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Disputed 2003 MSA Payments Resolved

An arbitration panel has the final word on the industry's 2003 MSA "diligent enforcement" dispute, paving the way for changes in calculating future NPM adjustments and new state enforcement efforts.

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As a result of the 1998 Master Settlement Agreement (MSA), every participating manufacturer (PM) is required to make an annual payment to the states that have joined the MSA (the settling states). This payment obligation is not applicable to non-signatories of the MSA, known as non-participating manufacturers (NPMs). However, the MSA contains a provision requiring each settling state to enact a statute to collect escrow from the NPMs, thereby imposing similar financial obligations.

The MSA requires the settling states to "diligently enforce" the escrow statutes. Pursuant to the so-called "NPM Adjustment," the PMs can contest whether a settling state has diligently enforced the collection of escrow from the NPMs for a particular calendar year. PMs have challenged the enforcement efforts of the settling states under the NPM Adjustment, seeking the refund of millions of dollars in settlement payments.

SETTLEMENT OF THE "DILIGENT ENFORCEMENT" DISPUTE

The PMs alleged that the settling states failed to adequately enforce the NPMs' escrow obligations, and as a result, the PMs disputed over $4 billion in settlement payments dating back to 2003. The PMs' claims are the subject of ongoing proceedings to resolve the payment disputes for each year. On December 18, 2012, 17 settling states and certain PMs announced a settlement of the PMs' claims that those states failed to satisfy their obligations to "diligently enforce" the NPMs' escrow requirements.

The following states and territories were original parties to the December 2012 settlement: Alabama, Arizona, Arkansas, California, Georgia, Kansas, Louisiana, Michigan, Nebraska, Nevada, New Hampshire, New Jersey, North Carolina, Tennessee, Virginia, West Virginia, Wyoming, the District of Columbia, and Puerto Rico. In early 2013, Oklahoma, South Carolina, and Connecticut also joined the Settlement.

Under the terms of the settlement, the PMs released the disputed payments to the states. In exchange, the Settling States and territories agreed to provide credits totaling $1.65 billion against the PMs' payments over the next five years. Significantly for the NPMs, the Settlement further incentivizes states to enforce existing laws as well as enact new laws pertaining to the NPMs' escrow obligations. In particular, the Settlement encourages the settling states to impose escrow requirements for sales on Indian reservations, as well as enact laws that impose bonding requirements for the NPMs. Under the terms of the Settlement, the Settling States could lose even more money if they fail to enact such laws.

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ARBITRATION PANEL'S DECISION ON THE 2003 PAYMENT DISPUTE

The Settling States that did not join the Settlement participated in an arbitration where a three-member federal arbitration panel (the "arbitration panel") would resolve the on-going payment disputes, for payments made by the PMs pursuant to the MSA, for each year since 2003. The arbitration panel has ruled on the 2003 payment dispute; however, the disputes from more recent years have not yet been resolved.

Under the terms of the arbitration clause in the MSA, the PMs must establish two factors to lodge a successful challenge to a settling state's enforcement of its escrow statute. First, a PM must show that it suffered a "market share loss" for the year in question. Second, it must be determined that the MSA provisions were a significant factor for the market share loss for the given year. If successful, the PMs will receive a credit for the year in question. The MSA contains a clause providing that disputes arising out of the calculation of payments shall be settled in arbitration.

On September 11, 2013, the arbitration panel issued a ruling on the payment dispute for the 2003 payments made by the PMs. The arbitration panel ruled in favor of nine states—New York, Iowa, Ohio, Washington, Colorado, Illinois, Oregon, North Dakota and Maine. The arbitration panel ruled in favor of PMs in six states—Indiana, Missouri, Pennsylvania, Maryland, Kentucky and New Mexico, which means these states will bear the full burden of the a negative adjustment for the PMs' 2003 payments. This article discusses the specifics of the arbitration panel's ruling with respect to two states—New York and New Mexico—one favorable to the state and one against the state.

RULING FAVORS NEW YORK

The arbitration panel ruled in favor of New York and denied the PMs a credit under the NPM Adjustment. The arbitration panel concluded that "the MSA's first condition for application of the 2003 NPM Adjustment was satisfied: the PMs had suffered a 'Market Share Loss' for 2003."

In particular, the independent auditor calculated approximately an 8 percent market-share shift from the PMs to the NPMs from 1997–2003. New York, along with the other 14 states, did not dispute the auditor's finding that the PMs suffered a market share loss in 2003.

Rather, New York and the other states only disputed whether a "significant factor" for the PMs' loss in market share was attributable to the MSA provisions. In determining whether the second step of the NPM Adjustment was met, the only contested issue in New York was "whether New York failed to diligently enforce its escrow statute because it did not impose an excise tax on the sales of units sold by Native American Tribes on their Reservations in New York State, or make any attempt to have escrow collected on those sales."

The PMs first argued that New York did not "diligently enforce" its escrow statute because it did not collect state excise taxes for NPM sales on tribal land. The arbitration panel recognized that the NPMs who sold cigarettes on tribal land had a cost advantage over the PMs with sales on tribal land. With that being said, the arbitration panel concluded that the PMs' argument that New York did not "diligently enforce" its escrow statute hinged on the definition of "units sold." New York's view, and that of the arbitration panel, was that under the plain meaning of the definition of "units sold," New York was not required to collect escrow for sales on tribal land because state excise taxes were not imposed on those sales.

Although New York's definition of "units sold" does not require that escrow be collected for sales on tribal land, the PMs next argued that New York was obligated either: (1) to change the definition of "units sold"; or (2) to change its policy of not collecting state excise taxes for sales on tribal land. Either of these changes would require the NPMs to pay escrow for sales on tribal land. The arbitration panel stated that, in order for the PMs to prevail on this argument, it must be shown that New York was not acting in good faith because the state does not collect escrow for NPM sales on tribal land. The arbitration panel examined whether New York had a history of collecting state excise taxes for sales on tribal land, and concluded that the New York Governor's decision not to collect state excise for sales on tribal land was consistent with the state's prior practices and did not amount to bad faith. Consequently, the arbitration panel concluded that New York satisfied its obligation to diligently enforce its escrow statute for 2003.

RULING AGAINST NEW MEXICO

Like New York, the state of New Mexico disputed whether a "significant factor" for the PMs' loss in market share was attributable to the MSA's provisions. In determining whether New Mexico diligently enforced its escrow statute and satisfied the second step of the NPM Adjustment, the arbitration panel assessed New Mexico's diligent enforcement efforts in light of eight factors. These factors include: collection rate; lawsuits filed; gathering reliable data; resources allocated to enforcement; preventing non-compliant NPMs from future sales; legislation enacted; actions short of legislation; and efforts to be aware of other states' enforcement efforts. Not all of the factors are given equal weight in assessing whether a state diligently enforced its escrow statute, and the arbitration panel discussed certain factors more than others when evaluating New Mexico's enforcement efforts.

In discussing New Mexico's collection rate, the arbitration panel recognized that, while it is a significant factor, a state's collection rate must be viewed in context because "[t]here are Settling States that had only a moderate collection rate but were found to have diligently enforced." Although the arbitration panel found that New Mexico's collection rate was fairly high, it relied on the remaining factors to find that New Mexico did not diligently enforce its escrow statute.

The arbitration panel found that New Mexico did not initiate any lawsuits against non-compliant NPMs in 2002 or 2003. The evidence demonstrated that New Mexico did not have in place methods for gathering reliable data, and distributors were only provided with information regarding their obligations upon request. New Mexico did not have a dedicated budget or personnel for escrow enforcement. The arbitration panel concluded that New Mexico's lack of enforcement efforts resulted in an increase in non-compliant NPM sales. The arbitration panel recognized that New Mexico enacted complementary legislation that took effect in 2003, but the legislation was not initially available on the Attorney General's website and distributors did not receive direct notice of the legislation. Additionally, the arbitration panel found that New Mexico did not take actions short of legislation—such as "seizures, injunctions, settlement efforts, or regulations that might have served as a supplemental tool for enforcement." Finally, the arbitration panel concluded that New Mexico did not take steps to learn what other states were doing for enforcement efforts.

MOVING FORWARD: A NEW FOCUS

The arbitration panel's ruling on the 2003 payment dispute may impact future enforcement efforts by settling states since decisions have not been rendered for subsequent years. As a result of the arbitration panel's ruling, states may enact legislation or enhance enforcement of existing legislation to ensure the NPMs satisfy their escrow obligations. The states that received favorable rulings from the arbitration panel, such as New York, will likely maintain their enforcement efforts to ensure positive rulings by the arbitration panel for subsequent years. Similarly, states in which the arbitration panel ruled in favor of the PMs, such as New Mexico, will likely strengthen their enforcement efforts to avoid having to provide additional credits to the PMs in the future. S

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