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Parsing the New Wave of State Tobacco Settlement Suits

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In late November, the New Mexico attorney general announced a lawsuit[1] in the Santa Fe County First Judicial District Court against Philip Morris USA Inc., R.J. Reynolds and other signatories to the tobacco master settlement agreement alleging their violation of the MSA and various state and common laws due to their withholding of payments to the state.

Iowa filed a similar lawsuit earlier in 2022,[2] *State of Iowa v. Philip Morris* in the Iowa District Court for Polk County, and both states are following in the footsteps of Montana, which reached a settlement with the same tobacco companies after filing a similar suit, *State of Montana v. Philip Morris* in the Montana First Judicial District Court, in 2020.

These lawsuits not only seek to recover money that will be used, in part, to fund attorney general offices, but they also highlight a growing trend of enforcement activity across all industry sectors.

The background for this dispute is somewhat complex. Almost 25 years ago, the major cigarette manufacturers signed the MSA, a settlement with 52 U.S. states and territories that gave the manufacturers a release from past and future legal claims by the states for the use of, or exposure to, cigarettes and smokeless tobacco products.

In return, the tobacco manufacturers that signed onto the MSA, known as the participating manufacturers, or PMs, agreed to make annual payments in perpetuity to the states, and substantially restrict their marketing and advertising activity.

The PMs each pay their portion of about $7 billion per year based on their respective market share of national cigarette sales. These payments are divided among the states pursuant to the MSA.

Not all tobacco manufacturers chose to join the MSA, however. These nonparticipating manufacturers, or NPMs, would be free to sell low-cost cigarettes to the detriment of the PMs and the public health were it not for some other intervention.

To level the playing field between PMs and NPMs, each settling state was given the option to pass and diligently enforce a model statute that obligates NPMs to either join the MSA or to make payments into escrow on their units sold into that state.

These payments are comparable to those paid by the PMs, are meant to neutralize the cost disadvantages suffered by the PMs, and are held in escrow for 25 years to cover any judgment obtained by the states in the event they sue an NPM for costs arising out of the NPM's sales of cigarettes in that state.

In order to protect their claim to annual MSA payments, states must pass the model escrow statute and "diligently enforce the provisions of such statute during [an] entire calendar year," according to the agreement.[3]

If a state fails to diligently enforce its escrow statute, it can be subjected to a process known as the NPM adjustment: a potential downward adjustment of the state's allocated annual payment, meant to offset a potential market loss caused by the state's failure to hold NPMs to their escrow payment obligations.

To date, when a PM believes an NPM adjustment should apply to a particular state, it has placed the disputed money in a separate disputed payments account or simply not paid it until after the state's diligent enforcement is arbitrated and the appropriate NPM adjustment is determined.

The process, as described below, can take many years to resolve, leaving large sums of money in the bank and not in the states' coffers.

If a state is shown to have failed to diligently enforce its escrow statute, it could lose up to its entire MSA payment allocation for that year.

Disputes Arise

The MSA provides two possible routes for dispute resolution. Generally, states or PMs can bring an action in state court "to enforce the terms of [the MSA]" or for "a declaration construing any such term" with respect to "disputes, alleged violations or alleged breaches within such Settling State."[4]

The MSA requires binding arbitration, however, for disputes, controversies or claims arising out of or relating to calculations performed by, or any determinations made by, the independent auditor.[5]

States have previously attempted to litigate the issue of whether they have diligently enforced their escrow statutes, but the courts of 47 states and territories, including Iowa and New Mexico, have ruled that such claims are subject to the MSA's binding arbitration provision.[6]

The PMs triggered the NPM adjustment process with respect to payments owed for 2004, and that arbitration lasted until October 2022. Arbitrations for payments owed in 2005 to 2007 are now ongoing.

As an alternative to continuing to arbitrate, 37 states have entered into a separate settlement agreement with the PMs regarding past NPM adjustment disputes, known as the NPM adjustment settlement.

In addition, the state of New York has entered into its own settlement agreement with the PMs that not only settles past NPM adjustment disputes, but provides a method for the automatic application of future NPM adjustments such that arbitration will no longer be necessary with respect to payments owed to New York.

This has left a contingent of nine states and four territories that have continued to arbitrate the NPM adjustment rather than joining the NPM adjustment settlement.

These jurisdictions take the position that the NPM adjustment settlement sacrifices too much of their annual payment and increases the risk of further reductions in the future.

The Holdout States Pursue Litigation

Frustrated with the lengthy arbitration process and what they claim are the PMs' unfounded assertions regarding diligent enforcement, some of the holdout states are now bringing the matter to their state courts.

The recent actions by Iowa and New Mexico follow in the footsteps of Montana, the first state to bring this type of case in 2020 under then-Attorney General Tim Fox.

Montana's case led to a settlement, requiring the tobacco company defendants to pay all the funds withheld from Montana up until 2020, plus a waiver of future similar claims through 2030.

The total value of the settlement to Montana was over $100 million over 10 years. Montana was in a unique position, however, as it is the only state that has succeeded in keeping disputes over its liability for the NPM adjustment in Montana state court instead of arbitration.

The Claims Asserted

Iowa and New Mexico are bringing their claims under new theories that go beyond the issue of diligent enforcement and accuse the PMs of violating the MSA itself and certain state and common laws.

Specifically, Iowa brought its claims under the MSA itself, the related state court consent decree and the Iowa False Claims Act, and asked the court for damages equal to the $133 million allegedly wrongly withheld, treble damages, punitive damages and maximum statutory penalties under the Iowa False Claims Act.

New Mexico's claims are even more creative, asserting not only a standard breach of contract but also more novel theories. New Mexico asserts that the PMs' conduct:

- Constitutes malicious abuse of process by misusing the arbitration process to pressure New Mexico into a settlement;

- Violates the New Mexico Unfair Practices Act — a consumer protection statute — because the PMs are attempting to gain an unfair advantage and engage in unfair trade practices by avoiding their MSA payment obligations;

- Implicates the Fraud Against Taxpayers Act because the PMs submitted false written responses to the independent auditor in order to trigger a diligent enforcement dispute; and

- Constitutes a conspiracy because the PMs have conspired in their attempts to delay payment obligations through arbitration over the NPM adjustment.

The lawsuit claims New Mexico could be owed at least $84 million. Using David and Goliath imagery, New Mexico asserts that:

Defendants are the largest and most profitable multinational tobacco companies in the world, whereas New Mexico is a small state with the third-highest rate of poverty in the United States.

Challenges Faced by the States

As noted above, an important threshold matter for the court's consideration will be whether it has jurisdiction over this dispute.

As stated above, the MSA requires that "any dispute, controversy or claim arising out of or relating to calculations performed by, or any determinations made by, the Independent Auditor" be submitted to binding arbitration before a panel of neutral arbitrators.

New Mexico claims that this is actually a dispute "to enforce the terms of [the MSA]" and for alleged breaches of the MSA, and therefore the Santa Fe County First Judicial District Court has jurisdiction.

It remains to be seen whether the court will agree that it may hear this dispute, or if it will take the position that, despite New Mexico's state law claims, the matter continues to be arising out of or relating to calculations or determinations performed by the independent auditor. If the latter, the disputes will be subject to arbitration.

If the suit survives this considerable hurdle, the state must still show that the PMs have indeed acted in concert in an effort to thwart their MSA payment obligations, rather than simply following the procedure outlined for dispute resolution related to payments owed and diligent enforcement.

While Iowa has been found diligent by the 2003 and 2004 NPM adjustment arbitration panels, both arbitration panels found that New Mexico did not, in fact, diligently enforce its escrow statutes in 2003 or 2004.

Challenges Faced by the Participating Manufacturers

While New Mexico paints itself as the metaphorical David in this action, the states may have additional logistical support behind them.

When suing the PMs, Iowa hired three law firms to represent the state in litigation. Two of the law firms are from Montana and represented the state of Montana in that action.

The third is a Florida-based law firm that hired former Montana Attorney General Tim Fox as a partner. While New Mexico's complaint does not include outside counsel, the language of the complaint is almost identical to Iowa's and implies possible involvement by the same outside counsel.

Regardless, it is clear that Montana's ability to obtain a win in its state court emboldened Iowa and New Mexico to try a new approach.

Overall, these cases are another example of the emboldening of attorneys general offices and their crackdown on perceived corporate misconduct. Many of these offices receive a significant portion of their funding from the MSA payments, and the withheld funds these offices are seeking would likely support further enforcement activity across all industry sectors.

This use of plaintiffs law firms to bring state claims against corporate interests continues a recent and troubling trend of state attorneys general.

Corporations would do well to take note of these enforcement trends and get ahead of them to avoid costly litigation proceedings. And, whenever possible, it is advisable for a corporation to maintain good working relationships with its regulators, especially the local attorney general.

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[1] https://www.nmag.gov/ag-balderas-sues-tobacco-companies-over-millions-in-withheld-payments/.

[2] https://www.iowaattorneygeneral.gov/media/cms/Motion_to_Enforce_Consent_Decree_an_50601277A4A15.pdf.

[3] MSA § IX(d)(2).

[4] MSA § VII(c)(1).

[5] MSA § XI(c).

[6] See *Iowa v. Philip Morris USA, Inc.*, No. CL 71048, at 5 (Iowa Dist. Ct. Aug. 16, 2006) and *State ex rel. King v. Am. Tobacco Co.*, 2008-NMCA-142, 145 N.M. 134, 194 P.3d 749.

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