determined that
25 the MSA’s first condition for application of the 2003 NPM Adjustment was satisfied: the PMs
26 had suffered a “Market Share Loss” for 2003. The Auditor calculated that there had been a
27 market-share shift of approximately 8% to the NPMs from 1997 to 2003, and thus a Market
28 Share Loss of approximately 6% after giving effect to the two percentage point buffer.

1 The States have not disputed the Independent Auditor's determination that the PMs
2 suffered a Market Share Loss for 2003, the magnitude of that loss or the amount of the 2003
3 NPM Adjustment.

4 After the Independent Auditor's finding of a Market Share Loss, the States and OPMs
5 instituted proceedings in April 2005 for a determination by the Firm as to whether the
6 disadvantages experienced by the PMs as a result of the provisions of the MSA were a
7 "significant factor" contributing to that Market Share Loss. The OPMs and States engaged the
8 Brattle Group to make this "significant factor" determination.

9 The OPMs and the States then participated in a 10-month evidentiary proceeding before
10 the Firm. On March 27, 2006, the Firm issued a 163-page opinion and final determination,
11 finding that the disadvantages experienced by the PMs as a result of the MSA were a "significant
12 factor" contributing to the 2003 Market Share Loss. The MSA expressly provides that the
13 Firm's significant factor determination is "conclusive and binding upon all parties" and "final
14 and non-appealable." *See* MSA § IX(d)(1)(C).

15 Following the Firm's determination in March 2006, the PMs requested that the
16 Independent Auditor apply the 2003 NPM Adjustment as a credit against their next MSA
17 payments. The Settling States opposed the request, asking the Independent Auditor to
18 "presume" diligent enforcement and to refuse to apply the 2003 adjustment.

19 Following the Independent Auditor's determination not to apply the NPM Adjustment,
20 some of the PMs paid the disputed amounts into a "Disputed Payment Account," and the PMs
21 requested that the Settling States arbitrate the dispute pursuant to the MSA's Arbitration Clause.
22 That clause, which is set forth in Section XI(c) of the MSA, provides that "[a]ny dispute,
23 controversy or claim arising out of or relating to" the Independent Auditor's calculations or
24 determinations "shall be submitted to binding arbitration" before a panel of three former federal
25 judges.

26 The Settling States initially refused to agree to arbitration, and sought relief in their
27 individual state courts, which was denied in virtually every case. It was not until January 30,
28 2009, that 45 Settling States had signed an Agreement to Arbitrate ("the ARA"). Pursuant to the

1 ARA's "partial liability reduction," the PMs will reimburse each of those 45 Settling States that
2 the Panel determines did not diligently enforce its Escrow Statute in 2003 with 20% of the
3 portion of the 2003 NPM Adjustment that it bears as a result. *See* ARA § 3(b). Four Settling
4 States—Ohio, Oklahoma, North Carolina, and Wisconsin—refused to sign the ARA, but were
5 ordered to arbitration by their state courts, and participated in this Arbitration. Thereafter, the
6 PMs and 48 Settling States, including the four Settling States that declined to sign the ARA,
7 negotiated a separate "Agreement Regarding Procedures for Formation of Arbitration Panel."
8 Pursuant to that Agreement and Section XI(c) of the MSA, this Panel was selected to resolve the
9 2003 NPM Adjustment dispute.

10 **B. The Arbitration Clause.**

11 The MSA is approximately 150 pages long, plus numerous exhibits. Despite the
12 complexity and uniqueness of the issues in this matter, and the large number of parties involved,
13 the Arbitration Clause ("the Clause") is virtually devoid of any procedural guidelines or
14 objective criteria to be used by the Panel in deciding this matter. The Clause merely states as
15 follows:

16 Resolution of Disputes. Any dispute, controversy or claim arising out of or
17 relating to calculations performed by, or any determinations made by, the
18 Independent Auditor (including, without limitation, any dispute concerning
19 the operation or application of any of the adjustments, reductions, offsets,
20 carry-forwards and allocations described in subsection IX(j) or subsection
21 XI(i)) shall be submitted to binding arbitration before a panel of three neutral
22 arbitrators, each of whom shall be a former Article III federal judge. Each of
the two sides to the dispute shall select one arbitrator. The two arbitrators so
selected shall select the third arbitrator. The arbitration shall be governed by
the United States Federal Arbitration Act.

23 MSA § XI(c).

24 **C. The Arbitration Panel.**

25 The Panel consists of the following Arbitrators, each of whom is a former Article III
26 federal judge:

27 Judge William G. Bassler, selected by the PMs;

28 Judge Abner J. Mikva, selected by the Settling States; and

1 Judge Fern M. Smith, selected by Judges Bassler and Mikva.

2 **CHAPTER III: THE PROCEDURAL HISTORY**

3 The actual proceedings in the Arbitration began with the Parties filing mutual Motions
4 for Case Management Schedule and Discovery Plan on July 2, 2010. The first joint status
5 hearing took place in Chicago, Illinois. At that time, 17 PMs and 52 States and territories were
6 parties of record, although several States appeared only with reservations of rights, including
7 objections to the Panel's jurisdiction. Because neither the Agreement nor the Clause gave
8 direction, decisions had to be made by the Panel as to the governing law, governing procedural
9 rules, *e.g.*, rules of evidence, type of hearings required, dispositive motions, if any, burden of
10 proof, priorities, and location of hearings, as well as other questions that arose as the Panel
11 proceeded. Because the pre-hearing process was lengthy, as well as complex and significant, a
12 meaningful summary is virtually impossible; therefore, the Panel has attached, as Appendix I, a
13 list of all of the Panel's pre-hearing rulings. (Note: The Panel's rulings, as well as all of the
14 Parties' filings, are posted on a LexisNexis data bank, which is available to authorized readers.)

15 **CHAPTER IV: THE CONTENTIONS OF THE PARTIES**

16 **A. The Claimants' Contentions.**

17 The PMs' Claim for Arbitration is almost 200 pages long, which is understandable, given
18 the number of Settling States against whom claims are made. In essence, however, the PMs
19 request that this Panel determine the following:

- 20 1. Determine that the Independent Auditor was required to apply the 2003 NPM
21 Adjustment to the PMs' April 2006 annual payments once the Firm determined that
22 the MSA was a significant factor contributing to the PMs' Market Share Loss for
23 2003.
- 24 2. Determine that the Independent Auditor erred when it refused to apply the 2003 NPM
25 Adjustment to the PMs' April 2006 annual payments and when it adopted a
26 presumption that each State had diligently enforced its Escrow Statute.
- 27 3. Determine that the Independent Auditor is required to immediately credit the 2003
28 NPM Adjustment, with applicable interest, to the PMs' next MSA payments.

- 1 4. Determine that individual States have the burden of proving diligent enforcement of a
2 Qualifying Statute.
- 3 5. Allow the discovery necessary for the parties—and the Panel—to evaluate and
4 determine individual States’ claims that they diligently enforced a Qualifying Statute
5 during 2003.
- 6 6. Determine the claims of individual States that they diligently enforced a Qualifying
7 Statute during 2003 and that, accordingly, their Allocable Share of the 2003 NPM
8 Adjustment should be reallocated to other States.
- 9 7. Determine such other issues related to the application, allocation, and recovery of the
10 2003 NPM Adjustment as the parties shall raise and the Panel shall deem appropriate.

11 The primary focus of this Arbitration has been on Contention Six, *i.e.*, which Settling
12 States “diligently enforced” their respective Qualifying Statute in 2003, and the individual state-
13 specific hearings have focused solely on that question. The first five Contentions were expressly
14 or implicitly decided in the pre-hearing determinations set forth in Appendix I. Contention
15 Seven will be addressed, if necessary, in these Awards.

16 **B. The Respondents’ Contentions.**

17 Each of the Settling States filed its own response to the PMs’ claims and contentions;
18 however, the majority of the defenses raised were duplicative and common to each of the
19 Settling States. There was also a joint response filed on behalf of all of the Settling States. By
20 the time the state-specific hearings were held, the only remaining question for the Panel to
21 answer was that set forth in PMs’ Contention Six, *i.e.*, did the Settling State “diligently enforce”
22 its Qualifying Statute in 2003.

23 **CHAPTER V: DISCUSSION AND DECISION**

24 **A. Common Findings/Conclusions.**

25 *1. Introduction.*

26 As stated above, the majority of defenses and issues raised by both the PMs and the
27 Settling States were common to all parties and were either resolved in pre-arbitration motion
28 proceedings, or were deferred until all of the state-specific hearings were completed. Included in

1 this Award, therefore, are final determinations of those deferred issues, each of which was a
2 significant factor in the Panel's ultimate Awards and each of which is common to the each state-
3 specific Award. They include the following:

- 4 ○ The Panel's definition of Diligent Enforcement
- 5 ○ The Panel's definition of Units Sold
- 6 ○ Whether a State used the Fabricator or Control Test in its enforcement efforts
- 7 ○ Defining "two knowing violations" in seeking injunctive relief
- 8 ○ Enforcement efforts against House of Prince/Carolina/Leonidias
- 9 ○ Whether a State had the obligation to amend or enact legislation as an aid to
10 enforcement
- 11 ○ The use of Allocable Share Releases
- 12 ○ The significance, *i.e.*, use/weight of a State's "collection rate"

13 It is critical to note that although all of the above were "factors," which the Panel
14 considered in deciding whether the defined diligent enforcement standard was met, the Panel did
15 not rank the factors or give them a numerical score, *i.e.*, each, except for the definition of
16 "diligent enforcement," was considered in the over-all context of a Settling State's existing
17 policies and circumstances in 2003. It is therefore not a useful exercise, or even valid, to
18 compare the decision as to one State against the decision as to another. It is also important to
19 note that the Panel has not distinguished between "Findings" and "Conclusions." Most of the
20 questions addressed are mixed questions, and the Panel views each with equal weight. All
21 findings and/or conclusions were decided by a unanimous Panel.

22 It was decided during pre-hearing motions (*see* Appendix 1) that the Settling States had
23 the burden of proof on the question of diligent enforcement. Thus, each State presented its case
24 in chief first.

25 2. "Diligent Enforcement" Defined.

26 Diligent Enforcement is an ongoing and intentional consideration of the requirements of a
27 Settling State's Qualifying Statute, and a significant attempt by the Settling State to meet those
28 requirements, taking into account a Settling State's competing laws and policies that may

1 conflict with its MSA contractual obligations. Both the legislative and executive branches of a
2 Settling State are bound by the MSA obligations.

3 That definition is measured by an objective standard, and the Panel has considered
4 numerous factors in determining whether that standard has been met. The Panel has not ranked
5 the factors, but has considered them as a whole in making its determination.

6 3. "Units Sold" Defined.

7 "Units Sold" is defined in Exhibit T to the MSA (commonly referred to in this
8 Arbitration as the "Model Statute") as follows:

9 "Units sold" means the number of individual cigarettes sold in the State by the
10 applicable tobacco product manufacturer (whether directly or through a
11 distributor, retailer or similar intermediary or intermediaries) during the year in
12 question, as measured by excise taxes collected by the State on packs (or "roll-
your-own" tobacco containers) bearing the excise tax stamp of the State

13 MSA Exhibit T, T-3, Definitions, (j).

14 As opposed to much of the MSA, that definition seems clear and unambiguous, and many
15 of the Settling States requested that the Panel find to be binding, as a question of law. The PMs,
16 however, as well as several of the Settling States, disagreed.

17 The PMs argued that the issue of "units sold" was state-specific and depended on the
18 facts and circumstances of each individual state. For example, the PMs argued that while a
19 minority of states attempted to exempt entire categories of NPM cigarette sales from the escrow
20 payment obligations, such as NPM cigarettes sold through Native American reservations or
21 unstamped roll-your-own cigarettes ("RYO"), other states assessed and attempted to enforce
22 escrow with respect to all NPM cigarettes sold in their state. The PMs argued that the different
23 states' understanding and course of performance in enforcing the NPM escrow obligations were
24 thus factual issues subject to discovery which would have bearing on the Panel's determination
25 of the "units sold" issue.

26 Because each side to this dispute raised colorable arguments, the Panel deferred ruling
27 until all state-specific hearings were completed. That time has now arrived, and the Panel finds
28 that the PMs have failed to support their arguments that the express definition means anything

1 other than what it says.

2 The collective evidence did show that different Settling States reacted in different ways
3 to the Model Statute definition, *e.g.*, some Settling States modified their Qualifying Statute, some
4 changed their practices regarding RYO or sales by tribes, and some took the stated definition
5 literally and declined to include certain types of sales as “units sold.” What the Panel did not see
6 was any evidence of collusive behavior, *i.e.*, no Settling State, in the Panel’s opinion,
7 manipulated the definition or counting of “units sold” in order to purposefully evade their
8 enforcement obligations. In particular, although some Settling States with large numbers of
9 cigarettes sold on Tribal Lands declined to change their policy regarding non-taxation of such
10 sales, those Settling States presented valid policy reasons for their decisions. Although the
11 Settling States had binding contractual obligations to “diligently enforce,” they were not required
12 to elevate those obligations above other statutory or rational policy considerations. Unless
13 otherwise stated in a state-specific Award, the Panel reaches the same conclusion for RYO sales.

14 For these reasons, the Panel finds, as a matter of law, that the Model Statute definition of
15 “units sold” is unambiguous and binding. Further, even if parol evidence were considered, the
16 PMs have failed to show that a different meaning should be applicable to any specific Settling
17 State.

18 4. Whether a State Used the “Fabricator” or “Control” Test.

19 This issue also arises under the “Model Statute,” which sets forth certain remedies that a
20 State has against a “Tobacco Product Manufacturer” (“TPM”), a term specifically defined under
21 the “Definitions” section of the Model Statute. In that definition, a TPM is defined as an entity
22 that “manufactures cigarettes anywhere that such manufacturer intends to be sold in the United
23 States, including cigarettes intended to be sold in the United States through an importer”
24 MSA Ex. T, T-3.

25 The “Requirements” section of the Model Statute establishes that the Attorney General of
26 a Settling State may file a civil action against a TPM under certain express conditions. MSA Ex.
27 T, T-5. The right to file a civil action is the only express remedy against TPMs that is set forth in
28 the MSA or Model Statute. The PMs argued in all state-specific hearings that the right to file a

1 lawsuit was critical to diligent enforcement and that the Settling States had an obligation to file
2 such suits often and as soon as possible.

3 The controversy over this term arose because some Settling States interpreted the
4 definition strictly, *i.e.*, as applying solely to manufacturers, many of which were in foreign
5 jurisdictions, and not easily amenable to jurisdiction (the “Fabricator Test”). Other Settling
6 States were more liberal in their interpretation, and included entities within the United States
7 who played a significant role in getting the subject cigarettes into the market, *e.g.*, distributors
8 and wholesalers (the “Control Test”). For obvious reasons, the Control Test made it easier and
9 faster to file lawsuits. The PMs argue that Settling States that used the Fabricator Test were less
10 “diligent” than followers of the Control Test. The Panel disagrees. The problem, if any, lies
11 with the drafting of the Model Statute, which expressly limits the right to file civil actions to
12 suits against “manufacturers.” In hindsight, the definition of TPM should have been broader, but
13 the fault for that does not lie with the Settling States.

14 5. Defining “Two Knowing Violations” in Seeking Injunctive Relief.

15 This question also arises out of the “Remedies” section of the Model Statute which
16 limited injunctive relief to TPMs that have committed “two knowing violations.” The dispute
17 centers on defining a “knowing violation,” and the differences among the Settling States in
18 making that determination. Again, the PMs ask the Panel to penalize those States that accepted a
19 more restrictive and literal definition of that term. The Panel finds no legal or equitable basis to
20 penalize a Settling State who reads the express words of the Model Statute in a rational way.
21 Again, the fault, if any, lies in the drafting of the Model Statute, for which the Settling States are
22 no more to blame than the PMs.

23 6. Enforcement Effort Against House of Prince/Carolina/Leonidas.

24 Much time was spent in discussing the role that these entities played, and, more
25 important, their status during the 2003 time period, *i.e.*, were they NPMs, SPMs, contract
26 manufacturers, etc. The value of understanding the relationships lies only in how their status
27 affected a given Settling State’s “compliance rate,” *i.e.*, the percentage of escrow paid against the
28 total number of units sold in a Settling State by NPMs. The PMs’ case rested in great part on the

1 use of expert testimony, an important facet of which was establishing a compliance rate for each
2 state. Because of the legitimate confusion over whether the above entities were NPMs or not,
3 many Settling States took a “wait and see” attitude and did not seek escrow from them, resulting
4 in a lower compliance rate, based on the PMs’ calculations. The Panel understands the PMs’
5 theory, but also is unwilling, in hindsight, to classify such decisions as a failure in diligent
6 enforcement. This is especially true because the status of those entities has since resolved.

7 7. Whether a Settling State Had the Obligation to Amend or Enact Legislation as an Aid to
8 Diligent Enforcement.

9 The PMs have argued both implicitly and explicitly that Settling States could have and
10 should have passed legislation that made enforcement easier to accomplish. The Panel has
11 considered that as a factor, especially the alacrity of a Settling State in passing what has been
12 referred to as “Complementary Legislation,” which was specifically aimed at increasing
13 remedies available against non-performing NPMs. On the other hand, the Panel has given less
14 weight to the argument that a Settling State should have legislatively changed, for example, its
15 taxation laws, in order to increase its escrow collection rate. The MSA put no such demand on
16 the Settling States.

17 8. Allocable Share Release.

18 Significant time was spent by the PMs discussing the negative effect of the Allocable
19 Share Release (“ASR”), which is set forth in the Model Statute. The Panel understands the PMs’
20 theory, but does not agree that the Settling States should be faulted for what was a poorly
21 conceived policy, set forth in the Model Statute. The deficiencies, if any, caused by the ASR
22 provision, were eliminated by most states in 2003 with the passing of additional legislation. The
23 Panel mentions the ASR in individual cases, if at all, only if it found that a Settling State’s
24 procedure for releasing ASR funds had a material effect on its enforcement results.

25 9. The Significance, i.e., Use/Weight of a State’s “Collection Rate.”

26 The PMs’ case-in-chief relied almost completely on the testimony of expert witnesses.
27 One category of expert testimony was provided by economists, who based their opinions
28 primarily on the “collection rate” of a Settling State, i.e., what amount of money was deposited

1 by NPMs into escrow accounts in a given year, as compared to the experts' determination of
2 what amount was actually due. The collection rates among and between the Settling States
3 differed significantly, and the variance was intended to be used in a comparative way for the
4 Panel to determine the lack of diligent enforcement. The Panel concurs that the collection rate is
5 a significant factor, but it is not the only factor, nor is it always the primary factor. Predicating a
6 Settling State's diligence, therefore, based solely on the collection rate is unlikely to be fruitful.
7 Further, because in most cases, the "underreported" collection rate is similar across states, the
8 Panel has not factored that into its analysis, except in unusual circumstances.

9 **B. State-Specific Findings and Conclusions as to the State of Washington.**

10 1. The Attorneys and Witnesses for the Washington Hearing.

11 a. The Attorneys for Washington

12 i. Washington State Office of the Attorney General

13 Rene Tomisser

14 David Hankins

15 b. The Attorneys for the PMs

16 i. Jones Day

17 Barbara Harding

18 Jason Winchester

19 Abby Wakefield

20 William Laxton

21 Graham Keithley

22 ii. Winston & Strawn LLP

23 Alexander Shaknes

24 iii. Greenberg Traurig LLP

25 Scott Martin

26 c. Witnesses for the State

27 i. Lee Smith

28

1 Excise tax examiner for cigarette excise tax in the Department of
2 Revenue

3 ii. David Hankins

4 Office of the Attorney General

5 d. Witnesses for the PMs

6 i. Daniel Garrett

7 Expert Witness

8 ii. Colleen Waring

9 Expert Witness

10 2. Factors Considered in the Determination of Diligent Enforcement.

11 The Panel has previously articulated a definition of diligent enforcement. In order to
12 objectively assess a Settling State's diligent enforcement in light of that definition, the Panel has
13 developed a number of components that it believes aid in evaluating a Settling State's
14 enforcement of its Qualifying Statute and its diligence in doing so. Those factors are:

15 a. Collection Rate

16 b. Lawsuits Filed

17 c. Gathering Reliable Data

18 d. Resources Allocated to Enforcement

19 e. Preventing Non-Compliant NPMs from Future Sales

20 f. Legislation Enacted

21 g. Actions Short of Legislation

22 h. Efforts to be Aware of NAAG and Other States' Enforcement Efforts

23 These factors are not listed in their order of importance nor are they necessarily given
24 equal weight. But overall they provide a reliable and objective metric to assess a Settling State's
25 obligation to enforce its Qualifying Statute with diligence in order to avoid the contractually
26 agreed upon determination that the PMs are entitled to a reduction in their payments for the
27 calendar year 2003.

1 3. Analysis.

2 The following is an analysis of those facts found by the Panel to be true and necessary to
3 the Award. To the extent that this recitation differs from any Party's position, that is the result of
4 determinations as to credibility of witnesses, including experts, determinations of relevance,
5 burden-of-proof considerations, and the weighing of the evidence, both oral and written. The
6 Panel has also considered the inferences that could or could not be drawn from the testimony and
7 documents.

8 It should be noted that the analysis for Washington, much like that for New York, focuses
9 to a great extent on Washington's policy regarding tobacco sales on tribal lands, and
10 Washington's view of "Units Sold." Because that issue predominated in the evidentiary hearing,
11 and because it appears to be at the core of the PMs' dispute with Washington, the Panel's
12 discussion of that issue is more detailed than for other factors. That does not mean, however,
13 that the other factors listed have not been taken into account.

14 a. Collection Rate

15 Based on the Levinsohn, Reiss, and Garrett analysis, the collection rate for reported sales was
16 62%, or 60% if one deducts ASR payments. Those numbers, however, do not count tribal sales,
17 the actual number of which is unknown, but which appears to be very large. If tribal sales are
18 ignored, the collection rate is better than average for the contested states.

19 b. Lawsuits Filed

20 Washington filed eighteen lawsuits before 2003 and twelve in 2004, but none in 2003,
21 although they were still actively litigating nine from prior years, not including the House of
22 Prince litigation. Because Complementary Legislation was pending, more effort was spent on
23 getting non-compliant NPMs out of the market than on filing new lawsuits.

24 c. Gathering Reliable Data

25 Lee Smith headed the day-to-day Department of Revenue responsibilities. The
26 Department of Revenue was in charge of receiving and computing monthly distributor reports as
27 they came in and sending the numbers to Mr. Hankins at the Office of the Attorney General. The
28 departments coordinated their efforts reasonably well and used a system of monthly distributor

1 reports and annual NPM certifications as a verification method, although they did not perform
2 audits. The Panel found the performance of the Department of Revenue to be limited, but its
3 deficiencies were balanced by the dedicated and effective monitoring of David Hankins.

4 d. Resources Allocated to Enforcement

5 There was little, if any, evidence regarding this factor, leading the Panel to believe that
6 the resources were sufficient.

7 e. Preventing Non-Compliant NPMs from Future Sales

8 Washington performed well in this regard. Although it filed no lawsuits in 2003, follow-
9 up efforts resulted in eight non-compliant NPMs making voluntary payments. Further, by the
10 end of 2003, the list of non-compliant NPMs went from fifteen to zero.

11 f. Legislation Enacted

12 In addition to having passed the Escrow Statute early on, Washington passed both
13 Complementary Legislation and ASR repeal legislation in 2003. Complicating the picture,
14 however, was the fact that in 2001 Washington passed legislation allowing tribes within the State
15 to change from the prior "allocation" system, to a "compact" system. By the end of 2003, seven
16 of the State's twenty-nine tribes had entered into compacts with Washington, and were selling
17 cigarettes under that system. The PMs do not dispute Washington's right to tribal compacts, but
18 seriously disagree with the concomitant decision that escrow was not due on any compact sales.
19 The PMs' position is understandable, especially because the PMs were including compact sales
20 in their MSA payment calculations, but were not getting what they perceive as "the benefit of the
21 bargain" in return.

22 There was, in fact, strong disagreement within the State as to whether products sold by
23 compact tribes should be escrowed and the disagreements continued throughout the year. David
24 Hankins, who was the chief escrow officer for the Office of the Attorney General, believed that
25 escrow obligations attached; however, the chief taxation officer for the Department of Revenue
26 disagreed, based on a strict interpretation of the unit sold definition. The Attorney General sided
27 with the Department of Revenue and overruled Hankins.

1 The PMs allege that NPM sales to tribes escalated sharply after the compacts were
2 signed; however, Washington provided rational policy reasons for instituting compacts with the
3 tribes, and the PMs provided no evidence to the contrary. Even if the Panel were to agree that
4 the PMs' and Hankins' position as to escrow was the correct one, the Panel's role is not to opine
5 on the wisdom of internal policy decisions or the correctness of their legal analysis.

6 g. Actions Short of Legislation

7 Washington formed a tobacco enforcement team in 2000, shortly after the MSA was
8 signed. The team was headed by David Hankins who did a very effective job. Both notice and
9 demand letters were sent.

10 h. Efforts to be Aware of NAAG and Other States' Enforcement Efforts

11 Mr. Hankins was actively involved in both NAAG and knowing what other states were
12 doing.

13 4. Conclusion.

14 The PMs ask the Panel to find that the Doctrine of Nullification applies in this case. The
15 Panel disagrees, although it does not endorse in any way a unilateral changing of any Settling
16 States' cigarette tax laws, without notice to the PMs. In fact, the Panel agrees that such action
17 will "raise a red flag." The Panel does not take a position as to when the PMs knew or should
18 have known that the tribal compacts had been legislated and entered into, although there was
19 admissible evidence of an active PM lobbyist within Washington. The Panel also notes that the
20 laws have since been changed in order to resolve the escrow problem as it relates to the
21 compacts.

22 Counsel for Washington made the following statement in his closing argument:

23
24 No matter how good the Court thinks it would have been . . . as a policy matter to
25 make this circle a lot bigger, and to make the units sold be on a cigarette upon
26 which excise tax was due, the fact of the matter is at the bargaining table, that isn't
27 what happened . . . [T]he shrinking of the circle is not a diligent enforcement
28 issue. What the state has to do is regardless of how large or small we make this
circle, we have to diligently enforce within it . . . It was, in fact, done as a matter
of government-to-government relations with the tribes to reduce the conflict, to
reduce the contraband traffic flowing through the tribes that were selling allocated

1 cigarettes, all things that are aboveboard, legitimate government decisions to
2 make, and not a bad faith effort to undermine NPM[s].

3 Washington Hearing Transcript, 1184:6-13; 1187:18-22; 1189:12-23 (Apr. 23, 2013). The Panel
4 does not agree that a Settling State has an unfettered right to a “shrinking of the circle;” however,
5 because a review of the record in this specific case indicates no evidence of intentional escrow
6 evasion, but rather a good faith effort to address an intractable problem, the Panel accepts
7 Counsel’s argument.

8 Considering the record as a whole, the Panel finds that Washington has met its burden by
9 a preponderance of the evidence.

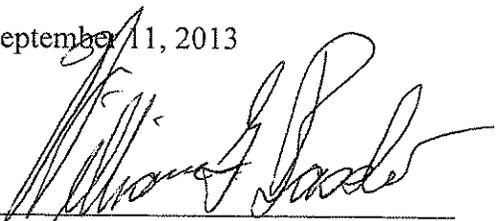
10 FINAL AWARD

11 The Panel unanimously finds that the State of Washington diligently enforced its
12 Qualifying Statute during calendar year 2003 and therefore is not subject to an NPM Adjustment
13 pursuant to Section IX(d)(2)(B) of the Master Settlement Agreement.

14 All other claims, if any, not specifically addressed in the Final Award are Denied. This
15 Final Award therefore resolves all claims set forth in this proceeding.

16 SO ORDERED.

17
18 Dated: September 11, 2013

19
20
21 
22 The Honorable William G. Bassler
23 Arbitrator

24 
25 The Honorable Abner J. Mikva
26 Arbitrator

27
28 
The Honorable Fern M. Smith
Chairperson