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 R.J. REYNOLDS TOBACCO COMPANY AND PHILIP MORRIS USA INC.

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STATEMENT OF JURISDICTION

As relevant here, Plaintiff, the State of Missouri, filed two motions in the Circuit Court of the City of St. Louis: (1) a motion to vacate an arbitration award entered during the resolution of a contract dispute concerning an annual payment under the tobacco Master Settlement Agreement ("MSA"), LF 156-57; and (2) a motion to compel arbitration of the next year's payment dispute in a Missouri-specific arbitration rather than a multi-state arbitration, LF 831-32.

The Circuit Court entered a final order and judgment ("CC Order") that granted in part Plaintiff's first motion by modifying the arbitration award at issue, and that denied Plaintiff's second motion by refusing to compel arbitration of the next year's payment dispute in the manner requested. Appx. A14-A15 (CC Order at 14-15). Defendants, certain cigarette manufacturers, filed timely notices of appeal of the first ruling (Nos. ED101576 & ED101605), and Plaintiff filed a timely notice of appeal of the second ruling (No. ED10154). LF 2428-39.

The Missouri Court of Appeals, Eastern District, had jurisdiction over the consolidated appeals: (1) the appeals are from a final judgment, § 512.020(5), RSMo; (2) the appeals do not involve any matters over which this Court has exclusive appellate jurisdiction, Mo. Const. Art. V § 3; and (3) the Circuit Court of the City of St. Louis is within the Eastern District's territorial jurisdiction, § 477.050, RSMo.

On September 22, 2015, a panel of the Eastern District issued an opinion ("COA Op.") that reversed both of the rulings challenged in the consolidated appeals. Appx. 16 (COA Op. at 1). On October 7, 2015, Defendants and Plaintiff each filed in the Eastern District motions for rehearing and applications for transfer. On December 2, 2015, the Eastern District transferred the consolidated appeals to this Court.

This Court has jurisdiction to hear the consolidated appeals transferred from the Court of Appeals. Mo. Const. Art. V § 10. Pursuant to this Court's order on April 13, 2016, Defendants' opening briefs are limited to their appeal of the Circuit Court's order modifying the arbitration award at issue.

STATEMENT OF FACTS

This case arises under the Master Settlement Agreement ("MSA") between numerous cigarette manufacturers (the "Participating Manufacturers," or "PMs") and the State of Missouri and 51 other States and Territories (the "MSA States"). In particular, it involves the arbitration of an MSA dispute concerning the "NPM Adjustment," which is a potential reduction to the PMs' annual payment to the MSA States. During the arbitration of the dispute over the NPM Adjustment for 2003, the PMs and 22 of the States (the "Signatory States") reached a settlement; Missouri and the other "Non-Signatory States" were also offered the settlement, but declined to join. Thus, the arbitrators — a Panel of three former federal judges

— had to resolve how the 2003 NPM Adjustment should be allocated to the Non-Signatory States under the MSA in light of the partial settlement. Missouri challenged the arbitrators' interpretation, the Circuit Court modified the award, and the Court of Appeals reversed the trial court.

A. The NPM Adjustment Under The MSA

Under the MSA, the PMs make an annual payment, subject to various adjustments, that is apportioned among the MSA States by each State's contractually specified "Allocable Share." Appx. A1 (CC Order at 1); LF 344, 1022-25 (MSA § IX(j), Exh. A). One of these potential downward adjustments is the "Non-Participating Manufacturer Adjustment" (the "NPM Adjustment"). Appx. A2 (CC Order at 2); LF 1000-18 (MSA § IX(d)).

The NPM Adjustment is a payment reduction designed to address the PMs' concern that the NPMs who are not subject to the MSA's constraints would gain "an advantage in the marketplace." Appx. A2 (CC Order at 2). For a given year, the Adjustment is available if (1) the PMs lost market share to the NPMs above a certain level, and (2) the MSA's disadvantages were a "significant factor" contributing to that loss. *See id.*; LF 1000-05 (MSA § IX(d)(1)).

When those conditions are satisfied, MSA § IX(d)(2)(A) provides that the NPM Adjustment "shall apply to all [MSA] States," with each State bearing its Allocable Share. *See* Appx. A2 (CC Order at 2); LF 1005-06 (MSA § IX(d)(2)).

But there is an exception in MSA § IX(d)(2)(B), under which an individual State may avoid its share of the Adjustment if it "diligently enforced" certain NPM-related obligations pursuant to the MSA during the year at issue. *See id*. Where the exception is met, MSA § IX(d)(2)(C) provides that the diligent States' shares are "reallocated among all [other MSA] States *pro rata* in proportion to their respective Allocable Shares." *See id*.

In sum, under MSA § IX(d)(2), diligent States are not responsible for any of the Adjustment, and non-diligent States are collectively responsible for the total available Adjustment, including the shares initially allocated to the diligent States.

B. The 2003 NPM Adjustment Dispute And Arbitration

There was a dispute over the MSA States' responsibility for the 2003 NPM Adjustment (which was roughly $1.15 billion). Although the conditions for that Adjustment were satisfied, the Independent Auditor that administers MSA payments decided not to apply it because the States' diligent enforcement had not yet been determined. *See* Appx. A2-A3 (CC Order at 2-3). The Auditor urged that the "dispute … be submitted to binding arbitration in accordance with subsection XI(c) of the MSA." LF 1149 (Auditor Notice 140 at 2).

MSA § XI(c) requires that the parties submit to a "binding arbitration" of "[a]ny dispute … arising out of or relating to … any determinations made by[ ] the Independent Auditor (including, without limitation, any dispute concerning … any

of the adjustments … described in subsection IX(j) …)," one of which is the NPM Adjustment. LF 1029. Section XI(c) further specifies that the arbitration Panel shall consist of "three … former Article III federal judge[s]," and that "[t]he arbitration shall be governed by the United States Federal Arbitration Act." *Id.* Moreover, wholly apart from § XI(c), the FAA governs the arbitration because the MSA involves interstate commerce. *See* 9 U.S.C. § 2.

Missouri and other MSA States refused to arbitrate the dispute and instead sought declaratory relief in their respective state courts. In particular, Missouri requested a declaratory judgment "construing the term 'diligently enforced.'" LF 1058 (Arbitrability Order at 2). But the Circuit Court granted the PMs' motion to compel arbitration. LF 1064 (*id.* at 8). It held that the diligent-enforcement dispute falls within the "clear" "language" of the MSA's arbitration provision, because it "arises out of and relates to" the Auditor's NPM Adjustment "calculations and determinations." *Id.* The courts in virtually every other MSA State also ordered arbitration (only Montana's courts disagreed). *McGraw v. Am. Tobacco Co.*, 681 S.E.2d 96, 103 n.7, 108-12 (W. Va. 2009) (collecting cases).

An arbitration Panel of three retired federal judges was selected to resolve the 2003 NPM Adjustment dispute. The States picked the Hon. Abner J. Mikva (D.C. Cir.), the PMs picked the Hon. William G. Bassler (D.N.J.), and Judges Mikva and Bassler then picked the Hon. Fern M. Smith (N.D. Cal.). LF 289-90.

C. The Panel's Rulings On Relevant Preliminary Issues

Before the Panel conducted evidentiary hearings on the diligence of individual States, the Panel entered various preliminary rulings. Three of them are relevant here because (1) they concern the Panel's interpretation of the NPM Adjustment provisions at issue, and (2) the Circuit Court relied on its understanding of the first ruling but did not mention that, as the Court of Appeals recognized, the Panel had clarified that initial ruling in the two subsequent ones.

First, when addressing who bears the burden of proof in an evidentiary hearing for a State whose diligence was contested in the arbitration, the Panel interpreted the MSA to provide that such a State must prove its diligence. LF 452-53 (Burden of Proof Order at 1-2); *see also* Appx. A2, A7 (CC Order at 2, 7).

Second, when addressing whether the Independent Auditor's initial application of the 2003 Adjustment correctly presumed that all States were diligent, the Panel interpreted the MSA to provide that no part of the NPM Adjustment could be allocated to any State by the Auditor "unless and until" that State is found non-diligent. LF 442 (Auditor Authority Order at 19). In doing so, the Panel distinguished its earlier Burden of Proof Order. The Panel agreed with the position advanced by Missouri and other States that "the Panel's finding that the States have the burden to establish diligent enforcement does not" require it also to find (1) that a State's "*non*-diligence" must be "presume[d]" or (2) that part

of the Adjustment is to be allocated to a State "unless and until" it proves its diligence. LF 429, 442-43 (*id.* at 6, 19-20).

Third, when addressing the treatment of a State whose diligence was no longer contested after discovery, the Panel interpreted the MSA to provide that such a State would be "deemed" to be diligent and its share of the Adjustment would be reallocated to those States that the Panel found were non-diligent. LF 516-17 (No-Contest Order at 17-18). The Panel again distinguished its Burden of Proof Order, holding that that Order addresses only the "narrow question" of "which party has the burden of proof at the arbitration hearing," and thus does not "come[ ] into play" where a State's "claim of diligent enforcement is not challenged." LF 512-13 (*id.* at 13-14).

Accordingly, as the Court of Appeals explained, the Panel made clear prior to the individual State diligence hearings that its Burden of Proof Order (1) meant only that each State would have to prove its diligence at its evidentiary hearing *if* its diligence were contested and such a hearing took place, and (2) did *not* mean that each State must be allocated a share of the Adjustment unless it proved its diligence. *See* Appx. A22-A23 (COA Op. at 7-8). Instead, no State would be allocated any part of the Adjustment "unless and until" it was found *non*-diligent, and States whose diligence was no longer contested would be "deemed" *diligent* and their shares of the Adjustment reallocated to the non-diligent States. *See id.*

Because these rulings meant that States found non-diligent would bear the shares of any States whose diligence was not contested, the Panel gave each State the opportunity to contest the diligence of any other State before the individual State hearings began. *See* LF 500 (No-Contest Order at 1). That way, if a State was concerned that the PMs might not continue to contest the diligence of some or all other States, it could request an evidentiary hearing at which those States would have to prove their diligence. But neither Missouri nor any other State took this opportunity: after discovery, only the PMs contested the diligence of any States, and they contested only 35 of the States. *See* LF 176 (MO Tr. Br. at 11).

D. The Partial Settlement

During the arbitration, and before the Panel had issued diligence determinations for any of the States, the PMs and 19 States agreed to a multi-year NPM Adjustment settlement. Appx. A3 (CC Order at 3). All other States were invited to join the settlement: 3 more States joined before the arbitration concluded, but Missouri chose not to join. *Id.* The 22 Signatory States had an aggregate Allocable Share of about 46% of the NPM Adjustment, and they consisted of 20 States that the PMs had contested to that point as well as 2 States that the PMs had previously decided not to contest. Appx. A3, A7 (*id.* at 3, 7).

With respect to the 2003 NPM Adjustment, the settlement provides for the Signatory States to give the PMs specified credits against future MSA payments

for part of that Adjustment. LF 260, 270-73 (Term Sheet § I & Appx. A). The settlement, of course, did not provide how to allocate the 2003 Adjustment among the Non-Signatory States in light of the uncertainty about the Signatory States' diligence — *i.e.*, given that their diligence would no longer be contested by the PMs and had never been contested by the Non-Signatory States. *See id.* That issue was instead properly left for the Panel to decide under the MSA and governing law.

In objecting to the settlement before the Panel, many of the Non-Signatory States, including Missouri, contended that the MSA's reallocation provision requires a determination as to the diligence of each State, regardless of whether a State has settled with the PMs. LF 2096 (Obj. Br. at 7). Yet, inconsistently, the Non-Signatory States did not contend that the Panel actually had to determine the diligence of the Signatory States in order to determine the Non-Signatory States' reallocated share of the Adjustment. Rather, the Non-Signatory States contended that the Panel should simply *treat* as *non*-diligent *all* the Signatory States that the PMs had contested, *whether or not* those Signatory States would have been found non-diligent absent the settlement. LF 2096, 2109-11 (*id.* at 7, 20-22).

Notably, the Non-Signatory States advanced this "all non-diligent" position notwithstanding that: (1) they had successfully advanced the exact opposite position in connection with the Auditor Authority Order, *see* pp. 6-7, above; (2) they had previously waived the opportunity that the Panel had given them to

contest the diligence of other States themselves, *see* LF 176 (MO Tr. Br. at 11); and (3) they expressly admitted that their position would make them better off than they would have been absent the settlement, because not all the contested Signatory States would have been found non-diligent if the Panel had made actual diligence determinations, *see* LF 2108 (Obj. Br. at 19 n.17).

E. The Settlement Award

The Panel ordered extensive briefing on the post-settlement reallocation issue and held four days of hearings. LF 242-43 (Settlement Award at 1-2). The Panel then unanimously entered a Settlement Award that rejected the objectors' "all non-diligent" position, and that interpreted the MSA to provide a different method for reallocating the NPM Adjustment after a partial settlement. *See id.*

The Panel first ruled that it "ha[d] jurisdiction to rule on the issues raised concerning the MSA reallocation provisions." LF 244 (Settlement Award at 3). Under MSA § XI(c), it had jurisdiction over all issues "relat[ing] to" the resolution of the "2003 NPM Adjustment dispute," including the Adjustment's allocation among the MSA States. *See* LF 243 (*id.* at 2). And under well-established caselaw, such jurisdiction covers "all matters necessary to dispose of the claim," including "the existence or effect of a settlement." *See* LF 243-44 (*id.* at 2-3).

Turning to the text of the MSA's reallocation provision, the Panel determined that "the MSA does not directly speak as to the process to be used

when some States settle diligent enforcement and some do not." LF 255 (*id.* at 14). Although the MSA instructs that diligent States are exempt from their share of the Adjustment (§ IX(d)(2)(B)), and that non-diligent States are subject to their initial and reallocated shares of the Adjustment (§ IX(d)(2)(C)), it does not instruct what to do where it is *unknown* whether a State is diligent or non-diligent because its diligence is no longer contested due to a settlement. *See id.*; LF 1005-06 (MSA § IX(d)(2)). That said, although the MSA's reallocation provision does not expressly dictate how to deal with the post-settlement uncertainty about the diligence of the Signatory States, the Panel concluded that the provision's language and structure do "indicate" an "appropriate" method in these circumstances. *See* LF 251-52 (Settlement Award at 10-11).

Namely, the Panel interpreted the MSA to provide that the 2003 NPM Adjustment should be subject to a "*pro rata* reduction," pursuant to which the total Adjustment amount that the Non-Signatory States are potentially responsible for is reduced by the aggregate Allocable Share of the Signatory States (46%) — *i.e.*, the $1.15 billion Adjustment is reduced by $528 million, and then reallocated solely among the Non-Signatory States that are found non-diligent. *See* LF 250-51 (*id.* at 9-10); LF 196 (MO Tr. Br. at 31). In other words, this *pro rata* interpretation provides that no part of the Signatory States' 46% share of the Adjustment will be reallocated to the Non-Signatory States (consistent with the uncertainty as to

whether the Signatory States were diligent for purposes of MSA § IX(d)(2)(B)), but it also provides that no part of the Non-Signatory States' 54% share of the Adjustment will be reallocated to the Signatory States (consistent with the uncertainty as to whether the Signatory States were non-diligent for purposes of MSA § IX(d)(2)(C)). *See id.*

As the Panel explained, the *pro rata* interpretation for reallocating the Adjustment where the diligence of some States is unknown due to a settlement is supported by what the language and structure of the MSA expressly provide for reallocating the Adjustment where the diligence of all States is known. In particular, given that § IX(d)(2) expressly reallocates diligent States' shares to the non-diligent States on a "pro rata" basis, rather than on the basis of the non-diligent States' relative fault, § IX(d)(2) should be interpreted as similarly providing for a reallocation method that accounts for the settling States based on their *pro rata* share, rather than their relative fault. *See* LF 252 (Settlement Award at 11).

As the Panel further explained, its *pro rata* interpretation was bolstered "in light of governing law." LF 255 (Settlement Award at 14). Under the well-established law of post-settlement judgment reduction, "[w]here multiple parties have a potential shared contractual obligation and some of them settle and some do not, the non-settling parties" are "entitled to a judgment reduction" pursuant to one of "three standard methods for reducing judgment against non-settling defendants

after a partial settlement." LF 251 (*id.* at 10). And one of those standard methods is the same "*pro rata*" method that the Panel adopted, under which the adjudicator "divides the amount of the total judgment by the number of settling and non-settling defendants, regardless of each defendant's culpability." *Id.*

As the Panel finally explained, its *pro rata* interpretation is also far superior to the objectors' "all Signatory States non-diligent" position. Presuming that all the settlers were fully liable would have no basis in the MSA, the law, or the facts, and would discourage partial settlements by giving the objectors a windfall profit. *See* LF 254-55 (*id.* at 13-14).

F. The Missouri Non-Diligence Award

At the conclusion of the arbitration, the Panel entered final awards for the 15 Non-Signatory States whose diligence for 2003 was still contested. Appx. A4 (CC Order at 4). The Panel unanimously held that Missouri and five other States were non-diligent, and that the remaining nine States were diligent. *Id.*; LF 187-88 (MO Tr. Br. at 22-23). Thus, the 2003 NPM Adjustment, as reduced under the *pro rata* method, was allocated among the six non-diligent Non-Signatory States pursuant to MSA § IX(d)(2) as interpreted in the Settlement Award. *See* LF 250 (Settlement Award at 9); LF 196 (MO Tr. Br. at 31).

G. The Circuit Court Order

Missouri filed a motion asking the Circuit Court for the City of St. Louis to vacate the Panel's *pro rata* judgment-reduction ruling and to replace it with the rule that all contested Signatory States must be treated as non-diligent for purposes of reallocating the 2003 NPM Adjustment among the Non-Signatory States. LF 170-73 (MO Tr. Br. at 5-8). The court granted the motion and so modified the Settlement Award. Appx. A14-A15 (CC Order at 14-15).

On the standard of judicial review, the court acknowledged that the vacatur provision in the Federal Arbitration Act ("FAA"), 9 U.S.C. § 10(a), authorizes setting aside the Settlement Award's *pro rata* judgment-reduction ruling here only if the Panel "exceeded [its] powers." *See* Appx. A4-A5 (CC Order at 4-5). And the court further acknowledged that, because the issue of "how to reallocate the NPM Adjustment" after "the partial settlement" was "clearly within the scope of the arbitration agreement," the Panel did in fact "ha[ve] the authority to determine the reallocation method." *See* Appx. A6-A7 (*id.* at 6-7). The court nevertheless held that the Panel had exceeded its authority under the FAA simply because the court believed that the "pro rata reallocation method is clearly erroneous" under the MSA. *See* Appx. A7 (*id.* at 7).

In so holding, the court cited no support for its premise that "clear error" is a sufficient basis to disturb the Panel's contract interpretation under the FAA. *See*

Appx. A4-A8 (*id.* at 4-8). Likewise, the court did not address the PMs' contrary argument that, under the FAA as construed by the U.S. Supreme Court in *Oxford Health Plans LLC v. Sutter*, 133 S. Ct. 2064 (2013), arbitrators do not exceed their powers when resolving a dispute within their jurisdiction even if their contract interpretation is clearly erroneous: instead, they do so only if they act in bad faith by abandoning their interpretive role to implement their own notions of justice, without even arguably interpreting the contract in good faith. *See id.* at 2068-71. Nor did the court find that the distinguished Panel of former judges had engaged in such misconduct. *See* Appx. A5-A8 (CC Order at 5-8).

Rather, on the merits, the court simply held that the "pro rata reallocation method is clearly erroneous" because it supposedly "amend[s] the MSA" without the consent of all "affected" parties, in contravention of MSA § XVIII(j). Appx. A7 (*id.* at 7). The court reasoned that the *pro rata* method "effectively amends [MSA] § IX(d)(2)" because the court treated that provision as requiring that all States "have to prove their diligent enforcement" in order to avoid being "subject to the NPM Adjustment" for reallocation purposes. *Id.* And the court further reasoned that, because the 20 contested Signatory States have "not proven" their diligence, "the only way for the Partial Settlement Award to not affect Missouri's rights is for [those States] to be treated as non-diligent when calculating the NPM Adjustment for Missouri." Appx. A7-A8 (*id.* at 7-8).

In so holding, the court did not identify any actual language in MSA § IX(d)(2) that provides that all States must "prove" their diligence to avoid being treated as non-diligent for purposes of reallocation of the NPM Adjustment. *See id*. To the contrary, the court agreed with the Panel that "[t]he MSA does not expressly address how to reallocate the NPM Adjustment among the non-signatory states where the diligence of the signatory states is no longer contested due to a settlement." Appx. A6 (*id.* at 6). Yet the court did not explain why the Panel was nevertheless wrong — much less clearly and maliciously wrong — in concluding (1) that it should interpret the MSA's language and structure in light of the established body of judgment-reduction law for partial settlements, and (2) that it should not convey a settlement-discouraging windfall on Missouri by treating all the contested Signatory States as non-diligent even though Missouri had conceded they were not all non-diligent, had never contested the diligence of any of them, and had successfully argued to the Panel that they should all be treated as diligent in the context of the Auditor Authority Order. *See* Appx. A6-A8 (*id.* at 6-8).

H. The Court Of Appeals Opinion

The Eastern District of the Court of Appeals reversed. Appx. A16 (COA Op. at 1). It ruled that, under the proper judicial-review standard, the arbitrators' decision could not be set aside on the merits. Appx. A28-A47 (*id.* at 13-32).

On the judicial-review standard, the court held that the FAA governed because the arbitration provision in MSA § XI(c) was "in a [contract] involving commerce" and, indeed, itself provided that "the arbitration shall be governed by the [FAA]." Appx. A30 (*id.* at 15). The court further held that, under FAA § 10(a)(4), "[i]t is not enough … to show that the [arbitrators] committed an error — or even a serious error"; instead, arbitrators exceed their powers on an issue within their jurisdiction "[o]nly if [they] … issu[e] an award that simply reflects [their] own notions of economic justice," as opposed to "even arguably construing or applying the contract" in good faith. Appx. A31-32 (*id.* at 16-17) (quoting *Oxford Health*, 133 S. Ct. at 2068). And thus the court finally held that "the trial court's modification of the Panel's award under a 'clearly erroneous' standard had no basis under the correct FAA standard applicable here." Appx. A42 (*id.* at 27).

On the merits, the court held that the Panel "d[id] not … exceed[ ] [its] authority" in its "ruling on how to treat a partial settlement when calculating the NPM Adjustment." Appx. A40-41 (*id.* at 25-26). The court concluded that it was "within the Panel's authority under the MSA to determine how to treat the 'Term Sheet' Signatory States and reallocate the NPM Adjustment liability in light of the Partial Settlement," since the "MSA does not expressly address how to reallocate the NPM Adjustment among the non-signatory states where the diligence of the Signatory States is no longer contested due to a settlement." Appx. A41 (*id.* at 26).

Having found the MSA "latently ambiguous" on the issue, the court concluded that the Panel acted appropriately by "look[ing] to the case law of post-settlement judgment reduction" and all other "circumstances that cast light on the intent of the parties." Appx. A43-A44 (*id.* at 28-29); *see also* A44-46 (*id.* at 29-31). And thus the court finally concluded that the Panel's *pro rata* ruling could not be disturbed under "the limited standard of review provided by [the] Supreme Court's precedent" in *Oxford Health*: "it [was] clear from the Panel's [Settlement Award] that the Panel took its decision-making role seriously … and made its decision carefully," by "constru[ing] the MSA just as it was asked to do" and "without any hint of using its own notions of economic justice." Appx. A42, A47 (*id.* at 27, 32).

POINTS RELIED ON

I. The Trial Court Erred In Modifying The Settlement Award Because It Went Beyond The Permissible Scope Of Judicial Review, In That (A) Judicial Review Of This Master Settlement Agreement Arbitration Is Governed By The Federal Arbitration Act, Which In This Case Requires The State To Show That The Arbitrators Exceeded Their Powers And Which Forecloses Second-Guessing The Merits Of Their Contract Interpretation, And (B) The Arbitrators Did Not Exceed Their Powers In Interpreting The MSA To Adopt The *Pro Rata* Method For Judgment Reduction After A Partial Settlement, And The Court Held Otherwise By Improperly Reviewing That Interpretation Under A "Clearly Erroneous" Standard

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

Hall St. Assocs., LLC v. Mattel, Inc., 552 U.S. 576 (2008)

Bunge Corp. v. Perryville Feed & Produce, Inc., 685 S.W.2d 837 (Mo. banc 1985)

Lorenzini v. Grp. Health Plan, Inc., 753 S.W.2d 106 (Mo. App. E.D. 1988)

9 U.S.C. § 10(a)

II. The Trial Court Erred In Modifying The Settlement Award Because Its Holding That The *Pro Rata* Ruling Was "Clearly Erroneous" Is Based On A Misinterpretation Of The Contract, In That (A) The MSA's Text, (B) The Background Law Of Judgment Reduction, (C) The Facts, And (D) The State's Own Inconsistent Position All Demonstrate That The Arbitrators' *Pro Rata* Interpretation Was Correct And At The Very Least Reasonable, And Also That The Court's "All Settlers Non-Diligent" Interpretation Was Incorrect And Unreasonably So

Eichenholtz v. Brennan, 52 F.3d 478 (3d Cir. 1995)

In re Enron Corp. Litig., 2008 U.S. Dist. Lexis 48516 (S.D. Tex. June 24, 2008)

Jensen v. ARA Servs., Inc., 736 S.W.2d 374 (Mo. banc 1987)

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

§ 431.150, RSMo.

ARGUMENT

In modifying the Settlement Award, the trial court made two independent legal errors: (I) it drastically exceeded the strict limits on its authority to review the arbitrators' contract interpretation; and (II) it fundamentally misinterpreted the contractual provisions at issue. Each of these legal errors is subject to *de novo* appellate review. *Behnen v. A.G. Edwards & Sons, Inc.*, 285 S.W.3d 777, 779 (Mo. App. E.D. 2009). Thus, as the Court of Appeals correctly did, this Court should reverse the trial court's order modifying the Settlement Award and reinstate the Panel's *pro rata* judgment-reduction ruling.

I. The Trial Court Erred In Modifying The Settlement Award Because It Went Beyond The Permissible Scope Of Judicial Review, In That (A) Judicial Review Of This Master Settlement Agreement Arbitration Is Governed By The Federal Arbitration Act, Which In This Case Requires The State To Show That The Arbitrators Exceeded Their Powers And Which Forecloses Second-Guessing The Merits Of Their Contract Interpretation, And (B) The Arbitrators Did Not Exceed Their Powers In Interpreting The MSA To Adopt The *Pro Rata* Method For Judgment Reduction After A Partial Settlement, And The Court Held Otherwise By Improperly Reviewing That Interpretation Under A "Clearly Erroneous" Standard

The trial court's threshold error was that it applied the wrong standard of judicial review. As detailed below, the court modified the arbitrators' decision on the ground that it was "clearly erroneous." Even assuming the Panel had clearly erred — though it did not err at all, *see* Point II, below — clear error is not a valid basis for modifying its decision. The FAA governs the standard for judicial review of this MSA arbitration. And under U.S. Supreme Court precedent that the trial court disregarded, the FAA does not permit judicial second-guessing of the merits of the arbitrators' interpretation of the contract on an issue within their jurisdiction so long as the arbitrators were at least arguably interpreting the contract in good faith. Here, the three former judges on the Panel indisputably acted in good faith in interpreting the MSA to resolve the post-settlement reallocation dispute that was properly before them. Thus, as the Court of Appeals correctly held, the trial court's failure to apply the proper FAA review standard is sufficient basis to reverse the trial court's order.

A. Under The Governing FAA Review Standard, Courts May Not Review The Merits Of The Arbitrators' Contract Interpretation In Any Respect

The FAA governs arbitration agreements in contracts that, like the MSA, involve interstate commerce. *See* 9 U.S.C. § 2; *Circuit City Stores, Inc. v. Adams*, 532 U.S. 105, 111-12 (2001). Moreover, the MSA's arbitration provision itself

expressly directs that an NPM Adjustment dispute is subject to a "binding arbitration" that "shall be governed by the United States Federal Arbitration Act." LF 1029 (MSA § XI(c)). Thus, as the Court of Appeals correctly held (Appx. A30 (COA Op. at 15)), the FAA controls the standard for judicial review of the Settlement Award's *pro rata* judgment-reduction ruling.

The FAA's judicial-review standard "is among the narrowest known to the law." *CPK/Kupper Parker Commc'ns, Inc. v. HGL/L. Gail Hart*, 51 S.W.3d 881, 883-84 (Mo. App. E.D. 2001). It generally requires courts to confirm covered arbitration awards, subject only to certain narrow grounds authorizing vacatur or modification. 9 U.S.C. §§ 9-11. Those grounds cover specific types of "extreme arbitral conduct" that are "egregious departures from the parties' agreed-upon arbitration." *Hall St. Assocs., LLC v. Mattel, Inc.*, 552 U.S. 576, 586 (2008). This "limited review … maintains arbitration's essential virtue of resolving disputes straightaway" and prevents arbitration from becoming "merely a prelude to a more cumbersome and time-consuming judicial review process." *Id.* at 588.

The trial court here held that the FAA authorized modifying the Settlement Award on the ground that the Panel had "exceeded its authority" because its *pro rata* ruling was "clearly erroneous." Appx. A5-A7 (CC Order at 5-7). But, as the Court of Appeals correctly held, although the FAA authorizes vacatur "where the arbitrators exceeded *their powers*," 9 U.S.C. § 10(a)(4) (emphasis added), that

provision does not authorize any review whatsoever *of the merits* of the arbitrators' good-faith contract interpretation on an issue within their jurisdiction. Appx. A31-A32, A41-A42 (COA Op. at 16-17, 26-27). As demonstrated below, that ban on merits review is clearly established by: (1) the text of FAA § 10(a)(4) itself; (2) the U.S. Supreme Court's controlling interpretation of FAA § 10(a)(4) in *Oxford Health*; and (3) the labor-law arbitration cases upon which *Oxford Health* relied in interpreting FAA § 10(a)(4).

1. Starting with the text of FAA § 10(a)(4), the phrase "where the arbitrators exceeded their powers" has a plain and straightforward meaning: where the arbitrators have *gone beyond* ("exceeded") *the authority that the parties vested in them to resolve certain disputes* ("arbitrators[']… powers"). The provision thus covers cases where arbitrators address a dispute that falls outside the jurisdiction conferred by the parties, or where arbitrators dishonestly resolve a dispute within their jurisdiction based on their own policy preferences rather than the parties' contract. But the provision does not cover cases where arbitrators construe the contract on the merits: even if the arbitrators make a mistake in doing so, the arbitrators have not *gone beyond their authority* to honestly resolve an arbitrable dispute; they have merely erred *in how they exercised that authority*.

This limited scope of FAA § 10(a)(4) is confirmed by the similarly limited scope of the rest of FAA § 10(a). The parallel provisions authorize vacatur for

various types of "corruption," "fraud," "partiality," and "misconduct." 9 U.S.C. § 10(a)(1)-(a)(3). Collectively, these terms all require *procedural misbehavior*, not just *substantive mistakes*. The phrase "exceeded their powers" in FAA § 10(a)(4) should be interpreted likewise under the "commonsense canon" that a statutory phrase "is given more precise content by the neighboring words with which it is associated." *Freeman v. Quicken Loans, Inc.*, 132 S. Ct. 2034, 2042 (2012); *see also Hall St.*, 552 U.S. at 586 ("'Fraud' and a mistake of law are not cut from the same cloth.").

2. The U.S. Supreme Court adopted this precise interpretation of FAA § 10(a)(4) in *Oxford Health*. Specifically, the Court held that, so long as a dispute was within the arbitrators' jurisdiction, a decision "'even arguably construing or applying the contract' must stand, regardless of a court's view of its (de)merits." *Oxford Health*, 133 S. Ct. at 2068 & n.2 (quoting *United Paperworkers Int'l Union v. Misco, Inc.*, 484 U.S. 29, 38 (1987)). In other words, arbitrators "act[ ] outside the scope of [their] contractually delegated authority" on issues within their jurisdiction "*[o]nly if* … [they] issu[e] an award that 'simply reflect[s] [their] own notions of [economic] justice.'" *Id.* at 2068 (quoting *Misco*, 484 U.S. at 38) (emphasis added). As the Court emphasized, this places "a heavy burden" on "[a] party seeking relief under [§ 10(a)(4)]." *Id.*

Oxford Health further explained why the arbitrators' good-faith merits decision, by definition, cannot have "exceeded" their "powers": "'[i]t is [their] construction [of the contract] which was bargained for; … [and thus] the courts have no business overruling [them] …'" because "[t]he potential for … mistakes is the price of agreeing to arbitration." *Id.* at 2070 (quoting *United Steelworkers v. Enterprise Wheel & Car Corp.*, 363 U.S. 593, 599 (1960)). Accordingly, only a bad-faith decision can be said to have "exceeded" the arbitrators' "powers" to resolve an issue within their jurisdiction: they must have willfully "abandoned their interpretive role," not just merely "misinterpreted the contract." *Id.*; *accord id.* (vacatur is permitted "only when the arbitrator strayed from his delegated task of interpreting a contract, not when he performed that task poorly").

Critically, *Oxford Health* admonished that this limitation on relief under FAA § 10(a)(4) applies even if "the arbitrator committed … a serious error." *Id.* at 2068. "[C]onvincing a court of an arbitrator's error — even his grave error — is not enough," because "[t]he arbitrator's construction holds, however good, bad, or ugly." *Id.* at 2070-71.

Finally, *Oxford Health* underscored that rule when applying it, by refusing even to consider, much less uphold in any respect, the merits of the arbitrator's contract interpretation at issue there. The Court stressed that "[n]othing we say in this opinion should be taken to reflect *any* agreement with the arbitrator's contract

interpretation, or *any* quarrel with Oxford's contrary reading." *Id.* at 2070 (emphasis added). Rather than determining for itself whether the arbitrator's interpretation was at least arguable on the merits, the Court looked solely to whether it was arguable that the arbitrator *himself* believed he was interpreting the contract: the Court thus found that he did "just by summarizing [his] decisions," because he "focused on the [contract]'s text, analyzing (whether correctly or not makes no difference) [its] scope." *Id.* at 2069. As the Court concluded, "[u]nder § 10(a)(4), the question for a judge is not whether the arbitrator construed the parties' contract correctly, but whether he construed it *at all*. Because he did, and *therefore* did not 'exceed his powers,' we cannot give Oxford the relief it wants." *Id.* at 2071 (emphasis added).

3. As noted above, when interpreting FAA § 10(a)(4) in *Oxford Health*, the Supreme Court relied heavily on its earlier decisions in *Enterprise Wheel* and *Misco*. *See Oxford Health*, 133 S. Ct. at 2068, 2070-71. Those decisions had developed common-law arbitration rules for purposes of federal labor law, in part by looking to the FAA. *See Enterprise Wheel*, 363 U.S. at 596; *Misco*, 484 U.S. at 40 & n.9. And those decisions further confirm that the standard of review adopted in *Oxford Health* does not permit any review of the merits of the arbitrators' good-faith contract interpretation, even in cases where clear error is alleged.

In *Enterprise Wheel*, the Supreme Court announced that "[t]he refusal of courts to review the merits of an arbitration award is the proper approach to arbitration." 363 U.S. at 596. The Court thus held that an arbitrator's decision on a contract dispute submitted to him by the parties cannot be disturbed unless "the arbitrator's words manifest *an infidelity* to [his] obligation" to interpret and apply the contract, which requires "a[ ] finding that the arbitrator *did not premise his award on his construction* of the contract." *Id.* at 597-98 (emphasis added).

Likewise, in *Misco*, the Supreme Court reaffirmed that "[t]he courts … have no business weighing the merits of the [dispute]" or even "determining whether there is particular language in the [contract] which will support the claim." 484 U.S. at 37. The Court thus held that an arbitrator acting within his jurisdiction cannot be reversed unless he fails to provide "his *honest* judgment." *Id.* at 38 (emphasis added). Accordingly, even where the contract has "plain language," arbitrators exceed their powers only if they intentionally "ignore" such language, not if they just accidentally "misread" it. *Id.*

Indeed, relying on *Enterprise Wheel* and *Misco*, the Supreme Court has held that an arbitration award cannot be vacated on the merits even if it rests on "irrational" findings. *Major League Baseball Players Ass'n v. Garvey*, 532 U.S. 504, 510-511 & n.2 (2001) (per curiam). And the Court deemed that proposition so well established in light of *Enterprise Wheel* and *Misco* that it *summarily*

reversed a federal appellate court's contrary conclusion. *Id.* at 505, 511-12. It is thus beyond all reasonable dispute that, even if a judge were to correctly determine that an arbitrator's contract interpretation was "clearly erroneous" on the merits, this would be a wholly inadequate basis to set aside such an arbitration award.

B. The Panel's *Pro Rata* Ruling Interpreted The MSA On An Issue Within The Panel's Jurisdiction, And Thus The Trial Court Should Have Upheld It Under The FAA Standard Rather Than Modifying It Under An Improper "Clearly Erroneous" Standard

As both the trial court and the Court of Appeals correctly held, under FAA § 10(a)(4), the Panel did not "exceed its powers" in terms of its jurisdiction. The Panel was plainly authorized to determine the proper method for reallocating the 2003 NPM Adjustment among the Non-Signatory States in light of the partial settlement between the Signatory States and the PMs, because that issue had to be decided in order to resolve the parties' dispute over the 2003 Adjustment. Appx. A6-A7 (CC Order at 6-7); Appx. A40-A42 (COA Op. at 25-27).

Accordingly, the only question here is whether the Panel "exceeded its powers" in terms of the merits of its resolution of the post-settlement reallocation issue. And as the Court of Appeals correctly held, the answer is no, because the Panel's *pro rata* judgment-reduction ruling was plainly based on its good-faith interpretation of the MSA. Appx. A42-A47 (COA Op. at 27-32). Thus, as the

Court of Appeals also correctly held, the trial court's modification of the *pro rata* ruling on the ground that it was "clearly erroneous" was itself plainly wrong. *Id.*

1. *Oxford Health* compels the conclusion that the Panel's decision cannot be set aside under FAA § 10(a)(4). The Supreme Court's rationale for why the arbitrator there was at least "'arguably construing' the contract" (133 S. Ct. at 2070) is equally applicable to the Panel's decision here. "[J]ust by summarizing the arbitrator[s'] decision[ ]," it is immediately obvious that the decision was an "interpretation[ ] of the parties' agreement" "through and through," as it "focused on the [contract's] text" in light of the applicable "default rule[s]" — here, the background law of post-settlement judgment reduction. *Compare id.* at 2069-70, *with* LF 250-52, 254-55 (Settlement Award at 9-11, 13-14). The correctness of the Panel's interpretation of the MSA will be detailed below in Point II, but the dispositive point under the FAA is that the Panel's honest "construction holds, however good, bad, or ugly." *Oxford Health*, 133 S. Ct. at 2071.

Indeed, the trial court did not even purport to find, as required by *Oxford Health*, that the three retired judges on the Panel had conspired to "abandon[ ] their interpretive role" in favor of their "own notions of economic justice." *Compare id.* at 2068, 2070, *with* Appx. A4-A7 (CC Order at 4-7). Rather, the court merely deemed the Panel's good-faith interpretation to be "clearly erroneous." *See id.*

2. As already demonstrated, the trial court's "clearly erroneous" standard has no basis in the FAA. *See* pp. 24-29, above. Tellingly, the court provided no justification whatsoever for that standard. *See* Appx. A4-A8 (CC Order at 4-8). It did not try to reconcile a "clearly erroneous" standard with the text of FAA § 10(a)(4) or with the Supreme Court's decision in *Oxford Health* (which it did not even cite). *See id.* Nor did it cite any contrary precedent for a "clearly erroneous" standard. *See id*. In short, the court invented its own improper standard of review.

Likewise, the FAA *Oxford Health* review standard was not applied by the intermediate appellate courts in two other MSA States that also modified the Settlement Award's *pro rata* ruling. *See State 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); *Commw. ex rel. Kane v. Philip Morris USA, Inc.*, 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). Instead, each of those courts held that their own respective state-law review standards applied and authorized modification of the *pro rata* ruling on the grounds that it was "irrational." *See Philip Morris*, 123 A.3d at 673-80; *Philip Morris USA*, 114 A.3d at 52-65. Thus, wholly apart from the fact that the *pro rata* ruling is not irrational, *see* Point II, below, the Maryland and Pennsylvania decisions are doubly inapposite in light of contrary Missouri law.

First, Missouri law squarely provides that the FAA governs here. This Court has held that Missouri courts are generally "obliged to apply [the FAA], and may not apply state law, substantive or procedural, which is in derogation of [that] federal law." *Bunge Corp. v. Perryville Feed & Produce, Inc.*, 685 S.W.2d 837, 839-40 (Mo. banc 1985); *cf. Volt Info. Sciences, Inc. v. Bd. of Trs. of Leland Stanford Jr. Univ.*, 489 U.S. 468, 477-48 (1989) (holding that the FAA preempts state laws that "undermine the goals and policies of the FAA"). And the Eastern District and the Western District have both held that Missouri courts are specifically required to apply the review standard in the FAA rather than the one in the Missouri arbitration statute where (as here) the arbitration agreement is in a contract that involves interstate commerce. Appx. A30 (COA Op. at 15); *Edward D. Jones & Co. v. Schwartz*, 969 S.W.2d 788, 793-95 (Mo. App. W.D. 1998); *cf. Hall St.*, 552 U.S. at 588 (holding that the FAA "substantiat[es] a national policy favoring arbitration with just the limited review needed to maintain arbitration's essential virtue of resolving disputes straightaway").

Second, in any event, Missouri law also squarely prohibits merits review of arbitration awards for "irrationality." Under the Missouri arbitration statute, "[a]n arbitrator's mistake of law or erroneous interpretation of the law does not constitute an act in excess of the arbitrator's powers." *Lorenzini v. Grp. Health Plan, Inc.*, 753 S.W.2d 106, 108 (Mo. App. E.D. 1988); *see also CPK*, 51 S.W.3d

at 883 ("The FAA and Missouri's Arbitration Act are substantially similar."). Thus, "[w]hether the arbitrator's interpretation of the … agreement was right or wrong is irrelevant." *Lorenzini*, 753 S.W.2d at 108. And that is so even if a court considers the arbitrator's interpretation to be "'irrational,'" because "[i]t was within the purview of the arbitrator's powers to clarify *what he considered* to be an ambiguity in the … agreement." *Id.* (emphasis added).[1]

* * *

In sum, as the Court of Appeals correctly held, it is plain that the trial court erred by applying a "clearly erroneous" review standard, and also plain that the Panel's decision cannot be set aside under the FAA *Oxford Health* review standard that properly applies. Accordingly, this point of error alone is sufficient basis to reverse the trial court's order and reinstate the Settlement Award's *pro rata* judgment-reduction ruling, wholly apart from the merits of that ruling.

[1] Insofar as the Maryland and Pennsylvania decisions alternatively suggested that the FAA itself authorizes merits review for "irrationality," *see Philip Morris*, 123 A.3d at 675-76; *Philip Morris USA*, 114 A.3d at 52-53, 57-58, those decisions are irreconcilable with the text of FAA § 10(a)(4) and with the Supreme Court's decisions in *Oxford Health* and its progenitors, *see* pp. 24-29, above.

II. The Trial Court Erred In Modifying The Settlement Award Because Its Holding That The *Pro Rata* Ruling Was "Clearly Erroneous" Is Based On A Misinterpretation Of The Contract, In That (A) The MSA's Text, (B) The Background Law Of Judgment Reduction, (C) The Facts, And (D) The State's Own Inconsistent Position All Demonstrate That The Arbitrators' *Pro Rata* Interpretation Was Correct And At The Very Least Reasonable, And Also That The Court's "All Settlers Non-Diligent" Interpretation Was Incorrect And Unreasonably So

The trial court further erred because it misinterpreted the MSA. As detailed below, the court concluded that the Panel's *pro rata* judgment-reduction ruling was "amending" the MSA's reallocation provision because the contested Signatory States had not "proven" their diligence and thus must all be "treated as non-diligent." But that conclusion is contradicted by the court's own concession that, as the Panel emphasized, the MSA does not expressly say how to reallocate the NPM Adjustment after a partial settlement, let alone instruct that the settling states must be treated as "non-diligent" unless and until their diligence is "proven."

Accordingly, the Panel appropriately resolved this question under the MSA by looking for guidance from the language and structure of the MSA's reallocation provision, from the well-established background law of post-settlement judgment reduction, and from the facts. The Panel's adoption of the *pro rata* judgment-

reduction method in light of those interpretive tools was correct, and at a minimum reasonable. By contrast, none of those interpretive tools provides any support for the contrary "all non-diligent" approach urged by the Non-Signatory States, which renders the trial court's adoption of that approach not just incorrect, but unreasonable. This is especially so given that Missouri itself had previously urged the exact opposite interpretation and has rightly conceded that its current interpretation would make it *better off* than it would have been absent the settlement because at least some of the contested Signatory States would have been found diligent — thereby resulting in a windfall for Missouri at the PMs' expense that would be contrary to public policy since it would discourage settlement.

Notably, the Court of Appeals expressly agreed with much of the Panel's reasoning, though it properly declined to resolve the interpretive question itself given the FAA review standard. This further illustrates that, even if the Panel's *pro rata* ruling were somehow incorrect (it was not), any such hypothetical error would not be remotely "clear," much less "irrational." And it also underscores that no arbitration award would be safe from judicial second-guessing if such a reasonable interpretation adopted in good faith by an arbitration Panel of three former judges could nevertheless be set aside. Thus, as the Court of Appeals correctly held, the trial court's order should be reversed and the Settlement Award's *pro rata* judgment-reduction ruling should be reinstated.

A. The MSA's Text Supports The Panel's *Pro Rata* Interpretation, While The Trial Court's "All Non-Diligent" Interpretation Rewrites That Text

1. Focusing on the MSA's text, the Panel correctly observed that § IX(d)(2) "does not directly speak as to the process to be used when some States settle diligent enforcement and some do not." LF 255 (Settlement Award at 14). That provision says only that the NPM Adjustment "shall apply" to all States "except" for States that "diligently enforced," and that the diligent States' shares are "reallocated" to the "other" non-diligent States. LF 1005-06 (MSA § IX(d)(2)(A)-(C)). It says nothing directly, much less clearly, about how reallocation operates where it is *unknown* whether a State is diligent or non-diligent due to a settlement. *Id.* On this interpretive point, the Court of Appeals expressly agreed with the Panel. Appx. A43-A44 (COA Op. at 28-29).

The Panel also correctly observed that, while § IX(d)(2) does not expressly dictate how to address the post-settlement uncertainty about the diligence of the Signatory States, the provision's language and structure do "indicate" that a *pro rata* judgment reduction is an "appropriate" method for reallocating the NPM Adjustment in these circumstances. *See* LF 251-52 (Settlement Award at 10-11).

For starters, the *pro rata* interpretation addresses the uncertainty about the Signatory States' diligence in a way that is *consistent with* the language and

structure of the MSA. As the Signatory States' diligence is unknown, the *pro rata* interpretation treats their diligence status as unknown under § IX(d)(2). Since it is unknown whether the Signatory States were diligent for purposes of § IX(d)(2)(B), none of their 46% share is reallocated to the Non-Signatory States; but since it is also unknown whether the Signatory States were non-diligent for purposes of § IX(d)(2)(C), they are not subject to reallocation of any of the Non-Signatory States' 54% share. *See* LF 250 (Settlement Award at 9).

Moreover, the *pro rata* interpretation addresses the uncertainty about the Signatory States' diligence in a way that is *supported by* the language and structure of the MSA. Where the diligence of all States is known, § IX(d)(2) expressly reallocates diligent States' shares to the non-diligent States on a "pro rata" basis, rather than on the basis of the non-diligent States' relative fault. LF 1006 (MSA § IX(d)(2)(C)). Thus, where the diligence of some States is unknown due to a settlement, § IX(d)(2) should be interpreted as similarly providing for a reallocation method that accounts for the settling States based on their *pro rata* share, rather than their relative fault. *See id.*

Given all this, the Court of Appeals agreed that the Panel's adoption of the *pro rata* interpretation was "a logical step." Appx. A46 (COA Op. at 31). Indeed, the Panel's decision was not just logical, but correct.

2. By contrast, the trial court's "all non-diligent" interpretation has no basis in the MSA's text. The court concluded that the *pro rata* method "effectively amends § IX(d)(2)" because the court interpreted that provision to say that the contested Signatory States "*have to prove their diligent enforcement*" in order to avoid being "subject to the NPM Adjustment" and "treated as non-diligent" for reallocation purposes. Appx. A7-A8 (CC Order at 7-8) (emphasis added); *see also Philip Morris*, 123 A.3d at 677-80; *Philip Morris USA*, 114 A.3d at 61-65. That conclusion is fatally flawed, for two reasons.

First, the trial court's claim that the Panel's *pro rata* ruling "amended" the MSA is refuted by the court's own opinion. Just one page earlier, the court conceded that "[t]he MSA does not expressly address how to reallocate the NPM Adjustment among the non-signatory states where the diligence of the signatory states is no longer contested due to a settlement." Appx. A6 (CC Order at 6). By definition, the Panel cannot have "amended" the MSA by *interpreting* it to resolve an issue that the court admits the contract "does not expressly address."

Second, MSA § IX(d)(2) simply does not say that States must be treated as non-diligent unless and until their diligence is "proven." Rather, it says only that the NPM Adjustment "shall apply" to all States "except" for States that "diligently enforced," and that the diligent States' shares are "reallocated" to the "other" non-diligent States. LF 1005-06 (MSA § IX(d)(2)(A)-(C)). It thus does not even

contain the word "prove" (or any variant thereof), let alone dictate that a State must be treated as non-diligent unless and until its diligence is "proven" notwithstanding that its diligence is no longer even contested by any party after a partial settlement. *Id.* In short, the trial court rewrote § IX(d)(2) by adding words that are not there.

Tellingly, the court gave no *textual* justification for its characterization of § IX(d)(2) as requiring all States to be treated as non-diligent unless and until their diligence is "proven." Appx. A7-A8 (CC Order at 7-8). Instead, the court appears to have been relying, not on the language of § IX(d)(2) itself, but on *the Panel's own interpretation* of that language in its earlier Burden of Proof Order. *See* Appx. A2 (CC Order at 2); LF 452-53 (Burden of Proof Order at 1-2). The court's reliance on the Burden of Proof Order is also fatally flawed, for three reasons.

First, as the Court of Appeals correctly recognized, the Panel itself had clarified, in two rulings issued between its Burden of Proof Order and the Settlement Award, that the Burden of Proof Order (1) applied only in the specific context of an evidentiary hearing for a State whose diligence was contested, and (2) did not otherwise generally require that a State whose diligence was not contested in an evidentiary hearing must nevertheless be treated as non-diligent unless and until its diligence was proven. *See* pp. 6-7, above. Quite the opposite: under the Auditor Authority Order and No-Contest Order, no State would be allocated any part of the Adjustment "unless and until" it were found *non*-diligent,

and States whose diligence was no longer contested would be "deemed" *diligent* and their shares of the Adjustment reallocated to the non-diligent States. *See id.*

Second, the Burden of Proof Order itself recognized that "[t]he text of the MSA does not mention burdens of proof" on diligence, which is why the Panel relied instead on the *background legal* "principle … in contract cases" that the "party seeking [the] benefit of an 'exception' in a contract 'must prove it.'" LF 455-57, 460 (Burden of Proof Order at 4-6, 9). And the Panel followed the *same interpretive method* in the Settlement Award, by again resolving an issue that the MSA's text does not directly address by looking for interpretive guidance from the relevant background law — in that context, the law of post-settlement judgment reduction. LF 251-52 (Settlement Award at 10-11); *see also* pp. 41-46, below. Although the relevant background law was of course different given the different context, that does not render the Panel's decisions incorrect in any way.

Third, even assuming that the Settlement Award's *pro rata* ruling was somehow inconsistent with the Burden of Proof Order, that would not mean that the Panel had "clearly" "amended" *the MSA's* language. Neither the trial court nor the State has cited a single case, and the PMs are unaware of one, that sets aside an arbitration award on the mere ground of alleged inconsistency with the arbitrators' own prior interpretation of the contract in a different context. (Of course, the

absence of such a case also reflects the fact that merits review of arbitration awards is flatly forbidden under both the FAA and the Missouri arbitration statute.)

In sum, neither MSA § IX(d)(2) nor the Panel's Burden of Proof Order justifies, much less compels, the trial court's "all non-diligent" approach. But § IX(d)(2) does support the Panel's adoption of the *pro rata* judgment-reduction method, as detailed above and further discussed below.

B. The Background Law Of Judgment Reduction Supports The Panel's *Pro Rata* Interpretation, While The Trial Court's "All Non-Diligent" Interpretation Ignores That Law

1. To bolster its interpretation of the MSA's language and structure, the Panel correctly explained that it could "interpret the contract in light of governing law" to help "determine what the appropriate process" was. LF 255 (Settlement Award at 14). On this interpretive point, the Court of Appeals again expressly agreed with the Panel. Appx. A43-46 (COA Op. at 28-31). Indeed, each step of the Panel's reliance on background law was correct.

First: It was appropriate for the Panel to look to the law for guidance in interpreting MSA § IX(d)(2). It is well settled that arbitrators, like courts, can use extrinsic tools of contract interpretation to help ascertain the parties' intent on questions that the contract's language does not directly address. *Gas Aggregation Servs., Inc. v. Howard Avista Energy, LLC*, 319 F.3d 1060, 1065 (8th Cir. 2003)

("the arbitrator must utilize other sources to determine the parties' intent" where "the written agreement is silent" or "there is no clear and unambiguous agreement"). Indeed, the arbitrators' award properly "draws its essence from the [contract] as long as it is derived from the agreement, viewed in light of its language, its context, and *any other indicia* of the parties' intention." *Id.* (emphasis added).

And it is equally well settled that one such interpretive tool that arbitrators may employ is "looking to 'the law' for help" in interpreting the contract. *Enterprise Wheel*, 363 U.S. at 598; *see also Alcan Packaging Co. v. Graphic Commc'n Conf.*, 729 F.3d 839, 842 (8th Cir. 2013) (upholding arbitral award that had interpreted the text of the contract at issue in light of "arbitral precedents" "interpreting similar contracts"). Indeed, "contractual language must be interpreted in light of existing law" because "the provisions of [such law] are regarded as implied terms of the contract" absent contrary indication. 11 Williston on Contracts § 30:19 (4th ed.); *see also Sadler v. Bd. of Educ.*, 851 S.W.2d 707, 712-13 (Mo. App. S.D. 1993) ("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").

Second: It was equally appropriate for the Panel to look to the law of post-settlement judgment reduction. That body of law was developed to apply in this

precise (and quite common) circumstance: when multiple defendants have shared potential liability (*e.g.*, under a contract, as joint tortfeasors, or under a statute), and some defendants wish to settle and some do not. The law recognizes that the strong public policy "favor[ing]" the "settlement of complex litigation" would be "inhibit[ed]" if non-settling defendants were allowed to obtain a windfall in the determination of their own share of the liability merely because of the uncertainty about the settling defendants' share of the liability. *See, e.g.*, *Eichenholtz v. Brennan*, 52 F.3d 478, 486 (3d Cir. 1995).

Accordingly, courts and legislatures around the nation — including in Missouri — have developed judgment-reduction rules for partial settlements that "harmonize" the "encouragement of settlement" with "fairness to [non-settling] defendants." *Id.*; *see also, e.g.*, *Jensen v. ARA Servs., Inc.*, 736 S.W.2d 374, 375-78 (Mo. banc 1987); § 431.150, RSMo. Under those rules, "the non-settling defendants are entitled to a setoff against any judgment ultimately entered against them," *Eichenholtz*, 52 F.3d at 486, but the setoff may not confer "a windfall" that "discourage[s] settlements" by enabling the non-settling defendants to avoid paying their fair share of liability, *Jensen*, 736 S.W.2d at 377-78.

As the Panel correctly explained, the three "standard" judgment-reduction methods for calculating the setoff are "*pro rata*," "*pro tanto*," and "proportionate fault." LF 251 (Settlement Award at 10); *see also, e.g.*, *Eichenholtz*, 52 F.3d at

487 & n.15; *In re Masters Mates & Pilots Litig.*, 957 F.2d 1020, 1028 (2d Cir. 1992); *In re Enron Corp. Litig.*, 2008 U.S. Dist. Lexis 48516, at *20-21 n.5 (S.D. Tex. June 24, 2008). They operate as follows:

Under the "*pro rata*" method, the adjudicator "divides the amount of the total judgment by the number of settling and non-settling defendants, regardless of [each] defendant's culpability." *In re Enron Corp. Litig.*, 228 F.R.D. 541, 560 (S.D. Tex. 2005). In reducing the total liability by the settlers' pro rata share (here, the Signatory States' 46% share of the NPM Adjustment), the *pro rata* method thus ensures that the non-settlers will not bear any of the settlers' pro rata share.

Under the "*pro tanto*" method, the adjudicator "reduces the non-settling defendant's liability for the judgment against him by the amount paid (dollar for dollar) by a settling defendant." *Id.* at 561. It thus uses the settlement amount, rather than the settlers' pro rata share of the total liability, as the basis for the reduction.

Under the "proportionate fault" method, the adjudicator determines "the relative culpability of both settling and non-settling defendants and the non-settling defendant pays a commensurate percentage of the judgment." *Id.* at 560. It thus requires evidentiary proceedings to determine the settlers' actual culpability and reduces judgment against the non-settlers accordingly — even if the reduction proves to be less than the settlers' pro rata share or the settlement amount.

Finally: It was also "appropriate" for the Panel to adopt the *pro rata* judgment-reduction method after "[c]onstruing the parties' contract" in light of the three standard methods. LF 251-52 (Settlement Award at 10-11). We have already set forth the Panel's reasons for why the *pro rata* method is appropriate given the MSA's language and structure. *See* pp. 36-37, above. And those reasons are bolstered by a few additional ones.

For starters, during the hearings on this issue, the objecting States refused to provide a definitive answer when the Panel repeatedly asked them for their view as to which of the three standard judgment-reduction methods was the most appropriate alternative if their "all non-diligent" position was rejected. *See, e.g.*, SLF 72-73 (Mar. 7, 2013, Hr'g Tr. at 241:7-245:19). And that includes Missouri, which had the opportunity to inform the Panel which alternative it would prefer, but never did so. *See, e.g.*, SLF 108 (Mar. 8, 2013, Hr'g Tr. at 378:14-379:5).

Moreover, at least some objectors indicated that their preferred alternative would in fact be the *pro rata* method. *See, e.g.*, SLF 144 (*id.* at 521:9-522:9). That was unsurprising, since the *pro rata* method *greatly benefited* them. The PMs had urged the Panel instead to generally adopt the *pro tanto* method, which limits the non-settlers' judgment reduction to the amount of the settlers' payment. *See* p. 44, above. The PMs had argued that the *pro tanto* method is the near-"universal" default rule in contract cases. *See Evanow v. M/V Neptune*, 163 F.3d 1108, 1119

(9th Cir. 1998); Restatement (Second) of Contracts § 294(3). In fact, Missouri law has long adopted the *pro tanto* method as the default contract rule. § 431.150, RSMo; *Monett State Bank v. Rathers*, 297 S.W. 45, 46 (Mo. 1927). As applied here, the *pro tanto* method would have given the Non-Signatory States a judgment reduction equal only to the amount the Signatory States paid to settle ($243 million) instead of their full 46% Allocable Share as under the *pro rata* method ($528 million). *See* LF 196 (MO Tr. Br. at 31); LF 260 (Term Sheet § I.A.2).

Thus, as the Court of Appeals correctly recognized (Appx. A46 (COA Op. at 31)), the Panel's adoption of the *pro rata* method gave the Non-Signatory States a collective reduction of almost $300 million more than they would have received under the default *pro tanto* rule that applies in Missouri and nearly every other MSA State. And in reducing the Adjustment by the Signatory States' full 46% Allocable Share rather than the dollar amount of the settlement, the Panel's ruling meant that the PMs would sacrifice far more of their potential Adjustment claim from the Non-Signatory States ($528 million) than they received in settlement from the Signatory States ($243 million).

In sum, the *pro rata* ruling is bolstered by the Panel's proper reliance on background judgment-reduction law when interpreting the MSA to resolve the post-settlement reallocation dispute.

2. By contrast, the trial court's "all non-diligent" interpretation has no basis in background judgment-reduction law. As the Panel correctly observed, *none* of the three "standard" judgment-reduction methods presumes that all settling defendants are liable, since settlement is not treated as "tantamount to an admission of liability" and "settling defendants are not regarded as necessarily culpable or liable." LF 254-55 (Settlement Award at 13-14); *see, e.g.*, *Enron*, 2008 U.S. Dist. Lexis 48516, at *56-57. Precisely because it is *unknown* whether the settling defendants are liable, judgment-reduction law does not presume that they are liable in calculating the reduction. Instead, that law either uses the settling defendants' pro rata share or the pro tanto settlement payment as a proxy, or else employs the proportionate fault method to make an actual determination of whether they are in fact liable. *See* pp. 43-44, above. Thus, treating all settlers as liable "would produce a considerably larger reduction in the [non-settlers'] potential obligations than any of th[ose] standard methods." LF 254 (Settlement Award at 13).

Accordingly, the trial court did not and could not cite any law supporting its "all settlers liable" position. Appx. A7-A8 (CC Order at 7-8). And it likewise failed to provide any justification for its refusal to consider judgment-reduction law, which it just completely ignored. *Id.*; *see also Philip Morris*, 123 A.3d at 678-79 (Maryland appellate court justifying its refusal to consider judgment-reduction law solely based on the flawed assertion that the MSA's text purportedly

required all contested Signatory States to be treated as non-diligent unless and until their diligence is determined).

Nor is there any merit to the Pennsylvania appellate court's assertion that "judgment reduction methodology" is inapposite here because it is "premised" on the existence of "joint tortfeasors." *Philip Morris USA*, 114 A.3d at 63. That court notably failed to cite any case that implements this alleged "premise" by refusing to apply judgment-reduction principles due to the absence of "joint tortfeasors." *Id.* And that is because no such "premise" underlies judgment-reduction law.

Insofar as the Pennsylvania court was suggesting that judgment-reduction principles are restricted to *tort* law and do not apply to contract disputes *at all*, that suggestion is demonstrably false: numerous States, including Missouri, have adopted default judgment-reduction rules for the partial settlement of contract disputes. *See* § 431.150, RSMo; *Monett*, 297 S.W. at 46; *see also, e.g.*, Restatement (Second) Contracts § 294(3) & cmt. f; *Evanow*, 163 F.3d at 1119; *Bd. of Educ. v. Zando, Martin & Milstead, Inc.*, 390 S.E.2d 796, 806-08 (W. Va. 1990); *W. Techs., Inc. v. All-American Golf Ctr., Inc.*, 139 P.3d 858, 861 & n.11 (Nev. 2006); *Fed. Land Bank v. Christiansen*, 298 N.W. 641, 645 (Iowa 1941); *Summit Props., Inc. v. Pub. Serv. Co.*, 118 P.3d 716, 730 (N.M. Ct. App. 2005); *RPR & Assocs. v. UNC-Chapel Hill*, 570 S.E.2d 510, 519-20 (N.C. Ct. App. 2002); *In re Haugen*, 998 F.2d 1442, 1451 (8th Cir. 1993). And insofar as the

Pennsylvania court was suggesting that judgment-reduction principles are restricted to *joint-and-several liabilities*, that suggestion lacks any principled basis: judgment-reduction law exists to address the inherent uncertainty that arises from the partial settlement of shared liability, *see* pp. 43-44, above, and that uncertainty is equally present regardless of whether the shared liability arises from legally imposed joint-damages rules or contractually specified payment-reallocation rules. In short, the Pennsylvania court's attempt to distinguish judgment-reduction law is no more successful than the effort of the trial court here simply to ignore it.

C. The Facts Support The Panel's *Pro Rata* Interpretation, While The Trial Court's "All Non-Diligent" Interpretation Contradicts The Facts

As the Court of Appeals correctly recognized, the Panel also appropriately considered the factual circumstance that the *pro rata* interpretation better reflects the uncertainty concerning the contested Signatory States' diligence than does the "all non-diligent" interpretation. Appx. A46 (COA Op. at 31). The range of possible outcomes depending on those States' diligence, and how the various judgment-reduction approaches compare to those outcomes, is illustrated in the following chart:

Approach	**Adjustment Amount Owed by MO**[2]
No reduction (assume all diligent)	$146 million
Pro Tanto	$140 million
Proportionate Fault > if (as before) MO did not contest Signatory States' diligence > if (unlike before) MO did contest Signatory States' diligence	$146 million $46 million to $146 million (depending on findings of the Signatory States' actual diligence)
Pro Rata	$96 million
"Assume all non-diligent"	$46 million

As the chart demonstrates, absent the settlement, Missouri's liability would have ranged from $46 million to $146 million, depending on how many contested Signatory States would have been found diligent. Under the *pro rata* method,

[2] With one exception, the numbers in this chart were calculated in the charts in the State's trial-court brief. *See* LF 188, 196 (MO Tr. Br. at 23, 31). The exception is the *pro tanto* amount, which was calculated here by modifying the State's *pro rata* calculation as appropriate. *See id.*; p. 46, above.

Missouri owes $96 million, which is thus a fair estimation of what its liability would have been. By contrast, under the "all non-diligent" approach, Missouri's liability would plummet to $46 million, which is what it would have been only if all 20 of the contested Signatory States would have been found non-diligent.

But that never would have happened. As the Panel instead found, after having observed nearly three years of proceedings by the time of the Settlement Award, "[t]here is no basis in the facts to assume that every [contested] Signatory State was non-diligent in 2003." LF 254 (Settlement Award at 13). Indeed, as noted, Missouri itself (1) had conceded to the Panel that the contested Signatory States were actually *not* all non-diligent, and (2) had previously declined to contest those States' diligence at all. *See* pp. 9-10, above.

The "all non-diligent" interpretation would thus improperly guarantee that the State *would be better off than if there had been no settlement*, potentially profiting by tens of millions of dollars. That is precisely the sort of "windfall" at the expense of settling parties that judgment-reduction law is designed to prevent in light of the strong public policy against "discourag[ing] settlements." *Jensen*, 736 S.W.2d at 377-78; *see also Eichenholtz*, 52 F.3d at 486; *Lowe v. Norfolk & W. Ry. Co.*, 753 S.W.2d 891, 894-95 (Mo. banc 1988) ("The policy of the law is to encourage settlements."). Nothing in the MSA suggests, let alone clearly provides,

that the parties intended to reject this established policy, to create obstacles to partial settlements, or to reward states that decline to participate.

Notably, neither the trial court here nor the Maryland or Pennsylvania appellate courts disputed the foregoing facts. *See* Appx. A7-A8 (CC Order at 7-8); *Philip Morris*, 123 A.3d at 678-80; *Philip Morris USA*, 114 A.3d at 63-65. And, other than their flawed assertion that the "all non-diligent" interpretation was supposedly compelled by the MSA's text, they provided no justification for interpreting that text to confer a massive windfall on the Non-Signatory States. *See id.* That deficiency underscores the unreasonableness of their interpretation and the reasonableness of the Panel's *pro rata* interpretation.

D. The State's Inconsistent Interpretations Of MSA § IX(d)(2) Refute The Trial Court's Holding That The Panel "Clearly" "Amended" That Provision

One final point provides stark confirmation that MSA § IX(d)(2) lacks the "clear" direction that the trial court asserted. Namely, earlier in the arbitration, the State itself argued *successfully* to the Panel that § IX(d)(2) meant *the exact opposite* of what the State convinced the trial court it meant.

The issue arose in the following context. After its Burden of Proof Order, the Panel faced the question whether the MSA requires the Independent Auditor to allocate all States a share of the NPM Adjustment until they prove their diligence.

See pp. 6-7, above. *There*, Missouri claimed that § IX(d)(2) — with "no ambiguity" — requires that "no State may be subject to an NPM Adjustment *unless and until it is found to have been non*-diligent." Appx. A61 (States' Auditor Br. at 9) (emphasis added). Missouri further said that its claim was unaffected by the Burden of Proof Order, because "the Panel's finding that the States have the burden to establish diligent enforcement does not" mean that a State's "*non*-diligence" must be "presume[d]." LF 429 (Auditor Authority Order at 6). And the Panel *agreed* with Missouri, opining (consistent with its later interpretation in the Settlement Award) that a State is not subject to the Adjustment "unless and until" it is determined non-diligent, and that its Burden of Proof Order did not mean the contrary. LF 442-43 (*id.* at 19-20).

Yet *here*, Missouri told the trial court that § IX(d)(2) means precisely the reverse. It convinced the court that § IX(d)(2) "clearly" requires that all States "have to prove their diligent enforcement" to avoid being "subject to the NPM Adjustment" and "treated as non-diligent" for reallocation purposes. Appx. A7-A8 (CC Order at 7-8). The following table compares the State's argument to the court with its prior argument to the Panel:

The State on MSA § IX(d)(2)	
To the Trial Court (2014)	**To the Panel (2011)**
> All States "have to prove their diligent enforcement" to avoid being "subject to the NPM Adjustment" for reallocation purposes	> "[N]o State may be subject to an NPM Adjustment unless and until it is found to have been non-diligent"
> Burden of Proof Order entails that all States must be "treated as non-diligent" until their diligence is "proven"	> Burden of Proof Order "does not" mean that a State's "*non*-diligence" may be "presume[d]"

The fact that the State has now *successfully* argued that § IX(d)(2) means diametrically opposite things provides proof positive that there are different *arguable* interpretations of that provision. This alone shows that the Panel was not "clearly" "amending" the provision. Thus, the trial court's ruling cannot stand even under its own (erroneous) standard of review.

* * *

The foregoing analysis demonstrates that the Panel's *pro rata* interpretation was correct and at a minimum reasonable, whereas the trial court's "all non-diligent" interpretation was not just incorrect but unreasonably so. More fundamentally, though, the analysis of the respective merits of those dueling interpretations eliminates any credible dispute about the following three points:

First, the arbitrators did not "abandon[ ] their interpretive role" to further their "own notions of economic justice," and thus the *pro rata* ruling cannot be set aside under the proper FAA standard, no matter how "good, bad, or ugly." *Oxford Health*, 133 S. Ct. at 2068, 2070-71. *Second*, even assuming that the arbitrators could have been reversed if they had committed "clear" or "irrational" error, they made no such error and their decision "must stand," because they "constru[ed] [and] appl[ied] the contract" in a manner that was at the very least "arguabl[e]," "regardless of a court's view of its (de)merits." *Cf. id.* at 2068. *Finally*, if the good-faith, reasonable arbitral interpretation of three former federal judges can nevertheless be set aside through a "full-bore legal … appeal[ ]," then arbitration truly has become "merely a prelude to a more cumbersome and time-consuming judicial review process," thereby "bring[ing] arbitration theory to grief in post-arbitration process." *Id.*; *Hall St.*, 552 U.S. at 588.

CONCLUSION

As the Court of Appeals correctly held, this Court should reverse the trial court's order modifying the Settlement Award and reinstate the Panel's *pro rata* judgment-reduction ruling.

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Respectfully submitted,

/s/ Jeffery T. McPherson

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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 June 30, 2016.

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