IN THE SUPREME COURT OF MISSOURI

No. SC95422

STATE OF MISSOURI ex rel. JEREMIAH W. (JAY) NIXON,
Appellant/Cross-Respondent

v.

AMERICAN TOBACCO CO., et al.,

Respondents/Cross-Appellants

Appeal from the Circuit Court of the City of St. Louis
The Honorable Jimmie M. Edwards, Circuit Judge

SUBSTITUTE OPENING BRIEF OF RESPONDENTS/CROSS-APPELLANTS CERTAIN SUBSEQUENT PARTICIPATING MANUFACTURERS

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STATEMENT OF JURISDICTION

The Subsequent Participating Manufacturers ("SPMs") listed under the signatures of counsel below join the Statement of Jurisdiction in the brief of R.J. Reynolds Tobacco Company and Philip Morris U.S.A., Inc. (collectively "Original Participating Manufacturers" or "OPMs").

STATEMENT OF FACTS

The SPMs are smaller tobacco manufacturers, with national market shares ranging from below one tenth of one percent to 3-4 percent. They joined the Master Settlement Agreement ("MSA") voluntarily though most of them were never sued by any state. A group of SPMs were the first to move to compel arbitration on the 2003 NPM adjustment, in June 2004. Now, after almost a decade of litigation and arbitration, the SPMs have obtained unanimous arbitral awards – entered by a panel of three former federal judges, including a judge selected by Missouri and the other states – that Missouri and five other states did not diligently enforce their escrow statutes during 2003 and thus are subject to the 2003 NPM Adjustment. Op. at 4 (LF 2396). Before the arbitration concluded, the SPMs also settled their disputes over the NPM Adjustment for the years 2003-2012 with 22 of the states. Op. at 3 (LF 2395). Missouri did not join the settlement, and subsequently moved to vacate the arbitrators' awards addressing the effect of the

settlement and finding Missouri liable for the NPM Adjustment because it did not diligently enforce its escrow statute.

The trial court denied Missouri's motion in part and granted it in part. The court recognized that it could not revisit the merits of the arbitrators' ruling, but could look only to whether there was "misconduct" on the part of the arbitrators. Op. at 4-5 (LF 2396-97). It upheld the panel's order finding Missouri did not diligently enforce and was thus liable for the 2003 NPM Adjustment. However it modified the panel's award determining the amount by which the partial settlement of the 2003 NPM Adjustment reduced the remaining potential exposure of the states that did *not* settle. It held that the panel's "pro rata" reduction of the non-settling states exposure was "clearly erroneous." Op. at 7 (LF 2399). It required instead that *all* of the states that settled must be treated as *fully liable* in determining the remaining potential exposure for the states that did not settle, Op. at 8 (LF 2400), even though Missouri conceded to the panel that not all the states that settled were in fact likely to be found liable, *see* Obj. Br. at 19 n.17 (LF 2108).

The Court of Appeals reversed the portion of the trial court's order addressing the effect of the settlement. It held that the trial court erred when it considered the merits of the panel's decision and modified it as "clearly

erroneous." OPM App. A28-A47.[1] No such merits review is permissible, the Court of Appeals held, when the panel did the job the parties have contracted for it to do and interpreted the contract: "It is clear … that the Panel took its decision-making role seriously, reviewed the post-settlement judgment reduction law, and made its decision carefully…. [W]e find the Panel construed the MSA just as it was asked to do." *Id.* A46-47 (quoting the holding of *Oxford Health Plans LLC v. Sutter*, 133 S. Ct. 2064 (2013), that "because the parties 'bargained for the arbitrator's construction of their agreement,'" a decision that "even arguably" construes the contract must be upheld, "regardless of a court's view of its (de)merits."). Moreover, the Court of Appeals found, "[a]fter a thorough review, we do not suggest that the Panel's analysis was incorrect." *Id.* A47.[2]

The SPMs otherwise join the OPMs' Statement of Facts.

[1] The SPMs have moved to join the OPMs' Appendix.

[2] The trial court rejected Missouri's argument that for the 2004 arbitration, unlike the 2003 arbitration, it is entitled to its own "single-state" arbitration with a separately-chosen panel of arbitrators. Op. at 11-15 (LF 2403-2407). The Court of Appeals reversed in the State's favor, and that issue is also before this Court.

POINTS RELIED ON

I. The trial court erred by modifying the settlement award as "clearly erroneous" because the governing Federal Arbitration Act standard and the MSA language directing "binding" arbitration do not permit courts to revisit the merits of arbitration awards.

Oxford Health Plans LLC v. Sutter, 133 S. Ct. 2064 (2013)

Grubb v. Leroy L. Wade & Son, Inc., 384 S.W.2d 528 (Mo. 1964)

Mo. Rev. Stat. § 435.405.1 (2013);

Cornelius v. Morrill, 302 S.W.3d 176 (Mo. Ct. App. 2009)

II. The trial court erred under any standard of review because the panel got it right: It correctly applied the MSA and black letter background law to reduce Missouri's potential liability to reflect the partial settlement, but did not give the State the massive windfall it sought.

Gas Aggregation Servs., Inc. v. Howard Avista Energy, LLC, 319 F.3d 1060 (8th Cir. 2003)

United Steelworkers v. Enterprise Wheel & Car Corp., 363 U.S. 593 (1960)

Alcan Packaging Co. v. Graphic Commc'n Conf., 729 F.3d 839 (8th Cir. 2013)

Sadler v. Bd. of Educ., 851 S.W.2d 707, 712-13 (Mo. App. S.D. 1993)

ARGUMENT

I. The Trial Court Erred By Modifying The Settlement Award As "Clearly Erroneous" Because The Governing Federal Arbitration Act Standard And The MSA Language Directing "Binding" Arbitration Do Not Permit Courts To Revisit The Merits Of Arbitration Awards

In the MSA, the parties agreed that their arbitration must be "binding" and "shall be governed by the United States Federal Arbitration Act." MSA § XI(c) (LF 332). There is also no dispute that the MSA is a contract that involves interstate commerce within the meaning of the FAA, *see* 9 U.S.C. §§ 1, 2, so the FAA applies to it irrespective of its language. Not surprisingly therefore the trial court and the Court of Appeals applied the correct FAA standard. Op. at 4-5 (LF 2396-97); OPM App. A30-32.

Moreover, both the trial court and the Court of Appeals recognized that a court reviewing an arbitration award "cannot reweigh the evidence presented to the arbitration panel, but can only look to whether there was misconduct in the proceedings." Op. at 5 (LF 2397); OPM App. A31-32. That is absolutely correct. Under 9 U.S.C. § 10(a) and governing Supreme Court precedent, no merits review whatsoever of arbitrators' contract interpretations (or legal conclusions or factual determinations) is permitted so long as the arbitrators are doing the job that the parties contracted for them to do – here, interpreting and applying the MSA.

Oxford Health, 133 S. Ct. at 2068-71 ("convincing a court of an arbitrator's error – even his grave error – is not enough. So long as the arbitrator was 'arguably construing' the contract … a court may not correct his mistakes under §10(a)(4)"; "the arbitrator's construction holds, however good, bad, or ugly"); *United Paperworkers v. Misco, Inc.*, 484 U.S. 29, 38 (1987) (courts do not review "claims of factual or legal error" by an arbitrator).

The MSA parties' agreement that the arbitration would be "binding" (MSA § XI(c) (LF 332)) further confirms their intent that the arbitration panel's determination would govern unless there was some misconduct rising well above the level of error. "Binding" arbitration means what it says: that the parties do *not* agree that the reviewing court can revisit the merits of the award. *See, e.g.,* Black's Legal Dictionary (Free Online Legal Dictionary 2nd ed.) ("binding arbitration" is "arbitration where the arbitrating parties must accept all of the findings and decisions of the arbitrator or arbitrators"), available at http://thelawdictionary.org/binding-arbitration/); *Grubb*, 384 S.W.2d at 534 ("Under the rule of law these parties have agreed upon, the decision of the conference committee is final and binding, and this court has no business weighing the merits of the grievance for in so doing we would be usurping a function which is entrusted to the arbitration tribunal… [I]t would be a useless procedure if the parties to a dispute, having participated in the proceedings until final disposition,

were not bound by the decision of the committee, but could relitigate the same question in the courts.") (internal citations and quotation marks omitted); *UHC Mgmt. Co. v. Computer Sciences Corp.*, 148 F.3d 992, 998 (8th Cir. 1998) ("UHC and Computer Sciences agreed to arbitration that would be 'binding,' rather than merely constituting a trial run of their claims precedent to a merits disposition in federal court. Thus, the district court correctly reviewed the award under the narrow standards of the FAA.").

Where the trial court and the Court of Appeals parted ways, however, was when the trial court nonetheless went on to find that the award was "clearly erroneous" on the merits and modify on that basis. Op. at 7 (LF 2399). That, as the trial court itself recognized, it could not do. Nor did it cite any other possible basis for modifying the award under the correct FAA standard – because, as set out in Section II below, there is none.

The only authority that the trial court cited for its conclusion was the opinion of the Pennsylvania trial court to the same effect. Op. at 5-6 (LF 2397-2398). However, the Pennsylvania court applied a *different standard of review* under what it saw as binding Pennsylvania law: in certain cases involving the State, a court may modify an arbitration award "where the award is contrary to law and is such that had it been a verdict of a jury the court would have entered a different judgment." 42 Pa.C.S.A. § 7302(d)(2); *Pennsylvania v. Philip Morris USA, Inc.*,

No. 970402443 at 13 (Phila. Ct. C.P. April 10, 2014), *aff'd*, 114 A.3d 37, 42-43 (Pa. Commw. Ct. 2015), *appeal denied*, 129 A.3d 1244 (Pa. 2015), *pet. for cert. filed*, No. 15-1299 (U.S. Apr. 21, 2016) (LF 2330). The Pennsylvania court interpreted that standard under Pennsylvania law to permit modification of the arbitration award if it "violates the unambiguous language" of the contract." *Id.* at 41 (LF 2358).[3]

There is absolutely no basis for a similar holding in Missouri, as the Court of Appeals recognized. First of all, the FAA standard governs under the parties' contract and Missouri law. *Edward D. Jones & Co. v. Schwartz*, 969 S.W.2d 788, 793-95 (Mo. App. W.D. 1998). And even if the Missouri Arbitration Act applied it would also forbid all merits review of an arbitration award. Mo. Rev. Stat. §

[3] The Maryland Court of Special Appeals also modified the award on the theory that the Maryland state arbitration law standard of review governs and permits some review on the merits. *Maryland v. Philip Morris, Inc.*, 123 A.3d 660, 663-64 (Md. Ct. Spec. App. 2015), *cert. denied*, 132 A.3d 195 (Md. 2016), *pet. for cert. filed*, No. 15-1537 (U.S. June 22, 2016). A Colorado decision, in contrast, relied on the FAA standard to deny a State motion to modify the award. *Colorado v. R.J. Reynolds Tobacco Co.*, No. 1997CV3432 at 4 (Colo. Dist. Ct. Feb. 11, 2014) at 4, *no appeal filed* (included in OPM Appendix filed in the Court of Appeals at A38).

435.405.1 (2013); *Cornelius*, 302 S.W.3d at 179 ("an arbitration panel's mistakes of law, like mistakes of fact, are not a sufficient reason to vacate an award."; "An arbitration award … finally concludes and binds the parties on the merits of all matters properly within the scope of the award, both as to law and facts, and the courts will have no inquiry as to whether the determination thereon was right or wrong, for the purpose of interfering with the award.") (internal quotation marks omitted).

For this reason alone – because courts are not permitted to modify arbitration awards simply because they believe they were erroneous – this Court should reverse the trial court's modification of the settlement award.

II. The Trial Court Erred Under Any Standard Of Review Because The Panel Got It Right: It Correctly Applied The MSA And Black Letter Background Law To Reduce Missouri's Potential Liability To Reflect The Partial Settlement, But Did Not Give The State The Massive Windfall It Sought

The trial court also erred because the panel's decision was correct: Application of the pro rata judgment reduction principle here was consistent with the MSA's language, the law, and the facts.

The panel found correctly that the MSA's language, although it did not expressly direct what would happen if there was a partial settlement of the NPM

Adjustment, did "indicate" that the pro rata approach was the "appropriate" interpretation of the MSA in these circumstances. Settlement Award at 10-11 (LF 251-52). It noted that the MSA already used the words "pro rata" in describing allocations, including in connection with the NPM Adjustment merits determinations. *Id.* It looked further to the law that has developed over time to address just such situations, when some parties to a shared liability settle and some do not, in order to uphold the strong policy encouraging settlements while ensuring that parties that do not settle have their potential exposure reduced by an appropriate amount to reflect the settlement but do not receive a "windfall" from it. *Id.* at 9-11, 14 (LF 249-51; 255) (discussing pro tanto, pro rata, and proportionate fault methods of judgment reduction). It rejected the PMs' arguments that the NPM adjustment should be reduced pro tanto (that is, dollar for dollar), the method that would have a substantially smaller reduction in potential liability for the states that did not settle. *Id.* at 9-11 (LF 250-252). It further rejected the states' argument that each and every state that settled should be treated as if it would lose the diligent enforcement determination, finding it contrary to the facts, the MSA, and the law. *Id.* at 13-14 (LF 254-255).

Finally, based on all this, the panel concluded that reducing the non-settling States' potential reduction pro rata, by the MSA share of the States that had settled – or 46% – was appropriate. *Id.* at 10-11, 14 (LF 251-252; 255). That decision

conferred an immense benefit on Missouri and the other States. The States' aggregate potential liability was reduced *by almost half*, by $528 million, with Missouri's potential liability reduced by $50 million. OPM Br. at 11-12

Each and every one of the steps in the panel's determination was correct. The panel's consideration of the issue was within its jurisdiction, as the trial court and the Court of Appeals both recognized (Op. at 6 (LF 2398); OPM App. A40-41), because the MSA provision defining the scope of the arbitration required the panel to address the appropriate allocation of the Adjustment. *See* MSA § XI(c) (directing arbitration of all issues "arising out of or relating to" MSA payment determinations, including "adjustments" and "allocations") (LF 332).

It is further entirely appropriate for arbitrators (or courts) to interpret a contract based on its language, its context, the appropriate background principles, and other indications of the parties' intent. That is exactly what the panel did here. Courts have repeatedly recognized the propriety of this approach. *Gas Aggregation Servs.*, 319 F.3d at 1065 ("the arbitrator must utilize other sources to determine the parties' intent" where "there is no clear and unambiguous agreement").

Black-letter law further provides that background legal principles are deemed incorporated into all contracts unless the parties agreed otherwise, and directs courts and arbitrators to consider them when appropriate, as this panel did.

United Steelworkers, 363 U.S. at 598 (arbitrator may "look[] to the law for help" in interpreting contracts); *see also, e.g., Alcan Packaging Co.*, 729 F.3d at 842 (upholding arbitral award that had interpreted the text of the contract at issue in light of "arbitral precedents" "interpreting similar contracts"); 11 R. Lord, Williston on Contracts § 30:19 (4th ed.); *see also Sadler*, 851 S.W.2d at 712-13 ("unless a contract provides otherwise, the law applicable thereto … is as much a part of the contract as though it were expressly referred to and incorporated in its terms").

As the OPMs' brief sets out in detail, moreover, the background law that the panel applied is the same law that Missouri and other states generally apply to shared liabilities when some parties settle and some do not. OPM Br. at 43-45. The panel looked to the three potentially-applicable methods, and concluded that the one most consistent with the MSA's language and purpose was the pro rata method, which reduced the potential liability for the states that did not settle by a substantial amount – indeed, much more than under the pro tanto method urged by the PMs.

The panel's interpretation also properly furthered the policy underpinning all of the various judgment reduction methods, favoring settlements. That policy is reflected in both the MSA and Missouri law. *See, e.g.,* MSA § VII(c) ("[w]henever possible, the parties shall seek to resolve an alleged violation of [the

MSA] by discussion"); *id.* § XVIII(m) (MSA parties must discuss disputes) (LF 342-343); *id.* § XVIII(l) (parties must "cooperate with each other" in MSA matters) (LF 342); *Lowe v. Norfolk & Western Ry. Co.*, 753 S.W.2d 891, 894-95 (Mo. banc 1988) ("[t]he policy of the law is to encourage settlements"); *accord Jensen v. ARA Services*, 736 S.W.2d 374, 378 (Mo. 1987) ("purpose of [Missouri judgment-reduction statute] is to encourage settlements").

By contrast, the trial court's interpretation of the MSA – deeming *all* of the contested Signatory States fully liable – would make future settlements highly unlikely. That approach puts the states that did not settle in a *better* position than they would have been absent the settlement (here, providing a windfall reduction of 70% of their potential liability), thereby discouraging all parties from settling.

Finally, and critically, the panel's order was consistent with the facts. As the panel recognized and as Missouri and the other States *conceded*, if there had been evidentiary proceedings addressing the diligence of the settling states, some would have likely been found diligent and some would have likely been found non diligent – just as occurred with the states that did not settle. *See* Obj. Br. at 19 n.17 (LF 2108). The trial court's direction that all states that settled must be assumed to be fully liable is contrary to those facts. The panel decision reducing the potential liability by a substantial amount but not the whole amount, in contrast, rests on the correct assumption that some of the settling parties were liable and some were not.

In short, the panel's determination is not only an interpretation of the contract – and thus unassailable under the FAA – but it is entirely correct. As the Court of Appeals found, "after a thorough review," it did not suggest that the panel's decision "was incorrect." OPM App. A47 .

The trial court, however, found that the panel's action was "clearly erroneous" because "it violates the parties' procedure for amending the MSA" and the MSA requires a State to "prove it diligently enforced" to avoid allocation of the NPM Adjustment." Op. at 2, 7 (LF 2394, 2399). Based on this reasoning, the trial court held that the "only way for the Partial Settlement Award not to affect Missouri's rights is for the 20 signatory States whose diligence was not contested, but not proven, to be treated as non-diligent when calculating the NPM Adjustment for Missouri." *Id.* at 7-8 (LF 2399-2400). There are a number of compelling reasons why this conclusion was error.

First, it makes no sense for the trial court to hold on the one hand that the MSA does not expressly address how to treat partial settlements (a conclusion with which the Court of Appeal agreed) and that the panel was required to decide that issue because it was within the scope of the arbitration, but then to hold on the other that the panel's required interpretation of the contract was an "amendment" to the MSA. If the MSA does not expressly address an issue, a decision interpreting the contract with respect to that issue is not an "amendment."

Second, the purported MSA requirement that States must "prove" diligent enforcement to avoid allocation of the Adjustment cited by the trial court is not in the MSA at all. The MSA does not say the *only* way a State can ever avoid allocation of the Adjustment in any circumstance is to affirmatively prove its diligence. What it says is that the Adjustment is allocated among States that are not diligent. MSA § IX(d)(2) (LF 1005-1010).

The arbitration panel interpreted this MSA language, in light of the MSA as a whole and background legal principles, in a variety of different but consistent ways during the arbitration. It initially held that although the MSA did not specifically address which side had the burden of proof in a hearing to determine diligent enforcement, that burden in a contested evidentiary proceeding under basic legal principles would properly be on the states. Burden of Proof Order at 4-6, 9 (LF 1171-1173, 1176). It opined later that the Independent Auditor was not required to apply the Adjustment in the year it is actually due even though no state had actually proven its diligent enforcement at that point. Auditor Authority Order at 20-21 (LF 444-445). Then it held, although the MSA did not expressly address what was required when the PMs and other states did not contest a state's diligence, the uncontested state could be deemed diligent even without carrying its burden of proof and thus avoid allocation of the Adjustment. No Contest Order at 13-16 (LF 1195-1198). And finally, in the order at issue here, it held that when the

PMs did not further challenge some states' diligence because they settled, those states could be treated as diligent but the total NPM Adjustment that the rest of the states potentially owed to the PMs should be cut by almost half to reflect the settlement. Settlement Award at 9-11, 13-14 (LF 250-252, 254-255). All those holdings are consistent with the panel's duty – recognized by the trial court and the Court of Appeals, Op. at 6 (LF 2398); OPM App. A30 – to interpret the MSA on issues that it does not expressly address.

The language on which the trial court relied – that a state must "prove" its diligence to avoid the NPM Adjustment – came not from the MSA but from the first of the panel's orders interpreting the MSA: the order holding that the states have the burden of proof in hearings held on diligent enforcement. Burden of Proof Order at 9 (LF 1176) ("[t]he text of the MSA does not mention burdens of proof"). A prior panel order interpreting a contract on an issue on which it is silent is not the same thing as actual contractual language. Moreover, and critically, in its later orders the panel made clear that the burden of proof order applied *only* to evidentiary hearings on diligent enforcement and was not relevant to other issues. Auditor Authority Order at 14-15 (burden of proof order did not govern) (LF 437-438); No Contest Order at 13-14 ("narrow" holding in the burden of proof order applied only to the question "which party has the burden of proof at the arbitration hearing") (LF 1195-1196). The panel's burden of proof order accordingly does not

support the trial court's conclusion that the MSA required settling states to be treated as having been found not diligent.

Third, and perhaps most tellingly, Missouri took positions before the panel directly contradicting its claim now that the MSA unambiguously provides that a state is always subject to the NPM Adjustment until it affirmatively proves diligent enforcement. Missouri first argued that *the PMs*, not the states, were required to prove lack of diligent enforcement. Burden of Proof Order at 2 (LF 1169). Next Missouri argued that the MSA unambiguously required that a state could *never* be subject to an NPM Adjustment "unless and until it is found to be non-diligent." Auditor Authority Br. at 9 (OPM App. A61); Auditor Authority Order at 2 (LF 425). Now, Missouri convinced the trial court to hold that the same MSA language unambiguously requires the opposite result, that states *must* be subject to the Adjustment unless and until they *affirmatively prove* their diligence. Op. at 2, 7 (LF 2394, 2399). If the language of the MSA really unambiguously requires all states to be deemed non-diligent in all circumstances until and unless they prove their diligence at a hearing, it is puzzling that Missouri argued precisely the opposite to the panel when it wanted the opposite result.[4]

[4] The SPMs join the remaining arguments in the OPMs' brief.

CONCLUSION

This Court should reverse the trial court's order to the extent that it modifies the Settlement Award and reinstate the Settlement Award's *pro rata* judgment-reduction ruling.

Dated: July 1, 2016

Respectfully submitted,

/s/ Jonathan F. Dalton

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CERTIFICATE OF SERVICE AND COMPLIANCE

A copy of this document was served on counsel of record through the Court's electronic notice system on July 1, 2016.

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