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Pennsylvania's Legal Battle Over MSA Payments Keeps Twisting

With $120 million at stake, major manufacturers appeal a state court decision over arbitration on disputed 2003 MSA escrow payments, forshdowing a long road ahead. **> BY BRYAN M. HAYNES**

A trial judge recently overruled the decision of an arbitration panel that would have allowed three major tobacco companies to keep more than $120 million in payments under the Master Settlement Agreement. In April, Judge Patricia McInerney in the Philadelphia County Court of Common Pleas ruled that an arbitration panel of three former judges erred in ruling against Pennsylvania. Philip Morris USA Inc., R.J. Reynolds Tobacco Co., and Lorillard Tobacco Co. have filed an appeal to the Commonwealth Court of Penn., claiming that the lower court overstepped its authority by modifying the arbitration panel's decision.

The dispute arises out of the 1998 Master Settlement Agreement, or MSA, which mandated that the major manufacturers make significant annual payments to the states. The settlement payments currently total roughly $6.00 per carton sold.

In order to ensure that the payments made by the settling companies do not create a windfall for non-settling tobacco companies, the agreement mandates that the participating tobacco companies could reduce or recoup the payments if companies lost market share to the non-settling tobacco companies and if the payments were a "significant factor" contributing to the loss. The reduction, or adjustment, would be borne by all the states.

However, the MSA has an exception that allows a state to avoid a payment reduction if that state "diligently enforced" a parallel statute which requires non-settlers to pay into an escrow fund according to the number of cigarettes sold in that state. In order to incentivize "diligent enforcement," the MSA provides that the non-diligent states would be solely responsible for the total available adjustment. Not only did this provision create an incentive for states to diligently enforce the escrow obligation, it also opened the door for litigation as to whether states were actually upholding their end of the agreement.

TURNING TO ARBITRATION

In 2010, an arbitration panel of three former federal judges was selected to determine whether the states diligently enforced the escrow obligations. Companies participating in the MSA hoped that the panel would find that the states failed to diligently collect payments from non-participating companies, thereby entitling them to recoup millions of dollars in settlement payments.

Before a decision was reached by the panel, however, 22 states reached a settlement agreement with the participating tobacco companies. Under the terms of that settlement, the participating companies released the disputed payments from 2003 to 2012 to the states. In exchange, the settling states agreed to provide credits totaling $1.65 billion to the participating companies. The 22 settling states together made up an aggregate share of about 46 percent of the adjustment or reduction.

Interestingly, the settlement did not address how the remainder of any adjustment should be allocated among non-settling states like Pennsylvania. That issue was left for the arbitration panel to decide under the MSA.

The arbitration panel ruled in favor of nine states—New York, Iowa, Ohio, Washington, Colorado, Illinois, Oregon, North Dakota and Maine—holding that those states were diligent in their enforcement of escrow payments on non-MSA companies. However, the panel determined that Pennsylvania, along with five other states, failed to diligently enforce its escrow statute because it had "a low collection rate [on escrow due], failed to adequately file and pursue lawsuits [against non-MSA companies],… [and] cavalierly declined to consider the impact of [certain non-MSA companies] sales on its obligations under the MSA." Accordingly, the panel mandated that Pennsylvania and those other non-diligent states bear the full adjustment from the participating companies' 2003 payments.

In determining the amount that the non-diligent states would be required to bear, the panel determined that the adjustment should be reduced by the share of the signatory states (i.e., 46 percent). In other words, the six non-settling, non-diligent states would be shouldered with the remaining 54 percent of the total reduction in payments. As a result of the panel's decision, Pennsylvania stood to lose over $240 million in funds from the participating tobacco companies.

the arbitration panel's method removes the settling states' 46 percent share of the adjustment, thereby ensuring that no part of the settling states' shares is reallocated to Pennsylvania and the other non-settling states. Conversely, the method used by the Pennsylvania court that treats the settling states as non-diligent not only removes the signing states' 46 percent share, but also reallocates to the settling states some of the non-settling states' shares. The court's method, in the opinion of the tobacco companies, creates a windfall for Pennsylvania because it's better off than if there had been no settlement in the first place. Treating the settling states as non-diligent "guarantees that Pennsylvania will profit from the settlement, potentially by hundreds of millions of dollars."

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PENN. APPEALS TO LOCAL COURT

The Commonwealth of Pennsylvania filed a motion in the Pennsylvania Court of Common Pleas asking the court to modify or vacate the arbitration panel's decision. The court deferred to the arbitration panel's decision that Pennsylvania did not diligently enforce the escrow obligation.

However, the court overturned the panel's decision reallocating the remaining portion of the adjustment on the remaining six non-diligent states, calling it not just wrong, but "irrational" under the terms of the MSA. Instead, the court held that the states that entered into the 2012 settlement agreement should be treated "as non-diligent," thereby reducing the total amount of the reduction Pennsylvania would have to bear by approximately $120 million.

MSA COMPANIES APPEAL

In October, Philip Morris, R.J. Reynolds, and Lorillard filed an appeal to the Commonwealth Court of Pennsylvania. The tobacco companies claim that "the trial court significantly exceeded the strict limits on its authority to interfere with the [arbitration] panel's contract interpretation, and it also fundamentally misconstrued the MSA." The brief also notes that "by decreeing the panel's decision to be irrational and substituting its own mistaken views, the court did a profound disservice not just to the [participating manufacturers] but to the three conscientious jurists on the [arbitration] panel."

According to the tobacco companies, the arbitration panel's method removes the settling states' 46 percent share of the adjustment, thereby ensuring that no part of the settling states' shares is reallocated to Pennsylvania and the other non-settling states. Conversely, the method used by the Pennsylvania court that treats the settling states as non-diligent not only removes the signing states' 46 percent share, but also reallocates to the settling states some of the non-settling states' shares. The court's method, in the opinion of the tobacco companies, creates a windfall for Pennsylvania because it's better off than if there had been no settlement in the first place. Treating the settling states as non-diligent "guarantees that Pennsylvania will profit from the settlement, potentially by hundreds of millions of dollars."

WHAT'S NEXT

While the Pennsylvania court has not been the only court to review the arbitration panel's decision, it is the only court to date that has sided against the arbitration panel—which are ordinarily given a high level of deference. The tobacco companies' brief notes that two courts in Maryland and Colorado have rejected similar motions to modify the arbitration panel's decision because the "panel's decision was a 'reasonable analysis' of the MSA which 'drew its essence from the contract.'"

J.J. Abbott, a spokesman for Pennsylvania Attorney General Kathleen Kane, said he believed the court's decision would be upheld, according to an article posted in *Law 360*. Abbott noted, "We believe Judge McInerney got it right and we are confident Commonwealth Court will so find," reports the same article.

Troutman Sanders Tobacco Team, Troutman Sanders LLP, *1001 Haxall Point, Richmond, Va. 23219, Tel: (804) 697-2206, Fax: (804) 697-1339, Web: www.troutmansanders.com, Email: bryan.haynes@troutmansanders.com.*