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 RESPONSE BRIEF OF APPELLANT/CROSS-RESPONDENT STATE OF MISSOURI

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STATEMENT OF THE CASE[1]

Nearly 20 years ago, Missouri and 51 other U.S. states and territories ("States") settled multiple consumer fraud and products liability lawsuits against dozens of Participating Manufacturers of Tobacco Products ("PMs") under the landmark Master Settlement Agreement ("MSA"). In that agreement, the PMs promised to make annual payments to the States in perpetuity. Each April, the PMs transfer several billion dollars into an escrow account to be distributed among the States according each State's Allocable Share as provided in Exhibit A to the MSA. For example, Missouri's Allocable Share is 2.2746011% while California's is 12.7639554%.

Not all cigarette manufacturers chose to join the MSA. Those that did not (and those that have come into business since) are referred to in the MSA as Non-Participating Manufacturers ("NPMs"). Because NPMs have no annual payment obligation to the States, they are able to sell their cigarettes at substantially lower prices that the PMs. The MSA attempts to reduce the NPMs' potential market advantage by incentivizing States to enact model legislation—called a Qualifying Statute—requiring NPMs to place into an

[1] The Statement of Facts in Missouri's Opening Brief included all facts relevant to both the State's own appeal and the PMs' cross-appeal and is incorporated here by reference.

escrow account (for 25 years) funds roughly equivalent to what they would owe the States if they had joined the MSA. To further incentivize the States, the MSA offers the PMs a substantial reduction in their annual payment obligation—called the NPM Adjustment——if two conditions are 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) An economist selected by the parties determines that the MSA was a "significant factor" contributing to that national Market Share Loss. *Id.* §IX(d)(1)(C), LF 323-24.

If both prerequisites are satisfied, the MSA provides that an "NPM Adjustment . . . *shall apply* to the Allocated Payments of all Settling States, *except*" for those that "diligently enforced the provisions of [their Qualifying Statute] during such entire calendar year. MSA §IX(d)(2)(A)-(B), LF 325-30 (emphasis added).

The "diligent enforcement" exemption is both a carrot and a stick. By enacting and "diligently enforcing" a Qualifying Statute, an individual State may avoid having its Allocable Share of the PMs' annual payment reduced by the NPM Adjustment. This potential safe harbor is the carrot. But, the

amount of money by which each "Diligent" State's annual payment would have been reduced (had that State *not* diligently enforced its Qualifying Statute) does not melt into the ether. Rather, each Diligent State's Allocable Share of the NPM Adjustment liability gets *re*-allocated among *all other States* that failed to enact or diligently enforce their own Qualifying Statute. MSA §§IX(d)(2)(B)-(D), LF 325. Depending on the number of States that qualify for the diligent enforcement exemption, a Non-Diligent State's *reallocated* share of the NPM Adjustment may be substantially greater than its own allocable share, potentially wiping out the State's entire MSA payment for that year. MSA §IX(d)(2)(C), LF 326 (limiting a State's liability for the NPM Adjustment to the amount of its annual payment. This threat of reallocation is the stick.

Thus, each Non-Diligent State's total NPM Adjustment liability has ***two components***. First, each Non-Diligent State is ***allocated*** a percentage of the NPM Adjustment equal to that State's Allocable Share, as set forth in MSA Exhibit A. (If every State is non-diligent, the calculation ends here; but if at least one State qualifies for the diligent enforcement exemption, the process continues.) Second, the remainder of the NPM Adjustment—the aggregate Allocable Shares of the Diligent States—is ***reallocated*** among the Non-Diligent States in proportion to their relative Allocable Shares (*i.e.*, each Non-Diligent State's Allocable Share is divided by the aggregate of all Non-

Diligent States' Allocable Shares). While the first half of this formula remains constant (*e.g.*, Missouri's *allocated* share is always 2.2746011%), the second half—the *reallocated* share—varies according to the number of Diligent States. As the number of Diligent States increases, so does the liability re-allocated among the pool of Non-Diligent State.

Most disputes arising out the MSA are committed to the exclusive jurisdiction of a designated state court—Missouri's MSA Court is the Hon. Jimmie Edwards in the 22nd Judicial Circuit. However, the MSA has a narrow arbitration clause under which "[a]ny dispute . . . arising out of or relating to calculations performed by, or determinations made by, the Independent Auditor," including the amount, allocation, and reallocation of the NPM Adjustment, "shall be submitted to binding arbitration before a panel of three neutral arbitrators, each of whom shall be a former Article III judge." MSA § XI(c), LF 322.

In 2006, the PMs claimed both perquisites for the NPM Adjustment had been met as to their 2003 payment to the States. However, the Independent Auditor that calculates all MSA payments would not apply the NPM Adjustment until it was determined whether any States qualified for the diligently enforcement exemption. Subsequently, the States and the PMs entered into an Agreement Regarding Arbitration ("ARA"), under which the parties would ask three former Article III judges to resolve "a dispute

between the Settling States and the Participating Manufacturers regarding whether under the Master Settlement Agreement ('MSA') the Participating Manufacturers are entitled to a 2003 NPM Adjustment, including whether the Settling States diligently enforced Qualifying Statues during 2003 *such that the 2003 NPM Adjustment does not apply to their Allocated Payments*..." ARA at 1 LF 763 (emphasis added). The ARA enumerated a non-exhaustive list of five substantive matters to be put to the arbitrators, including "[w]hether individual Settling States diligently enforced a Qualifying Statute in 2003," "whether the Settling States or the Participating Manufacturers bear the burden of proof on diligent enforcement," and "[t]o the extent a Settling State may assert that the 2003 NPM Adjustment should be applied to another Settling Statue pursuant to Section IX(d)(2) of the MSA, *a determination as to the validity of any such determination*." ARA at 13, LF 775 (emphasis added). The arbitration was to be governed by the MSA (which incorporates the Federal Arbitration Act) and the ARA.[2]

The first issue ruled by the Panel was whether the States or the Participating Manufacturers ("PMs") bore the burden of proof as to diligent enforcement. The PMs argued that MSA §IX(d)(2)(A) allocates liability for the entire NPM Adjustment among all States by default, and that any State claiming the exemption under MSA §IX(d)(2)(B-C) must bear the burden of

[2] MSA §XI(c) at LF 332, ARA at LF 762.

proving to the Panel that it had, in fact, diligently enforced its Qualifying Statute throughout 2003. The States argued instead that the PMs must prove the non-diligence of each State before any of the NPM Adjustment liability could be apportioned to any State. Though it did not allow the PMs to claim the NPM Adjustment *by default—i.e.*, the Panel affirmed the Independent Auditor's refusal to apply the NPM Adjustment until each State's diligence had been determined—the Panel agreed with the PMs that each State had to prove its own diligent enforcement before it could be considered exempt from the allocation and reallocation of the total NPM Adjustment under MSA §§IX(d)(2)(A-C).[3] Subsequently, the Panel scheduled State-specific hearings to determine the diligence of each and every State whose diligence was contested by any party.

At that point in the arbitration, the rules of engagement were clearly established. No State claiming the benefits of the diligent enforcement exemption could avoid a hearing to prove its diligence *unless* none of the PMs *and none of the other States* contested its diligence. Thus, each State whose diligence was contested by *any* party had only two options: either prove its diligence or pay both its allocated and reallocated share of the NPM Adjustment for 2003. However, midway through the schedule of State-specific diligence hearings, the PMs announced a "Term Sheet" Settlement with 19

[3] MSA §§IX(d)(2)(A-C) at LF 325-326.

(now 24) States. If approved by the Panel, the Term Sheet would allow any State that signed it to avoid the very diligence determinations that the Panel's Burden of Proof Order (and its subsequent Independent Auditor and No Contest Orders) had construed MSA §§ IX(d)(2)(A-C) to require for each and every State. Essentially, the Term Sheet States would be treated as though they were diligent notwithstanding the fact that their diligence or lack of diligence would remain forever unknown. Over the vehement objection of Missouri and the other States that declined the settlement, the PMs and the Term Sheet States persuaded the Panel to approve their side deal by entering a Stipulated Partial Settlement and Award ("Partial Award").

By giving effect to the Term Sheet, the Panel not only changed the rules of engagement it had established two years earlier *at the PMs' behest*, it amended the reallocation provisions of the MSA itself for 2003 and all subsequent payment years. Though the Panel had construed MSA §§IX(d)(2)(A-C) to require each State ***to prove its diligence*** **or** ***pay its two-part share*** of the NPM Adjustment—its own allocated share, plus a share *re*allocated from States proven to be diligent in fact—the Panel declined to determine the diligence of any of Term Sheet States even though the PMs had consistently contested the diligence of all but two of them. Nor did the Panel provide Missouri and the other objecting States any opportunity to prove the non-diligence of the Term Sheet States themselves. The Panel

simply released the Term Sheet States from bearing any part of the MSA's reallocation process, which necessarily increased the NPM Adjustment liability reallocated from the 25 Diligent States onto the six States (including Missouri) eventually found not to have diligently enforced.

The Panel's Partial Award effectively amended the MSA by supplanting its explicit reallocation provisions in §§IX(d)(2)(A-C) with a new contract exemption and a common law "judgment reduction" system to which Missouri never agreed. Under MSA §XVIII(j), the MSA may only be amended with the express consent of all *affected* parties. Disputes about the operation of §XVIII(j) are not among the subjects enumerated in the MSA's narrow arbitration clause, *cf.* MSA §XI(c), and are therefore reserved to the *sole* jurisdiction of state court. Neither the MSA nor the ARA (nor the FAA) vested the Panel with any authority to "construe" §XVIII(j), much less effect a unilateral amendment to the MSA's express reallocation provisions. Nonetheless, the Panel took it upon itself to rule (1) that it had jurisdiction to "construe" MSA §XVIII(j)'s amendments clause, (2) that the word "affect" as used in that clause really means "materially prejudices," (3) that none of the States objecting to the Term Sheet Settlement was materially prejudiced (notwithstanding the increased reallocation of NPM Adjustment liability), and therefore, (4) that none of its actions "amended" the MSA.

The Panel's ruling abrogated Missouri's (and the other objectors') MSA rights of contribution from the Term Sheet States by releasing them from their obligation ***to have their diligence determined*** **or** ***pay their share*** of the 2003 NPM Adjustment. Up until that moment, the PMs consistently (and emphatically) asserted that 17 of the 19 (now 22 of 24) Term Sheet States had not diligently enforced in 2003. If the Panel had agreed with the PMs about those States' non-diligence, each would have borne its two-part share of the NPM Adjustment. The pro rata judgment reduction method the Panel applied instead of the MSA's express reallocation provisions accounted for the first part of the Term Sheet States' liability – their original allocable share – by reducing the total available NPM Adjustment by their Term Sheet States' aggregate Allocable Shares of 46%. That was money owed to the PMs, and the PMs were free to compromise it. But the Panel's ruling overlooked the *second* part of the Term Sheets States' liability, the part that would have been *re*allocated to them from the Diligent States. By reducing the pool of States among which the Diligent States' Allocable Shares would be reallocated, the Panel necessarily increased the amount reallocated to each of the Non-Diligent States that rejected the Term Sheet. That liability was an obligation between the States and each other, yet the PMs purported to compromise it as well, and the Panel let them do it.

Missouri moved to vacate or modify the Panel's Partial Award in the trial court as an unauthorized amendment of the MSA that increased Missouri's ultimate NPM Adjustment liability by approximately $50 million. Citing and applying the correct vacatur standard under the FAA, the trial court ruled that the Panel had exceeded its powers because the Partial Award "effectively amends §IX(d)(2), since the [Term Sheet] states are no longer subject to the NPM Adjustment and do not have to prove their diligent enforcement." LF2399. The trial court found that "the only way for the Partial Settlement Award to not affect Missouri's rights is for the 20 [Term Sheet] states whose diligence was contested, but not proven, to be treated as non-diligent when calculated the NPM Adjustment for Missouri." LF2399-2400.

The court of appeals reversed because it found "the MSA is latently ambiguous in its silence on the issue of a Partial Settlement when allocating the NPM Adjustment," and thus the Panel acted within their authority to resolve that ambiguity by importing a pro rata judgment reduction method. *State v. American Tobacco Co.*, No. ED 101542, 2015 WL 5576135, at *13 (Mo. App. E.D. Sept. 22, 2015). However, neither party argued to the court of appeals (or to the arbitration panel or the trial court) that *any* section of the MSA at issue in this case is ambiguous. Missouri does not take the position that any section of the MSA, particularly §IX, is ambiguous because the MSA

declares §IX to be a "Nonseverable Provision." MSA §XVIII(o)(1), SLF 149-151. Court rulings that address Nonseverable Provisions of the MSA in specified ways can place additional burdens on the parties to the MSA:

> (2) If a court materially modifies, renders unenforceable, or finds to be unlawful any of the Nonseverable Provisions, the NAAG executive committee shall select a team of Attorneys General (the "Negotiating Team") to attempt to negotiate an equivalent or comparable substitute term or other appropriate credit or adjustment (a "Substitute Term") with the Original Participating Manufacturers…If any Original Participating Manufacturer does not agree to a Substitute Term, this Agreement shall be terminated in all Settling States affected by the court's ruling…If any affected Settling State does not approve the proposed Substitute Term, this Agreement in such Settling State shall be terminated.

MSA §XVIII(o)(2), SLF 149-151.

Since the court of appeals transferred the present case to this Court, two other States' highest courts have considered the same issue. Like the trial court, the courts of last resort in Maryland and Pennsylvania have independently determined that the Arbitration Panel exceeded its powers by

amending the MSA with its Stipulated Partial Settlement and Award ("Partial Award"). This Court should follow the reasoning of its sister courts and affirm the trial court's modification order.

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

The central issue raised in the PMs' appeal—whether the Arbitration Panel's Partial Award *amended* the MSA or merely *construed* it—has already been decided by the courts of last resort in both Pennsylvania and Maryland. *See Commonwealth v. Philip Morris USA, Inc.*, 114 A.3d 37 (Pa. Commw. Ct.), appeal denied, 129 A.3d 1244 (Pa. 2015), pet. for cert. filed, No. 15-1299 (U.S. April 21, 2016)("Pennsylvania Decision"); *State v. Philip Morris, Inc.*, 123 A.3d 660, 680 (2015), appeal denied, 132 A.3d 195 (2016), pet. for cert. filed, No. 15-1537 (U.S. June 22, 2016)("Maryland Decision"). The high courts in both of those States concluded that the Panel exceeded its authority by amending the MSA itself. Both courts ruled against the PMs on the merits of the same issue after a full and fair opportunity to litigate the issue. Under the Full Faith and Credit Clause of the United States Constitution, the PMs should be collaterally estopped from taking a third bite at the apple in this Court. *See* Part I, *infra*.

Even if those rulings were not entitled to preclusive effect, the trial court properly modified the Partial Award under the Federal Arbitration Act's highly deferential standard of review because the Panel exceeded its powers. The Panel's Partial Award amended provisions of the MSA governing *all* States' shared liability for the NPM Adjustment, the potential exemption from the adjustment of individual states that diligently enforced their

Qualifying Statutes, and the reallocation of exempt States' liability to non-exempt States. Indeed, the Panel even amended the MSA provision *that prohibits the MSA from being amended* without the consent of all "affected" States. The Partial Award abrogated the States' rights of contribution against one another, shifted an additional $50 million of NPM Adjustment liability onto Missouri, and forever increased Missouri's risk of losing its entire MSA payment in future years. Because the Panel lacked the authority to amend the parties' contract, the trial court's order modifying the Partial Award should be affirmed. *See* Part II, *infra*.

The Panel's authority to adjudicate the present dispute derived from the MSA and the parties' Agreement Regarding Arbitration ("ARA"), which included a non-exhaustive list of five substantive matters to be submitted for arbitration. Among these were "[w]hether individual Settling States diligently enforced a Qualifying Statute in 2003," and "[t]o the extent a Settling State may assert that the 2003 NPM Adjustment should be applied to another Settling State pursuant to Section IX(d)(2) of the MSA, a determination as to the validity of such determination. LF 775. Despite the clarity of the questions asked of them, the Panel refused to determine the diligence of *more than half* of the States whose diligence was contested by the PMs for a full year after the no-contest deadline, even as Missouri and other States "assert[ed] that the 2003 NPM Adjustment should be applied to [those

states] pursuant to Section IX(d)(2) of the MSA." Rather than finishing the job it was hired to do, the Panel stitched into to the fabric of the MSA a new, extra-contractual exemption from the States' shared liability for the NPM Adjustment and replaced the MSA's express reallocation provisions with a common law judgment reduction method reflecting its own "notions of economic justice rather than drawing its essence from the contract." *Oxford Health Plans LLC,* 133 S.Ct. 2068 (internal punctuation omitted). The trial court's modification order should be affirmed because the Panel "so imperfectly executed [its delegated powers] that a final and definite award upon the subject matter submitted" was not—*and never will be—made*. 9 U.S.C. § 10(a)(4). *See* Part III, *infra*.

I. The PMs are collaterally estopped from relitigating the issue of whether the Panel exceeded its powers by amending the MSA to effectuate its Partial Award.

(Part I advances an independent argument for affirming the trial court and does not respond to any portion of Cross-Appellants' Briefs)

The highest courts in Maryland and Pennsylvania have ruled that the Arbitration Panel exceeded its powers in violation of the FAA because its Partial Award ("Partial Award") effectively changes the terms of the parties'

contract. Rejecting the *same* arguments the PMs now advance in this Court, the Maryland Court of Special Appeals held:

> the Panel exceeded its powers . . . . when it reallocated the 2003 NPM Adjustment without first determining the diligence of all contested states. Not only did the Panel lack jurisdiction to issue the Partial Settlement Award pursuant to MSA § XVIII(j), its decision lacked rationality in light of MSA § IX(d)(2)(B). In turn, the circuit court erred in affirming the Panel's ruling."

State v. Philip Morris, Inc., 123 A.3d 660, 680 (2015), cert. denied by the Court of Appeals of Maryland, 132 A.3d 195 (2016), pet. for cert. filed, No. 15-1537 (U.S. June 22, 2016)("Maryland Decision"). The Commonwealth Court of Pennsylvania reached the *identical* conclusion: "***under any standard of review***, we conclude the panel exceeded its powers by acting beyond the material terms of the MSA, from which its authority was derived. The trial court properly modified the award in accordance with the MSA's express terms." *Com. ex rel. Kane v. Philip Morris USA, Inc.*, 114 A.3d 37 (Pa. Commw. Ct.), appeal denied by the Supreme Court of Pennsylvania, 129 A.3d 1244 (Pa. 2015, pet. for cert. filed, No. 15-1299 (U.S. April 21, 2016)("Pennsylvania Decision").

Article IV, § 1, of the United States Constitution provides that "Full Faith and Credit shall be given in each State to the . . . judicial Proceedings

of every other State." Federal law further provides that "judicial proceedings . . . shall have the same full faith and credit in every court within the United States and its Territories and Possessions as they have by law or usage in the courts of such State ...." *San Remo Hotel, L.P. v. City & Cty. of San Francisco, Cal.*, 545 U.S. 323, 336 (2005) (quoting 28 U.S.C. § 1738). These constitutional and statutory requirements "encompass the doctrine[] of collateral estoppel, or 'issue preclusion.'" *Id.* Under this doctrine, "once a court has decided an issue of fact or law necessary to its judgment, that decision may preclude relitigation of the issue in a suit on a different cause of action involving a party to the first case." *Allen v. McCurry*, 449 U.S. 90, 94 (1980). "[C]ollateral estoppel relieve[s] parties of the cost and vexation of multiple lawsuits, conserve[s] judicial resources, and, by preventing inconsistent decisions, encourage[s] reliance on adjudication." *Id.*

This Court has identified four factors that must be considered before giving preclusive effect to a prior adjudication under collateral estoppel principles: (1) whether the issue decided in the prior case is identical to the issue presented in the current action; (2) whether the prior case resulted in a judgment on the merits; (3) whether the party against whom estoppel is asserted was a party to the prior adjudication; and (4) whether the party against whom collateral estoppel is asserted had a full and fair opportunity to litigate the issue in the prior suit. *James v. Paul*, 49 S.W.3d 678, 682-83 (Mo.

2001)(citing *Oates v. Safeco Ins. Co. of Am.*, 583 S.W.2d 713, 719 (Mo. banc 1979)). In this case, all four factors weigh in favor of collateral estoppel.

A. The issue now on appeal before this Court is identical to the issue decided by the Maryland and Pennsylvania courts of last resort.

Applying the FAA's highly deferential standard of review,[4] the trial court determined that the Panel's Partial Award "effectively amends [the MSA] since the [Term Sheet] states are no longer subject to the NPM Adjustment and do not have to prove their diligent enforcement." LF 2399. "There is no question," the trial court explained, "that Missouri is materially affected by the Partial Settlement and the pro rata reallocation of the NPM Adjustment" and that "Missouri, and the other non-[Term Sheet] states, did not agree to such amendment of the calculation of their annual payment." *Id.*

[4] Quoting 9 U.S.C. § 10(a)(4), the trial court identified the FAA's standard of review as follows: "The Federal Arbitration Act permits vacatur . . . where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made." LF 2396.

The trial court concluded that "the only way for the Partial Settlement Award to not affect Missouri's rights is for the 20 [Term Sheet] states whose diligence was contested, but not proven, to be treated as non-diligent when calculating the NPM Adjustment for Missouri." *Id.* at 2399-2400. Accordingly, the court ordered:

> [t]he Independent Auditor shall treat each Settling State that has signed the Term Sheet referenced in the Stipulated Partial Settlement and Award as if such Settling State did not diligently enforce a Qualifying Statute for purposes of section IX(d) of the MSA when the Independent Auditor calculates the amounts owed to Missouri under the MSA for the sales year 2003, unless the diligence of such Settling State was not contested for the arbitration panel issued a separate final award determining that such Settling State was diligent.

Id. at LF 2406-2407.

In reaching its conclusion, the trial court noted that "a Pennsylvania court decided *this very issue* in favor of the Commonwealth of Pennsylvania." LF 2397 (emphasis added). As in this case, the Pennsylvania court found that the Partial Award "violated section XVIII(j) of the MSA, which provides the MSA can only be amended 'by a written instrument executed by all . . .

Settling States affected by the amendment.'" *Kane v. Philip Morris USA, Inc.*, 2014 WL 3709672, at *26 (quoting MSA § XVIII(j). "When the Panel adopted the pro rata reallocation method and instructed the Independent Auditor to treat all of the [Term Sheet] States as diligent," the Pennsylvania court explained, "it effectively rewrote the MSA and affected Pennsylvania's contractual rights." *Id.* "As 20 of the [Term Sheet] States' diligence was contested, but not proven," the Pennsylvania court concluded that "the only way for the Partial Settlement Award to not affect Pennsylvania's rights—and amount to an unauthorized amendment of the MSA—is for these 20 [Term Sheet] States to be treated as non-diligent when calculating the NPM Adjustment for Pennsylvania." *Id.* at *20. Consequently, the Pennsylvania Court ordered:

> the Independent Auditor shall treat each Settling State that has signed the Term Sheet referenced in the Stipulated Partial Settlement and Award as if such Settling State did not diligently enforce a Qualifying Statute for purposes of section IX(d) of the MSA when the Independent Auditor calculates the amounts owed to Pennsylvania under the MSA for the sales year 2003, unless the diligence of such Settling State was not

> contested or the arbitration panel issued a separate final award determining that such Settling State was diligent.

Id. at *26.

After both the Pennsylvania and Missouri courts ruled the Panel's Partial Award was an unauthorized amendment of the MSA, Maryland's Court of Special Appeals reached the same conclusion. Like Pennsylvania and Missouri, the State of Maryland argued to its MSA court that "the Panel exceeded its powers when it amended the MSA without Maryland's consent, by ratifying the Term Sheet and by issuing the Partial Settlement Award." *State v. Philip Morris, Inc.*, 123 A.3d at 676 (internal quotations omitted). The Maryland Court of Special Appeals agreed with the State, holding that "the Panel's Partial Settlement Award 'imposed an unauthorized amendment to the MSA by changing the MSA's method for reallocating the NPM Adjustment among states that did not prove their diligence.'" *Id.* at 679 (quoting *Kane v. Philip Morris USA*, 2014 WL 3709672, at *26). In its remand order, the Maryland court held that the Independent Auditor must be ordered "to treat the 20 Term Sheet States, whose diligence was contested but not determined, as non-diligent, when reallocating the 2003 NPM Adjustment." *Id.*

The issue on appeal in this case is *identical* to the issue decided in both the Pennsylvania and Maryland cases: whether the Panel exceeded its

authority because its Partial Award amended the MSA without the consent of all affected States. That issue was resolved conclusively against the PMs in both of the other jurisdictions that have considered it. There is no legal or equitable basis for giving the PMs a third bite at the apple in this Court.

B. The Maryland and Pennsylvania courts resolved the issue on the merits.

To have preclusive effect, the prior case addressing the identical issue must have been resolved "on the merits." *State ex rel. Johns v. Kays*, 181 S.W.3d 565, 566 (Mo. 2006); *see also Wilson & Co. v. Hartford Fire Ins. Co.*, 300 Mo. 1, 254 S.W. 266, 277 (1923)(identifying kinds of judgments considered not "on the merits," e.g., dismissals for lack of jurisdiction, etc.). There is no question that both of the prior decisions on which Missouri premises its collateral estoppel argument in this case were judgments "on the merits." The Commonwealth Court of Pennsylvania ruled "*under any standard of review*" that "the panel exceeded its powers by acting beyond the material terms of the MSA, from which its authority was derived. The trial court properly modified the award in accordance with the MSA's express terms." *Kane v. Philip Morris USA, Inc.*, 114 A.3d at 65. Likewise, the Court of Special Appeals of Maryland ruled, "The Panel exceeded its powers . . .

when it reallocated the 2003 NPM Adjustment without first determining the diligence of all contested states. Not only did the Panel lack jurisdiction to issue the Partial Settlement Award pursuant to MSA § XVIII(j), its decision lacked rationality in light of MSA § IX(d)(2)(B)." *State v. Philip Morris, Inc.*, 123 A.3d at 680. Both decisions resolved the merits of the parties' arguments; therefore, both have preclusive effect.

C. The PMs were parties in both the Pennsylvania and Maryland cases.

The party against whom collateral estoppel is asserted must be the same party or in privity with a party in the prior adjudication. *State ex rel. Johns v. Kays*, 181 S.W.3d 565, 566 (Mo. 2006). There will be no dispute that the PMs appealing from the trial court's Amended Order and Judgment in this case were all parties to the Pennsylvania[5] and Maryland cases for which

[5] The following PMs are listed as parties in the Pennsylvania case: Philip Morris USA, Inc.; R.J. Reynolds Tobacco Company; Lorillard Tobacco Company; Liggett Group Inc.; Commonwealth Brands, Inc.; Daughters and Ryan, Inc.; Farmers Tobacco Company of Cynthiana, Inc.; House of Prince A/S; Sherman 1400 Broadway N.Y.C. Inc.; King Maker Marketing, Inc.; Top Tobacco; L.P., Japan Tobacco International U.S.A., Inc.; Kretek

Missouri seeks preclusive effect. Those cases, like this one, arose out of the 2003 NPM Adjustment Arbitration initiated by these same PMs pursuant to the MSA. The same PMs are bound by the decisions of the highest courts in Pennsylvania and Maryland and may therefore be estopped from relitigating here the identical issue decided in those cases.

D. The PMs have had a full and fair opportunity to litigate this issue in two other States.

A party is not subject to the preclusive effect of a prior judgment unless they had a full and fair opportunity to litigate the relevant issue in the prior suit. *State v. Kays,* 181 S.W.3d 565, 566 (Mo. 2006). The PMs have had that opportunity at *every level* of the Pennsylvania and Maryland judicial systems. In Maryland, the PMs submitted extensive briefing and presented oral argument to the Circuit Court for Baltimore City (Maryland's MSA Court) and the Court of Special Appeals of Maryland (Maryland's intermediate appellate court), *see State v. Philip Morris, Inc.*, 123 A.3d 660, 671 (2015).

International, Inc.; Peter Stokkebye Tobaksfabrik A/S; P.T. Djarum; Santa Fe Natural Tobacco Company, Inc.; and Von Eicken Group. *See Kane v. Philip Morris USA, Inc.*, 114 A.3d 37 (Pa. Commw. Ct.), appeal denied, 129 A.3d 1244 (Pa. 2015).

Their petition for writ of certiorari to the Court of Appeals of Maryland (Maryland's court of last resort) was denied February 22, 2016, *see State v. Philip Morris, Inc.*, 132 A.3d 195 (2016). In Pennsylvania, the PMs submitted extensive briefing and presented oral argument to the Philadelphia County Court of Common Pleas (Pennsylvania's MSA Court), *see Kane v. Philip Morris USA, Inc.*, 2014 WL 3709672 (Ct. Comm. Pl April 14, 2014), and the Commonwealth Court of Pennsylvania (Pennsylvania's intermediate appellate court), *see Kane v. Philip Morris USA, Inc.*, 114 A.3d 37 (Pa. Commw. Ct. April 10, 2015). The PMs' appeal to the Pennsylvania Supreme Court was denied on December 23, 2015. *See Kane v. Philip Morris USA, Inc.*, 129 A.3d 1244 (Pa. 2015).

The PMs have now exhausted every level of litigation available to them in the courts of Pennsylvania and Maryland. Unless the U.S. Supreme Court happens to grant one of their pending petitions for writ of certiorari, the decisions of those States' courts of last resort will stand. Moreover, the PMs have not raised any arguments in this case that they have not previously raised in both Pennsylvania and Maryland. They could not have had a fuller or fairer opportunity to litigate those arguments already. This Court should hold the PMs collaterally estopped from doing so yet again in Missouri.

II. Applying the FAA's highly deferential standard of review, the trial court properly modified the Partial Award because the Arbitration Panel exceeded its powers by amending the Master Settlement Agreement without Missouri's consent.

(Part II responds to Section I of Respondents'/Cross-Appellants' Substitute Opening Briefs)

Although the plain language of the MSA expressly provides how the NPM Adjustment should be divided among the States, the Panel fashioned its own ad hoc method for apportioning liability among only a subset of States. By substituting its own reallocation system and releasing half of the States from their duty of contribution to their sister States, the Panel effectively amended the MSA itself. Even arbitrators cannot go that far. "An arbitrator's paramount obligation is to apply the parties' agreement in a way that gives effect to their intent." *Boise Cascade Corp. v. Paper Allied-Indus., Chem., and Energy Workers, Local 7-0159,* 309 F.3d 1075, 1081 (8th Cir.2002). "It is well-established that '[t]he arbitrator 'may interpret ambiguous language,' but he may not, however, 'disregard or modify unambiguous contract provisions.'" *Missouri River Services, Inc. v. Omaha Tribe of Nebraska*, 267 F.3d 848, 855 (8th Cir. 2001) (citations omitted). "In other words, '[i]f the arbitrator 'interprets unambiguous language in any way

different from its plain meaning, [the arbitrator] amends or alters the agreement and acts without authority.'" *Id.* (citations omitted).

A. The trial court correctly found that the Panel's powers were limited by the express terms of the MSA's arbitration clause.

Missouri and the PMs agreed when they signed the MSA that all of their MSA-related disputes would be resolved in Missouri state court except for those few disputes specifically identified for an arbitration governed by the Federal Arbitration Act.[6] MSA §XI(c), LF 332. The trial court recognized the parties' grant of authority to the Panel was governed and limited by MSA §XI(c). LF 2404-2405. The *only* disputes designated by the parties for

[6] Section XI(c) of the MSA provides that the Federal Arbitration Act shall govern the arbitration at issue in this appeal, and thus Missouri moved the trial court for vacatur under 9 U.S.C.A. §10(a)(3) and (4). However, because the MSA also provides (at §XVIII(n)) that Missouri law governs disputes between the State and the PMs, Missouri also moved the trial court for vacatur under RSMo §§435.405.1 and 435.370 (2). The language of the federal and state statutes is nearly identical and the trial court cited to both the federal and state statutes. LF 2396-2397.

arbitration are those relating to the Independent Auditor's calculations performed under MSA §IX(j) (payments, generally) and §XI(i)(calculation and disbursement of payments, generally). LF 332. Thus, any other dispute, such as the effect of MSA §XVIII(j)'s prohibition on non-unanimous amendments to the master document, was beyond the jurisdiction of the Panel.[7]

B. The trial court reviewed the Partial Award under the correct FAA standard for vacatur rather than a "clear error" standard.

Throughout their opening brief, the PMs repeat a single refrain: the trial court should be reversed because it mistakenly applied a "clearly erroneous" standard instead of the more deferential standard required by the FAA. The only thing the PMs point to in support of this argument is a single sentence in which the court observed that the Panel's "pro rata reallocation method is clearly erroneous as it violates the MSA's procedure for amending the MSA." Subs. Opening Br. of RJ Reynolds and Philip Morris at 14 (quoting Amended Order and Judgment at 7. The PMs condemn the trial court for

[7] The court of appeals correctly acknowledged that "express provisions excluding particular grievances from arbitration are enforceable." *State v. American Tobacco Co.*, 2015 WL 5576125, at *16.

"cit[ing] no support for its premise that 'clear error' is a sufficient basis to disturb the Panel's contract interpretation under the FAA." Subs. Opening Br. of RJ Reynolds and Philip Morris at 14.

The PMs protest too much. The trial court "cited no support for the premise that 'clear error' is a sufficient basis" because the court was not attempting to articulate a legal standard in that sentence. Indeed, the court had already cited the appropriate standard three pages earlier:

> The Federal Arbitration Act ("FAA") permits vacatur "where the arbitrators were guilty of misconduct in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced," 9 U.S.C. §10(a)(3); or "where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made." Id., §10(a)(4). Under Missouri's Uniform Arbitration Act, vacatur is required where the arbitrators engage in "misconduct prejudicing the rights of a party," or where the arbitrators conduct the hearing "so as to prejudice substantially the rights of any party." Section 435.405.1 RSMo. The Court cannot reweigh the evidence presented to the arbitration panel, but can only look to whether there was

misconduct in the proceedings. Crawford Group, Inc. v. Holekamp, 543 F.3d 971, 978 (8th Cir. 2008).

LF 2396-2397. Not only did the court cite the same standard advanced by the PMs, there is a presumption under Missouri law that trial judges are presumed to "know the law and to apply it in making their decisions." *State v. Feltrop*, 803 S.W.2d 1, 15 (Mo. Banc. 1991) (*overruled on other grounds by Joy v. Morrison*, 254 S.W.3d 885 (Mo. Banc. 2008), *citing Walton v. Ariz.*, 497 U.S. 639 (1990)); *State v. Poole*, 216 S.W.3d 271, 277 (Mo. App. S.D. 2007)(rejecting defendant's argument that trial judge applied incorrect burden of proof because "trial judges are presumed to know the law and to apply it in making their decisions.")

Despite the presumption that it knew and applied the law correctly, the PMs contend that the trial court applied—without any citation—an incorrect legal standard entirely different from the one it had recited just three pages earlier. It is a ridiculous assertion, especially when the court's words are read in context:

> Although the panel had the authority to determine the reallocation method, its pro rata reallocation method is clearly erroneous ***as it violates the MSA's procedure for amending the MSA***. The MSA prohibits amendment unless it is 'by a written instrument executed by all . . .

> Settling States affected by the amendment.' MSA §XVIII(j). MSA section IX(d) states that an NPM Adjustment 'shall apply' to 'all' Settling States 'except' those that "continuously had a Qualifying Statute . . . in full force and effect . . . and diligently enforced the provisions of such statute during such entire calendar year.' *The Stipulated Partial Settlement and Award effectively amends §IX(d)(2), since the [Term Sheet] states are no longer subject to the NPM Adjustment and do not have to prove their diligent enforcement.*

LF 2399-2400 (emphasis added). The salient point is that the Panel ***amended*** the MSA itself, not that the specific way in which it did so was "clearly erroneous."

The PMs' focus on this one errant phrase is misdirection. Even if the trial court did apply the wrong standard—which *did not* happen here—the fact remains that the Panel *amended* the MSA itself, replacing its express reallocation provisions with a common law judgment reduction method that undisputedly shifted and additional $50 million in NPM Adjustment liability onto Missouri. As found by the Commonwealth Court of Pennsylvania: "*under any standard of review*, . . . the panel exceeded its powers by acting beyond

the material terms of the MSA, from which its authority was derived." *Pennsylvania Decision*, 114 A.3d at 37.

C. Pursuant to the applicable federal law, the trial court correctly found that the Panel had exceeded the limited powers granted it by the MSA's arbitration clause and properly modified the Partial Award.

Unlike every federal FAA case relied on by both parties to this appeal (in which "any and all disputes" of the parties are referred to arbitration), the MSA's arbitration clause reserves nearly all disputes for litigation and refers to arbitration only specified disputes over specified sections of the MSA. Thus, the trial court (or appellate court) on review must even more carefully scrutinize the Panel's award for any overreach of its limited jurisdiction and vacate if that limited power has been exceeded.

Both parties rely on the Supreme Court's most recent ruling on arbitration in *Oxford Health Plans LLC v. Sutter,* 133 S. Ct. 2064 (2013), where the Court declined to vacate under 9 U.S.C.A. §10(a)(4) because the parties had specifically authorized the arbitrator to interpret their arbitration clause which provided that "any and all" of their disputes were subject to arbitration. 133 S.Ct. at 2067, 2071. The PMs thus direct this Court to the finding that the *Oxford Health* parties had specifically

"bargained for the arbitrator's construction" of the very clause submitted to him for interpretation and thus upheld his action "even arguably construing or applying the contract" clause that was submitted to arbitration. *Id*. at 2068, 2070. However, given the narrowly-drawn MSA arbitration clause, the real significance here of the *Oxford Health* case is the Court's admonition that vacatur is indeed appropriate where "the arbitrator act[s] outside the scope of his contractually delegated authority – issuing an award that simply reflects [his] own notions of [economic] justice rather than draw[ing] its essence from the contract." *Id*. at 2068 (internal citations and punctuation omitted). Specifically, the *Oxford Health* Court confirmed that 9 U.S.C.A. §10(a)(4) requires courts to vacate arbitral awards "when the arbitrator strayed from his delegated task of interpreting" the contract (or contract clause) that was referred to his arbitration. *Id*. at 2070.

In *Oxford Health*, the Court affirmed its earlier holding in *Stolt-Nielsen S.A. v. Animal Feeds International Corp*., which vacated an arbitral award for class arbitration under an arbitration clause that submitted "any dispute" to arbitration because the panel exceeded its powers under the FAA by imposing its own view of sound policy. 559 U.S. 662 (2010). Both *Oxford Health* and *Stolt-Nielsen* are consistent with the Supreme Court's 1960 decision in *United Steelworkers of America v. Enterprise Wheel and Car Corp* which is not a Federal Arbitration Act case, but which is the original source

of the law that "an arbitrator is confined to interpretation and application" of the contract referred to him for arbitration and thus he cannot "sit to dispense his own brand of industrial justice." 363 U.S. 593, 597 (1960). In *Enterprise Wheel*, the Court carefully inquired into whether the arbitrator had "abused the trust the parties confided in him" by exceeding "the areas marked out for his consideration." *Id*. at 598.

Further, the Eighth Circuit Court of Appeals has consistently confirmed that, within this Circuit, the "extraordinary level of deference" that is normally afforded arbitral awards will be adhered to *only* "so long as the arbitrator is even arguably construing or applying the contract" referred to him for arbitration and is therefore "acting within the scope of his authority." *Crawford Group, Inc. v. Holekamp*, 543 F.3d 971, 976 (8th Cir. 2008); *Boise Cascade Corp. v. Paper Allied-Industrial, Chemical and Energy Workers (PACE)*, 309 F.3d 1075, 1080 (8th Cir. 2003).

Thus, these cases establish a *two-part inquiry* for courts considering whether to vacate (or to affirm the vacatur of) an arbitration award under 9 U.S.C.A. §10(a)(4) because the arbitrator exceeded his powers. *First*, the trial or appellate court on review must determine whether the contract provisions construed by the arbitrator were "within the areas marked out for his consideration," *i.e.*, whether those provisions were actually referred to arbitration. If it is determined that the arbitrator exceeded the powers

granted by the parties, vacatur is mandated and any further analysis of the arbitrator's action or intentions is superfluous. Only if it is confirmed that the contract provisions construed by the arbitrator were indeed submitted to his or her authority, does the trial or appellate court properly move to the *second* prong of the test to determine whether the arbitrator "even arguably" construed those provisions submitted by the parties to arbitration.

As correctly found by the trial court, the Panel's Partial Award cannot survive the first prong of the vacatur analysis because the Panel exceeded its authority by "construing" provisions of the MSA that were not (even tangentially) part of the dispute these parties submitted to its jurisdiction for arbitration. The trial court found that while the Panel had authority under §XI(c) to construe the "reallocation" provided in the express terms of MSA §IX(d)(2)(C) because related to the Independent Auditor's calculations, it did not have the authority to construe the MSA's provision regarding amendments to the master document, §XVIII(j). LF 2399. Finding the Panel had exceeded its authority by construing §XVIII(j) to permit it to substitute a common law judgment reduction method for the express terms of the MSA for

reallocation, the trial court stated that was "clearly erroneous as it violates the MSA's procedures for amending the MSA." LF 2399.[8]

The MSA's arbitration clause (§XI(c)) does *not* submit to arbitration disputes arising out of the construction or application of the MSA's clause that bans any non-unanimous amendments that "affect" the parties to the MSA (§XVIII(j)). Yet, over Missouri's and other States' objections, the Panel deigned to construe the entire MSA "contract" and specifically the language of §XVIII(j), ruling that its ban on non-unanimous amendments that "affect" MSA parties really amounted only to a ban on non-unanimous amendments that "materially prejudiced" MSA parties, thus permitting the Panel to

[8] The court of appeals also ruled correctly (initially) in finding that the Panel's construction of MSA §XVIII(j) was "beyond the scope of [its] authority to resolve disputes related to calculations made by the [Independent Auditor]." *State v. American Tobacco Co.*, 2015 WL 5576135, at *10 and *12. The court of appeals' inquiry should have ended at that point in affirmation of the trial court. But the court of appeals then engaged in the superfluous act of examining the actions of the arbitrators and inexplicably found that the Panel had "construed the [entire] MSA just as it was asked to do…" and held that the trial court had erred in vacating/modifying the effect of the Panel's Partial Award on Missouri. *Id*. at *15, *20.

substitute common law pro rata judgment reduction for MSA reallocation. LF 252, 255-256.

The trial court correctly found that the Panel had exceeded its jurisdiction because its Award "violates the MSA's procedure for amending the MSA [by] effectively amend[ing] §IX(d)(2), since the [Term Sheet] states are no longer subject to the NPM Adjustment and do not have to prove their diligent enforcement." LF 2399. The trial court further found that the Panel's unauthorized amendment to Missouri's MSA rights caused a $50 million reduction in its annual payment[9] and thus "materially affected" the State

[9] The court of appeals also correctly found that the State lost an additional $50 million due to the Panel's Partial Award. *State v. American Tobacco Co.*, 2015 WL 5576135, at *5. The PMs agree that Missouri lost an additional $50 million. Substitute Opening Brief of Respondents'/Cross-Appellants, pages 50-51 ($50 million difference between the $96 million the PMs argue Missouri fairly "owes" and the $46 million the PMs say Missouri would "owe" if it prevails on this issue). This agreement of the parties as to the *amount* in dispute is what is relevant to this appeal, not the method of calculating that amount, particularly in light of the fact that PriceWaterhouseCoopers spends extraordinary effort making such calculations annually, and of late, neither the PMs nor the States have agreed that PwC's calculations are accurate.

which "did not agree to such amendment of the calculation of [its] annual payment." LF 2396, 2399. The trial court then properly found that "the only way for the Partial Settlement Award to not affect Missouri's rights is for the 20 [Term Sheet] states whose diligence was contested, but not proven, to be treated as non-diligent when calculating the NPM Adjustment for Missouri." LF 2399-2400.

The trial court then properly modified the effect of the Panel's Partial Award on Missouri (and no other state) by ordering the Independent Auditor to "treat each Settling State that has signed the Term Sheet referenced in the Stipulated Partial Settlement and Award as if such Settling State did not diligently enforce a Qualifying Statute for purposes of section IX(d) of the MSA when the Independent Auditor calculates the amounts owed to Missouri under the MSA for the sales year 2003…." LF 2406-2407 and 2400.

The trial court's Amended Order and Judgment regarding the Panel's Partial Award must be affirmed because it comports with the applicable law and the weight of the evidence.

III. The trial court's modification order should be affirmed because the Panel "so imperfectly executed [its delegated powers] that a final and definite award upon the subject matter submitted" was not—*and never will be—made.*

(Response to Sections II of Respondents'/Cross-Appellants' Substitute Opening Briefs)

The Panel and the court of appeals both accepted the PMs' argument that their Term Sheet Settlement with then 19 (now 24) States presented a situation not addressed by the text of the MSA. The PMs have consistently characterized the issue to be addressed by each successive tribunal, including this Court, as whether the panel had the authority under the FAA to fill in the gaps when the MSA failed to "expressly say how to reallocate the NPM Adjustment after a partial settlement."[10] The real issue presented by the

[10] Substitute Opening Brief of Respondents/Cross-Appellants, page 34. Although in its analysis the trial court embraced the PMs' argument that "the MSA does not expressly say how to reallocate the NPM adjustment among the non-[Term Sheet] states," it correctly found that Missouri did not agree to the Panel's detrimental amendment of the MSA's calculation of Missouri's annual payment by substituting a common law pro rata judgment reduction for the text of §IX(d)(2)(A-C). LF 2398-2399. The court of appeals

PMs' side deal, though, is how to allocate the NPM Adjustment among jointly liable States when half of those States collude with the PMs to avoid the very inquiry necessary to determine the each State's appropriate share of that joint liability.

A. MSA §§IX(d)(2)(A-C) compels both allocation and reallocation of NPM Adjustment liability among all States not found diligent after diligence determinations have been made for all States,

Sections IX(d)(2)(A-C) provide that all States will fall into one of only two categories: 1) States that diligently enforced their Qualifying Statutes

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accepted the PMs' argument that the MSA did not address the situation presented by the side settlement and even reached beyond that argument to find the MSA "latently ambiguous on its silence on the issue of a Partial Settlement." *State v. American Tobacco Co.*, 2015 WL 5576135, at *13. No party argued to the court of appeals that the MSA is ambiguous, and Missouri disagrees that the MSA or its §IX is ambiguous, particularly given that MSA §XVIII(o) declares §IX a "Nonseverable Provision" of the MSA for which certain court orders can impose additional burdens on the MSA parties. SLF 149-151.

during the calendar year at issue, and 2) all other States. LF 325-326. And, per §§IX(d)(2)(A-C), the full NPM Adjustment liability is allocated among all States according to each's Allocable Share, and then the shares allocated to the Diligent States are *re*-allocated to the States that are not determined to have diligently enforced. In its Burden of Proof Order, the Panel first analyzed MSA §§IX(d)(2)(A) and (B) and found correctly that "though the NPM Adjustment applies generally to each State's allocated payment, a State can avoid this adjustment" by diligently enforcing its Qualifying Statute during the year in question. LF 454. As the Panel noted, "[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."[11] LF 454. At this early point in the

[11] The PMs agree. At page 4 of their Substitute Opening Brief, the PMs acknowledge that, "under MSA §IX(d)(2), diligent States are not responsible for any of the Adjustment, and non-diligent States are collectively responsible for the total available Adjustment, including the shares initially allocated to the diligent States." Given the PMs' choice to assist the Term Sheet States to avoid diligence determinations, the only MSA-compliant action will be to hold

arbitration, the Panel understood that part of every non-diligent State's total NPM Adjustment liability comes from the shares re-allocated from Diligent States. The Panel made clear that the diligence or non-diligence of all States must be determined, concluding 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. Thus, 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 NPM Adjustment." LF 465.

The Panel's subsequent orders reaffirmed the result compelled by the MSA's language and what the Panel had made the law of the case: once every State's diligence has been determined, States that have not been determined

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all non-diligent States, and all States that avoided diligence determinations, collectively responsible for the NPM Adjustment liability reallocated from the 16 No-Contest States and the 9 States found diligent by the Panel. No Missouri court has jurisdiction over the Term Sheet States and so Missouri does not request any additional liability be shifted to them. However, the PMs are subject to this Court's jurisdiction and Missouri requests them be barred from shifting the Term Sheet States' liability to Missouri.

diligent must bear their own Allocable Shares plus a share reallocated from the all the States that were determined diligent. Dividing NPM Adjustment liability is a two-step process. The First Step distributes the entire NPM Adjustment among all 52 States according to their Allocable Shares. In the Second Step, the aggregate allocable shares of every State found to have diligently enforced is then re-allocated among those that were not found to have diligently enforced. In its Independent Auditor Order, the Panel reiterated "that the States had the burden of proving that they had diligently enforced their qualifying statutes if they wanted to avoid the NPM Adjustment," LF 437, and again reaffirmed its holding that the MSA did not "support 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 438. The Panel further held that "there must be an individual determination of each State's diligence prior to the [Independent] Auditor's application of the NPM Adjustment." LF 443.

Two months later, the Panel issued its Order clarifying "the operation and effect" of the PMs' and the State's opportunities to "No-Contest" certain States, finding 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." LF 512 (emphasis added). The Panel held that "[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 [MSA] Section IX(d)(2)(B)-(C)" *to have "diligently enforced* its Qualifying Statute for that year only and is therefore not subject [to] the 2003 NPM Adjustment." LF 516-517 (emphasis added). 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 516-517. After an opportunity for discovery into the diligence cases of all 51 States and Territories, the PMs ultimately chose to issue "No-Contests" to 12 of the smallest States and 4 Territories. LF 497-98. The PMs chose to contest the 35 remaining States and presumably had a good faith basis to continue to challenge the diligence of those remaining States. *Id.* The Panel then gave the remaining "Contested States" 30 days to decide whether they would challenge the diligence of the 16 "No-Contest" States themselves. However, as the PMs—which had every incentive to hold each State to its burden of proof—did not see a good faith basis for challenging the diligence of the 16 No-Contest States, none of the 35 Contested States challenged their diligence either. Thus, the 16 No-Contest States were considered to have diligence

enforced because their diligence had not been contested by any PM *or any State*.

Missouri's case was the first to be heard. Even though the Panel's deadline for Contested State to challenge the diligence of the No-Contest States had expired six months earlier, the Panel requested verification that none of the 35 Contested States were challenging the diligence of any of the 16 No-Contest States. LF 560-561. Counsel for Missouri confirmed that no such claims were pending *against the 16 No-Contest States*, but *expressly* reserved Missouri's right to challenge the diligence of any of the 34 other Contested States if the PMs later decided, for any reason, to no longer contest them. The Panel Chair replied, "Sure." LF 560-561. Yet, when that very scenario occurred the following December—when the PMs settled their claims with 17 (now 22) of the Contested States—the 15 remaining Contested States were not allowed to challenge the diligence of any of the "Term Sheet States." Thus, 17 (now 22) of the States with the worst enforcement records in the country, avoided any determination of their diligence.

In its Amended Order and Judgment, the trial court understood the Panel's early arbitration rulings as consistent with the MSA and the Panel's authority. The trial court understood the Panel to have ruled that "[i]t is the individual state's burden to prove it diligently enforced its qualifying statute." LF 2394. The trial court also noted the Panel's early rulings that

"MSA §IX(d)(2) states that an NPM Adjustment 'shall apply' to 'all' Settling States 'except' those that 'continuously had a Qualifying Statute…in full force and effect…and diligently enforced the provisions of such statute during such entire calendar year." LF 2399. Under MSA §IX(d)(2)'s allocation and reallocation provisions, "[t]hose states who cannot prove diligent enforcement are then hit ***twice*** with a reduction in their annual payment: first, their payment is reduced by the pro rata amount of the NPM Adjustment allocable to that state, and then the state's payment is reduced ***again*** because the amount of the NPM Adjustment that would have otherwise been allocated pro rata to those states who prove diligent enforcement is reallocated to the non-diligent states." LF 2394 (emphasis added).

The trial court observed that, up to the moment the Term Sheet Settlement was executed, "[t]he PMs had contested the diligence of 20 out of 22 of the [Term Sheet States], or over 90%." LF 2398-2399. Yet, the Panel's Partial award giving effect to the Term Sheet excused those Contested Term Sheet States from having their diligence determined—an inquiry necessary to the second step of the allocation and reallocation process. Thus, the trial court concluded, the Partial Award "effectively amends [MSA]§IX(d)(2), since the [Contested Term Sheet States] are no longer subject to the NPM Adjustment and do not have to prove their diligent enforcement." LF 2399. Accordingly, the trial court concluded that the Panel had exceeded its powers

by improperly releasing the Contested Term Sheet States from both their diligence determinations *and* their share of the liability reallocated from the 16 No-Contest States and the 9 States eventually found by the Panel to be diligent. Moreover, the Panel had denied Missouri the opportunity to protect its MSA rights of contribution from the Term Sheet States when it reneged on its assurance at Missouri's hearing that Missouri would have an opportunity to contest the diligence of any State the PMs let out of the arbitration after Missouri's hearing had concluded. As a result, Missouri's payment was "further reduced by another $50 million due to the [common law pro rata judgment reduction] reallocation of the NPM Adjustment…." LF 2396.

Because the trial court had no jurisdiction over the Term Sheet States, it correctly concluded that "the only way for the Partial Settlement Award to not affect Missouri's rights is for the 20 [Term Sheet] states whose diligence was contested, but not proven, to be treated as non-diligent when calculating the NPM Adjustment for Missouri."[12] LF 2399-2400, 2406-2407. Specifically, the trial court properly ruled that:

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[12] As set forth fully in Section II of this brief, the courts of last resort of Pennsylvania and Maryland came to the same conclusion on this same issue regarding their States – the only way to prevent the Panel's amendment to

> The Independent Auditor shall treat each Settling State that has signed the Term Sheet referenced in the Stipulated Partial Settlement and Award as if such Settling State did not diligently enforce a Qualifying Statute for purposes of section IX(d) of the MSA *when the Independent Auditor calculates the amounts owed to Missouri under the MSA for the sales year 2003.*

LF 2406-2407 (emphasis added).

This is not a judgment or determination of "all non-diligent" for all the Term Sheet States over which the trial court had no jurisdiction. The trial court modified the Panel's Partial Award only "as to how Missouri's award is calculated," and not to have any effect on moneys owed or received by any other State. LF 2406.

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the MSA rights of Missouri, Pennsylvania and Maryland (found non-diligent by the Panel) is for Missouri's, Pennsylvania's and Maryland's courts to issue orders instructing the Independent Auditor to treat the Term Sheet States (whose diligence the Panel permitted to remain undetermined) as not-diligent only for purposes of calculating the NPM Adjustment liability for Missouri, Pennsylvania and Maryland.

B. Over Missouri's objection, the Panel's unauthorized common law pro rata judgment reduction and its refusal to determine the diligence of all States addressed only "allocation" of the NPM Adjustment liability, and shifted the burden of "reallocation" to Missouri and the other 5 States found non-diligent by the Panel.

The text of MSA §§IX(d)(2)(A-C) provides for only "diligent" States and "all other" States, and requires allocation *and* reallocation of the total NPM Adjustment liability among those "all other" States. LF 325-326. But, the Panel (and the court of appeals) wrongly concluded that the Term Sheet Settlement (which buried the facts of the Term Sheet States' diligence or non-diligence) presented a situation unaddressed by the MSA such that common law should be instead applied to apportion liability among the States that declined the settlement.

The Term Sheet Settlement was announced midway through the presentation of the state-specific cases of diligent enforcement, and so to address the effect of this side deal on the ongoing arbitration, the Panel conducted a two day hearing in January, 2013 and a two day hearing in March, 2013. LF 243. Contrary to the PMs' assertion at page 45 of their

Substitute Opening Brief, Missouri and the other States that did not accept the Term Sheet Settlement vigorously opposed the Panel's implementation of that settlement by any method of judgment reduction other than that provided in MSA §IX(d)(2)(A-C).[13]

Missouri and the other objecting States argued that common law judgment reduction methods abrogated their MSA rights of contribution and increased their liability because the Term Sheet States would escape paying their fair shares of the second half of the NPM Adjustment (the reallocation of the shares of the No-Contest States and of the States eventually found to be diligent), and that additional liability (in the form of "hundreds of millions of dollars") was going land on any objecting State eventually found non-diligent. SLF 5, 10-11. Missouri and the other States that declined the settlement made clear their position that these common law judgment reduction methods urged by the PMs would not only affect but prejudice them and thus constituted an unauthorized amendment of the MSA in violation of

[13] Regardless of Missouri's opening position on issues addressed during the course of the arbitration, the Panel's rulings on Burden of Proof, Independent Auditor and No-Contests became the "law of that case" and must bind the PMs (and the Term Sheet States) as well as Missouri in this case on appeal.

MSA §XVIII(j)'s prohibition on non-unanimous amendments that "affect" the rights of MSA parties. SLF 6-7, 9.

In seeking to have the Panel approve the Term Sheet Settlement by proposing common law judgment reduction methods as opposed to what the MSA required, the PMs sought (and continue to seek in this appeal) a windfall of millions of dollars (possibly billions throughout the years) by changing the parties' obligations in the MSA – in direct contravention of MSA § XVIII(j). The PMs were within their rights to settle with the Term Sheet States and to relieve each of them from bearing their Allocated Share of the NPM Adjustment. However, what the PMs could not do – without amending the MSA in violation of its clause which requires unanimous consent to amendments – was to release the Term Sheet States from their obligations to the objecting States (including Missouri) to bear their share of the NPM Adjustment liability that would be *re*-allocated from the 16 No-Contest States (who were deemed diligent without objection) and the none States that the Panel would eventually determine to be diligent.

The PMs' math at pages 11-12 and 37 of their Substitute Opening Brief is partially misleading. They are correct that the Panel's 46% judgment reduction eliminated the Term Sheet States' liability under the first step of the reallocation process by removing their Allocated Shares from the available NPM Adjustment amount. However, the PMs are wrong in

suggesting that the remaining 54% of the total NPM Adjustment is what is "reallocated" under §IX(d)(2)(C). The burden of reallocation on Missouri is not just the Term Sheet States' original Allocated Shares but also their proportional share of the liability *re*-allocated from the 16 No Contest States' and the nine States eventually found diligent in the second half of the process. Since the burden of reallocation is to be divided among "all other States" that did not diligently enforce, the Term Sheet States should have each been re-allocated their proportional share from the 16 No-Contest States and the nine Contested States the Panel actually found to have diligently enforced.

The following calculations illustrate the why the Panel's common law judgment reduction method actually imposed a greater burden on Missouri. Under the plain language of the MSA as construed by the Panel in its Burden of Proof Order, the 2003 NPM Adjustment applies pro rata to reduce *all* 52 States' MSA payments unless a State can prove that it is entitled to an exemption. If no State qualifies for an exemption, each State would be responsible for its own allocable share of the potential $1,148,000,000 NPM Adjustment for 2003. For example, California's allocable share of the PMs' annual MSA payments is 12.76%; Missouri's is 2.27%; New Mexico's is .06%; Pennsylvania's is 5.75%; and the remaining States add up to 79.16%. If all 52

States were found non-diligent, Missouri's share of the NPM Adjustment would be just over $26,000,000. See Figure 1.

State(s)	Default Allocable Shares	Pro Rata Share of the 2003 NPM Adjustment If No State Proves that It Diligently Enforced its Statute
CA	12.76%	$146,484,800.00
MO	2.27%	**$26,059,600.00**
NM	.06%	$688,800.00
PA	5.75%	$66,010,000.00
Other 48 States	79.16%	$1,121,940,400.00
Total	100%	$1,148,000,000.00

Figure 1

The MSA exempts individual States from paying their allocable shares of the 2003 NPM Adjustment *only* if they enacted and diligently enforced a Qualifying Statute throughout 2003. (MSA §§ IX(d)(2)(B)-(C), App. 3, pgs. 63-64). If a State qualifies for the Diligent Enforcement exemption, its allocable share of the NPM Adjustment gets *reallocated* to all other States that do not qualify for the exemption. Remember that there are two components to the NPM Adjustment liability of a Non-Diligent State: (a) the State's *original* allocable share of the NPM Adjustment; plus (b) a *pro rata* allotment of the Allocable Shares re-allocated from the Diligent States.

For example, if every contested State other than Indiana, Kentucky, Maryland, Missouri, New Mexico, and Pennsylvania (whose combined allocable share is 14.68%) had actually *proven* its diligence at trial, the other 46 States' combined Allocable Shares of 85.32% would have been re-allocated to the six non-diligent States pro rata. If reallocation would shift more liability onto a State than it actually received for that year's MSA payment, that State's liability is capped at the amount of its MSA payment. See Figure 2.

State(s)	(a) Non-Diligent States' *Allocable* Share of	(b) Non-Diligent States' *Reallocated* Share of	(a) + (b) Non-Diligent States' total share of the NPM Adjustment	The Non-Diligent States divide the $1,148,000,000 NPM Adjustment pro rata [illegible]	However . . . Non-Diligent States' Shares of NPM Adjustment are capped at their 2003 MSA payments
IN	2.04%	11.86%	13.90%	$159,572,000.00	$131,260,418.48
KY	1.76%	10.23%	11.99%	$137,645,200.00	$113,329,758.24
MD	2.26%	13.14%	15.40%	$176,792,000.00	$145,459,384.14
MO	2.27%	13.19%	15.46%	$177,480,800.00	**$146,369,550.57**
NM	0.60%	3.49%	4.09%	$46,953,200.00	$38,377,407.08
PA	5.75%	33.41%	39.16%	$449,556,800.00	$369,807,760.89
Others	0.00%	0.00%	0.00%	$0.00	
Total	14.68%	85.32%	100.00%	$1,148,000,000.00	$944,604,279.39

Figure 2

A Non-Diligent State's reallocated portion of the NPM Adjustment may be substantially greater than its base share, depending on the ratio of diligent to non-diligent States. As illustrated in the hypothetical above, Missouri would have a base share of 2.27%, plus a pro rata portion of the 85.32% allocable shares *re*allocated from the diligent States—about 13.19%. Due to reallocation, then, Missouri would be liable for a total 15.46% of the entire NPM Adjustment, or $177,480,800.00. Because Missouri's 2003 MSA payment was only $146,369,550.57, however, our share of the 2003 NPM Adjustment would be capped at $146,369,550.57.

Liability for the NPM Adjustment is a zero-sum game. As the number of Non-Diligent States *increases*, each Non-Diligent State's share of the NPM Adjustment *decreases*. This occurs because (1) fewer Diligent States' allocable shares are reallocated to Non-Diligent States *and* (2) more Non-Diligent States are available in the reallocation pool across which the full burden of the NPM Adjustment is spread. Thus, the total NPM Adjustment borne by any single, Non-Diligent State depends on ***both*** (1) the aggregate allocable shares of the Diligent States (whose shares of the NPM Adjustment will be shifted onto the Non-Diligent States), and (2) the aggregate allocable shares of the Non-Diligent States (among which the total NPM Adjustment must be divided pro rata).

For example, if California were found non-diligent in addition to the six states in the previous hypothetical, each of the original six states would bear a *much* smaller portion of the NPM Adjustment for two reasons. First, California would have to pay its own 12.76% allocable share (column **(a)**), which would no longer be reallocated among the other six states. Second, *California would join the other States in the reallocation pool* and bear a portion of the shares re-allocated from the Diligent States (column **(b)**). See Figure 3.

State	(a) Non-Diligent States' *Base* Share of NPM Adjustment	(b) Non-Diligent States' *Reallocated* Share of the NPM Adjustment	(a) + (b) Non-Diligent States' total share of NPM Adjustment After	Reallocation of $1,148,000,000 NPM Adjustment among non-diligent States	Decrease in the Six States' Liability if California is non-diligent.
CA	12.76%	33.74%	46.50%	$533,836,734.69	
IN	2.04%	5.39%	7.43%	$85,346,938.78	$45,913,479.70
KY	1.76%	4.65%	6.41%	$73,632,653.06	$39,697,105.18
MD	2.26%	5.98%	8.24%	$94,551,020.41	$50,908,363.73
MO	2.27%	6.00%	8.27%	$94,969,387.76	**$51,400,162.81**
NM	0.60%	1.59%	2.19%	$25,102,040.82	$13,275,366.26
PA	5.75%	15.20%	20.95%	$240,561,224.49	$129,246,536.40
Others	0.00%	0.00%	0.00%	$0.00	
Total	27.44%	72.56%	100.00%	$1,148,000,000.00	

Figure 3

As illustrated above, California's addition to the reallocation pool would reduce Missouri's share of the NPM Adjustment by over $50 million—more than a third of Missouri's liability in the previous example. And that's just California. If, as illustrated below, the other 19 Contested Term Sheet States were *also* non-diligent, Missouri's liability plunges by more than $100 million! See Figure 4.

State(s)	**(a)** Non-Diligent States' *Base* Share of NPM Adjustment	**(b)** Non-Diligent States' *Reallocated* Share of the NPM Adjustment	**(a) + (b)** Non-Diligent States' total share of NPM Adjustment After Reallocation	Reallocation of $1,148,000,000 NPM Adjustment among 26 non-diligent States	Decrease in the Six States' Liability when all contested Term Sheet States
20 Contested Term Sheet States	41.98%	41.98%	74.09%	$850,553,200.00	
IN	2.04%	2.04%	3.60%	$41,328,000.00	$89,932,418.48
KY	1.76%	1.76%	3.10%	$35,588,000.00	$77,741,758.24
MD	2.26%	2.26%	3.99%	$45,805,200.00	$99,654,184.14
MO	2.27%	2.27%	4.01%	$46,034,800.00	**$100,334,750.57**
NM	0.60%	0.60%	1.06%	$12,168,800.00	$26,208,607.08
PA	5.75%	5.75%	10.15%	$116,522,000.00	$253,285,760.89
Diligent States		43.34%	0	0	
Total		100%	100.00%	$1,148,000,000.00	

Figure 4

Thus, whether any of the Contested Term Sheet States would have been found non-diligent has a *profound* impact on Missouri's ultimate liability.

The dependence of each Non-Diligent State's liability on every other State's diligence determination also influences each State's behavior because "diligently enforce" is not defined in the MSA. Because a State could not know in advance what enforcement efforts would be considered diligent, each State would be wise to expend *at least as much* effort to enforce its Qualifying Statute as the majority of its sister States. If a court or arbitration panel later found that State's level of effort insufficient to satisfy the diligent enforcement exemption, at least that State could be assured that the re-allocated portion of the NPM Adjustment would be spread out over every State that expended *the same or less* effort. That was the risk we accepted when we signed the MSA in 1998.

The Panel's Partial Settlement frustrates more than decade of Missouri's enforcement efforts. Where once Missouri could protect itself from the catastrophic effects of the NPM Adjustment by monitoring and replicating the enforcement efforts of most other States, the Partial Settlement allows States that expended significantly less effort that Missouri not only **(a)** to avoid paying their own allocable share of the NPM Adjustment, *but even more importantly* **(b)** to avoid paying any part of the shares re-allocated from the Diligent States. By permanently removing

almost half of the States from the reallocation pool, the Panel increases a State's share of the 2003 NPM Adjustment. Thus, if at least some of the Term Sheet States expended less effort than Missouri in 2003, the Panel's Partial Settlement has increased Missouri's share of the 2003 NPM Adjustment—something that the MSA expressly prohibits without unanimous written consent.

Given that litigation risk is one of the most important factors in deciding whether to settle a case, it is rational to assume that most States accepting the PMs' settlement offer believed that they had a greater chance of being found non-diligent than those States that did not accept the PMs' offer. The Panel did not have to rely on assumption in this case, however, because the evidence developed during the course of the proceedings suggested that at least some of the Term Sheet States were non-diligent. Prior to the PMs' presentation of the "term sheet" for approval, the Panel had conducted evidentiary hearings for four of the Term Sheet States: Connecticut, District of Columbia, Kansas, and South Carolina. The record for these hearings evidences that all four States expended considerably less effort to enforce their Qualifying Statutes than Missouri did. At the end of the Kansas hearing, for example, the Panel suggested that it would not be able to find Kansas diligent because it had essentially done *no enforcement* for the first 8 months of the year. (Kan. Hrg. Tr. at 858:4-9, App. 27). Yet, through its

Partial Settlement, the Panel has in fact treated Kansas as though it had been diligent.

It is reasonable to assume that, like Kansas, the other 19 contested Term Sheet States feared an eventual finding of "non-diligence"—and the reallocated burden that would come with it—and decided to purchase a *de facto* diligence ruling by signing on to the Term Sheet. For example, Puerto Rico (another Term Sheet State) conceded in deposition that it *never hired a single employee* to enforce its Qualifying Statute until 2004 (Puerto Rico Dep. Tr. at 76:21-78:1, App. 28); it failed to retain any records proving escrow deposits were made by NPMs in 2002 through 2004 (*Id*. at 27:1-15); and it had no idea if a lawsuit was filed against any non-compliant NPMs because no records were maintained (*Id.* at 54:14-55:4). Yet, under the Partial Settlement, Puerto Rico is treated as having been found diligent and the portion of the NPM Adjustment that should have been reallocated to Puerto Rico from the States that *actually* proved their diligence gets re-reallocated to Missouri, Indiana, Kentucky, Maryland, New Mexico, and Pennsylvania—all of which did far more to enforce their own Qualifying Statutes.

The PMs' ingenious settlement offer actually coerced the States with the *weakest* enforcement records to settle for significant consideration to avoid paying any shares re-allocated from the Diligent states. Due to those weaker States' removal from the reallocation pool, States like Missouri—

which would have fallen somewhere in the middle of the pack—are now not only at the bottom of the list of those that took their claims to verdict, but more importantly, *the reallocated portion of NPM Adjustment* gets spread over far fewer States—thereby increasing the portion of the Adjustment borne by Missouri and the other States found non-diligent.

In a perfunctory effort to mitigate the unfairness of shifting the Term Sheet States' NPM Adjustment liability onto Non-Diligent Non-Term Sheet States, the Panel replaced the MSA's express reallocation provisions—the very provisions on which the Panel based its Burden of Proof Order—with a "pro rata judgment reduction" scheme, which reduced the total available NPM Adjustment by the aggregate allocable shares of the Term Sheet States, approximately 46.07%. (Partial Settlement at 9-10, App. 1). The Panel reasoned that by removing the Term Sheet States' Allocable Shares from the total potential NPM Adjustment, no liability attributable to those States would ever be reallocated to Non-Diligent States. ***But the Panel's "fix" cures only half of the problem*** because a Non-Diligent State must pay both **(a)** its own "base share" of the NPM Adjustment, *plus* **(b)** an additional share *reallocated from the Diligent States* and divided pro rata among *all* Non-Diligent States. Reducing the total NPM Adjustment by the aggregate shares of the Term Sheet States fixes part **(a)** of that equation by ensuring that those States initial Allocable Shares are not shifted onto the Non-Term Sheet

States. But the judgment reduction scheme does nothing to remedy part **(b)** of the equation: the Non-Diligent Non-Term Sheet States are still left to bear not only their own reallocated shares but also the shares that should have been reallocated onto the Non-Diligent Term Sheet States but for their deal with the PMs.

If all of the Term Sheet States were indeed diligent, the six Non-Diligent States *would be* better off with the Panel's judgment reduction than without it, as illustrated below, because it protects the non-diligent Non-Term Sheet States from paying any part of the Term Sheet States' *original* allocable shares. Missouri, for example, pays $50 million less with the Panel's judgment reduction than without it—again, assuming all of the Term Sheet States were diligent—because none of the Term Sheet States' original allocable shares are reallocated onto Missouri under part (a) of the reallocation formula. See Figure 5.

State(s)	Non-Diligent States' NPM Adjustment Liability **without** Panel's 46.07% Judgment Reduction	Non-Diligent States' NPM Adjustment Liability **with** Panel's 46.07% Judgment Reduction	Amount Panel's Judgment Reduction lowers Non-Diligent States' NPM Adjustment Liability, assuming none of the Term Sheet States would have been found non-diligent.
IN	$131,260,418.48	$86,019,073.57	$45,241,344.91
KY	$113,329,758.24	$74,212,534.06	$39,117,224.18
MD	$145,459,384.14	$95,295,640.33	$50,163,743.81
MO	**$146,369,550.57**	$95,717,302.45	**$50,652,248.12**
NM	$38,377,407.08	$25,299,727.52	$13,077,679.56
PA	$369,807,760.89	$242,455,722.07	$127,352,038.82
46 Other States Deemed Diligent	$0.00	$0.00	
Total	$944,604,279.40	$619,000,000.00	

Figure 5

But that savings only exists if all the Term Sheet States would have been found diligent—which, as discussed above, is exceedingly unlikely. If, on the contrary, just one third of the Term Sheet States *would have been* found non-diligent had they gone to verdict, Missouri and the other five Non-Diligent States are worse off under the Partial Settlement—even after the Panel's judgment reduction scheme—than under the MSA's express reallocation provision. Even though the total NPM Adjustment to be reallocated among the Non-Diligent States—part **(a)** of the MSA's reallocation formula—would have been almost twice as large without the judgment reduction, there would have been *more than twice* as many Non-Diligent States in the reallocation pool to share the portion of the NPM Adjustment *re*-allocated from the Diligent States—part **(b)** of the reallocation formula.

Consider the following illustrations. If just one-third of the Contested Term Sheet States (by allocable share) would have been found non-diligent, the Panel's Partial Settlement increased Missouri's liability by nearly $5 million. See Figure 6.

State(s)	Non-Diligent States' Total Allocable Share With 46.07% Judgment Reduction	Non-Diligent States' Final NPM Adjustment With 46.07% Judgment Reduction	Non-Diligent States' Total Allocable Share if one-third (13.99%) of the Contested Term Sheet States Were Non-Diligent and There Were No Judgment Reduction	Non-Diligent States' Final NPM Adjustment if one-third (13.99%) of the Contested Term Sheet States Were Non-Diligent and there were no Judgment Reduction	Amount by which the Panel's Stipulated Award prejudices the non-diligent States if one-third (13.99%) of the Contested Term Sheet States Were Non-Diligent
Diligent States	0	0	0	0	0
IN	13.90%	$86,019,073.57	7.12%	$81,737,600.00	$4,281,473.57
KY	11.99%	$74,212,534.06	6.14%	$70,487,200.00	$3,725,334.06
MD	15.40%	$95,295,640.33	7.88%	$90,462,400.00	$4,833,240.33
MO	15.46%	$95,717,302.45	7.92%	$90,921,600.00	**$4,795,702.45**

NM	4.09%	$25,299,727.52	2.09%	$23,993,200.00	$1,306,527.52
PA	39.16%	$242,455,722.07	20.05%	$230,174,000.00	$12,281,722.07
1/3 Sig States	0.00%	$0.00	48.80%	$560,224,000.00	
1/3 Sig States	0.00%	$0.00	0.00%	$0.00	
1/3 Sig States	0.00%	$0.00			
Total	100.00%	$601,000,000.00	100.00%	$1,148,000,000.00	$31,224,000.00

Figure 6

The increase to Missouri's liability is *seven times greater* if two-thirds of the Contested Term Sheet States (by allocable share) would have been found non-diligent. In that instance, the Panel's judgment reduction scheme costs Missouri over $34 million more than we would have owed if the MSA were enforced as written. See Figure 7.

State(s)	Non-Diligent States' Total Allocable Share With 46.07% Judgment Reduction	Non-Diligent States' Final NPM Adjustment With 46.07% Judgment Reduction	Non-Diligent States' Total Allocable Share if two-thirds (27.98%) of the Contested Term Sheet States Were Non-Diligent and There Were No Judgment Reduction	Non-Diligent States' Final NPM Adjustment if two-thirds (27.98%) of the Contested Term Sheet States Were Non-Diligent an no Judgment Reduction	Amount by which the Panel's Stipulated Award Prejudices the non-diligent States if two-thirds (27.98%) of the Contested Term Sheet States Were Non-Diligent
Diligent States	0	0	0	0	
IN	13.90%	$86,019,073.57	4.78%	$54,874,400.00	$31,144,673.57
KY	11.99%	$74,212,534.06	4.12%	$47,297,600.00	$26,914,934.06
MD	15.40%	$95,295,640.33	5.31%	$60,958,800.00	$34,336,840.33
MO	15.46%	$95,717,302.45	5.32%	$61,073,600.00	**$34,643,702.45**
NM	4.09%	$25,299,727.52	1.40%	$16,072,000.00	$9,227,727.52

PA	39.16%	$242,455,722.07	13.47%	$154,635,600.00	$87,820,122.07
1/3 Sig States	0.00%	$0.00	65.60%	$753,088,000.00	
1/3 Sig States	0.00%	$0.00			
1/3 Sig States	0.00%	$0.00	0.00%	$0.00	
Total	100.00%	$619,000,000.00	100%	$1,148,000,000.00	$224,088,000.00

Figure 7

And if *all* of the Contested Term Sheet States would have been found non-diligent—the only result consistent with the Panel's Burden of Proof Order—the Panel's judgment reduction scheme has increased Missouri's share of the NPM Adjustment by nearly $50 million. See Figure 8.

State(s)	Non-Diligent States' Total Allocable Share With 46.07% Judgment Reduction	Non-Diligent States' Final NPM Adjustment With 46.07% Judgment Reduction	Non-Diligent States' Total Allocable Share if all Contested Term Sheet States Were Non-Diligent and No Judgment Reduction	Non-Diligent States' Final NPM Adjustment if all Contested Term Sheet States Were Non-Diligent an no Judgment Reduction	Amount Panel's Stipulated Award Prejudices non-diligent States if all Contested Term Sheet States Were Non-Diligent
Diligent	0	0	0	0	
IN	13.90%	$86,019,073.57	3.60%	$41,328,000.00	$44,691,073.57
KY	11.99%	$74,212,534.06	3.10%	$35,588,000.00	$38,624,534.06
MD	15.40%	$95,295,640.33	3.99%	$45,805,200.00	$49,490,440.33
MO	15.46%	$95,717,302.45	4.01%	$46,034,800.00	**$49,682,502.45**
NM	4.09%	$25,299,727.52	1.06%	$12,168,800.00	$13,130,927.52
PA	39.16%	$242,455,722.07	10.15%	$116,522,000.00	$125,933,722.07
Term	0.00%	$0.00	74.09%	$850,553,200.00	
Total	100.00%	$619,000,000.00	100%	$1,148,000,000.00	$321,553,200.00

Figure 8

Under the plain language of the MSA, as interpreted in the Panel's Burden of Proof Order, any Term Sheet State that fails to prove diligent enforcement is liable not only for **(a)** its own allocable share but also **(b)** a pro rata portion of the allocable shares *re*allocated from the diligent States. (MSA§ IX(d)(2) App. 3, pp. 63-68; Burden of Proof, App. 8). The judgment reduction scheme in the Panel's Partial Settlement contravenes the MSA's plain language by removing all Term Sheet States from the reallocation pool outright without those states first proving diligent enforcement. Although the Panel's judgment reduction scheme eliminated the prejudice to the Non-Diligent States caused by part **(a)** of the reallocation formula, the Panel's "fix" actually *increases* the prejudice to the Non-Diligent States caused by part **(b)** of the reallocation formula—assuming, conservatively, that only one third of the contested Term Sheet States would have been found non-diligent.

In any event, the PMs concede that Missouri's liability under the Panel's Partial Award is $50 million higher than if the contested Term Sheet States were assigned (though not required to pay) their fair share of the NPM Adjustment reallocated from the 25 Diligent States (16 No Contest + 9 States actually found to be diligent).

C. Recognizing that its Partial Award would necessarily increase the liability reallocated to the Non-Diligent States, the Panel instructed aggrieved parties to seek relief in their MSA courts.

The language in the Panel's Partial Award evidences the Panel's excess of its powers, and its understanding that its use of a common law pro rata judgment reduction would shift MSA reallocation liability away from the Term Sheet States and fully onto the States it would eventually find non-diligent. The Panel stated that "the 2003 NPM Adjustment will be *allocated*" by reducing the total amount of the Adjustment "by a percentage equal to the aggregate allocable shares" of the Term Sheet States. LF 250 (emphasis added). Thus, the 46% reduction of the Adjustment resulted from the Panel's acknowledgment of the Term Sheet States' responsibility for MSA "allocation."

The Panel declined to determine the diligence of the Term Sheet States and simply instructed the Independent Auditor to "treat the [Term Sheet] States as not subject" to the reallocation mandated by §§IX(d)(2)(B-C). LF 250. The Panel could not and did not find or deem these Term Sheet States

"diligent" because they had not yet presented their evidence to the Panel,[14] except for Kansas which the Panel had previously warned it would not likely find diligent given it had essentially done no enforcement for the first 8 months of 2003. LF 746. The Panel also declined to find the Term Sheet States "not diligent," even though the Panel was well aware that the PMs had contested the diligence of all but 2 of the Term Sheet States "to that point" the Term Sheet was executed. *See* PM. Br. at 8. Additionally, the Panel did not at any point in its Award or at any time prior to the conclusion of the arbitration provide Missouri and the objecting States with any opportunity to

[14] Although the Panel declined to find the Term Sheet States either diligent or non-diligent, and refused to give Missouri and the other objecting States an opportunity to prove the non-diligence of the Term Sheet States, the practical effect of the Panel's instruction to the Independent Auditor was that all Term Sheet States were treated as though they had been determined on the facts to be diligent such that they were spared any liability for MSA reallocation. This "all diligent" status which resulted in a $50 million loss to Missouri was orchestrated by the PMs and the Term Sheet States and is more objectionable than the "all not diligent" approach effectively advocated by Missouri (and Pennsylvania and Maryland) as a shield from unjust shifting of liability.

preserve their MSA rights of contribution by challenging the diligence of the Term Sheet States, even though the Panel had earlier and properly provided such an opportunity with regard to the 16 No-Contest States, and had specifically assured Missouri that it would be provided opportunity to preserve its rights of contribution against the 34 other States for which the PMs initially pursued their allegations of non-diligence. LF 512-513, 516-517, 560-561.

The Panel acknowledged that, under its common law pro rata judgment reduction, and given its refusal to determine the diligence of the Term Sheet States, the *reallocation* of the Adjustment would occur only "among all Non-[Term Sheet] States that did not diligently enforce." LF 250. Perhaps recognizing the ultimate authority of the state courts regarding MSA disputes,[15] the Panel invited any State it eventually found non-diligent to apply to its State court for relief from the Partial Award:

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[15] Although the Panel (and the court of appeals) chose to approve the PMs' settlement with the Term Sheet States, to Missouri's detriment, both tribunals acknowledged the black letter law that withholds judicial approval of settlements where the rights of third parties are not properly protected. *State v. American Tobacco Co.*, 2015 WL 5576135, at *14 (internal citation to Panel's Partial Award omitted).

> Should any Objecting State, found by the Panel to be non-diligent, have a good faith belief that the *pro rata* deduction does not adequately compensate them for a [Term Sheet] State's removal from the re-allocation pool, their relief, if any, is by appeal to their individual MSA court.

LF 255. The trial court properly accepted this invitation, declared and applied the correct standard for vacatur, and held that the Panel's Award must be modified as to its effect on Missouri.

As the trial court correctly found, under the terms of the MSA, the only permissible implementation of the Term Sheet Settlement as it effects Missouri's 2003 NPM Adjustment liability is that the Contested Term Sheet States are considered non-diligent so that their share of the reallocated liability from the diligent States is not shifted to Missouri. Any other conclusion is a result of the arbitration Panel acting "outside the scope of [its] contractually delegated authority" and "issuing an award that simply reflects [its] own notions of economic justice rather than drawing its essence from the contract." *Oxford Health Plans LLC,* 133 S.Ct. 2068 (internal punctuation omitted).

At the time of the Panel's decision issuing the Partial Award, no State had yet been determined non-diligent. Thus, during the argument before the Panel, the objecting States could only hypothesize what their damage would

be from the judgment reduction method sought by the PMs. At the conclusion of the arbitration, Missouri and 5 other States were found non-diligent and we now know what Missouri's damage is. Unless the trial court's ruling is affirmed, Missouri will lose $50 million based on a settlement agreed to by *other parties* to the MSA and on an arbitration Panel's decision to exceed its authority by construing MSA terms outside of its jurisdiction to amend a contract that Missouri (and all other parties) agreed 16 years ago could not be amended without the unanimous consent of all parties. MSA § XVIII(j), LF 341.

The trial court's Amended Order and Judgment regarding the Panel's Partial Award must be affirmed because it comports with the applicable law and the weight of the evidence.

CONCLUSION

Missouri respectfully requests that this Court affirm the trial court's Amended Order and Judgment modifying the Panel's March 12, 2013 Partial Award as to how Missouri's award is calculated.

Respectfully submitted,
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CERTIFICATES OF SERVICE AND COMPLIANCE

I hereby certify that I filed electronically and served via Missouri Case.Net this Substitute Response Brief of Appellant/Cross-Respondent State of Missouri on this 1st day of August, 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 16,146 words exclusive of cover, signature block, and certificates.

/s/ J. Andrew Hirth
J. ANDREW HIRTH
Deputy General Counsel