

EXECUTIVE COUNCIL OF IOWA AGENDA

State Capitol - Robert D. Ray Conference Room (G09) 10:00 a.m.

DECEMBER 15, 2014

1. Approval of minutes of meeting held December 8, 2014
2. Payment of Cost Items – Page 1
TAB # 1

2. **Payment of Cost Items**

- A. Nyemaster Goode P.C.....\$120.00
700 Walnut Street
Suite 1600
Des Moines, IA 50309
Collections of Accounts in Court

Jeffrey S. Thompson, Solicitor General, has reviewed these invoices and recommends payment. Payment will be made from the funds of the Economic Development Authority.

- B. Simmons Perrine Moyer Bergman PLC.....\$125,059.91
115 Third Street SE, Suite 1200
Cedar Rapids, IA 52402
Tobacco Settlement Authority

Jeffrey S. Thompson, Solicitor General, has reviewed this invoice and recommends payment. Payment will be made from the funds of the Tobacco Settlement Authority.

TAB # 1

- C. McDowell, Rice, Smith & Buchanan.....\$63,008.32
605 West 47th Street, Suite 350
Kansas City, MO 64112
Tobacco Settlement Authority

Jeffrey S. Thompson, Deputy Attorney General, has reviewed this invoice and recommends payment. Payment will be made from the funds of the Tobacco Settlement Authority.

TAB #1

- D. LaMarca & Landry, P.C.....\$121,057.93
1820 N.W. 118th Street, Suite 200
Des Moines, IA 50325
Godfrey v. State of Iowa et al, civil rights complaint

Jeffrey S. Thompson, Solicitor General, Iowa Department of Justice has reviewed this invoice and recommends payment.

EXECUTIVE COUNCIL

THOMAS J. MILLER
ATTORNEY GENERAL

2014 DEC 10 AM 8:28



JEFFREY S. THOMPSON
SOLICITOR GENERAL

Iowa Department of Justice

ADDRESS REPLY TO:
1305 E. Walnut Street
Des Moines, IA 50319
www.IowaAttorneyGeneral.org

Telephone: 515/281-4419
Fax: 515/281-4209
Jeffrey.Thompson@Iowa.gov

December 8, 2014

GeorgAnna Madsen
Executive Secretary
Executive Council
State Capitol
LOCAL

Re: Payment of Claims for Fees by Special Counsel

Dear GeorgAnna:

Our office is forwarding to the Executive Council approval for payment of attorney fees and costs in the amount of \$125,059.91 from Roger W. Stone, Simmons Perrine Moyer Bergman PLC, , who was appointed pursuant to Iowa Code section 13.7 to handle tobacco settlement related litigation to establish diligent enforcement of the non-participating tobacco manufacturers' escrow statute.

As indicated on the enclosure, the amount is for seven statements dated June through December of 2014. This billing relates to the 2004 NPM Adjustment dispute. We have reviewed both the billing and the Services Agreement and recommend payment. Pursuant to the terms of our agreement, payment should be made from the Tobacco Settlement Authority and not from the General Fund.

Sincerely,

A handwritten signature in black ink, appearing to read "Jeffrey S. Thompson", with a long horizontal flourish extending to the right.

JEFFREY S. THOMPSON
Solicitor General

Encl.

Simmons Perrine Moyer Bergman PLC

Date of EC Itr.	Amount
6/2/2014	30,359.50
6/30/2014	42,259.65
7/28/2014	26,012.69
9/4/2014	16,904.46
10/7/2014	5,315.00
10/27/2014	4,208.61
TOTAL:	125,059.91

THOMAS J. MILLER
ATTORNEY GENERAL

EXECUTIVE COUNCIL

2014 DEC 10 AM 8:28



JEFFREY S. THOMPSON
SOLICITOR GENERAL

Iowa Department of Justice

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1305 E. Walnut Street
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Jeffrey.Thompson@Iowa.gov

December 8, 2014

GeorgAnna Madsen
Executive Secretary
Executive Council
State Capitol
LOCAL

Re: Payment of Claims for Fees by Special Counsel

Dear GeorgAnna:

Our office is forwarding to the Executive Council approval for payment of attorney fees and costs in the amount of \$63,008.32 from Kristie Orme of McDowell Rice Smith & Buchanan PC, who was appointed pursuant to Iowa Code section 13.7 to handle tobacco settlement related litigation to establish diligent enforcement of the non-participating tobacco manufacturers' escrow statute.

As indicated on the enclosure, the amount is for seven statements dated June through December of 2014. This billing relates to the 2004 NPM Adjustment dispute. We have reviewed both the billing and the Services Agreement and recommend payment. Pursuant to the terms of our agreement, payment should be made from the Tobacco Settlement Authority and not from the General Fund.

Sincerely,

A handwritten signature in black ink, appearing to read "Jeff S. Thompson", written over a horizontal line.

JEFFREY S. THOMPSON
Solicitor General

Encl.

McDowell Rice Smith Buchanan PC

Date of EC ltr.	Amount
6/4/2014	10,934.54
7/3/2014	23,460.53
8/5/2014	11,163.28
9/9/2014	11,177.36
10/7/2014	2,515.61
11/5/2014	435.80
12/3/2014	3,321.20
TOTAL:	63,008.32

Iowa Tobacco Master Settlement Agreement

NPM Adjustment Arbitration Update

December 2014

I. Background

In 1998, Iowa participated in the Master Settlement Agreement (MSA) with the four major tobacco companies (OPMs) to settle the healthcare, fraud, and other claims that the state had brought against those companies. After the initial settlement, additional smaller companies also joined (SPMs). Now, over forty tobacco companies are part of the MSA. Collectively, these companies are known as the Participating Manufacturers (PMs).

This landmark agreement required significant business changes by the PMs, including a prohibition on marketing cigarettes to children, a ban on ads on billboards and public transit and a ban on the use of brand names to promote sporting events or merchandise. In addition, the PMs agreed to make annual MSA payments to Iowa in perpetuity. To date, Iowa has received over \$960,000,000 in MSA payments (this includes over \$133,000,000 in Strategic Contribution Fund payments which Iowa receives because of the leadership role of Attorney General Tom Miller in negotiating the MSA).

The MSA payments are made annually each April 15th. In April 2014, Iowa received more than \$71,600,000. This amount included a regular payment of \$65,500,000 and an additional \$6.1 million -- previously withheld by the PMs -- released to Iowa as a result of its recent success in the 2003 NPM adjustment arbitration.

II. The NPM Adjustment Arbitration

A. The NPM Adjustment

Under the terms of the MSA, the PMs must make annual payments based upon sales volume, subject to a number of adjustments. One such adjustment is the “NPM adjustment” which can reduce the PM payments to compensate for market share losses attributable to the MSA. That is, market losses to companies (the Non-Participating Manufacturers or NPMs) that did not join the MSA and are not subject to its marketing restrictions and payment obligations.

In order for the NPM adjustment to apply, two conditions must be met: (1) the PMs must suffer a “market share loss”, and (2) the MSA must have been a “significant factor” in that market share loss. In addition, the MSA permits a Settling State to avoid the application of the NPM adjustment to its “allocable share” of an annual payment if the State establishes that it “diligently enforced” its qualifying statute¹ for the year in question. Notably, the allocable share of states found to be diligent for a particular year is “reallocated” against the payments of the non-diligent states. Thus, a state could lose up to the full amount of its MSA payment for a particular year.

B. The 1998-2002 NPM Adjustment Settlement

Following the signing of the MSA in 1998, despite the fact that the Settling States all enacted qualifying statutes, PMs lost market share to NPMs at significant rates. This shift of market share has triggered the NPM Adjustment provision of the MSA for

¹ The Qualifying Statute is the statute contained in Exhibit T of the MSA. It requires the NPMs to make escrow payments against potential future claims by the states similar to those brought against the OPMs that led to the MSA. The escrow payments are intended to help neutralize the price advantage that the NPMs would have against the PMs who need to cover their MSA payment obligations. Iowa’s Qualifying Statute is Iowa Code chapter 453C.

multiple years. The PMs and the Settling States settled the NPM Adjustments through payment year 2002 but left subsequent years unresolved.

C. The 2003 NPM Adjustment Dispute

1. Preliminary Matters

In connection with its April 2004 calculations for the PM's 2003 MSA payment, the MSA Independent Auditor determined that the PMs had suffered a "market share loss" for 2003. The Independent Auditor's determination, the magnitude of the loss and the resulting proposed 2003 NPM Adjustment was not disputed by the Settling States.

In April 2005, the PMs and the Settling States instituted a proceeding to determine whether the MSA was a "significant factor" contributing to the "market share loss" experienced by the PMs for 2003. The Brattle Group determined that the MSA was a "significant factor" in March 2006. The determination was final and non-appealable.

Following the March 2006 "significant factor" determination, the PMs and Settling States then could not agree about the method for the Independent Auditor's application of the NPM Adjustment. The PMs ultimately invoked the MSA's arbitration clause. The States refused to arbitrate, then sued and lost in state courts. Finally, in January 2009, the PMs and Settling States agreed to arbitrate the 2003 NPM Adjustment.

2. 2003 NPM Adjustment Arbitration

In July 2010, the arbitration commenced with the appointment of a panel of three former federal judges, as required by the MSA. Because this was a matter of first impression for all of the parties, there were a number of preliminary procedural and substantive legal issues, including the scope of discovery, the burden of proof, and even the MSA's definition of "diligent enforcement" and "units sold." The panel ultimately

conducted a separate hearing on these common issues and then conducted individual state hearings.

The parties filed over 2,800 motions, briefs, and pleadings with the panel. Discovery was conducted over the first 10 months of 2011. Iowa provided the PMs with over 85,000 documents. A representative of the Iowa Attorney General's office was deposed for 7½ hours. The PMs provided the states with thousands of pages of documents, and representatives from most of the companies were deposed by state attorneys.

Hearings were held in California, Colorado, Florida, Illinois, Massachusetts, and DC. The common issues evidentiary hearing was held in Chicago in April 2012. Iowa Assistant Attorney General Donald Stanley was one of three state representatives who testified on behalf of the states. His direct testimony and cross-examination lasted over one full hearing day.

Iowa's individual hearing was held October 16-19, 2012, in Chicago. Iowa's case (which was limited to 11 hours of presentation time) included testimony from three attorneys from the Iowa Attorney General's office and one person from the Iowa Department of Revenue. Iowa also had one expert testify on foreign law issues and one rebuttal expert on Iowa law. The PMs solicited testimony from four expert witnesses. They had no factual witnesses to support their claim that the state failed to diligently enforce its law.

During the course of the proceedings, the PMs decided not to contest the diligence of twelve states. In addition, twenty-two states reached a settlement with the PMs to resolve all NPM adjustment claims through 2014. Ultimately, fifteen individual state

cases were heard and decided. In the end, Iowa and eight other states were found to have been diligent: six states were found to have been non-diligent.

The arbitration panel concluded:

Iowa exemplified a Settling State where all the state actors worked together to enforce and improve its Qualifying Statute, from the legislature to the Attorney General's Office to the Department of Revenue. Iowa's witnesses convincingly demonstrated that they were concerned about and focused on enforcing its Qualifying Statute and, within the parameters of Iowa's law, continuously and persistently did so.

The panel's Iowa decision is attached for your reference.

As a result of the diligence finding, Iowa received \$6.1 million withheld by the PMs from previous payments in dispute of the 2003 NPM adjustment. The state also preserved the full \$50.4 million in MSA payment that had been received for 2003 – up to that amount could have been deduction from the 2014 MSA payment had the arbitration panel ruled against the state.²

As an illustration of what was at risk: Each of the six states that lost their 2003 arbitration was subject to an NPM Adjustment of approximately 71% of their 2003 MSA payment (as a result of the “reallocation” provision of the MSA) which converted to about a 64% reduction of their April 2014 MSA payment. Thus, had Iowa not been found to have “diligently enforced” its statute, Iowa's April 2014 MSA payment would have been reduced by approximately \$35.8 million.

² The exact amount would have been subject to allocation and reallocation calculations by the Independent Auditor.

D. 2004 NPM Adjustment Dispute

The NPM Adjustment for 2004 remains disputed. Negotiations have begun between the PMs and the remaining Settling States to set the ground-rules for the 2004 arbitration. The PMs, for now, appear to be insisting that the whole process be repeated.

The risk to Iowa in the 2004 NPM adjustment dispute is similar to the risk in the 2003 dispute. The PMs withheld over \$6 million from prior payments. In addition, the state received \$54 million in MSA payments that year. Thus, as with the 2003 NPM adjustment, up to the full amount of the payment received could be deducted from a future MSA payment should Iowa not establish that it “diligently enforced” its Qualifying Statute.

E. Beyond the 2004 NPM Adjustment Arbitration

Under the MSA, the NPM Adjustment is calculated and may be applied each year. As noted above, the Independent Auditor has found a “market share loss” for each year, and the States have agreed not to contest the “significant factor” finding through 2012. At this point it is not clear how far the PMs will push the NPM Adjustment issue. For Iowa, at least, the economic risk associated with an NPM Adjustment drops significantly after 2004.



1 Hon. Fern M. Smith (Ret.)
2 JAMS
3 Two Embarcadero Center, Suite 1500
4 San Francisco, CA 94111
5 Telephone: (415) 982-5267
6 Fax: (415) 982-5287

7 ARBITRATOR

8
9 ARBITRATION

10 In the 2003 NPM Adjustment
11 Proceedings

JAMS Ref No. 1100053390

**FINAL AWARD RE:
STATE OF IOWA**

12
13
14
15 **CHAPTER I: THE PARTIES TO A SPECIFIC STATE AWARD**

16 Petitioners are manufacturers of tobacco products that have joined the MSA ("Master
17 Settlement Agreement"), entered into in 1998, and agreed to be bound by its terms. The MSA
18 refers to such manufacturers as "Participating Manufacturers" or "PMs." *See* MSA § II(jj). The
19 PMs fall into two categories. The "Original Participating Manufacturers," or "OPMs," are those
20 manufacturers that were original parties to the MSA: Philip Morris USA Inc., R.J. Reynolds
21 Tobacco Company, and Lorillard Tobacco Company. *See* MSA § II(hh). (A fourth OPM,
22 Brown & Williamson Tobacco Corporation, combined with R.J. Reynolds Tobacco Company in
23 2004.) The "Subsequent Participating Manufacturers," or "SPMs," are smaller manufacturers,
24 most of which were never sued by the States, but joined the MSA thereafter. *See* MSA § II(tt).
25 The following SPMs claim entitlement to an NPM Adjustment for 2003 and are petitioners in
26 these proceedings: Commonwealth Brands, Inc., Compania Industrial de Tabacos Monte Paz,
27 S.A., Daughters & Ryan, Inc., House of Prince A/S, Japan Tobacco International U.S.A. Inc.,
28 King Maker Marketing, Inc., Kretek International, Liggett Group LLC, Peter Stokkebye

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

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

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

27 Although numerous references may be made to the National Association of Attorneys
28 General ("NAAG") and the "NAAG Tobacco Project," which assist the states in implementing

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

16 CHAPTER II: THE BACKGROUND

17 A. Origin of the Dispute.

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

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

1 Manufacturers ("NPMs").

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

10 The MSA's annual base payment amounts are subject to various adjustments, including
11 an Inflation Adjustment and a Volume Adjustment (under which the base payments are increased
12 or decreased in proportion to changes in the OPMs' nationwide volume of sales). *See* MSA §§
13 IX(c), XI(a). According to the PMs, and not disputed, the OPMs' aggregate annual payments
14 after these and other adjustments (other than the NPM Adjustment) since the MSA was entered
15 into have been as follows: 1999-\$3.545 billion; 2000-\$4.022 billion; 2001-\$5.066 billion;
16 2002-\$4.967 billion; 2003-\$5.950 billion; 2004-\$6.048 billion; 2005-\$6.128 billion; 2006-
17 \$6.221 billion; 2007-\$7.076 billion; 2008-\$7.011 billion; and 2009-\$6.497 billion. These
18 payments are split among the OPMs in proportion to their relative market shares. *See* MSA §§
19 IX(c)(1)-(2).

20 Each SPM makes annual payments that, on a per-cigarette basis, approximate the OPMs'
21 annual payments and that are likewise based on the SPMs' sales volume during the year in
22 question. *See* MSA § IX(i). The SPMs' aggregate annual payments for each year have been
23 claimed as follows: 1999-\$46.4 million; 2000-\$98.5 million; 2001-\$200.4 million; 2002-
24 \$319.0 million; 2003-\$484.5 million; 2004-\$433.7 million; 2005-\$441.5 million; 2006-\$517.7
25 million; 2007-\$475.0 million; 2008-\$569.5 million; and 2009-\$571.5 million.

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

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

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

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

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

27
28 [The] NPM Adjustment provides [an] incentive to ameliorate these adverse
 effects [*i.e.*, "undermin[ing] the MSA's public health goals" and "unfairly

1 disadvantag[ing] companies that had chosen to” join the MSA. It provides that if,
2 because of the disadvantages imposed on them by the MSA, the PMs lose
3 “Market Share” to NPMs, the PMs’ payments to the States can be reduced.

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

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

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

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

17 The only exception is where a State demonstrates that it has enacted and “diligently
18 enforced” a “Qualifying Statute.” MSA § IX(d)(2)(B). A “Qualifying Statute” is defined as a
19 statute that “effectively and fully neutralizes the cost disadvantages that the Participating
20 Manufacturers experience vis-à-vis Non-Participating Manufacturers within such Settling State
21 as a result of [the MSA].” MSA § IX(d)(2)(E). States are thus not required either to enact or
22 enforce such a statute, but if they want the benefit of the contractual exemption from the NPM
23 Adjustment, they must do both.

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

1 Adjustment shall be available “. . . if such Settling State continuously had a Qualifying Statute
2 (as defined in subsection (2)(E) below) in full force and effect during the entire calendar year
3 immediately preceding the year in which the payment in question is due and diligently enforced
4 the provisions of such statute during such entire calendar year . . .” *Id.* Thus, defining what
5 standard is required before a State qualifies for this critical exception is left for this Panel to
6 decide.

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

24 The MSA defines a “Qualifying Statute” as one that, among other things, “effectively and
25 fully neutralizes the cost disadvantages that the [PMs] experience vis-à-vis [NPMs] within such
26 Settling State as a result of” the MSA. MSA § IX(d)(2)(E). Exhibit T to the MSA provides a
27 model for such a statute: a “model” Escrow Statute. The MSA provides that this “model”
28 Escrow Statute, if enacted with those modifications necessary to reflect “particularized state

1 procedural or technical requirements” will “constitute a Qualifying Statute.” *Id.*

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

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

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

23 As a beginning and necessary step leading to this Arbitration, in connection with its April
24 2004 calculation of the PMs’ MSA payment for 2003, the Independent Auditor determined that
25 the MSA’s first condition for application of the 2003 NPM Adjustment was satisfied: the PMs
26 had suffered a “Market Share Loss” for 2003. The Auditor calculated that there had been a
27 market-share shift of approximately 8% to the NPMs from 1997 to 2003, and thus a Market
28 Share Loss of approximately 6% after giving effect to the two percentage point buffer.

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

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

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

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

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

26 The Settling States initially refused to agree to arbitration, and sought relief in their
27 individual state courts, which was denied in virtually every case. It was not until January 30,
28 2009, that 45 Settling States had signed an Agreement to Arbitrate ("the ARA"). Pursuant to the

1 ARA's "partial liability reduction," the PMs will reimburse each of those 45 Settling States that
2 the Panel determines did not diligently enforce its Escrow Statute in 2003 with 20% of the
3 portion of the 2003 NPM Adjustment that it bears as a result. *See* ARA § 3(b). Four Settling
4 States—Ohio, Oklahoma, North Carolina, and Wisconsin—refused to sign the ARA, but were
5 ordered to arbitration by their state courts, and participated in this Arbitration. Thereafter, the
6 PMs and 48 Settling States, including the four Settling States that declined to sign the ARA,
7 negotiated a separate "Agreement Regarding Procedures for Formation of Arbitration Panel."
8 Pursuant to that Agreement and Section XI(c) of the MSA, this Panel was selected to resolve the
9 2003 NPM Adjustment dispute.

10 **B. The Arbitration Clause.**

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

16 Resolution of Disputes. Any dispute, controversy or claim arising out of or
17 relating to calculations performed by, or any determinations made by, the
18 Independent Auditor (including, without limitation, any dispute concerning
19 the operation or application of any of the adjustments, reductions, offsets,
20 carry-forwards and allocations described in subsection IX(j) or subsection
21 XI(i)) shall be submitted to binding arbitration before a panel of three neutral
22 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.

23 MSA § XI(c).

24 **C. The Arbitration Panel.**

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

27 Judge William G. Bassler, selected by the PMs;

28 Judge Abner J. Mikva, selected by the Settling States; and

1 Judge Fern M. Smith, selected by Judges Bassler and Mikva.

2 **CHAPTER III: THE PROCEDURAL HISTORY**

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

15 **CHAPTER IV: THE CONTENTIONS OF THE PARTIES**

16 **A. The Claimants' Contentions.**

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

- 20 1. Determine that the Independent Auditor was required to apply the 2003 NPM
21 Adjustment to the PMs' April 2006 annual payments once the Firm determined that
22 the MSA was a significant factor contributing to the PMs' Market Share Loss for
23 2003.
- 24 2. Determine that the Independent Auditor erred when it refused to apply the 2003 NPM
25 Adjustment to the PMs' April 2006 annual payments and when it adopted a
26 presumption that each State had diligently enforced its Escrow Statute.
- 27 3. Determine that the Independent Auditor is required to immediately credit the 2003
28 NPM Adjustment, with applicable interest, to the PMs' next MSA payments.

- 1 4. Determine that individual States have the burden of proving diligent enforcement of a
2 Qualifying Statute.
- 3 5. Allow the discovery necessary for the parties—and the Panel—to evaluate and
4 determine individual States’ claims that they diligently enforced a Qualifying Statute
5 during 2003.
- 6 6. Determine the claims of individual States that they diligently enforced a Qualifying
7 Statute during 2003 and that, accordingly, their Allocable Share of the 2003 NPM
8 Adjustment should be reallocated to other States.
- 9 7. Determine such other issues related to the application, allocation, and recovery of the
10 2003 NPM Adjustment as the parties shall raise and the Panel shall deem appropriate.

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

16 **B. The Respondents’ Contentions.**

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

23 **CHAPTER V: DISCUSSION AND DECISION**

24 **A. Common Findings/Conclusions.**

25 *1. Introduction.*

26 As stated above, the majority of defenses and issues raised by both the PMs and the
27 Settling States were common to all parties and were either resolved in pre-arbitration motion
28 proceedings, or were deferred until all of the state-specific hearings were completed. Included in

1 this Award, therefore, are final determinations of those deferred issues, each of which was a
2 significant factor in the Panel's ultimate Awards and each of which is common to the each state-
3 specific Award. They include the following:

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

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

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

25 2. "Diligent Enforcement" Defined.

26 Diligent Enforcement is an ongoing and intentional consideration of the requirements of a
27 Settling State's Qualifying Statute, and a significant attempt by the Settling State to meet those
28 requirements, taking into account a Settling State's competing laws and policies that may

1 conflict with its MSA contractual obligations. Both the legislative and executive branches of a
2 Settling State are bound by the MSA obligations.

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

6 3. "Units Sold" Defined.

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

9 "Units sold" means the number of individual cigarettes sold in the State by the
10 applicable tobacco product manufacturer (whether directly or through a
11 distributor, retailer or similar intermediary or intermediaries) during the year in
12 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

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

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

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

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

1 other than what it says.

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

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

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

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

24 MSA Ex. T, T-3.

25 The "Requirements" section of the Model Statute establishes that the Attorney General of
26 a Settling State may file a civil action against a TPM under certain express conditions. MSA Ex.
27 T, T-5. The right to file a civil action is the only express remedy against TPMs that is set forth in
28 the MSA or Model Statute. The PMs argued in all state-specific hearings that the right to file a

1 lawsuit was critical to diligent enforcement and that the Settling States had an obligation to file
2 such suits often and as soon as possible.

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

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

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

23 6. Enforcement Effort Against House of Prince/Carolina/Leonidas.

24 Much time was spent in discussing the role that these entities played, and, more
25 important, their status during the 2003 time period, *i.e.*, were they NPMs, SPMs, contract
26 manufacturers, etc. The value of understanding the relationships lies only in how their status
27 affected a given Settling State's "compliance rate," *i.e.*, the percentage of escrow paid against the
28 total number of units sold in a Settling State by NPMs. The PMs' case rested in great part on the

1 use of expert testimony, an important facet of which was establishing a compliance rate for each
2 state. Because of the legitimate confusion over whether the above entities were NPMs or not,
3 many Settling States took a “wait and see” attitude and did not seek escrow from them, resulting
4 in a lower compliance rate, based on the PMs’ calculations. The Panel understands the PMs’
5 theory, but also is unwilling, in hindsight, to classify such decisions as a failure in diligent
6 enforcement. This is especially true because the status of those entities has since resolved.

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

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

17 8. Allocable Share Release.

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

25 9. The Significance, i.e., Use/Weight of a State’s “Collection Rate.”

26 The PMs’ case-in-chief relied almost completely on the testimony of expert witnesses.
27 One category of expert testimony was provided by economists, who based their opinions
28 primarily on the “collection rate” of a Settling State, i.e., what amount of money was deposited

1 by NPMs into escrow accounts in a given year, as compared to the experts' determination of
2 what amount was actually due. The collection rates among and between the Settling States
3 differed significantly, and the variance was intended to be used in a comparative way for the
4 Panel to determine the lack of diligent enforcement. The Panel concurs that the collection rate is
5 a significant factor, but it is not the only factor, nor is it always the primary factor. Predicating a
6 Settling State's diligence, therefore, based solely on the collection rate is unlikely to be fruitful.
7 Further, because in most cases, the "underreported" collection rate is similar across states, the
8 Panel has not factored that into its analysis, except in unusual circumstances.

9 **B. State-Specific Findings and Conclusions as to the State of Iowa.**

10 *1. The Attorneys and Witnesses for the Iowa Hearing.*

11 a. The Attorneys for Iowa

12 i. Simmons Perrine Moyer Bergman PLC

13 Roger W. Stone

14 ii. McDowell, Rice, Smith & Buchanan

15 Kristie Remster Orme

16 b. The Attorneys for the PMs

17 i. Baker Hostetler LLP

18 Robert Brookhiser

19 Elizabeth McCallum

20 Nina Liao

21 ii. Winston & Strawn LLP

22 Alexander Shaknes

23 iii. Jones Day

24 Kelly Marino

25 c. Witnesses for Iowa

26 i. Donald Stanley

27 Primary person in the Iowa Office of the Attorney General responsible
28 for enforcement of the MSA in 2002-2003

1 ii. Marsha Ternus

2 Expert Witness; former Chief Justice of Iowa Supreme Court

3 iii. Dale Thede

4 Program Manager of Excise Taxes for Iowa Department of Revenue

5 iv. Glenn Hendrix

6 Expert Witness; Managing Partner of Arnall Golden Gregory LLP

7 v. Lucille Hardy

8 Associate Attorney General in the Iowa Revenue Division in 2002-

9 2003.

10 d. Witnesses for the PMs

11 i. Peter Reiss

12 Expert Witness

13 ii. Richard Briffault

14 Expert Witness

15 iii. Franco Ferrari

16 Expert Witness

17 iv. David Hancox

18 Expert Witness

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

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

24 a. Collection Rate

25 b. Lawsuits Filed

26 c. Gathering Reliable Data

27 d. Resources Allocated to Enforcement

28 e. Preventing Non-Compliant NPMs from Future Sales

1 f. Legislation Enacted

2 g. Actions Short of Legislation

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

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

9 3. Analysis.

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

16 a. Collection Rate

17 Iowa is a good example of a Settling State wherein the collection rate, standing alone, is
18 not an accurate reflection of enforcement. Dr. Reiss testified that the Initial Collection rate was
19 44%, and looking at ASRs, the 25-year rate was only 29%. Persuasive testimony from Mr.
20 Stanley, however, showed a different perspective.

21 Iowa's own collection rate calculation was 47-49%, depending on whether the later
22 payments were counted. GTC, a perennial problem NPM, accounted for 73% of the unpaid
23 escrow, and the PMs conceded that Iowa sued on over 91% of the 2002 delinquent escrow in
24 2002. Of those sued, 47% voluntarily complied, and of the 53% of the escrow owed that was not
25 collected, 41% was from GTC, whom Iowa sued; 7% was from Mighty Corp., whom Iowa sued,
26 and other judgments were obtained against NPMs responsible for another 4% of non-compliant
27 units, leaving less than 1% of total sales that were not subject to deposit, judgment, or settlement.

1 b. Lawsuits Filed

2 Iowa pursued lawsuits from earlier years in 2003, including those against Mighty Corp.
3 and GTC. Both NPMs continued selling until Iowa established its Directory. Iowa filed lawsuits
4 against foreign manufacturers, most of which ended in default judgments, although it did not
5 then make an effort to collect those lawsuits by filing actions abroad.

6 The parties presented dueling expert testimony by Glenn Hendrix (IA) and Franco Ferrari
7 (PMs) on the ability to enforce judgments abroad and whether foreign courts recognize default
8 judgments. The Panel found Iowa's decision in this regard to be a rational policy. The PMs'
9 expert, David Hancox, conceded that Iowa made "good pre-litigation efforts."

10 Of the five lawsuits pending against the largest non-compliant NPMs in late 2003, one
11 was dismissed and re-filed in 2004. Generally, Iowa sued all companies who owed more than
12 \$500, unless there was a reason not to sue at the time. All non-compliant NPMs received default
13 notices; and all were then sued and had a judgment entered against them, except for one NPM
14 who settled and paid what they owed after they were sued. Although no Settling State ever
15 collected a judgment from GTC (a Canadian Tribal company), GTC was sued in 2003, service
16 was obtained in 2004, and a default judgment was obtained by the end of 2004.

17 The PMs criticize Iowa, as they have other states, for adopting the strict "fabricator test"
18 for determining which entity was deemed to be the "manufacturer" responsible for making
19 escrow deposits instead of the control test. Under its test, Iowa sued foreign "fabricators" rather
20 than suing domestic trademark holders or other controlling entities. Similarly, the PMs indict
21 Iowa with lack of diligent enforcement, as they have other Settling States, because Iowa
22 interpreted its statute to require a "second knowing violation" requirement for obtaining an
23 injunction. Undoubtedly, Iowa's interpretation of the statutory language hampered its
24 enforcement efforts. But a Settling State cannot be charged with lax enforcement when it makes
25 a good faith interpretation—whether it is right or wrong—that it feels is legally compelled by the
26 wording of the statute.

1 c. Gathering Reliable Data

2 Of the 145 licensed distributors in Iowa, about twenty sold NPM product. Iowa had a
3 quarterly reporting system for distributors which the PMs criticize, because some reports were
4 missing (primarily from smaller distributors), and reports were not required monthly.

5 Iowa sent a quarterly notice in 2002 and 2003 to licensed distributors, explaining their
6 obligations and requesting that the distributors attach actual invoices to their reports (the PMs
7 take issue with the fact that Iowa requested invoices but did not require them).

8 When Iowa changed from a reporting system of asking for only NPM data to asking for
9 all sales, it requested that distributors re-report their 2003 first-quarter sales. After
10 Complementary Legislation passed, Iowa implemented a penalty system for failure to file a
11 report. There is persuasive evidence that most reports were filed.

12 In 2000, Iowa instituted a database to track distributor sales for both NPM and non-NPM
13 sales and hired an outside consultant to build the database.

14 Iowa sent notices to NPMs in February and March 2003 notifying them of reporting
15 obligations. Invoices were also requested from NPMs. The reports were reviewed for errors and
16 then entered into the database. They were later matched against the tax returns that came in from
17 the distributors.

18 Eleven of the fifteen largest distributors, as measured by 2002 volume, were audited at
19 least once between 2001 and 2005, and six of the eleven were audited at least twice, based on
20 Mr. Stanley's testimony. In all, there were twenty-three audits in 2001-2002 and ten audits in
21 2003. The Panel discounts Mr. Hancox's criticism that there should have been an "audit plan" as
22 an example of form over substance.

23 d. Resources Allocated to Enforcement

24 The Office of the Attorney General received a special \$50,000 appropriation to set up the
25 Directory and \$25,000 for the years after to maintain it.

26 Appropriations from the State paid for a number of salaries of the Office of the Attorney
27 General, and it appeared that the Department of Revenue was adequately staffed.

1 e. Preventing Non-Compliant NPMs from Future Sales

2 Non-compliant sales virtually stopped after the Directory was published on July 30, 2003,
3 based on testimony from Mr. Stanley. Although Mr. Hancox disputed that testimony, the Panel
4 finds that, overall, Iowa's record in this regard was convincing and effective. The Panel has
5 considered the PMs' argument that Iowa could have/should have sought injunctions against the
6 distributors, but have found that contention to be persuasively rebutted by testimony from former
7 Chief Justice Ternus.

8 f. Legislation Enacted

9 Complementary Legislation was passed, the ASR process was repealed, and the status of
10 RYO was clarified in 2003. The Iowa Directory was published July 30, 2003. Further, in 2002,
11 pre-complementary legislation, drafted by Lucille Hardy, was passed by both houses of the
12 legislature and contained many of the tools later included in Complementary Legislation (the
13 ability to ban non-compliant brands, quarterly certification, and subjecting distributors to civil
14 penalties). An 11th hour objection from counsel for R.J. Reynolds Tobacco Company led to the
15 Attorney General's request that the Governor veto the bill.

16 g. Actions Short of Legislation

17 Good cooperation existed between the Department of Revenue and the Office of the
18 Attorney General, with regular communications between the departments. Notices were sent out
19 to NPMs about filing requirements, and further notices were sent out to NPMs about the
20 Directory after Complementary Legislation passed. The State passed regulations to implement
21 Complementary Legislation requiring quarterly deposits.

22 Iowa began some seizures in fall 2003, based on reports that a few companies were
23 selling off-Directory or contrary to the Directory. Fines were issued, as well as penalties of
24 disgorgement of profits. The Panel does not find the PMs' criticism of Iowa's procedures in this
25 regard to be material.

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

27 Iowa was very involved in NAAG activities. It communicated regularly with other
28 Settling States about investigations and Mr. Stanley was involved in a number of NAAG

1 working groups. Iowa's information was shared with other states. Mr. Thede of the Department
2 of Revenue, Ms. Hardy of the Revenue Division, and Attorney General Miller were also
3 involved in NAAG and inter-state activities. The PMs do not dispute this activity.

4 4. Conclusion.

5 The case of Iowa establishes that while the collection rate may provide a useful indication of
6 the success of a Settling State's efforts to collect escrow, it does not, standing alone, provide a
7 reliable indicator of a Settling State's diligent enforcement. Iowa exemplified a Settling State
8 where all the state actors worked together to enforce and improve its Qualifying Statute, from the
9 legislature to the Attorney General's Office to the Department of Revenue. Iowa's witnesses
10 convincingly demonstrated that they were concerned about and focused on enforcing its
11 Qualifying Statute and, within the parameters of Iowa's law, continuously and persistently did
12 so.

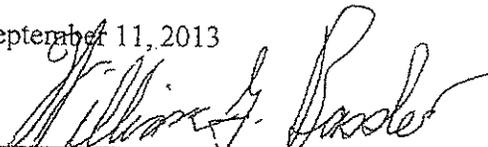
13 FINAL AWARD

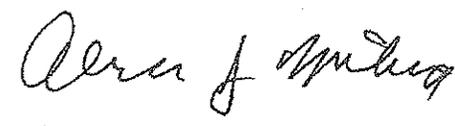
14 The Panel unanimously finds that the State of Iowa diligently enforced its Qualifying
15 Statute during calendar year 2003 and therefore is not subject to an NPM Adjustment pursuant to
16 Section IX (d)(2)(B) of the Master Settlement Agreement.

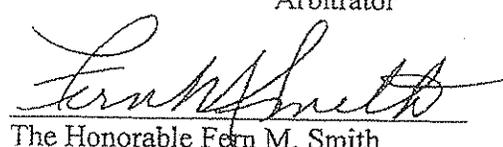
17 All other claims, if any, not specifically addressed in the Final Award are Denied. This
18 Final Award therefore resolves all claims set forth in this proceeding.

19
20 SO ORDERED.

21
22 Dated: September 11, 2013

23 
24 _____
25 The Honorable William G. Bassler
Arbitrator

23 
24 _____
25 The Honorable Abner J. Mikva
Arbitrator

26 
27 _____
28 The Honorable Fern M. Smith
Chairperson



State of Iowa Courts

Type: ORDER FOR JUDGMENT

Case Number Case Title
LACL071048 STATE ETAL V RJ REYNOLDS TOBACCO CO ETAL

So Ordered

A handwritten signature in cursive script that reads "Scott D. Rosenberg".

Scott D. Rosenberg, District Court Judge,
Fifth Judicial District of Iowa

**ORDER PURSUANT TO 9 U.S.C. § 9 ENTERING JUDGMENT CONFIRMING
THE ARBITRATION PANEL'S FINAL AWARD RE: STATE OF IOWA IN THE
2003 NON-PARTICIPATING MANUFACTURERS (NPM) ADJUSTMENT
PROCEEDINGS, DATED SEPTEMBER 11, 2013**

Pursuant to 9 U.S.C. § 9, the State of Iowa filed a Motion to Confirm the Final Award re State of Iowa in the 2003 NPM Adjustment Proceedings dated September 11, 2013.

IT IS HEREBY ORDERED THAT:

Pursuant to 9 U.S.C. § 9, this Court enters judgment confirming the Final Award re State of Iowa in the 2003 NPM Adjustment Proceedings dated September 11, 2013 and attached hereto as Exhibit A, which is incorporated by this reference into this Order.

The Court hereby enters an Order confirming the Final Award of the distinguished Panel of Arbitrators and enters judgment in favor of State of Iowa and against the PMs: (1) that the State of Iowa diligently enforced its Qualifying Statute during the entire calendar year 2003; (2) that the State of Iowa is not subject to an NPM adjustment pursuant to the Section IX(d)(2)(B) of the Master Settlement Agreement; (3) that all other claims, if any, presented in the Arbitration proceeding and not specifically addressed in the Final Award are Denied; and (4) that the Final Award in the Arbitration resolved all claims set forth in that proceeding.

The Honorable _____

Fifth Judicial District of Iowa District Court

The Iowa District Court in and for Polk County

STATE OF IOWA ex rel, THOMAS J.
MILLER.

Plaintiff,

v.

PHILIP MORRIS USA, R.J. REYNOLD
TOBACCO COMPANY, LORILLARD
TOBACCO COMPANY, ANDERSON
TOBACCO COMPANY LLC,
BECKENTON USA, CANARY ISLAND
CIGAR COMPANY, CHANCELLOR
TOBACCO COMPANY, PLC,
COMMONWEALTH BRANDS, INC.,
COMPANIA INDUSTRIAL DE
TABACOS MONTE PAZ, S.A.,
DAUGHTERS AND RYAN, INC.,
FARMERS TOBACCO COMPANY,
GENERAL TOBACCO, HOUSE OF
PRINCE A/S, INTERNATIONAL
TOBACCO GROUP (LAS VEGAS), INC.,
JAPAN TOBACCO INTERNATIONAL
USA, INC., KING MAKER
MARKETING, INC., KONCI G&D
MANAGEMENT, KRETEK
INTERNATIONAL, LIBERTY BRANDS,
LLC, LIGGETT GROUP, INC., M/S
DHANRAJ INTERNATIONAL, INC.,
PACIFIC STANFORD
MANUFACTURING CORPORATION,
PETER STOKKEBYE INTERNATIONAL
A/S, PT DJARUM, SANTA FE
NATURAL TOBACCO COMPANY,
INC., SHERMAN 1400 BROADWAY
N.Y.C, TOP TOBACCO, L.P., VIRGINIA
CAROLINA CORPORATION, INC.,
VON EICKEN GROUP, and WIND
RIVER TOBACCO COMPANY, LCC.,

Defendants.

Civ. No. CL71048

**PROPOSED ORDER ENTERING
JUDGMENT CONFIRMING FINAL
AWARD RE: STATE OF IOWA IN THE
2003 NPM ADJUSTMENT
PROCEEDINGS**