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ARBITRATOR

ARBITRATION

In the 2003 NPM Adjustment Proceedings

JAMS Ref No. 1100053390

FINAL AWARD RE: STATE OF NEW MEXICO

CHAPTER I: THE PARTIES TO A SPECIFIC STATE AWARD

Petitioners are manufacturers of tobacco products that have joined the MSA ("Master Settlement Agreement"), entered into in 1998, and agreed to be bound by its terms. The MSA refers to such manufacturers as "Participating Manufacturers" or "PMs." *See* MSA § II(jj). The PMs fall into two categories. The "Original Participating Manufacturers," or "OPMs," are those manufacturers that were original parties to the MSA: Philip Morris USA Inc., R.J. Reynolds Tobacco Company, and Lorillard Tobacco Company. *See* MSA § II(hh). (A fourth OPM, Brown & Williamson Tobacco Corporation, combined with R.J. Reynolds Tobacco Company in 2004.) The "Subsequent Participating Manufacturers," or "SPMs," are smaller manufacturers, most of which were never sued by the States, but joined the MSA thereafter. *See* MSA § II(tt). The following SPMs claim entitlement to an NPM Adjustment for 2003 and are petitioners in these proceedings: Commonwealth Brands, Inc., Compania Industrial de Tabacos Monte Paz, S.A., Daughters & Ryan, Inc., House of Prince A/S, Japan Tobacco International U.S.A. Inc., King Maker Marketing, Inc., Kretek International, Liggett Group LLC, Peter Stokkebye

Tobaksfabrik A/S, P.T. Djarum, Santa Fe Natural Tobacco Company, Inc., Sherman 1400 Broadway N.Y.C., Inc., Top Tobacco LP, and Von Eicken Group. All Petitioners are collectively referred to as PMs for purposes of this Award, and a finding as to one PM is a finding as to all, unless specifically noted.

Respondents in the Petitioners' claim were initially listed as the 52 States and Territories that are parties to the MSA. The MSA refers to these States and Territories as "Settling States."

The Settling States originally consisted of Alabama, Alaska, American Samoa, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, District of Columbia, Georgia, Guam, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, the Northern Marianas Islands, Ohio, Oklahoma, Oregon, Pennsylvania, Puerto Rico, Rhode Island, South Carolina, South Dakota, Tennessee, U.S. Virgin Islands, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, and Wyoming. (Four States–Florida, Minnesota, Mississippi, and Texas–had entered into separate settlements with certain PMs prior to the MSA and, therefore, are not parties to the MSA.) Since this proceeding began, the PMs have dismissed their allegations against several states (Alaska, Delaware, Hawaii, Idaho, Massachusetts, New Jersey, Rhode Island, South Dakota, Utah, Vermont, Wisconsin, Wyoming, Guam, the Northern Mariana Islands, American Samoa, and the U.S. Virgin Islands; *see* Participating Manufacturers' Notice of Contest as to Certain States' Claims of Diligent Enforcement, filed November 3, 2011). Further, numerous other states entered into a Settlement Agreement with the PMs, dated March 12, 2013, leaving 15 States who remain in this proceeding for whom Awards are now addressed by this Arbitration Panel (the "Panel"). Numerous issues ("Global Issues") are decided and applicable to all remaining Parties; however, because each remaining Settling State may have recourse to its own MSA Court, the Panel will issue a separate Award for each specific state, including therein both the Global Issues and also determinations that are specific to that state only.

Although numerous references may be made to the National Association of Attorneys General ("NAAG") and the "NAAG Tobacco Project," which assist the states in implementing the MSA and through which the states often act with respect to NPM Adjustment issues and enforcement of the Escrow Statutes, NAAG was never made a party to this Arbitration proceeding. NAAG is defined in the Definitions section of the MSA as "the National Association of Attorneys General, or its successor organization that is directed by the Attorneys General to perform certain functions under this Agreement." MSA § II(bb). It is undisputed that NAAG served as an advisory and legal resource to the Settling States, including interpreting the MSA and opining on potential requirements for "diligent enforcement." These Awards may also refer to determinations made by the MSA's "Independent Auditor," which since 1998 has been PricewaterhouseCoopers LLP ("PwC"). The MSA provides that the "Independent Auditor" is responsible for "calculat[ing] and determin[ing] all payments" under the MSA, applying the MSA's various "adjustments, reductions and offsets" (including the NPM Adjustment) to those payments, and determining "the allocation of such payments, reductions, offsets . . . among the Settling States." MSA § XI(a)(1). Although the Independent Auditor plays a major role in the implementation of the MSA, it is not a party to this Arbitration, and the Panel has no jurisdiction over its actions or determinations.

CHAPTER II: THE BACKGROUND

A. Origin of the Dispute.

This section is set forth as a summary and does not constitute either findings of fact or conclusions of law by the Panel.

Both the Supreme Court and the Settling States have referred to the MSA as a "landmark" public health agreement. *Lorillard Tobacco Co. v. Reilly*, 533 U.S. 525, 533 (2001); NAAG March 8, 2006 News Release. The MSA settled and released past and future claims by the Settling States for, among other things, recovery of health-care costs attributed to smoking-related illnesses. In exchange, the PMs agreed to make substantial annual payments in perpetuity based upon their annual nationwide cigarette sales and to be subject to an array of advertising, marketing, and other restrictions. Since the MSA was first signed in November 1998, over 50 tobacco companies have agreed to be bound by its terms. Tobacco product manufacturers who have not joined the MSA and agreed to its terms are referred to as Non-Participating

Manufacturers ("NPMs").

Pursuant to the MSA, each PM makes a single annual payment based on its nationwide cigarette sales volume during each calendar year. The annual payment on a year's volume is due on April 15 of the following year. It is alleged, and not disputed, that these annual payments total in the billions of dollars each year. For example, the OPMs' aggregate base payment obligation was approximately $8 billion for 2003 (the year in question here). *See* MSA §§ IX(c)(1)-(2). The SPMs make separate annual payments also based on their sales volume during the year. *See* MSA § IX(i). The PMs' annual payments are calculated by an "Independent Auditor" agreed to by the parties. *See* MSA § XI(a)(1).

The MSA's annual base payment amounts are subject to various adjustments, including an Inflation Adjustment and a Volume Adjustment (under which the base payments are increased or decreased in proportion to changes in the OPMs' nationwide volume of sales). *See* MSA §§ IX(c), XI(a). According to the PMs, and not disputed, the OPMs' aggregate annual payments after these and other adjustments (other than the NPM Adjustment) since the MSA was entered into have been as follows: 1999–$3.545 billion; 2000–$4.022 billion; 2001–$5.066 billion; 2002–$4.967 billion; 2003–$5.950 billion; 2004–$6.048 billion; 2005–$6.128 billion; 2006–$6.221 billion; 2007–$7.076 billion; 2008–$7.011 billion; and 2009–$6.497 billion. These payments are split among the OPMs in proportion to their relative market shares. *See* MSA §§ IX(c)(1)-(2).

Each SPM makes annual payments that, on a per-cigarette basis, approximate the OPMs' annual payments and that are likewise based on the SPMs' sales volume during the year in question. *See* MSA § IX(i). The SPMs' aggregate annual payments for each year have been claimed as follows: 1999–$46.4 million; 2000–$98.5 million; 2001–$200.4 million; 2002–$319.0 million; 2003–$484.5 million; 2004–$433.7 million; 2005–$441.5 million; 2006–$517.7 million; 2007–$475.0 million; 2008–$569.5 million; and 2009–$571.5 million.

These annual payments continue each year into perpetuity. The PMs' total MSA payments to the Settling States to date exceed $70 billion, including the annual payments listed above and additional "initial" payments made by the OPMs.

The PMs do not make these payments to individual States. Instead, each PM makes a single, nationwide payment in the overall amount calculated and determined by the Independent Auditor. The Independent Auditor then allocates those nationwide payments among the States by applying pre-set "Allocable Share" percentages previously negotiated by the States (and set forth in Exhibit A to the MSA), which represent each State's percentage share of the PMs' nationwide payments. *See* MSA §§ II(f)-(g); IX(b)-(c); IX(j), clause thirteenth; MSA Ex. A.

The MSA's payment obligations impose substantial costs on the PMs. The NPMs, by contrast, do not bear these MSA costs and thus do not reflect them in their pricing. Absent enforcement of statutes imposing similar costs on NPMs, that differential cost between the PMs and the NPMs could be harmful to both the PMs and to the States, as well as to the public, by undermining the goals and purpose of the MSA.

In an attempt to minimize that disadvantage, the MSA included the prospect of reduced payments to supply an incentive for each Settling State to enact and enforce a statute that imposes similar payment obligations on NPMs and thereby neutralizes the MSA-related cost disadvantage imposed on PMs. Moreover, if Settling States nevertheless failed to enact and enforce such a statute, the payment reduction would compensate the PMs for their MSA-related loss of sales.

The NPM Adjustment was made a part of the MSA to address that cost differential or, as the PMs describe it, to "level the playing field." The MSA provides that "[t]o protect the public health gains achieved by this Agreement," the PMs' annual MSA payments "shall" be subject to an NPM Adjustment. *See* MSA § IX(d)(1)(A). The Adjustment provides for a potential reduction in the PMs' MSA payments in event of an MSA-related market-share shift to NPMs above a specified threshold. It is designed to give the States an incentive to eliminate the MSA cost disadvantage faced by PMs, and with it the threat to the MSA's public health gains–and to provide compensation to the PMs in the event such a market-share shift nevertheless occurs. The NAAG Tobacco Project has thus described the NPM Adjustment as follows:

> [The] NPM Adjustment provides [an] incentive to ameliorate these adverse effects [*i.e.*, "undermin[ing] the MSA's public health goals" and "unfairly

> disadvantag[ing] companies that had chosen to" join the MSA. It provides that if, because of the disadvantages imposed on them by the MSA, the PMs lose "Market Share" to NPMs, the PMs' payments to the States can be reduced.

NAAG Tobacco Project, *Understanding and Enforcing the NPM Statute*, MSA Issues Seminar (Oct. 15-16, 2001).

The NPM Adjustment is set forth in Section IX(d) of the MSA (beginning at page 58 of the Agreement). The first subsection, Section IX(d)(1), governs when the NPM Adjustment applies. It provides that the Adjustment "shall apply" to the PMs' annual payment for the year in question if two conditions are met. MSA § IX(d)(1)(C).

First, the PMs must have suffered a "Market Share Loss," which is defined to mean that the PMs' collective market share during that year decreased by more than two percentage points compared to their collective market share in 1997, the last full year before the MSA was signed. MSA §§ IX(d)(1)(A); IX(d)(1)(B).

Second, a nationally recognized firm of economic consultants jointly selected and retained by the OPMs and the States (the "Firm") must have determined that the disadvantages experienced by the PMs as a result of the provisions of the MSA were a "significant factor" contributing to the Market Share Loss for the year in question. *See* MSA § IX(d)(1)(C).

The only exception is where a State demonstrates that it has enacted and "diligently enforced" a "Qualifying Statute." MSA § IX(d)(2)(B). A "Qualifying Statute" is defined as a statute 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 MSA]." MSA § IX(d)(2)(E). States are thus not required either to enact or enforce such a statute, but if they want the benefit of the contractual exemption from the NPM Adjustment, they must do both.

If an individual Settling State demonstrates that it diligently enforced such a statute during the year in question, the NPM Adjustment still applies to the PMs' MSA payments for that year, but none of it is allocated to that Settling State's share of those payments. *See* MSA § IX(d)(2)(B). It is of critical import that nowhere in the MSA or any of the supporting exhibits, is the term "diligent enforcement" defined. The MSA merely states that an exception to the NPM

Adjustment shall be available ". . . 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 . . ." *Id.* Thus, defining what standard is required before a State qualifies for this critical exception is left for this Panel to decide.

Where an individual Settling State qualifies for this exception, the MSA provides that its share of the NPM Adjustment will be reallocated to all other States that do not qualify for the exception because they have not demonstrated diligent enforcement of their own Qualifying Statute. Section IX(d)(2)(C) of the MSA thus provides that the "aggregate amount of the NPM Adjustments that would have applied" to Settling States that prove they fall within the diligent enforcement exception "shall be reallocated among all other Settling States pro rata in proportion to their respective [payment shares]," and that those States' MSA payments "shall be further reduced" up to the full amount of their MSA payments for that year. MSA § IX(d)(2)(C); *see also id.* § IX(d)(2)(D). As a result of this reallocation provision, the greater the number of Settling States that did not diligently enforce a Qualifying Statute, the more widely the NPM Adjustment is spread and the less the share of the Adjustment that each such State bears. Conversely, if only a few Settling States fail to prove diligent enforcement, those Settling States face a more concentrated application of the NPM Adjustment – and hence a greater reduction of their payments, subject only to the limitation that the Adjustment applied to a Settling State can be no greater than the total MSA payment it received for that year. The diligent enforcement and reallocation provisions thus create a dual incentive for individual Settling States to enact and enforce a Qualifying Statute.

The MSA defines a "Qualifying Statute" as one that, among other things, "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). Exhibit T to the MSA provides a model for such a statute: a "model" Escrow Statute. The MSA provides that this "model" Escrow Statute, if enacted with those modifications necessary to reflect "particularized state procedural or technical requirements" will "constitute a Qualifying Statute." *Id.*

The "model" Escrow Statute provides for each NPM to make escrow deposits on the cigarettes it sells in the enacting Settling State in the year in question. The escrow deposits are to be made into a "[q]ualified escrow fund," which is defined as an escrow arrangement with a qualifying financial institution in which the deposits are held for the benefit of the State. *See* MSA, Ex. T, at T-2 (§ (f)). The deposits are to remain in escrow for 25 years except insofar as they are used to pay a judgment to or settlement with the State for liability on claims like those the Settling States settled against the PMs in the MSA. *See* MSA, Ex. T, at T-4 & T-5 (§ (b)(2)(A)-(C)). The escrow deposits thus guarantee the State a source of recovery should it subsequently sue or settle with that NPM on claims like those the State settled against the PMs in the MSA, and avoid the risk that NPMs would otherwise use their MSA-related "cost advantage to derive large, short-term profits . . . and then becom[e] judgment-proof before liability [to the State] may arise." MSA Ex. T, at T-1 (§§ (a), (f)).

The Settling States all enacted Escrow Statutes following the MSA. But following the signing of the MSA in 1998, and despite the Settling States' universal enactment of Escrow Statutes imposing payment obligations on NPMs, the NPMs' market share increased at significant rates.

This shift of market share from PMs to NPMs has triggered the NPM Adjustment provision of the MSA for multiple years. The PMs and the States settled the NPM Adjustments through 2002. The NPM Adjustments for 2003 and subsequent years, however, were not resolved, and the dispute over the Adjustment for the first of these years–2003–has culminated in the proceedings before this Panel.

As a beginning and necessary step leading to this Arbitration, in connection with its April 2004 calculation of the PMs' MSA payment for 2003, the Independent Auditor determined that the MSA's first condition for application of the 2003 NPM Adjustment was satisfied: the PMs had suffered a "Market Share Loss" for 2003. The Auditor calculated that there had been a market-share shift of approximately 8% to the NPMs from 1997 to 2003, and thus a Market Share Loss of approximately 6% after giving effect to the two percentage point buffer.

The States have not disputed the Independent Auditor's determination that the PMs suffered a Market Share Loss for 2003, the magnitude of that loss or the amount of the 2003 NPM Adjustment.

After the Independent Auditor's finding of a Market Share Loss, the States and OPMs instituted proceedings in April 2005 for a determination by the Firm as to whether the disadvantages experienced by the PMs as a result of the provisions of the MSA were a "significant factor" contributing to that Market Share Loss. The OPMs and States engaged the Brattle Group to make this "significant factor" determination.

The OPMs and the States then participated in a 10-month evidentiary proceeding before the Firm. On March 27, 2006, the Firm issued a 163-page opinion and final determination, finding that the disadvantages experienced by the PMs as a result of the MSA were a "significant factor" contributing to the 2003 Market Share Loss. The MSA expressly provides that the Firm's significant factor determination is "conclusive and binding upon all parties" and "final and non-appealable." *See* MSA § IX(d)(1)(C).

Following the Firm's determination in March 2006, the PMs requested that the Independent Auditor apply the 2003 NPM Adjustment as a credit against their next MSA payments. The Settling States opposed the request, asking the Independent Auditor to "presume" diligent enforcement and to refuse to apply the 2003 adjustment.

Following the Independent Auditor's determination not to apply the NPM Adjustment, some of the PMs paid the disputed amounts into a "Disputed Payment Account," and the PMs requested that the Settling States arbitrate the dispute pursuant to the MSA's Arbitration Clause. That clause, which is set forth in Section XI(c) of the MSA, provides that "[a]ny dispute, controversy or claim arising out of or relating to" the Independent Auditor's calculations or determinations "shall be submitted to binding arbitration" before a panel of three former federal judges.

The Settling States initially refused to agree to arbitration, and sought relief in their individual state courts, which was denied in virtually every case. It was not until January 30, 2009, that 45 Settling States had signed an Agreement to Arbitrate ("the ARA"). Pursuant to the

ARA's "partial liability reduction," the PMs will reimburse each of those 45 Settling States that the Panel determines did not diligently enforce its Escrow Statute in 2003 with 20% of the portion of the 2003 NPM Adjustment that it bears as a result. *See* ARA § 3(b). Four Settling States–Ohio, Oklahoma, North Carolina, and Wisconsin–refused to sign the ARA, but were ordered to arbitration by their state courts, and participated in this Arbitration. Thereafter, the PMs and 48 Settling States, including the four Settling States that declined to sign the ARA, negotiated a separate "Agreement Regarding Procedures for Formation of Arbitration Panel." Pursuant to that Agreement and Section XI(c) of the MSA, this Panel was selected to resolve the 2003 NPM Adjustment dispute.

B. The Arbitration Clause.

The MSA is approximately 150 pages long, plus numerous exhibits. Despite the complexity and uniqueness of the issues in this matter, and the large number of parties involved, the Arbitration Clause ("the Clause") is virtually devoid of any procedural guidelines or objective criteria to be used by the Panel in deciding this matter. The Clause merely states as follows:

> 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.

MSA § XI(c).

C. The Arbitration Panel.

The Panel consists of the following Arbitrators, each of whom is a former Article III federal judge:

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.

CHAPTER III: THE PROCEDURAL HISTORY

The actual proceedings in the Arbitration began with the Parties filing mutual Motions for Case Management Schedule and Discovery Plan on July 2, 2010. The first joint status hearing took place in Chicago, Illinois. At that time, 17 PMs and 52 States and territories were parties of record, although several States appeared only with reservations of rights, including objections to the Panel's jurisdiction. Because neither the Agreement nor the Clause gave direction, decisions had to be made by the Panel as to the governing law, governing procedural rules, *e.g.*, rules of evidence, type of hearings required, dispositive motions, if any, burden of proof, priorities, and location of hearings, as well as other questions that arose as the Panel proceeded. Because the pre-hearing process was lengthy, as well as complex and significant, a meaningful summary is virtually impossible; therefore, the Panel has attached, as Appendix I, a list of all of the Panel's pre-hearing rulings. (Note: The Panel's rulings, as well as all of the Parties' filings, are posted on a LexisNexis data bank, which is available to authorized readers.)

CHAPTER IV: THE CONTENTIONS OF THE PARTIES

A. The Claimants' Contentions.

The PMs' Claim for Arbitration is almost 200 pages long, which is understandable, given the number of Settling States against whom claims are made. In essence, however, the PMs request that this Panel determine the following:

1. Determine that the Independent Auditor was required to apply the 2003 NPM Adjustment to the PMs' April 2006 annual payments once the Firm determined that the MSA was a significant factor contributing to the PMs' Market Share Loss for 2003.
2. Determine that the Independent Auditor erred when it refused to apply the 2003 NPM Adjustment to the PMs' April 2006 annual payments and when it adopted a presumption that each State had diligently enforced its Escrow Statute.
3. Determine that the Independent Auditor is required to immediately credit the 2003 NPM Adjustment, with applicable interest, to the PMs' next MSA payments.

4. Determine that individual States have the burden of proving diligent enforcement of a Qualifying Statute.
5. Allow the discovery necessary for the parties–and the Panel–to evaluate and determine individual States' claims that they diligently enforced a Qualifying Statute during 2003.
6. Determine the claims of individual States that they diligently enforced a Qualifying Statute during 2003 and that, accordingly, their Allocable Share of the 2003 NPM Adjustment should be reallocated to other States.
7. Determine such other issues related to the application, allocation, and recovery of the 2003 NPM Adjustment as the parties shall raise and the Panel shall deem appropriate.

The primary focus of this Arbitration has been on Contention Six, *i.e.*, which Settling States "diligently enforced" their respective Qualifying Statute in 2003, and the individual state-specific hearings have focused solely on that question. The first five Contentions were expressly or implicitly decided in the pre-hearing determinations set forth in Appendix I. Contention Seven will be addressed, if necessary, in these Awards.

B. The Respondents' Contentions.

Each of the Settling States filed its own response to the PMs' claims and contentions; however, the majority of the defenses raised were duplicative and common to each of the Settling States. There was also a joint response filed on behalf of all of the Settling States. By the time the state-specific hearings were held, the only remaining question for the Panel to answer was that set forth in PMs' Contention Six, *i.e.*, did the Settling State "diligently enforce" its Qualifying Statute in 2003.

CHAPTER V: DISCUSSION AND DECISION

A. Common Findings/Conclusions.

1. Introduction.

As stated above, the majority of defenses and issues raised by both the PMs and the Settling States were common to all parties and were either resolved in pre-arbitration motion proceedings, or were deferred until all of the state-specific hearings were completed. Included in this Award, therefore, are final determinations of those deferred issues, each of which was a significant factor in the Panel's ultimate Awards and each of which is common to the each state-specific Award. They include the following:

- The Panel's definition of Diligent Enforcement
- The Panel's definition of Units Sold
- Whether a State used the Fabricator or Control Test in its enforcement efforts
- Defining "two knowing violations" in seeking injunctive relief
- Enforcement efforts against House of Prince/Carolina/Leonidias
- Whether a State had the obligation to amend or enact legislation as an aid to enforcement
- The use of Allocable Share Releases
- The significance, *i.e.*, use/weight of a State's "collection rate"

It is critical to note that although all of the above were "factors," which the Panel considered in deciding whether the defined diligent enforcement standard was met, the Panel did not rank the factors or give them a numerical score, *i.e.*, each, except for the definition of "diligent enforcement," was considered in the over-all context of a Settling State's existing policies and circumstances in 2003. It is therefore not a useful exercise, or even valid, to compare the decision as to one State against the decision as to another. It is also important to note that the Panel has not distinguished between "Findings" and "Conclusions." Most of the questions addressed are mixed questions, and the Panel views each with equal weight. All findings and/or conclusions were decided by a unanimous Panel.

It was decided during pre-hearing motions (*see* Appendix 1) that the Settling States had the burden of proof on the question of diligent enforcement. Thus, each State presented its case in chief first.

2. <u>"Diligent Enforcement" Defined.</u>

Diligent Enforcement is 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. Both the legislative and executive branches of a Settling State are bound by the MSA obligations.

That definition is measured by an objective standard, and the Panel has considered numerous factors in determining whether that standard has been met. The Panel has not ranked the factors, but has considered them as a whole in making its determination.

3. *"Units Sold" Defined.*

"Units Sold" is defined in Exhibit T to the MSA (commonly referred to in this Arbitration as the "Model Statute") as follows:

> "Units sold" means the number of individual cigarettes sold in the State by the applicable tobacco product manufacturer (whether directly or through a distributor, retailer or similar intermediary or intermediaries) during the year in question, as measured by excise taxes collected by the State on packs (or "roll-your-own" tobacco containers) bearing the excise tax stamp of the State . . . .

MSA Exhibit T, T-3, Definitions, (j).

As opposed to much of the MSA, that definition seems clear and unambiguous, and many of the Settling States requested that the Panel find to be binding, as a question of law. The PMs, however, as well as several of the Settling States, disagreed.

The PMs argued that the issue of "units sold" was state-specific and depended on the facts and circumstances of each individual state. For example, the PMs argued that while a minority of states attempted to exempt entire categories of NPM cigarette sales from the escrow payment obligations, such as NPM cigarettes sold through Native American reservations or unstamped roll-your-own cigarettes ("RYO"), other states assessed and attempted to enforce escrow with respect to all NPM cigarettes sold in their state. The PMs argued that the different states' understanding and course of performance in enforcing the NPM escrow obligations were thus factual issues subject to discovery which would have bearing on the Panel's determination of the "units sold" issue.

Because each side to this dispute raised colorable arguments, the Panel deferred ruling until all state-specific hearings were completed. That time has now arrived, and the Panel finds that the PMs have failed to support their arguments that the express definition means anything other than what it says.

The collective evidence did show that different Settling States reacted in different ways to the Model Statute definition, *e.g.*, some Settling States modified their Qualifying Statute, some changed their practices regarding RYO or sales by tribes, and some took the stated definition literally and declined to include certain types of sales as "units sold." What the Panel did not see was any evidence of collusive behavior, *i.e.*, no Settling State, in the Panel's opinion, manipulated the definition or counting of "units sold" in order to purposefully evade their enforcement obligations. In particular, although some Settling States with large numbers of cigarettes sold on Tribal Lands declined to change their policy regarding non-taxation of such sales, those Settling States presented valid policy reasons for their decisions. Although the Settling States had binding contractual obligations to "diligently enforce," they were not required to elevate those obligations above other statutory or rational policy considerations. Unless otherwise stated in a state-specific Award, the Panel reaches the same conclusion for RYO sales.

For these reasons, the Panel finds, as a matter of law, that the Model Statute definition of "units sold" is unambiguous and binding. Further, even if parol evidence were considered, the PMs have failed to show that a different meaning should be applicable to any specific Settling State.

4. Whether a State Used the "Fabricator" or "Control" Test.

This issue also arises under the "Model Statute," which sets forth certain remedies that a State has against a "Tobacco Product Manufacturer" ("TPM"), a term specifically defined under the "Definitions" section of the Model Statute. In that definition, a TPM is defined as an entity that "manufactures cigarettes anywhere that such manufacturer intends to be sold in the United States, including cigarettes intended to be sold in the United States through an importer . . . ." MSA Ex. T, T-3.

The "Requirements" section of the Model Statute establishes that the Attorney General of a Settling State may file a civil action against a TPM under certain express conditions. MSA Ex. T, T-5. The right to file a civil action is the only express remedy against TPMs that is set forth in the MSA or Model Statute. The PMs argued in all state-specific hearings that the right to file a lawsuit was critical to diligent enforcement and that the Settling States had an obligation to file such suits often and as soon as possible.

The controversy over this term arose because some Settling States interpreted the definition strictly, *i.e.*, as applying solely to manufacturers, many of which were in foreign jurisdictions, and not easily amenable to jurisdiction (the "Fabricator Test"). Other Settling States were more liberal in their interpretation, and included entities within the United States who played a significant role in getting the subject cigarettes into the market, *e.g.*, distributors and wholesalers (the "Control Test"). For obvious reasons, the Control Test made it easier and faster to file lawsuits. The PMs argue that Settling States that used the Fabricator Test were less "diligent" than followers of the Control Test. The Panel disagrees. The problem, if any, lies with the drafting of the Model Statute, which expressly limits the right to file civil actions to suits against "manufacturers." In hindsight, the definition of TPM should have been broader, but the fault for that does not lie with the Settling States.

5. Defining "Two Knowing Violations" in Seeking Injunctive Relief.

This question also arises out of the "Remedies" section of the Model Statute which limited injunctive relief to TPMs that have committed "two knowing violations." The dispute centers on defining a "knowing violation," and the differences among the Settling States in making that determination. Again, the PMs ask the Panel to penalize those States that accepted a more restrictive and literal definition of that term. The Panel finds no legal or equitable basis to penalize a Settling State who reads the express words of the Model Statute in a rational way. Again, the fault, if any, lies in the drafting of the Model Statute, for which the Settling States are no more to blame than the PMs.

6. Enforcement Effort Against House of Prince/Carolina/Leonidias.

Much time was spent in discussing the role that these entities played, and, more important, their status during the 2003 time period, *i.e.*, were they NPMs, SPMs, contract manufacturers, etc. The value of understanding the relationships lies only in how their status affected a given Settling State's "compliance rate," *i.e.*, the percentage of escrow paid against the total number of units sold in a Settling State by NPMs. The PMs' case rested in great part on the use of expert testimony, an important facet of which was establishing a compliance rate for each state. Because of the legitimate confusion over whether the above entities were NPMs or not, many Settling States took a "wait and see" attitude and did not seek escrow from them, resulting in a lower compliance rate, based on the PMs' calculations. The Panel understands the PMs' theory, but also is unwilling, in hindsight, to classify such decisions as a failure in diligent enforcement. This is especially true because the status of those entities has since resolved.

7. *Whether a Settling State Had the Obligation to Amend or Enact Legislation as an Aid to Diligent Enforcement.*

The PMs have argued both implicitly and explicitly that Settling States could have and should have passed legislation that made enforcement easier to accomplish. The Panel has considered that as a factor, especially the alacrity of a Settling State in passing what has been referred to as "Complementary Legislation," which was specifically aimed at increasing remedies available against non-performing NPMs. On the other hand, the Panel has given less weight to the argument that a Settling State should have legislatively changed, for example, its taxation laws, in order to increase its escrow collection rate. The MSA put no such demand on the Settling States.

8. *Allocable Share Release.*

Significant time was spent by the PMs discussing the negative effect of the Allocable Share Release ("ASR"), which is set forth in the Model Statute. The Panel understands the PMs' theory, but does not agree that the Settling States should be faulted for what was a poorly conceived policy, set forth in the Model Statute. The deficiencies, if any, caused by the ASR provision, were eliminated by most states in 2003 with the passing of additional legislation. The Panel mentions the ASR in individual cases, if at all, only if it found that a Settling State's procedure for releasing ASR funds had a material effect on its enforcement results.

9. *The Significance, i.e., Use/Weight of a State's "Collection Rate."*

The PMs' case-in-chief relied almost completely on the testimony of expert witnesses. One category of expert testimony was provided by economists, who based their opinions primarily on the "collection rate" of a Settling State, *i.e.*, what amount of money was deposited by NPMs into escrow accounts in a given year, as compared to the experts' determination of what amount was actually due. The collection rates among and between the Settling States differed significantly, and the variance was intended to be used in a comparative way for the Panel to determine the lack of diligent enforcement. The Panel concurs that the collection rate is a significant factor, but it is not the only factor, nor is it always the primary factor. Predicating a Settling State's diligence, therefore, based solely on the collection rate is unlikely to be fruitful. Further, because in most cases, the "underreported" collection rate is similar across states, the Panel has not factored that into its analysis, except in unusual circumstances.

B. State-Specific Findings and Conclusions as to the State of New Mexico.

1. The Attorneys and Witnesses for the New Mexico Hearing.

a. The Attorneys for New Mexico

i. Thomson Law Office

David Thomson

ii. Office of the New Mexico Attorney General

Ari Biernoff

Al Lama

Rebecca Parish

Claudia Ravanelli

Philip Bachicha

b. The Attorneys for the PMs

i. Jones Day

Carol Hogan

Paula Quist

Jason Winchester

Kelly Marino

ii. Winston & Strawn LLP

Alexander Shaknes

c. Witnesses for the New Mexico

i. Stephanie Dennis

Supervisor in the special tax program of the Department of Taxation and Revenue in 2002-2003

ii. Shannon Baxter

Assistant Bureau Chief of the Albuquerque division office, Department of Taxation and Revenue in 2002-2003

iii. Dustin Sparks

Intern at the Office of the Attorney General in 2002-2003

iv. Thomas Buckner

1006 Witness

v. Glenn Smith

Special Counsel, Office of the Attorney General in 2002-2003

vi. Scott Taylor

Expert Witness

vii. Svetla Tzenova

Expert Witness

d. Witnesses for the PMs:

i. Daniel Garrett

Expert Witness

ii. Colleen Waring

Expert Witness

2. *Factors Considered in the Determination of Diligent Enforcement.*

The Panel has previously articulated a definition of diligent enforcement. In order to objectively assess a Settling State's diligent enforcement in light of that definition, the Panel has developed a number of components that it believes aid in evaluating a Settling State's enforcement of its Qualifying Statute and its diligence in doing so. Those factors are:

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 and Other States' Enforcement Efforts

These factors are not listed in their order of importance nor are they necessarily given equal weight. But overall they provide a reliable and objective metric to assess a Settling State's obligation to enforce its Qualifying Statute with diligence in order to avoid the contractually agreed upon determination that the PMs are entitled to a reduction in their payments for the calendar year 2003.

3. Analysis.

The following is an analysis of those facts found by the Panel to be true and necessary to the Award. To the extent that this recitation differs from any Party's position, that is the result of determinations as to credibility of witnesses, including experts, determinations of relevance, burden-of-proof considerations, and the weighing of the evidence, both oral and written. The Panel has also considered the inferences that could or could not be drawn from the testimony and documents.

a. Collection Rate

The Panel has said in other Awards, and repeats, that although the "Collection Rate" is a significant factor, it is not the only one and cannot be viewed out of context. There are Settling States that had only a moderate collection rate but were found to have diligently enforced. New Mexico illustrates the opposite end of that spectrum. Although its initial collection rate was found to be 69%, not including sales on tribal lands, and 81% if Carolina and Leonidias were treated as PMs, those rates are subject to serious scrutiny. For example, an unusually high number of monthly distributor reports (26%) were either missing or incorrect, and there was direct evidence of significant underreporting. These issues were basically ignored by New

Mexico because Glenn Smith, Special Counsel to the Office of the Attorney General, was of the opinion that the obligation to report was solely that of the NPMs and distributors and that the State had no duty to notify or follow-up. Of the top ten NPMs for the calendar year 2003, five were in compliance, one partially complied, and four failed to comply. Overall, thirteen NPMs out of twenty-nine complied, two partially complied, and fourteen failed to comply.

b. Lawsuits Filed

New Mexico filed no lawsuits in either 2002 or 2003 against non-compliant NPMs. Moreover, seven of these NPMs were non-compliant in prior years. The State was implicitly aware, however, of the usefulness of lawsuits and did file some in later years over 2003 sales.

c. Gathering Reliable Data

New Mexico had no formal plan or guidelines for data collection. In fact, distributors and NPMs were sent no information about required information unless they requested it. As stated above, the sales data when received was rife with missing or incorrect reports and was not systematically verified or audited. No Notice letters were sent, only two Demand letters (which resulted in payment) were sent, and there was little communication between the Office of the Attorney General and the Department of Taxation and Revenue to monitor or increase what information was available. Dustin Sparks, an unpaid intern during 2003, did what he could to improve the situation, but he worked less than five hours per week on escrow matters. There was also a critical conflict between the testimony of Glenn Smith and that of Dustin Sparks as to what Mr. Sparks's responsibility actually was with respect to the collection of accurate information from the Department of Taxation and Revenue.

d. Resources Allocated to Enforcement

The State had no dedicated budget for escrow enforcement, even though Glenn Smith had testified before the Tobacco Settlement Review Oversight Committee that lack of resources could endanger the State's MSA payment. Despite those warnings, there was no full-time employee or the equivalent assigned to escrow enforcement, and no monies were ever granted for enforcement efforts. This was in stark contrast to the monies granted for excise tax enforcement, especially after New Mexico significantly raised its excise tax rate.

e. Preventing Non-Compliant NPMs from Future Sales

New Mexico's lack of efforts resulted in an increase in non-compliance. As one example, sales by Intercontinental rose from 144,000 in 2001 to 3.3 million sticks in 2003. Overall, nine million non-compliant cigarettes were sold between May-December 2003, and by the end of 2003, 2.5 million off-Directory sticks were still being sold.

f. Legislation Enacted

New Mexico enacted Complementary Legislation, effective as of April 2003, but it was not posted on the Attorney General's website until September. No direct notice of the new legislation was sent by either the Attorney General or the Department of Taxation and Revenue, which was the main contact agency with distributors.

New Mexico also had available the Cigarette Enforcement Act of 2000, which allowed seizure of foreign cigarettes, if no certificate of compliance was filed. New Mexico made no use of that statute insofar as escrow enforcement was concerned. This is notable because New Mexico had an existing program of retail inspections for excise tax purposes.

g. Actions Short of Legislation

The record is basically void of any actions taken by New Mexico, *e.g.*, seizures, injunctions, settlement efforts, or regulations that might have served as a supplemental tool for enforcement.

h. Efforts to Be Aware of NAAG and Other States' Enforcement Efforts

Again, New Mexico's performance in this final factor was poor. Although Glenn Smith allegedly attended some NAAG meetings, he wrote no memos about what had occurred or communicated the information to anyone else either in the Office of the Attorney General or the Department of Taxation and Revenue. There is no indication in the record that New Mexico took part in any NAAG working groups or participated in any national litigation.

4. Conclusion.

Despite a Collection Rate that is reasonable on a superficial level, further consideration of that number, plus New Mexico's lack of efforts or results in virtually all other enforcement areas, indicate an overall culture of non-compliance. Therefore, the Panel finds that New Mexico has failed to meet its burden of proof of diligent enforcement.

FINAL AWARD

The Panel unanimously finds that the State of New Mexico did not diligently enforce its Qualifying Statute during calendar year 2003 and therefore is subject to an NPM Adjustment pursuant to Section IX (d)(2)(B) of the Master Settlement Agreement.

All other claims, if any, not specifically addressed in the Final Award are Denied. This Final Award therefore resolves all claims set forth in this proceeding.

SO ORDERED.

Dated: September 11, 2013

The Honorable William G. Bassler
Arbitrator

The Honorable Abner J. Mikva
Arbitrator

The Honorable Fern M. Smith
Chairperson