No. _____

In the Supreme Court of the United States

R.J. REYNOLDS TOBACCO COMPANY, PHILIP MORRIS USA INC., COMMONWEALTH BRANDS, INC., ET AL.,

v.

STATE OF MARYLAND

On Petition For A Writ Of Certiorari To The Court Of Special Appeals Of Maryland

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether, when the Federal Arbitration Act ("FAA") governs an arbitration, the FAA's judicial-review standards apply in state court and preempt application of different state-law judicial-review standards.

2. Whether, when arbitrators have jurisdiction to resolve a contract dispute, the FAA prohibits a court from holding that they "exceeded their powers" based on the court's conclusion that their contract interpretation is "plainly" and "irrationally" incorrect on the merits.

PARTIES TO THE PROCEEDING AND RULE 29.6 STATEMENT

The Petitioners here, who were Appellees below, are: R.J. Reynolds Tobacco Company; Philip Morris USA Inc.; Commonwealth Brands, Inc.; Compania Industrial de Tabacos Monte Paz, SA; Daughters and Ryan, Inc.; House of Prince A/S; Japan Tobacco International U.S.A., Inc.; King Maker Marketing, Inc.; Kretek International, Inc.; Liggett Group LLC; Peter Stokkebye Tobaksfabrick A/S; P.T. Djarum; Santa Fe Natural Tobacco Company, Inc.; Sherman 1400 Broadway N.Y.C. Inc.; Top Tobacco, L.P.; Von Eicken Group; and Farmer's Tobacco Company of Cynthiana, Inc. (Another Appellee below, Lorillard Tobacco Company, has since merged with R.J. Reynolds Tobacco Company.)

The Respondent here, who was Appellant below, is the State of Maryland.

Petitioner R.J. Reynolds Tobacco Co. is a wholly owned subsidiary of R.J. Reynolds Tobacco Holdings, Inc., which in turn is a wholly owned subsidiary of Reynolds American Inc., a publicly held company. British American Tobacco p.l.c. and its subsidiaries collectively own more than 10% of the common stock of Reynolds American, Inc.

Petitioner Philip Morris USA Inc. is a wholly owned subsidiary of Altria Group, Inc. Altria Group, Inc. has no parent company, and no publicly held company owns 10% or more of its stock.

Petitioner Commonwealth Brands, Inc. is a subsidiary of CBHC, Inc. Imperial Brands P.L.C. indirectly owns more than 10% of the stock of Commonwealth Brands, Inc.

Petitioner Compania Industrial de Tabacos Monte Paz, SA has no parent company, and no publicly held company owns 10% or more of its stock.

Petitioner Daughters & Ryan, Inc. has no parent company, and no publicly held company owns 10% or more of its stock.

Petitioner House of Prince A/S is a subsidiary of British American Tobacco, p.l.c., and no other publicly held company owns 10% or more of its stock.

Petitioner Japan Tobacco International U.S.A., Inc. is a subsidiary of JTI (US) Holding Inc. Japan Tobacco Inc. indirectly owns more than 10% of the stock of Japan Tobacco International U.S.A., Inc.

Petitioner King Maker Marketing, Inc. is a subsidiary of ITC Ltd., and no other publicly held company owns 10% or more of its stock.

Petitioner Kretek International, Inc. has no parent company, and no publicly held company owns 10% or more of its stock.

Petitioner Liggett Group LLC is a subsidiary of VGR Holding LLC. Vector Group Ltd. indirectly owns 10% or more of the stock of Liggett Group LLC.

Petitioner Peter Stokkebye Tobaksfabrik, A/S is a subsidiary of Scandinavian Tobacco Group Assens A/S. Scandinavian Tobacco Group A/S indirectly owns 10% or more of the stock of Peter Stokkebye Tobaksfabrik, A/S.

Petitioner P.T. Djarum has no parent company, and no publicly held company owns 10% or more of its stock.

Petitioner Santa Fe Natural Tobacco Company is a subsidiary of Reynolds American Inc., and no other publicly held company owns 10% or more of its stock. British American Tobacco p.l.c. and its subsidiaries

collectively own more than 10% of the common stock of Reynolds American, Inc.

Petitioner Sherman 1400 Broadway N.Y.C. Inc. is a subsidiary of Sherman Group Holdings Inc., and no publicly held company owns 10% or more of its stock.

Petitioner Top Tobacco L.P. has no parent company, and no publicly held company owns 10% or more of its stock.

Petitioner Von Eicken Group has no parent company, and no publicly held company owns 10% or more of its stock.

Petitioner Farmers Tobacco Company of Cynthiana, Inc. has no parent company, and no publicly held company owns 10% or more of its stock.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page(s)

CASES

STATUTES

OTHER AUTHORITIES

OPINIONS

The opinion of the Court of Special Appeals of Maryland (Pet.App. 1a) is reported at 123 A.3d 660. That opinion reversed an opinion of the Circuit Court for Baltimore City (Pet.App. 54a) that is unreported. The opinions reviewed an arbitration award (Pet.App. 81a).

JURISDICTION

The Court of Special Appeals of Maryland entered judgment on October 2, 2015. Pet.App. 1a. The Court of Appeals of Maryland denied petitions for a writ of certiorari on February 22, 2016. Pet.App. 80a. On May 4, 2016, Chief Justice Roberts extended the time within which to file a certiorari petition until June 22, 2016. No. 15A1136. Jurisdiction rests on 28 U.S.C. § 1257.

PROVISIONS INVOLVED

The appendix reproduces relevant statutory provisions in the Federal Arbitration Act ("FAA"), 9 U.S.C. § 1 *et seq.*, and the Maryland Uniform Arbitration Act ("MUAA"), Md. Code Ann., Cts. & Jud. Proc. § 3-201 *et seq*. The appendix also reproduces relevant contractual provisions in the tobacco Master Settlement Agreement ("MSA").

STATEMENT OF THE CASE

In this multi-hundred-million-dollar dispute under the landmark tobacco MSA, the state court below invalidated as "irrational" an arbitration award that had been unanimously issued by a Panel of three former federal judges, including Judge Abner Mikva of the D.C. Circuit. This remarkable rejection of the arbitrators' decision was based on two holdings about the scope of the FAA's judicial-review standards that warrant this Court's review.

First, the court below held that, even when an arbitration is governed by the FAA, the standards for judicial review in state court are governed by state law rather than the FAA. This issue has divided several state courts of last resort. And the side of the split adopted below flouts this Court's decisions concerning the FAA's objectives, because it allows states that are hostile to arbitration to undermine FAA-governed arbitration agreements by mandating more stringent judicial review of arbitration awards than the FAA authorizes. That is an especially grave threat to the FAA because judicial review of FAA-governed arbitrations typically occurs in state court rather than federal court.

Second, in an effort to equate the judicial-review standards under state law and the FAA, the court below held that the FAA's "exceeded their powers" standard allows a court to reverse the arbitrators' contract interpretation if the court concludes on the merits that the interpretation is "plainly" and "irrationally" wrong. But that holding conflicts with this Court's unanimous decision in *Oxford Health Plans LLC v. Sutter*, 133 S. Ct. 2064 (2013), which does not allow any merits review whatsoever.

Instead, *Oxford Health* held that arbitrators exceed their powers on an issue within their jurisdiction *only* if they willfully adopt their "own notions of economic justice" — and thus *not* if they are even "arguably construing" the contract on the merits, *no matter how* "good, bad, or ugly." *See id.* at 2068-71. It is important that this Court reverse the court below for failing to follow *Oxford Health*: if a court can ever discard as "irrational" the arbitrators' contract interpretation, let alone the carefully reasoned interpretation of the MSA that was unanimously adopted by the distinguished Panel of former federal judges here, then no FAA award is safe from being judicially second-guessed.

Indeed, state appellate courts have divided on whether this very arbitration award must be upheld under the FAA. While a Pennsylvania appellate court reached the same conclusions as the Maryland appellate court did here, a Missouri appellate court held that the FAA review standard applied and required upholding the award. *Compare Commw. ex rel. Kane v. Philip Morris USA, Inc.*, 114 A.3d 37 (Pa. Commw. Ct. 2015), *appeal denied*, 129 A.3d 1244 (Pa. 2015), *pet. for cert. filed,* No. 15-1299 (U.S. Apr. 21, 2016), *with State v. Am. Tobacco Co.*, No. ED 101542, --- S.W. 3d ----, 2015 WL 5576135 (Mo. Ct. App. Sept. 22, 2015), *appeal transferred to Mo. S. Ct.* (Mo. Ct. App. Dec. 2, 2015). This Court should definitively resolve these critical questions.

1. This case involves the arbitration of a dispute under the landmark MSA that was entered into between certain cigarette manufacturers (the "Participating Manufacturers" or "PMs") and 52 States and Territories (the "MSA States"). The

dispute concerns the "NPM Adjustment," which is a potential reduction to the PMs' annual payment to the MSA States. During the arbitration of the dispute over the NPM Adjustment for 2003, the PMs and 22 of the States (the "Signatory States") reached a settlement — one that Maryland and the other "Non-Signatory States" were offered, but declined to join. The arbitrators thus had to interpret the MSA with respect to how the 2003 NPM Adjustment should be allocated to the Non-Signatory States in light of the partial settlement.

a. Under the MSA, the PMs make an annual payment, subject to various potential adjustments, that is apportioned among the MSA States by each State's contractually specified "[A]llocable [S]hare[ ]." Pet.App. 5a-6a. One of these potential downward adjustments is the "NPM Adjustment." *Id.* 6a; *see also id.* 155a (MSA § IX(d)).

Under MSA § IX(d)(2)(A), the NPM Adjustment, when it applies, shall apply to all MSA States, with each State bearing its Allocable Share. *Id.* 6a-8a, 160a-161a. But there is an exception in MSA § IX(d)(2)(B), under which an individual State may avoid its share of the Adjustment if it "diligently enforced" certain obligations pursuant to the MSA. *Id.* Where the exception is met, MSA § IX(d)(2)(C) provides that the diligent States' shares are "reallocate[d]" among all other States *"pro rata* in proportion to their respective Allocable Shares." *Id.*

In sum, under § 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 that were initially allocated to the diligent States.

b. There was a dispute over the MSA States' responsibility for the 2003 NPM Adjustment, which was roughly $1.15 billion. *See id.* 8a-9a. The PMs requested arbitration pursuant to MSA § XI(c). *Id.* 9a; *see also id.* 173a. MSA § XI(c) requires that the parties submit payment disputes, including over the NPM Adjustment, to "binding arbitration." *Id.* It further specifies that the arbitration shall be conducted by "three … former Article III federal judge[s]," and that "[t]he arbitration shall be governed by the United States Federal Arbitration Act." *Id.* Moreover, wholly apart from § XI(c), the FAA governs the arbitration because the MSA involves interstate commerce. *See* 9 U.S.C. § 2.

Maryland and other MSA States refused to arbitrate the dispute and instead sought declaratory relief in their respective state courts. Pet.App. 9a. But the courts in virtually every MSA State ordered that the dispute be arbitrated (only Montana's courts disagreed). *See id.* 9a-10a. Eventually, an arbitration Panel was selected. The States picked the Hon. Abner J. Mikva (D.C. Cir.), the PMs picked the Hon. William G. Bassler (D.N.J.), and Judges Mikva and Bassler then picked the Hon. Fern M. Smith (N.D. Cal.). *See id.* 11a n.3.

Because the diligence of a State affects the reallocation of the NPM Adjustment among the non-diligent States, the Panel afforded each State the opportunity to contest the diligence of any other State before the individual State hearings began. *See id.* 12a-13a. But neither Maryland nor any other State took this opportunity: after discovery, only the PMs contested the diligence of any States, and they contested only 35 of the States. *See id.*

c. During the arbitration, and before the Panel had issued diligence determinations for any of the States, the PMs and 19 States agreed to a multi-year NPM Adjustment settlement. *Id.* 13a. All other States were invited to join the settlement, and 3 more States joined before the arbitration concluded. *Id.* Maryland declined to join. *Id.* The 22 Signatory States had an aggregate Allocable Share of about 46% of the NPM Adjustment, and they consisted of 20 States that the PMs had contested to that point as well as 2 States that the PMs had decided not to contest. *Id.*

With respect to the 2003 Adjustment, the settlement provides for the Signatory States to give the PMs specified credits against future MSA payments for part of that Adjustment. *See id.* 13a, 104a. The settlement, of course, did not provide how to allocate the 2003 Adjustment among the Non-Signatory States in light of the uncertainty about the Signatory States' diligence — *i.e.*, given that their diligence would no longer be contested by the PMs and had never been contested by the Non-Signatory States. *See id.* 13a. That issue was properly left for the Panel to decide under the MSA. *See id.*

The PMs and Signatory States contended that the MSA's reallocation provision did not directly address the issue and thus the Panel should look to background law to inform its interpretation. *See id.* 14a. By contrast, many of the Non-Signatory States, including Maryland, contended that the MSA's reallocation provision requires a determination as to the diligence of each State, regardless of whether a State has settled with the PMs. *See id.* Yet, inconsistently, the Non-Signatory States did not

contend that the Panel actually had to determine the diligence of the Signatory States in order to determine the Non-Signatory States' reallocated share of the Adjustment. Rather, the Non-Signatory States contended that the Panel should simply *treat* as *non*-diligent *all* the Signatory States that the PMs had contested, *whether or not* those Signatory States would have been found non-diligent absent the settlement. *See id.*

d. The Panel ordered extensive briefing on this post-settlement reallocation issue and held four days of hearings. Pet.App. 81a-82a. The Panel then unanimously entered a Settlement Award that rejected the Non-Signatory States' objection, and that interpreted the MSA in light of background law to provide a different method for reallocating the NPM Adjustment after a partial settlement. *See id.*

The Panel first ruled that it "ha[d] jurisdiction to rule on the issues raised concerning the MSA reallocation provisions." *Id.* 84a. Under MSA § XI(c), it had jurisdiction over all issues "relat[ing] to" the resolution of the "2003 NPM Adjustment dispute," including the Adjustment's allocation among the MSA States. *See id.* 83a, 173a. And under well-established caselaw, such jurisdiction covers "all matters necessary to dispose of the claim," including "the existence or effect of a settlement." *See id.* 83a-84a.

Turning to the text of the MSA's reallocation provision, the Panel determined that "the MSA does not directly speak as to the process to be used when some States settle diligent enforcement and some do not." *Id.* 97a. Although the MSA instructs that diligent States are exempt from their share of the

Adjustment (§ IX(d)(2)(B)), and that non-diligent States are subject to their initial and reallocated shares of the Adjustment (§ IX(d)(2)(C)), those provisions do not instruct what to do where it is *unknown* whether a State is diligent or non-diligent because its diligence is no longer contested due to a settlement. *See id.*; *id.* 160a-161a.

The Panel thus concluded that it had "to interpret the contract in light of governing law" to determine the appropriate process where there is a partial settlement. *Id.* 97a. The Panel looked to the well-established law of post-settlement judgment reduction. It found that "[w]here multiple parties have a potential shared contractual obligation and some of them settle and some do not, the non-settling parties" are "entitled to a judgment reduction" pursuant to one of "three standard methods" — the "*pro rata*" method, the "*pro tanto*" method, or the "proportionate fault" method. *Id.* 92a-93a.

The Panel concluded that the "*pro rata*" method is most appropriate under the MSA's language and structure, and that it is far superior to the objectors' "all Signatory States non-diligent" position, which has no basis in the MSA, the law, or the facts, and which would discourage partial settlements by giving the objectors a windfall profit. *See id.* 93a-94a, 96a-97a. Under the *pro rata* method, the 2003 NPM Adjustment amount that the Non-Signatory States are potentially subject to is reduced by the aggregate Allocable Share of the Signatory States (46%) — *i.e.*, the $1.15 billion Adjustment is reduced by $528 million. *See id.* 92a.

e. At the conclusion of the arbitration, the Panel entered final awards for the 15 Non-Signatory States whose diligence for 2003 was still contested. *Id.* 19a. The Panel unanimously held that Maryland and five other States were non-diligent, and that the remaining nine States were diligent. *Id.* Thus, the 2003 NPM Adjustment, as reduced under the *pro rata* method, was allocated among the six non-diligent Non-Signatory States pursuant to MSA § IX(d)(2) as interpreted in the Settlement Award. *See id.* 92a.

2. Maryland filed a petition in state court that sought, as relevant here, to vacate or modify the Settlement Award's *pro rata* judgment-reduction ruling. *Id.* 20a-21a.

a. The Circuit Court for Baltimore City denied the petition. *Id.* 79a. It concluded that, under the governing standard for judicial review of the arbitration award, the Panel's decision could not be set aside on the merits. *Id.* 66a-75a.

First, on the judicial-review standard, the court held that the FAA governed review of this MSA arbitration. *Id.* 68a-70a. It further held that, under FAA § 10(a)(4) as interpreted by this Court, arbitrators do not "exceed[ ] their powers" when resolving a contract dispute within their jurisdiction unless the award "simply reflects [their] *own notions of economic justice*" rather than their good-faith attempt to construe the contract. *See id.* 70a (citing *Oxford Health*, 133 S. Ct. at 2068). In short, vacatur is permitted "only when [an] arbitrator strayed from his delegated task of interpreting a contract, not when he performed that task poorly." *Id.* (quoting *Oxford Health*, 133 S. Ct. at 2070).

Second, on the merits, the court held that the Panel had not exceeded its authority in issuing the *pro rata* ruling. *Id.* 72a-75a. The court recognized that "the MSA is silent on a procedure for reallocating the NPM adjustment among non-settling states when the diligence of [settling states] is no longer contested." *Id.* 72a. It thus concluded that, under MSA § XI(c), the Panel had "jurisdiction" to "interpret[ ] the MSA and determin[e] the appropriate method for reallocating the 2003 NPM Adjustment post-settlement." *Id.* 72a-73a. And it further concluded that the Panel's *pro rata* interpretation was "based on a reasonable analysis of [MSA § IX(d)(2)] and review of applicable judgment-reduction principles of contract law." *Id.* 73a-74a. Accordingly, the court "d[id] not find any indication … that the Panel was substituting its own notions of fairness and/or economic justice." *Id.* 74a.

b. The Court of Special Appeals reversed. *Id.* 4a-5a. Its judgment rested on several key conclusions of federal law.

First, on the judicial-review standard, the court held that state law governed, not the FAA. *See id.* 24a-32a. The court provided two rationales in support of that holding.

The court's primary rationale was that the FAA's judicial-review standards are "procedural" rules that neither apply in state court nor preempt the application in state court of different state-law judicial-review standards. *See id.* 27a-29a. The court noted that the FAA's substantive objective is to ensure the enforcement of the arbitration *agreement*, and the court asserted that this objective purportedly is not frustrated by applying different state-law

judicial-review standards to the arbitration *award*. *See id.* But the court provided no reason why nominal enforcement of the underlying arbitration agreement would satisfy the FAA when the resulting arbitration award is nullified through more stringent judicial review than the FAA authorizes. *See id.*

The court's secondary rationale was that, in any event, there is no conflict here between the FAA standards and the state-law standards because the relevant provisions are effectively equivalent. *See id.* 29a-31a. The court claimed that, under decisions applying MUAA § 3-224(b)(3), arbitrators exceed their powers when resolving a dispute within their jurisdiction if their construction of the contract is "completely irrational" given the contract's "plain language." *Id.* 30a, 36a. But the court failed to reconcile that type of merits review with this Court's interpretation of FAA § 10(a)(4), which it never even mentioned. *Id.* 29a-31a. In particular, the court ignored *Oxford Health*'s admonition that "[i]t is not enough … to show that the [arbitrators] committed … a serious error," because "[their contract] construction holds, however good, bad, or ugly," "[s]o long as [they were] 'arguably construing' the contract" rather than imposing their "own notions of economic justice." 133 S. Ct. at 2068, 2070-71.[1]

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[1] The court separately held that the proper judicial-review standard is an issue that can be decided only by the courts, not by the parties. *See* Pet.App. 26a-27a. Under that holding, it is irrelevant whether the parties agreed to a standard of review. Nevertheless, the court also suggested that the parties' express incorporation of the FAA in MSA § XI(c)'s arbitration provision was limited to the conduct of the arbitration itself and thus did not extend to the FAA's judicial-review standards. *See id.* 27a.

Second, on the merits, the court held that the Panel had exceeded its authority in issuing the *pro rata* ruling. Pet.App. 32a-40a. The court's analysis vividly illustrates that it was engaging in merits-based review, not the limited non-merits review authorized by the FAA *Oxford Health* standard.

The court rejected the *pro rata* ruling on the ground that it "lacked rationality" because it contravened "the plain language" of MSA § IX(d)(2)'s reallocation provision. *Id.* 36a, 40a. Specifically, despite acknowledging that § IX(d)(2) "was silent on the effect of a partial settlement regarding [the reallocation of] the NPM Adjustment," the court nevertheless claimed that § IX(d)(2) unambiguously prohibits "reallocating the 2003 NPM Adjustment post-settlement without *first* determining the diligence of [all contested settling] states." *Id.* 36a-37a. And the court further claimed that "the only possible remedy" for the Panel's alleged failure to determine the diligence of the contested Signatory States was "to treat the[m] … as non-diligent" when determining Maryland's reallocated share of the 2003 Adjustment. *Id.* 40a.[2]

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[2] Notwithstanding its disagreement with the merits of the Panel's *pro rata* ruling, the court recognized that the Panel had "jurisdiction" to "interpret[ ] the MSA and determin[e] the appropriate method for reallocating the 2003 NPM Adjustment post-settlement." Pet.App. 35a-36a. Although the court also stated that the Panel "lack[ed] jurisdiction" to issue the *pro rata* ruling "pursuant to MSA § XVIII(j)," *id.* 40a — which provides that any "amendment" to the MSA must be approved by all "affected" parties, *id.* 38a, 174a — the court's conclusion that the *pro rata* ruling was an "amendment" to the MSA was just a restatement of its conclusion that the Panel's interpretation of the MSA was incorrect *on the merits*. *See id.* 38a-39a.

Notably, the court did not hold that the arbitrators had actually "abandoned their interpretive role" based solely on their "own notions of economic justice." *Compare id.* 35a-40a, *with Oxford Health*, 133 S. Ct. at 2068, 2070. Nor could the court have so held, because it is indisputable from the face of the Settlement Award that Judge Mikva and the other former federal judges on the Panel were at least conscientiously interpreting the MSA in good faith. *See* Pet.App. 92a-94a, 96a-97a. Indeed, the Panel's reasons for adopting the *pro rata* interpretation rather than the "all non-diligent" interpretation were not just given in good faith and entirely rational; they are compelling and correct. *Infra* at Part II.B.

c. The PMs filed timely petitions for a writ of certiorari in the Court of Appeals of Maryland. Pet.App. 80a. The petitions were denied. *Id.*

3. In parallel litigation in other MSA States, appellate courts have divided on whether the Settlement Award's *pro rata* ruling must be upheld under the FAA. The Commonwealth Court of Pennsylvania reached the same conclusions as the Court of Special Appeals of Maryland. *See Philip Morris USA*, 114 A.3d at 50-65. But the Missouri Court of Appeals reached the exact opposite conclusions. It held that the FAA review standard applied, and that the *pro rata* ruling could not be set aside under FAA § 10(a)(4) because the Panel was interpreting the MSA in good faith, rather than willfully adopting its own notions of economic justice. *See Am. Tobacco*, 2015 WL 5576135, at *7-15.

REASONS FOR GRANTING THE PETITION

Because "[s]tate courts rather than federal courts are most frequently called upon to apply the [FAA]," "[i]t is a matter of great importance … that [they] adhere to a correct interpretation of the legislation." *Nitro-Lift Techs., L.L.C. v. Howard*, 133 S. Ct. 500, 501 (2012) (per curiam). The state court here adopted two critical interpretations of the FAA to justify invalidating a multi-hundred-million-dollar arbitration award on the merits by accusing a distinguished Panel of former federal judges — including Judge Abner Mikva — of adopting an interpretation of the MSA that was "plainly" and "irrationally" wrong. Namely, the court held that the FAA's judicial-review standard (1) does not preempt state courts from engaging in such merits review, and (2) in fact itself authorizes such review.

Those two holdings, in turn, warrant this Court's review. The holdings implicate conflicts among the decisions of several state courts of last resort as well as conflicts with the decisions of this Court. Moreover, the holdings threaten to eviscerate the extraordinary deference that is due to arbitration awards under the FAA as construed by this Court in *Oxford Health*. States that are hostile to arbitration would be allowed to undermine FAA-governed arbitration agreements by mandating merits-based judicial review that goes beyond the extremely narrow non-merits judicial review permitted by the FAA. Such expanded state-law review is particularly problematic because judicial review of FAA-governed arbitrations typically occurs in state courts given that the FAA provides no independent basis for federal-court jurisdiction. And divergent state-law

standards are especially troubling in the context of the MSA, where there have been and will continue to be multi-State arbitrations reviewed in different state courts. Indeed, another state appellate court in parallel MSA litigation has held that the FAA requires upholding this very same arbitration award.

Accordingly, this Court should grant plenary review. Alternatively, this Court may wish to consider summarily vacating and remanding in light of *Oxford Health*: *i.e.*, reversing the holding below that the FAA itself authorized modification of the award, and then remanding for reconsideration of the holding below that the FAA did not preempt state-law modification of the award.

I. THIS COURT SHOULD RESOLVE WHETHER THE FAA PREEMPTS CONTRARY STATE-LAW JUDICIAL-REVIEW STANDARDS

The FAA governs arbitration agreements in contracts that, like the MSA, involve interstate commerce. *Circuit City Stores, Inc. v. Adams*, 532 U.S. 105, 111-12 (2001). Section 2 of the FAA generally requires courts to enforce covered arbitration agreements, subject to certain narrow defenses. 9 U.S.C. § 2; *Circuit City*, 532 U.S. at 111-12. And Sections 9-11 of the FAA generally require courts to confirm covered arbitration awards, subject to certain narrow grounds for vacatur or modification. 9 U.S.C. §§ 9-11; *Hall St. Assocs., LLC v. Mattel, Inc.*, 552 U.S. 576, 586-88 (2008). Notably, MSA § XI(c) itself expressly provides that the NPM Adjustment arbitration shall be "binding" and "governed by the United States Federal Arbitration Act." Pet.App. 173a.

The FAA is typically enforced in state courts because it does not confer independent jurisdiction on federal courts. *See Nitro-Lift*, 133 S. Ct. at 501; *Hall St.*, 552 U.S. at 581-82. Accordingly, the FAA preempts any state law that "stands as an obstacle to the accomplishment and execution of [its] full purposes and objectives." *Volt Info. Sciences, Inc. v. Bd. of Trs. of Leland Stanford Jr. Univ.*, 489 U.S. 468, 477-78 (1989). This Court has thus repeatedly held that the FAA preempts contrary state laws that permit state courts to refuse "to enforce … agreements to arbitrate … in accordance with their terms." *See id.* at 478-79. But this Court has not yet decided whether the FAA likewise preempts state laws that permit state courts to subject arbitration awards to different standards of judicial review. *See Hall St.*, 552 U.S. at 590 (reserving the question).

This Court should now resolve that question. Several state courts of last resort have divided on it. So too have the state appellate courts in the parallel MSA litigation at issue here. And the reasoning of the decision below is contrary to this Court's decisions addressing the FAA's objectives.

A. State Courts Of Last Resort Have Split On Whether The FAA's Judicial-Review Standards Govern In State Court

Contrary to the court below, "a number of other state appellate courts … recogniz[e] the applicability of the [FAA] § 10 standards in appeals in state courts from arbitration awards" where the arbitration itself was governed by the FAA. *Birmingham News Co. v. Horn*, 901 So. 2d 27, 46 (Ala. 2004). Indeed, six state courts of last resort have so held. For example, the Court of Appeals of New York has ruled: "[a]s this

matter affects interstate commerce, the vacatur of the arbitration award is governed by the Federal Arbitration Act." *US Elecs., Inc. v. Sirius Satellite Radio, Inc.*, 958 N.E.2d 891, 892 (N.Y. 2011); *see also Vold v. Broin & Assocs., Inc.*, 699 N.W.2d 482, 487 (S.D. 2005); *Hecla Min. Co. v. Bunker Hill Co.*, 617 P.2d 861, 865 (Idaho 1980). Likewise, the Supreme Court of Georgia has concluded: "[s]ince the Federal Arbitration Act created a body of substantive federal law, if a state court has jurisdiction to vacate an award, federal law rather than state law governs the vacation of the award." *Hilton Constr. Co. v. Martin Mech. Contractors, Inc.*, 308 S.E. 2d 830, 832 (Ga. 1983); *see also Dowd v. First Omaha Secs. Corp.*, 495 N.W.2d 36, 41-42 (Neb. 1993); *Horn*, 901 So. 2d at 44-46. (These rationales apply even more strongly here, where the MSA itself expressly provides that the FAA governs the arbitration. Pet.App. 173a.)

By contrast, like the court below, at least two state courts of last resort have held that the FAA does not govern the judicial-review standard in state court. *See Henderson v. Summerville Ford-Mercury Inc.*, 748 S.E. 2d 221, 225-27 (S.C. 2013); *Atlantic Painting & Contracting Inc. v. Nashville Bridge Co.*, 670 S.W.2d 841, 846-47 (Ky. 1984). And another two state courts of last resort have issued decisions that contain broad language so suggesting, but that could be distinguished on the ground that the parties there had explicitly agreed to a non-FAA review standard. *See Cable Connection, Inc. v. DIRECTV, Inc.*, 190 P.3d 586, 597-99 (Cal. 2008); *Nafta Traders, Inc. v. Quinn*, 339 S.W.3d 84, 97-101 (Tex. 2011); *cf. Raymond James Fin. Servs., Inc. v. Honea*, 55 So. 3d 1161, 1166-69 (Ala. 2010) (drawing this distinction).

In sum, among state courts of last resort, there is either a lopsided 6-2 split or a more balanced 6-4 split. Either way, there is a significant conflict that warrants this Court's resolution.

B. State Appellate Courts In Parallel MSA Litigation Also Have Split On This Issue

Just like the court below, the Commonwealth Court of Pennsylvania held that state law governed its review of the Settlement Award's *pro rata* ruling. *Philip Morris USA*, 114 A.3d at 56-58. And it so held based on the same reasoning: namely, state-law standards for judicial review of arbitration awards are purportedly "procedural" rules for state courts that are not preempted because they do not frustrate the FAA's substantive objective of ensuring that the underlying arbitration agreement is enforced. *Id.*

In direct conflict with these courts, however, the Missouri Court of Appeals held that the FAA governed its review of the *pro rata* ruling. *Am. Tobacco*, 2015 WL 5576135, at *7. And it so held for the same reason as the state courts of last resort discussed above: namely, the arbitration agreement was "in a [contract] involving commerce" — indeed, a contract that expressly provided that "the arbitration shall be governed by the [FAA]." *Id.*

That state appellate courts have split on this question in the context of the very MSA arbitration award at issue here confirms the propriety of this Court's intervention. The directly conflicting results on identical facts underscore that this is a conflict on a pure question of federal law that warrants this Court's definitive resolution. And that is so regardless of how the pending appeal in the Missouri

Supreme Court is resolved, as the conflict among state courts of last resort will persist in any event.

C. The Decision Below Is Erroneous Under This Court's Decisions Explaining The FAA's Objectives

As discussed, the primary rationale of the court below was that state-law standards for judicial review of arbitration awards are mere "procedural" rules that do not frustrate the FAA's substantive "goal of enforcing" the underlying "arbitration agreements." Pet.App. 27a-29a. But that reasoning is contrary to this Court's repeated characterization of the FAA's objectives.

As this Court has squarely held, the FAA establishes "a national policy favoring arbitration with just the limited review needed to maintain arbitration's essential virtue of resolving disputes straightaway." *Hall St.*, 552 U.S. at 588; *see also Oxford Health*, 133 S. Ct. at 2068. The FAA's policy of limited review is an indispensable aspect of the FAA's "policy … to ensure the enforceability [of] … agreements to arbitrate." *See Volt*, 489 U.S. at 476.

After all, it would be meaningless to preempt state laws that refuse to enforce arbitration agreements on the front end if States nevertheless could implement their "hostil[ity] to arbitration" by nullifying arbitration awards on the back end through stringent judicial review. *See Circuit City*, 532 U.S. at 112. That would allow hostile States to "render informal arbitration merely a prelude to a more cumbersome and time-consuming judicial review process," thereby "bring[ing] arbitration theory to grief in postarbitration process." *See Hall*

St., 552 U.S. at 588. Indeed, "[a]ny other reading [would] open[ ] the door to … full-bore legal and evidentiary appeals," including even *de novo* review. *See id.* And expanded merits review in state court would be especially problematic because "[s]tate courts rather than federal courts are most frequently called upon to apply the [FAA]," *Nitro-Lift*, 133 S. Ct. at 501, given that the FAA "bestow[s] no federal jurisdiction but rather require[s] an independent jurisdictional basis" to file in federal court, *Hall St.*, 552 U.S. at 581-82.

Thus, while *Hall Street* reserved the question whether *the parties* "may contemplate enforcement under state statutory or common law … where judicial review of different scope is arguable," that reservation in no way suggested that *a State may compel* parties to submit to expanded review despite the FAA. *Id.* at 590. To the contrary, this Court expressly admonished that it was "deciding nothing about other possible avenues [besides the FAA] for judicial enforcement of arbitration awards." *Id.*

Likewise, while Congress specified a particular federal district court where judicial review may be sought, 9 U.S.C. §§ 9-11, that provision in no way suggested that the FAA's review standards are inapplicable in state courts. As this Court has held, those "venue provisions" are merely "permissive," not "restrictive," such that review may be sought wherever venue is proper. *See Cortez Byrd Chips, Inc. v. Bill Harbert Constr. Co.*, 529 U.S. 193, 197-204 (2000). And it is hornbook law that state courts are generally proper forums to hear federal claims. *See Tafflin v. Levitt*, 493 U.S. 455, 458-61 (1990) (so holding for federal civil RICO statute, which likewise

contains a "permissive, not mandatory," provision authorizing suit "in any appropriate United States district court"); *see also Horn*, 901 So. 2d at 46 (applying FAA § 10 even though it "facially is applicable only to the federal district courts").

Finally, in light of all this, it is unsurprising that the court below tried to hedge its blanket holding that the FAA review standards lack preemptive force by also holding that the FAA § 10(a)(4) standard is basically the same as the relevant state-law standard here. *See* Pet.App. 29a-31a. But this secondary rationale fails to salvage the court's judgment. To the contrary, it underscores the need for this Court's review because it directly conflicts with *Oxford Health*, as demonstrated next.

II. THIS COURT SHOULD REAFFIRM THAT THE FAA DOES NOT AUTHORIZE REVIEWING THE MERITS OF AN ARBITRATION AWARD IN ANY RESPECT

As discussed, the court below asserted that the MUAA "completely irrational" review standard is virtually identical to the "exceeded their powers" review standard under FAA § 10(a)(4). Pet.App. 29a-31a. And the court further asserted that an award "lack[s] rationality" if it is contrary to the contract's "plain language." *Id.* 36a, 40a.

Critically, however, the court's treatment of the FAA § 10(a)(4) standard is irreconcilable with *Oxford Health*. That decision forecloses any level of merits review of the arbitrators' contract interpretation on issues within their jurisdiction. And the court's application of its purported standard underscores the importance of reaffirming the line that *Oxford Health* drew. No FAA award would be safe from

judicial second-guessing if even the careful contract interpretation here by three distinguished former federal judges can be blithely deemed "irrational."

A. The Decision Below Conflicts With This Court's Decision In *Oxford Health*

At the outset, *Oxford Health* noted that a party "bears a heavy burden" when asking a court to set aside an arbitration award under FAA § 10(a)(4) on the ground that the arbitrators "exceeded [their] powers." 133 S. Ct. at 2068. That is "[b]ecause the parties 'bargained for the arbitrator[s'] construction of their agreement'" with respect to the disputes covered by the arbitration clause. *Id.*

Accordingly, *Oxford Health* held that, so long as a dispute was within the arbitrators' jurisdiction, a decision "'even arguably construing or applying the contract' must stand, regardless of a court's view of its (de)merits." *Id.* at 2068 & n.2. By definition, the arbitrators' merits decision cannot have exceeded their "powers": "[i]t is [their] construction of the contract which was bargained for," and thus "the courts have no business overruling [them]" because "[t]he potential for … mistakes is the price of agreeing to arbitration." *Id.* at 2070.

Instead, *Oxford Health* held that arbitrators "act[ ] outside the scope of [their] contractually delegated authority" on issues within their jurisdiction "*[o]nly if* … [they] issu[e] an award that 'simply reflects [their] own notions of economic justice.'" *Id.* at 2068 (emphasis added). In other words, the arbitrators must have willfully "abandoned their interpretive role," not just merely "misinterpreted the contract." *Id.* at 2070.

Critically, *Oxford Health* emphasized that this is true even if "the arbitrator committed … a serious error." *Id.* at 2068. "[C]onvincing a court of an arbitrator's error — even his grave error — is not enough," because "[t]he arbitrator's construction holds, however good, bad, or ugly." *Id.* at 2070-71.

Oxford Health thus forecloses *any* merits review of the arbitrators' good-faith contract interpretation, including a merits review that is purportedly limited to "plain" or "irrational" errors. And that is confirmed by this Court's application of the *Oxford Health* standard to the arbitration award at issue in that case. This Court refused even to consider, much less uphold in any respect, the merits of the arbitrator's interpretation: "[n]othing we say in this opinion should be taken to reflect *any* agreement with the arbitrator's contract interpretation, or *any* quarrel with Oxford's contrary reading." *Id.* at 2070 (emphasis added). In concluding that the arbitrator was at least arguably interpreting the contract, this Court did not assess the rationality of his decisions, but instead found that conclusion evident "just by summarizing [his] decisions": he "focused on the [contract]'s text, analyzing (whether correctly or not makes no difference) [its] scope." *Id.* at 2069.

Tellingly, here, the court below did not even mention *Oxford Health* at all. Pet.App. 29a-31a. Instead, it quoted (*id.* 36a) an earlier decision by this Court stating that an "an arbitrator may not ignore the plain language of the contract." *United Paperworkers Int'l Union v. Misco, Inc.*, 484 U.S. 29, 38 (1987). However, the key word in that sentence is not "plain," but "ignore": this Court was restating the point that arbitrators must provide an "honest

judgment" about the contract's meaning, rather than imposing their "own notions of [economic] justice." *Id.* Indeed, the very next sentence in *Misco* admonished that "a court should not reject an award on the ground that the arbitrator misread the contract," whether plain or otherwise. *Id.*

Likewise, while the Commonwealth Court of Pennsylvania did at least discuss *Oxford Health*, it failed to quote any language from that decision using any variant of the words "irrational," "plain," or "unambiguous," because no such language exists. *Philip Morris USA*, 123 A.3d at 52-53.

By contrast, the Missouri Court of Appeals properly held that the relevant question under *Oxford Health* is not whether the Panel rationally construed the MSA's language, but whether the Panel maliciously implemented its "own notions of economic justice." *Am. Tobacco*, 2015 WL 5576135, at *13-15. And that court correctly held that there was not even "any hint" of such misconduct: "it is clear from the [Settlement Award] that the Panel took its decision-making role seriously … and made its decision carefully," by "construe[ing] the MSA just as it was asked to do … to resolve the dispute regarding the NPM Adjustment … in light of [the] Partial Settlement." *See id.*

In sum, the decision below is irreconcilable with *Oxford Health*. This Court should not permit state courts to engage in such flagrant defiance of its precedent. And that is particularly true where the precedent is recent, unanimous, and involves the FAA — which itself targets "state courts" that are "hostile to arbitration," *Circuit City*, 532 U.S. at 112.

B. The Merits Review Sanctioned By The Court Below Is Especially Excessive And Harmful To Arbitral Finality

This case underscores why *Oxford Health* was right to bar any type of merits review of the arbitrators' contract interpretation. After carefully considering the MSA's text, the background law of judgment reduction, and the facts, the Panel determined that the *pro rata* interpretation was superior to the "all non-diligent" interpretation. No FAA award would be safe from judicial second-guessing if the state court below nevertheless is permitted to substitute its preferred interpretation for the interpretation unanimously adopted by Judge Mikva and the other former federal judges on the Panel — especially if courts can simply deem the arbitrators' interpretation to be "plainly" wrong and thus ipso facto "irrational." Indeed, although the merits discussion that follows is not necessary under *Oxford Health*, it illustrates how the court below rendered arbitration "merely a prelude to a more cumbersome and time-consuming judicial review process." *Oxford Health*, 133 S. Ct. at 2068.

1. Starting with the MSA's text, the Panel correctly observed that § IX(d)(2) "does not directly speak as to the process to be used when some States settle diligent enforcement and some do not." Pet.App. 97a. That provision says only that the NPM Adjustment "shall apply" to all States "except" for States that "diligently enforced," and that the diligent States' shares are "reallocated" to the "other" non-diligent States. Pet.App. 160a-161a. It says nothing, much less plainly, about how reallocation operates where it is *unknown* whether a State is

diligent or non-diligent due to a settlement. *See Am. Tobacco*, 2015 WL 5576135, at *13.

The Panel's *pro rata* interpretation addresses that uncertainty in a way that is consistent with the MSA's text. As the Signatory States' diligence is unknown, the *pro rata* interpretation *treats their diligence status as unknown* under § IX(d)(2). Since it is unknown whether the Signatory States were diligent for purposes of § IX(d)(2)(B), none of their 46% share is reallocated to the Non-Signatory States; but since it is also unknown whether the Signatory States were non-diligent for purposes of § IX(d)(2)(C), they are not subject to reallocation of any of the Non-Signatory States' 54% share. Indeed, § IX(d)(2) itself expressly reallocates diligent States' shares to the non-diligent States on a "pro rata" basis, not on a relative-fault basis. *See* Pet.App. 92a-94a; *see also Am. Tobacco*, 2015 WL 5576135, at *14.

By contrast, the state court's "all non-diligent" interpretation has no basis in the MSA's text. The court claimed that "the plain language" of § IX(d)(2) prohibits "reallocating the 2003 NPM Adjustment post-settlement without *first* determining the diligence of [all contested settling] states," and that "the only possible remedy" for the Panel's failure to determine the diligence of the contested Signatory States was "to treat the[m] … as non-diligent." Pet.App. 36a, 40a. But § IX(d)(2) simply does not say that a State's diligence must still be determined even where it has settled and its diligence is no longer contested by any party. And § IX(d)(2) certainly does not say that a State must be treated as non-diligent just because the Panel did not determine its diligence, let alone where the non-settling States like

Maryland *opposed* the Panel's determination of its diligence. *Id.* 14a, 37a n.11.

2. Given the MSA's lack of express instruction, the Panel correctly explained that it could "interpret the contract in light of governing law" to help "determine what the appropriate process" was. Pet.App. 97a; *see also, e.g.*, *United Steelworkers v. Enterprise Wheel & Car Corp.*, 363 U.S. 593, 598 (1960); 11 Williston on Contracts § 30:19 (4th ed.).

The Panel likewise correctly explained that the law of "judgment reduction" was the appropriate background law to look to for guidance, because it was developed to apply in this common circumstance where multiple defendants have shared potential liability (*e.g.*, under a contract, as joint tortfeasors, or under a statute), and some defendants wish to settle and some do not. Pet.App. 92a-93a. Around the nation, courts and legislatures have developed judgment-reduction rules for partial settlements because the strong public policy "favor[ing]" the "settlement of complex litigation" would be "inhibit[ed]" if non-settling defendants were allowed to obtain a windfall in the determination of their own share of the liability merely because of the uncertainty about the settling defendants' share of the liability. *See, e.g.*, *Eichenholtz v. Brennan*, 52 F.3d 478, 486-87 (3d Cir. 1995); Restatement (Second) of Contracts § 294(3); *see also Am. Tobacco*, 2015 WL 5576135, at *14. And the Panel also correctly explained that the three "standard" judgment-reduction methods for calculating the non-settling defendants' setoff are "*pro rata*," "*pro tanto*," and "proportionate fault." Pet.App. 92a-93a.

As for the Panel's selection of the *pro rata* method, Petitioners have explained why that method is consistent with the MSA's text. *Supra* at 25-26. It also warrants emphasis that Maryland and the other objecting States did not ask the Panel to adopt one of the other two methods, but rather asked for all the contested Signatory States to be treated as non-diligent — even though the proportionate-fault method would have determined their diligence. Pet.App. 14a, 37a n.11.

By contrast, the state court's "all non-diligent" interpretation has no basis in background judgment-reduction law. As the Panel explained, settlement is *not* treated as "tantamount to an admission of liability" and "settling defendants are not regarded as necessarily culpable or liable." *Id.* 96a-97a. The court below thus did not and could not cite any law supporting its "all settlers liable" position. *Id.* 36a-40a. Nor did it provide any justification for its refusal to consider judgment-reduction law, apart from its flawed assertion that the MSA's text plainly required the Panel to determine the diligence of all contested Signatory States. *Id.* 37a-38a.

3. Finally, the Panel's *pro rata* interpretation better reflects the factual uncertainty concerning the contested Signatory States' diligence than does the state court's "all non-diligent" interpretation. This is seen through the following chart:

Approach	**Adjustment Amount Owed by MD**
No reduction (assume all diligent)	$145 million
Pro Tanto	$139 million
Proportionate Fault > if (as before) MD did not contest Signatory States' diligence	$145 million
> if MD did contest Signatory States' diligence	$45 million to $145 million (depending on findings of the Signatory States' actual diligence)
Pro Rata	$95 million
"Assume all non-diligent"	$45 million

Absent the settlement, Maryland's liability would have ranged from $45 million to $145 million, depending on how many contested Signatory States would have been found diligent. Under the *pro rata* method, Maryland owes $95 million, which is thus a fair estimation of what its liability would have been. By contrast, under the "all non-diligent" approach, Maryland's liability would plummet to $45 million, which is what it would have been only if all 20 of the contested Signatory States would have been found non-diligent.

But that never would have happened. As the Panel instead found, "[t]here is no basis in the facts to assume that every [contested] Signatory State was

non-diligent in 2003." Pet.App. 97a. The "all non-diligent" interpretation would thus improperly guarantee that Maryland *will profit* from the partial settlement, potentially by hundreds of millions of dollars. That windfall, which comes at the expense of the settling parties, contravenes the strong public policy to "encourage settlement." *See Eichenholtz*, 52 F.3d at 486. Nothing in the MSA suggests, let alone plainly provides, that the parties intended to reject this established policy, to create obstacles to partial settlements, or to reward the states that decline to participate in them.

III. THIS CASE IS A PARTICULARLY GOOD VEHICLE TO ADDRESS THE QUESTIONS PRESENTED

A. This Court's review of the questions presented will be facilitated because this case arises in the MSA context. Most importantly, the issues have been well ventilated through parallel litigation in different MSA States, and so further percolation is unnecessary in light of the three extensive appellate opinions. Moreover, the parties to the MSA are sophisticated companies and sovereign entities, which means that the case will be well litigated on both sides and also avoids any concern that some Justices may have about one-sided arbitrations in the consumer context.

The significance of the questions presented is also heightened in the MSA context. Most obviously, hundreds of millions of dollars turn on the validity of the Settlement Award's *pro rata* ruling. Moreover, the parties need a definitive resolution of the rules governing judicial review of MSA arbitrations because there will inevitably be many more awards challenged in state courts in the future, given that

state courts have jurisdiction over such challenges under the MSA, there are already pending NPM Adjustment disputes for each year since 2003, and the MSA's annual payment obligations continue into perpetuity. *See Philip Morris USA*, 114 A.3d at 43-44. Indeed, the very reason that the MSA provides for "a single, nationwide arbitration" of NPM Adjustment disputes is to obtain "a uniform determination," *McGraw v. Am. Tobacco Co.*, 681 S.E.2d 96, 112 (W. Va. 2009), and that objective will be thwarted unless state courts consistently apply the FAA review standard.

B. It is not a vehicle problem that the court below suggested, erroneously, that the arbitration provision in MSA § XI(c) incorporates the FAA only for the conduct of the arbitration, not for judicial review of the arbitration. *See* Pet.App. 27a. That is immaterial to Petitioners' argument: namely, that where the FAA governs the arbitration because the agreement involves interstate commerce, the FAA's judicial-review standards *themselves* preempt contrary state-law review standards, wholly apart from whether the parties have *also agreed* to the FAA standards. *Supra* at Part I.

Nor is it a vehicle problem that the court below further suggested, again erroneously, that the choice-of-law provision in MSA § XVIII(n) instead incorporates the state-law review standards. *See* Pet.App. 27a. That is so for two reasons.

First, the court itself held that the proper judicial-review standard is an issue that can be decided *only* by the courts, *not* by the parties. *See id.* 26a-27a. Accordingly, for that reason alone, this Court can and should review the holdings below that

pass on the proper scope of the FAA's review standard under federal law. *Supra* at 10-11.

Second, earlier this Term and after the state court's decision, this Court held that the FAA preempts state courts from discriminating against arbitration when interpreting arbitration clauses. *See DIRECTV, Inc. v. Imburgia*, 136 S. Ct. 463, 471 (2015). Yet that is precisely what the state court here did. In particular, when interpreting the MSA's arbitration provision — which says that "[t]he arbitration shall be governed by the [FAA]" — the court implausibly suggested that the parties only agreed to have the FAA govern "the arbitration" *itself*, not judicial review of the arbitration. Pet.App. 27a, 173a. But then, when interpreting the MSA's choice-of-law provision — which says that "[t]his Agreement … shall be governed by the laws of the relevant [MSA] State" — the court inconsistently suggested that the parties agreed to have state law govern, not just "the Agreement" *itself*, but *also* judicial review of an arbitration provided for in the MSA yet governed by the FAA. *Id.* 27a, 174a.

As in *Imburgia* (136 S. Ct. at 469-70), the state court therefore has inconsistently interpreted a contractual phrase in a manner that disfavors arbitration: here, by inconsistently interpreting the phrase "[subject] shall be governed by [law]" in order to expand judicial review of the arbitration. Moreover, as in *Imburgia* (*id.* at 469), the contrary interpretation of the MSA's arbitration provision is unambiguously correct: this Court has already squarely held that "the best way to harmonize [a] choice-of-law provision with [an] arbitration provision" is that the former "covers the rights and

duties of the parties" under the contract whereas the latter "covers arbitration" rules, such that "neither sentence intrudes upon the other." *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52, 63-64 (1995). Thus, as in *Imburgia*, the FAA preempts the state court's discriminatory interpretation of the arbitration clause. Accordingly, for that reason as well, the court's interpretation of the MSA poses no obstacle to this Court's review of the questions presented concerning the FAA.

C. In light of the foregoing, this Court should grant plenary review on both questions presented. Each one is independently important and warrants this Court's definitive resolution.

Alternatively, this Court may wish to consider summarily reversing on the second question and then remanding for reconsideration of the first question. In particular, *Oxford Health* squarely forecloses the state court's interpretation of the FAA's review standard. *Supra* at Part II.A. And this Court has often summarily reversed state courts that fail to comply with FAA precedent. *See, e.g.*, *Nitro-Lift*, 133 S. Ct. at 501-04; *Marmet Health Care Ctr., Inc. v. Brown*, 132 S. Ct. 1201, 1202-04 (2012) (per curiam). Moreover, here, the state court's erroneous interpretation of the FAA review standard was at least part of the basis for the court's holding that the FAA does not preempt application of the state-law review standard. *Supra* at 21. And this Court has often summarily vacated the judgments of state courts that were at least potentially tainted by a clearly erroneous understanding of the FAA. *See, e.g.*, *Marmet*, 132 S. Ct. at 1204; *KPMG LLP v. Cocchi*, 132 S. Ct. 23, 24-26 (2011) (per curiam).

Finally, although Petitioners do not believe that either option above is precluded by the state court's interpretation of the MSA's arbitration and choice-of-law provisions, if this Court has any doubts, it should at a minimum GVR in light of its intervening decision in *Imburgia*. With the benefit of *Imburgia*, the state court could and should reconsider its improper interpretations of the MSA, thus eliminating any conceivable obstacle to this Court's review if the state court persists in its erroneous interpretations of the FAA.

CONCLUSION

This Court should grant the petition for a writ of certiorari. Alternatively, this Court may wish to consider a summary vacatur and remand in light of *Oxford Health*, or a GVR in light of *Imburgia*.

June 2016

Respectfully submitted,

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APPENDIX

APPENDIX A

REPORTED

IN THE COURT OF SPECIAL APPEALS

OF MARYLAND

No. 1256

September Term, 2014

STATE OF MARYLAND

v.

PHILIP MORRIS, INC., ET AL.

Wright,

Reed,

Kenney, James A., III

(Retired, Specially Assigned),

JJ.[1]

Opinion by Wright, J.

Filed: October 2, 2015

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[1] Judge Andrea M. Leahy and Judge Dan Friedman did not participate in the Court's decision to designate this opinion for publication in the Maryland Appellate Reports pursuant to Maryland Rule 8-605.1.

I. INTRODUCTION

This appeal arises from a Master Settlement Agreement ("MSA") between appellees, who are numerous cigarette manufacturers (the "Participating Manufacturers" or "PMs"), [1] and appellant, the State of Maryland ("Maryland"), along with 51 other states and territories (collectively, the "Settling States"). Specifically, it involves the multi-state arbitration of an MSA dispute over the "Non-Participating Manufacturer Adjustment" ("NPM Adjustment")—a potential reduction to the annual payment that the PMs make to the Settling States under the MSA, which is allocated among those states who failed to diligently enforce certain obligations under the MSA.

During the arbitration of the 2003 NPM Adjustment dispute, the PMs reached a settlement ("Term Sheet" agreement) with 22 states (the "Term Sheet States") before it was determined whether those states were diligent or non-diligent. Maryland and the other "Non-Term Sheet States" were also offered the settlement, but declined to join. In light of this partial settlement, the arbitrators (a "Panel"

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[1] The original PMs, Philip Morris USA, Inc., R.J. Reynolds Tobacco Co., and Lorillard Tobacco Co., filed one brief, and another brief was filed by certain subsequent PMs—including Commonwealth Brands, Inc., Compania Industrial de Tabacos Monte Paz, S.A., Daughters & Ryan, Inc., House of Prime A/S, Liggett Group LLC, Sherman 1400 Broadway N.Y.C Inc., King Maker Marketing, Inc., Top Tobacco, LP, Japan Tobacco International U.S.A., Inc., Kretek International, Inc., Peter Stokkebye Tobaksfabrik A/S, P.T. Djarum, Santa Fe Natural Tobacco Company, Inc., Von Eicken Group—and also on behalf of Farmers Tobacco Co. of Cynthiana, Inc.

of three former federal judges) were tasked with resolving how the 2003 NPM Adjustment should be allocated to any Non-Term Sheet States who were found non-diligent. On March 12, 2013, the Panel interpreted the MSA's language and concluded that the NPM Adjustment should be allocated post-settlement pursuant to the "pro rata" method of judgment reduction.

After holding individual evidentiary hearings for the Non-Term Sheet States, whose diligence for 2003 was still contested, the Panel concluded that Maryland and five other Non-Term Sheet States were non-diligent and thus subject to the 2003 NPM Adjustment. On September 11, 2013, after assessing Maryland's enforcement record for 2003, the Panel found that Maryland lacked "a culture of compliance" and that its efforts "fell short of its efforts in earlier years."

Maryland filed motions in the Circuit Court for Baltimore City to vacate the Panel's awards for the 2003 NPM Adjustment that adopted the pro rata judgment-reduction method and that found Maryland to be non-diligent. On November 12, 2013, Maryland also filed a motion to compel the PMs to arbitrate Maryland's diligence for 2004 in a state-specific arbitration, rather than as part of a multi-state arbitration of the entire 2004 Adjustment dispute. On July 28, 2014, the circuit court denied all three motions, and on August 20, 2014, Maryland noted this appeal.

II. QUESTIONS PRESENTED

We have rephrased Maryland's questions as follows:[2]

1) Did the circuit court err in refusing to vacate the Panel's award which adopted the pro rata judgment-reduction method in reallocating the 2003 NPM Adjustment only among the non-diligent, Non-Term Sheet States?

2) Did the circuit court err in refusing to vacate the Panel's finding that Maryland was not diligent in 2003?

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[2] In its brief, Maryland asked:

1) Did the Arbitration Panel exceed its authority when it approved a side agreement between the Participating Manufacturers and the Term Sheet States that altered the MSA's reallocation provision, where the MSA prohibits amendments absent specific agreement by all affected parties, Maryland and other parties to the MSA expressly objected to the Panel's approval of the side agreement, and the Panel's approval of the side agreement operated to the substantial detriment of Maryland?

2) Did the Arbitration Panel refuse to consider material evidence related to the enforcement efforts of the contested Term Sheet States, given that all of the states had entered an agreement for a national arbitration to determine, in one proceeding, the diligence of each of the states?

3) Did the circuit court err in failing to order the Participating Manufacturers to arbitrate in a Maryland-specific proceeding their claim that Maryland did not diligently enforce the provisions of its Qualifying Statute during 2004, in light of the terms of the MSA and the prejudice Maryland experienced in the multi-state arbitration for 2003?

3) Did the circuit court err in failing to order the PMs to arbitrate Maryland's diligence for 2004 in a state-specific arbitration?

For the reasons that follow, we answer only the first question in the affirmative, and reverse the circuit court's judgment regarding that issue. Accordingly, we remand the case for further proceedings not inconsistent with this opinion.

III. FACTS

A. MSA

In 1998, Maryland and the 51 other Settling States entered the MSA, thus settling their claims for "wrongful marketing and advertising of cigarettes, as well as damages based upon the costs of treating smoking-related illnesses," against three major cigarette manufacturers—Philip Morris USA, Inc., R.J. Reynolds Tobacco Co., and Lorillard Tobacco Co. (collectively, "Original Participating Manufacturers" or "OPMs"). *State v. Philip Morris Inc.*, 179 Md. App. 140, 142-43 (2008). Since then, more than forty subsequent participating manufacturers ("SPMs") have joined the MSA. *Id.* at 145 n.2. In exchange for the dismissal of "any pending action and [a] release [of] all past and future claims" against them, the PMs agreed "to restrict the manner in which they market and advertise tobacco products and . . . to make a substantial annual payment to be allocated among the settling states." *Id.* at 145.

Pursuant to the MSA, the PMs do not make the annual payment ("MSA Payment") directly to the Settling States. *Id.* Rather, each PM is "required to make a single, nationwide annual payment into an escrow account on or before April 15" of each year,

the exact amount of which is calculated annually by an "Independent Auditor . . . pursuant to a comprehensive formula contained within the MSA." *Id.* at 145-46. "The calculation begins with each original participating manufacturer paying into an escrow account its relative market share of the base amount for the calendar year." *Id.* at 146 (citing MSA § IX(c)(1)). That amount is then subject to several reductions and adjustments, including the NPM Adjustment. *Id.* (citing MSA §§ IX(c)(j), XI(a)(1)). Thereafter, the funds are "allocated among the settling states according to formulae set forth in the MSA." *Id.* at 146 n.3. Pursuant to the "allocable shares," Maryland is entitled to 2.2604570 percent of the PMs' annual payment. *Id.* (citing MSA § II(f)).

The NPM Adjustment, governed by Section IX(d) of the MSA, is a payment reduction designed to address the PMs' concern that "they would incur a competitive disadvantage to the non-participating manufacturers [("NPMs")], who were not subject to the MSA's strict marketing restrictions and payment obligations." *Id.* at 146-47. Each year, PMs "may be eligible to take a NPM Adjustment if (1) the independent auditor determines that, during the year in question, the participating manufacturers collectively lose more than two percent of their pre-MSA market share to non-participating manufacturers and (2) an economic consulting firm determines that the MSA was a 'significant factor' contributing to that loss." *Id.* at 147 (citing MSA § IX(d)(1)). If these conditions are satisfied, then the PMs are entitled to the NPM Adjustment on their annual payment as to all Settling States, subject to

one exception—the "diligence exception." *See* MSA § IX(d)(2).

Pursuant to the diligence exception, "[a] Settling State's Allocated Payment shall not be subject to an NPM Adjustment . . . if such Settling State continuously had a Qualifying Statute . . . in full force and effect during the calendar year immediately preceding the year in which the payment in question is due, and diligently enforced the provisions of such statute during such entire calendar year." MSA § IX(d)(2)(B). The MSA defines a "Qualifying Statute" as a "statute, regulation, law and/or rule . . . that effectively and fully neutralizes the cost disadvantages that the [PMs] experience vis-à-vis [NPMs] within such Settling State as a result of [the MSA]." MSA § IX(d)(2)(E). "Maryland enacted the model 'qualifying statute' contained in Exhibit T to the MSA, which is codified as Maryland's Escrow Act [Md. Code (1992, 2010 Repl. Vol.), § 16-401 *et seq.* of the Business Regulation Article]." *Philip Morris Inc.*, 179 Md. App. At 147. It requires all NPMs to:

> deposit into escrow a fixed sum per cigarette sold that is slightly less than the per-cigarette cost imposed by the MSA on participating manufacturers. These escrowed funds may ultimately be used to satisfy a judgment that the State may obtain against a non-participating manufacturer. If the funds are not so used within twenty-five years, they are returned to the non-participating manufacturer.

Id. at 148 (internal citations omitted). "[I]f a state has a 'qualifying statute' in full force and effect and diligently enforces that statute, the auditor must

reallocate that state's share of the NPM Adjustment among the other states that do not qualify, 'pro rata in proportion to their respective Allocable Shares.'" *Id.* at 147 (quoting MSA § IX(d)(2)(C) ("Reallocation Provision")).

In other words, to incentivize the Settling States to be diligent, the MSA provides that the non-diligent States are collectively responsible for the total available NPM Adjustment, including what would have been the shares of the diligent states. Accordingly, the greater the number of diligent states, the larger the amount of NPM Adjustment that is reallocated to non-diligent states. *See id.* at 163 ("[T]he granting of an exemption to one Settling State will inexorably lead to the reallocation of its allocated portion of the NPM Adjustment to all other non-exempt Settling States. Each Settling State thus has a vital interest in the granting or denial of each other Settling State's individual claim for exemption.") (Citation omitted); *Com. ex rel. Kane v. Philip Morris USA, Inc.*, 114 A.3d 37, 44 (Pa. Commw. Ct. 2015) ("Generally, as the number of diligent states increase, the burden on non-diligent states increases. This is because an increase in the number of diligent states means that there is more adjustment reallocated among a smaller group.").

B. 2003 NPM Adjustment

In the present appeal, the primary dispute concerns the NPM Adjustment for 2003. Although the PMs were entitled to take an NPM Adjustment that year, the Independent Auditor decided not to apply it because the Settling States' diligence in enforcing their respective Qualifying Statutes had

not yet been determined. *See Philip Morris Inc.*, 179 Md. App. at 148-49 ("[T]he participating manufacturers requested that the auditor apply the 2003 NPM Adjustment to their April 2006 payments. Maryland and the other settling states, however, urged the auditor to deny the NPM Adjustment on the ground that the settling states 'diligently enforced' their qualifying statutes."). Therefore, the PMs requested arbitration pursuant to MSA § XI(c), *id.* at 143, which states:

> Any dispute, controversy or claim arising out of or relating to calculations performed by, or any determinations made by, the Independent Auditor (including, without limitation, any dispute concerning the operation or application of any of the adjustments, reductions, offsets, carry-forwards and allocations described in subsection IX(j) or subsection XI(i)) shall be submitted to binding arbitration before a panel of three neutral arbitrators, each of whom shall be a former Article III federal judge. Each of the two sides to the dispute shall select one arbitrator. The two arbitrators so selected shall select the third arbitrator. The arbitration shall be governed by the United States Federal Arbitration Act [9 U.S.C. § 1 *et seq.*].

On May 18, 2006, Maryland asked the Circuit Court for Baltimore City "for declaratory relief, declaring that the auditor properly determined not to reduce the participating manufacturers' MSA payments to reflect a NPM Adjustment." *Philip Morris Inc.*, 179 Md. App. at 149 (footnote omitted). After hearing arguments on October 5, 2006, the circuit court issued an order on January 19, 2007,

compelling arbitration, and we affirmed that decision on March 27, 2008. *Id.* at 150, 167.

In December, 2008, the PMs entered into an Agreement Regarding Arbitration ("ARA") with almost every Settling State, including Maryland. According to the ARA, "[t]he 2003 NPM Adjustment shall be resolved through [a nationwide arbitration] pursuant to Section XI(c) of the MSA" in order to determine:

> 1. Whether the Independent Auditor was correct in not applying the 2003 NPM Adjustment to the [PMs'] 2006 or prior annual payments. . . .
>
> 2. Whether the June 2003 settlement agreements release in whole or in part, or provide a basis for excluding evidence relating to, the 2003 NPM Adjustment.
>
> 3. Whether individual Settling States diligently enforced a Qualifying Statute in 2003 . . . .
>
> 4. (a) Whether under Section XI(i)(2)(A) of the MSA, a transfer from the Disputed Payments Account to a [PM] should be accomplished through a transfer from the Disputed Payments Account to such [PM] or through an offset in favor of such [PM] accompanied by a transfer to the Settling States; and (b) under Section XI(i)(1)(B) of the MSA, under what circumstances, if any, should a transfer be made from the Disputed Payments Account to a Settling State that is determined to have diligently enforced a Qualifying Statute

> or whose diligent enforcement the [PMs] no longer contest.
>
> 5. To 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 any such assertion.

The Panel[3] began proceedings on July 2, 2010, and entered various preliminary orders governing the conduct of the hearings. For example, on January 19, 2011, it concluded that the Settling States "must bear the burden of proving that they diligently enforced their respective Qualifying Statutes for purposes of the 2003 NPM Adjustment." In particular, the Panel determined 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." (Citation omitted).

By order dated May 23, 2011, the Panel added that "although the conditions to application of the NPM Adjustment under section IX(d)(1) had been met, without the diligent enforcement determination, there was no 'Available NPM Adjustment for the Auditor to apply and there would be no Available NPM Adjustment unless and until the diligent enforcement determination was made.'" Thus,

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[3] The Panel consisted of Judge William G. Bassler, selected by the PMs; Judge Abner J. Mikva, selected by the Settling States; and Judge Fern M. Smith, selected by Judges Bassler and Mikva. All three arbitrators were former Article III federal judges.

according to the Panel, the Independent Auditor could not apply the 2003 NPM Adjustment and properly declined to do so.

Then, in an order dated July 1, 2011, the Panel concluded, in pertinent part:

> (3) Any Settling State whose diligent enforcement for the year 2003 is not contested by any PM or State[4] will be deemed [] by the Independent Auditor for purposes of Section IX(d)(2)(B)-(C) of the MSA as a Settling State that diligently enforced its Qualifying Statute for that year only and is therefore [] not subject [to] the 2003 NPM Adjustment.
>
> (4) 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.

In that order, the Panel noted that "[b]ecause a state bears the burden of proof when its claim of diligent enforcement [] is not challenged does not mean that there must be a hearing when the claim is

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[4] The Panel set deadlines for PMs to contest the diligence of Settling States, and for Settling States to contest the diligence of other Settling States. However, neither Maryland nor any other Settling State contested the diligence of any other Settling State.

unchallenged." Rather, "the burden to prove diligent [] enforcement comes into play only when a state's contested claim is required to [be] resolved."

On or about November 3, 2011, the PMs filed a notice of their intent to contest the diligence of 35 Settling States, including Maryland. Thereafter, the Panel scheduled individual evidentiary hearings for each of those 35 Settling States. A hearing devoted to Maryland's enforcement evidence took place from 8:30 a.m. to 5:00 p.m. on October 22-23, 2012, and from 8:30 a.m. to 3:30 p.m. on October 24, 2012. During that time, Maryland presented the testimony of two lay witnesses, one document summary witness, and three expert witnesses. Meanwhile, the PMs had three expert witnesses testify on their behalf.

On or about December 17, 2012, before the Panel had finished all of the state-specific hearings, the PMs and 19 of the Settling States "agreed to a Term Sheet for settlement" that purported to "resolve[] the 2003-12 NPM Adjustments as to the signatory States and revise[] the NPM Adjustment provision as to those States for the years following 2012." All of the remaining Settling States were invited to join the settlement, and three more did. Maryland declined the invitation.

The 22 total Term Sheet States had an aggregate allocable share of approximately 46% of the NPM Adjustment. Of those 22 states, the PMs had contested the diligence of 20. The Term Sheet, which was to become binding "upon the Panel's approval," did not address the MSA's Reallocation Provision—in particular, its effect on the reallocation of the 2003 NPM Adjustment among the Non-Term Sheet States.

In January 2013, the PMs and Term Sheet States filed a Proposed Stipulated Partial Award with the Panel, presenting alternatives for "how the 2003 NPM Adjustment will be allocated among the [Non-Term Sheet] States in light of the settlement." On February 22, 2013, many of the Non-Term Sheet States, including Maryland, filed a brief in opposition to the Proposed Stipulated Partial Award. In pertinent part, they argued that "the reallocation provisions of the proposed award are contrary to the MSA, adversely affect the majority states, and are not remedied by the proposed set-offs." Particularly, they urged:

> If the Panel chooses to enter an award regarding the settlement, the order should instruct the Independent Auditor to treat any contested [Term Sheet] State as non-diligent for purposes of calculating the allocation of the NPM Adjustment. That result is mandated by the plain language of the MSA unless and until the contested [Term Sheet] States prove their diligence. The MSA's reallocation structure requires a determination as to the diligence of each State because each State's potential exposure to an NPM Adjustment depends on every other State's diligence. The MSA's reallocation procedure requires that each State be determined diligent or not diligent and contains no exception for a partial settlement.

(Footnote omitted).

After hearing argument on the issues surrounding the Proposed Stipulated Partial Award, the Panel issued a Stipulated Partial Settlement and Award

("Partial Settlement Award") on March 12, 2013.[5] At the outset, the Panel noted that "the MSA does not directly speak as to the process to be used when some States settle diligent enforcement and some do not." The Panel then ruled that it "ha[d] jurisdiction to rule on the issues raised concerning the MSA reallocation provisions and to determine how the 2003 NPM Adjustment will be allocated among the [Non-Term Sheet] States in light of the settlement." According to the Panel, its "jurisdiction to interpret and determine the operation of the reallocation provisions is no less where a State is no longer contested because of a settlement."

Turning to the merits, the Panel concluded, in pertinent part:

> 1. In light of the settlement, the 2003 NPM Adjustment will be allocated among the [Non-Term Sheet] States as follows. The dollar amount of the 2003 NPM Adjustment will be reduced by a percentage equal to the aggregate Allocable Shares of the [Term Sheet] States as of the date of the Panel's Final Award . . . . The Independent Auditor will treat the [Term Sheet] States as not subject to the 2003 NPM Adjustment, as that Adjustment amount is reduced as provided above, will be governed by the reallocation provisions of Sections IX(d)(2)

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[5] The Partial Settlement Award largely tracked the Proposed Stipulated Partial Award, with one significant addition—namely that the "relief, if any," for objecting states that believe they are negatively affected by the Partial Settlement Award, would be an "appeal to their individual MSA court." Maryland's MSA court is the Circuit Court for Baltimore City.

and IX(d)(4) of the MSA, and will thus be reallocated among all [Non-Term Sheet] States that did not diligently enforce a Qualifying Statute during 2003 as provided in those provisions. The maximum portion of the 2003 NPM Adjustment that can be applied to a [Non-Term Sheet] State remains as provided by Section IX(d)(2)(D) of the MSA.

2. This judgment reduction is appropriate and adequate under the MSA and governing law. Where multiple parties have a potential shared contractual obligation and some of them settle and some do not, the non-settling parties cannot necessarily block the settlement, but may be entitled to a judgment reduction. The "three standard methods for reducing judgment against non-settling defendants after a partial settlement" are "*pro rata* (court divides the amount of the total judgment by the number of settling and non-settling defendants, regardless of each defendant's culpability), proportionate fault (after a partial settlement and trial of the non[-]settling defendants, the jury determines the relative culpability of all the defendants and the non-settling defendant pays a commensurate percentage of the total judgment), and *pro tanto* (the court reduces the non-settling defendant's liability for the judgment against him by the amount previously paid by the settling defendants, without regard to proportionate fault)."

3. Where non-settling defendants are given the protection of the applicable judgment-reduction method required under the contract

and law, they are not prejudiced by the partial settlement.

4. Under Paragraph 1, the [Non-Term Sheet] States receive the *pro rata* reduction, under which the dollar amount of the 2003 NPM Adjustment will be reduced by a percentage equal to the aggregate Allocable Shares of the [Term Sheet] States. Construing the parties' contract, the Panel concludes that the MSA reallocation provisions indicate that the *pro rata* method is appropriate. These provisions use the specific term "pro rata," stating that the shares of diligent States are to be "reallocated among all other Settling States *pro rata* in proportion to their respective Allocable Shares." MSA § IX(d)(2)(C) (emphasis added); *see also* MSA § IX(d)(2)(D) ("pro rata in proportion to their respective Allocable Shares"). More fundamentally, the MSA also provides that the reallocation is not done on a relative fault basis. The amount of a diligent State's share that is reallocated is its *pro rata* share of the whole, not an amount derived from its particular fault level. Likewise, the amount of reallocated share that a non-diligent State receives is derived from its *pro rata* share of the liable States, not its fault level. If the reallocation of diligent States' shares is done on a *pro rata* basis in this way, the Panel reads the MSA as likewise meaning that a judgment reduction arising from some States' settlement of the diligent enforcement issue should be *pro rata* as well.

(Internal citations omitted).

Addressing the Non-Term Sheet States' objections, the Panel stated that the Partial Settlement Award and the Term Sheet "do not legally prejudice or adversely affect the [Non-Term Sheet] States." It continued:

> The Panel does not agree with the Objecting States' contention that all [Term Sheet] States must be treated as non-diligent for the purposes of the 2003 NPM Adjustment. There is no basis in the facts to assume that every [Term Sheet] State was non-diligent in 2003. Moreover, the Objecting States' position does not reflect any of the three standard methods of judgment reduction. Such an assumption would produce a considerably larger reduction in the [Non-Term Sheet] States' potential obligations than any of the standard methods. It is also contrary to the underlying principle of judgment reduction that, because a settlement is not tantamount to an admission of liability, settling defendants are not regarded as necessarily culpable or liable.
>
> The Objecting States argue that the MSA reallocation provisions must be wholly inapplicable to a State's share unless there is an actual determination that the State was diligent. They claim that any approach by which any State's share is otherwise subject to reallocation is an "amendment" to the MSA requiring their consent. But the MSA does not directly speak as to the process to be used when some States settle diligent enforcement and some do not. It is thus within the Panel's jurisdiction to interpret the contract in light of governing law to determine what the appropriate process and

> judgment reduction is where there is a partial settlement of diligent enforcement involving fewer than all of the States. There is thus no "amendment" to the MSA in the Panel doing so. 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. The cut-off date for interstate suits set forth in the Panel's "no contest" order, is not applicable to such procedure.

(Internal citation omitted).

On September 11, 2013, the Panel issued diligence rulings for the remaining 15 Non-Term Sheet States whose diligence had been contested by the PMs ("Final Awards"). The Panel determined that six of those states, including Maryland, failed to diligently enforce their Qualifying Statutes.

In its Final Award for Maryland, the Panel began its analysis with "common" findings and conclusions for all States, including the general standard and specific factors that it had used to objectively assess the diligence of each contested State. The Panel explained that it had interpreted "diligent enforcement" to mean "an ongoing and intentional consideration of the requirements of a Settling State's Qualifying Statute, and a significant attempt by the Settling State to meet those requirements, taking into account a Settling State's competing laws and policies that may conflict with its MSA contractual obligations." "In order to objectively

assess a Settling State's diligent enforcement in light of that definition," the Panel also considered a list of eight factors:

a. Collection Rate

b. Lawsuits Filed

c. Gathering Reliable Data

d. Resources Allocated to Enforcement

e. Preventing Non-Compliant NPMs from Future Sales

f. Legislation Enacted

g. Actions Short of Legislation

h. Efforts to be Aware of NAAG [National Association of Attorneys General] and Other States' Enforcement Efforts

Applying these factors "objectively" to assess Maryland's diligent enforcement, the Panel concluded that "Maryland failed to meet its burden of proof." According to the Panel, "Maryland did not exhibit a culture of compliance" for most of 2003, and its "efforts in 2003 actually fell short of its efforts in earlier years." As such, it ruled that Maryland was "subject to an NPM Adjustment pursuant to Section IX(d)(2)(B) of the [MSA]."

C. Circuit Court

On March 26, 2013, following the Panel's issuance of the Partial Settlement Award but prior to its issuance of the Final Awards, Maryland filed a "Petition to Vacate Arbitration Award" in its MSA court, the Circuit Court for Baltimore City. In its petition, Maryland argued that the Partial

Settlement Award "vastly exceed[ed] the scope of the Panel's power under the MSA, purport[ed] to alter the terms of the MSA without the concurrence of Maryland and other states, and fail[ed] to adhere to clear and undisputed contractual language." Acknowledging that "the full implications of the Partial [Settlement] Award [would] not be known until the arbitration is fully concluded," Maryland requested that the circuit court "enter an order setting the briefing and hearing schedule [as proposed by Maryland], or, in the alternative vacating the Partial [Settlement] Award without further argument."

On November 12, 2013, Maryland filed a "Motion to Compel a Maryland-Specific Arbitration on the Issue of Whether Maryland Diligently Enforced during 2004." In that request, Maryland averred that "[t]he MSA entitles the State to its own arbitration of the dispute over whether it diligently enforced" its Qualifying Statute in 2004. Furthermore, Maryland argued that "[a] State-specific arbitration would advance the fairness, efficiency, and other purposes of arbitration, while the only alternative to an individual arbitration, a multi-state arbitration, would defeat those same purposes."

Soon thereafter, on November 18, 2013, Maryland filed a "Petition to Vacate Arbitration Award Finding that [Maryland] Did Not Diligently Enforce its Qualifying Statute During 2003." In that petition, Maryland contended that "[t]he Panel's Final Award must be vacated because the Panel refused to hear evidence material to the controversy."

Following a hearing on the motions on February 19, 2014, the circuit court entered a memorandum opinion and order on July 28, 2014, denying all three of Maryland's petitions. In reviewing the Panel's decisions, the court applied the vacatur standards of the FAA, which provide that "a reviewing court shall vacate an arbitration award, if the arbitrators exceeded their powers due to an error in their construction of the agreement; or the arbitrators were guilty of misconduct or misbehavior by which the rights of any party have been prejudiced."

With regard to the Panel's issuance of the Partial Settlement Award, the circuit court found:

> [T]he Partial Settlement Award and the NPM reallocation adjustment disputes do arise from the MSA; and are all clearly subject to the arbitration agreement and within the Panel's authority. Accordingly, this Court finds that the Panel did not lack jurisdiction, nor did it exceed its powers in interpreting the MSA and determining the appropriate method for reallocating the 2003 NPM Adjustment post-settlement.
>
> Further, this Court finds the Panel's conclusion of the *pro-rata* method to be based on a reasonable analysis of the MSA and review of applicable judgment-reduction principles of contract law . . . .
>
> While Maryland argues that the Panel disregarded the plain language of the MSA, this Court finds this argument to be without merit as the Panel did not and could not disregard the

> language of the MSA, as § IX(d)(2)(C)-(D) of the MSA is silent on the issue of the reallocation of the NPM Adjustment among non-settling states *where diligence is no longer contested due to settlement* . . . . This Court does not find any indication in the Panel's Award that the Panel was substituting its own notions of fairness and/or economic justice. Rather, the Panel was engaged in a good faith interpretation of the MSA and applicable law. Therefore, this Court finds that Maryland has failed to meet the requisite burden to establish that the Panel, in issuing the Partial Settlement Award, engaged in misconduct by failing to construe the MSA or by substituting its own notion of fairness and/or economic justice . . . .

(Internal citations and footnotes omitted) (emphasis in original).

With regard to its denial of Maryland's request for a state-specific arbitration, the circuit court concluded that "the only reasonable interpretation of the MSA is that nationwide arbitration is required." The court explained that, under the text of the MSA's arbitration provision, the "two sides to the dispute" are "the MSA States in opposition to the downward adjustment, and the PMs." The circuit court also stated that "[t]he only way for the payment structure to remain 'nationwide and unitary,' as intended, is for the arbitration itself to be nationwide and unitary, since the diligence determinations made at the arbitration are directly tied to the reallocation provision." (Citing *Philip Morris, Inc.*, 179 Md. App. at 162) (footnote omitted).

Finally, with regard to the Panel's Final Award, the circuit court found that the Panel did not "refuse[] to hear pertinent and material evidence," as Maryland alleged, because "Maryland never requested the Panel to consider the comparative non-diligence of the contested 'term sheet states,'" nor did Maryland make "any substantive argument to the Panel that the Panel needed to consider the enforcement record of the 'term sheet states' when making diligence determinations for the non-settling states." The court also noted that Maryland's argument failed on the merits because "it [was] clear that the Panel's diligence determination focused on the objective standard and assessing diligence that was common to all states, and then applying that standard to each State's individual enforcement for 2003," instead of comparing Maryland with any other contested state. (Emphasis and citation omitted). The court then concluded by noting that "[e]ven if some, most or all of the 'term sheet states' were less diligent than Maryland, from the facts there is no guarantee that the Panel would have found Maryland to be diligent."

Additional facts will be included as they become relevant to our discussion, below.

IV. STANDARD OF REVIEW

At the outset, we must determine the applicable standard of review in a case such as this, where the Panel issued an award in an arbitration governed by the United States Federal Arbitration Act ("FAA")—as mandated by the MSA—but directed aggrieved parties to appeal to their respective state courts.

Maryland contends that "the standard of review is governed by Maryland law and is *de novo*." Although Maryland acknowledges that this Court may rely on decisions interpreting the FAA because the Maryland Uniform Arbitration Act ("MUAA") is the FAA's state analogue, Maryland maintains that we are not bound by the federal procedural provisions of the FAA. Instead, Maryland avers that this Court must look to the pertinent state law relating to arbitration agreements to determine whether the circuit court erred in denying the relief sought.

In response, the PMs argue that the circuit court correctly applied "the FAA's extremely narrow judicial-review standards," and that Maryland's claim that a *de novo* standard applies is "both waived and wrong." First, the PMs contend that "Maryland waived [its] argument by not raising it below." Specifically, the PMs note that Maryland "repeatedly acknowledged that the MSA requires application of the FAA" through its opening and subsequent briefs, and its post-hearing submission. Second, relying on the MSA, the PMs aver that "the FAA will 'govern' MSA arbitrations" and, thus, the circuit court acted properly in applying the vacatur standards of the FAA. Third, the PMs argue that "to the extent . . . that Maryland law would authorize broader judicial review in this case, it would be *preempted* by the FAA." (Emphasis in original). Lastly, the PMs contend that "the Maryland standard of review is equally or nearly as narrow as the FAA standard," and its application would not, therefore, lead to a different result.

We agree with Maryland that judicial review of the arbitrator's decision in this case is governed by

Maryland law. We explain and address each of the PMs' contentions.

The PMs first argue that Maryland waived its present claim by not raising it in the circuit court, but they cite no authority to support their position that the applicable standard of review can be waived. Indeed, although no Maryland court has ruled on this matter, several federal courts have stated that "a party cannot 'waive' the proper standard of review by failing to argue it." *Brown v. Smith*, 551 F.3d 424, 428 n.2 (6th Cir. 2008) (citations omitted); *see also Ward v. Stephens*, 777 F.3d 250, 257 n.3 (5th Cir. 2015) ("A party cannot waive, concede, or abandon the applicable standard of review.") (Citations omitted), *petition for cert. filed*, U.S. No. 14-10033 (June 2, 2015); *Gardner v. Galetka*, 568 F.3d 862, 879 (10th Cir. 2009) (holding that "the standard of review under AEDPA cannot be waived by the parties") (citations omitted); *Vizcaino v. Microsoft Corp.*, 120 F.3d 1006, 1022 n.4 (9th Cir. 1997) (*en banc*) (O'Scannlain, J., concurring in part and dissenting in part) ("[A] party cannot, by waiver or estoppel, change the applicable standard of review."); *Ingle v. Metro. Life Ins. Co.*, 947 F. Supp. 2d 1163, 1167 (N.D. Okla. 2013) (citing *Izzarelli v. Rexene Products Co.*, 24 F.3d 1506, 1519 (5th Cir. 1994), and stating that "at least one circuit court has explicitly held that a party cannot waive the standard of review in an ERISA case"). This is because it is "the court, not the parties, [who] must determine the standard of review[.]" *Worth v. Tyer*, 276 F.3d 249, 262 n.4 (7th Cir. 2001) (citation omitted). Therefore, "[s]uch a determination remains for this court to make for

itself." *K & T Enterprises, Inc. v. Zurich Ins. Co.*, 97 F.3d 171, 175 (6th Cir. 1996).[6]

Next, citing the MSA, the PMs argue that judicial review of the Panel's decision is governed by the FAA. In advancing this argument, the PMs correctly note that, pursuant to MSA § XI(c), NPM Adjustment disputes are subject to an "*arbitration* [that] 'shall be governed by the [FAA].'" (Emphasis added). But, they fail to acknowledge that the MSA does not mandate that judicial review of such an arbitration award would be governed by the FAA as well. Rather MSA § XVIII(n), entitled "Governing Law," provides that the MSA "shall be governed by the laws of the relevant Settling State, without regard to conflict of law rules of such Settling State." *See also* MSA § VII(a) (stating that the MSA Court retains exclusive jurisdiction); and MSA § II(p) (defining "Court" as the "respective court in each Settling State").

Alternatively, the PMs contend that "the FAA standard would govern under constitutional preemption principles" because applying a broader state law review standard "would undercut the FAA's national policy favoring arbitration with just [a] limited review" and "would thwart the FAA's primary purpose of ensuring that private agreements to

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[6] Even if the standard were waivable, this Court could exercise its discretion to entertain Maryland's argument. Md. Rule 8-131(a) ("Ordinarily, the appellate court will not decide any other issue unless it plainly appears by the record to have been raised in or decided by the trial court, but *the Court may decide such an issue if necessary or desirable to guide the trial court or to avoid the expense and delay of another appeal*.") (Emphasis added).

arbitrate are enforced according to their terms." (Citations omitted). Contrary to the PMs' contention, however, the Maryland Court of Appeals has repeatedly stated that "our procedural rules are not preempted by national policy favoring arbitration[.]" *Addison v. Lochearn Nursing Home*, LLC, 411 Md. 251, 287 (2009) (citing *Wells v. Chevy Chase Bank*, F.S.B., 363 Md. 232, 242 (2001) ("we conclude that Maryland procedural law . . . is not preempted by the FAA"); *accord Walther v. Sovereign Bank*, 386 Md. 412, 423 (2005) ("In enforcing . . . the FAA, however, state courts are not bound by the federal procedural provisions of the FAA . . . but may generally apply their own procedures.").[7] In fact, the United States Supreme Court has stated that "[t]he FAA contains no express pre-emptive provision, nor does it reflect a congressional intent to occupy the entire field of arbitration." *Volt Info. Sciences, Inc. v. Bd. of Trustees of Leland Stanford Junior Univ.*, 489 U.S. 468, 477 (1989) (citation omitted). Instead, "state law may . . . be pre-empted to the extent that it actually conflicts with federal law—that is, to the extent that it 'stands as an obstacle to the accomplishment and execution of the full purposes and objectives of

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[7] We likewise reject the PMs' contention, based on the Missouri Court of Appeals's decision in *Edward D. Jones & Co. v. Schwartz*, 969 S.W.2d 788 (Mo. Ct. App. 1998), that the matter at hand is "substantive rather than procedural." Although the Court in that case acknowledged that the FAA "create[d] a body of substantive federal law on arbitration[,]" it nonetheless "utilize[ed] Missouri procedural rules" while "apply[ing] federal substantive law" in a case involving arbitration pursuant to the FAA. *Id.* at 793, 795.

Congress.'" *Id.* (quoting *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941)).

Therefore, in order for the PMs to prevail on their argument, it must be evident that application of the Maryland standard of review would not only serve to frustrate the underlying goals of the FAA, but would also result in a failure to carry out the arbitration provision of the MSA as the parties had intended. Application of the Maryland standard of review does neither. As the PMs recognize in their briefs and as we shall further explain below, "[t]he Maryland arbitration statute is virtually identical in substance to the FAA," and would also promote the goal of enforcing arbitration agreements. (Citation omitted). *See Hall St. Assocs., L.L.C. v. Mattel, Inc.*, 552 U.S. 576, 590 (2008) ("The FAA is not the only way into court for parties wanting review of arbitration awards: they may contemplate enforcement under state statutory or common law, for example, where judicial review of different scope is arguable."). And, with regard to the terms of the parties' agreement to arbitrate, we have already explained that application of Maryland law would not violate any MSA provision governing post-arbitration judicial review.

Having determined that Maryland standard of review applies in reviewing the Panel's decisions, we direct our attention to the applicable statute governing the vacation of an arbitration award, Md. Code (1973, 2013 Repl. Vol.), § 3-224(b) of the Courts & Judicial Proceedings Article ("CJP"), which provides:

The court shall vacate an award if:

> (1) An award was procured by corruption, fraud, or other undue means;
>
> (2) There was evident partiality by an arbitrator appointed as a neutral, corruption in any arbitrator, or misconduct prejudicing the rights of any party;
>
> (3) The arbitrators exceeded their powers;
>
> (4) The arbitrators refused to postpone the hearing upon sufficient cause being shown for the postponement, refused to hear evidence material to the controversy, or otherwise so conducted the hearing, contrary to the provisions of § 3-213 of this subtitle, as to prejudice substantially the rights of a party; or
>
> (5) There was no arbitration agreement as described in § 3-206 of this subtitle, the issue was not adversely determined in proceedings under § 3-208 of this subtitle, and the party did not participate in the arbitration hearing without raising the objection.

Here, Maryland's issues with the Panel's decisions are rooted in CJP § 3-224(b)(3) & (4).

In the past, Maryland courts have held that "arbitrators exceed their powers not only when the substance of their award lacks a scintilla of rationality, but also where the award is founded upon a mistaken assertion of jurisdiction." *Snyder v. Berliner Const. Co.*, 79 Md. App. 29, 37 (1989) (citation & footnote omitted); *see also Downey v. Sharp*, 428 Md. 249, 258 (2012) (noting that "awards which were 'completely irrational,' or which

demonstrated 'manifest disregard of the law,' or which were contrary to the State's public policy, had been overturned"). Thus, "'an award issued by an arbitration panel acting without jurisdiction should be accorded no deference at all on appeal.'" *Snyder*, 79 Md. App. at 38 (quoting *Stephen L. Messersmith, Inc. v. Barclay Townhouse Assocs.*, 313 Md. 652, 664 (1988)).

By contrast, "factual findings by an arbitrator are virtually immune from challenge and decisions on issues of law are reviewed using a deferential standard on the far side of the spectrum away from a usual, expansive *de novo* standard." *Mandl v. Bailey*, 159 Md. App. 64, 92 (2004) (citations omitted); *see also Downey*, 428 Md. at 266 ("reviewing courts generally defer to the arbitrator's findings of fact and applications of law") (citations omitted). As a result, "courts are fairly reluctant to disturb the award of an arbitrator where the award reflects the honest decision of the arbitrator and is the product of a full and fair hearing of the parties." *Balt. Teachers Union, Am. Fed'n of Teachers, Local 340, AFL-CIO v. Mayor & City Council of Balt.*, 108 Md. App. 167, 181 (1996) (citations omitted).

With regard to the appellate process, the parties do not dispute—and we agree—that this Court's review of the circuit court's decision is *de novo*, regardless of whether the circuit court disposed of the outstanding motions before it pursuant to the FAA or the MUAA. *See First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938, 947-48 (1995) ("when reviewing a district court decision that refuses to vacate, or confirms, an arbitration award," a court of appeals should "accept[] findings of fact that are not 'clearly erroneous' but

decid[e] questions of law *de novo*") (internal citations omitted); *Delta Queen Steamboat Co. v. Dist. 2 Marine Engineers Beneficial Ass'n, AFL-CIO*, 889 F.2d 599, 602 (5th Cir. 1989) ("Thus, since this jurisdictional challenge focuses upon whether the award is grounded in the . . . agreement, we will review the [trial] court's decision *de novo*.") (Citation omitted); *Stephen L. Messersmith, Inc.*, 313 Md. at 664 ("the appropriate standard of review when an arbitration award is attacked for lack of jurisdiction . . . is . . . *de novo*"); *Prince George's Cnty., Md. ex rel. Prince George's Cnty. Police Dep't v. Prince Georges Cnty. Police Civilian Employees Ass'n*, 219 Md. App. 108, 119 (2014) ("A circuit court's decision to grant or deny a petition to vacate or confirm an arbitration award is akin to an order granting or denying a motion for summary judgment. The standard of review is *de novo*.") (Internal citations omitted), *cert. granted*, 441 Md. 217 (2015). "Therefore, we review that court's disposition for legal error." *Montgomery Cnty., Maryland v. Fraternal Order of Police, Montgomery Cnty. Lodge 35, Inc.*, 427 Md. 561, 572 (2012) (citation omitted). To that end, we accept any relevant factual findings by the circuit court that are not "clearly erroneous[.]" *See First Options of Chicago, Inc.*, 514 U.S. at 947-48.

V. DISCUSSION

A. Partial Settlement Award

Maryland first argues 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. According to Maryland, the Partial Settlement Award

"impermissibly allowed the contested Term Sheet States to bypass a diligence inquiry and treated them as not subject to the NPM Adjustment." Maryland further contends that, in ruling as it did, the Panel's actions "conflicted with rules of conduct and ethics for arbitrators" and "detrimentally affected Maryland." Accordingly, Maryland argues that the circuit court erred in refusing to vacate the Partial Settlement Award, and it now urges us to reverse that judgment and remand with instructions to have the Independent Auditor "treat all of the Term Sheet States [whose diligence was contested] as non-diligent for the purpose of calculating Maryland's NPM Adjustment liability for 2003."[8]

In response, the PMs aver that "the circuit court correctly held that the Panel did not exceed its powers in entering the [Partial] Settlement Award's *pro rata* judgment-reduction ruling," and its decision "furthered the strong policy in favor of settlements." According to the PMs, the court acted properly in applying the FAA standard and finding that the Panel not only had jurisdiction to interpret the MSA, but also acted in good faith in issuing the Partial Settlement Award.[9] Alternatively, the PMs contend

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[8] In its reply brief, Maryland notes that *Com. ex rel. Kane*, *supra*, 114 A.3d 37, is "the only appellate ruling on point," and that the Commonwealth Court of Pennsylvania, in that case, correctly "affirmed a ruling by a Pennsylvania trial court that had vacated the Partial [Settlement] Award as to Pennsylvania and directed that the contested Term Sheet States be deemed non-diligent for purposes of calculating Pennsylvania's NPM Adjustment obligation."

[9] As we previously explained, the FAA's vacatur standards do not apply here. Therefore, we need not address this argument.

that, even when reviewed under Maryland's standard, "the Panel's *pro rata* judgment-reduction ruling was also a rational interpretation of the MSA." In that regard, the PMs argue that "MSA § IX(d)(2) simply does not say what [Maryland] alleges[;]" rather, they insist that the Panel's interpretation was warranted because "§ IX(d)(2) does not 'directly speak' to, and is indeed 'silent on,' the proper method for reallocating the NPM Adjustment after a partial settlement." Finally, the PMs contend that Maryland waived its argument because it vehemently opposed the Panel's adoption of the proportionate fault judgment-reduction method, which would have allowed the Panel to conduct diligence hearings for any Term Sheet States.

In its reply brief, Maryland argues that the PMs' argument "begins at the wrong place." We agree. As Maryland stated, in pertinent part:

> The [PMs'] argument takes as its starting point a presumption that the Panel was confronted with a need to fashion an appropriate method of judgment reduction due to an absence of guidance from the MSA. Leaping from that faulty premise, they would ask this Court to determine that the Panel's choice of a *pro rata* methodology was, in that context, a rational one. However, the issue raised in this appeal is not whether the Panel made the appropriate selection among available judgment reduction methodologies, but whether it was empowered to look outside the MSA to find a judgment reduction methodology at all.

(Internal citations omitted). Our analysis begins with the MSA.

MSA § XI(c) provides that "[a]ny dispute, controversy or claim arising out of or relating to calculations performed by, or any determinations made by, the Independent Auditor . . . shall be submitted to binding arbitration before a panel of three neutral arbitrators" in an arbitration governed by the FAA. The Supreme Court has stated that, in order "[t]o resolve disputes about the application of a[n] . . . agreement, an arbitrator must find facts" and is free to "interpret[] . . . the contract." *United Paperworkers Int'l Union, AFL-CIO v. Misco, Inc.*, 484 U.S. 29, 38 (1987). Moreover, when "'parties . . . attempt to settle an issue, otherwise arbitrable, by agreement, any disagreement as to the existence or effect of that settlement agreement would itself be a matter for the arbitrator to decide.'" *United Steel, Paper & Forestry, Rubber, Mfg., Energy, Allied Indus. & Serv. Workers Int'l Union v. TriMas Corp.*, 531 F.3d 531, 538-39 (7th Cir. 2008) (quoting *Employees Protective Ass'n v. Norfolk & Western Rwy. Co.*, 571 F.2d 185, 193 (4th Cir. 1977)); *see also Shaw's Supermarkets, Inc. v. United Food & Commercial Workers Union, Local 791, AFL-CIO*, 321 F.3d 251, 254 (1st Cir. 2003) (stating that, when parties enter into a valid agreement to arbitrate, "other issues relating to the substance of the dispute or the procedures of arbitration are for the arbitrator") (citation omitted).[10] Therefore, the circuit court did

[10] Because the MSA provided that the arbitration would be governed by the FAA, we look to federal cases to delineate the scope of the Panel's jurisdiction in carrying out said arbitration.

not err in concluding that "the Panel did not lack jurisdiction . . . in interpreting the MSA and determining the appropriate method for reallocating the 2003 NPM Adjustment post-settlement."

Where the Panel erred, however, was in reallocating the 2003 NPM Adjustment post-settlement without *first* determining the diligence of certain states. Stated differently, by ratifying the Proposed Stipulated Partial Award and issuing the Partial Settlement Award, the Panel disregarded MSA § IX(d)(2)(B), which provides that "[a] Settling State's Allocated Payment shall not be subject to a NPM Adjustment . . . if such Settling State continuously had a Qualifying Statute . . . *and diligently enforced* the provisions of such statute during such entire calendar year." (Emphasis added). The Supreme Court has stated that an "arbitrator may not ignore the plain language of the contract." *United Paperworkers Int'l Union, AFL-CIO*, 484 U.S. at 38 (citation omitted). But, in this case, certain Term Sheet States' Allocated Payments were deemed not subject to an NPM Adjustment even though the Panel never found that such states diligently enforced their respective Qualifying Statutes. As such, the Panel's error did not lie simply in reallocating the 2003 NPM Adjustment and in doing so according to the *pro rata* method of judgment

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As previously explained, however, the Panel's rulings are subject to Maryland's vacatur standards on judicial review.

reduction; [11] its error was in doing both before determining the diligence of all contested states.[12]

We agree with the Commonwealth Court of Pennsylvania that "[a]lthough the MSA does not address the effect of a partial settlement on the reallocation, it is not ambiguous." *Com. ex rel. Kane*, 114 A.3d at 62. Indeed, the PMs' main contention is not that the MSA was ambiguous; rather, they argue in large part that the Panel properly issued the Partial Settlement Award because the MSA was silent on how to reallocate the NPM Adjustment "where only some parties settle and consent." We have previously recognized, however, that "[a] contract's silence on a particular issue does not, by itself, create ambiguity as a matter of law." *Azat v. Farruggio*, 162 Md. App. 539, 551 (2005) (citing Richard A. Lord, *Williston on Contracts*, § 30.4 at 47-51 (4th ed. 1999)). Silence creates ambiguity only "when it involves a matter naturally within the scope of the contract." *Id.* (citation omitted). Here, although the MSA was silent on the effect of a partial settlement regarding the NPM Adjustment, that settlement—or Term Sheet—was not a matter naturally within the scope of the MSA and, thus, did not create an ambiguity. As such, the Panel was not empowered to bypass the diligence determination in reallocating the NPM Adjustment. *See Com. ex rel. Kane*, 114 A.3d at 63 ("Regardless of who bore the

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[11] Therefore, it matters not that Maryland opposed the Panel's adoption of the proportionate fault method of judgment reduction.

[12] We reach this conclusion regardless of which ethical standards the parties deem appropriate in this instance.

burden, relief from the NPM Adjustment and Reallocation Provision depended on a determination of diligence.").

Likewise, the Panel erred in concluding: "Where multiple parties have a potential shared contractual obligation and some of them settle and some do not, the non-settling parties cannot necessarily block the settlement." Although "[t]he general rule . . . is that a non-settling party does not have standing to object to a settlement between other parties," as the Panel noted, that rule cannot apply in cases such as this, where the settlement (*i.e.*, Term Sheet) went against the provisions of an underlying agreement (*i.e.*, MSA) involving both the settling and non-settling parties (*i.e.*, Term Sheet and Non-Term Sheet States, respectively). By issuing the Partial Settlement Award, the Panel violated MSA § XVIII(j), which governs "Amendment and Waiver," and states:

> This Agreement may be amended by a written instrument executed by all Participating Manufacturers affected by the amendment and by all Settling States affected by the amendment. The terms of any such amendment shall not be enforceable in any Settling State that is not a signatory to such amendment. The waiver of any rights conferred hereunder shall be effective only if made by written instrument executed by the waiving party or parties. The waiver by any party of any breach of this Agreement shall not be deemed to be or construed as a waiver of any other breach, whether prior, subsequent or contemporaneous, nor shall such waiver be deemed to be or construed as a waiver by any other party.

As Maryland correctly notes, 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." *See Com. ex rel. Kane*, 114 A.3d at 63 ("By treating the Term Sheet States as diligent and allowing them to shift their share of the reallocation, the panel departed from the MSA's clear terms and 'amended' the MSA without agreement of 'all' parties 'affected by the amendment.'"). Accordingly, the Panel erred in concluding that the Partial Settlement Award and the Term Sheet "do not legally prejudice or adversely affect" the Non-Term Sheet States. And, we need not engage in speculation as to how much Maryland stands to gain or lose to determine that it and the other non-diligent, Non-Term Sheet States were adversely affected by the Panel's ruling.

The PMs place great weight on the fact that no Settling State contested the diligence of other Settling States. Their argument, however, is flawed because it assumes that a Term Sheet State whose diligence had been contested by another Settling State would have benefited by a diligence determination by the Panel. But, we do not know whether such Term Sheet State would have been found diligent, as was the case with Term Sheet States whose diligence was contested by the PMs, but were deemed not subject to the 2003 NPM Adjustment.

In sum, the Panel exceeded its powers, in violation of CJP § 3-224(b)(3), 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.

In order to bring the Partial Settlement Award in line with the MSA, we now grant Maryland's request and reverse the circuit court's denial of Maryland's Petition to Vacate Arbitration Award. We remand the case to the circuit court so that it may vacate the Partial Settlement Award and instruct the Independent Auditor to treat the 20 Term Sheet States, whose diligence was contested but not determined,[13] as non-diligent, when reallocating the 2003 NPM Adjustment. As Maryland states, "given that the arbitration was closed," this is "the only possible remedy at this point."

B. Evidentiary Hearing

Next, Maryland argues that "the Panel's Final Award should be vacated because the Panel's refusal to hear material evidence deprived Maryland of a full and fair hearing." Specifically, Maryland avers that in implementing the Partial Settlement Award, the Panel "refus[ed] to allow Maryland and other states to put at issue the diligence of the contested Term Sheet States," but later "considered the evidence regarding all of the states for which it made diligence determinations when the Panel rendered its [diligence] decisions." Acknowledging that it did not advocate comparative diligence determinations nor

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[13] To be clear, this includes Settling States that signed the Term Sheet except those whose diligence was not contested or those that were found by the Panel to be diligent.

attempt to introduce evidence regarding the diligence of other states, Maryland contends that "once the Panel [decided] to engage in a comparative analysis, and actually did so in the context of an arbitration governed by the ARA, it was improper—and beyond any legitimate justification—for the Panel to refuse to hear material evidence regarding the contested Term Sheet States." As such, Maryland argues that the circuit court erred failing to vacate the Final Award.

In response, the PMs argue that the circuit court correctly held that the Panel did not commit evidentiary misconduct and properly refused to vacate the Final Award. In making their argument, the PMs emphasize that: (1) "Maryland never requested, and actively opposed, [a] comparative state analysis;" (2) the Panel found Maryland to be non-diligent "based solely on an objective analysis of state-specific circumstances" and "not on a relative analysis that compared [Maryland] against other contested states;" and (3) Maryland fails to demonstrate that any prejudice occurred as a result of the Panel's alleged error. Applying the vacatur standards of the FAA, the PMs assert that the circuit court properly denied Maryland's Petition to Vacate Arbitration Award Finding that [Maryland] Did Not Diligently Enforce its Qualifying Statute During 2003.

Following the motions hearing in this case, the circuit court found that the Panel did not refuse to hear pertinent and material evidence as Maryland alleged. In pertinent part, the court reasoned that Maryland never requested the Panel to consider the enforcement record of all contested Term Sheet States; that the Panel's diligence determination

focused on the objective standard; and that "[e]ven if some, most or all of the 'term sheet states' were less diligent than Maryland, from the facts there is no guarantee that the Panel would have found Maryland to be diligent."

Although the circuit court erred in applying the FAA's vacatur standards in issuing its ruling, we ultimately reach the same conclusion after applying the Maryland standard of review. Initially, we note that, as we are remanding the case with instructions for the Independent Auditor to consider all contested Term Sheet States as non-diligent, Maryland will already receive part of the relief it seeks when the 2003 NPM Adjustment is reallocated among a larger number of non-diligent states. But, to the extent that Maryland challenges the Panel's finding that Maryland was not diligent in enforcing its Qualifying Statute, we perceive no error on the Panel's part and, accordingly, affirm the circuit court's judgment.

As previously mentioned, CJP § 3-224(b)(4) authorizes courts to vacate an arbitral award when the arbitrators "refused to hear evidence material to the controversy . . . as to prejudice substantially the rights of a party." "The party challenging the arbitration award bears the burden of proving the existence of one of the grounds for vacating it." *Mandl, supra*, 159 Md. App. at 86 (citations omitted). The question we must address on appeal, then, is whether, on the facts, the Panel "as a matter of law improperly refused to hear evidence material to the parties' controversy, to the substantial prejudice of [Maryland's] rights." *Id.* at 91-92 (citing CJP § 3-224(b)(4)).

Citing the ARA and the Panel's July 1, 2011 order regarding burden of proof, Maryland contends that "[t]he Panel's failure to hear the contested Term Sheet States' enforcement records violated the Panel's own prior orders and Maryland's legitimate contract expectations." In particular, Maryland looks to the Panel's statement that "'the reallocation provisions of the MSA do not apply unless and until diligent enforcement determinations are made for those states whose diligence is contested by either the [PMs] or the states,'" (emphasis added by Maryland), as well as the following ARA provision:

> The Arbitration panel shall not disclose or otherwise make known its determinations as to whether any Settling State diligently enforced a Qualifying Statute during 2003 until after the conclusion of *the presentation of all evidence* and written or oral argument in the Arbitration proceeding with respect to the diligent enforcement of *all Settling States that join the arbitration* by the date that the third arbitrator is selected and whose diligent enforcement the Signatory PMs contested in the Arbitration
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> . . . .

ARA § 2(i) (emphasis added by Maryland).

Maryland's reliance on those statements, however, is misplaced because in issuing the Partial Settlement Award, the Panel believed (albeit mistakenly) that diligent enforcement determinations had already been made for all contested states. More importantly, those statements do not provide support for Maryland's assertion that "once the Panel [decided] to engage in a comparative analysis, . . . it

was improper . . . for the Panel to refuse to hear material evidence regarding the contested Term Sheet States." Nothing in the record reflects that the parties to the ARA and the Panel agreed to employ a comparative method in determining each state's diligence; nor does Maryland point to any case law to indicate that such was the proper procedure.

Overall, Maryland failed to meet its burden of proving that the Panel refused to hear evidence material to the controversy, to the substantial prejudice of Maryland's rights, when the Panel found that Maryland was not diligent in enforcing its Qualifying Statute. We agree with the circuit court that "the Panel's diligence determination focused on the objective standard and assessing diligence that was common to all states, and then applying that standard to each State's individual enforcement for 2003." It was not irrational for the Panel to do so. *See Downey, supra*, 428 Md. at 258; *Snyder, supra*, 79 Md. App. at 37. As the Panel explained in its Final Award for Maryland, "[i]t is . . . not a useful exercise, or even valid, to compare the decision as to one State against the decision as to another" because the Panel considered the various factors relating to diligence "in the over-all [sic] context of a Settling State's existing policies and circumstances in 2003."

Furthermore, based on the record, there was enough evidence to support the Panel's finding of non-diligence on Maryland's part. Assessing Maryland based on the eight relevant factors, the Panel first noted that Maryland's collection rate of 47% for 2003 was less than its rates in the year before (75.4%) and after (55.3%). Second, the Panel stated that although "[e]scrow was not paid on 68.2

million NPM cigarettes sold in 2002" and "Maryland identified lawsuits as being an important part of the enforcement effort," it "filed only one lawsuit in 2003." Third, with regard to gathering reliable data, the Panel found that Maryland "received little help and insufficient sales data from the Comptroller's Office, which basically was a non-participant in enforcement efforts." Fourth, the Panel determined that "Maryland's enforcement efforts were seriously hampered by lack of sufficient[ly] committed and trained personnel." Fifth, the Panel noted that although Maryland may have been well-positioned for diligent enforcement in 2004, its efforts were "not enough to credit Maryland for an 'ongoing and intentional consideration of the requirements of a State's Qualifying Statute.'" Sixth, the Panel recognized that "[a]lthough Maryland passed its Qualifying Statute and Complementary Legislation in a timely manner, it did little to implement it until . . . toward the end of 2003." Seventh, the Panel concluded that Maryland's record in the area of "Actions Short of Legislation" was "extremely poor." For example, "it conducted no desk or field audits," "conducted retail inspections for state excise tax but none for escrow compliance," and "sent notice letters, but only two demand letters were sent to non-compliant NPMs." Lastly, the Panel found "little, if any, information" about the eighth factor, "Efforts to be Aware of NAAG and Other States' Enforcement Efforts." As "factual findings by an arbitrator are virtually immune from challenge," *Mandl*, 159 Md. App. at 92, we cannot say that the circuit court erred in refusing to vacate the Panel's finding of non-diligence.

Finally, we agree with the circuit court that "[e]ven if some, most or all of the 'term sheet states' were less diligent than Maryland, from the facts there is no guarantee that the Panel would have found Maryland to be diligent." As the PMs state in their brief, Maryland "failed to identify adequate evidence that it would have benefited from a comparison to the contested [Term Sheet] States," because the most that Maryland can assert is that "some 'evidence . . . suggests that the contested [Term Sheet] States would not have compared favorably.'" The use of such conclusory statements, however, is inadequate to show substantial prejudice. *See, e.g., Owens-Corning Fiberglas Corp. v. Garrett*, 343 Md. 500, 525 (1996) (stating that "conclusory allegations" of prejudice are "certainly not sufficient"); *Forensic Advisors, Inc. v. Matrixx Initiatives, Inc.*, 170 Md. App. 520, 530 (2006) (stating that "a particular and specific demonstration of fact, as distinguished from general, conclusory statements," is necessary to reveal "some injustice, prejudice, or consequential harm") (citation omitted); *Gen. Acc. Ins. Co. v. Scott*, 107 Md. App. 603, 616 (1996) (stating that "conclusory allegations" are "insufficient, as a matter of law, to raise a genuine dispute as to whether [a party] suffered actual prejudice").

C. State-Specific Arbitration

Finally, Maryland argues that the circuit court erred in denying Maryland's motion to compel state-specific arbitration. First, Maryland contends that pursuant to the plain meaning of the MSA, Maryland, by itself, constitutes a single "side" to the dispute to be submitted to arbitration, "with at least the [PMs],

and perhaps other states, on the other side."[14] Next, Maryland avers that "[n]othing in . . . the MSA's arbitration clause, or any other provision of the MSA, can reasonably be read to require [a multi-state arbitration]." Similarly, Maryland argues that although this Court, in *Philip Morris Inc., supra*, 179 Md. App. 140, held that Maryland must arbitrate the dispute over the 2003 NPM Adjustment, we did not decide "whether [Maryland] was required to arbitrate that dispute in a multi-state proceeding." Lastly, Maryland contends that "the public interest supports a Maryland-specific arbitration" as it would "ensur[e] that a panel of arbitrators could give their attention to Maryland's enforcement of [its] statute" and "Maryland's interest in defending its practices would no longer be frustrated by the need to compromise with other states that have different interests."

In response, the PMs contend that the circuit court acted properly in denying Maryland's motion for a state-specific arbitration. According to the PMs, "this Court in Philip Morris . . . already decided that the MSA requires NPM Adjustment disputes . . . to be arbitrated in a nationwide arbitration." In addition,

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[14] As previously mentioned, MSA § XI(c) provides, in pertinent part:

> Any dispute, controversy or claim arising out of or relating to calculations performed by, or any determinations made by, the Independent Auditor . . . shall be submitted to binding arbitration before a panel of three neutral arbitrators, each of whom shall be a former Article III federal judge. Each of the *two sides* to the dispute shall select one arbitrator. The two arbitrators so selected shall select the third arbitrator.

(Emphasis added).

the PMs argue that "the MSA's text, its structure, and extensive, uniform authority from other [jurisdictions] . . . all confirm the trial court's decision." Lastly, the PMs aver that Maryland's policy argument is "irrelevant and meritless" because it does not explain how "the myriad proceedings necessary to determine the diligence of each of the other 27 States would function more equitably than a nationwide arbitration." We agree with the PMs.

In *Philip Morris, Inc.*, 179 Md. App. at 162-63, we determined that the structure of the MSA requires arbitration due, in part, to the "[n]eed for uniformity:"

> The State contends that "[a] nationwide arbitration concerning the diligence of [fifty-two] states and territories in enforcing their own laws might well represent the ultimate in 'chaos.'"
>
> The State, however, cannot explain how a proceeding that is subject to one final and binding determination would be less workable or expeditious than litigating the issue fifty-two times in fifty-two separate court systems with the imminent possibility of delays and appeals.
>
> The MSA's payment structure is nationwide and unitary. The independent auditor calculates and determines the participating manufacturers' annual payments and then allocates those funds among the settling states. In the case of diligent enforcement, a single decision-maker is vitally important because the determination for one state affects every other settling state pursuant to § IX(d)(2)(C)'s "reallocation" provision.

The question of diligent enforcement cannot be made in a vacuum. We concur with the numerous jurisdictions that have held that the present dispute must be resolved under one clear set of rules that apply with equal force to every settling state. We find the rationale of the Superior Court of Connecticut particularly compelling:

> The problem is even more acute, however, when the resolution of a dispute as to calculations and determinations by the Independent Auditor will necessarily have different effects on different Settling States. Unless such disputes are presented to and decided by tribunals that have the power to hear from and bind each affected Settling State as a party, great mischief can be done and substantial unfairness can result. Where, for example, as in this case, it is claimed that an individual Settling State is exempt from the NPM Adjustment for a given year because it diligently enforced a Model Statute that was in full force and effect throughout that year, the decision of the tribunal deciding that issue will not only affect the interests of the Settling State seeking to qualify for the exemption, but those of all other Settling States as well. This is so because the granting of an exemption to one Settling State will inexorably lead to the reallocation of its allocated portion of the NPM Adjustment to all other non-exempt Settling States. Each Settling State thus has a vital

> interest in the granting or denial of each other Settling State's individual claim for exemption, and for obvious reasons, their interests are conflicting. Submitting such a dispute to a neutral panel of competent arbitrators affords all interested parties the right to be heard on a level playing field where no interested party enjoys an apparent home-field advantage.
>
> *Connecticut v. Philip Morris, Inc.*, 279 Conn. 785, 905 A.2d 42, 50-51 (2006) . . . .

Although Maryland is correct that this Court's original opinion included language that more definitively supported a requirement that Maryland participate in multi-state arbitration, and that such language was removed pursuant to Maryland's motion to reconsider, the final version of our opinion clearly still contemplated a single, nationwide arbitration.[15] To the extent that we previously did not hold as such, we do so now.

First, there is no merit to Maryland's argument that, when considering the terms of the MSA, Maryland constitutes a single "side" to the dispute to be submitted to arbitration, "with at least the [PMs], and perhaps other states, on the other side." When the Panel convened to hear this matter, the parties agreed that the dispute centered on whether the PMs were entitled to the 2003 NPM Adjustment. Particularly, "the participating manufacturers requested that the auditor apply the 2003 NPM

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[15] We originally filed our opinion in *Philip Morris, Inc.* on February 1, 2008, and filed the final version on March 27, 2008.

Adjustment to their April 2006 payments. Maryland and the other settling states, however, urged the auditor to deny the NPM Adjustment on the ground that the settling states 'diligently enforced' their qualifying statutes." *Philip Morris Inc.*, 179 Md. App. at 148. Thus, the circuit court correctly recognized the "two sides to the dispute" to be "the MSA States in opposition to the downward adjustment, and the PMs."

Next, in addition to our previous determination that having "a single decision-maker is vitally important" in light of the MSA's "nationwide and unitary" payment structure, *id.* at 162, Maryland's proposed state-specific arbitration would not necessarily advance the public interest. As the PMs point out, "every State would have an interest in the decision on diligence for every other state" and in each state-specific proceeding, "up to 27 other States would need to intervene to protect their interest, which would multiply exponentially the cost, complexity, and burden of resolving the 2004 NPM Adjustment dispute." This would have a tremendous effect on all parties, especially the SPMs, which are smaller companies with more limited resources.

Lastly, our holding is supported by courts in other jurisdictions. *See McGraw v. Am. Tobacco Co.*, 681 S.E.2d 96, 112 (W. Va. 2009) ("All courts addressing arguments . . . against the requirement of a single, nationwide arbitration of the diligent enforcement determination have consistently and logically rejected the same. Both the structure and plain meaning of the MSA require a uniform determination of this issue due to the impact the determination relevant to one settling state will have upon all other

settling states."); *State, ex rel. Carter v. Philip Morris Tobacco Co.*, 879 N.E.2d 1212, 1220 (Ind. Ct. App. 2008) ("Both the language and the structure of the MSA require that the dispute concerning the 2003 NPM Adjustment, including the Settling States' claims of diligent enforcement of their Qualifying Statutes, must be submitted to a single, national arbitration panel."); *State ex rel. Riley v. Lorillard Tobacco Co.*, 1 So. 3d 1, 14 (Ala. 2008) ("we conclude that the agreement requires a national, as opposed to a local, arbitration proceeding"); *State v. Philip Morris USA Inc.*, 945 A.2d 887, 894 (Vt. 2008) ("Other courts addressing this issue, however, have found 'compelling logic' in having disputes over diligent enforcement handled by one arbitration panel rather than separate courts in each settling state . . . . We agree.") (Citation omitted); *State v. Phillip Morris, Inc.*, 905 A.2d 42, 51 n.12 (Conn. 2006) (noting that the language of the MSA "envisions that the settling states would select one arbitrator and the participating manufacturers would select one arbitrator") (citation omitted); *State of N.M. ex rel. N.M. Attorney Gen. Gary K. King*, 194 P.3d 749, 755 (N.M. Ct. App. 2008) (affirming an order "compelling arbitration before a single, nationwide arbitration panel"); *State v. Philip Morris Inc.*, 858 N.Y.S.2d 134 (N.Y. App. Div. 2008) ("This Court rejected . . . arguments that each Settling State constituted a 'side' to the dispute, under section XI (c) of the Master Settlement Agreement, with the right to select its own arbitrator") (citation omitted); *People v. Lorillard Tobacco Co.*, 865 N.E.2d 546, 554 (Ill. App. Ct. 2007) ("Moreover, we agree with those courts before us that have pointed out the 'compelling logic

to having these disputes handled by a single arbitration panel of three federal judges, rather than numerous state and territorial courts.'") (Citation omitted). Accordingly, the circuit court did not err in denying Maryland's motion to compel a state-specific arbitration.

VI. CONCLUSION

For all of the foregoing reasons, we reverse the circuit court's denial of Maryland's Petition to Vacate Arbitration, and affirm its denial of Maryland's Motion to Compel a Maryland-Specific Arbitration on the Issue of Whether Maryland Diligently Enforced during 2004 and Petition to Vacate Arbitration Award Finding that [Maryland] Did Not Diligently Enforce its Qualifying Statute During 2003. We remand the case with instructions to have the Independent Auditor treat all 20 of the contested Term Sheet States as non-diligent when calculating Maryland's 2003 NPM Adjustment liability.

JUDGMENT OF THE CIRCUIT COURT FOR BALTIMORE CITY AFFIRMED IN PART AND REVERSED IN PART. CASE REMANDED FOR PROCEEDINGS NOT INCONSISTENT WITH THIS OPINION COSTS TO BE DIVIDED EQUALLY BETWEEN THE PARTIES.

APPENDIX B

STATE OF MARYLAND	*	IN THE
	*	
Plaintiff,	*	CIRCUIT COURT
	*	
	*	FOR
v.	*	
	*	BALTIMORE CITY
	*	
PHILIP MORRIS, INC, ET AL.	*	
	*	
	*	Case No. 24-C-
	*	96122017/CL211487
Defendants.	*	
	*	

* *

MEMORANDUM OPINION

NANCE, J.

HISTORY

This case comes before this Court on a Petition of the State of Maryland (Maryland) to Vacate a 2013 Arbitration Award of the 2003 NPM Adjustment Arbitration Panel, finding the State of Maryland non-diligent in its enforcement of the Qualifying Statute in 2003. In 1998, all fifty states[1], including Maryland, and certain tobacco product manufactures (Philip Morris USA, Inc., R.J. Reynolds Tobacco Co., and

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[1] The District of Columbia and the U.S. territory of Puerto Rico also.

Lorillard Tobacco Co.) as well as more than forty small tobacco manufactures (Subsequent Participating Manufacturers) [2] signed a Master Settlement Agreement (MSA).[3] Pursuant to the MSA, the PMs are required to make annual payments in perpetuity, which is allocated among the settling states in exchange for a release of liability.

An Independent Auditor calculates each PM's annual payment obligation pursuant to a comprehensive formula contained within the MSA. The annual payments are divided at a state's pre-set "allocable share" percentage. Maryland's Allocable Share is approximately 2.26%, which in 2003 was $145 million. The annual payments are subject to an adjustment, i.e. the Non-Participating Manufacturers (NPM) Adjustment that can increase or decrease the payment obligation. The NPM Adjustment will reduce a state's payment, if a PM experiences a "market share loss" and satisfies other enumerated conditions.[4] A state may avoid a reduction of its state payment (NPM Adjustment), if the state

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[2] Subsequent Participating Manufacturers were not original parties to the MSA.

[3] The purpose of the MSA is to resolve consumer fraud and products liability claims against the tobacco companies (PMs) for the wrongful marketing of cigarettes.

[4] The NPM Adjustment refers to the adjustment made if a PM experiences a "market share loss," a decrease by more than two percent of the PM's collective market share during that year compared to their collective market share in 1997; where the MSA was a "significant factor" in the loss. MSA § IX(d)(l)(C). The purpose is to protect PMs from being disadvantaged in comparison to tobacco companies that did not enter into the MSA.

"diligently enforced" the terms of its Qualifying Statute[5] for the relevant year. In that case, the state's allocable share of the NPM Adjustment is reallocated to the non-diligent states by "*pro-rata*" proportion. MSA §IX(d)(2)(C). A state that fails to prove diligent enforcement not only remains subject to the state-specific payment reduction of the NPM Adjustment; but also subject to a secondary reduction due to the reallocation of the NPM Adjustment attributable to all non-diligent states.[6] On January 19, 2007, this Court held that Maryland's NPM Adjustment dispute to be subject to arbitration pursuant to MSA §XI(c)[7] . On March 27, 2008, the

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[5] Md. Code Ann., Bus. Reg. § 16-401(f)(1) ("It would be contrary to the policy of the State if tobacco product manufacturers who determine not to enter into such a settlement could use a resulting cost advantage to derive large, short-term profits in the years before liability may arise without ensuring that the State will have an eventual source of recovery from them, if they are proven to have acted culpably. (2) It is in the interest of the State to require such tobacco product manufacturers to establish a reserve fund to guarantee a source of compensation in order to prevent them from deriving large, short-term profits and then becoming judgment-proof before liability may arise.")

[6] Under the NPM Adjustment rubric, the greater the *number of diligent states*, the further the state payments are reduced to the non-diligent states.

[7] *Resolution of Disputes*. "Any dispute, controversy or claim arising *out of or relating to calculations performed by, or any determinations made by*, the independent auditor including without limitation, any dispute concerning the operation or application of any of the adjustments, reductions, offsets, carry-forwards and allocations described...shall be submitted to binding arbitration before a panel of three neutral arbitrators, each of whom shall be a former Article III federal judge." MSA §XI(c).

Maryland Court of Special Appeals affirmed this Court's decision.[8]

In 2009, the PMs, Maryland and most MSA States entered into an arbitration agreement, the Agreement Regarding Arbitration (ARA), to settle the NPM Adjustment dispute for the year 2003. A nationwide arbitration was done, during which an Arbitration Panel was retained to determine whether individual settling states diligently enforced their qualifying statute in 2003. Pursuant to the MSA and ARA, *supra*, every settling state participating in the nationwide arbitration was to receive a diligent enforcement determination for 2003. MSA §IX(d)(2)(C); ARA Exhibit A (3).

On March 12, 2013, the Arbitration Panel created a Stipulated Partial Settlement and Award (Partial Settlement Award) that implemented a "settlement term sheet" agreed to by the PMs and twenty (20) states, which resolved the 2003 arbitration dispute of those twenty states.[9] The Partial Settlement Award prevented those twenty "term sheet states" any further diligence determinations by deeming them "not subject to the NPM Adjustment for purposes of § IX (d)(2)(B)-(C) of the MSA" for the years 2003

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[8] *State v. Philip Morris Inc.*, 179 Md. App. 140, 162 (2008) (finding that the MSA's payment structure is nationwide and unitary ...and that the present dispute must be resolved under one clear set of rules that apply with equal force to every settling state).

[9] The Arbitration Panel held that it had jurisdiction to determine how the 2003 NPM Adjustment will be allocated among the Non-Signatory States in light of the Settlement pursuant to MSA §XI(c).

through 2014. *See Partial Settlement Award* at 9-11. The Partial Settlement Award instructed the Independent Auditor to treat these "term sheet states" as if they had been found diligent; avoiding any potential NPM Adjustment liability. *Id.* at 13-14. The Partial Settlement Award included a *pro-rata* judgment reduction to the total NPM Adjustment, where the court would divide the amount of the total judgment by the number of "term sheet states" and non-settling states regardless of each state's culpability, in order to compensate states that did not join the partial settlement.[10] *Id.*

In September 2013, the Arbitration Panel made diligence determinations for fifteen of the fifty-two MSA States. Of the remaining thirty-six states initially in the arbitration, twenty states were the "term sheet states," *supra*, whose diligence had been contested, but avoided pursuant to the Partial Settlement Award.

On September 11, 2013, the Arbitration Panel found six of the fifteen MSA States, including Maryland, non-diligent. In assessing a state's diligent enforcement, the Panel began its analysis by considering seven objective factors: (1) collection rate; (2) lawsuits filed; (3) gathering reliable data; (4) resources allocated to enforcement; (5) preventing non-compliant Non-Participating Manufacturers from future sales; (6) legislation enacted; (7) actions

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[10] The Partial Settlement Award declared that if the *pro-rata* judgment reduction does not adequately compensate...for a term sheet *state's removal from the re-allocation pool, the state's relief, if any, is by appeal to their individual MSA court. Partial Settlement Award* at 14.

short of legislation; and (8) efforts to be aware of NAAG[11] and other State's enforcement efforts. *See* 2003 Arbitration Award at 19-20. The Panel made state-specific determinations. The Panel determined that Maryland was non-diligent in 2003 and thus subject to the NPM Adjustment. The Arbitration Panel found that Maryland's collection rate in 2003 was only 47%, significantly lower than its collection rates for 2002 and 2004. Maryland, in 2003, sued only 1 of the 11 non-compliant NPMs[12] even though 10 of the 11 non-compliant NPMs were repeat offenders that could have been enjoined. The State Comptroller's Office appeared virtually absent in the enforcement and the State lacked sufficient, committed personnel. *See* 2003 Arbitration Award at 20-22.

ISSUES

Maryland asserts that (1) the Arbitration Panel's Non-Diligence Final Award should be vacated, arguing that the Panel refused to hear pertinent and material evidence, specifically the enforcement records of the twenty "term sheet states." Maryland further argues that (2) the Stipulated Partial Settlement Award exceeded the Panel's jurisdiction; because the Panel disregarded what Maryland considers as plain contract language in the MSA, by failing to make diligence determinations for the

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[11] The National Association of Attorneys General (NAAG). The NAAG Tobacco Staff is dedicated to helping the attorneys general of the signatory states ("settling states") interpret, implement, and enforce the MSA agreement.

[12] Maryland did file successful lawsuits for unpaid escrow post-2003.

twenty "term sheet states," causing a shift to Maryland of $55.9 million dollars in NPM Adjustment liability; or in the alternative, Maryland seeks an independent appeal of the *pro-rata* judgment reduction under the Partial Settlement Award's appeal provision. And, Maryland argues that (3) a state-specific arbitration should be compelled for the year 2014 to determine whether Maryland diligently enforced its Qualifying Statute in 2004.

DISCUSSION

Petition to Vacate the 2003 Non-Diligence Arbitration Award

An arbitration award can be vacated, if the moving party sustains the heavy burden of proving one of the grounds specified in the Federal Arbitration Act or one of the limited common law grounds.[13] *Three S Delaware, Inc. v. DataQuick Info. Sys., Inc.*, 492 F.3d 520, 527 (4th Cir. 2007). Pursuant to the Federal Arbitration Act,[14] a reviewing court may vacate an

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[13] *See Patten v. Signator Ins. Agency, Inc.*, 441 F.3d 230, 234 (4th Cir. 2006) (finding common law grounds to include when an award fails to draw its essence from the contract, or the award evidences a *manifest disregard of the law*).

[14] The FAA states that vacatur of an award is also appropriate on any of the following grounds: (1) where the award was procured by corruption, fraud, or undue means (2) where there was evident partiality or corruption in the arbitrators, or either of them (3) where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or 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; or (4) where the arbitrators exceeded their powers, or so imperfectly executed them that a

arbitration award 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*, *and* the arbitrator's refusal to hear pertinent and material evidence deprives a party to the proceeding of a fundamentally fair hearing.[15] 9 U.S.C. §10(a)(3)(4); *UMWA v. Marrowbone Dev. Co.*, 232 F.3d 383, 388 (4th Cir. 2000); *Teamsters, Chauffers et al. v. E.D. Clapp Corp.*, 551 F. Supp. 570, 577-578 (N.D.N.Y 1982); *Hoteles Condado Beach, La Concha & Convention Ctr. v. Union De Tronquistas Local 901*, 763 F.2d 34, 40 (1st Cir. 1985). However, the arbitrators' procedural ruling may not be overturned unless the said ruling was in *bad faith or so gross* as to amount to affirmative misconduct. *See Wachovia Sec., LLC v. Brand*, 671 F.3d 472, 479 (4th Cir. 2012) ("a mere mistake lacks the requisite intentionality to qualify as misconduct under § 10(a)(3)").

Maryland argues that the Non-Diligence Award should be vacated under 9 U.S.C §10(a)(3); because the Arbitration Panel engaged in misconduct, when over Maryland's objection, it did not consider the alleged evidence that the "term sheet states" were comparatively less diligent than Maryland.

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mutual, final, and definite award upon the subject matter submitted was not made. 9 U.S.C.A. § 10(a).

[15] The Maryland Uniform Arbitration Act provides that vacatur is required when "there was evident partiality by an arbitrator appointed as a neutral, corruption in any arbitrator, or *misconduct prejudicing the rights of any party." Md Courts & Judicial Proceedings § 3-224 (b)(2).*

Specifically, Maryland argues that the Arbitration Panel was *required* under the "black letter law" of the MSA to make diligence determinations for each of the twenty "term sheet states." *MSA Settlement Agreement* § IX (d)(2)(A)-(C). Maryland contends that this was a breach of the MSA agreement and the International Institute for Conflict Prevention & Resolution (CPR) ethical standards [16] by the Arbitration Panel that resulted in a process and standard that exposed Maryland to what it called a "bell curve"[17], leading to a determination of non-diligence; costing Maryland more than $55.9 million. Maryland contends that the excluded evidence was clearly relevant and material, because this was the type of evidence that the Panel considered as part of the objective factors in determining the enforcement of the remaining fifteen states. Further, Maryland argues that it had contractual expectations that the Panel would issue diligence determinations for the

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[16] *See CPR Rules for Non-Administered Arbitration (Nov. 1, 2007) Rule 19.4* (If the parties settle the dispute before an award is made, the Tribunal shall terminate the arbitration and *if requested by all the parties and accepted by the Tribunal* may record the settlement in the form of an award made *by consent of the parties*). *See also ABA/AAA Code of Ethics for Arbitrators in Commercial Disputes (Feb. 9, 2004)* Canon V ("In the event that all parties agree upon a settlement of issues in dispute and request the arbitrator to embody that agreement in an award, the arbitrator may do so....").

[17] During oral arguments, Maryland stressed that by allowing 20 of the 35 contested states to avoid diligence determinations pursuant to the Panel's Partial Settlement Award, Maryland was detrimentally graded "on a curve" as it was being compared to only stronger states, as arguably the weaker states now avoided diligence determinations entirely.

twenty "term sheet states," a significant reason for Maryland's initial participation in the nationwide arbitration.

The PMs direct this Court to the narrow standard for vacating an arbitral award under the Federal Arbitration Act, clearly a heavy burden to satisfy. Specifically, the PMs point out the standard to establish misconduct under 9 U.S.C §10(a)(3), the procedural error by the Panel must be in bad faith and otherwise so gross as to constitute affirmative misconduct. The PMs argue that Maryland was not deprived of a fundamentally fair hearing, i.e. the Arbitration Panel *never refused* to hear evidence, as Maryland never sought leave of the Panel to consider the diligence of the contested signatory states *for the purpose of determining Maryland 's own diligence*, or even attempt to submit the said evidence. Further, the PMs point out that the excluded comparative enforcement evidence of the contested "term sheet states" was not material; because the Panel conducted an objective determination of Maryland's diligence. And, since Maryland can only speculate that it was more diligent than the contested "term sheet states;" Maryland cannot allege any suffered "prejudice" in the arbitration proceedings.

This Court finds that Maryland never requested the Panel to consider the comparative non-diligence of the contested "term sheet states" for the purpose of determining Maryland 's own diligence.[18] Further, in

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[18] *See* Maryland's Motion to Compel Signatory States at 1–2 (Apr. 26, 2013) (arguing that purpose of this motion is to protect Maryland's ability to take the issue of inadequate compensation to its MSA court *if the Panel were to find Maryland non-*

review of the record, this Court finds no evidence that Maryland made any substantive argument to the Panel that the Panel needed to consider the enforcement record of the "term sheet states" when making diligence determinations for the non-settling states.[19] Accordingly, this Court cannot and does not find that the Panel refused to hear pertinent and material evidence under 9 U.S.C §10(a)(3).

Notwithstanding, assuming arguendo, that the Panel did refuse to hear pertinent and material evidence, Maryland fails to establish that the Arbitration Panel committed *any* misconduct, depriving Maryland of a fundamentally fair hearing. From the record, it is clear that the Panel's diligence determination focused on the objective standard and assessing diligence that was common to all states, and then applying that standard to *each State's individual enforcement record* for 2003. *See* 2003 Arbitration Award at 20–22; *Nat'l Post Office, et al. v. US. Postal Serv.*, 751 F.2d 834, 841 (6th Cir. 1985)

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diligent). Maryland clearly pointed out that it was *not arguing* the diligence or non-diligence of the "term sheet states" at this time. *Id*. at 4. This request was subsequently denied by the Panel for failure to show good cause.

[19] *See* Brief of the Majority States in Opposition to the Proposed Stipulated Partial Award at 20–21 (Feb. 22, 2013) (The non-settling states, including Maryland, requested the opportunity to protect their interests by challenging fellow State's diligence should the Panel decline to order that the "term sheet states" are subject to the 2003 NPM Adjustment). This request once again challenges the adequacy of the Settlement Award's judgment reduction in the event of Maryland's non-diligence determination; the non-settling states' preferred method for post-settlement reallocation was for the Panel to treat any contested Signatory State as non-diligent.

(stressing that an arbitrator is not required to hear *any and all evidence* that a party might wish to offer, regardless of its length, repetitiveness or irrelevance, when the record simply fails to demonstrate any arbitrary violation of a fair hearing). While the Panel did mention the escrow collection rates of other states in the Arbitration Award, this Court finds these references only to be illustrations of how the Panel was applying the objective standard and the feasibility of certain enforcement results. Further, this Court finds the Panel's determination to be solely focused on Maryland's own enforcement record of the qualifying statute for 2003, and notably absent in the Non-Diligence Award is any direct comparison of Maryland and any other contested state. See 2003 Arbitration Award at 18–22.

While Maryland argues that the "term sheet states'" comparative diligence is relevant; because Maryland was consequently graded "on a curve," this Court finds overwhelming evidence showing that the Panel made its determination, relying solely on Maryland's own enforcement record in 2003, which appears worse than the applicable standard, given the circumstances presented.[20] Even if some, most or all

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[20] Maryland relies on the *PMs filings* contesting the diligence findings of the twenty term sheet states prior to settlement; thus making the argument that the term sheet states were *most likely* to be found non-diligent. *Maryland Brief 34–39*. Nevertheless, this Court cannot find this to be conclusive evidence that the Panel was to independently find *all or most of* the contested term sheet states to be non-diligent, when the Panel disagreed with the PMs concerning the diligence of 9 out of the 15 contested non-settling states and when the Panel did not contest the diligence of two of the term sheet states.

of the "term sheet states" were less diligent than Maryland, from the facts there is no guarantee the Panel would have found Maryland to be diligent. This Court finds Maryland's arguments to be professionally creative; but flawed. There is no viable correlation between the Panel finding Maryland *objectively* non-diligent and the Panel's decision that all or most of the twenty "term sheet states" were less diligent or non- diligent in comparison. Therefore, this Court finds that Maryland has failed to meet the requisite burden under the Federal Arbitration Act to establish that the Panel engaged in misconduct, depriving Maryland of a fundamentally fair hearing, or that Maryland's rights were prejudiced by the 2003 Maryland Non-Diligence Arbitration Award pursuant to 9 U.S.C §10(a)(3).

Petition to Vacate or Appeal the Partial Settlement Award *Pro-Rata* Judgment

Pursuant to the Federal Arbitration Act, a party to arbitration maintains a *right to appeal* from an order[21], an interlocutory order granting, continuing, or modifying an injunction against an arbitration, or a final decision with respect to an arbitration that is subject to title 9 U.S.C § 16(1)(2)(3).[22] Further, a

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[21] The types of appealable orders include: (A) refusing a stay of an action under section 3 of this title, (B) denying a petition under section 4 of this title to order arbitration to proceed, (C) denying an application under section 206 of this title to compel arbitration, (D) confirming or denying confirmation of an award or partial award, or (E) modifying, correcting, or vacating an award. 9 U.S.C § 16(a).

[22] *Right of Review* – "All orders and other judicial determinations made by any court in connection with this Agreement or any Consent Decree shall be subject to all

party to arbitration may ask a court to issue an order *modifying or correcting* an award when there was evident material miscalculations of figures in the award; where the arbitrators have awarded upon a matter not submitted to them, unless it is a matter not affecting the merits of the decision upon the matter submitted; or where the award is imperfect in matter of form, not affecting the merits of the controversy.[23] 9 U.S.C § 11(a)(b)(c).

Maryland argues that it is entitled to an independent *de novo* appeal in this Court, their MSA Court - should this Court decide not to vacate the Partial Settlement Award under the Federal Arbitration Act. Specifically, Maryland argues that it is entitled to a *de novo* appeal to contest the adequacy of the *pro-rata* judgment reduction pursuant to the "appeal provision" in the Partial Settlement Award, which states:

> Should any non-signatory 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 signatory state's removal from the re-allocation pool, their relief, *if any*, is *by appeal to their individual MSA court*. The cut-off date for the inter-state suits set forth in the Panel's "no-contest" order, is not applicable in this procedure.

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available appellate review, and nothing in this Agreement or any Consent Decree shall be deemed to constitute a waiver of any right to any such review." MSA VII(d).

[23] The Maryland Uniform Arbitration Act provides the same grounds for modification or correction of an award.

Partial Settlement Award at 14. Maryland points out that the standard the Arbitration Panel articulated in the appeal provision i.e. a "good faith belief" that the *pro-rata* judgment reduction does not "adequately compensate" a state is inconsistent with any established grounds for vacatur under the Federal Arbitration Act. As a result, Maryland argues that the Panel knowingly provided non-settling states, including Maryland, a separate forum for relief of *de novo* appeal, independent of Maryland's petition for vacatur under the Federal Arbitration Act.

Conversely, the PMs argue that Maryland is not entitled to an independent *de novo* appeal; because the Arbitration Panel lacked the power under federal and/or state law to create an "appeal" independent of the Federal Arbitration Act standard or the contract language of MSA. And, the PMs contend the Panel's mention of any appeal language was simply a generic reference to the vacatur petition, instructing non-settling states that any objections to the Partial Settlement Award, after diligence determinations were issued, should be directed to a state's MSA Court. As a result, the PMs argue the appeal provision in the Partial Settlement Award addresses a non-settling state's *standing* to seek relief, *if any*, for vacating the award under the Federal Arbitration Act.

In review of the record, this Court finds no evidence in the language of the Partial Settlement Award to indicate that the Panel provided non-settling states, including Maryland, with an independent forum for relief, separate from the arbitration agreement; and not subject to the Federal

Arbitration Act standard of review.[24] While the Panel utilized the word "appeal" in the Partial Settlement Award, this Court does not find that the Panel in doing so established a "new standard" for contesting the *pro-rata* judgment reduction that is independent of the Federal Arbitration Act, or the limited enumerated appeal provisions, *supra*, set therein. On the other hand, this Court does find Maryland's arguments challenging the adequacy of the *pro-rata* judgment to squarely fall within Sections 10 (3) & (4) of the Federal Arbitration Act standard for vacating an award.[25] Accordingly, pursuant to §XI(c) of the MSA[26], this Court cannot and does not find Maryland entitled to the relief sought of *de novo* appeal, independent of the Federal Arbitration Act standard governing the arbitration proceeding. Notwithstanding, Maryland's petition seeking to vacate the Partial Settlement Award's *pro-*

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[24] *See Hall St. Associates, L.L.C. v. Mattel, Inc.*, 552 U.S. 576, 588 (2008) ("the grounds in the Federal Arbitration Act either for vacating, or for modifying or correcting an arbitration award constitute the *exclusive grounds* for expedited vacatur and modification of an award; state and federal courts cannot expand this scope of judicial review under the Federal Arbitration Act").

[25] (3) Where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or 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 (4) 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. 9 U.S.C.A. § 10 (b)(3)(4).

[26] "The arbitration shall be governed by the United States Federal Arbitration Act." MSA § XI(c).

rata reduction under the Federal Arbitration Act merits appropriate review.

Pursuant to the Federal Arbitration Act, a reviewing court shall vacate an arbitration award, if the arbitrators exceeded their powers due to an error in their construction of the agreement; or the arbitrators were guilty of misconduct or misbehavior by which the rights of any party have been prejudiced. 9 U.S.C. §10 (a)(3)(4); *Oxford Health Plans LLC v. Sutter*, 133 S. Ct. 2064, 2070 (2013). And, if the Arbitration Panel issues an award that simply reflects *its own notions of economic justice* rather than the essence of the contract; then a reviewing court may overturn its determination. *Id.* at 2068 (finding that §10(a)(4) "permits courts to vacate an arbitral decision only when the arbitrator strayed from his delegated task of interpreting a contract, not when he performed that task poorly"). However, an Arbitration Panel exceeds its powers, if its award is founded upon a mistaken assertion of jurisdiction. *Snyder v. Berliner Constr. Co. Inc.*, 79 Md. App. 29, 37 (1989); *see also Howsam v. Dean Witter Reynolds, Inc.*, 537 U.S. 79, 83 (2002).

Maryland argues that the Panel, in issuing the Partial Settlement Award, failed to abide with key contractual rights agreed upon in the MSA and ARA; prejudicing Maryland by shifting reallocated costs to Maryland and other non-settling states that were found non-diligent.[27] First, Maryland asserts that

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[27] In the alternative, Maryland asks this Court to vacate only the Partial Settlement Award's instruction to the Independent Auditor to treat the "term sheet states" as diligent for purposes of calculating Maryland's NPM Adjustment for 2003; thus

the Arbitration Panel, in failing to make diligence determinations, disregarded the plain contract language in §IX(d)(2)(B)–(C) of the MSA, directing the Panel to exempt from the NPM Adjustment "only those [MSA] states who enacted and diligently enforced the provisions of a qualifying statute during that calendar year." Second, Maryland asserts that the Panel erroneously established a new exception to the NPM Adjustment, one not found in the MSA, by directing the Independent Auditor to treat the "term sheet states" as if they had been found diligent and not subject to NPM Adjustment liability. Maryland argues that any such changes must be by an amendment to the MSA, and any amendment to the MSA must be made in writing and signed by *every party* affected pursuant to §XVIII(j) of the MSA, which was not done. Third, Maryland contends that the Panel failed to interpret the MSA by substituting a *pro-rata* judgment reduction premised on the law of damages liability, a law inapposite to the terms of the MSA and contract law principles.

Conversely, the PMs argue that Maryland fails to meet the narrow standard for vacating an arbitral award pursuant to the Federal Arbitration Act[28] and assert that the Arbitration Panel, relying on §XI(c) of the MSA, made a good faith determination of the

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eliminating the portion of the award that shifts to Maryland costs that should have been allocated to other states.

[28] "….whether the arbitrator failed to construe the contract *at all*….a good faith misinterpretation of the contract [if any] is never grounds for vacatur, because the arbitrator's construction holds, however good, bad, or ugly." *Oxford Health Plans LLC v. Sutter*, 133 S. Ct. 2064, 2068–71 (2013).

reallocation provision in the MSA, which the Panel clearly recognized, "does not directly speak to the process to be used when some states settle diligent enforcement and some do not." MSA §IX(d)(2)(B); Partial Settlement Award at 10–11. Further, the PMs argue that the Panel, in making its good faith interpretation of the MSA, on an issue not expressly addressed in the text, carefully reviewed established methods for reducing judgments, which led the Panel to conclude that the *pro-rata* method was most consistent with the MSA.

In the case subjudice, all parties concede that the MSA is silent on a procedure for reallocating the NPM adjustment among non-settling states when the diligence of "term sheet states" is no longer contested due to settlement. However, this Court finds the Partial Settlement Award and the NPM reallocation adjustment disputes do arise from the MSA; and are all clearly subject to the arbitration agreement and within the Panel's authority.[29] *United Steel, etc. Union v. Trimas Corp.*, 531 F.3d 531, 539 (7th Cir. 2008). Accordingly, this Court finds that the Panel did not lack jurisdiction, nor did it exceed its powers in interpreting the MSA and determining the

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[29] *State v. Philip Morris Inc.*, 179 Md. App. 140, 162 (2008); *see also Resolution of Disputes.* "Any dispute, controversy or claim arising *out of or relating to calculations performed by, or any determinations made by*, the independent auditor including without limitation, any dispute concerning the operation or application of any of the adjustments, reductions, offsets, carry-forwards and allocations described ...shall be submitted to binding arbitration before a panel of three neutral arbitrators, each of whom shall be a former Article III federal judge." MSA §XI(c).

appropriate method for reallocating the 2003 NPM Adjustment post-settlement.

Further, this Court finds the Panel's conclusion of the *pro-rata* method to be based on a reasonable analysis of the MSA and review of applicable judgment-reduction principles of contract law.[30] *See Partial Settlement Award* at 10. In review of the record, this Court finds that the Panel approached the question in the same manner as a "No Contest Decision," which led the Panel to decide, based on the text and function of the MSA reallocation provision, with diligence of the "term sheet states" no longer contested; the non-settling states subject to the 2003 NPM Adjustment were to receive a *pro-rata* reduction of liability rather than litigation-intensive fault liability. *See Partial Settlement Award* at 9–11. Specifically, the Panel found that the since the non-settling states were given the protection of the *pro-rata* method, the Stipulated Partial Agreement and Term Sheet Award could not prejudice or adversely affect those non-settling states. *See Partial Settlement Award* at 10 ("Where non-settling defendants are given the protection of the applicable judgment-reduction method required under contract law, they are *not prejudiced* by the partial agreement") (citing *In re Enron Corp. Secs., Deriv. & ERISA Litig., 2008 U.S. Dist. Lexis 48516 at 20*).

While Maryland argues that the Panel disregarded the plain language of the MSA, this Court finds this

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[30] The three standard methods for reducing judgment against non-settling defendants after a partial settlement are *pro-rata, proportionate fault, and pro-tanta. Partial Settlement Award* at 10.

argument to be without merit as the Panel did not and could not disregard the language of the MSA, as § IX(d)(2)(C)–(D) of the MSA is silent on the issue of the reallocation of the NPM Adjustment among non-settling states *where diligence is no longer contested due to settlement*. However, the Panel faced this same exact scenario when deciding the Partial Settlement Award i.e. how to reallocate the NPM Adjustment when some states settle diligent enforcement determination and other states do not.[31] This Court finds the Panel construed the language of the MSA and seriously considered various judgment reduction method-options available in making its determination. The Panel determined it to be more appropriate to apply the *pro-rata* method than any other method for reducing judgment against non-settling defendants, satisfying the Federal Arbitration Act standard. *See* MSA § IX(d)(2)(B); *Partial Settlement Award* at 10–11. This Court does not find any indication in the Panel's Award that the Panel was substituting its own notions of fairness and/or economic justice. Rather, the Panel was engaged in a good faith interpretation of the MSA and applicable law. Therefore, this Court finds that Maryland has failed to meet the requisite burden to establish that the Panel, in issuing the Partial Settlement Award, engaged in misconduct by failing to construe the MSA or by substituting its own notion

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[31] In the Agreement Regarding Arbitration (ARA), all parties agreed to reserve the question whether a non-diligent State's share should be reduced as a result of payment or consideration....in connection with the PMs notice that they are no longer contesting such State's diligent enforcement. ARA § 9(c).

of fairness and/or economic justice pursuant to 9 U.S.C. § 10(a)(3)(4).

Maryland's Petition to Compel State-Specific Arbitration for the Year 2014

Maryland seeks this Court to compel a state-specific arbitration on the issue of whether the PMs are entitled to a downward adjustment to their 2004 MSA payment.[32] The MSA arbitration provision states:

> Any dispute, controversy or claim arising out of or relating to calculations performed by, or any determinations made by, the Independent Auditor...shall be submitted to binding arbitration before a panel of three neutral arbitrators… *Each of the two sides to the dispute* shall select one arbitrator. The two arbitrators so selected shall select the third arbitrator.

Master Settlement Agreement § XI(c) (emphasis added). Maryland interprets this to mean that they are not required to submit to nationwide arbitration, because Maryland contends that there are more than two sides to the dispute. The PMs define the dispute as one side seeking an NPM Adjustment and the other opposing it, but Maryland argues that the MSA States cannot make up one side. Maryland's reasoning for this argument is three-fold: (1) that the

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[32] The determination at arbitration is whether or not Maryland diligently enforced an MSA "qualifying state" during 2004. Maryland's statute requires an NPM selling cigarettes in Maryland to make annual escrow deposits, for certain cigarettes sold during the year, on or before April 15 of the following year. *Md Code Ann., Bus. Reg. § 16-403.*

Panel did not make uniform decisions for each state; (2) that some of the facts and issues are individual to each state; and (3) the reallocation provision creates a situation where one state wins, the other state loses.

Courts frequently see cases where more than two parties are involved, commonality of interest outweighs the difference with multiple defendants, whose interests may be conflicting or even adverse to each other, on "one side" as party defendants.[33] Regardless of the perceived differences, the MSA States all share a common goal, including upholding the denial of the NPM Adjustment. The purpose of the arbitration is to determine whether the PMs are entitled to a downward adjustment, and all the MSA States would oppose that adjustment, the PMs would like to uphold it. Therefore, there are two sides to the dispute, i.e. MSA States in opposition to the downward adjustment, and the PMs. As the MSA Arbitration Provision requires, the two sides must select one arbitrator.

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[33] A useful analogy here is the certification of a class—while each class member might have facts specific to him or her, there can still be questions of law and fact common enough to the class to allow certification. *See, e.g. Philip Morris Inc. v. Angeletti*, 358 Md. 689, 734, 752 A.2d 200, 225 (2000) (which held that commonality "does not require that all, or even most issues be common, nor that common issues predominate, but only that common issues exist"); *Anne Arundel Cnty. v. Halle Dev., Inc.*, 408 Md. 539, 571–72, 971 A.2d 214, 233 (2009) (which held that having to determine the fees available for refund for each class member did not complicate the case so much that class decertification was warranted); *see, contra Cutler v. Wal-Mart Stores, Inc.*, 175 Md. App. 177, 193, 927 A.2d 1, 10 (2007) (where the class was not certified because of the possible existence of different implied contracts).

Maryland requests state-specific arbitration for the 2004 NPM Adjustment, primarily because it believes the arbitration of the 2003 NPM Adjustment was unfair. Maryland argues (1) that nationwide arbitration is not required as proven by the states' option to settle, and (2) the Panel was not equipped to handle such a large arbitration, which led to a three-year process and a ten-hour hearing that Maryland does not feel fully addressed the issues.[34] More importantly, Maryland argues that when it agreed to nationwide arbitration, it did so on the presumption that there would be thirty-five (35) other states participating; therefore, the arbitration that Maryland received was not what it had bargained for. Maryland agrees that the MSA must be interpreted to require arbitration, but asserts that there is an ambiguity in the MSA that allows for state-specific arbitration, and that this Court should compel state-specific arbitration in the interest of fairness.

The PMs disagree, arguing that what matters is that arbitration includes all of the MSA States that dispute the PMs' right to a downward adjustment; the "term sheet states" are not required to go to arbitration, because they no longer dispute the NPM Adjustment. The PMs contend that state-specific arbitrations would lead to up to thirty separate proceedings, which would be an unfair burden. In addition, the PMs suggest that there would have to be a provision for other states to intervene, further lengthening the process. The PMs also point out that

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[34] Maryland's estimate is that in a state-specific arbitration, filings could take place in three months, and the total time from discovery to resolution of issues could be one year.

Maryland did not dispute or challenge the amount of time allotted for argument at the time of arbitration.

While this Court sympathizes with Maryland's argument that the nationwide arbitration of the 2003 NPM Adjustment was not perfect and not what Maryland had expected, this Court cannot compel state-specific arbitration in violation of an unambiguous arbitration provision. The ability of some states to settle does not nullify the MSA Arbitration Provision, particularly when the remaining MSA States did not object to the Partial Settlement Award. Further, the Maryland Court of Special Appeals held that "the MSA's payment structure is nationwide and unitary...the present dispute must be resolved under one clear set of rules that apply with equal force to every settling state." *State v. Philip Morris Inc.*, 179 Md. App. 140, 162 (2008).[35] The only way for the payment structure to remain "nationwide and unitary," as intended, is for the arbitration itself to be nationwide and unitary, since the diligence determinations made at arbitration are directly tied to the reallocation provision.[36]

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[35] While not controlling, several other jurisdictions have reached this same conclusion. *See, e.g., McGraw v. Am. Tobacco Co.*, 224 W. Va. 211, 227, 681 S.E.2d 96, 112 (2009); *Indiana ex rel. Carter v. Philip Morris Tobacco Co.*, 879 N.E.2d 1212, 1219 (Ind. Ct. App. 2008); *Alabama ex rel. Riley v. Lorillard Tobacco Co.*, 1 So. 3d 1, 13 (Ala. 2008); *State of Missouri, ex rel. Jeremiah W Nixon v. The American Tobacco Company, et al.*, Cause No. 22972- 01465, Division No. 19 (2014).

[36] This Court finds merit in the PM-cited West Virginia case, where the Court held that, "both the structure and plain meaning of the MSA require a uniform determination of this

As discussed *supra*, the only reasonable interpretation of the MSA is that nationwide arbitration is required. The fact that Maryland intended to compete against more states or expected the arbitration process to go more favorably, cannot weigh into this Court's decision. *General Motors Acceptance Corp. v. Daniels*, 303 Md. 254, 261 (1985) ("[C]lear and unambiguous language of an agreement will not give away to what the parties thought that the agreement meant"). Therefore, Maryland's Petition for state-specific arbitration is denied.

CONCLUSION

For the reasons set forth *supra*, this Court finds that the Arbitration Panel's Non-Diligence Final Award and Stipulated Partial Settlement Award are hereby Affirmed pursuant to 9 U.S.C. §10(a)(3)(4). Further, Maryland's request for state-specific arbitration for the year 2014 is hereby Denied.

July 23, 2014

Judge's signature appears on the original of this document.

JUDGE ALFRED NANCE
Circuit Court for
Baltimore City

AN/sa
Court File

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issue due to the impact the determination relevant to one settling state will have upon all other settling states. Efficiency, logic and the plain meaning of the terms and structure of the MSA lead to the inescapable conclusion that all challenges to a diligent enforcement determination under the MSA are subject to arbitration before a single, nationwide, panel of three former Article III judges." *McGraw v. Am. Tobacco Co.*, 224 W. Va. 211, 227, 681 S.E.2d 96, 112 (2009).

APPENDIX C

PHILIP MORRIS, INC., et al.	*	**IN THE**
	*	
	*	**COURT OF APPEALS**
v.	*	**OF MARYLAND**
	*	
	*	**Petition Docket No. 493**
	*	**September Term, 2015**
	*	
STATE OF MARYLAND	*	**(No. 1256, Sept. Term,**
	*	**2014, Court of Special**
	*	**Appeals)**

O R D E R

Upon consideration of the petitions for a writ of certiorari to the Court of Special Appeals, the supplement, the conditional cross-petition and the answers filed thereto, in the above entitled case, it is

ORDERED, by the Court of Appeals of Maryland, that the petitions, the supplement and the conditional cross-petition be, and they are hereby, denied as there has been no showing that review by certiorari is desirable and in the public interest.

/s/ Mary Ellen Barbera
Chief Judge

* Judge McDonald did not participate in the consideration of this matter.

DATE: February 22, 2016

APPENDIX D

Hon. Fern M. Smith (Ret.)
JAMS
Two Embarcadero Center, Suite 1500
San Francisco, CA 94111
Telephone: (415) 982-5267
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ARBITRATOR

ARBITRATION

In the 2003 NPM Adjustment Proceedings	**JAMS Ref No. 1100053390** **STIPULATED PARTIAL SETTLEMENT AND AWARD**

The signatory Participating Manufacturers ("PMs") and 19 of the States and Territories that are parties to this Arbitration have agreed to a Term Sheet to settle their dispute concerning the 2003 NPM Adjustment. The Term Sheet is attached as Exhibit A to this Stipulated Partial Settlement and Award, including an addendum reflecting the parallel provisions that the Term Sheet requires for Subsequent Participating Manufacturers ("SPMs").

The States and Territories that have signed the Term Sheet are 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. This Stipulated Partial Settlement and Award refers to these States and Territories as "Signatory States" and to the PMs and the Signatory States collectively as the "Settling Parties."

32 of the States and Territories that are parties to this Arbitration have not signed the Term Sheet, and 27 of them have objected to the Term Sheet on a number of grounds. This Stipulated Partial Settlement and Award refers to the Settling States that have not signed the Term Sheet as Non-Signatory States and to the 27 States that have objected as Objecting States.

The Panel heard initial presentations from the Settling Parties and the Objecting States regarding the Term Sheet and the objections at a two-day status conference on January 22-23, 2013. At that conference, the Panel made clear that it would neither "approve" the Term Sheet nor mediate a settlement, but that it would consider entering a stipulated partial award. The Settling Parties then jointly submitted a proposed stipulated partial award to whose entry they agreed. The Panel has reviewed that proposed award, has reviewed extensive briefs and supporting materials filed by the Settling Parties and the Objecting States, and has heard argument on the issues at a hearing on March 7-8, 2013. The Panel now awards as follows.

I. *The Panel's Jurisdiction*

1. The Panel has jurisdiction to enter this Stipulated Partial Settlement and Award and to rule on the objections as part of its jurisdiction over the 2003 NPM Adjustment dispute. As the Panel has previously explained, its jurisdiction under Section XI(c) of the MSA and the court orders compelling arbitration includes "all issues 'related to'" the 2003 NPM Adjustment dispute, including, but not limited to, whether or not the States diligently enforced their Qualifying Statutes for the year 2003. Order Re: Jurisdictional Objections, at 7, 13 (Lexis ID #34056745).

2. The MSA provides that this arbitration is "governed by the . . . Federal Arbitration Act." MSA § XI(c). Once a dispute is committed to arbitration under the FAA, "the arbitrators normally have the authority to decide all matters necessary to dispose of the claim." *Ross Brothers Constr. Co. v. International Steel Servs.*, 283 F.3d 867, 875 (7th Cir. 2002); *see Ansari v. Qwest Commc'n Corp.*, 414 F.3d 1214, 1220-21 (10th Cir. 2005); *Shaw's Supermarkets, Inc. v. United Food & Commercial Workers*, 321 F.3d 251, 254 (1st Cir. 2003).

3. This includes authority to interpret and apply the parties' contract, to resolve any "issues relating to the substance of the dispute," and to decide "procedural questions ancillary to the substantive one." *United Paperworkers Int'l. Union v. Misco, Inc.*, 484 U.S. 29, 38 (1987); *Shaw's Supermarkets*, 321 F.3d at 254; *Nat'l Cas. Co. v. First State Ins. Grp.*, 430 F.3d 492, 499-500 (1st Cir. 2005). It also includes authority to determine the existence

or effect of a settlement of the dispute. *United Steel Workers Int'l Union v. TriMas Corp.*, 531 F.3d 531, 539 (7th Cir. 2008).

4. The Panel has jurisdiction to rule on the issues raised concerning the MSA reallocation provisions and to determine how the 2003 NPM Adjustment will be allocated among the Non-Signatory States in light of the settlement. These are issues that are a central part of the 2003 NPM Adjustment dispute before the Panel and that involve interpretation of the MSA. The Panel has previously resolved issues concerning the reallocation provisions in the related context of "no contest" determinations, and no party disputed that the Panel had jurisdiction to do so. Order Re: PMs' Motion For Clarification on No-Contest Issue, at 18 (Lexis ID #38479237) ("No-Contest Order"). The Panel's jurisdiction to interpret and determine the operation of the reallocation provisions is no less where a State is no longer contested because of a settlement.

5. The Panel also has jurisdiction to incorporate and direct the Independent Auditor to implement those provisions of the settlement that govern the amount and mechanism of monetary payments as among the Settling Parties, specifically the amounts to be received by the PMs and the Disputed Payments Account ("DPA") funds to be released. These are integral provisions to the Settling Parties' settlement of the 2003 NPM Adjustment dispute in this Arbitration. As these provisions would need to be applied and administered by the Independent Auditor, as the Objecting States object that the Independent Auditor may not implement them, and as the Panel has jurisdiction

under Section XI(c) of the MSA to give direction to the Independent Auditor, it falls within the Panel's authority to rule on the objections and to provide appropriate direction to the Independent Auditor so that the Settling Parties will know whether their settlement will be given effect.

6. That the direction to the Independent Auditor includes implementation of the referenced settlement provisions as they pertain to years beyond 2003 does not necessarily take the Panel beyond its jurisdiction. Parties frequently enter into settlements that cover more than the claim they are litigating or arbitrating at the moment. Tribunals have jurisdiction to issue orders approving or giving effect to such broader settlements even where they would lack jurisdiction to adjudicate the additional claims being resolved. *Abramson v. Pennwood Inv. Corp.*, 392 F.2d 759, 762 (2d Cir. 1968); *F.M. v. Palm Beach County*, 912 F. Supp. 514, 515 (S.D. Fla. 1995), *aff'd*, 84 F.3d 438 (11th Cir. 1996) (summary order). Such jurisdiction exists even in the class-action context, where courts are asked not only to formally "approve" the settlement but also to render it binding on absent class members. *Nottingham Partners v. Trans-Lux Corp.*, 925 F.2d 29, 34 (1st Cir. 1991); *In re Corrugated Container Antitrust Litig.*, 643 F.2d 195,221 (5th Cir. 1981).

7. Here, moreover, the Panel is not "approving" the Term Sheet, much less rendering it binding on absent class members. It is just giving effect to the Settling Parties' agreed settlement payments as among themselves, by directing the Independent Auditor to implement the settlement provisions at issue. In doing so, the Panel is not

assessing the merits of any NPM Adjustment dispute, including particularly questions of diligence or non-diligence for any years other than 2003. Instead, the Objecting States' objections to these settlement provisions are based on legal arguments regarding MSA interpretive issues that are the same as to 2003 as to subsequent years.

8. Finally, even if there any were question about the Panel's jurisdiction to give that direction as to post-2003 years, the Settling Parties can agree to give the Panel jurisdiction to do so, as long as the Panel concludes (as it has) that the direction to the Independent Auditor does not adversely affect the legal rights of the Non-Signatory States. The Settling Parties have informed the Panel that they confer the Panel with the jurisdiction necessary to enter this Stipulated Partial Settlement and Award and agree to the Panel's exercising such jurisdiction.

II. *Scope of Stipulated Partial Settlement and Award*

1. This Stipulated Partial Settlement and Award among the PMs and Signatory States resolves with finality the Settling Parties' dispute concerning the 2003 NPM Adjustment and certain subsequent years as to limited issues and provides direction to the Independent Auditor concerning releases from the DPA and amounts to be received by the PMs pursuant to the settlement.

2. This Stipulated Partial Settlement and Award is limited to: (a) incorporating the provisions of the Term Sheet that govern the amount and mechanism of monetary payments (amounts to be received by the PMs and the DPA funds to be

released) as among the Settling Parties;[1] (b) directing the Independent Auditor to implement those provisions; (c) ruling how the 2003 NPM Adjustment will be allocated in light of the settlement among the Non-Signatory States that did not diligently enforce a Qualifying Statute during 2003; and (d) ruling on the objections raised by the Objecting States.

III. *Directions To The Independent Auditor*

1. The Independent Auditor is directed to implement the provisions of the Term Sheet incorporated in Section II above.

2. In implementing those provisions, the Independent Auditor will order the release of funds from the DPA as described in the Term Sheet and specified below, and allocate the released funds as described in the Term Sheet and specified below. In so doing, the Independent Auditor will ensure that the Non-Signatory States' aggregate Allocable Share of both the NPM Adjustment funds now in the DPA (principal and earnings) and the additional amounts to be paid into the DPA under the first sentence of Paragraph 5 of Appendix A to the Term Sheet remains in the DPA. The Independent Auditor will also apply the amounts to be received by the PMs as described in the Term Sheet and specified below. In so doing, the Independent Auditor will ensure that no part of those amounts are allocated to the Non-Signatory States.

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[1] These are Term Sheet §§ I, II, III.B.1, III.B.3-4, III.C.1, IV.A, IV.H, IV.I, IV.J.3, IV.K, Appendix A and the SPM addendum to the Term Sheet.

3. The Independent Auditor will, in performing the duties under Paragraphs 1-2 above, (a) order the release of the funds in the DPA as provided by Paragraphs 5-7 of Appendix A to the Term Sheet, (b) allocate those released DPA funds solely among the Signatory States in the manner provided by Paragraph 6 of Appendix A to the Term Sheet and as they direct, (c) apply the amounts the PMs are to receive under § I of the Term Sheet and Paragraphs 1-3 and 7-8 of Appendix A to the Term Sheet and allocate those amounts among the PMs as they direct, (d) allocate those amounts solely among the Signatory States as they direct in the manner provided by § I.B of the Term Sheet and Paragraphs 4 and 6 of Appendix A to the Term Sheet, (e) apply the amounts the PMs are to receive under §§ II, III.B and III.C of the Term Sheet, allocate those amounts among the PMs as they direct, and allocate those amounts solely among the Signatory States in the manner provided by those provisions, and (f) make all calculations and determinations required of it under the provisions of the Term Sheet incorporated in Section II of this Stipulated Partial Settlement and Award. These directions apply as to the parallel provisions for SPMs in the SPM addendum to the Term Sheet.

4. Based on the current Signatory States, the Independent Auditor's performance of the above requirements in connection with the April 2013 MSA payment will include:

(a) ordering that [$1,760,176,204.21] NPM Adjustment funds (plus the accumulated earnings thereon) be released from the DPA and that [$2,483,161,178.12] NPM Adjustment funds (plus the

accumulated earnings thereon) will remain in the DPA. These amounts are based upon payment into the DPA of the amounts required to be paid under the first sentence of Paragraph 5 of Appendix A to the Term Sheet and are subject to each Signatory State's right under Paragraph 5 of Appendix A to the Term Sheet to defer the release of its DPA funds;[2]

(b) allocating the amount released solely among the Signatory States as they direct, except for $10 million that will be allocated to the Data Clearinghouse as provided by § I.A.3 of the Term Sheet;

(c) applying a credit of [$815,937,317.90] to the Original Participating Manufacturers' ("OPMs") MSA payment due on April 15, 2013[3] and allocating that credit among the OPMs as they direct; and

(d) allocating that credit solely among the Signatory States as they direct in the manner provided by Paragraph 4 of the Appendix A to the Term Sheet.

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[2] [The numbers in this Paragraph 4 and Paragraph 6 below are subject to verification by the parties and Independent Auditor as being consistent with the provisions of Paragraphs 2-3, as the Independent Auditor has broader access to the relevant data, including the precise amount of NPM Adjustment funds in the DPA. The numbers are also subject to change if additional parties join the settlement.]

[3] Parallel credits for the SPMs are included in the SPM Appendix attached hereto. [Note: The amounts in Paragraph 4(c) and the SPM Appendix assume that the 2012 NPM Adjustment is identical to the 2011 NPM Adjustment and will need to be revised once the Independent Auditor calculates the actual 2012 NPM Adjustment in the upcoming weeks.]

(e) These instructions would be subject to change if additional States join the settlement. The Independent Auditor will act in accordance with Paragraphs 2-3 and the provisions of the Term Sheet referenced in Section II of this Stipulated Partial Settlement and Award in implementing the Stipulated Partial Settlement and Award as to MSA payments after April 2013 and as to the SPMs' MSA payments due on April 15, 2013.

5. There are NPM Adjustment amounts that are not yet in the DPA because the PMs' right to pay them into the DPA has not yet accrued: for example, the 2010-2012 NPM Adjustments for the OPMs, the 2012 NPM Adjustment for SPMs, and the NPM Adjustments for subsequent years for all PMs. The Term Sheet provides that the Signatory States' Allocable Shares of these amounts will not be held in the DPA, except as provided in § IV.A of the Term Sheet with respect to NPM Adjustments for 2015 and subsequent years. Unless the second exception in § IV.A of the Term Sheet applies, the Independent Auditor will instruct the PMs to deposit the Signatory States' Allocable Shares of these amounts into the DPA and will then promptly order the release of those Shares allocated as follows: (a) with respect to the 2010-14 NPM Adjustments, in the manner provided by Paragraph 6(ii) of Appendix A to the Term Sheet or as the Signatory States direct; and (b) with respect to the NPM Adjustments for 2015 and subsequent years, among the Signatory States and PMs in the manner provided by §§ IV.A and IV.J.3 of the Term Sheet, and (in the case of funds released to the Signatory States) as the Signatory States direct and (in the case of funds released to the

PMs) as the PMs direct. If a PM also pays the Non-Signatory States' Allocable Shares of its portion of an NPM Adjustment covered by this Paragraph into the DPA, the Independent Auditor will ensure that only the Signatory States' aggregate Allocable Share of the amount deposited is released and that the Non-Signatory States' aggregate Allocable Share of the amount deposited remains in the DPA.

6. The Independent Auditor's performance of the requirements of Paragraph 5 in connection with the April 2013 MSA payment will include: (a) instructing the OPMs to deposit into the DPA the Signatory States' Allocable Shares of the 2010 NPM Adjustment for the OPMs, which based on the current Signatory States equals [$322,970,319.02]; (b) promptly ordering the release of that amount allocated among the Signatory States in the manner provided by Paragraph 6(ii) of Appendix A to the Term Sheet or as the Signatory States direct; and (c) if an OPM also pays the Non-Signatory States' Allocable Shares of its portion of the 2010 NPM Adjustment into the DPA, ensuring that only the Signatory States' aggregate Allocable Share of the amount deposited is released and that the Non-Signatory States' aggregate Allocable Share of the amount deposited remains in the DPA. These instructions would be subject to change if additional States join the settlement. The Independent Auditor will act in accordance with Paragraph 5 as to the SPMs in connection with the April 2013 MSA payment.

IV. *Operation of MSA Reallocation Provisions*

1. In light of the settlement, the 2003 NPM Adjustment will be allocated among the Non-Signatory States as follows. The dollar amount of the 2003 NPM Adjustment will be reduced by a percentage equal to the aggregate Allocable Shares of the Signatory States as of the date of the Panel's Final Award (as of the date of this Stipulated Partial Settlement and Award, that percentage is 41.9964405%). The Independent Auditor will treat the Signatory States as not subject to the 2003 NPM Adjustment for purposes of Section IX(d)(2)(B)-(C) of the MSA. The Signatory States' shares of the 2003 NPM Adjustment, as that Adjustment amount is reduced as provided above, 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 Non-Signatory States that did not diligently enforce a Qualifying Statute during 2003 as provided in those provisions. The maximum portion of the 2003 NPM Adjustment that can be applied to a Non-Signatory State remains as provided by Section IX(d)(2)(D) of the MSA.

2. This judgment reduction is appropriate and adequate under the MSA and governing law. Where multiple parties have a potential shared contractual obligation and some of them settle and some do not, the non-settling parties cannot necessarily block the settlement, but may be entitled to a judgment reduction. The "three standard methods for reducing judgment against non-settling defendants after a partial settlement" are "*pro rata* (court divides the amount of the total judgment by the number of settling and non-settling defendants, regardless of

each defendant's culpability), proportionate fault (after a partial settlement and trial of the nonsettling defendants, the jury determines the relative culpability of all the defendants and the non-settling defendant pays a commensurate percentage of the total judgment), and *pro tanto* (the court reduces the non-settling defendant's liability for the judgment against him by the amount previously paid by the settling defendants, without regard to proportionate fault)." *In re Enron Corp. Secs., Deriv. & ERISA Litig.*, 2008 U.S. Dist. Lexis 48516, at *20-21 (S.D. Tex. 2008); *see In re Masters Mates & Pilots Pens. Pl. Litig.*, 957 F.2d 1020, 1028 (2d Cir. 1992); *In re Jiffy Lube Secs. Litig.*, 927 F.2d 155, 160-61 & n.3 (4th Cir. 1991).

3. Where non-settling defendants are given the protection of the applicable judgment-reduction method required under the contract and law, they are not prejudiced by the partial settlement. *See*, *e.g.*, *Enron*, 2008 U.S. Dist. Lexis 48516, at *60-61; *Eichenholtz v. Brennan*, 52 F.3d 478, 486-87 (3d Cir. 1996).

4. Under Paragraph 1, the Non-Signatory States receive the *pro rata* reduction, under which the dollar amount of the 2003 NPM Adjustment will be reduced by a percentage equal to the aggregate Allocable Shares of the Signatory States. Construing the parties' contract, the Panel concludes that the MSA reallocation provisions indicate that the *pro rata* method is appropriate. These provisions use the specific term "*pro rata*," stating that the shares of diligent States are to be "reallocated among all other Settling States *pro rata* in proportion to their respective Allocable Shares." MSA § IX(d)(2)(C)

(emphasis added); *see also* MSA § IX(d)(2)(D) ("pro rata in proportion to their respective Allocable Shares"). More fundamentally, the MSA also provides that the reallocation is not done on a relative fault basis. The amount of a diligent State's share that is reallocated is its *pro rata* share of the whole, not an amount derived from its particular fault level. Likewise, the amount of reallocated share that a non-diligent State receives is derived from its *pro rata* share of the liable States, not its fault level. If the reallocation of diligent States' shares is done on a *pro rata* basis in this way, the Panel reads the MSA as likewise meaning that a judgment reduction arising from some States' settlement of the diligent enforcement issue should be *pro rata* as well.

V. *Objections of Objecting States*

1. The Objecting States contend that the Term Sheet violates their rights under the MSA. While no party has claimed that the Term Sheet is not a good faith settlement, the Objecting States object to a number of its provisions, including the provisions for release of DPA funds and its lack of terms addressing how the reallocation provisions of the MSA (§§ IX(d)(2) and IX(d)(4)) would apply to the Signatory States' Allocable Shares of the NPM Adjustment. The Objecting States claim the Term Sheet's DPA provisions and its potential effect on the reallocation provisions adversely affect them. They also claim that these and other Term Sheet provisions constitute an amendment to the MSA that would require their consent under MSA § XVIII(j).

2. After reviewing the Objecting States' arguments and submissions, the Panel concludes that

the objections are not grounds that bar entry of the Stipulated Partial Settlement and Award or that otherwise bar the Settling Parties from proceeding with the settlement pursuant to the Term Sheet.

3. The "general rule . . . is that a non-settling party does not have standing to object to a settlement between other parties." *Jamie S. v. Milwaukee Pub. Schs.*, 668 F.3d 481, 501 (7th Cir. 2012). Non-settling parties have standing only if they allege the settlement creates "plain legal prejudice" to their rights. That standard is satisfied, for example, where the non-settling parties allege that the settlement strips them of a legal claim or cause of action. Importantly, however, that standard is not satisfied where the non-settling parties instead allege merely that the settlement denies them special benefits or imposes practical disadvantages on them. *See*, *e.g.*, *id.*; *In re Integra Realty Resources, Inc.*, 262 F.3d 1089, 1102-03 (10th Cir. 2001); *In re Vitamins Antitrust Class Actions*, 215 F.3d 26, 28-31 (D.C. Cir. 2000); *Agretti v. ANR Freight Sys., Inc.*, 982 F.2d 242, 246-48 (7th Cir. 1992).

4. The Panel concludes that the Stipulated Partial Settlement and Award and the Term Sheet do not legally prejudice or adversely affect the Non-Signatory States. The Panel reasons as follows:

DPA. It is undisputed that, under the MSA, the PMs have the right of first recovery for NPM Adjustment funds in the DPA. *See* Order re: Transfers From DPA, at 2 (Lexis ID #37754064); *see also* MSA §§ XI(f)(2), XI(i)(l)(B). Under the Term Sheet, the PMs have waived that right for the Signatory States, allowing the Signatory States to

recover their Allocable Share of those DPA funds. *See* Term Sheet Appendix ¶¶ 5-6.

The PMs' limited DPA waiver for the Signatory States in no way prejudices the Non-Signatory States, legally or otherwise. The Non-Signatory States have no entitlement to the favorable treatment that the PMs have afforded the Signatory States as part of the consideration for settling their dispute. Nor will that favorable treatment harm the Non-Signatory States. They have failed to demonstrate any reasonable likelihood that they will recover less from the DPA than they would have recovered absent the settlement. Moreover, the PMs have expressly committed that, if any Non-Signatory State ever later demonstrates that it is at risk of recovering less from the DPA than it would have recovered from the DPA absent the settlement, the PMs will allow that State to recover the extra amount from the DPA and will themselves recover any resulting unpaid share of the NPM Adjustment through an appropriate credit against the next year's annual payment.

Reallocation. The operation of the MSA reallocation provisions with respect to the 2003 NPM Adjustment will be as provided in Section IV. As described in Section IV, this provides the Non-Signatory States with appropriate and adequate protection under the MSA and the law from potential prejudice arising from the settlement's removal of the Signatory States from further contribution towards the 2003 NPM Adjustment.

The Panel does not agree with the Objecting States' contention that all Signatory States must be treated as non-diligent for purposes of the 2003 NPM

Adjustment. There is no basis in the facts to assume that every Signatory State was non-diligent in 2003. Moreover, the Objecting States' position does not reflect any of the three standard methods of judgment reduction. Such an assumption would produce a considerably larger reduction in the Non-Signatory States' potential obligations than any of the standard methods. It is also contrary to the underlying principle of judgment reduction that, because a settlement is not tantamount to an admission of liability, settling defendants are not regarded as necessarily culpable or liable.

The Objecting States argue that the MSA reallocation provisions must be wholly inapplicable to a State's share unless there is an actual determination that the State was diligent. They claim that any approach by which any State's share is otherwise subject to reallocation is an "amendment" to the MSA requiring their consent. But the MSA does not directly speak as to the process to be used when some States settle diligent enforcement and some do not. It is thus within the Panel's jurisdiction to interpret the contract in light of governing law to determine what the appropriate process and judgment reduction is where there is a partial settlement of diligent enforcement involving fewer than all of the States. *United Paperworkers*, 484 U.S. at 38. There is thus no "amendment" to the MSA in the Panel doing so. 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 Signatory State's removal from the re-allocation pool, their relief, if any, is by appeal to their individual MSA court. The cut-

off date for inter-state suits set forth in the Panel's "no contest" order, is not applicable to such procedure.

Other objections. None of the Term Sheet's provisions imposes new legal obligations on the Non-Signatory States or deprives those States of existing legal rights. Thus, to the extent that the Objecting States object to the Term Sheet in other respects than those discussed above, the Panel hereby concludes that the Objecting States have not suffered "plain legal prejudice" from and are not adversely affected by the Term Sheet.

6. Neither this Stipulated Partial Settlement and Award nor the Term Sheet constitutes an amendment to the MSA that requires the consent of any Non-Signatory States under MSA § XVIII(j). As a threshold matter, the Term Sheet is not an "amendment" of the MSA at all. Rather, it is a *settlement* of disputes that have arisen under the MSA as written, which does not address the procedures to be used should partial settlements take place. In any event, even if an amendment were involved, the MSA provides that it only must be signed by "all Participating Manufacturers affected by the amendment and by all Settling States affected by the amendment." MSA § XVIII(j). The Panel construes the term "affected by" to mean "materially prejudiced by." For the reasons discussed above, none of the Term Sheet's provisions "affect" the Non-Signatory States within the meaning of the contract. The only States bound by any terms in the Term Sheet are the Signatory States, i.e. the ones that have signed it, including, but not limited to, definitional changes regarding "Units Sold" or other terms in the MSA.

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VI. *Conclusion*

This Stipulated Partial Settlement and Award is entered on the Panel's understanding based on the representation of the Settling Parties that: (a) the second sentence of § IV.F of the Term Sheet regarding Panel oversight of the documentation process is not operative and (b) this Stipulated Partial Settlement and Award satisfies the condition in § IV.E.2 of the Term Sheet regarding a Panel order as to the Term Sheet, such that the Term Sheet is now binding on all signatories.[4]

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[4] As of this date, the Participating Manufacturers that are signatories to the Term Sheet are: Philip Morris USA Inc., RJ. Reynolds Tobacco Co., Lorillard Tobacco Co., Commonwealth Brands, Inc., Compania Industrial de Tabacos Monte Paz, S.A., Daughters & Ryan, Inc., Ets L Lacroix Fils S.A. (Belgium), Farmer's Tobacco Co. of Cynthiana, Inc., House of Prince A/S, Imperial Tobacco Limited/ITL (UK), Imperial Tobacco Mullingar (Ireland), Imperial Tobacco Polska S.A. (Poland), Imperial

SO ORDERED.

Dated: March 12, 2013

___s/William G. Bassler___
The Honorable William G. Bassler Arbitrator

_____s/Abner J. Mikva_____
The Honorable Abner J. Mikva Arbitrator

s/ Fern M. Smith
The Honorable Fern M. Smith
Chairperson

Tobacco Production Ukraine, Imperial Tobacco Sigara ve Tutunculuk Sanayi Ve Ticaret S.A. (Turkey), Japan Tobacco International U.S.A., Inc., King Maker Marketing, Inc., Kretek International, Liggett Group LLC, Lignum-2, Inc., OOO Tabaksfacrik Reemtsma Wolga (Russia), Peter Stokkebye Tobaksfabrik A/S, Premier Manufacturing, Inc., P.T. Djarum, Reemtsma Cigarettenfacbriken GmbH (Reemtsma), Santa Fe Natural Tobacco Company, Inc., Scandinavian Tobacco Group Lane Ltd (formerly Lane Limited), Sherman 1400 Broadway N.Y.C., Inc., Societe National d'Exploitation Industrielle des Tabacs et Allumettes (SEITA), Top Tobacco, L.P., Van Nelle Tabak Nederland B.V. (Netherlands), Vector Tobacco Inc., Von Eicken Group.

SPM APPENDIX

As directed by section III, paragraphs (2) and (3), of the Stipulated Partial Award, amounts to be credited to SPMs' April 15, 2013 payments are:[1]

Commonwealth Brands, Inc.	$16,817,216
Compania Industrial de Tabacos Monte Paz, S.A.	$156,667
Daughters & Ryan, Inc.	$57,811
House of Prince A/S	$979,764
Japan Tobacco International U.S.A., Inc.	$1,632,410
King Maker Marketing, Inc.	$1,723,694
Kretek International	$255,848
Lane Limited	$175,007
Lignum-2, Inc.	$388,979
Peter Stokkebye Tobaksfabrik A/S	$297,081
Premier Manufacturing, Inc.	$1,332,213
P.T. Djarum	$893,022
Reemtsma Cigarettenfabriken GmbH (Reemtsma)	$60
Santa Fe Natural Tobacco	$2,405,747

[1] Note: The amounts in this Appendix assume that the 2012 NPM Adjustment is identical to the 2011 NPM Adjustment and will need to be revised once the Independent Auditor calculates the actual 2012 NPM Adjustment. The numbers in this Appendix remain subject to verification. These numbers would be subject to change if the identity of the Signatory States changes.

Company, Inc.	
Sherman 1400 Broadway N.Y.C., Inc.	$250,061
Top Tobacco, L.P.	$2,832,749
U.S. Flue-Cured Tobacco Growers, Inc.	$676,935
Von Eicken Group	$27,963

Some SPMs do not have an MSA payment due in 2013 sufficient to absorb the credit listed above. The Auditor shall permit any such SPM to carry forward its credit to April 15, 2013 payments for use in future years. Alternatively, if such SPM and any other PM jointly notify the Independent Auditor that the credit to be applied in 2013 has been transferred from the SPM to the other PM (the "transferee PM"), the Auditor shall credit the amount otherwise due the SPM with respect to its April 15, 2013 above to the transferee PM.

EXHIBIT A TO
STIPULATED PARTIAL SETTLEMENT
AND AWARD

November 14, 2012

TERM SHEET

I. ACCRUED CLAIMS FOR 2003 TO 2011 AND 2012 NPM ADJUSTMENT

Accrued claims relating to the NPM Adjustment disputes for 2003 to 2011 and the 2012 NPM Adjustment would be handled as follows:

A. The basic methodology from the August 2010 MOU would be retained, with the following adjustments:

1. All amounts related to the 2010, 2011 and 2012 NPM Adjustments would be added to the terms of the settlement.

2. The settlement value would be increased from 29.5% to a percentage ranging from 37.5% to 46%. The applicable percentage within that range depends on the aggregate Allocable Share of the signatory Settling States as follows:

Aggregate Allocable Share	*Settlement Value Percentage*
80% or more	37.5%
75-79.9%	38.5%
70-74.9%	39.5%
65-69.9%	40.5%
60-64.9%	42.5%
55-59.9%	44.5%
50-54.9%	46%

Appendix A sets forth the reference date for determining the aggregate Allocable Share and the increased settlement value applicable to States that sign this Term Sheet after December 14, 2012 (or, in the case of States with December hearing dates, after the start of their hearing).

3. The amount contributed to fund the Data Clearinghouse would be reduced from $20,000,000 to $10,000,000.

B. The signatory Settling States would allocate the settlement amounts (either the application of the credits to the PMs or the receipt of amounts released from the DPA, or both) among themselves so as to fully compensate those signatory Settling States whose diligent enforcement for 2003 was uncontested for their share of the 2003 NPM Adjustment, plus interest.

C. These provisions would be implemented as provided in Appendix A.

II. TRANSITION

A. There will be a two-year transition period covering sales years 2013-2014 during which the revised NPM Adjustment will operate as follows.

B. The revised adjustment for non-SET-paid sales under Section III.C will not apply for those years. The revised adjustment for SET-paid sales under Section III.B will apply for those years, except for the final sentence of Section III.B.2.c and the tribal tax clause of footnote 1.

C. In addition, for each of those years, the signatory PMs will receive the amounts detailed in Section II.A.3 of the MOU, except that the percentage in (a) of that Section will be 25% and the Market Share Loss referred to in (a)-(d) of that Section will be the 2011 Market Share Loss.

III. NPM ADJUSTMENT FOR SUBSEQUENT YEARS

A. The terms of the MOU would be abandoned and replaced with the adjustments outlined herein.

B. SET-Paid NPM Sales[1]

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[1] SET includes state cigarette excise tax or other state tax on the distribution or sale of cigarettes (other than a state or local sales tax that is applicable to consumer products generally and is not in lieu of an excise tax), and, for NPM cigarettes sold after 2014, an excise or other tax imposed by a state- or federally-recognized tribe on the distribution or sale of cigarettes. Except if otherwise indicated, references to "NPM sales," "NPM cigarettes" and "NPM volume" in this Term Sheet refer to NPM

1. *Adjustment*. Each year, an adjustment will be applied to a signatory Settling State's share of the OPMs' MSA Payment equal to the adjustment amount for each non-compliant NPM cigarette on which SET is paid in the state. The adjustment amount will be three times the per-cigarette escrow deposit rate in the Model Escrow Statute for the year of the sale, including the inflation adjustment in the statute. There will be a proportional adjustment for each signatory SPM in proportion to the size of its MSA payment for that year.
2. *Meaning of non-compliant NPM cigarettes*. Non-compliant NPM cigarettes are SET-paid NPM cigarettes as to which escrow was (i) not deposited at the Escrow Statute rate or (ii) released or refunded except as provided in the Escrow Statute as amended by Allocable Share Repeal. The term non-compliant NPM cigarettes does not include:
    a. cigarettes on which the escrow was deposited at the statutory rate by either: (i) the NPM or any other entity liable for such payments under the laws of the individual signatory Settling State, or (ii) a person or entity in the distribution chain on behalf of such NPM or other entity liable for such payments under such laws, so long as such state did not release or refund any part of the deposit,

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Cigarettes, with the term "Cigarette" having the meaning given in the MSA.

unless released pursuant to the terms of the Escrow Statute, as amended by Allocable Share Repeal;

b. cigarettes on which a signatory Settling State recovered at the statutory rate on an escrow bond posted pursuant to the laws of that state, so long as such state did not release or refund any part of the deposit so recovered, unless released pursuant to the terms of the Escrow Statute, as amended by Allocable Share Repeal;

c. cigarettes as to which the state is barred from requiring escrow deposits from all entities liable for such payments under its individual state law, and from recovery on a remaining escrow bond, by an automatic stay or subsequent order in a federal bankruptcy proceeding or by order of a court of competent jurisdiction that requiring escrow deposits is barred by federal or state constitutional law (other than state constitutional provisions added or amended after the signature date of this document or state constitutional law as it may impact or be applied in relation to sovereign immunity or other Native American issues) or federal statutory or common law, so long as: (i) the state opposes and appeals the stay or order,[2] and (ii) the

[2] Subject to any limitation arising from Rule 11 or similar state ethical rules.

NPM and brand at issue were properly on the state's approved-for-sale directory, either in accordance with the terms of Complementary Legislation or pursuant to the order of a court of competent jurisdiction barring removal of the NPM or brand from that directory, within 30 days prior to the time of sale. This paragraph only applies to signatory Settling States that have requirements in effect that the NPM in question post a bond in at least the amount described in section 17(b) of the Appendix to the MOU and that importers are jointly and severally liable for escrow deposits due from an NPM with respect to NPM cigarettes that they import; or

d. SET-paid NPM cigarettes sold after 2014 in a signatory Settling State on which escrow was timely deposited in an amount equal to or greater than the Escrow Statute rate, but as to which the State releases a portion of such amount not to exceed 50% of the Escrow Statute rate pursuant to a tribal compact to a federally recognized tribe (or tribe that was recognized by that State as of January 1, 2012) with a reservation in that State where each of the following is true: (i) the release occurs no earlier than one year after the deposit is made, (ii) the cigarettes on which the escrow is released were sold in retail transactions to consumers on that tribe's reservation,

(iii) the money released is provided to the tribe itself and used solely for public safety on such tribe's reservation and/or social services for tribal members (e.g., health care, education) and not for any function that could directly or indirectly promote or reduce the costs of cigarette production, marketing or sales, (iv) the money released is not used in any way for the benefit of an NPM or to facilitate NPM sales, (v) the compact makes the requirements of Section IV.L applicable to the tribe, and the tribe is in conformity with such requirements, and (vi) the State has amended its Escrow Statute to remove the NPM's right to reversion and interest as to (but only as to) the escrow to be released in conformity with the above requirements.[3] Provided, however, that (i) a signatory Settling State may not release more than $1 million in escrow

[3] This paragraph applies only with respect to cigarettes of NPMs that existed in the U.S. market as of June 1, 2012 and does not apply with respect to cigarettes of NPMs that entered the U.S. market after that date. In addition, this paragraph does not apply where any NPM involved in the production, distribution or sale of the cigarettes at issue is one (or an affiliate or successor of one) affiliated with the tribe (or any members of the tribe) to which the escrow would be released. For purposes of this paragraph, a tribe with reservation land located in more than one State is considered to have a reservation in, and to be eligible for release of escrow from, only the State in which the largest portion of its reservation land is located.

as described in this paragraph in any year to all tribes collectively; and (ii) in the event a court strikes down a signatory Settling State's removal of the NPMs' right to reversion and interest described in (vi) above, such State may pay to tribes the amounts authorized under the remainder of this paragraph out of its general fund (subject to all other conditions and limits set forth above). A State that releases escrow as described in this paragraph has the responsibility of ensuring that (i)-(vi) and the terms of the preceding sentence are met.

3. *Safe Harbor*. No adjustments under this section will be applied to a signatory Settling State for any year in which the state demonstrated (a) that escrow was deposited on at least 96% of all NPM cigarettes sold in the state during that year on which SET was paid in the state, or (b) that the number of SET-paid NPM cigarettes sold in the state during that year on which escrow was not deposited did not exceed 2 million cigarettes.

4. *Timing*. The adjustment amount with respect to a signatory Settling State will be applied to that state's share of the signatory PMs' next annual MSA Payment. If a stay or order, as referenced *supra*, is reversed or otherwise becomes no longer operative and escrow is not then deposited on the cigarettes at issue, the adjustment on those

cigarettes will be applied to that state's share of the signatory PMs' next annual MSA Payment unless a further stay or order is entered. Adjustment amounts applied to a state's share will be subject to appropriate repayments by the signatory PMs if escrow is deposited on the cigarettes at issue after application of the adjustment.

5. *Process*. The process will be as specified in Sections II.B.5 and IV.B of the MOU. The final settlement agreement will include provisions as to communication of information to the Data Clearinghouse.

C. Non-SET-Paid NPM Sales

1. Non-SET-Paid NPM Sales would be handled as to the signatory Settling States per the terms of the MSA, with the following adjustments:

   a. The total NPM Adjustment liability (if any) of each signatory Settling State under the original formula for a year would be reduced by a percentage. The percentage would equal the sum of (i) the percentage represented by the fraction of the total SET-paid NPM volume in the MSA States divided by nationwide FET-paid NPM volume for that year;[4] plus (ii) in the case of a

[4] The total SET-paid NPM volume in the MSA States will be calculated as follows. SET-paid NPM volume in a signatory Settling State will be the number of SET-paid NPM sales in that State in that year as determined through the process described in Section III.B.5. SET-paid NPM volume in a non-

signatory Settling State that has, as of January 1 of the year at issue, executed documentation approving the PSS amendment, the percentage represented by the fraction of (x) the total equity-fee-paid NPM sales in those PSS that had in effect for the entire year at issue an NPM equity fee law that, by its terms, imposed a per-pack fee equal to or greater than 90% of the escrow rate for sales made that year under the Escrow Statute on all cigarette sales in such state that it has the authority under federal law to tax, divided by (y) nationwide FET-paid NPM volume. [5]

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signatory Settling State will be NPM sales in that State in that year on which the State's cigarette excise tax was paid (or on which another state tax on the distribution or sale of cigarettes or an excise or other tax imposed by a tribe was paid if that State in that year treated NPM sales on which such tax was paid as fully subject to the escrow requirement under that State's Escrow Statute). For a non-signatory Settling State, such volume will be as reported by that State under the Significant Factor procedures agreement (or other agreement among the parties as to the Significant Factor issue for that year), provided that any signatory PM or signatory Settling State may challenge that reported volume in the arbitration referenced in Sections III.C.4 and IV.J.1 as an inaccurate measure of the volume described in the preceding sentence. In the event of such a challenge, the arbitration panel's determination of the volume will be final and binding on all signatory PMs and signatory Settling States. References to "FET" include arbitrios de cigarillos in Puerto Rico.

[5] The final settlement agreement will include provisions addressing how the information for calculating the total equity-fee-paid NPM sales in each such PSS will be obtained. The

b. The liability reduction under paragraph (a) would be effectuated by each signatory Settling State that is found non-diligent and allocated a share of the NPM Adjustment amount receiving a reimbursement by the signatory PMs through the methodology detailed in Paragraph 3(a) of the Agreement Regarding Arbitration.

2. The Diligent Enforcement standard applies to all FET-paid NPM sales that the State reasonably could have known about and on which such State has the authority under federal law to tax or collect escrow, including (i) all such sales made via the

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current fee laws in MS and MN will be deemed to meet the requirements of clause (x) even though they otherwise would not so long as the per pack amount in effect under them remains at least as large as it is now. The signatory PMs further agree to the following: (i) the signatory OPMs agree to support the enactment in FL and TX of legislation meeting the requirements of clause (x) provided that such legislation is not in conjunction with any other legislative proposal and does not contain any provision that applies to the OPMs or their products or businesses; (ii) if the PSS amendment has become effective, the signatory SPMs agree not to oppose the enactment in FL and TX of legislation meeting the requirements of clause (x) provided that such legislation is not in conjunction with any other legislative proposal; and (iii) if a signatory PM supports the enactment in FL or TX of an equity fee law that does not meet the requirements of clause (x) and such law is enacted, the law will be deemed to meet the requirements of clause (x) as to that signatory PM (and, if enactment of the law was supported by signatory PMs with more than 60% Market Share, the law will be deemed to meet the requirements of clause (x) as to all signatory PMs).

Internet, (ii) all such tribal sales or sales on tribal lands, and (iii) all such sales that may otherwise constitute contraband.[6]

3. Factors relevant to the Diligent Enforcement determination include, but are not limited to: (i) whether the number of NPM sales in the State that were SET-paid and addressed under Section III.B was reduced by virtue of a policy or agreement not to require/collect SET or enforce an SET stamping requirement, or an indifference to SET collection or to enforcement of an SET stamping requirement; and/or (ii) whether the actual number of SET-paid NPM sales in the State during that year was significantly greater than the number of such sales addressed under Section III.B.[7]

4. The signatory Settling States agree that diligent enforcement will be determined as to them in a single arbitration each year. Future arbitrations under this Term Sheet would be governed by the arbitration terms outlined within the MOU, except to the extent necessary for a future merged

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[6] The following are exempt from the Diligent Enforcement standard: (i) NPM cigarette sales on a federal installation in a transaction that is exempt from state taxation under federal law, and (ii) NPM cigarette sales on a tribe's reservation by an entity owned and operated by that tribe or member of that tribe to a consumer who is an adult member of that tribe in a transaction that is exempt from state taxation under federal law.

[7] A finding referenced in (ii) will not increase the adjustment applicable to the State under Section III.B or the reduction under Section III.C.1(a)(i).

arbitration to proceed as described in Section IV.J.1 below.

5. The signatory Settling States and the PMs will continue to discuss in good faith on an ongoing basis whether there are other actions that they can reasonably take to prevent non-SET-paid NPM sales.

IV. OTHER TERMS

A. *Withholding/Disputed Payment Accounts.* Except as provided in Section J below, the PMs will not withhold or pay into the DPA based on a dispute arising out of the revised NPM Adjustment, except if the dispute was noticed for arbitration by the PM over one year prior to the payment date and the arbitration has not begun despite good faith efforts by the PM.

B. *Most Favored Nations.* The MFN clause provided within the MOU would be retained.

C. *RYO.* Those terms relating to RYO in the MOU as to applying the SET-paid sales provision to RYO would be retained (i.e., it applies if tax other than SET is paid, and whether or not the state law requires that the containers be stamped). The signatory Settling States and the signatory PMs will continue to discuss in good faith on an ongoing basis the issues of pipe tobacco being sold for use as RYO and of cigarette rolling machines being located at retail establishments and clubs.

D. *Office.* Those terms of the MOU designating an office within each signatory Settling State

as a point-of-contact on tobacco-related matters would be retained.

E. *Conditions of Settlement*. The terms of this Term Sheet are conditioned upon: (1) joinder by a critical mass of PMs and a critical mass of Settling States by December 14, 2012; and (2) approval of this Term Sheet's terms by the Arbitration Panel. On December 17, 2012, each party that has signed this Term Sheet will determine, in each party's sole discretion, whether a critical mass of PMs and Settling States have joined such that it will proceed with the settlement, provided that the signatory PMs agree that a critical mass of Settling States will have joined if the aggregate Allocable Share of the Settling States that sign this Term Sheet by December 14, 2012 and determine to proceed with the settlement on December 17, 2012 is 50% or more and such States include the States that participated directly in the drafting of this Term Sheet (AZ, AR, CA, MI, NE, NV, TN). If the settlement proceeds, additional Settling States and PMs may join the settlement following December 14, 2012 by signing this Term Sheet or the final settlement agreement up to the end date of the last individual State diligent enforcement hearing in the 2003 Arbitration, although they will have different payment obligations or payment rights as detailed in Appendix A. Settling States may join the settlement after the end date of the last individual State diligent enforcement hearing in the 2003 Arbitration if the

signatory PMs, in their sole discretion, agree. PMs may join the settlement after the end date of the last individual State diligent enforcement hearing in the 2003 Arbitration if the signatory Settling States, in their sole discretion, agree.

F. *Settlement Agreement*. The parties will cooperate in the drafting and execution of a comprehensive final settlement agreement incorporating the terms of this Term Sheet, as well as all other customary terms and conditions acceptable to the parties. The documentation process will be subject to the oversight of the Arbitration Panel. Pending the execution of the final settlement agreement, this Term Sheet is binding on all signatories provided the conditions of Section IV.E are met.

G. *Necessary legislation*. All signatory Settling States must have the Escrow Statute, Complementary Legislation and Allocable Share Repeal in full force and effect. A signatory Settling State that does not currently have Allocable Share Repeal in full force and effect will have until the end of 2013 to put it into full force and effect. If it does not do so, starting with NPM cigarettes sold in 2014, NPM cigarettes on which that State releases escrow that would not be released under Allocable Share Repeal will be treated as non-compliant NPM cigarettes under Section II.B.

H. *Significant Factor*. The signatory Settling States agree that the significant factor condition to the NPM Adjustment is no longer operative as to them. Beginning for 2022, no NPM Adjustment will be applicable to the signatory Settling States for any year in which NPM Market Share is 3% or less.[8]

I. *Profit Adjustment*. The final settlement agreement will include appropriate provisions ensuring that the OPMs will not be subject to a profit adjustment under Section B(ii) of Exhibit E arising from payments under Sections I-II being concentrated or recognized in less than 10 years.

J. *Relation with non-joining States*. If there are Settling States that are not signatory Settling States and the parties agree to proceed with the settlement:

1. The parties will cooperate in merging the arbitration under Section III.C.4 for a year with the diligent enforcement arbitration under Section XI(c) of the MSA as to non-joining States for that year.

2. The 2015 arbitration under Section III.C will not commence until the 2015 diligent enforcement arbitration begins as to non-joining States. The provisions of Section

[8] This Section does not affect the calculation of the amount of the NPM Adjustment under the MSA or this Term Sheet applicable to the signatory Settling States for any year in which NPM Market Share is greater than 3%.

III.B will continue to apply on the schedule described in that Section.

3. In the interim, the signatory Settling States and the PMs will split the amounts at issue under III.C for 2015 and each subsequent year on a 50-50 basis, subject to repayment without interest by the PMs or credit without interest by the signatory Settling States after the arbitration for that year concludes. No more than 1 year would be subject to repayment or credit in any one year.

4. Notwithstanding the above, the PMs would have the right to commence the 2015 arbitration under Section III.C as to the signatory Settling States in advance of the above schedule if the volume of non-SET-paid NPM sales exceeds 9 billion cigarettes in each of any two years. After the first such year, the PMs and signatory Settling States would discuss measures that could be taken to avoid such sales. Notwithstanding the above, the signatory Settling States would have the right to commence the 2015 arbitration under Section III.C. as to the PMs in advance of the above schedule if the volume of non-SET-paid NPM sales is less than 2 billion cigarettes in each of any two years. Any early commencement under this paragraph requires the unanimous approval of the signatory members of the side seeking early commencement.

K. *Cap of MSA payment*. A signatory Settling State may not be subject to a total NPM Adjustment under this Term Sheet for a year in excess of its total MSA payment for that year.

L. *Taxes*. If a signatory Settling State has a law, regulation, systematic policy, compact or agreement with respect to taxes (applicability, amount, collection or refund) or stamping that is different for any NPM cigarettes than any PM cigarettes or a law, regulation, systematic policy, compact or agreement with respect to stamping that does not set forth specific requirements regarding when and what stamps are required, the law, regulation, systematic policy, compact or agreement will be relevant to the Diligent Enforcement determination.[9] In addition, if the difference between NPM and PM cigarettes with respect to taxes or stamping is material, the reduction in liability described in Section III.C. 1(a)(i) will not be applied with respect to that State (if found non-exempt from the NPM Adjustment) for a year in which the difference is in effect.

M. *Additional Legislation*. If requested by a signatory Settling State, the PMs will support

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[9] This does not include (i) taxes or stamping requirements that differ for reservation sales and non-reservation sales provided that the taxes and stamping requirements applicable to reservation and non-reservation sales respectively are the same for both PM and NPM sales, or (ii) requirements that NPM cigarettes bear a stamp of a different color solely for purposes of identification.

the enactment of legislation, provided that such legislation is not in conjunction with any other legislative proposal and contains no deviation of substance from the model language referred to below, which: (i) permits the release of taxpayer-confidential information to the Data Clearinghouse for the purpose of fulfilling its responsibilities under the settlement; (ii) imposes the bonding requirement described in Section III.B.2.c above, (iii) imposes the joint-and-several liability requirement described in Section III.B.2.c above, (iv) modifies the Escrow Statute in a manner consistent with Section III.C.2-3 above with respect to the subjects described in those Sections, and/or (v) permits a compact meeting the conditions described in Section III.B.2.d above and modifies the Escrow Statute in the manner described in Section III.B.2.d(vi) above. The final settlement agreement will include model language for the above modifications (including appropriate severability language) that signatory Settling States may choose, at their option, to use, and the PMs agree that the model language (or language containing no material deviation of substance from it) will not affect the status of a signatory Settling State's Escrow Statute as a Qualifying or Model Statute or any prior agreement to that effect. In addition, if requested by a signatory Settling State, the PMs will not oppose the Model Legislation set forth in Appendix A to the MOU. The signatory Settling States and

the signatory PMs will continue to discuss in good faith on an ongoing basis support for other appropriate legislative enactments that would enhance enforcement of and/or improve compliance with the escrow requirement and for legislation prohibiting or limiting the sale of cigarettes to any consumer who is not in the physical presence of the seller at the time of sale.

N. *Potential New Participating Manufacturers*. Subject to the condition specified in the last sentence of this section, the PMs agree to waive rights under Section XVIII(b) of the MSA as to NPMs signing the MSA and becoming a Participating Manufacturer without making back-payments for sales in prior years that would otherwise be required under Section II(jj) of the MSA and/or without making full escrow deposits on such prior sales, provided that the following conditions are met: (i) the NPM signs the MSA within 120 days of the execution of the final settlement agreement; (ii) the NPM turns over the full amount on deposit in its existing escrow accounts to the Settling States; (iii) all other MSA terms are applicable to the NPM and the NPM waives any claim of immunity from enforcement of its MSA obligations; (iv) the NPM agrees to the other customary terms and conditions, apart from back-payments and escrow deposits, that the States have required for new Participating Manufacturers (including quarterly payments and de-listing); and (v) the NPM agrees that substantial non-

compliance with its MSA obligations during the first five years after joining the MSA in the absence of a good-faith dispute would trigger the back-payment obligations that would otherwise have been required of it. The PMs do not waive rights under Section XVIII(b) of the MSA as to a new Participating Manufacturer's performance of its MSA obligations going forward. This section is conditioned upon the delivery to the PMs within 60 days of the execution of the final settlement agreement a binding agreement executed by all Settling States and the Foundation that NPMs that sign the MSA pursuant to this provision without making full back-payments will not be considered Participating Manufacturers for purposes of Section IX(e) of the MSA.[10]

O. *Release of Escrow*. Except pursuant to the unanimous consent of the signatory PMs, signatory Settling States will not release or refund escrow deposited for the resolved years 1999-2012 or transition years 2013-2014 except to a State or as provided in the Escrow Statute as amended by Allocable Share Repeal. Any release or refund of escrow deposited for subsequent years will be addressed as provided in Section III.B for SET-paid NPM sales and as provided in Section III.C and the Diligent

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[10] This provision does not apply to any entity that had previously agreed to sign the MSA and to make any back-payments. The PMs retain their rights under Section XVIII(b) of the MSA as to any such entity.

Enforcement standard for non-SET-paid NPM sales.

APPENDIX A:

1. The OPMs receive a total amount equal to (a) the aggregate Allocated Settlement Percentage of the signatory Settling States multiplied by $6.52 billion; and (b) the aggregate Allocated Settlement Percentage of the signatory Settling States multiplied by the OPMs' full 2010-12 NPM Adjustments. Each signatory Settling State's Allocated Settlement Percentage equals the product of its Allocable Share percentage and the applicable settlement value percentage under Paragraph 2.[11]

2. (A) For Settling States that sign this Term Sheet by 6:00 P.M. PST on the initial sign-on date and determine to proceed with the settlement on December 17, 2012, the applicable settlement value percentage is that reflected in the grid below, with the aggregate Allocable Share being the aggregate Allocable Share of the Settling States that sign this Term Sheet by the Reference Date and proceed with the settlement:

Aggregate Allocable Share	*Settlement Value Percentage*
80% or more	37.5%
75-79.9%	38.5%
70-74.9%	39.5%
65-69.9%	40.5%
60-64.9%	42.5%

[11] References to a State's "Allocable Share" percentage in this Term Sheet are to the percentage set forth for that State as listed in Exhibit A of the MSA.

55-59.9%	44.5%
50-54.9%	46%

Except as provided below, the initial sign-on date is December 14, 2012. For Settling States whose individual State diligent enforcement hearing in the 2003 Arbitration is scheduled to begin in December 2012 (WA, AZ and CO), the initial sign-on date is the day preceding the beginning of its hearing unless the beginning of its hearing is deferred until after December 14, 2012. At the present time, WA and AZ have agreed to such deferral, and their initial sign-on date will be December 14, 2012 so long as the Panel approves the deferral.

(B) For Settling States that sign this Term Sheet (or, in the case of Settling States that do not sign this Term Sheet, the final settlement agreement) after the initial sign-on date, the applicable settlement value percentage is 59%. The signatory PMs, in their sole discretion, may waive all or part of the increase above the applicable settlement value percentage under subparagraph (A) as to such a State without triggering the MFN clause in this Term Sheet and without any obligation to provide a similar waiver to any other State.[12]

(C) The Reference Date is December 21, 2012. A Settling State that signs this Term Sheet after the initial sign-on date but by the

[12] Approval by signatory PMs representing at least 85% Market Share in 2011 will be sufficient for this waiver and will bind the remaining signatory PMs.

Reference Date will be counted as part of the aggregate Allocable Share under subparagraph (A) whether or not the signatory PMs waived the increased percentage applicable to such State under subparagraph (B).

3. (A) The amount under Paragraph 1 will be provided by the OPMs receiving credits reflecting the total amount specified in Paragraph 1 (the "Total OPM Amount"). Subject to Section IV.I, the credits will be applied as follows: (i) 50% of the Total OPM Amount as a credit against the OPMs' MSA annual payment due in April 2013; and (ii) a [___]% reduction in the OPMs' MSA annual payment under Section IX(c)(l) of the MSA due in each of April 2014-2017, plus interest on the amount of each reduction (except as provided in the accompanying footnote) at the Prime Rate calculated from April 15, 2013.[13]

   (B) The amount of the percentage in subparagraph (A)(ii) will be the percentage that, when applied to the OPMs' estimated MSA annual payments due in April 2014-2017 (the estimate being after the Inflation Adjustment, Volume Adjustment and Previously Settled States Reduction, but before the remaining adjustments, reductions and offsets under the MSA), yields a total reduction equal to 50% of the Total OPM Amount. (For

[13] Interest will only be paid on the portion of each reduction that exceeds 20% of the signatory Settling States' aggregate Allocable Share of amounts previously withheld by an OPM and paid into the DPA pursuant to Paragraph 5.

example, if 50% of the Total OPM Amount were $1 billion and the OPMs' estimated MSA annual payments for 2014-2017 (as adjusted as specified above) were $5 billion per year, the percentage in subparagraph (A)(ii) would be 5%.) The percentage will be filled in with respect to the MSA annual payment due in April 2014 pursuant to these specifications as of the Reference Date (once the Total OPM Amount is known), subject to change in the event additional Settling States sign this Term Sheet or the final settlement agreement after the Reference Date. With respect to each of the reductions to the MSA annual payments due in April 2015-2017, the percentage will be recalculated annually on October 15 of the year prior to the year the payment is due (for example, on October 15, 2014 for the MSA annual payment due in April 2015) to reflect the percentage that, when applied to an estimate of the OPMs' next annual payment based upon inflation and volume in the first 9 months of the year prior to the year the payment is due, yields a reduction equal to 12.5% of the Total OPM Amount.[14]

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[14] The reductions to be applied in 2014-2017 do not count in calculating the NPM Adjustment or toward the cap in Section IV.K (the final settlement agreement will include provisions addressing how the OPMs will receive the funds at issue if such a State does not have a sufficient MSA payment remaining in any such year to apply the reductions due that year). In addition, the final settlement agreement will include provisions regarding the accrual of the reductions.

(C) The final settlement agreement will include provisions that will apply in the event the Total OPM Amount increases after the Auditor's Final Calculation of the MSA annual payment due on April 15, 2013 as a result of increased State participation after that date and that specify how the increased part of that Amount will be provided to the OPMs. Unless the parties agree otherwise, those provisions will be consistent with the principles of this Appendix, including providing for payment of 50% of the increased part of that Amount by first-available credit and of the remaining 50% by reduction.

(D) Each credit and reduction will be allocated among the OPMs as directed by the OPMs.

4. The credit and reductions under Paragraph 3 will be allocated solely among the signatory Settling States and will not be allocated to the Allocated Payment of any non-signatory Settling State. Except as provided in Section I.B or as may be agreed upon by the parties in the final settlement agreement, the credit and each of the reductions will be allocated among the signatory Settling States in proportion to their respective Shares. A signatory Settling State's "Share" means the percentage yielded by dividing its Allocated Settlement Percentage by the aggregate Allocated

Settlement Percentages of all signatory Settling States.[15]

5. Any OPM that withheld amounts with respect to an NPM Adjustment will pay that amount into the DPA by seven days after approval of this Term Sheet's terms by the Arbitration Panel. Each OPM that paid amounts attributed to the 2003, 2004, 2006, 2007, 2008 or 2009 NPM Adjustments into the DPA (including previously withheld amounts paid into the DPA pursuant to the preceding sentence) will, as of the date it receives confirmation from the Independent Auditor that it will apply all of the credits and reductions described in Paragraphs 1-3 and allocate them as described in Paragraphs 4

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[15] Subject to the limits specified below, a signatory Settling State that signs this Term Sheet by the Reference Date may elect, by notice to the parties no later than the Reference Date, for its Share of the Total OPM Amount to be applied entirely as a credit against the OPMs' MSA annual payment due in April 2013. In that event, the overall amounts of the respective credit and reductions under Paragraph 3 will not change, but the credit and reductions will be allocated among the signatory Settling States differently so that (i) each electing State is allocated a portion of the April 2013 credit equal to its Share of the Total OPM Amount and is allocated none of the 2014-2017 reductions, and (ii) each other signatory Settling State is allocated a lower portion of the April 2013 credit and a corresponding higher portion of each of the 2014-2017 reductions as necessary to fulfill the provisions of Paragraph 4. Unless the OPMs agree otherwise, the election right will not be available if it would result in a profit adjustment under Section B(ii) of Exhibit E of the MSA or if it is not possible to apply the preceding sentence because too many signatory Settling States have already sought to make that election.

and 6, instruct the Escrow Agent and the Independent Auditor to release to the signatory Settling States from the DPA an amount equal to the total amounts attributed to such NPM Adjustments (plus the accumulated earnings thereon) multiplied by the aggregate Allocable Share percentage of the signatory Settling States, less amounts allocated to the Data Clearinghouse per Section I.A.3 above. Individual signatory Settling States may choose to have their DPA releases spread over 2013-2017. This would not affect any credits, adjustments or other calculations.

6. The signatory Settling States and OPMs will jointly instruct the Escrow Agent and Independent Auditor: (i) to apply all of the credits and reductions described in Paragraphs 1-3, and to allocate them among the OPMs as described in Paragraph 3 and solely among the signatory Settling States as described in Paragraph 4; and (ii) to allocate the amount released from the DPA under Paragraph 5 solely among the signatory Settling States in proportion to their respective Allocable Shares, except for those amounts allocated to the Data Clearinghouse.

7. There will be parallel provisions for SPMs so that each signatory SPM receives the same (*i.e.*, no greater) relative payment amounts on the same general timetable and makes the same relative releases (including amounts paid into the DPA attributed to the 2010-11 NPM Adjustments) through an equivalent process.

8. The remaining methodology in the August 2010 MOU would be retained, including as to SPMs that withheld funds (including in excess of their total payment amounts under this Term Sheet), SPMs that are not current on their undisputed or adjudicated MSA payment amounts or that expressly waived or assigned Adjustment claims, and late-joining Settling States or PMs. Late-joining Settling States would be eligible to join subject to the provisions of Section IV.E, but their payment amount would be as provided in Paragraph 2. Any late-joining OPM will be treated in the same manner as a late-joining SPM was to have been treated under the August 2010 MOU. A PM or Settling State that signs this Term Sheet after the initial sign-on date (for PMs, 6:00 P.M. PST on December 14, 2012; for States, as provided in Paragraph 2) will be considered late-joining, provided that, in the case of a late-joining Settling State, the signatory PMs may waive all or part of the increased payment from that State as provided in Paragraph 2.

SPM ADDENDUM

The following reflects the parties' agreement as to the parallel provisions under Paragraph 7 of Appendix A with respect to the individual SPMs listed in Exhibit A hereto.[1]

1. Each listed SPM will receive a total amount equal to (a) the aggregate Allocated Settlement Percentage of the signatory Settling States multiplied by the amount listed for that SPM in the attached Exhibit A; and (b) the aggregate Allocated Settlement Percentage of the signatory Settling States multiplied by that SPM's full 2010-12 NPM Adjustments.

2. Each listed SPM that paid amounts attributed to any of the 2003, 2004 or 2006-2011 NPM Adjustments into the DPA, will, as of the date it receives confirmation from the Independent Auditor that it will apply all of the credits, payments, and reductions described in Paragraph 4 below (or in the case of Liggett and Vector, Paragraph 5 below) and allocate them consistent with Paragraphs 4 and 6 of Appendix A and Paragraph 3 below, instruct the Escrow Agent and the Independent Auditor to release to the signatory Settling States from the DPA an amount equal to the total amounts attributed to such NPM Adjustments (plus the accumulated earnings thereon) multiplied by the aggregate Allocable Share percentage of the signatory Settling States.

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[1] The definitions in the Term Sheet and Appendix A apply to this Addendum. References to Appendix A are to Appendix A to the Term Sheet.

3. The parallel provisions to Paragraphs 4 and 6 of Appendix A will include provisions for instructions to the Escrow Agent and Independent Auditor (i) to apply all of the credits, payments, and reductions described in Paragraphs 4 and 5 below and to allocate them solely among the signatory Settling States; (ii) to allocate amounts paid or released by each SPM solely among the signatory Settling States; and (iii) to recognize and apply the provisions regarding carryforward and transfer of credits described in footnote 2 below.

4. The amount under Paragraph 1 will be provided by each listed SPM (except for Liggett and Vector) receiving credits reflecting the total amount specified for that SPM in Paragraph 1 in one of the following three ways:

(i) the SPM receiving its full amount under Paragraph 1 as a credit against its MSA annual payment under Section IX(c)(l) of the MSA due in April 2013;

(ii) the SPM receiving (a) 50% of its amount under Paragraph 1 as a credit against its MSA annual payment under Section IX(c)(l) of the MSA due in April 2013; and (b) a [___]% reduction in its MSA annual payment under Section IX(c)(l) of the MSA due in each of April 2014-2017, plus interest on the amount of each reduction at the Prime Rate calculated from April 15, 2013; or

(iii) the SPM receiving (a) 30% of its amount under Paragraph 1 as a credit against its MSA annual payment under Section IX(c)(l) of the MSA due in April 2013, and (b) a [___]% reduction in the SPM's MSA annual payment under Section IX(c)(1) of the

MSA due in each of April 2014-2016, plus interest on the amount of each reduction for the years 2014, 2015, and 2016 at the Prime Rate calculated from April 15, 2013.

(iv) The option in subparagraph (iii) is available only if enough listed SPMs have selected options (i) or (ii) above such that, in combination with the amounts that would be credited in 2013 under subparagraph (iii)(a), at least 50% of the aggregate amounts due to all listed SPMs under Paragraph 1 are credited in 2013. For purposes of this calculation, the amounts for Liggett and Vector under Paragraph 1 will be deemed credited in 2013, although those amounts will be conferred as provided in Paragraph 5 below.

(v) The percentages in subparagraphs (ii) and (iii) will be the percentage that, when applied to the listed SPM's estimated MSA annual payments due in April 2014-2017 (in the case of subparagraph (ii)) or April 2014-2016 (in the case of subparagraph (iii)), in each case with the estimate being after the Inflation Adjustment and Volume Adjustment but before the remaining adjustments, reductions and offsets under the MSA, yields a total reduction equal to 50% of the amount due the listed SPM under Paragraph 1 (in the case of subparagraph (ii)) or 70% of the amount due the listed SPM under Paragraph 1 (in the case of subparagraph (iii)). The percentages will be filled in with respect to the MSA annual payment due in April 2014 pursuant to these specifications as of the Reference Date (once the amount due the listed SPM under Paragraph 1 is known), subject to change in the event additional Settling States sign this Term

Sheet or the final settlement agreement after the Reference Date. With respect to each of the reductions to the MSA annual payments due after April 2014, the percentage will be recalculated annually on October 15 of the year prior to the year the payment is due (for example, on October 15, 2014 for the MSA annual payment due in April 2015) to reflect the percentage that, when applied to an estimate of the listed SPM's next annual payment based upon inflation and volume in the first 9 months of the year prior to the year the payment is due, yields a reduction equal to 12.5% of the amount due the listed SPM under Paragraph 1 (in the case of subparagraph (ii)) or 23.3333333% of the amount due the listed SPM under Paragraph 1 (in the case of subparagraph (iii)).[2]

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[2] The reductions to be applied in 2014-2017 do not count in calculating the NPM Adjustment or toward the cap in Section IV.K (the final settlement agreement will include provisions addressing how the SPMs will receive the funds at issue if such a State does not have a sufficient MSA payment remaining in any such year to apply the reductions due that year). In addition, the final settlement agreement will include provisions regarding the accrual of the reductions. A listed SPM that has no MSA payment obligation in 2013 against which the credit under Paragraph 4 due in 2013 may be applied, or whose MSA payment obligation for 2013 is less than the amount of the credit to which it is entitled that year under Paragraph 4 may, if it chooses, carry the unused portion of the credit forward and apply it in future years or may transfer the unused portion of the credit to another PM that may apply such credit against its own payment. An SPM that is not current on its undisputed or adjudicated payment obligations under the MSA or any amendment to the MSA, or that has been delisted by any State as of August 31, 2012 for failure to generally perform its MSA

5. With respect to Liggett and Vector, which withheld certain funds, the amount under Paragraph 1 will be handled pursuant to this Paragraph. Liggett and Vector will receive no credit against their MSA payments and instead will receive the benefit of the settlement and address previously withheld amounts for the 2004-2010 adjustments as follows. No later than April 15, 2013, each of those companies will pay to the signatory Settling States the excess of (a) $44,098,572 (for Liggett) or $2,624,625 (for Vector) multiplied by the aggregate Allocable Share percentage of the signatory Settling States; over (b) the amount to which that company is entitled under Paragraph 1; plus (c) 12.8090288% of $27,185,288 (for Liggett) or $1,834,639 (for Vector) multiplied by the aggregate Allocable Share percentage of the signatory Settling States. Following these payments, the amount Liggett and Vector have withheld with respect to NPM Adjustments shall be reduced by $44,098,572 (for Liggett) and $2,624,625 (for Vector) multiplied by the aggregate Allocable Share percentage of the signatory Settling States, plus the amount of all accrued interest on those amounts, reflecting the settlement between Liggett and Vector and the Signatory States with respect to those States'

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financial obligations when due, shall (in addition to treatment specified under the term sheet and Appendix A) not be entitled to carry the unused portion of the credit forward or transfer it to another PM, and any amounts to be received by such an SPM under the Term Sheet, and any amounts transferred to it under this footnote, will be applied to its unpaid obligations and will not otherwise be credited to that SPM except to the extent such amounts exceed the signatory Settling States' aggregate Allocable Share of such unpaid obligations.

Allocable Share of the NPM Adjustment claims. With respect to the 2003, 2007 (for Vector), 2011, and 2012 NPM Adjustments, Liggett and Vector will be governed by Paragraph 2.

6. With respect to Farmers Tobacco Company of Cynthiana, Inc., which withheld certain funds, the amount under Paragraph 1 will be handled pursuant to this Paragraph. Farmers Tobacco will receive no credit against its MSA payments and instead will receive the benefit of the settlement and address previously withheld amounts for the 2003-2009 adjustments as follows. No later than April 15, 2013, Farmers Tobacco will pay to the signatory Settling States the excess of (a) $20,028,552 multiplied by the aggregate Allocable Share percentage of the signatory Settling States; over (b) the amount to which Farmers Tobacco is entitled under Paragraph 1. Following these payments, the amount Farmers Tobacco has withheld with respect to NPM Adjustments shall be reduced by $20,028,552 multiplied by the aggregate Allocable Share percentage of the signatory Settling States, plus the amount of all accrued interest on those amounts, reflecting the settlement between Farmers Tobacco and the Signatory States with respect to those States' Allocable Share of the NPM Adjustment claims. (The amount for Farmers Tobacco in Exhibit A referenced in Paragraph l(a) is not multiplied by 112.8090288%.)[16]

7. The final settlement agreement will include provisions that will apply in the event the amounts

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[16] The numbers in Exhibit A and Paragraphs 5 and 6 remain subject to verification.

due the SPMs under Paragraph 1 increase after the Auditor's Final Calculation of the MSA annual payment due on April 15, 2013 as a result of increased State participation after that date and that specify how the increased part of that Amount will be provided to each SPM. Unless the parties agree otherwise, those provisions will be consistent with the principles of this Addendum. Also, this Addendum may be supplemented to address additional SPMs joining the Term Sheet.

EXHIBIT A

Formula derivation:

OPM NPM Adjustments 2003-2009	$5,779,679,225
OPM Amount Specified in App. A, ¶ 1	$6,520,000,000
Percent by which OPM Amount Specified in App. A, ¶ 1 exceeds 2003-2009 Adjustments	12.8090288%

SPM (to be verified)	**NPM Adj. 2003-2009**	**112.8090288% of NPM Adj 2003-09 (¶ 1 amount)**
Commonwealth Brands, Inc.	$201,218,098	$226,992,182
Compania Industrial de Tabacos Monte Paz, S.A.	$468,522	$528,536
Daughters & Ryan, Inc.	$269,022	$303,481
Farmers Tobacco of Cynthiana	$20,028,552	$20,028,552
House of Prince A/S	$4,495,813	$5,071,683
Japan Tobacco International U.S.A., Inc.	$3,888,474	$4,386,550
King Maker Marketing, Inc.	$7,257,720	$8,187,364
Kretek International	$1,158,476	$1,306,866
Lane Limited	$803,048	$905,911

Liggett Group LLC	$37,006,861	$41,747,081
Lignum-2, Inc.	$1,138,201	$1,283,994
Peter Stokkebye Tobaksfabrik A/S	$1,229,041	$1,386,469
Premier Manufacturing, Inc.	$4,945,073	$5,578,489
P.T. Djarum	$4,143,605	$4,674,360
Reemtsma Cigarettenfabriken GmbH (Reemtsma)	$275	$311
Santa Fe Natural Tobacco Company, Inc.	$19,446,985	$21,937,955
Sherman 1400 Broadway N.Y.C., Inc.	$885,232	$998,621
Top Tobacco, L.P.	$12,941,925	$14,599,660
Vector Tobacco Inc.	$2,141,354	$2,415,641
Von Eicken Group	$118,127	$133,257
U.S. Flue Cured Tobacco Growers, Inc.	$1,751,910	$1,976,312
Total	$325,336,312	$364,443,024

APPENDIX E

9 U.S.C. § 1

§ 1. "Maritime transactions" and "commerce" defined; exceptions to operation of title

"Maritime transactions", as herein defined, means charter parties, bills of lading of water carriers, agreements relating to wharfage, supplies furnished vessels or repairs to vessels, collisions, or any other matters in foreign commerce which, if the subject of controversy, would be embraced within admiralty jurisdiction; "commerce", as herein defined, means commerce among the several States or with foreign nations, or in any Territory of the United States or in the District of Columbia, or between any such Territory and another, or between any such Territory and any State or foreign nation, or between the District of Columbia and any State or Territory or foreign nation, but nothing herein contained shall apply to contracts of employment of seamen, railroad employees, or any other class of workers engaged in foreign or interstate commerce.

9 U.S.C. § 2

§ 2. Validity, irrevocability, and enforcement of agreements to arbitrate

A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

9 U.S.C. § 3

§ 3. Stay of proceedings where issue therein referable to arbitration

If any suit or proceeding be brought in any of the courts of the United States upon any issue referable to arbitration under an agreement in writing for such arbitration, the court in which such suit is pending, upon being satisfied that the issue involved in such suit or proceeding is referable to arbitration under such an agreement, shall on application of one of the parties stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement, providing the applicant for the stay is not in default in proceeding with such arbitration.

9 U.S.C. § 4

§ 4. Failure to arbitrate under agreement; petition to United States court having jurisdiction for order to

compel arbitration; notice and service thereof; hearing and determination

A party aggrieved by the alleged failure, neglect, or refusal of another to arbitrate under a written agreement for arbitration may petition any United States district court which, save for such agreement, would have jurisdiction under Title 28, in a civil action or in admiralty of the subject matter of a suit arising out of the controversy between the parties, for an order directing that such arbitration proceed in the manner provided for in such agreement. Five days' notice in writing of such application shall be served upon the party in default. Service thereof shall be made in the manner provided by the Federal Rules of Civil Procedure. The court shall hear the parties, and upon being satisfied that the making of the agreement for arbitration or the failure to comply therewith is not in issue, the court shall make an order directing the parties to proceed to arbitration in accordance with the terms of the agreement. The hearing and proceedings, under such agreement, shall be within the district in which the petition for an order directing such arbitration is filed. If the making of the arbitration agreement or the failure, neglect, or refusal to perform the same be in issue, the court shall proceed summarily to the trial thereof. If no jury trial be demanded by the party alleged to be in default, or if the matter in dispute is within admiralty jurisdiction, the court shall hear and determine such issue. Where such an issue is raised, the party alleged to be in default may, except in cases of admiralty, on or before the return day of the notice of application, demand a jury trial of such issue, and

upon such demand the court shall make an order referring the issue or issues to a jury in the manner provided by the Federal Rules of Civil Procedure, or may specially call a jury for that purpose. If the jury find that no agreement in writing for arbitration was made or that there is no default in proceeding thereunder, the proceeding shall be dismissed. If the jury find that an agreement for arbitration was made in writing and that there is a default in proceeding thereunder, the court shall make an order summarily directing the parties to proceed with the arbitration in accordance with the terms thereof.

9 U.S.C. § 5

§ 5. Appointment of arbitrators or umpire

If in the agreement provision be made for a method of naming or appointing an arbitrator or arbitrators or an umpire, such method shall be followed; but if no method be provided therein, or if a method be provided and any party thereto shall fail to avail himself of such method, or if for any other reason there shall be a lapse in the naming of an arbitrator or arbitrators or umpire, or in filling a vacancy, then upon the application of either party to the controversy the court shall designate and appoint an arbitrator or arbitrators or umpire, as the case may require, who shall act under the said agreement with the same force and effect as if he or they had been specifically named therein; and unless otherwise provided in the agreement the arbitration shall be by a single arbitrator.

9 U.S.C. § 6

§ 6. Application heard as motion

Any application to the court hereunder shall be made and heard in the manner provided by law for the making and hearing of motions, except as otherwise herein expressly provided.

9 U.S.C. § 7

§ 7. Witnesses before arbitrators; fees; compelling attendance

The arbitrators selected either as prescribed in this title or otherwise, or a majority of them, may summon in writing any person to attend before them or any of them as a witness and in a proper case to bring with him or them any book, record, document, or paper which may be deemed material as evidence in the case. The fees for such attendance shall be the same as the fees of witnesses before masters of the United States courts. Said summons shall issue in the name of the arbitrator or arbitrators, or a majority of them, and shall be signed by the arbitrators, or a majority of them, and shall be directed to the said person and shall be served in the same manner as subpoenas to appear and testify before the court; if any person or persons so summoned to testify shall refuse or neglect to obey said summons, upon petition the United States district court for the district in which such arbitrators, or a majority of them, are sitting may compel the attendance of such person or persons

before said arbitrator or arbitrators, or punish said person or persons for contempt in the same manner provided by law for securing the attendance of witnesses or their punishment for neglect or refusal to attend in the courts of the United States.

9 U.S.C. § 8

§ 8. Proceedings begun by libel in admiralty and seizure of vessel or property

If the basis of jurisdiction be a cause of action otherwise justiciable in admiralty, then, notwithstanding anything herein to the contrary, the party claiming to be aggrieved may begin his proceeding hereunder by libel and seizure of the vessel or other property of the other party according to the usual course of admiralty proceedings, and the court shall then have jurisdiction to direct the parties to proceed with the arbitration and shall retain jurisdiction to enter its decree upon the award.

9 U.S.C. § 9

§ 9. Award of arbitrators; confirmation; jurisdiction; procedure

If the parties in their agreement have agreed that a judgment of the court shall be entered upon the award made pursuant to the arbitration, and shall specify the court, then at any time within one year after the award is made any party to the arbitration may apply to the court so specified for an order confirming the award, and thereupon the court must

grant such an order unless the award is vacated, modified, or corrected as prescribed in sections 10 and 11 of this title. If no court is specified in the agreement of the parties, then such application may be made to the United States court in and for the district within which such award was made. Notice of the application shall be served upon the adverse party, and thereupon the court shall have jurisdiction of such party as though he had appeared generally in the proceeding. If the adverse party is a resident of the district within which the award was made, such service shall be made upon the adverse party or his attorney as prescribed by law for service of notice of motion in an action in the same court. If the adverse party shall be a nonresident, then the notice of the application shall be served by the marshal of any district within which the adverse party may be found in like manner as other process of the court.

9 U.S.C. § 10

§ 10. Same; vacation; grounds; rehearing

(a) In any of the following cases the United States court in and for the district wherein the award was made may make an order vacating the award upon the application of any party to the arbitration--

(1) where the award was procured by corruption, fraud, or undue means;

(2) where there was evident partiality or corruption in the arbitrators, or either of them;

(3) where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or 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; or

(4) 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.

(b) If an award is vacated and the time within which the agreement required the award to be made has not expired, the court may, in its discretion, direct a rehearing by the arbitrators.

(c) The United States district court for the district wherein an award was made that was issued pursuant to section 580 of title 5 may make an order vacating the award upon the application of a person, other than a party to the arbitration, who is adversely affected or aggrieved by the award, if the use of arbitration or the award is clearly inconsistent with the factors set forth in section 572 of title 5.

9 U.S.C. § 11

§ 11. Same; modification or correction; grounds; order

In either of the following cases the United States court in and for the district wherein the award was made may make an order modifying or correcting the award upon the application of any party to the arbitration—

(a) Where there was an evident material miscalculation of figures or an evident material mistake in the description of any person, thing, or property referred to in the award.

(b) Where the arbitrators have awarded upon a matter not submitted to them, unless it is a matter not affecting the merits of the decision upon the matter submitted.
(c) Where the award is imperfect in matter of form not affecting the merits of the controversy.

The order may modify and correct the award, so as to effect the intent thereof and promote justice between the parties.

9 U.S.C. § 12

§ 12. Notice of motions to vacate or modify; service; stay of proceedings

Notice of a motion to vacate, modify, or correct an award must be served upon the adverse party or his attorney within three months after the award is filed or delivered. If the adverse party is a resident of the district within which the award was made, such service shall be made upon the adverse party or his attorney as prescribed by law for service of notice of motion in an action in the same court. If the adverse party shall be a nonresident then the notice of the application shall be served by the marshal of any district within which the adverse party may be found in like manner as other process of the court. For the purposes of the motion any judge who might make an order to stay the proceedings in an action brought in the same court may make an order, to be served with the notice of motion, staying the proceedings of the adverse party to enforce the award.

9 U.S.C. § 13

§ 13. Papers filed with order on motions; judgment; docketing; force and effect; enforcement

The party moving for an order confirming, modifying, or correcting an award shall, at the time such order is filed with the clerk for the entry of judgment thereon, also file the following papers with the clerk:

(a) The agreement; the selection or appointment, if any, of an additional arbitrator or umpire; and each written extension of the time, if any, within which to make the award.

(b) The award.

(c) Each notice, affidavit, or other paper used upon an application to confirm, modify, or correct the award, and a copy of each order of the court upon such an application.

The judgment shall be docketed as if it was rendered in an action.

The judgment so entered shall have the same force and effect, in all respects, as, and be subject to all the provisions of law relating to, a judgment in an action; and it may be enforced as if it had been rendered in an action in the court in which it is entered.

9 U.S.C. § 14

§ 14. Contracts not affected

This title shall not apply to contracts made prior to January 1, 1926.

9 U.S.C. § 15

§ 15. Inapplicability of the Act of State doctrine

Enforcement of arbitral agreements, confirmation of arbitral awards, and execution upon judgments based on orders confirming such awards shall not be refused on the basis of the Act of State doctrine.

9 U.S.C. § 16

§ 16. Appeals

(a) An appeal may be taken from—

(1) an order—

(A) refusing a stay of any action under section 3 of this title,

(B) denying a petition under section 4 of this title to order arbitration to proceed,

(C) denying an application under section 206 of this title to compel arbitration,

(D) confirming or denying confirmation of an award or partial award, or

(E) modifying, correcting, or vacating an award;

(2) an interlocutory order granting, continuing, or modifying an injunction against an arbitration that is subject to this title; or

(3) a final decision with respect to an arbitration that is subject to this title.

(b) Except as otherwise provided in section 1292(b) of title 28, an appeal may not be taken from an interlocutory order—

(1) granting a stay of any action under section 3 of this title;

(2) directing arbitration to proceed under section 4 of this title;
(3) compelling arbitration under section 206 of this title; or
(4) refusing to enjoin an arbitration that is subject to this title.

Md. Code Ann., Cts. & Jud. Proc. 3-224

§ 3-224. Vacation of arbitration award

Petition to vacate award

(a)(1) Except as provided in paragraph (2), a petition to vacate the award shall be filed within 30 days after delivery of a copy of the award to the petitioner.

(2) If a petition alleges corruption, fraud, or other undue means it shall be filed within 30 days after the grounds become known or should have been known to the petitioner.

Grounds for vacation of award

(b) The court shall vacate an award if:

(1) An award was procured by corruption, fraud, or other undue means;

(2) There was evident partiality by an arbitrator appointed as a neutral, corruption in any arbitrator, or misconduct prejudicing the rights of any party;

(3) The arbitrators exceeded their powers;

(4) The arbitrators refused to postpone the hearing upon sufficient cause being shown for the postponement, refused to hear evidence material to the controversy, or otherwise so conducted the hearing, contrary to the provisions of § 3-213 of

this subtitle, as to prejudice substantially the rights of a party; or

(5) There was no arbitration agreement as described in § 3-206 of this subtitle, the issue was not adversely determined in proceedings under § 3-208 of this subtitle, and the party did not participate in the arbitration hearing without raising the objection.

Relief granted by court of law or equity

(c) The court shall not vacate the award or refuse to confirm the award on the ground that a court of law or equity could not or would not grant the same relief.

APPENDIX F

MASTER SETTLEMENT AGREEMENT

* * *

VII. ENFORCEMENT

(a) *Jurisdiction*. Each Participating Manufacturer and each Settling State acknowledge that the Court: (1) has jurisdiction over the subject matter of the action identified in Exhibit D in such Settling State and over each Participating Manufacturer; (2) shall retain exclusive jurisdiction for the purposes of implementing and enforcing this Agreement and the Consent Decree as to such Settling State; and (3) except as provided in subsections IX(d), XI(c) and XVII(d) and Exhibit O, shall be the only court to which disputes under this Agreement or the Consent Decree are presented as to such Settling State. Provided, however, that notwithstanding the foregoing, the Escrow Court (as defined in the Escrow Agreement) shall have exclusive jurisdiction, as provided in section 15 of the Escrow Agreement, over any suit, action or proceeding seeking to interpret or enforce any provision of, or based on any right arising out of, the Escrow Agreement.

* * *

IX. PAYMENTS

* * *

(d) *Non-Participating Manufacturer Adjustment*.

(1) *Calculation of NPM Adjustment for Original Participating Manufacturers*. To protect the public health gains achieved by this Agreement, certain payments made pursuant to this Agreement shall be subject to an NPM Adjustment. Payments by the Original Participating Manufacturers to which the NPM Adjustment applies shall be adjusted as provided below:

(A) Subject to the provisions of subsections (d)(1)(C), (d)(1)(D) and (d)(2) below, each Allocated Payment shall be adjusted by subtracting from such Allocated Payment the product of such Allocated Payment amount multiplied by the NPM Adjustment Percentage. The "NPM Adjustment Percentage" shall be calculated as follows:

(i) If the Market Share Loss for the year immediately preceding the year in which the payment in question is due is less than or equal to 0 (zero), then the NPM Adjustment Percentage shall equal zero.

(ii) If the Market Share Loss for the year immediately preceding the year in which the payment in question is due is greater than 0 (zero) and less than or equal to 16 2/3 percentage points, then the NPM Adjustment Percentage shall be equal to the product of (x) such Market Share Loss and (y) 3 (three).

(iii) If the Market Share Loss for the year immediately preceding the year in which the payment in question is due is greater than 16 2/3 percentage points, then the NPM Adjustment Percentage shall be equal to the sum of (x) 50 percentage points and (y) the

product of (1) the Variable Multiplier and (2) the result of such Market Share Loss minus 16 2/3 percentage points.

(B) Definitions:

(i) "Base Aggregate Participating Manufacturer Market Share" means the result of (x) the sum of the applicable Market Shares (the applicable Market Share to be that for 1997) of all present and former Tobacco Product Manufacturers that were Participating Manufacturers during the entire calendar year immediately preceding the year in which the payment in question is due minus (y) 2 (two) percentage points.

(ii) "Actual Aggregate Participating Manufacturer Market Share" means the sum of the applicable Market Shares of all present and former Tobacco Product Manufacturers that were Participating Manufacturers during the entire calendar year immediately preceding the year in which the payment in question is due (the applicable Market Share to be that for the calendar year immediately preceding the year in which the payment in question is due).

(iii) "Market Share Loss" means the result of (x) the Base Aggregate Participating Manufacturer Market Share minus (y) the Actual Aggregate Participating Manufacturer Market Share.

(iv) "Variable Multiplier" equals 50 percentage points divided by the result of (x) the Base Aggregate Participating

Manufacturer Market Share minus (y) 16 2/3 percentage points.

(C) On or before February 2 of each year following a year in which there was a Market Share Loss greater than zero, a nationally recognized firm of economic consultants (the "Firm") shall determine whether the disadvantages experienced as a result of the provisions of this Agreement were a significant factor contributing to the Market Share Loss for the year in question. If the Firm determines that the disadvantages experienced as a result of the provisions of this Agreement were a significant factor contributing to the Market Share Loss for the year in question, the NPM Adjustment described in subsection IX(d)(1) shall apply. If the Firm determines that the disadvantages experienced as a result of the provisions of this Agreement were not a significant factor contributing to the Market Share Loss for the year in question, the NPM Adjustment described in subsection IX(d)(1) shall not apply. The Original Participating Manufacturers, the Settling States, and the Attorneys General for the Settling States shall cooperate to ensure that the determination described in this subsection (1)(C) is timely made. The Firm shall be acceptable to (and the principals responsible for this assignment shall be acceptable to) both the Original Participating Manufacturers and a majority of those Attorneys General who are both the Attorney General of a Settling State and a member of the NAAG executive committee at the time in question (or in the event no such firm or

no such principals shall be acceptable to such parties, National Economic Research Associates, Inc., or its successors by merger, acquisition or otherwise ("NERA"), acting through a principal or principals acceptable to such parties, if such a person can be identified and, if not, acting through a principal or principals identified by NERA, or a successor firm selected by the CPR Institute for Dispute Resolution). As soon as practicable after the MSA Execution Date, the Firm shall be jointly retained by the Settling States and the Original Participating Manufacturers for the purpose of making the foregoing determination, and the Firm shall provide written notice to each Settling State, to NAAG, to the Independent Auditor and to each Participating Manufacturer of such determination. The determination of the Firm with respect to this issue shall be conclusive and binding upon all parties, and shall be final and non-appealable. The reasonable fees and expenses of the Firm shall be paid by the Original Participating Manufacturers according to their Relative Market Shares. Only the Participating Manufacturers and the Settling States, and their respective counsel, shall be entitled to communicate with the Firm with respect to the Firm's activities pursuant to this subsection (1)(C).

(D) No NPM Adjustment shall be made with respect to a payment if the aggregate number of Cigarettes shipped in or to the fifty United States, the District of Columbia and Puerto Rico in the year immediately preceding the year in which the payment in question is due by those Participating

Manufacturers that had become Participating Manufacturers prior to 14 days after the MSA Execution Date is greater than the aggregate number of Cigarettes shipped in or to the fifty United States, the District of Columbia, and Puerto Rico in 1997 by such Participating Manufacturers (and any of their Affiliates that made such shipments in 1997, as demonstrated by certified audited statements of such Affiliates' shipments, and that do not continue to make such shipments after the MSA Execution Date because the responsibility for such shipments has been transferred to one of such Participating Manufacturers). Measurements of shipments for purposes of this subsection (D) shall be made in the manner prescribed in subsection

II(mm); in the event that such shipment data is unavailable for any Participating Manufacturer for 1997, such Participating Manufacturer's shipment volume for such year shall be measured in the manner prescribed in subsection II(z).

(2) *Allocation among Settling States of NPM Adjustment for Original Participating Manufacturers*.

(A) The NPM Adjustment set forth in subsection (d)(1) shall apply to the Allocated Payments of all Settling States, except as set forth below.

(B) A Settling State's Allocated Payment shall not be subject to an NPM Adjustment: (i) if such Settling State continuously had a Qualifying Statute (as defined in subsection (2)(E) below) in full force and effect during the entire calendar year immediately preceding the year in which the payment in question is due, and diligently

enforced the provisions of such statute during such entire calendar year; or (ii) if such Settling State enacted the Model Statute (as defined in subsection (2)(E) below) for the first time during the calendar year immediately preceding the year in which the payment in question is due, continuously had the Model Statute in full force and effect during the last six months of such calendar year, and diligently enforced the provisions of such statute during the period in which it was in full force and effect.

(C) The aggregate amount of the NPM Adjustments that would have applied to the Allocated Payments of those Settling States that are not subject to an NPM Adjustment pursuant to subsection (2)(B) shall be reallocated among all other Settling States pro rata in proportion to their respective Allocable Shares (the applicable Allocable Shares being those listed in Exhibit A), and such other Settling States' Allocated Payments shall be further reduced accordingly.

(D) This subsection (2)(D) shall apply if the amount of the NPM Adjustment applied pursuant to subsection (2)(A) to any Settling State plus the amount of the NPM Adjustments reallocated to such Settling State pursuant to subsection (2)(C) in any individual year would either (i) exceed such Settling State's Allocated Payment in that year, or (ii) if subsection (2)(F) applies to the Settling State in question, exceed 65% of such Settling State's Allocated Payment in that year. For each Settling State that has an excess as described in the preceding sentence, the excess amount of NPM Adjustment shall be further reallocated

among all other Settling States whose Allocated Payments are subject to an NPM Adjustment and that do not have such an excess, pro rata in proportion to their respective Allocable Shares, and such other Settling States' Allocated Payments shall be further reduced accordingly. The provisions of this subsection (2)(D) shall be repeatedly applied in any individual year until either (i) the aggregate amount of NPM Adjustments has been fully reallocated or (ii) the full amount of the NPM Adjustments subject to reallocation under subsection (2)(C) or (2)(D) cannot be fully reallocated in any individual year as described in those subsections because (x) the Allocated Payment in that year of each Settling State that is subject to an NPM Adjustment and to which subsection (2)(F) does not apply has been reduced to zero, and (y) the Allocated Payment in that year of each Settling State to which subsection (2)(F) applies has been reduced to 35% of such Allocated Payment.

(E) A "Qualifying Statute" means a Settling State's statute, regulation, law and/or rule (applicable everywhere the Settling State has authority to legislate) that effectively and fully neutralizes the cost disadvantages that the Participating Manufacturers experience vis-à-vis Non-Participating Manufacturers within such Settling State as a result of the provisions of this Agreement. Each Participating Manufacturer and each Settling State agree that the model statute in the form set forth in Exhibit T (the "Model Statute"), if enacted without modification or addition (except for particularized state

procedural or technical requirements) and not in conjunction with any other legislative or regulatory proposal, shall constitute a Qualifying Statute. Each Participating Manufacturer agrees to support the enactment of such Model Statute if such Model Statute is introduced or proposed (i) without modification or addition (except for particularized procedural or technical requirements), and (ii) not in conjunction with any other legislative proposal.

(F) If a Settling State (i) enacts the Model Statute without any modification or addition (except for particularized state procedural or technical requirements) and not in conjunction with any other legislative or regulatory proposal, (ii) uses its best efforts to keep the Model Statute in full force and effect by, among other things, defending the Model Statute fully in any litigation brought in state or federal court within such Settling State (including litigating all available appeals that may affect the effectiveness of the Model Statute), and (iii) otherwise complies with subsection (2)(B), but a court of competent jurisdiction nevertheless invalidates or renders unenforceable the Model Statute with respect to such Settling State, and but for such ruling the Settling State would have been exempt from an NPM Adjustment under subsection (2)(B), then the NPM Adjustment (including reallocations pursuant to subsections (2)(C) and (2)(D)) shall still apply to such Settling State's Allocated Payments but in any individual year shall not exceed 65% of the amount of such Allocated Payments.

(G) In the event a Settling State proposes and/or enacts a statute, regulation, law and/or rule (applicable everywhere the Settling State has authority to legislate) that is not the Model Statute and asserts that such statute, regulation, law and/or rule is a Qualifying Statute, the Firm shall be jointly retained by the Settling States and the Original Participating Manufacturers for the purpose of determining whether or not such statute, regulation, law and/or rule constitutes a Qualifying Statute. The Firm shall make the foregoing determination within 90 days of a written request to it from the relevant Settling State (copies of which request the Settling State shall also provide to all Participating Manufacturers and the Independent Auditor), and the Firm shall promptly thereafter provide written notice of such determination to the relevant Settling State, NAAG, all Participating Manufacturers and the Independent Auditor. The determination of the Firm with respect to this issue shall be conclusive and binding upon all parties, and shall be final and non-appealable; provided, however, (i) that such determination shall be of no force and effect with respect to a proposed statute, regulation, law and/or rule that is thereafter enacted with any modification or addition; and (ii) that the Settling State in which the Qualifying Statute was enacted and any Participating Manufacturer may at any time request that the Firm reconsider its determination as to this issue in light of subsequent events (including, without limitation, subsequent judicial review, interpretation,

modification and/or disapproval of a Settling State's Qualifying Statute, and the manner and/or the effect of enforcement of such Qualifying Statute). The Original Participating Manufacturers shall severally pay their Relative Market Shares of the reasonable fees and expenses of the Firm. Only the Participating Manufacturers and Settling States, and their respective counsel, shall be entitled to communicate with the Firm with respect to the Firm's activities pursuant to this subsection (2)(G).

(H) Except as provided in subsection (2)(F), in the event a Qualifying Statute is enacted within a Settling State and is thereafter invalidated or declared unenforceable by a court of competent jurisdiction, otherwise rendered not in full force and effect, or, upon reconsideration by the Firm pursuant to subsection (2)(G) determined not to constitute a Qualifying Statute, then such Settling State's Allocated Payments shall be fully subject to an NPM Adjustment unless and until the requirements of subsection (2)(B) have been once again satisfied.

(3) *Allocation of NPM Adjustment among Original Participating Manufacturers*. The portion of the total amount of the NPM Adjustment to which the Original Participating Manufacturers are entitled in any year that can be applied in such year consistent with subsection IX(d)(2) (the "Available NPM Adjustment") shall be allocated among them as provided in this subsection IX(d)(3).

(A) The "Base NPM Adjustment" shall be determined for each Original Participating Manufacturer in such year as follows:

(i) For those Original Participating Manufacturers whose Relative Market Shares in the year immediately preceding the year in which the NPM Adjustment in question is applied exceed or are equal to their respective 1997 Relative Market Shares, the Base NPM Adjustment shall equal 0 (zero).

(ii) For those Original Participating Manufacturers whose Relative Market Shares in the year immediately preceding the year in which the NPM Adjustment in question is applied are less than their respective 1997 Relative Market Shares, the Base NPM Adjustment shall equal the result of (x) the difference between such Original Participating Manufacturer's Relative Market Share in such preceding year and its 1997 Relative Market Share multiplied by both (y) the number of individual Cigarettes (expressed in thousands of units) shipped in or to the United States, the District of Columbia and Puerto Rico by all the Original Participating Manufacturers in such preceding year (determined in accordance with subsection II(mm)) and (z) $20 per each thousand units of Cigarettes (as this number is adjusted pursuant to subsection IX(d)(3)(C) below).

(iii) For those Original Participating Manufacturers whose Base NPM Adjustment, if calculated pursuant to subsection (ii) above, would exceed $300 million (as this number is adjusted pursuant to subsection IX(d)(3)(C) below), the Base NPM Adjustment shall equal

$300 million (or such adjusted number, as provided in subsection IX(d)(3)(C) below).

(B) The share of the Available NPM Adjustment each Original Participating Manufacturer is entitled to shall be calculated as follows:

(i) If the Available NPM Adjustment the Original Participating Manufacturers are entitled to in any year is less than or equal to the sum of the Base NPM Adjustments of all Original Participating Manufacturers in such year, then such Available NPM Adjustment shall be allocated among those Original Participating Manufacturers whose Base NPM Adjustment is not equal to 0 (zero) pro rata in proportion to their respective Base NPM Adjustments.

(ii) If the Available NPM Adjustment the Original Participating Manufacturers are entitled to in any year exceeds the sum of the Base NPM Adjustments of all Original Participating Manufacturers in such year, then (x) the difference between such Available NPM Adjustment and such sum of the Base NPM Adjustments shall be allocated among the Original Participating Manufacturers pro rata in proportion to their Relative Market Shares (the applicable Relative Market Shares to be those in the year immediately preceding such year), and (y) each Original Participating Manufacturer's share of such Available NPM Adjustment shall equal the sum of *(1)* its Base NPM Adjustment for such year, and *(2)* the amount allocated to such Original

Participating Manufacturer pursuant to clause (x).

(iii) If an Original Participating Manufacturer's share of the Available NPM Adjustment calculated pursuant to subsection IX(d)(3)(B)(i) or IX(d)(3)(B)(ii) exceeds such Original Participating Manufacturer's payment amount to which such NPM Adjustment applies (as such payment amount has been determined pursuant to step B of clause "Seventh" of subsection IX(j)), then *(1)* such Original Participating Manufacturer's share of the Available NPM Adjustment shall equal such payment amount, and *(2)* such excess shall be reallocated among the other Original Participating Manufacturers pro rata in proportion to their Relative Market Shares.

(C) Adjustments:

(i) For calculations made pursuant to this subsection IX(d)(3) (if any) with respect to payments due in the year 2000, the number used in subsection IX(d)(3)(A)(ii)(z) shall be $20 and the number used in subsection IX(d)(3)(A)(iii) shall be $300 million. Each year thereafter, both these numbers shall be adjusted upward or downward by multiplying each of them by the quotient produced by dividing (x) the average revenue per Cigarette of all the Original Participating Manufacturers in the year immediately preceding such year, by (y) the average revenue per Cigarette of all the Original Participating Manufacturers in the year immediately preceding such immediately preceding year.

(ii) For purposes of this subsection, the average revenue per Cigarette of all the Original Participating Manufacturers in any year shall equal (x) the aggregate revenues of all the Original Participating Manufacturers from sales of Cigarettes in the fifty United States, the District of Columbia and Puerto Rico after Federal excise taxes and after payments pursuant to this Agreement and the tobacco litigation Settlement Agreements with the States of Florida, Mississippi, Minnesota and Texas (as such revenues are reported to the United States Securities and Exchange Commission ("SEC") for such year (either independently by the Original Participating Manufacturer or as part of consolidated financial statements reported to the SEC by an Affiliate of the Original Participating Manufacturers) or, in the case of an Original Participating Manufacturer that does not report income to the SEC, as reported in financial statements prepared in accordance with United States generally accepted accounting principles and audited by a nationally recognized accounting firm), divided by (y) the aggregate number of the individual Cigarettes shipped in or to the United States, the District of Columbia and Puerto Rico by all the Original Participating Manufacturers in such year (determined in accordance with subsection II(mm)).

(D) In the event that in the year immediately preceding the year in which the NPM Adjustment in question is applied both (x) the Relative Market

Share of Lorillard Tobacco Company (or of its successor) ("Lorillard") was less than or equal to 20.0000000%, and (y) the number of individual Cigarettes shipped in or to the United States, the District of Columbia and Puerto Rico by Lorillard (determined in accordance with subsection II(mm)) (for purposes of this subsection (D), "Volume") was less than or equal to 70 billion, Lorillard's and Philip Morris Incorporated's (or its successor's) ("Philip Morris") shares of the Available NPM Adjustment calculated pursuant to subsections (3)(A)-(C) above shall be further reallocated between Lorillard and Philip Morris as follows (this subsection (3)(D) shall not apply in the year in which either of the two conditions specified in this sentence is not satisfied):

(i) Notwithstanding subsections (A)-(C) of this subsection (d)(3), but subject to further adjustment pursuant to subsections (D)(ii) and (D)(iii) below, Lorillard's share of the Available NPM Adjustment shall equal its Relative Market Share of such Available NPM Adjustment (the applicable Relative Market Share to be that in the year immediately preceding the year in which such NPM Adjustment is applied). The dollar amount of the difference between the share of the Available NPM Adjustment Lorillard is entitled to pursuant to the preceding sentence and the share of the Available NPM Adjustment it would be entitled to in the same year pursuant to subsections (d)(3)(A)-(C) shall be reallocated to Philip Morris and used to decrease or increase, as the case may be, Philip

Morris's share of the Available NPM Adjustment in such year calculated pursuant to subsections (d)(3)(A)-(C).

(ii) In the event that in the year immediately preceding the year in which the NPM Adjustment in question is applied either (x) Lorillard's Relative Market Share was greater than 15.0000000% (but did not exceed 20.0000000%), or (y) Lorillard's Volume was greater than 50 billion (but did not exceed 70 billion), or both, Lorillard's share of the Available NPM Adjustment calculated pursuant to subsection (d)(3)(D)(i) shall be reduced by a percentage equal to the greater of *(1)* 10.0000000% for each percentage point (or fraction thereof) of excess of such Relative Market Share over 15.0000000% (if any), or *(2)* 2.5000000% for each billion (or fraction thereof) of excess of such Volume over 50 billion (if any). The dollar amount by which Lorillard's share of the Available NPM Adjustment is reduced in any year pursuant to this subsection (D)(ii) shall be reallocated to Philip Morris and used to increase Philip Morris's share of the Available NPM Adjustment in such year.

(iii) In the event that in any year a reallocation of the shares of the Available NPM Adjustment between Lorillard and Philip Morris pursuant to this subsection (d)(3)(D) results in Philip Morris's share of the Available NPM Adjustment in such year exceeding the greater of (x) Philip Morris's Relative Market Share of such Available NPM Adjustment (the applicable Relative Market

Share to be that in the year immediately preceding such year), or (y) Philip Morris's share of the Available NPM Adjustment in such year calculated pursuant to subsections (d)(3)(A)-(C), Philip Morris's share of the Available NPM Adjustment in such year shall be reduced to equal the greater of (x) or (y) above. In such instance, the dollar amount by which Philip Morris's share of the Available NPM Adjustment is reduced pursuant to the preceding sentence shall be reallocated to Lorillard and used to increase Lorillard's share of the Available NPM Adjustment in such year.

(iv) In the event that either Philip Morris or Lorillard is treated as a Non-Participating Manufacturer for purposes of this subsection IX(d)(3) pursuant to subsection XVIII(w)(2)(A), this subsection (3)(D) shall not be applied, and the Original Participating Manufacturers' shares of the Available NPM Adjustment shall be determined solely as described in subsections (3)(A)-(C).

(4) *NPM Adjustment for Subsequent Participating Manufacturers*. Subject to the provisions of subsection IX(i)(3), a Subsequent Participating Manufacturer shall be entitled to an NPM Adjustment with respect to payments due from such Subsequent Participating Manufacturer in any year during which an NPM Adjustment is applicable under subsection (d)(1) above to payments due from the Original Participating Manufacturers. The amount of such NPM Adjustment shall equal the product of (A) the NPM Adjustment Percentage for such year multiplied by (B) the sum of the payments

due in the year in question from such Subsequent Participating Manufacturer that correspond to payments due from Original Participating Manufacturers pursuant to subsection IX(c) (as such payment amounts due from such Subsequent Participating Manufacturer have been adjusted and allocated pursuant to clauses "First" through "Fifth" of subsection IX(j)). The NPM Adjustment to payments by each Subsequent Participating Manufacturer shall be allocated and reallocated among the Settling States in a manner consistent with subsection (d)(2) above.

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XI. CALCULATION AND DISBURSEMENT OF PAYMENTS

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(c) *Resolution of Disputes*. Any dispute, controversy or claim arising out of or relating to calculations performed by, or any determinations made by, the Independent Auditor (including, without limitation, any dispute concerning the operation or application of any of the adjustments, reductions, offsets, carry-forwards and allocations described in subsection IX(j) or subsection XI(i)) shall be submitted to binding arbitration before a panel of three neutral arbitrators, each of whom shall be a former Article III federal judge. Each of the two sides to the dispute shall select one arbitrator. The two arbitrators so selected shall select the third arbitrator. The arbitration shall be governed by the United States Federal Arbitration Act.

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XVIII. MISCELLANEOUS

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(j) *Amendment and Waiver*. This Agreement may be amended by a written instrument executed by all Participating Manufacturers affected by the amendment and by all Settling States affected by the amendment. The terms of any such amendment shall not be enforceable in any Settling State that is not a signatory to such amendment. The waiver of any rights conferred hereunder shall be effective only if made by written instrument executed by the waiving party or parties. The waiver by any party of any breach of this Agreement shall not be deemed to be or construed as a waiver of any other breach, whether prior, subsequent or contemporaneous, nor shall such waiver be deemed to be or construed as a waiver by any other party.

* * *

(n) *Governing Law*. This Agreement (other than the Escrow Agreement) shall be governed by the laws of the relevant Settling State, without regard to the conflict of law rules of such Settling State. The Escrow Agreement shall be governed by the laws of the State in which the Escrow Court is located, without regard to the conflict of law rules of such State.

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