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Official Publication of the International Premium Cigar & Pipe Retailers Association (IPCPR)

AUGUST 2012

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MSA Arbitration Heats Up Over Escrow Refunds

An arbitration panel hears dispute regarding 2003 settlement payments, the outcome of which could have a significant bearing on both state's MSA income and future escrow obligation enforcement. **>BY TROUTMAN SANDERS TOBACCO TEAM**

n arbitration panel of three former federal judges is in the process of hearing evidence between the parties to the 1998 tobacco Master Settlement Agreement ("MSA"). The manufacturers that signed the MSA (known as "participating manufacturers") claim that they are entitled to a refund of their settlement payments because of lost sales arising from their obligations under the MSA. On the other hand, the states and territories that signed the MSA (known as the "settling states") contend that they have satisfied their obligation under the MSA to collect escrow payments from non-signatories (known as "non-participating manufacturers") and that no refund is due.

The state-specific evidentiary hearings will continue into 2013. The panel has announced that it will rule on the individual state disputes only after all of the state-specific claims have been heard. The outcome of the arbitration could have a significant impact on both state coffers and on future enforcement of state escrow obligation.

MSA'S KEY PROVISIONS

The MSA was a settlement agreement resolving state claims against the original participating manufacturers (Philip Morris, R.J. Reynolds, Brown & Williamson, and Lorillard). The settling states asserted that these manufacturers engaged in unlawful conduct in the sale and marketing of their cigarettes, the result of which was increased health care costs for the states. Forty-six states (Minnesota, Florida, Mississippi and Texas have separate individual settlements agreements) and six United States territories are part of the MSA. In addition to the original participating manufacturers, other cigarette manufacturers were given the opportunity to "join" the MSA after it was originally signed in November 1998. There are now more than forty participating manufacturers.

The MSA requires the participating manufacturers to make annual payments based on their United States market share. The payments are then allocated among the settling states according to an agreed formula. The settlement payments currently total roughly \$6.00 per carton sold.

The MSA also provides a mechanism whereby participating manufacturers potentially can obtain a refund of their settlement payments. The participating manufacturers were apparently concerned that their settlement payment obligations would create a cost advantage for non-signatories. Accordingly, the MSA contains a provision requiring the settling states to enact escrow statutes that obligate non-participating manufacturers to make escrow payments based on their annual sales. The escrow payments are in an amount roughly equivalent to the participating manufacturers' settlement payments.

The escrow statutes were said to be necessary to neutralize the MSA's cost disadvantages, as well as to provide a judgment fund in the event that a nonparticipating manufacturer was proven to have acted culpably in the manner that prompted the MSA. Without enacting and "diligently enforcing" their escrow statutes, states are potentially subject to a reduction in their settlement payments, known as the "NPM Adjustment."

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Under the MSA, the participating manufacturers also agreed to restrictions on their marketing and lobbying. For example, the participating manufacturers agreed to restrictions on advertising to minors, such as the use of cartoon characters to promote their products. The participating manufacturers also agreed to limit their sponsorship of artistic, cultural, or social events to one such sponsorship. Many of the MSA's advertising and marketing restrictions now apply to all cigarette manufacturers by virtue of the 2009 Family Smoking Prevention and Tobacco Control Act, which gave tobacco regulatory authority to the United States Food & Drug Administration.

Section IX(d) of the MSA outlines the applicability of the NPM Adjustment to the signatory states' payments. Under § IX(d)(1), a state's MSA payments can be reduced by the NPM Adjustment if the signatory manufacturers have lost market share, and an economic consultant determines that the MSA's "disadvantages" were a "significant factor" contributing to the lost market share.

However, under § IX(d)(2), a state's MSA payments are not subject to the NPM Adjustment if the state has a "qualifying statute" and "diligently enforced" that statute. A "qualifying statute" is defined under § IX(d)(2)(E) as a state's law that "effectively and fully neutralizes >In order to avoid a loss in their settlement payments, the states must "diligently enforce" their escrow statutes...Unfortunately, the MSA does not define what "diligent enforcement" means.

the cost disadvantages" that signatory manufacturers purportedly experience vis-à-vis non-signatories.

Significantly, § IX(d)(2)(E) also provides that the Model Statute set forth in Exhibit T to the MSA, if enacted without modification or addition (except for particularized state procedural or technical requirements), constitutes a "qualifying statute."

Thus, under § IX(d) of the MSA, as long as a state enacts and "diligently enforces" an escrow statute that is identical to the MSA's Model Statute, the state is immune from the NPM Adjustment. The settling states all passed statutes that are virtually identical to the MSA's Model Statute. Accordingly, in order to avoid a loss in their settlement payments, the states must "diligently enforce" their escrow statutes.

THE "DILIGENT ENFORCEMENT" DISPUTE AND ARBITRATION

Unfortunately, the MSA does not define what "diligent enforcement" means, and the ambiguity surrounding the issue has led to the present arbitration regarding the participating manufacturers' refund claims. Participating manufacturers and settling states resolved all of their disputes pertaining to NPM Adjustments for 1999 through 2002. Disputes remain as to whether the participating manufacturers are entitled to NPM Adjustments from 2003 to the present. Only the 2003 NPM Adjustment is being addressed in the arbitration. For the 2003 sales year, an independent auditor found that the participating manufacturers incurred a market share loss. An economic consulting firm then determined that the MSA's disadvantages were a significant factor contributing to this loss. The independent auditor calculated the potential NPM adjustment at \$1.1 billion, but declined to apply the adjustment because all of the settling states had escrow statutes in effect in 2003 and because there had been no finding as to whether any state had "diligently enforced" its escrow statute.

The participating manufacturers objected to the decision not to apply the NPM Adjustment. They also contended—at least initially—that no state diligently enforced its escrow statute in 2003.

The settling states argued that this dispute should be resolved in individual state proceedings. The participating manufacturers claimed that the dispute should be addressed in a single nationwide arbitration. The state courts uniformly ruled in favor of the participating manufacturers on this issue, leading to the current nationwide arbitration.

As noted above, the arbitration is being overseen by a three-member panel of former federal court judges—Abner Mikva, William Bassler, and Fern Smith. The state signatories designed Judge Bassler of the District of New Jersey as their arbitrator. The states designated Judge Mikva, formerly of the U.S. Court of Appeals for the D.C. Circuit, as their arbitrator. Judges Mikva and Bassler selected the third member, Judge Smith.

Although the arbitration is focused primarily on whether the settling states diligently enforced their escrow statutes, the participating manufacturers have also contended that two states—Virginia and New Mexico—did not have in place a Qualifying Statute in 2003. In New Mexico, for example, the participating manufacturers have contended that New Mexico should have collected escrow payments for sales on Native American reservations. However, the New Mexico escrow statute only requires escrow payments for "units sold" (defined as sales for which state excise taxes have been collected) and New Mexico did not tax tribal sales in 2003.

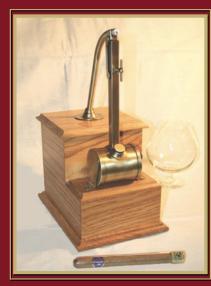
The initial evidentiary hearing in the arbitration, which was in April 2012, focused on the circumstances behind the MSA and general issues pertaining to all states, such as enforcement of escrow obligations against foreign manufacturers and issues pertaining to escrow collections from manufacturers that became insolvent. The parties are now in the process of state-specific evidentiary proceedings. The order of the state-specific proceedings occurs by alternating selection-the participating manufacturers choose the first state, the settling states choose the second state, etc. until all statespecific claims have been heard. Missouri's state-specific claim, which was chosen first by the participating manufacturers, occurred in May 2012. Illinois (chosen by the settling states) is next, followed by New York (chosen by the participating manufacturers). Thirty-two states remain in the arbitration and potentially subject to the NPM Adjustment.

The outcome of the arbitration could have two significant impacts. First is the potential loss of state revenue during a time where most states are cash-strapped. This potential impact is magnified by the fact that, if only a few states are found to have failed to diligently enforce their statutes, those few states could bear the entire brunt of the NPM Adjustment.

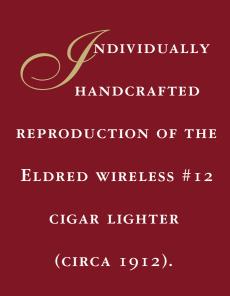
The other potential impact is changes to how the states enforce their escrow statutes. Depending on how the arbitrators rule, the industry could see substantial changes in how the escrow obligations are enforced against non-participating manufacturers. The industry could also see substantial changes to the laws themselves in order to enhance enforcement of escrow obligations and/or to broaden the coverage of escrow obligations.

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