IN THE SUPREME COURT OF MISSOURI

STATE OF MISSOURI ex rel. JEREMIAH W. (JAY) NIXON,	)	
Appellant/Cross-Respondent,	)	
v.	)	Case No. SC95422
THE AMERICAN TOBACCO COMPANY, INC., et al.,	)	
Respondents/Cross-Appellants.	)	

SUBSTITUTE OPENING BRIEF OF APPELLANT/CROSS-RESPONDENT STATE OF MISSOURI

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JURISDICTIONAL STATEMENT

Appellant/Cross-Respondent State of Missouri appeals from a final Order and Judgment issued on June 2, 2014 by the Honorable Jimmie Edwards, Circuit Judge of the Missouri Circuit Court 22nd Judicial Circuit. On September 22, 2015, the Missouri Court of Appeals Eastern District granted Missouri's appeal, but also granted the cross-appeal of Respondents/Cross-Appellants. The appellate court transferred this case to this Court on December 2, 2015. This Court has exclusive jurisdiction under Article V, § 3 of the Missouri Constitution.

STATEMENT OF THE CASE

In late 1998, Missouri and 51 other States and U.S. Territories ("States") settled then-pending state-by-state litigation by entering into the Master Settlement Agreement ("MSA") with certain manufacturers of tobacco products, referred to in the MSA as Participating Manufacturers ("PMs"). All other manufacturers of tobacco products—those not joining the MSA—are referred to as Non-Participating Manufacturers ("NPMs"). The MSA contains a narrowly-drawn arbitration clause that preserves Missouri's and the PMs' rights to resolve nearly all their MSA disputes before a single Missouri circuit judge—the Hon. Jimmie Edwards of the 22nd Judicial Circuit. Only a few disputes are specifically identified for resolution through arbitration instead. The MSA's arbitration clause provides that the Federal Arbitration Act ("FAA") shall govern, and it refers to the duty of "each of the two sides to the dispute" to select an arbitrator. It does not define the terms "sides" or "dispute" and is completely silent regarding multi-party, nationwide, collective, or class arbitration. And, anticipating the complexity of the disputes that would surely arise under the MSA (whether resolved by litigation or arbitration), the parties agreed to an integral and indispensable limitation on their ability to modify their contract—the MSA cannot be amended without the consent of all affected parties.

In 2007, the trial court granted the PMs' motion to compel Missouri to arbitrate the 2003 dispute over the availability to the PMs of a downward NPM Adjustment to their annual payment to all States, and also whether Missouri had diligently enforced its Qualifying Statute during 2003. As neither the MSA's arbitration clause nor the trial court's order compelling that arbitration mentions multi-party, nationwide, collective or class arbitration, let alone *requires* it, the PMs offered Missouri a 20% reduction in any potential liability (ultimately totaling approximately $5 million) as an inducement to *voluntarily* join Missouri's pending arbitration with similar arbitrations the PMs had pending against all other States. In 2009, Missouri thus signed the "Agreement Regarding Arbitration" between the PMs and 47 other States to join each state's pending arbitration with the PMs into a truly national arbitration to be heard by a single panel of arbiters.

Fifty-one States and the PMs commenced that first-ever collective arbitration in July 2010 which concluded in September 2013 with diligence determinations made for only 31 States. As will be described in the Statement of Facts, Missouri's experience with that arbitration was so

horrendous that part of the Panel's award was vacated by the trial court.[1] Having observed the inequities of collective arbitration and endured its

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[1] The Panel's Stipulated Partial Settlement and Award ("Partial Settlement") implementing the PMs' Term Sheet Settlement with 19 (24 as of the filing of this brief) Signatory States affected the settlement of the Signatory States' 2003–2014 NPM Adjustment liability to the PMs but did not determine those Signatory States' diligence or non-diligence and so did not settle those Signatory States' liability for contribution to their sister states. The Panel's Partial Settlement thus shifted onto Missouri $50 million in additional 2003 NPM Adjustment liability. Under the requirements of the MSA, it would have been reallocated from the 9 States found diligent to the Signatory States instead because they had not proven their diligence and thus their right to the exemption from the burden of the downward adjustment to their payments. Finding the Panel exceeded its jurisdiction when it effected this unauthorized amendment to Missouri's MSA rights of contribution from the Signatory States, the trial court modified the arbitration award to prevent that additional liability from being foisted off on to Missouri, without affecting the award or liability of any other State. Missouri defends the trial

inherent prejudice to the rights of individual states once already, Missouri is not inclined to agree to participate in a collective arbitration to resolve the PMs' next-in-line dispute with Missouri. So, pursuant to the MSA's arbitration clause, Missouri moved the trial court to compel the PMs (each of the two "sides") into an arbitration of their narrowly-framed "dispute": Did Missouri diligently enforce its Qualifying Statute during the 2004 calendar year? There are only two sides to this dispute, just as there are only two sides to this appeal.[2]

But, the trial court denied Missouri's motion, concluding erroneously that the parties when signing the MSA in 1998 intended to require nationwide arbitration for their 2004 dispute. That ruling should be reversed because, as correctly found by the court of appeals (I) the text of the MSA and the parties' course of conduct since 1998 demonstrates that Missouri did not consent to collective arbitration of any disputes; (II) the PMs' decision to settle their disputes with half the States operates as their concession that a

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court's modification of that arbitration award, and addresses the appellate court's erroneous conclusion on that issue, in the PMs' cross appeal.

[2] The PMs did not move to compel Missouri into arbitration of any additional or different issues, or with any other parties.

collective arbitration with all States is neither required under the MSA nor now possible to convene; and (III) a collective arbitration is inherently prejudicial to Missouri's right to due process.

STATEMENT OF FACTS

A. Missouri and 51 other states and territories settle their individual lawsuits against the tobacco industry by entering into the MSA.

In the late 1990s, Missouri sued more than a dozen tobacco companies in the Circuit Court for the City of St. Louis to recover healthcare costs the State incurred in treating smoking-related illnesses. Many other states filed similar lawsuits in their own courts around the same time. In November 1998, 52 sovereign states and territories ("States") settled their pending lawsuits by entering into the Master Settlement Agreement ("MSA") with a number of tobacco companies, which the MSA refers to as Participating Manufacturers ("PMs"). In exchange for the States dismissing their consumer protection claims that the PMs had engaged in fraudulent and deceptive trade practices for decades, the PMs agreed: (a) to restrict their advertising, sponsorship, lobbying, and litigation activities, particularly those related to youth (*See generally*, MSA); and (b) to make annual payments to the States in perpetuity. MSA §IX (c), LF 998. The MSA was hailed as a "landmark agreement." *Lorillard Tobacco Co. v. Reilly*, 533 U.S. 525 (2001). Since 1998, several dozen companies have joined the MSA and become PMs.

Cigarette producers that do not join the MSA are referred to as Non-Participating Manufacturers ("NPMs").

The MSA sets forth the specific amounts *all* PMs agree to pay the States each year based on their relative market share, subject to a number of upward or downward adjustments calculated by an Independent Auditor ("IA").[3] MSA §IX, LF 318. Once the IA calculates all the adjustments, the PMs make their annual payments to an escrow agent, who then apportions the funds to each State according to its previously negotiated "allocable share." MSA at Exhibit A, LF 343. Missouri's allocable share is 2.2746011%, meaning that each year Missouri receives approximately 2.27% of the total annual payments made by the PMs. MSA at Exhibit A, LF 343. Based on 2002 sales, for example, the PMs were obligated to pay the States

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[3] These adjustments include the Inflation Adjustment, the Volume Adjustment, the Previously Settled States Reduction, the Non-Settling States Reduction, the Non-Participating Manufacturer ("NPM") Adjustment, the offset for miscalculated or disputed payments, the Federal Tobacco Legislation Offset, the Litigating Releasing Parties Offset, and the offsets for claims over. MSA §IX(c), LF 318-20, 334, 336. The adjustment at the center of this dispute is the NPM Adjustment.

approximately $6.4 billion on April 15, 2003. Of that amount, Missouri's share was approximately $146 million.

B. The MSA offers a potential reduction to the PMs' annual settlement payments if they lose market share to the NPMs due to the MSA.

Because the NPMs are not required to make annual payments to the States, they may be able to price their cigarettes at a lower and more competitive rate than the PMs. That lower price for NPM cigarettes has the potential to undermine the MSA's public health goals by shifting market share from PMs to the NPMs, which are not bound by the MSA's restrictions on advertising, particularly to youth.

The MSA attempts to ameliorate any cost disparity between PMs and NPMs by potentially reducing the PMs' annual payment obligations to the States, if the PMs can prove two conditions have been met:

1) The PMs suffer a "Market Share Loss," meaning that in considering the national market (not the market in any given State), the PMs' market share decreased by more than two percentage points as compared to 1997 levels. MSA §§IX(d)(1)(A) and IX(d)(1)(B)(iii), LF 321-22; and

2) The IA finds that the MSA was a "significant factor" contributing to that national Market Share Loss. *Id.* §IX(d)(1)(C), LF 323-24.

If both conditions are proved, an "NPM Adjustment" is available to the PMs, which could lower their payment obligation that year by three times the percentage of national market share the PMs lost in excess of the 2% threshold. The downward NPM Adjustment is then available to be deducted from *every* State's MSA payment on a *pro rata* basis according to its allocable share. *See* MSA §IX(d)(2), LF 325-30.

The NPM Adjustment offers both a carrot and a stick to the States. Individual States can avoid their allocable share of the downward NPM Adjustment by enacting and "diligently enforcing" model legislation[4] (also called a Qualifying Statute). States that then diligently enforce their Qualifying Statute do not have their annual MSA payments reduced by the

[4] The legislation requires NPMs selling product in the State to escrow funds to pay future judgments on a per-cigarette basis roughly equivalent to the PMs' per cigarette payment under the MSA. Missouri enacted its Qualifying Statute on July 1, 1999. *See* RSMo. §§196.1000-1003.

NPM Adjustment. The possibility of the diligent enforcement exemption is the carrot.

However, the amount of money by which each Diligent State's payment would have been reduced by the NPM Adjustment, had it not diligently enforced its Qualifying Statute, does not disappear. That financial liability gets *re*allocated among all other States that failed to enact and then diligently enforce their own model legislation. MSA §§IX(d)(2)(B)-(D), LF 325. Thus, there are two components to the NPM Adjustment liability of any "Non-Diligent" State: (a) the Non-Diligent State's original allocable share of the NPM Adjustment, plus (b) a pro rata portion of the NPM Adjustment that has been *reallocated* from the "Diligent States." A Non-Diligent State's total loss from the NPM Adjustment (after reallocation) is capped at the amount of its annual payment from the PMs because, depending on the ratio of Diligent to Non-Diligent States, the reallocated portion of the NPM Adjustment may be substantially greater than a Non-Diligent State's own allocable share. MSA §IX(d)(2)(C), LF 326. The harshness of reallocation is the stick.

The PMs have successfully argued that the burden of proving the two conditions precedent to the NPM Adjustment (Market Share Loss and Significant Factor) lies with the PMs, while the burden of proving diligent enforcement lies with the State claiming the exemption. The PMs lost

national market share to the NPMs in 2003[5], resulting in a potential NPM Adjustment of $1.148 billion. Final Award re: State of Missouri at 8, LF 287. Missouri's original allocable share of the 2003 NPM Adjustment was approximately $26 million. *See* MSA at Exhibit A, LF 343. However, the reallocation process could have cost Missouri up to its full 2003 MSA payment of $146 million if it had been the only State found non-diligent.

C. The MSA requires disputes over annual payment calculations to be resolved through binding arbitration, and prohibits amendments to the MSA absent consent of all affected parties.

All MSA-related disputes between Missouri and the PMs are to be resolved in Missouri state court except for those few specifically identified for arbitration:

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[5] Although the PMs lost *national* market share to the NPMs from 2002 to 2003, the PMs actually *gained* market share over the NPMs in Missouri from 2002 to 2003. Mo. Hrg. Tr. 5/25/12 at 1014:15-19, LF 618. Thus, the Panel's finding that Missouri was responsible for even a portion of the market share loss the PMs experienced in other States during 2003 was against the weight of the evidence.

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

MSA §XI(c), LF 332; *see also* §§IX(j) & XI(i), LF 872-75, 877-83. The present dispute between Missouri and the PMs—whether Missouri diligently enforced its Qualifying Statute during the 2004 calendar year—is a "dispute arising out of or relating to calculations performed by … the Independent Auditor." MSA §XI(c), LF 332. Anticipating the complexity of these and other disputes that would surely arise under the MSA, which binds 52 sovereigns and nearly an entire industry, the States and the PMs agreed that the MSA

cannot be amended without the consent of all affected parties. MSA §XVIII(j), LF 341.

D. The trial court compels Missouri to arbitrate the *2003* NPM Adjustment Dispute.

The MSA's arbitration provision was first examined by the trial court in 2006 when the PMs moved pursuant to §XI(c) of the MSA to compel Missouri to arbitrate the availability of an NPM Adjustment to the PMs and Missouri's diligent enforcement during 2003. PMs' Motion to Compel Arbitration, LF 348. At that time, the PMs argued that the MSA's "unitary payment system" required each state to have its diligent enforcement arbitrated before a single arbitral body. LF 353. As the PMs acknowledged before the trial court: "Each [ ] State has a vital—and conflicting—interest in whether other states are subject to the Adjustment" due to Section IX(d)(2)(C) of the MSA, which reallocates a Diligent State's portion of the NPM Adjustment to the Non-Diligent States, "causing a further downward adjustment in the amount [the non-diligent States] receive under the MSA." LF 353.

The State of Missouri opposed the PMs' Motion and requested instead that the trial court issue declaratory relief construing the MSA term

"diligently enforced" under Missouri law. Mo. Ct. Order, Jan. 22, 2007 at 2, LF 369. The trial court denied Missouri's request and granted the PMs' motion to compel arbitration, holding that: "The parties are ordered to submit their dispute to arbitration as provided for in §XI(c) of the MSA." LF 375. The order did not require Missouri to consolidate its arbitration with any other State's, nor did it require Missouri to submit to a "nationwide" or collective arbitration proceeding. LF 375. The trial court held only that Missouri and the PMs must arbitrate "their dispute" in accordance with the terms of the MSA. LF 375.

E. For valuable consideration from the PMs, Missouri agrees to join a "nationwide" 2003 arbitration to resolve several legal issues common to most states.

In order to induce the States to participate in a collective arbitration before a single arbitration panel to resolve issues with national scope and every State's 2003 diligent enforcement, the PMs offered Missouri and the other States significant incentives. Missouri and 47 other States then entered into an Agreement Regarding Arbitration ("ARA"), in which the PMs agreed, among other things: 1) to provide a liability reduction of 20% for any State ultimately found non-diligent by the panel; and 2) to release over $500

million held in a disputed payments account (of which Missouri received a share). ARA §§3 & 4, LF 769-70. The States and the PMs agreed to arbitrate pursuant to the MSA's arbitration clause, MSA §XI(c), and they defined their NPM Adjustment dispute broadly: Whether the PMs are entitled to a 2003 NPM Adjustment, including the diligent enforcement of individual Settling States. LF 763-64. They further agreed to arbitrate 5 additional, specifically-articulated disputes. LF 775. The States and the PMs did not agree to submit any other section of the MSA, or any other dispute, to the Panel's jurisdiction. *See generally*, ARA, LF 763-75.

The parties selected a three-member arbitration panel (the "Panel"), which convened in July 2010, to adjudicate the rights and obligations of 51 States[6] with regard to their articulated disputes. For nearly two years, the

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[6] Fifty-one of the MSA's 52 States participated at the onset of the national arbitration, even though only 48 States had signed the ARA. The MSA States include the District of Columbia, and the Territories of Puerto Rico, the Virgin Islands, American Samoa, Guam, and the Northern Mariana Islands and all States except Texas, Florida, Minnesota, and Mississippi, which entered into settlement agreements with the tobacco companies separate from the MSA. Montana was the only MSA State that did not

PMs and the States conducted extensive discovery (complete with extensive discovery disputes), and briefed and argued the disputes set forth in their ARA before the Panel which convened hearings in cities around the country—all before the state-specific hearings regarding diligent enforcement began.

F. The 2003 Arbitration Panel rules that the PMs are not entitled to the NPM Adjustment until every State arbitrates whether it diligently enforced, with the burden of proof on the States.

At the commencement of the 2003 arbitration, all 51 States claimed to have diligently enforced their Qualifying Statutes during 2003, and the PMs disputed the diligence claims of every State. The Panel then addressed and issued orders on a number of the disputes submitted to it by the parties under their ARA. Significantly, the Panel acknowledged that its jurisdiction was limited. Panel Order Re: Independent Auditor at 27, LF 450. Seven months into the arbitration, the Panel accepted the PMs' argument that each individual State bears the burden of proving its own diligence if it wants to

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participate in the national arbitration. Although Montana had signed the ARA, its MSA court retained jurisdiction over Montana's dispute with the PMs, rather than ordering it into arbitration.

avoid its share of the NPM Adjustment. Panel Order Re: Burden of Proof ("Burden of Proof Order"), LF 457. The PMs had argued that the diligent enforcement safe harbor is an exemption from the States' *joint* obligation to pay the NPM Adjustment, not an element of the PMs' claim against each individual State:

> Section IX(d)(2) expressly states that the general rule is that the Adjustment applies to 'all Settling States,' and that diligent enforcement is an 'except[ion]' to that general rule for individual States. Indeed, ***if a State did not claim diligent enforcement, the MSA is clear that the Adjustment would apply to that State*** once the Market Share Loss and Significant Factor conditions were met. *See* MSA § IX(d)(2)(A).

PM Mem. on Burden of Proof at 11-12, LF 482-83 (emphasis added). In other words, according to the PMs, if a State does nothing to prove its diligence, it *must* share in the NPM Adjustment *by default*.

The Panel analyzed MSA §§IX(d)(2)(A) and (B) and found that "though the NPM Adjustment applies generally to each State's allocated payment, a State can avoid this adjustment" by diligently enforcing its Qualifying Statue

during the year in question. LF 454. The Panel then analyzed MSA §IX(d)(2)(C) and found that:

> [w]here an individual State has 'diligently enforced' its Qualifying Statute, the NPM Adjustment applies still to the PMs' annual payments, but none is allocated to that State's share of the payment obligation. Rather, that State's share is 'reallocated' to all other non-qualifying States that have not diligently enforced their own Qualifying Statute.

LF 454.

The Panel further found that "diligent enforcement is an 'except[ion]' to the general rule that the Adjustment applies to 'all Settling States,'" LF 458, and specifically found that "no language in the MSA supports a finding that the States can by-pass an inquiry regarding whether they satisfied their contractual obligation for avoiding a payment adjustment through the NPM Adjustment." LF 462. The Panel ruled that MSA §IX(d)(2) requires that "the States must bear the burden of proving that they diligently enforced their respective Qualifying Statutes for purposes of the 2003 NPM Adjustment." LF 465. At no point in its Burden of Proof Order did the Panel limit the applicability of its ruling to any particular time in the arbitration, such as the close of discovery or the evidentiary hearing of any State.

Four months after issuing its Burden of Proof Order, the Panel issued its Order regarding the IA's refusal to allocate the NPM Adjustment to all States prior to determinations of each State's diligent enforcement. May 23, 2011 Order Re: PMs' Request for Order Re: Independent Auditor Authority, LF 424-50. In this Independent Auditor Order, the Panel cited affirmatively to its earlier Burden of Proof Order in which it "decided that the States had the burden of proving that they had diligently enforced their qualifying statutes if they wanted to avoid the NPM Adjustment" and "concluded that even if the NPM Adjustment is appropriate at first blush under [MSA §IX](d)(1), it nevertheless shall not be applied if a State enforced diligently its qualifying statute at all relevant times, as per subsection (d)(2)." LF 437. The Panel further reaffirmed its holding in the Burden of Proof Order that the MSA did not "support a finding that the state can by-pass an inquiry regarding whether they satisfied their contractual obligation for avoiding a payment adjustment through the NPM Adjustment." LF 438.

The Panel distinguished its earlier inquiry into the MSA's burden on the States to prove their diligent enforcement in order to avoid a downward NPM Adjustment to their annual payments from the Panel's inquiry into "what the [Independent] Auditor's duties were, what the Auditor should have done or when the Auditor should have done it." LF 442. The Panel found that

there was "no Available NPM Adjustment unless and until the diligent enforcement determination was made, and thus for 2003 the Auditor could not [have already] appl[ied] the NPM Adjustment." LF 442. Further enforcing each State's obligation to prove its diligence, the Panel held "that there must be an individual determination of each States' diligence prior to the [Independent] Auditor's application of the NPM Adjustment." LF 443.

The PMs took extensive discovery to determine which States' claims of diligent enforcement the PMs would continue, in "good faith," to contest. On November 3, 2011, the PMs declared they would no longer contest the diligence of 12 of the smallest states and 4 territories (the 16 "No-Contest States") but would continue to contest the diligence claims of all the remaining States. PM Notice of Contest, LF 496. The Panel provided Missouri and all other still-contested States 30 days to challenge the diligence of these 16 No-Contest States because releasing even one State from the reallocation process necessarily increases the potential liability of all remaining States. *See* Panel Order Re: PM Mot. for Clarification on No-Contest Issue, LF 500. No State chose to contest the diligence of the 16 No-Contest States, however, because even the PMs–with every incentive to dispute it—believed they were diligent. Subsequently, the Panel found that

> [i]f no PM or state challenges the diligent enforcement of a particular state, when all have had the opportunity to do so, there is no rational basis for conducting a hearing. Where there is no challenge to a state's claim to diligent enforcement, a No-Contest decision can be interpreted by the Panel as the functional equivalent of diligent enforcement by the uncontested state.

Panel Order Re: PM Mot. for Clarification on No-Contest Issue at 17-18, LF 512, and 516-17. The Panel reiterated that "each State bears the burden of proof when its claim of diligent enforcement is challenged" but that "the burden to prove diligent enforcement comes into play only when a state's contested claim is required to be resolved [and] the Burden of Proof Order did not address the question of what process the Panel should employ when the claim of diligent enforcement is not challenged" by either the PMs or any State. LF 512-13.

The Panel then actually determined the diligence of the 16 No-Contest States and acknowledged that the MSA's reallocation provision would shift their NPM Adjustment liability to any States eventually found not diligent, holding:

> [a]ny Settling State whose diligent enforcement for the year 2003 is not contested by any PM or State will be deemed by the

> Independent Auditor for purposes of Section IX(d)(2)(B)-(C) of the MSA as a Settling State that diligently enforced its Qualifying Statute for that year only and is therefore not subject [to] the 2003 NPM Adjustment [and] the share of the 2003 NPM Adjustment (if any) of a Settling State whose diligent enforcement is not contested by any PM or State will be governed by the reallocation provisions of Sections IX(d)(2) and IX(d)(4) of the MSA, and will thus be reallocated among all Settling States that did not diligently enforce a Qualifying Statute during 2003 as provided in those provisions.

LF 516-17.

G. During Missouri's state-specific diligence hearing, the 2003 Panel assures Missouri it will have an opportunity to contest the diligence of any State that later settles with the PMs.

To determine the diligence of the remaining 35 States (the "Contested States"), the Panel held an initial evidentiary hearing on issues common to all Contested States in April 2012, followed by a series of state-specific evidentiary hearings from May 2012 through May 2013. *See* Common Case Hearing Transcript, LF 622. When it finished hearing all the States' cases,

the Panel was to determine the diligence of all 35 Contested States. The IA could then reallocate the NPM Adjustment liability shares of the Contested States the Panel found had diligently enforced their Qualifying Statutes during 2003 (plus those of the 16 No-Contest States) to any States found not diligent by the Panel. *See* Final Award Re: State of Missouri, 2003 NPM Adjustment Proceedings at 13, LF 292. The PMs and the States agreed that Missouri would be the first State to present its case. In addition to the evidence presented at the Missouri hearing, Missouri and the PMs agreed that the record of evidence for Missouri's case would also include certain evidence received in the Common Case Hearing.[7]

On the first day of Missouri's state-specific hearing, the Panel wished to verify that none of the Contested States had asserted claims challenging the diligence of any of the 16 No-Contest States. Mo. Hrg. Tr. 5/21/12 at 13:15-20, LF 560. Counsel for Missouri responded that there were no State v. State claims pending at that moment, but *expressly reserved* Missouri's right

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[7] *See* Missouri's and PMs' Joint Submission of Exhibits and Demonstratives from the Missouri Hearing ("Joint Submission from Mo. Hrg."), LF 519-57.

to assert claims against any Contested State if the PMs later decided to release any contested state from the arbitration for any reason:

> We believe [that there are no State v. State clams pending], Your Honor, with one caveat. There was some discussion earlier on as to whether *sometime late in the arbitration* the PMs might decide to let out additional States rather than continuing to contest them. At that point, we will have already passed the deadline for us to file a contest, *so we simply ask to reserve the right to be able to do so at that time*.

Mo. Hrg. Tr. 5/21/12 at 13:24-14:7, LF 560-61 (emphasis added). The Panel Chair replied, "Sure," and Missouri understood that it would have the opportunity to protect its right of contribution by contesting another State if the PMs ceased to contest that State themselves. *See* Mo. Hrg. Tr. 5/21/12 at 14:8, LF 561.

Missouri called five fact witnesses during its case-in-chief, including the Hon. Paul Wilson, who had worked at the Missouri Attorney General's Office when the MSA was signed. *See* Final Award Re: State of Missouri, 2003 NPM Adjustment Proceedings at 18, LF 297. Judge Wilson testified that both the States and the PMs understood diligent enforcement to be a

good faith, efforts-based standard at the time of contracting rather than an objective, results-based "compliance rate" standard. *See* Mo. Hrg. Tr. 5/21/12 at 104:3-20, LF 562. Judge Wilson thus corroborated testimony from the PMs' own Common Case witness, Bhavani Parameshwar, that the Parties had always contemplated diligent enforcement to be a function of efforts rather than results. *See* Common Hrg. Tr. 4/24/12 at 2045:20–2046:16, LF 632–33. Missouri then called forensic accountant Donna Beck Smith to summarize Missouri's documented efforts to enforce its Qualifying Statute during 2003. *See* Mo. Hrg. Tr. 5/23/12 at 364, LF 582. Of the 47 non-compliant NPMs who sold cigarettes in Missouri in 2002, Missouri took various enforcement actions against all but two of them in 2003. *See* Mo. Hrg. Tr. 5/23/12 at 426, LF 590. Between them, those two NPMs sold only 21,976 cigarettes—approximately 0.00002% of the total number of cigarettes sold in Missouri in 2002. *See* Mo. Hrg. Tr. 5/23/12 at 425:22–426:13, 396:8–397:4, LF 589–90, 584–85. Of the 34 non-compliant NPMs who sold cigarettes in Missouri in 2003, Missouri took various enforcement actions against all but one, which had sold only 1,200 cigarettes that year—an "infinitesimal" percentage of the total number of cigarettes sold in Missouri in 2003. Mo. Hrg. Tr. 5/23/2012 at 430:9–431:9, LF 591–92. Finally, Ms. Smith testified that, in Missouri, the PMs actually gained market share over the NPMs from 2002 to 2003. *See* Mo.

Hrg. Tr. 5/25/12 at 1014:15-19, LF 618; Joint Submission from Mo. Hrg. at Ex. MOH EX_0267, App. 12, LF 535-36.

During their case-in-chief—and contrary to the testimony of their own fact witness from the Common Case—the PMs called expert witnesses to opine that "diligent enforcement" should be measured not by the efforts Missouri took to enforce its Qualifying Statute in 2003 but rather by the results Missouri achieved. The PMs' experts testified that NPMs deposited escrow moneys in compliance with Missouri's Qualifying Statute as to only 24% of the cigarettes they sold in 2002, as compared to an alleged 79% "national average compliance rate" in the No-Contest States. *See* Mo. Hrg. Tr. 5/23/12 at 530:17-531:24, LF 597-98. On cross examination, the PMs' experts conceded that, although there was no evidence that underreporting of NPM sales occurred in Missouri, they had assumed massive underreporting when calculating Missouri's 24% "compliance rate" but had not assumed any underreporting in any other States when estimating their 79% national average compliance rate. Mo. Hrg. Tr. 5/23/12 at 599:2-5; 562:9-24; 566:4-16; 571:1-22, LF 599-602, 606.

At the conclusion of Missouri's five-day hearing in May 2012, Missouri believed that the Record in its case was closed. Mo. Hrg. Tr. 5/25/12 at 1145:4–1146:2, LF 619-20.

H. The 2003 Panel receives additional evidence about Missouri's diligence during 12 of the 18 subsequent hearings without providing Missouri notice or an opportunity to be heard.

Following Missouri's hearing, 18 other States tried their cases before the Panel. During 12 of those hearings, and without notice to Missouri, the Panel allowed the PMs and the other States to offer argument and testimony that Missouri allegedly failed to diligently enforce its Qualifying Statute in 2003.

During Illinois's state-specific hearing, for example, all three arbitrators asked PM counsel to elaborate on the testimony his expert had given in Missouri's hearing about its alleged 24% "compliance rate" as compared to the expert's differently-calculated "national compliance rate" of 79%. Ill. Hrg. Tr. 5/29/12 at 96:1-20, LF 645. Though Missouri counsel had discredited the expert's flawed and inconsistent calculations during the Missouri hearing, the Panel allowed the PMs to rehabilitate their witness during the Illinois hearing without notice or the opportunity for cross-examination by Missouri. *See* Mo. Hrg. Tr. 593:4-596:15, 599:2-23, 621:13-622:8, 629:2-630:18, LF 602-10; *compare* Ill. Hrg. Tr. 5/29/12, LF 640-51. Further, though the PMs' expert conceded during Missouri's hearing that he had no evidence of underreporting in Missouri, PM counsel represented to the

Panel during the Illinois hearing that Missouri's failure to conduct field audits of distributors led to underreporting by those distributors in Missouri. *See* Ill. Hrg. Tr. 5/29/12 at 31:12-17, LF 642. Drawing a contrast between Illinois and Missouri, PM counsel criticized Missouri's refusal to embrace the PMs' results-based "compliance rate" standard notwithstanding the uncontroverted evidence offered during the Common Case and Missouri's hearing that Missouri and the PMs understood diligent enforcement to be an efforts-based standard at the time the MSA was signed. *See* Ill. Hrg. Tr. 5/29/12 at 46:23-47:5, LF 643-44.

During New York's hearing, a New York witness singled-out Missouri as the only State that failed to enact Allocable Share Release Reform Legislation. *See* N.Y. Hrg. Tr. 6/25/12 at 498:24–499:6, LF 655-56.

At Connecticut's hearing, the PMs' expert again testified that there had been a high incidence of distributor underreporting of NPM cigarette sales in Missouri. *See* Conn. Hrg. Tr. 9/11/12 at 673:19–675:14, LF 660-662.

In the Iowa hearing, the Panel heard testimony that Iowa should be viewed more favorably than Missouri, because Missouri had 4 to 6 times the cigarette sales of Iowa but only twice the population. Iowa Hrg. Tr. 10/17/12 at 50:19 –22, LF 666.

In the Washington hearing, the Panel heard excerpts from Missouri's deposition of a PM witness regarding sales of NPM cigarettes in 2002 in Missouri. Wash. Hrg. Tr. 4/22/13 at 632:17–633:16, LF 670-71.

During Indiana's hearing, State counsel argued that Indiana should be viewed more favorably than Missouri because Missouri failed to file any lawsuits in 2003 against non-compliant NPMs, while Indiana had filed 13. Ind. Hrg. Tr. 7/26/12 at 1119:15–1120:8, LF 682-83. Additionally, PM counsel was again given the opportunity to rehabilitate his expert's admission on cross-exam during the Missouri hearing that his calculation of Missouri's allegedly-low "compliance rate" was based on mere "intuition" rather than any evidence of underreporting. Both the Panel and Indiana counsel questioned the PMs' witness about the evidence and testimony in Missouri's case, which allowed the expert to restyle the basis for his partner's discredited opinion as a much more weighty-sounding "economic intuition." Ind. Hrg. Tr. 7/26/12 at 867:15–871:1, LF 675-79.

In the New Mexico hearing, which was held a full ten months after Missouri's hearing, the Panel again engaged PM counsel in ex parte communications about the unsupported 79% "national compliance rate," which the Panel had come to believe—incorrectly—was offered as the objective standard for diligent enforcement during Missouri's hearing. *See*

N.M. Hrg. Tr. 3/21/13 at 962:24–963:17, LF 691-92. Tellingly, PM counsel admitted during the New Mexico hearing that the 79% national compliance rate "was not included in any expert report at any point. And it was referred to in the testimony only once in Missouri, and in a very narrow sense, to respond to a very particular and unexpected" offer of evidence by Missouri that Missouri had made more efforts to diligently enforce its Qualifying Statute than many of the 16 States that the PMs had no-contested. N.M. Hrg. Tr. 3/21/13 at 969:1-11, 964:5–968:24, 699:6–700:14, LF 687-88, 693-98. Nonetheless, PM counsel continued to urge the Panel to use 79% as an objective standard for determining States' diligence in requiring NPMs to deposit escrow moneys.

In the Pennsylvania hearing, the arbitrators permitted PM counsel to argue that Missouri's low "collection rate" resulted from Missouri's efforts to "duck [its] diligent enforcement requirement." Pa. Hrg. Tr. 11/13/12 at 94:16–95:3, LF 702-03.

In the Colorado hearing, the Panel again engaged in ex parte communications with both Colorado counsel and a PM expert witness about the 79% national average compliance rate, against which they argued Missouri's 24% rate should be unfavorably compared. *See* Colo. Hrg. Tr. 12/13/12 at 959:21–961:1, LF 707-09.

In the South Carolina hearing, State counsel used a demonstrative that highlighted Missouri's low state excise tax ("SET") on cigarettes and its failure to enact Allocable Share Release Reform legislation. *See* S.C. Hrg. Tr. 7/27/12 at 291:1–292:8, LF 713-14.

In the Kentucky hearing, PM counsel attempted to undermine evidence from Missouri witness Judge Paul Wilson—who had testified a full year earlier that the parties had always intended an efforts-based standard rather than a results-based standard for "diligent enforcement"—by misrepresenting to the Panel that it had stricken Judge Wilson's testimony from the Missouri hearing as "inadmissible hearsay." *See* Ky. Hrg. Tr. 5/21/13 at 96:20–97:3, 120:4-10, LF 719-20, 724. To the contrary, despite the PMs' urging, the arbitrators had "decline[d] to strike" Judge Wilson's testimony. Order re: PMs' Motion to Strike Testimony of Paul Wilson, June 12, 2012, at 1, LF 732. Additionally, counsel for Kentucky erroneously claimed that the Panel had heard evidence during Missouri's hearing that Missouri's Legislature failed to timely pass its Qualifying Statute. *See* Ky. Hrg. Tr. 5/21/2013 at 56:5-15, LF 718. Finally, in the Kentucky hearing, the arbitrators received ex parte testimony that a wholesaler allegedly underreported NPM cigarette sales in Missouri. *See* Ky. Hrg. Tr. 5/21/2013 at 339:6–14, 342:10–24, 345:5–347:1, LF 726–30.

No representatives from Missouri were present at any of these hearings because Missouri received no notice that the Panel would entertain additional testimony and argument about Missouri's 2003 diligent enforcement efforts. Even if members of Missouri's trial team had traveled to every other State's hearing, it is doubtful the Panel would have allowed Missouri to rebut either testimony or argument.

I. The 2003 Panel permits the PMs to settle with 24 States halfway through the arbitration without giving Missouri the opportunity to challenge those States' diligence.

After the Panel held Missouri's and several other State's hearings, the PMs announced that they had reached a Term Sheet Settlement with a group of 19 "Signatory States".[8] *See* Partial Settlement, LF 242. The diligence of 17 of those 19 Signatory States was contested by the PMs until the moment the settlement was executed, and 15 of those Signatory States had not yet put on

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[8] By the end of the arbitration proceedings, 3 additional States (whose diligence was contested by the PMs) joined the settlement. After the Panel issued its Final Awards, 2 of the States found non-diligent joined the settlement. The number of Signatory States as of the date of this brief is 24.

their cases before the Panel. LF 242. Kansas was one of the 2 Signatory States that had already tried its case to the Panel and which the panel had declared during Kansas' hearing that it would not likely find Kansas diligent because it had done no enforcement for the first 8 months of 2003. Kan. Hrg. Tr. 8/3/12 at 858:4-11, LF 746. The Term Sheet purported to settle the PMs' and Signatory States' disputes for not only the 2003 NPM Adjustment, but all NPM Adjustments through 2014, and it required the Panel to "approve" its terms before it became binding on the PMs and the Signatory States. *See* Partial Settlement, LF 242.

To address the effect of this side deal on the ongoing arbitration, the Panel conducted hearings on January 22-23, 2013, and March 7-8, 2013. LF 243. Missouri and the other States that did not accept the Term Sheet Settlement objected to the Panel's implementation of it by any method of judgment reduction other than that provided in the MSA, explaining that common law judgment reduction methods abrogate their MSA rights of contribution, thus impermissibly increasing their liability and effectually amending the terms of the MSA. Settlement Hrg. Tr. 3/7/13 at 248:4-23, SLF 5 and 255:10-21, SLF 8. Missouri and the other Objecting States explained that under the MSA, their MSA rights of contribution could only be preserved by effectuating the Term Sheet Settlement in a way that deemed its

Signatory States "non-diligent," but only for the purpose of calculating the Objecting States' NPM Adjustment liability, thus preventing any portion of the Signatory States' shares of the NPM Adjustment liability from being foisted off onto Missouri and the other States that declined the Term Sheet Settlement. *Id*. at 253:20-254:6, SLF 6-7. Missouri and the other Objecting States explained further that the Panel's reliance on common law judgment reduction methods constituted an unauthorized amendment to the MSA in violation of MSA §XVIII(j)'s requirement that all "affected" parties unanimously consent in writing to any amendment to the MSA. *Id*. at 253:12-254:6, SLF 6-7 and 257:19-24, SLF 9. Missouri and the other objecting States pleaded with the Panel not to allow the PMs and the collaborating Signatory States to impose "hundreds of millions of dollars" of greater liability on Missouri and the other Objecting States as punishment for declining the PMs' Term Sheet Settlement. *Id*. at 258:18-259:4, SLF 10-11 and 254:7-21, SLF 7.

When it issued its Stipulated Partial Settlement and Award ("Partial Settlement") on March 12, 2013, the Panel identified Kansas and the other 18 States and Territories that had at that time agreed to the Term Sheet Settlement. LF 242. The Panel acknowledged that, in effectuating the settlement of the disputes between the PMs and the States that accepted the

Term Sheet Settlement, it had no authority to "adversely affect the legal rights" of Missouri and the other Objecting States. LF 245-46. However, at no point in its Partial Settlement or at any time prior to the conclusion of the arbitration did it provide Missouri or any Objecting State with an opportunity to preserve its MSA right of contribution by challenging the diligence of any of the States that accepted the Term Sheet Settlement. Nor did the Panel find or deem the Signatory States to be non-diligent, even though Missouri and the other Objecting States had explained that was the only judgment reduction method authorized by the MSA. Settlement Hrg. Tr. 3/7/13 at 253:20-254:6, SLF 6-7. The Panel also did not find or deem the Signatory States to be diligent, as it had done earlier with the No-Contest States once the deadline had passed for Missouri and the other Contested States to challenge diligence or waive their MSA rights of contribution from the No-Contest States. Instead, the Panel declined to rule on the diligence or non-diligence of the States that accepted the Term Sheet Settlement, stating simply that the "Independent Auditor will treat the Signatory States as not subject to the 2003 NPM Adjustment." LF 250.

Addressing the objections of Missouri and the other States that declined the Term Sheet Settlement, and despite its earlier pronouncement that it would likely have found Kansas non-diligent, the Panel found that

"[t]here is no basis in the facts to assume that every Signatory State [to the Term Sheet] was non-diligent in 2003." LF 254. The Panel found further that, even if its award constituted an amendment to the MSA, it was permissible because the Panel construed MSA §XVIII(j)'s prohibition on any non-unanimous amendment that merely "affects" the rights of objecting MSA parties as only a prohibition of non-unanimous amendments that "materially prejudice" objecting MSA parties. LF 256. The Panel then found that its action had not materially prejudiced the Objecting States, but it acknowledged that its ruling might increase liability for States found non-diligent, and so suggested that any Non-Diligent State should appeal to its MSA Court to correct any injustice imposed by the Panel's Partial Settlement: "Should any Objecting State, found by the Panel to be non-diligent, have a good faith belief that the pro rata reduction does not adequately compensate them for a Signatory State's removal from the re-allocation pool, their relief, if any, is by appeal to their individual MSA court." Partial Settlement at 14, LF 255.

J. The 2003 Panel finds Missouri failed to diligently enforce, citing evidence presented after the close of Missouri's State-Specific hearing.

On September 11, 2013, the Panel issued final awards regarding the diligence of the 15 contested States who had tried their cases before the Panel and declined the Term Sheet Settlement. Nine were found diligent. Six—including Missouri—were not. Although the Panel's Final Award against Missouri is *devoid of any citation to evidence*, the significantly detailed conclusions are unmistakably grounded in the ex parte testimony and argument presented at other States' hearings.

The Panel ignored the evidence from Missouri's Record that the MSA parties had intended Missouri's diligence to be judged not by the results it obtained but rather by the efforts it took to enforce its Qualifying Statute, and the Panel ignored the evidence that Missouri's enforcement efforts against NPMs were in fact diligent because the PMs had not suffered any market share loss in Missouri. The Panel's decision to find Missouri non-diligent by applying a results or compliance rate standard (LF 297, 299-300) is grounded in its ex parte communications in the hearings for Illinois (LF 640-651), New Mexico (687-88, 691-98), Pennsylvania (LF 702-03), Colorado (LF 707-09), and Kentucky (LF 719-20, 724). Despite the PMs' expert's

admission during the Missouri hearing that he relied on his "intuition" rather than any evidence that any NPM sales had been underreported in Missouri, the Panel found underreporting by Missouri distributors (LF 301-302), which is attributable to the Panel's ex parte communications during the hearings for Illinois (LF 642), Connecticut (LF 660-62), Iowa (LF 666), Washington (LF 670-71), and Indiana (LF 675-79). The Panel's finding that Missouri failed to file any lawsuits (LF 300) is grounded in its ex parte communications during the Indiana hearing (LF 682-83). The Panel's finding that Missouri had large volumes of "contraband" cigarette sales (LF 301-02) is based on ex parte communications that occurred in the Kentucky hearing (LF 726-30). And the Panel's criticism of Missouri's failure to enact and diligently enforce legislation beyond the MSA's Qualifying Statute (LF 296, 302) is grounded in the ex parte testimony and argument presented at the hearings for NY (LF 655-56), South Carolina (LF 713-14), and Kentucky (LF 718).

K. Missouri moves to vacate the 2003 Panel's Awards and to compel single-state arbitration of whether Missouri diligently enforced its Qualifying Statute in 2004.

After the 2003 Panel issued its final rulings, Missouri moved to vacate both the Partial Award and the finding of non-diligence. The trial court

confirmed the Panel's finding that Missouri was non-diligent, but it modified the Partial Award. That ruling is the subject of the PMs' cross appeal, which Missouri will address in its Respondent's Brief.

Contemporaneously with its vacatur motion, Missouri also moved the trial court under §435.355, RSMo, 9 U.S.C. §2, and §XI(c) of the MSA to compel the PMs to arbitrate in a single-state proceeding whether Missouri diligently enforced its Qualifying Statute in 2004. *See* Circuit Court Docket Sheet, LF 16.

The PMs opposed Missouri's motion[9], arguing that the MSA required a single panel to arbitrate the 2004 diligent enforcement of Missouri and all other States that had declined their Term Sheet Settlement of the 2003–2014 NPM Adjustment disputes. *See generally* PMs' Opp'n to Mo.'s Mot. to Compel a Single State Arbitration, LF 1470. The PMs specifically argued to the trial court that all MSA §XI(c) disputes over the IA's calculations involve all States on one "side" and all PMs on the other "side" because"[t]he MSA does not provide that 'each State' or 'each Participating Manufacturer' select its own

[9] The PMs did not move to compel Missouri into arbitration for any additional or different dispute, or with any other parties.

arbitrator or that there be separate arbitration panels for each 'issue' or 'defense.'" LF 1497.

The trial court then denied Missouri's motion for a single-state arbitration, finding that the drafters of the MSA envisioned a nationwide arbitration of this dispute because all disputes regarding the IA's calculations would always involve all PMs on one side and all States on the other side. *See* Am. Order & J. at 11-15, LF 2403-07.[10] But, the PMs subsequently admitted to the court of appeals and to a Pennsylvania court that MSA §XI(c) has always provided for 2-party disputes "that arise out of the [I]ndependent [A]uditor's calculations and determinations that are not national in character," and even gave an example of a current dispute between a PM on one "side" and another PM on the other "side" that is indeed governed by the

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[10] Although the trial court erred in denying Missouri's motion for a single-state arbitration of these parties' discrete 2004 dispute, it properly declared and applied the FAA standard for vacatur to modify the application of the Partial Settlement only as to how Missouri's award is calculated, thus affecting no payments owed or received by any other State. Missouri defends that order by the trial court, and addresses the court of appeals' erroneous handling of that issue, in the PMs' cross-appeal.

MSA's arbitration clause. *Commonwealth of Pennsylvania by Kathleen G. Kane, in her official capacity as Attorney General of the Commonwealth of Pennsylvania v. Philip Morris USA, Inc., et al.*, No. 2443 (Pa. Ct. Common Pleas Philadelphia Cty. Feb. 23, 2015).

POINTS RELIED ON

I. The trial court erred in denying Missouri's motion to compel single-state arbitration because its conclusion—that the MSA requires 28 individual States' diligent enforcement claims be consolidated into a single "nationwide" arbitration—erroneously applies the law and is against the weight of the evidence in that neither the plain language of the MSA nor the parties' course of conduct demonstrates Missouri's consent to collective arbitration with other sovereign states..

Stolt-Neilsen, S.A. v. Animal Feeds Int'l Corp., 559 U.S. 662 (2010)

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

Dunn Indus. Group, Inc. v. City of Sugar Creek, 112 S.W.3d 421 (Mo. 2003)

Baesler v. Continental Grain Co., 900 F.2d 1193 (8th Cir. 1990)

II. The trial court erred when it denied Missouri's motion to compel a single-state arbitration of its dispute with the PMs over Missouri's diligent enforcement of its Qualifying Statute during 2004 because that ruling is against the weight of the evidence in that a nationwide arbitration has been rendered impossible by the PMs, who must be estopped from using their settlement with some but not all States to

amend the MSA and extinguish Missouri's rights of contribution from the 24 States that cannot be compelled into arbitration for any dispute regarding diligent enforcement during the years 2003 to 2014.

State v. Am. Tobacco Co., No. ED 101542, 2015 WL 5576135 (Mo. App. E.D. 2015)

Restatement (Second) of Contracts § 202(5)

III. The trial court erred when it denied Missouri's motion to compel a single-state arbitration of its dispute with the PMs over Missouri's diligent enforcement of its Qualifying Statute during 2004 because it is against the weight of the evidence in that the very nature of a collective arbitration will deny Missouri's right to fundamental due process.

State v. Am. Tobacco Co., No. ED 101542, 2015 WL 5576135 (Mo. App. E.D. 2015)

9 U.S.C. §10(a)(3)&(4)

Sections 435.405.1(2)(3)&(4), RSMo

Section 435.370(2), RSMo

STANDARD OF REVIEW

"The trial court's judgment will be affirmed unless there is no substantial evidence to support it, it is against the weight of the evidence, or it erroneously declares or applies the law." *Eaton v. CMH Homes, Inc.*, 461 S.W.3d 426, 431 (Mo. 2015); *see also Murphy v. Carron*, 536 S.W.2d 30, 32 (Mo. banc 1976). "Whether the trial court should have granted a motion to compel arbitration is a question of law decided de novo." *Ellis v. JF Enterprises, LLC*, 482 S.W.3d 417, 419 (Mo. 2016).

ARGUMENT

I. Missouri did not agree when it signed the MSA that every arbitral dispute it has with the PMs must be consolidated into a "nationwide" arbitration of similar disputes between the PMs and other States.

All parties to this appeal agree that they must arbitrate whether Missouri diligently enforced its Qualifying Statute in 2004. However, the trial court *denied* Missouri's Motion to Compel a Single-State Arbitration—the only motion to compel arbitration of any kind submitted to the trial court as to the current dispute—because that court "believe[d] that a single decision maker has the best chance for producing consistent awards." Am. Order & J. at 14, LF 2406.

The trial court's ruling erroneously applies the Federal Arbitration Act ("FAA") and Supreme Court precedent by inferring Missouri's consent to collective or consolidated arbitration from an arbitration clause that is silent as to that consolidation, and it erroneously applies Missouri law by construing contract provisions in such a way as to render certain words meaningless. The ruling is also against the weight of the evidence as to the parties' course of dealing over the last decade, which shows that Missouri did not agree to collective arbitration merely by signing the MSA. The Amended

Order and Judgment denying Missouri's motion to compel should be reversed and the parties ordered to arbitrate their current dispute in a proceeding to which only Missouri and the PMs are parties.

A. The trial court erroneously applied federal law by inferring Missouri's consent to collective arbitration solely from the multistate nature of the MSA.

The MSA's arbitration clause is silent as to whether the PMs may consolidate all arbitral disputes they have with individual states into a collective, multistate proceeding. Nonetheless, the trial court inferred from the multistate nature of the MSA that "a nationwide arbitration was envisioned by the parties" because "it is the most logical mechanism for the resolution of the dispute." *See* Am. Order & J. at 14, LF 2406. Even assuming a multistate proceeding is the most logical way to resolve similar disputes between the PMs and individual states—a conclusion belied by Missouri's own experience of the 2003 NPM Adjustment Arbitration, *see, infra,* Section III—"the goal of the FAA is to enforce the agreement of the parties, not to effect the most expeditious resolution of claims." *Dominium Austin Partners, L.L.C.*, 248 F.3d 720, 729 (8th Cir. 2001). Forcing sovereign states into a single proceeding to arbitrate whether individual states

diligently enforced their own laws in a given year may be more expeditious for the PMs, but it "is fundamentally at war with the foundational FAA principle that arbitration is a matter of consent." *Stolt-Nielsen S.A. v. AnimalFeeds Int'l Corp.*, 559 U.S. 662, 684 (2010).

"Underscoring the consensual nature of private dispute resolution," the Supreme Court has held that "parties are generally free to structure their arbitration agreements as they see fit." *Stolt-Nielsen S.A. v. AnimalFeeds Int'l Corp.*, 559 U.S. 662, 683 (2010)(internal quotations omitted). Parties may choose which issues to submit to arbitration, and they "may specify *with whom* they choose to arbitrate their disputes." *Id.* at 684 (emphasis in original). From these basic principles, "it follows that a party may not be compelled under the FAA to submit to class arbitration unless there is a contractual basis for concluding that the party *agreed* to do so." *Id.* (emphasis in original); *see also Oxford Health Plans LLC v. Sutter*, 133 S. Ct. 2064, 2066 (2013)("An arbitrator may employ class procedures only if the parties have authorized them."). "[A]bsent a provision in an arbitration agreement authorizing consolidation, a district court is without power to consolidate arbitration proceedings." *Baesler v. Cont'l Grain Co.*, 900 F.2d 1193, 1195 (8th Cir. 1990).

Despite the extraordinarily deferential standard of review applied to arbitrators' interpretations of parties' contracts under the FAA, the Supreme Court held in *Stolt-Neilsen* that arbitrators may not infer an "implicit agreement to authorize class-action arbitration ... solely from the fact of the parties' agreement to arbitrate." 559 U.S. at 685. The law looks favorably on arbitration agreements because they permit parties to "forgo the procedural rigor and appellate review of the courts in order to realize the benefits of private dispute resolution: lower costs, greater efficiency and speed, and the ability to choose expert adjudicators to resolve specialized disputes." *Id.* But "the switch from bilateral to class arbitration sacrifices the principal advantage of arbitration—its informality—and makes the process slower, more costly, and more likely to generate procedural morass than final judgment." *AT&T Mobility LLC v. Concepcion*, 563 U.S. 333, 348 (2011). Consolidating the individual claims of multiple parties into a single proceeding "changes the nature of arbitration to such a degree that it cannot be presumed the parties consented to it by simply agreeing to submit their disputes to an arbitrator." *Stolt-Nielsen*, 559 U.S. at 685. The same reasoning applies even more forcefully when a court (as opposed to an arbitration panel) infers consent to class arbitration from a silent arbitration clause: a legal error of sufficient magnitude to vacate an arbitration award

under the FAA's extremely deferential standard of review is more than sufficient to reverse a trial court on *de novo* review.

No provision in the MSA expressly provides for consolidated, collective, or class arbitration. *See State v. American Tobacco Co.*, No. ED 101542, 2015 WL 5576135, at *16 (Mo. App. E.D. (Sept. 22, 2015)("the arbitration clause is silent as to whether the arbitration must be conducted collectively with all States in a nationwide arbitration, or done in a single-state fashion"), *appeal transf'd* (Dec, 3, 2015). The MSA's arbitration clause refers only to the "two sides to the dispute." Am. Order & J. at 13, LF 2405. The trial court acknowledged that "there is no question that the states' interests are not the same; if shown to be non-diligent, each state has a vital and conflicting interest to show that other states are also non-diligent." *Id.* Yet, the court "d[id] not believe that this necessarily means the states are not on one 'side.' The court frequently sees cases where there are more than two parties involved. There may be numerous defendants, for instance, whose interests are conflicting and adverse to each other. Nonetheless, they are 'aligned' as party defendants, and, in that sense, are 'one side.'" *Id.* The court further reasoned, "The two 'parties' to the MSA are the 'Participating Manufacturers' and the 'Settling States.' It is clear that these two groups are the 'two sides'

envisioned by the arbitration provision, and all the Settling States collectively comprise one side." *Id.*

The trial court's analogy is flawed. It may be true that criminal defendants "whose interests are conflicting and adverse to each other . . . are 'aligned' as party defendants, and, in that sense, are 'one side.'" But criminal defendants tried together are joint participants in the same illegal conduct. The States that signed the MSA are not criminal defendants, nor are they arbitrating the same underlying conduct. It is the wholly separate conduct of individual sovereigns that is being arbitrated: each State enforces *its own* Qualifying Statute within *its own* sovereign borders according to *its own* sovereign judgment. *Every sovereign is its own "side."*

It is not enough to say—as the trial court did—that the States are all parties to the same settlement agreement and therefore must have consented to arbitrate their claims jointly. That line of reasoning turns *Stolt-Neilsen* on its head. Instead of enforcing the Supreme Court's presumption *against* collective arbitration in the absence of any contract provision expressly permitting it, the trial court adopted a presumption *in favor* of collective arbitration of future disputes of varying parties so long as it is not expressly prohibited by their common settlement agreement.

It is true that all 52 Settling States signed the same MSA, but that single document resolved 52 separate lawsuits in 52 separate jurisdictions, each of which required its own "Consent Decree" to achieve "State-Specific Finality" before that State could reap the benefits of the MSA. *See* MSA § XIII(b)(2) ("each Settling State shall seek entry of an order of dismissal of claims dismissing with prejudice all claims against the Participating Manufacturers . . . in such Settling State's [lawsuit]"). Even the word "Court" as used in the MSA has a different meaning to each Settling State. MSA §2(p)(defining "Court" as "the respective court in each Settling State to which this Agreement and the Consent Decree are presented for approval and/or entry *as to that Settling State*.")(emphasis added). In Missouri, for example, "Court" means the Honorable Jimmie Edwards of the 22nd Judicial Circuit. And the consent decree entered by that Court is binding on Missouri and all PMs but not on, say, the State of Illinois. In fact, the MSA expressly prohibits individual States from seeking to enforce their sister States' consent decrees. MSA §VII(b).

In a sense, the MSA is a collection of 52 separate settlement agreements between the PMs and 52 individual plaintiffs. Just because Missouri settled its original claims against the PMs by signing the same document as the other Settling States does not, in the absence of an express

provision, commit Missouri to consolidate every future dispute it has with the PMs into a nationwide proceeding with all similar disputes between the PMs and other States.

B. The trial court erroneously applied Missouri contract law when it identified the "two sides to the dispute" over Missouri's diligent enforcement exemption as *all* States and *all* PMs.

Under Missouri law, a court must compel arbitration if it determines that the parties agreed to arbitrate the dispute. *Dunn Industrial Group, Inc. v. City of Sugar Creek*, 112 S.W.3d 421, 427-28 (Mo. 2003). A motion to compel arbitration of a particular dispute should not be denied unless it may be said with positive assurance that the arbitration clause is not susceptible to an interpretation that covers the asserted dispute. *Id.* at 429. When interpreting an arbitration clause, "the usual rules and cannons of contract interpretation govern the subsistence and validity of an arbitration clause." *Id.* at 428. "If a contract is unambiguous, the intent of the parties is to be discerned from the contract alone based on the plain and ordinary meaning of the language used." *State ex rel. Hewitt v. Kerr*, 461 S.W.3d 798, 814 (Mo. 2015), reh'g denied (June 30, 2015). Doubts as to arbitrability should be resolved in favor of coverage. *Dunn*, 112 S.W.3d at 429.

There is no question that Missouri and the PMs agreed to arbitrate their present dispute. Nor is there any question that arbitration of *the dispute between Missouri and the PMs* must determine whether Missouri diligently enforced its Qualifying Statute in 2004. The point of contention is whether arbitration of *the dispute between Missouri and the PMs* must *also* determine whether Alaska, American Samoa, Colorado, Delaware, the District of Columbia, Guam, Idaho, Illinois, Iowa, Maine, Maryland, Massachusetts, New Mexico, North Dakota, the North Marianas Islands, Ohio, Oregon, Pennsylvania, Puerto Rico, Rhode Island, South Dakota, Utah, Vermont, the Virgin Islands, Washington, and Wisconsin each diligently enforced its own Qualifying Statute in 2004. Under the plain and ordinary meaning of the words used in the parties' arbitration clause, the answer must be "No."

The MSA's arbitration clause provides that "[e]ach of the two sides to the dispute shall select one arbitrator." MSA §XI(c). The trial court interpreted the clause to mean that "the 'Participating Manufacturers' and the 'Settling States' . . . are the 'two sides' envisioned by the arbitration provision, and *all* the Settling States collectively comprise one side." Am. Order & J. at 14, LF 2406 (emphasis added). But that construction of the arbitration clause "violate[s] a cardinal rule of contract construction by

rendering a portion of the Agreement superfluous." *TAP Pharm. Products Inc. v. State Bd. of Pharmacy*, 238 S.W.3d 140, 144 (Mo. 2007).

Under Missouri law, "a contract must be construed as a whole so as to not render any terms meaningless, and a construction that gives a reasonable meaning to each phrase and clause and harmonizes all provisions is preferred over a construction that leaves some of the provisions without function or sense." *State ex rel. Riverside Pipeline Co., L.P. v. Pub. Serv. Comm'n of State*, 215 S.W.3d 76, 84 (Mo. 2007). Giving a reasonable meaning to each phrase and clause in the arbitration clause, the phrase "[e]ach of the two sides" is qualified by the phrase "to the dispute." But if "two sides" can only ever refer to *all PMs* on one side and *all Settling States* on the other—as the trial court concluded—then the qualifying phrase "to the dispute" is surplusage. For the latter phrase to have any meaning at all, the "two sides" must change depending on the specific "dispute" to be arbitrated.

It should be obvious that more than one kind of dispute can arise out of calculations by the Independent Auditor, not all of which would concern *every* party to the MSA or be "nationwide" in scope. Indeed, the PMs admitted to Pennsylvania's MSA court that MSA §XI(c) permits arbitrations between as few as two parties and are "not national in character." *See Commonwealth of Pennsylvania by Kathleen G. Kane, in her official capacity as Attorney*

General of the Commonwealth of Pennsylvania v. Philip Morris USA, Inc., et al., No. 2443 (Pa. Ct. Common Pleas Philadelphia Cty. Feb. 23, 2015). They even gave an example of a current dispute between two PMs, one on "each side," that is being arbitrated under the same MSA's arbitration clause.

By way of example, assume that Philip Morris and RJ Reynolds are entitled to the interest on monies held in the MSA's disputed payments account, but they disagree as to how that interest should be apportioned between them; *i.e.*, the total amount of interest is not in question, merely how much of it belongs to the two PMs respectively. Further assume that the Independent Auditor determines the lion's share of the interest belongs to Philip Morris, and that RJ Reynolds disputes the calculation. Giving the words used in the arbitration clause their plain and ordinary meaning, Reynolds's claim is subject to arbitration because it is a "dispute, controversy or claim arising out of or relating to calculations performed by, or any determinations made by, the Independent Auditor." MSA § XI(c). The "dispute" in this hypothetical is over how much interest should be allocated to Philip Morris and RJ Reynolds, respectively. Consequently, the "two sides" to this "dispute" must be Philip Morris (on one side) and RJ Reynolds (on the other). Yet, under the trial court's interpretation of the arbitration clause, Philip Morris and RJ Reynolds would be on the *same* "side" of this

hypothetical arbitration even though they are adverse to one another, and *all* States would be on the other "side" even though they have no dog in the fight. That cannot be what the parties intended when they drafted the MSA. Giving effect to the plain and ordinary meaning of every word in the parties' arbitration clause, the identity of the "two sides" in this case can only be determined after first identifying the "dispute" to be arbitrated.

In its motion to compel arbitration, Missouri describes the present dispute as "whether Missouri diligently enforced its Qualifying Statute in 2004." Presumably, the PMs have similar disputes with the other 27 States that did not accept the PMs' Term Sheet Settlement. But Missouri is not a party to *any* of those other disputes; it has no evidence to put on; it has no burden of proof to meet. Whether Alaska, Illinois, or Wisconsin diligently enforced its own Qualifying Statute in 2004 is a dispute solely between the PMs and those individual States. Missouri does not want or need participate in those disputes any more than those States want or need to participate in Missouri's.[11]

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[11] To be sure, whether each of the other Settling States diligently enforced its own Qualifying Statute in 2004 may affect how the Independent Auditor applies the 2004 NPM Adjustment to Missouri (if at all). But Missouri has no

Missouri's narrow description of the parties' dispute jibes with the relevant text of the MSA, which provides that *"[s]ubject to the provisions of subsection[] . . . (d)(2) below,"* the PMs annual settlement payment to the States "shall be subject to the an NPM Adjustment" if two conditions precedent are satisfied. MSA § IX(d)(1)(A). ***First***, the PMs must have suffered a "Market Share Loss" during the previous year—meaning that the PMs' aggregate share of the national cigarette market has decreased at least two percent since 1997. MSA§§ IX(d)(1)(A) & IX(d)(1)(B)(iii), LF 321-22. ***Second***, an accounting firm chosen by the parties must have determined that the burdens imposed on the PMs by the MSA were a "significant factor"

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role to play in determining whether the other States diligently enforced in 2004. As discussed further in Part II, *infra*, the PMs made it *impossible* for Missouri to play any role in determining the diligence of at least half of the Settling States when they settled with 24 of them during the 2003 arbitration over Missouri's objection. If Missouri was not a party to the diligent enforcement determinations of the States who settled during the 2003 arbitration—as the PMs insisted at the time—then Missouri need not be a party to the diligent enforcement determinations of the 27 states that did not settle. The PMs cannot have it both ways.

contributing to the PMs' Market Share Loss. Id. at IX(d)(1)(C), LF 323-24. Once those conditions are satisfied, the NPM Adjustment is available to reduce the PMs' annual MSA payment "[s]ubject to the provisions of subsection[] . . . (d)(2)." MSA § IX(d)(1)(A). Subsection (d)(2) provides that an individual State's share of the PMs' annual payment "shall not be subject to an NPM Adjustment" if such State (i) has enacted a Qualifying Statute, and (ii) diligently enforced the statute during the prior calendar year. MSA § IX(d)(2)(B)(i)-(ii).

In this case, Missouri *agrees* with the PMs that both of conditions precedent to the NPM Adjustment have already been satisfied for 2004. Consequently, Missouri also agrees that the 2004 NPM Adjustment should be available to reduce the PMs' annual payment for 2004, "[s]ubject to the provisions of subsection[] . . . (d)(2)." MSA § IX(d)(1)(A). The only point on which Missouri and the PMs still *disagree* is the extent to which Missouri's responsibility (if any) for the 2004 NPM Adjustment is subject to the provisions of subsection (d)(2). Stated differently, the only variable Missouri and the PMs have left to argue about is a single yes-or-no question: *Did Missouri diligently enforced its Qualifying Statute in 2004*. If the answer is yes, Missouri's next annual MSA payment will not be reduced by application of the 2004 NPM Adjustment. If the answer is no, Missouri's next annual

MSA payment will be reduced accordingly. There is nothing else for an arbitration panel to determine in order for the Independent Auditor to know whether or not the 2004 NPM Adjustment applies *to Missouri*.

It is true that the *amount* by which Missouri's next annual payment is reduced—if it is reduced—by application of the 2004 NPM Adjustment depends on how many other States are found not to have diligently enforced their own Qualifying Statutes in 2004. But the other States' diligence determinations have no bearing on *whether* Missouri's next annual payment is reduced, nor does Missouri have the desire to put on evidence against any other State. Missouri is not bound by the consent decree entered in another other State's MSA court. Indeed, the MSA *expressly* provides that "[a] Settling State may not seek to enforce the Consent Decree of another Settling State." MSA §VII(b).

The only "dispute" Missouri seeks to arbitrate is whether it diligently enforced its Qualifying Statute in 2004, and the only parties Missouri seeks to arbitrate it with are the PMs. Missouri is one "side" to that dispute, and the PMs are the other "side." Pursuant to the MSA's arbitration clause, each of those "two sides" is to select an arbitrator (who will then agree on a third arbitrator). *See* MSA at § X(c), LF 332. No other interpretation gives effect to

every word and phrase in the arbitration clause. The trial court's interpretation to the contrary was erroneous and should be reversed.

C. The trial court's conclusion that a nationwide arbitration was envisioned by the parties in drafting the MSA is against the weight of the evidence submitted regarding the parties' course of dealing.

When the trial court granted the PMs' motion to compel Missouri to arbitrate the availability and application of the *2003* NPM Adjustment a decade ago, it *did not* require Missouri to consolidate its dispute with similar disputes between the PMs and other States, nor did it require Missouri to participate in a collective arbitration proceeding. *State v. Am. Tobacco Co.*, 2015 WL 5576135, at *18. Unable to force Missouri into joining a nationwide arbitration of the 2003 NPM Adjustment through the judicial process, *the PMs offered to pay Missouri to do so voluntarily*. In exchange for our (and other States') agreement to consolidate our claims into a single proceeding, the PMs promised (1) to discount the liability of any State ultimately found non-diligent by 20%, and (2) to release over $500 million in disputed escrow funds to the States. The offer was memorialized in a separate contract called the Agreement Regarding Arbitration ("ARA"). *See* ARA at §§3 & 4, LF 769-70; *State v. Am. Tobacco Co.*, 2015 WL 5576135, at *18.

In light of the substantial concessions offered by the PMs, Missouri and all but 4 other States signed onto the ARA. Under that agreement, a national arbitration panel would first determine whether an NPM Adjustment was even available to reduce the PMs' 2003 MSA payment. If so, the panel would determine each individual State's liability (if any). LF 763-764. The ARA also identified five threshold legal issues common to every State's diligent enforcement claim—such as which party had the burden of proof—for submission to the national panel. [12] LF 775. Missouri and the PMs did not agree to submit any other sections of the MSA, or any other issues, to the Panel's jurisdiction. *See generally* ARA, LF 763.

The weight of the evidence before the trial court regarding the parties' course of conduct demonstrates that the parties had no meeting of the minds

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[12] At page 2 of its Amended Order and Judgment, the trial court correctly noted that the threshold issues submitted to the national panel—including whether the NPM Adjustment was even available for 2003—made the 2003 dispute much, much broader in scope than the present dispute, in which the only issue left to be resolved is whether Missouri diligently enforced its Qualifying Statute during 2004. *See* Am. Order & J. at 13, LF 2394; *State v. Am. Tobacco Co.*, 2015 WL 5576135, at *18 and Footnote 15.

regarding national or collective arbitration when they signed the MSA. That the PMs were willing to pay—and did pay—Missouri and 47 other States hundreds of millions of dollars to induce the States' participation in a nationwide arbitration regarding the 2003 NPM Adjustment is strong evidence that the PMs *know* Missouri did not consent to collective arbitration simply by joining the MSA. Consequently, the trial court's finding "that a nationwide arbitration was envisioned by the parties in drafting the MSA," Am. Order at 14, is against the weight of the evidence of the parties' course of dealing over the last decade and should be reversed.

II. The PMs' prior settlement with half of the States renders a single, nationwide arbitration of all States' diligent enforcement claims both unnecessary and impossible.

The PMs' settlement with half of the States midway through the 2003 arbitration frustrated the very "unitary payment system" on which the PMs rely as the basis for needing a "nationwide arbitration" of the 2004 NPM Adjustment. They cannot have it both ways.

A decade ago, when they moved to compel Missouri to arbitrate the availability and application of the 2003 NPM Adjustment, the PMs argued that "[e]ach [ ] State has a vital – and conflicting – interest in whether other States are subject to the Adjustment." PMs' 2006 Mot. to Compel Arbitration,

LF 349. This was so, the PMs argued, because each "diligent" State's share of the available NPM Adjustment gets reallocated among all "non-diligent" States, causing "a further downward adjustment in the amount [the non-diligent States] receive under the MSA." *Id*. at 5-6, LF 353-54. Under this "unitary payment system," the PMs argued, no State's annual payment could be calculated and paid unless and until every State's diligence had been determined. MSA §§ XI (e), (f)(2), (i) and (j), LF 1035, 1036, 1045-51.

However, midway through the 2003 NPM Adjustment arbitration proceedings (and months after Missouri's individual diligence hearing had concluded), the PMs entered into a "Term Sheet Settlement" with now 24 States, 22 of which the PMs claimed were not diligent right up to the minute each of those States signed the Term Sheet. Seeking approval for their settlement with these now 24 States in the form of a final award from the 2003 Panel (Stipulated Partial Settlement and Award, "Partial Settlement"), the PMs "changed their course and persuaded the national Panel to disregard the MSA's 'unitary payment system"; decline to finish the inquiry into those States' diligence so as to fairly determine the remaining States' reallocated shares; and order immediate payment of disputed funds to the now 24 States

that accepted the Partial Settlement.[13] *State v. Am. Tobacco Co.*, 2015 WL 5576135, at *19.

The Partial Settlement purports to release 24 States from any determination of their diligence or non-diligence for the years 2003–2014. In giving those 24 States a decade-long free pass and an immediate payment of disputed funds, the PMs unilaterally extinguished the MSA's unitary payment system and any MSA obligations those States had *to Missouri* to prove their diligence or pay their share of any NPM Adjustment. Implicit in the PM's Partial Settlement is their concession that the MSA does not require that the diligence over every state be determined by a single arbitral body—or at least it does not any more.[14]

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[13] The trial court correctly found the arbitration Panel had exceeded its jurisdiction because its Partial Settlement was an unauthorized amendment to the MSA, and vacated the effects of that award only as to Missouri's annual payment. Missouri will defend that ruling of the trial court, and distinguish the erroneous *conclusion* of the court of appeals regarding the Partial Settlement, in Missouri's responsive brief to be filed August 1, 2016.

[14] *State v. Am. Tobacco Co.*, 2015 WL 5576135, at *19. *See also Restatement (Second) of Contracts* § 202(5) ("Whenever reasonable, the

Persuaded by the PMs' arguments, the trial court found that the drafters of the MSA envisioned a nationwide arbitration of this discrete 2004 dispute because it erroneously believed *all* disputes regarding the IA's calculations would always involve all PMs on one "side" and all States on the other "side." *See* Am. Order 7 J at 11-15, LF 2403-2407. But, subsequent to the trial court's ruling, the PMs admitted to the court of appeals and to a Pennsylvania court that MSA §XI(c) has always provided for arbitrations between fewer than all MSA signatories for disputes "that arise out of the [I]ndependent [A]uditor's calculations and determinations that are not national in character." *Commonwealth of Pennsylvania by Kathleen G. Kane, in her official capacity as Attorney General of the Commonwealth of Pennsylvania v. Philip Morris USA, Inc., et al.,* No. 2443 (Pa. Ct. Common Pleas Philadelphia Cty. Feb. 23, 2015). The PMs even gave an example of a current dispute between a PM on one "side" and another PM on the other "side" that is indeed governed by the MSA's arbitration clause.

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manifestations of intention of the parties to a promise or agreement are [to be] interpreted as consistent with each other and with any relevant course of performance, course of dealing or usage of trade.").

If, under the PMs' current reading of the requirements of the MSA, 24 States can be released from their obligations to prove their diligence before any arbitral body *at all*, and two PMs can conduct an MSA arbitration over a dispute because that is not national in character, then the MSA certainly permits the trial court, the court of appeals, and this Court to compel a single-state arbitration between Missouri and the PMs regarding only Missouri's diligent enforcement for 2004. For purposes of calculating liability for any 2004 NPM Adjustment, the determination of Missouri's diligence rendered by this "single-state arbitration panel can be communicated to all interested parties as easily as the Partial Settlement is communicated." *State v. Am. Tobacco Co.*, 2015 WL 55761, at *19. The PMs are estopped from arguing to the trial court, the court of appeals, and to this Court that Missouri must arbitrate its 2004 diligent enforcement dispute with the PMs in a single proceeding with all other States because the PMs unilaterally excused half of those States from the table.

By the PMs' own admissions, it is now impossible to conduct a "nationwide" arbitration of any of the remaining 2004–2014 NPM Adjustment disputes. The 24 States that accepted the Partial Settlement will not agree to participate, nor can they be compelled to participate, in any

arbitration.[15] *See* PM's Opp. to Mo.'s Mot. to Compel a Single-State Arbitration at 26, LF 1501; *State v. Am. Tobacco Co.*, 2015 WL 5576135, at *19.

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[15] Further indisputable proof that the PMs' actions have rendered a single "nationwide" arbitration impossible is the fact that *two* "nationwide" arbitrations regarding the 2004 NPM Adjustment *are already underway*. Some of the States that declined the Term Sheet Settlement are arbitrating with the PMs before one Panel, while others are arbitrating with the PMs before a *second* Panel. Disagreement among the PMs regarding the issues to be arbitrated and the choice of their appointed arbitrator resulted in two Panels. One group of PMs selected Judge Birch as their arbitrator. *State of Colorado ex rel. Cynthia Coffman, Attorney General v. R.J. Reynolds Tobacco Co., et al.*, No. 97CV3432 (Co. Dist. Ct. Denver Cty. Dec. 7, 2015): *State of Iowa v. Philip Morris USA Inc., et al.*, No. LACL071048 (Iowa Dist. Ct. Polk Cty. Dec. 28, 2015). The other group selected Judge Legg. *Illinois v. Philip Morris, Inc., et al.*, No. 96L13146 (Ill. Cir. Ct. Cook Cty. Jan. 25, 2016); *Vermont v. Philip Morris USA Inc., et al.* No. S7447-97CnC (Vt. Sup. Ct. Jan. 28, 2016); *Rhode Island v. Brown&Williamson Tobacco Corp., et al.*, No. 97-3058 (R.I. Sup. Ct. Mar. 9, 2016). Due to the PMs inability to agree with one

The trial court's conclusion that a "single decision maker has the best chance of producing consistent awards…and that a nationwide arbitration was envisioned by the parties," Am. Order & J. at 14, LF 2395 is against the weight of the evidence. *Indeed, it is no longer even possible.* The trial court's denial of Missouri's motion to compel the PMs into a single-state arbitration of Missouri's 2004 diligent enforcement dispute should be reversed.[16]

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another—because they are not on the "same side"—the same three arbitrators will not make diligence determinations for every one of the States.

[16] The court of appeals correctly found that "a 'nationwide' arbitration will not take place, regardless, as a result of the Partial Settlement, where twenty-[four] States accepted the Partial Settlement and no longer have reason to participate," and the court of appeals correctly held that "[b]ecause the parties agreed to arbitrate, and the arbitration clause is one that is susceptible to an interpretation that covers this specific dispute, based on the evidence before us, the motion to compel arbitration in a single-state fashion should not have been denied by the trial court." *State v. Am. Tobacco Co.*, 2015 WL 5576135, at *19.

III. Consolidating an arbitral dispute between Missouri and the PMs with one of the two already-pending, "nationwide" arbitrations of similar disputes between the PMs and two separate groups of other States is inherently prejudicial to Missouri.

During 12 of the 18 state-specific hearings that followed Missouri's hearing in the 2003 national arbitration, and without any notice to Missouri, the Panel allowed the PMs and the other States to offer argument and testimony that Missouri failed to diligently enforce its Qualifying Statute during 2003. The 2003 Panel's Final Award finding Missouri non-diligent does not even reference the evidence contained in the Record from Missouri's hearing of the fact that PMs *gained* market share over NPMs in Missouri, and that Missouri and the PMs had intended Missouri's diligent enforcement of its Qualifying Statute against those NPMs to be judged by its efforts, rather than by the amount of escrow deposited by NPMs. To the contrary, the 2003 Panel's specific criticisms of Missouri's alleged failures to prevent sales of contraband cigarettes, to discern underreporting of sales by NPMs, to file any lawsuits, and to enact and diligently enforce its Qualifying Statute as well as additional legislation are all unmistakably grounded in the ex parte

testimony and argument presented at those 12 hearings which had been noticed up only for the diligence determinations of those 12 other States.

The salient lesson from the 2003 arbitration is that collective arbitration before a single arbitration panel deprived Missouri of a fair hearing because the PMs and other States were permitted numerous additional opportunities to undermine Missouri's evidence during subsequent hearings at which Missouri was not present and could not cross-examine the witnesses whose testimony would be used against Missouri by the Panel. "[A] national arbitration appears to have prejudiced Missouri [because] States supposedly on Missouri's 'side' of the arbitration went on the attack" during twelve of the hearings that followed Missouri's hearing, "essentially contesting Missouri's diligence as a means to bolster their own." *State v. Am. Tobacco Co.*, 2015 WL 5576135, at *19.

The MSA's arbitration clause requires that arbitrations "be governed by the United States Federal Arbitration Act." MSA at §11(c), LF 332. Arbitrations conducted under the FAA must protect the parties' rights from prejudice. *See* 9 U.S.C. §10(a)(3). The due process rights of arbitrating parties are further protected by the prohibition on arbitrators from exceeding the authority granted them by the parties. *See* 9 U.S.C. §10(a)(4). Similarly, Missouri's Uniform Arbitration Act ("MUAA") mandates the protection of a

party's rights "to be heard, to present evidence material to the controversy and to cross-examine witnesses appearing at the hearing." Sections435.405.1, RSMo (2) & (4); Section 435.370 (2), RSMo. The MUAA also prohibits arbitrators from exceeding their authority as granted by the parties to the arbitration. Section 435.405.1(3), RSMo.

If arbitrators engage in the misconduct or misbehavior of receiving and relying on evidence and argument obtained through ex parte communications, reviewing courts will vacate that arbitration award as a denial of due process. *See Pacilli v. Philips Appel & Walden, Inc.,* No. 90-0263 1991 WL 193507 *6 (E.D. Pa. Sept. 24, 1991) (Vacatur of award rendered after ex parte receipt of testimony by the arbitrators at a hearing held after the party had been dismissed from arbitration where the testimony prejudiced the cross-claims asserted against the previously-dismissed party); *Maaso v. Singer*, 203 Cal. App. 4th 362, 368 (Cal. Ct. App. 2012) (affirming vacatur of arbitration award where *ex parte* contact "called into question 'the irregularity and integrity of the decision-making process.'"); *Hahn v. A.G. Becker Paribas, Inc.,* 518 N.E.2d 218, 225 (Ill. App. 1987) (Vacatur of award where evidence was received through "undue means" and "misconduct" of arbitrators in receiving ex parte evidence); *Goldfinger v. Lisker*, 500 N.E. 2d 857, 860 (NY App. 1986) (Vacatur ordered because arbitrator failed to rely

"only upon proof adduced at a hearing of which due notice ha[d] been given to each party").

Similarly, an arbitrator's refusal to receive pertinent and material evidence deprives a party of a fair hearing and the fundamental right to be heard. *Fairchild & Company, Inc. v. Richmond, Fredricksburg and Potomac Railroad Co.*, 516 F. Supp. 1305, 1314 (D.C. 1981); *Cofinco, Inc. v. Bakrie & Bros.*, 395 F. Supp. 613, 615 (S.D.N.Y. 1975). "In general, reviewing courts leave procedural issues for the arbitrators to decide." *Dow Corning Corp. v. Safety Nat'l Cas. Corp.,* 335 F.3d 742, 749 (8th Cir.2003) (citation omitted). However, "[t]he procedure employed must give each party the opportunity to present its arguments and evidence." *El Dorado Sch. Dist. # 15 v. Cont'l Cas. Co.,* 247 F.3d 843, 848 (8th Cir.2001) (citing *Scott v. Prudential Sec., Inc.*, 141 F.3d 1007, 1016-17 (11th Cir. 1998)). The FAA allows for a court to vacate an award if the Panel "refus[ed] to hear evidence pertinent and material to the controversy9 U.S.C. §10(a)(3).

Further, courts have recognized that the integrity of arbitration as a process that provides parties a fair hearing must be safeguarded if arbitration is to remain a valid method of dispute resolution. *Pacilli*, 1991 WL 193507 at *4-5; *Goldfinger*, 500 N.E.2d at 857; *Tilcon Conn., Inc. v. Romano*, No. CV0305241975, 2004 WL 772050, at *3 (Conn. Super. Ct. March

23, 2004) (vacating arbitration award where arbitrator received evidence outside of hearing and recognizing that while "courts strongly support arbitration…in order to strengthen and uphold arbitration we must keep it free of any taint") (quoting *Peerless Ins. Co. v. Roberto,* No. CV 91-07019225, 1992 WL 67583, at *3) (Conn. Super. Ct. March 30, 1992)).

The trial court below correctly acknowledged that "[i]t is a fundamental principle of fairness in arbitration that awards must be based solely on evidence presented at the hearings, with all parties in attendance [and that] the ex parte receipt of evidence by arbitrators from one party, without notice to the other party, is 'misbehavior' prejudicial to the innocent party's rights." Am. Order & J. at 8, LF 2400. It further found that "[f]ollowing the close of Missouri's hearing, eighteen other states tried their cases before the arbitration panel. In twelve of the eighteen hearings, statements and arguments regarding Missouri's enforcement efforts were heard. Missouri's counsel was not present during these other states' hearings." Am. Order & J. at 8, LF 2395-96. At page 10 of its Order and Judgment, the trial court noted that the PMs had conceded that information about Missouri had been repeated during hearings that occurred after the conclusion of Missouri's hearing.

Missouri did ask the trial court to vacate "Missouri's Final Award" regarding the 2003 Panel's finding of non-diligence based on the ex parte evidence and argument that occurred at other States' hearings. The trial court denied Missouri's Motion to Vacate Missouri's Final Award, and Missouri does not appeal that ruling here. However, the trial court's conclusions of law requiring arbitrators to afford due process to all parties, and the trial court's findings of fact regarding the 2003 Panel's ex parte communications (discussed above) are relevant to this appeal.

The trial court declined to vacate Missouri's Final Award because the bar for vacating an arbitral award is high. However, the bar for determining whether the MSA's arbitration clause constitutes agreement to a nationwide arbitration is not so high and the trial court failed to properly evaluate the weight of the evidence of prejudice in the 2003 national arbitration to Missouri's due process rights.

For the 2003 dispute, Missouri got to try its case one time. In 12 of the 18 hearings that followed Missouri's, the PMs continued to supplement and modify their case against Missouri, and other States attempted to build up their cases by tearing Missouri's down. While Missouri may have agreed to a one-time 2003 national arbitration, it never agreed to a process whereby the PMs and other States would be permitted repeated, prejudicial, and

fundamentally unfair ex parte contact with the arbitration Panel *about Missouri's diligent enforcement*.

Additionally, the 2003 national arbitration attempted at the onset (perhaps unwisely) to adjudicate the rights of 51 sovereigns. While this process was agreed to by Missouri and the other States in exchange for one-time significant consideration by the PMs, nothing in the MSA mandates a national or collective arbitration for the dispute between Missouri and the PMs regarding Missouri's diligent enforcement for 2004, and the lessons from the 2003 NPM Adjustment Arbitration teach that it cannot be done fairly.

The sheer volume of information and documents, numerous state-specific issues, and complexity and length of the 2003 proceeding clearly made it difficult for the 2003 Panel to fairly and accurately judge the dispute of any one State on its own merits. *See, e.g., Malcom v. Nat'l Gypsum Co.,* 995 F.2d 346, 350 (2d. Cir. 1993)("The systemic urge to aggregate litigation must not be allowed to trump our dedication to individual justice, and we must take care that each individual plaintiff's—and defendant's—case not be lost in the shadow of towering mass litigation."); *Banacki v. Onewest Bank, FSB,* 276 F.R.D. 567, 572 (E.D. Mich. 2011)("[C]onsiderations of convenience and economy must yield to a paramount concern for a fair and impartial trial.")(internal citation omitted).

The impossibility of fairly balancing the due process rights of all parties was also made apparent in the 2003 Panel's handling of the Partial Settlement. The 2003 Panel held that Missouri and the other States that did not settle would, if eventually found to be non-diligent, carry a much greater NPM Adjustment liability than that mandated by the plain language of the MSA. The 2003 Panel acknowledged that, while it was doing what it thought best for the now 24 States that accepted the Partial Settlement, it might not have been adequately protecting the interests of Missouri and the remaining States that rejected the Partial Settlement. *See* Partial Settlement at 14, LF 255. In significant contrast, the Panel presiding over a 2004 arbitration between only Missouri and the PMs will be authorized solely to determine Missouri's diligent enforcement and will not have the opportunity to prioritize any other State's interests over Missouri's due process rights.

The weight of the evidence from the 2003 arbitration compels the conclusion that another national or collective arbitration will result in another denial of Missouri's rights to fundamental due process—the right to be heard on the merits of its evidence, to have notice of evidence being taken against it and the opportunity to cross-examine all witnesses who testify about its diligent enforcement. "[A] nationwide arbitration where the States conflict with their own 'side' without adequate representation infringes upon

their due process rights." *State v. Am. Tobacco Co.*, 2015 WL 5576135, at *19. The trial court's denial of Missouri's motion to compel the PMs to arbitrate the dispute of Missouri's diligent enforcement of its Qualifying Statute in 2004 in a single-state arbitration is against the weight of the evidence and must be reversed.

CONCLUSION

Missouri respectfully requests that this Court reverse the trial court's denial of Missouri's Motion to Compel a Single-State Arbitration to Determine Whether Missouri Diligently Enforced its Qualifying Statute in 2004. Because the MSA's arbitration clause is silent on nationwide or collective arbitration, and "[a]s evidence of the parties' course of conduct makes apparent, and experience arbitrating the 2003 NPM Adjustment highlights, a nationwide arbitration was not intended by the parties in drafting the MSA and did not serve efficiency and equity…[t]he parties agreed to arbitrate, so the trial court *was required* to grant the motion to compel arbitration, which was requested as a single-state proceeding." *State v. Am. Tobacco Co.*, 2015 WL 5576135, at *20.

Missouri further requests that this Court (1) compel arbitration of Missouri's diligent enforcement of its Qualifying Statute during 2004 in a proceeding *solely* between Missouri and the PMs; and (2) order that

Missouri's arbitration shall not be consolidated with any other State's 2004 NPM Adjustment dispute, including a *de facto* consolidation which would arise from participation of any arbitrator involved in any other such dispute.

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CERTIFICATES OF SERVICE AND COMPLIANCE

I hereby certify that I filed electronically and served via Missouri Case.Net this Substitute Opening Brief of Appellant/Cross-Respondent State of Missouri on this first day of July, 2016 upon Counsel of Record.

I hereby certify that this brief contains the information required by Rule 55.03, complies with the limitations contained in Rule 84.06(b), and contains 17,018 words exclusive of cover, signature block, and certificates.

/s/ J. Andrew Hirth
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Deputy General Counsel