Landmark Settlements: Lessons from the Master Settlement Agreement

Andrew J. Haile, *Elon University*
LANDMARK SETTLEMENTS:
LESSONS FROM THE MASTER SETTLEMENT AGREEMENT

ANDREW J. HAILE* and MATTHEW W. KRUEGER-ANDES**

ABSTRACT

Nearly fourteen years ago forty-six states and the nation’s major tobacco manufacturers entered the Master Settlement Agreement, the largest civil settlement in United States history. This Article examines a current controversy under the MSA and why, as a result of that controversy, states may be required to return up to $7 billion in MSA payments to tobacco manufacturers. The Article focuses specifically on how New York’s seemingly unrelated policy decision not to collect excise taxes on cigarettes sold on Indian reservations may end up costing the state billions of dollars in MSA payments. After explaining the current controversy and New York’s particular situation, the Article extracts pertinent lessons from the states’ experience with the MSA. Those lessons might prove useful in avoiding “unintended consequences”—such as the one currently faced by New York—in future landmark settlements, including the recently-announced settlement between forty-nine states and five of the nation’s largest mortgage servicing companies.

* Associate Professor, Elon University School of Law.
** Law Clerk, Hon. Robert N. Hunter, Jr., North Carolina Court of Appeals. The views expressed in this Article are those of the author and do not reflect those of his employer.
# Table of Contents

**Introduction** ........................................................................................................... 1  
I. **MSA Payment Obligations** .................................................................................. 4  
II. **The NPM Adjustment** ......................................................................................... 10  
   A. *Mechanics of the NPM Adjustment Calculation* ........................................ 10  
   B. *The Significant Factor Determination* .......................................................... 12  
   C. *Qualifying Statutes and the “Units Sold” Issue* ............................................ 14  
III. **Authority to Collect Excise Tax on Reservation Sales to Non-Tribe Members** ...... 19  
    A. *Background* .................................................................................................. 19  
    B. *New York’s Efforts to Tax Reservation Sales After Moe* .......................... 22  
IV. **Failure to Collect Excise Tax and Diligent Enforcement** ............................ 34  
    A. *New York’s Position on Diligent Enforcement and Reservation Sales* ....... 34  
    B. *Dissonance Between the Branches* .............................................................. 38  
V. **Lessons from the MSA and the NPM Adjustment** ....................................... 41  
   A. *Simplicity* .................................................................................................... 41  
   B. *Precision* ..................................................................................................... 43  
   C. *Communication* .......................................................................................... 44  
**Conclusion** ............................................................................................................. 45
INTRODUCTION

In November 1998, forty-six states and the nation’s four major tobacco manufacturers entered into the largest financial settlement in U.S. history. That settlement, known as the Master Settlement Agreement (the “MSA”), resolved the states’ claims against the tobacco companies for damages associated with the health care costs of treating sick smokers. Among other things, the MSA requires that the tobacco companies make annual payments to the states in perpetuity, with the value of those payments estimated at $206 billion for the first 25 years of the agreement.

Health advocates celebrated the MSA, as several states proclaimed the intention to use as much as 20% of their annual settlement payments to combat the adverse health issues caused by smoking. Those initial intentions have not been sustained, though, and in 2011 the states

---

1 Prior to the MSA, four states – Mississippi, Minnesota, Texas, and Florida – had entered into separate settlement agreements with the largest tobacco companies.

2 Over forty smaller tobacco manufacturers subsequently joined the MSA, preemptively resolving similar claims that the states might otherwise have brought against them. See State of New York v. Philip Morris Inc., 8 N.Y.3d 574, 577 (2007) (stating “the ‘Original Participating Manufacturers, as they are known, were later joined by more than 40 smaller tobacco companies, referred to as the Subsequent Participating Manufacturers (SPMs)”).

3 See Frank Sloan and Lindsey Chepke, Litigation, Settlement, and the Public Welfare: Lessons From the Master Settlement Agreement, 17 WIDENER L. REV. 159 (2011) (stating that estimated payments for the first 25 years of the MSA are $206 billion).

collectively used less than 2% of their annual MSA payments to fund smoking control and prevention programs.\textsuperscript{5}

The use of MSA funds by the states constitutes just one unanticipated aspect of the agreement. Given the length and complexity of the MSA, there were sure to be others, and in fact another unexpected aspect of the agreement is currently winding toward resolution through an arbitration proceeding between the states and the tobacco manufacturers. The arbitration will ultimately determine whether any states must pay MSA funds back to the tobacco manufacturers based on the states’ failure to meet certain requirements set forth in the settlement. The amount at stake is considerable—currently over $7 billion, with additional amounts expected to be added to this figure in future years. Moreover, the way the MSA operates, a single state could potentially bear the full burden of the amount in dispute, effectively wiping out that state’s MSA payments for years to come. Cash-strapped states, many of which have become dependent on the annual receipt of MSA payments from the tobacco companies, could face significant financial hardship if they lose several years’ worth of MSA payments as a result of the on-going arbitration.

This Article explains and analyzes the current dispute between the states and the tobacco companies, with the goal of identifying lessons from the controversy that will help states avoid repeating the same mistakes in future landmark settlement agreements, such as the recently-announced settlement with the nation’s major mortgage servicing companies.\textsuperscript{6} To appreciate these lessons, however, the Article first

\textsuperscript{5} Campaign for Tobacco Free Kids, \textit{A Broken Promise to Our Children}, http://www.tobaccofreekids.org/what_we_do/state_local/tobacco_settlement.

\textsuperscript{6} On February 8, 2012, the media reported that the attorneys general of forty-nine states and five of the nation’s largest mortgage servicers—including Bank of America and Wells Fargo—had agreed to a $26 billion settlement relating to various foreclosure-related abuses. See Nelson D. Schwartz and Shaila Dewan, \textit{States Negotiate $26 Billion
explains the current controversy under the MSA and why a seemingly unrelated policy decision by New York, the decision by that state’s governor not to impose the state’s cigarette excise tax on any cigarettes sold on Indian reservations, might potentially cost the state several years’ worth of MSA payments.

To frame the controversy, Part I of the Article provides background information about the payment provisions of the MSA. Part II examines in detail the provision in the MSA, called the “NPM Adjustment,” which may reduce or eliminate some states’ (including New York’s) MSA payments for several years. Part III discusses the history of New York’s decision not to collect excise taxes on cigarettes sold on Indian reservations. Part IV explains how New York’s voluntary forbearance from collecting cigarette excise taxes on reservation sales might cause the state to lose its MSA payments for several years. Finally, Part V discusses lessons learned from the current controversy, lessons that might be applied to future landmark settlements like the states’ settlement with major mortgage servicing companies.

I. MSA PAYMENT OBLIGATIONS

Under the terms of the MSA, the settling companies, known as “Participating Manufacturers,” agreed to restrict their marketing practices and to make annual payments to the states in perpetuity. The base amount of the annual payments owed from the four largest Participating Manufacturers.


7 See MSA § III for various marketing and other restrictions on Participating Manufacturers. See MSA § IX for the Participating Manufacturers’ payment obligations under the MSA.
Manufacturers (the original signatories to the MSA, called “Original Participating Manufacturers” in the agreement), is as follows:  

<table>
<thead>
<tr>
<th>Year</th>
<th>Base Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>$4,500,000,000</td>
</tr>
<tr>
<td>2001</td>
<td>$5,000,000,000</td>
</tr>
<tr>
<td>2002-2003</td>
<td>$6,500,000,000</td>
</tr>
<tr>
<td>2004-2007</td>
<td>$8,000,000,000</td>
</tr>
<tr>
<td>2008-2017</td>
<td>$8,139,000,000</td>
</tr>
<tr>
<td>2018 and each year thereafter</td>
<td>$9,000,000,000</td>
</tr>
</tbody>
</table>

But while the MSA sets the base amounts of the annual payments, the actual amount paid from the Participating Manufacturers to the “Settling States” differs each year from the amounts shown above. This is because various adjustments apply to either increase or decrease the amount of the actual payments. For example, the MSA’s “Inflation Adjustment” increases the base payment amount owed in a particular year by at least 3% over the previous year’s base amount before the application of any other adjustments. Subsequently-applied adjustments may operate to reduce the amount of the annual payments.

---

8 In addition to these annual payments, the four Original Participating Manufacturers agreed to pay an additional $861 million each year from 2008-2017. These additional payments are known as “strategic contribution payments.” See MSA § IX(c)(2). The Participating Manufacturers that joined the MSA after the Original Participating Manufacturers (called “Subsequent Participating Manufacturers” under the MSA) have their own additional payment obligations under § IX(i) of the MSA.

9 See MSA § IX(c).

10 MSA § II(x); IX(c), IX(j), Exhibit C.
One of the downward adjustments in the MSA is known as the “NPM Adjustment.”\textsuperscript{11} The NPM Adjustment was included in the MSA to compensate Participating Manufacturers for the market share they expected to lose to tobacco companies that did not join the MSA. While dozens of tobacco manufacturers have joined the MSA, many others have not.\textsuperscript{12} The companies that are not signatories to the MSA are known under the settlement agreement as “Non-Participating Manufacturers” or “NPMs.”\textsuperscript{13} By not joining the MSA, NPMs run the risk that states may bring health care-related claims against them (as some states had brought against the four largest tobacco manufacturers before the MSA), but in exchange for accepting this risk the NPMs are not bound by the onerous payment obligations or marketing restrictions imposed by the settlement agreement. Anticipating that the NPMs would increase their share of the U.S. cigarette market because of the competitive advantage they have as a result of not having to comply with the MSA’s obligations, the Participating Manufacturers bargained to include the NPM Adjustment in the MSA.

As it turns out, the Participating Manufacturers’ concern over the possible loss of market share was well-founded, at least for the largest Participating Manufacturers. The Original Participating Manufacturers (the four largest U.S. tobacco manufacturers at the time of the MSA) held,

\begin{itemize}
\item \textsuperscript{11} MSA § IX(d).
\item \textsuperscript{13} MSA § II(cc); II(jj).
\end{itemize}
in the aggregate, over 97% of the U.S. cigarette market share in 1997 (before the MSA). In 2010, these companies’ aggregate market share had declined to approximately 83%. Some of this 14% loss of market share was picked up by smaller Participating Manufacturers, but a significant portion has been taken by Non-Participating Manufacturers.

Unlike the Inflation Adjustment, the NPM Adjustment is not a simple mathematical calculation. There are three steps to the NPM Adjustment and only one is “objective” in nature. First, to qualify for the NPM Adjustment, Participating Manufacturers— in the aggregate— must lose at least 2% of the market share they held prior to the MSA. Second, a “nationally recognized firm of economic consultants” must determine that the “disadvantages experienced as a result of the provisions of [the MSA] were a significant factor contributing to the Market Share Loss for the year in question.” Finally, even if these two requirements are met, a state may still avoid the application of the NPM Adjustment to the amount of the annual MSA payment that it receives if, during the year in question, the state (i) had in effect a statute intended to mitigate the competitive advantage enjoyed by the NPMs (called a “Qualifying Statute” in the MSA), and (ii) “diligently enforced” that statute.

---

16 Id.
17 MSA § IX(d)(1)(B)(i) (subtracting 2 percentage points from the initial market share loss calculation at the onset of the calculation).
18 MSA § IX(d)(1)(C).
19 MSA § IX(d)(2)(E).
20 MSA § IX(d)(2)(B).
Even if a state enacts and “diligently enforces” a Qualifying Statute, however, the total NPM Adjustment available to the Participating Manufacturers is not reduced. Instead, that state’s potential share of the NPM Adjustment is reallocated to any states that did not have or did not “diligently enforce” Qualifying Statutes. In other words, up to the full amount of the NPM Adjustment falls only on those states that failed to enact or diligently enforce Qualifying Statutes.

Should an NPM Adjustment apply, the potential amount and allocation rules relating to the adjustment could have major effects on the budgets of those states found not to have diligently enforced Qualifying Statutes. The maximum aggregate NPM Adjustments available for years 2003 through 2010 total over $7 billion. Market share loss and “significant factor” findings have already been established for 2003 through 2009, leaving only the issue of whether the states diligently enforced Qualifying Statutes in each of those years before application of the NPM Adjustment. That issue – known as the “diligent enforcement” issue – is the subject of ongoing arbitration proceeding between the states and the Participating Manufacturers. If only a few states are ultimately determined in the arbitration to have failed to enact or diligently enforce Qualifying Statutes,

---

21 MSA § IX(d)(2)(C).
22 NAAG, supra note 18.
24 Id.
those states alone will bear a potentially massive reduction in their MSA payments for the years at issue. Some states could potentially see their entire MSA annual payment wiped out for several years.25

With so much at stake, the issue of what constitutes “diligent enforcement” of a Qualifying Statute has taken on substantial importance. The MSA does not define what “diligent enforcement” means. Nevertheless, each state will undoubtedly take the position in arbitrating the issue that it has met the standard of diligent enforcement, whatever that standard is ultimately determined to be. Some states may face challenges, however, in making their case. New York, in particular, faces such a challenge because of its treatment of cigarettes sold on Indian reservations. Until 2010, New York elected, for political reasons, not to impose excise taxes on cigarettes sold on Indian reservations to non-tribe members.26 As a result of this decision, New York did not enforce its Qualifying Statute with respect to NPM cigarettes sold on reservations. New York contends that under the terms of the MSA it had no obligation to collect escrow payments on these cigarettes.27 The arbitration panel making the diligent enforcement determination may find otherwise.

25 The MSA does not explain what happens if a state’s share of the NPM Adjustment exceeds the state’s total allocate payment under the MSA for the year in question. The Participating Manufacturers could argue that they are entitled to receive the full amount of the NPM Adjustment from the states subject to the adjustment in the year that the diligent enforcement question is finally resolved. Alternatively, the reduction in MSA payment could carry over to future years, with the Participating Manufacturers receiving a credit against the amounts they owe under the MSA in those future years.


If so, New York’s decision not to impose excise taxes on cigarettes sold on Indian reservations could have massive implications for the state’s budget. Should New York be the only state or one of only a handful of states not to have diligently enforced its Qualifying Statute for the years 2003-2010, it stands to lose most or all of its MSA payment for each of those years, amounting to a total of several billion dollars.

II. THE NPM ADJUSTMENT

A. Mechanics of the NPM Adjustment Calculation

Despite its potentially significant impact on state revenues, exactly how the NPM Adjustment operates has received relatively little attention from the popular press or the academic community. Perhaps one reason for this is the relative complexity and length of the NPM Adjustment provision, which constitutes the single longest provision in the MSA.

The MSA states that the NPM Adjustment applies to “protect the public health gains achieved by this Agreement.” 28 As previously explained, however, the effect of the NPM Adjustment is to compensate Participating Manufacturers (tobacco companies that have joined the MSA and are therefore bound by its onerous payment and restrictive advertising requirements) for their loss of the U.S. cigarette market share to NPMs (tobacco companies that have not joined the MSA and therefore do not bear the same burdens as Participating Manufacturers). The NPM Adjustment potentially applies on an annual basis to reduce the Participating Manufacturers’ annual payment obligation. But it only applies if the Participating Manufacturers have suffered a “Market Share Loss” for the year in question.

28 MSA § IX(d)(1).
The MSA defines “Market Share Loss” as the amount of U.S. domestic market share lost by the Participating Manufacturers (in the aggregate) as compared to their aggregate 1997 market share, less 2%. In other words, if the Participating Manufacturers held 99% of the U.S. cigarette market share in 1997, but only held 91% in 2003, they have a 6% Market Share Loss for 2003 [(99% - 91%) – 2%]. In effect, the first 2% of actual market share loss is ignored for purposes of calculating “Market Share Loss” as defined in the MSA.

Once a Market Share Loss is found to exist, the MSA then calculates the “NPM Adjustment Percentage” by multiplying that Market Share Loss by three. So, using our example of a 6% Market Share Loss for 2003, the NPM Adjustment Percentage for that year would be 18% [6% x 3]. The NPM Adjustment Percentage is then multiplied by the amount that the Participating Manufacturers would otherwise owe the Settling States for the year in question – after the base payment amount has already been modified by the various other adjustments provided for under the MSA – to calculate the maximum amount of the NPM Adjustment for that year.

The Market Share Loss, NPM Adjustment Percentage, and amount of the maximum potential NPM Adjustment for each of the years 2003 through 2010 is set forth below:

<table>
<thead>
<tr>
<th>TABLE II</th>
</tr>
</thead>
</table>

---

29 MSA § IX(d)(1)(B)(i).
30 This is the calculation so long as the Participating Manufacturers’ Market Share Loss is less than or equal to 16 2/3%. If it is greater than 16 2/3%, the calculation of the NPM Adjustment is more complex than just applying a three-time multiplier. See MSA § IX(d)(1)(A)(iii). In no year since the inception of the MSA has the Market Share Loss exceeded 16 2/3%.
31 MSA § IX(d)(1)(A).
32 NAAG, supra note 18.
**NPM Adjustment Amounts**

<table>
<thead>
<tr>
<th>Year</th>
<th>Market Share Loss</th>
<th>NPM Adjustment %</th>
<th>Maximum Potential NPM Adjustment</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>5.94%</td>
<td>17.83%</td>
<td>$1,147,566,064</td>
</tr>
<tr>
<td>2004</td>
<td>5.85%</td>
<td>17.55%</td>
<td>$1,137,395,924</td>
</tr>
<tr>
<td>2005</td>
<td>3.82%</td>
<td>11.47%</td>
<td>$753,345,637</td>
</tr>
<tr>
<td>2006</td>
<td>3.46%</td>
<td>10.39%</td>
<td>$700,344,418</td>
</tr>
<tr>
<td>2007</td>
<td>3.49%</td>
<td>10.47%</td>
<td>$791,031,874</td>
</tr>
<tr>
<td>2008</td>
<td>4.05%</td>
<td>12.14%</td>
<td>$920,103,746</td>
</tr>
<tr>
<td>2009</td>
<td>4.05%</td>
<td>12.15%</td>
<td>$859,004,221</td>
</tr>
<tr>
<td>2010</td>
<td>4.09%</td>
<td>12.27%</td>
<td>$853,902,136</td>
</tr>
</tbody>
</table>

$7,162,694,020

**B. The Significant Factor Determination**

Even if a potential NPM Adjustment exists based on the Participating Manufacturers’ Market Share Loss, the Settling States can still avoid its application to their annual payments if the MSA is determined not to be a “significant factor contributing to the Market Share Loss for the year in question.”33 The MSA calls for a “nationally recognized firm of economic consultants (the ‘Firm’)” to make this determination.34

On March 27, 2006, an economic consulting firm known as “The Brattle Group,” headed by Nobel prize-winning economist Daniel McFadden, determined that the MSA was in fact a significant factor in the Participating Manufacturers’ Market Share Loss for the year 2003.35 In reaching this conclusion, The Brattle Group considered the expert

---

33 MSA § IX(d)(1)(C).
34 Id.
35 Final Determination, supra note 17 at ¶358.
opinions and analytical models of several of the country’s top economists. The Brattle Group also determined various issues of interpretation relating to the MSA. For example, in its written determination The Brattle Group stated that it interpreted “significant factor” to mean a factor that “an economist, considering the totality of the economic evidence, would view as having significant explanatory power.” Also, The Brattle Group found that neither party had the burden of persuasion with respect to the significant factor determination.

Drawing from the econometric models proposed by both sides’ experts but upon its own expertise, The Brattle Group found that 3.5 to 4.0% of the total 7.95% market share loss that the Participating Manufacturers experienced in 2003 was attributable to the MSA. As such, The Brattle Group concluded that a “reasonable economist” would view this impact as constituting a “significant factor” in the Participating Manufacturers’ Market Share Loss.

Subsequently, The Brattle Group also found the MSA to be a “significant factor” in the Participating Manufacturers’ Market Share Loss

---

36 See Final Determination, supra note 17 at pp. 84-109.
37 Id. at ¶ 14.
38 Id. at ¶ 155.
39 Id. at ¶ 357.
40 Despite the fact that the MSA provides that the Firm’s significant factor determination “shall be conclusive and binding upon all parties, and shall be final and non-appealable,” New York sought a declaratory judgment that the Firm had improperly construed the MSA and should have discounted the first 2% of its determination regarding how much of the Participating Manufacturers’ market share loss was attributable to the MSA. In other words, The Brattle Group found that 3.5-4.0% of the 7.95% market share loss was attributable to the MSA. New York contended that because the first 2% of the Participating Manufacturers’ market share loss is ignored for purposes of calculating the NPM Adjustment (under the defined term, “Market Share Loss”), only 1.5-2.0% of the market share loss should have been attributed to the MSA. The New York courts rejected this argument by the state. See State v. Philip Morris, Inc., 840 N.Y.S.2d 55 (1st Dept. 2007).
for 2004 through 2006. Following these determinations, the Settling States agreed that for 2007 through 2009, they would not contest whether the MSA constituted a significant factor. Consequently, both the Market Share Loss and significant factor requirements for the NPM Adjustment have been definitely established for the years 2003-2009. A Market Share Loss occurred in 2010 and, as indicated in Table II above, the maximum potential NPM Adjustment for 2010 is approximately $854 million. The significant factor determination for that year will not commence until April 2012, presumably with a new “nationally recognized firm of economic consultants,” as the states have elected to replace The Brattle Group. With respect to approximately $6.3 billion of NPM Adjustments, however, the only factor yet to be determined is which of the Settling States had and “diligently enforced” a Qualifying Statute.

C. Qualifying Statutes and the “Units Sold” Issue

The previously discussed requirements for the NPM Adjustment – the existence of a Market Share Loss and the finding that the MSA was a “significant factor” in that Market Share Loss – determine whether an NPM Adjustment is potentially applicable in a particular year. In contrast, the issue of whether an individual state had and diligently enforced a “Qualifying Statute” in that year will determine whether the NPM Adjustment applies against that specific state. In other words, the Market Share Loss and significant factor determinations are generally applicable, but the diligent enforcement determination is state-specific.

Under the terms of the MSA, if a state had in effect and diligently enforced a “Qualifying Statute” for the year at issue, the potential NPM

41 Altria Group, supra note 26.
42 Altria Group, supra note 26.
43 This $6.3 figure represents the potential NPM Adjustment available for years 2003-2009. See Table II, supra.
Adjustment applicable to that state is instead allocated to any other states that did not have or did not diligently enforce their own Qualifying Statutes.\textsuperscript{44} A “Qualifying Statute” is defined in the MSA as “a Settling State’s statute, regulation, law and/or rule (applicable everywhere the Settling State has authority to legislate) that effectively and fully neutralizes the cost disadvantages that the Participating Manufacturers experience vis-à-vis Non-Participating Manufacturers within such Settling State as a result of the provisions of [the MSA].”\textsuperscript{45} The MSA further provides that “if enacted without modification or addition,” a form statute set forth as an exhibit to the MSA and known as the “Model Statute” constitutes a Qualifying Statute.\textsuperscript{46} In effect, the Model Statute serves as a safe-harbor for Settling States. If a state enacts the Model Statute, then the issue of whether the state has a “Qualifying Statute” is eliminated, and the only question that remains is whether the state has “diligently enforced” the statute for the year at issue.\textsuperscript{47}

As for the purpose of requiring a Qualifying Statute, the prefatory language to the MSA’s Model Statute explains:

It would be contrary to the policy of the State if tobacco product manufacturers who determine not to enter into [the MSA, \textit{i.e.}, NPMs] could use a resulting cost advantage to derive large, short-term profits in the years before liability [for the health care costs associated with their products] may arise without ensuring that the State will have an

\textsuperscript{44} See MSA § IX(d)(2)(C).
\textsuperscript{45} MSA § IX(d)(2)(E).
\textsuperscript{46} Id.
\textsuperscript{47} The Participating Manufacturers have only challenged whether two states — New Mexico and Virginia — have a “Qualifying Statute.” New Mexico, \textit{supra} note 23. For all of the other “Settling States,” the only issue is whether they diligently enforced the Qualifying Statutes they have.
eventual source of recovery from them if they are proven to have acted culpably. It is thus in the interest of the State to require that such manufacturers establish a reserve fund to guarantee a source of compensation to prevent such manufacturers from deriving large, short-term profits and then becoming judgment-proof before liability may arise.48

In sum, the Qualifying Statute was intended to neutralize the cost advantage of the NPMs and ensure that a pool of money is available to the state if an NPM is found liable for smoking-related health care costs borne by the state. The Model Statute accomplishes these goals by providing that all NPMs must pay annually into a qualified escrow account a specified amount for each of the “units sold” by the NPM.49 The term “units sold” is defined in the Model Statute as “the number of individual cigarettes sold in the State by the applicable tobacco product manufacturer . . . during the year in question, as measured by excise taxes collected by the State on packs . . . bearing the excise tax stamp of the State.” 50 In effect, then, the Model Statute—and presumably any Qualifying Statute—requires NPMs to pay into escrow a specified amount for each cigarette sold by the NPM in the applicable state, with the number of cigarettes sold by the NPM measured by the excise taxes collected on the NPM’s sales.

The amount per unit sold to be paid into escrow is set forth in the Model Statute:

---

48 MSA, Exhibit T at T-1.
49 Id. at T-4.
50 Id. at T-3.
**TABLE III**

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount to be paid into escrow per unit sold</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>$0.0094241</td>
</tr>
<tr>
<td>2000</td>
<td>$0.0104712</td>
</tr>
<tr>
<td>2001-2002</td>
<td>$0.0136125</td>
</tr>
<tr>
<td>2003-2006</td>
<td>$0.0167539</td>
</tr>
<tr>
<td>2007 and thereafter</td>
<td>$0.0188482</td>
</tr>
</tbody>
</table>

So, an NPM is supposed to pay into escrow slightly less than $0.02 for every “unit sold” by the NPM in a Settlement State in 2007 and all years thereafter. These escrow payments were intended to approximate the cost to Participating Manufacturers of the annual payments under the MSA, thereby neutralizing the financial advantage that NPMs would otherwise enjoy. The payments by an NPM into escrow are to be held until (i) released to the State to satisfy any judgment obtained by the State against the NPM or, (ii) released to the NPM, if no such judgment is obtained within twenty-five years of the escrow payment.\(^{52}\)

To summarize, a state must enact a Qualifying Statute to avoid a reduction to its annual MSA payment by the NPM Adjustment. Under the safe-harbor Qualifying Statute set forth in the MSA (known as the “Model Statute”), those tobacco manufacturers that choose not to join the MSA (NPMs) must make payments into an escrow account, with the amount of those payments intended to replicate the financial burden faced by tobacco manufacturers that have joined the MSA (Participating Manufacturers). While the states’ Qualifying Statutes have been challenged under various legal theories—including anti-trust, Commerce Clause, and Tenth

---

\(^{51}\) *Id.* at T-4. These amounts are subject to an adjustment for inflation. *Id.*

\(^{52}\) *Id.*
Amendment claims—to date no Qualifying Statute has been struck down.  

Of course, a state must not only enact a Qualifying Statute, it must also “diligently enforce” the statute to avoid the application of a potential NPM Adjustment. What this means is not specified in the MSA and is the subject of pending arbitration between the Participating Manufacturers and the Settling States. One of the issues the arbitration panel will have to consider is whether New York’s failure to require escrow payments from NPMs for cigarettes sold on Indian lands, based on the state’s political decision not to impose excise taxes on those cigarettes, means that New York did not diligently enforce its Qualifying Statute. As previously explained, the stakes involved with this question are potentially massive and could potentially wipe out New York’s entire annual MSA payment for several years.

53 See Freedom Holdings, Inc. v. Cuomo, 624 F.3d 28 (2d Cir. 2010) (finding that New York’s Qualifying Statute did not violate the Sherman Act or the Commerce Clause); See also A.B. Coker, Inc. v. Foti, 2006 WL 3307445 (W.D. La. Nov. 9, 2006) (dismissing Tenth Amendment claims relating to Louisiana’s Qualifying Statute).


55 Between 1998 and 2011, New York received a total of approximately $9.8 billion in MSA payments. See Campaign for Tobacco Free Kids, Actual Tobacco Settlement Payments Received By the States, 2002-2011 available at http://www.tobaccofreekids.org/research/factsheets/pdf/0365.pdf (Last visited February 26, 2012). The amount of the NPM Adjustment currently in dispute for years 2003-2010 is over $7 billion. See NAAG, supra note 16. Because of the “reallocate provision relating to the NPM Adjustment in the MSA, if one or only a handful of states are found not to have diligently enforced Qualifying Statutes for the years 2003-2010, the full
New York has argued that because it did not collect excise taxes on NPM cigarettes sold on Indian lands to non-tribe members, these cigarettes were not “units sold.” Under the state’s reasoning, the NPMs therefore were not required to pay escrow on those sales. The Participating Manufacturers will surely take a contrary position. To analyze this argument, we must first examine whether New York had authority to impose its excise tax on reservation sales and the history behind the state’s decision not to do so.

III. AUTHORITY TO COLLECT EXCISE TAX ON RESERVATION SALES TO NON-TRIBE MEMBERS

A. Background

Since 1939, New York has imposed and collected an excise tax on cigarettes sold within the state. New York’s tax collection regime is embodied in Tax Law § 471, which utilizes a tax stamp scheme to strictly regulate the placement of cigarettes into the state’s stream of commerce. Under this regime, state-licensed stamp agents are the only entities vested with the authority to purchase cigarettes from cigarette manufacturers. These agents—who are often wholesalers—must purchase tax stamps from the state, and then affix the stamps to cigarette packages as proof the tax has been paid. After the agent-wholesalers have prepaid the excise tax by purchasing the tax stamps from the state, the agent-wholesalers incorporate the cost of the tax into the price of the cigarettes and “pass on” the tax burden to cigarette retailers who purchase and resell the

amount of the NPM Adjustment could fall on a very limited number of states. See MSA § IX(d)(2)(C).

56 See NY Brief, supra note 30.
58 See generally N.Y. Tax Law § 471
59 NYC.R.R. § 74.3(a)(1)(iii)
60 N.Y. Tax Law §471(2)
cigarettes.\textsuperscript{61} Retailers in turn pass the cost of the excise tax on when they sell cigarettes to consumers, such that consumers ultimately bear the cost of the tax. This result effectuates Tax Law 471’s expressed intent that “the ultimate incidence of and liability for the tax shall be upon the consumer.”\textsuperscript{62}

The plain language of Tax Law § 471 dictates that the excise tax described therein “shall be paid . . . on all cigarettes possessed in the state by any person for sale.”\textsuperscript{63} This sweeping mandate, however, is qualified by language stating that the tax is not to be applied under circumstances where the state is “without power to impose such tax.”\textsuperscript{64} The state recognized at the time it enacted Tax Law § 471 that it was “without power” to tax the sale of cigarettes on Indian reservations.\textsuperscript{65} And while there are a variety of reasons—political, practical, and otherwise—that account for the state's historical reluctance to impose its excise tax upon cigarettes sold on Indian reservations, this reluctance can be explained at least in part by the state’s recognition of Indian reservations as independent sovereign territories.\textsuperscript{66}

The concept of Native American sovereignty vests each Indian tribe with the right of self-governance, and, as the tribes vigorously contend, precludes state regulatory activities, such as taxation, within the confines of their tribal lands.\textsuperscript{67} While it is true that Indian tribes are still

\textsuperscript{61} N.Y. Tax Law §§471(2)-(3)
\textsuperscript{62} N.Y. Tax Law §471(2)
\textsuperscript{63} N.Y. Tax Law §471(1).
\textsuperscript{64} N.Y. Tax Law §471(1); Cayuga at 623.
\textsuperscript{65} Id.
\textsuperscript{66} Andrea VanVulkenburg, Tribes Celebrate Cigarette-Tax Stay, PRESS REPUBLICAN (September 5, 2010), http://pressrepublican.com/0100_news/x1901576163/Tribes-celebrate-cigarette-tax-stay.
\textsuperscript{67} Id.
recognized as independent sovereigns to some extent, the courts have continued to chip away at this idea of Native American sovereignty over the course of the last 130 years. In *United States v. Kagama*, for example, the United States Supreme Court expressly rejected the idea that Indian tribes possess the full sovereignty attributable to foreign nations and explained that Indian tribes were to be regarded “not as States, not as nations, not as possessed of the full attributes of sovereignty, but as a separate people with the power of regulating their internal and social relations.” More recently, in *McClanahan v. State Commission of Arizona*, the Court described the historical arc of its Indian law jurisprudence as moving “away from the idea of inherent Indian sovereignty as a bar to state jurisdiction,” and explained that federal preemption in the form of applicable treaties and statutes—not the notion of Native American sovereignty—should serve as the basis for determining limits on state jurisdiction. *McClanahan* laid the groundwork for the Court’s seminal ruling in *Moe v. Confederated Salish & Kootenai Tribes of the Flathead Reservation*, where the Court again addressed a state law that tested the boundaries of state regulatory authority in Indian country, this time in the context of a Montana law that

---

68 Indian tribes have an inherent sovereign power to tax transactions occurring on tribal lands that involve tribal members. See *Merrion v. Jicarilla Apache Tribe*, 455 U.S. 130 (1982).
69 118 U.S. 375, 379, 381-82 (1886).
70 To bolster its conclusion, the Court pointed to language in the Indian Commerce Clause, which gives Congress the power to “regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.” U.S. CONST. art. I, § 8, cl. 3. This language, the Court reasoned, would be redundant if not interpreted to treat “foreign Nations” distinctly from “Indian Tribes.” *Id.* at 381-82.
72 *Id.* at 172.
sought to tax the sale of cigarettes on Indian reservations.\textsuperscript{74} The Montana law at issue required tribal retailers to add the state excise tax to the sales price of cigarettes sold to non-tribe members, thereby aiding the state’s collection and enforcement of its tax with respect to sales made to non-Indians.\textsuperscript{75} The tribes argued that the law unduly burdened the tribal retailers, infringed upon tribal sovereignty, and was preempted by federal law. The Court rejected the tribes’ contentions and upheld the Montana statute, reasoning that the statute imposed only a minimal burden on the tribal retailers, a burden that was justified to achieve the statute’s goal of preventing non-Indians from avoiding the state’s cigarette excise tax.\textsuperscript{76}

Addressing the issue of preemption, the Court noted that Montana’s tax collection regime did not run “afoul of any congressional enactment dealing with the affairs of reservation Indians.”\textsuperscript{77} The \textit{Moe} Court established a two-pronged analysis to test the validity of a state tax applied to tribal activities. The test considers (1) the degree to which the state’s regime interferes with tribal activities,\textsuperscript{78} and (2) whether federal law preempts the state’s regime,\textsuperscript{79} in testing the validity of a state tax applied to tribal activities.\textsuperscript{80} Courts continue to apply this test today.

\textsuperscript{74} A “smoke shop” proprietor and member of the Confederated Salish and Kootenai Tribes was arrested for operating without a cigarette retailer’s license and for selling nontax-stamped cigarettes on the tribal reservation, both misdemeanors under Montana law. Id. at 465, 468.

\textsuperscript{75} Id. at 482-83.

\textsuperscript{76} Id. at 483.

\textsuperscript{77} Id.

\textsuperscript{78} This prong of the test revitalizes the concept of Native American sovereignty as a factor in the court’s determination.

\textsuperscript{79} This prong reflects the Court’s ruling in McClanahan. \textit{See} supra note 74 and accompanying text.

\textsuperscript{80} \textit{See} Washington \textit{v.} Confederated Tribes of the Colville Indian Reservation, 447 U.S. 134, 155-59, 160-61 (1980) (rejecting claims that the state’s taxation authority was federally preempted by numerous statutes including the Indian Reorganization Act of 1934, the Indian Financing Act of 1974, the Indian Self-Determination and Education
B. New York’s Efforts to Tax Reservation Sales After Moe

*Moe* authorized states, including New York, to begin taxing cigarette sales made to non-tribe members on Indian reservations.\(^81\) New York soon realized the practical difficulties associated with enforcement, however, as non-Indians simply ignored the excise tax imposed under Tax Law § 471. Non-Indians seeking to avoid the tax traveled to Indian reservations where tribal retailers continued to sell cigarettes—to tribe members and non-tribe members alike—without collecting the statutorily mandated tax. The retailers had no incentive to collect the tax from non-Indian consumers, as that would mean losing the competitive advantage they had previously enjoyed over “off-reservation” vendors.\(^82\) Moreover, Indian Nations enjoyed immunity from civil suit by the state, thus further motivating tribal retailers simply to disregard the state’s excise tax statute.\(^83\) New York recognized the loss of excise tax revenue it incurred as a result of the tribal retailers’ refusal to collect the tax and the state’s inability to seek redress against the retailers. The extent of this tax loss

---

\(^{81}\) Provided that the state tax regime was not preempted by federal law and did not interfere with tribal activities (i.e. the regime must satisfy the two-pronged Moe test). Tribe members were and continue to be exempt from the state’s cigarette tax.

\(^{82}\) See Cayuga, 930 N.E. 2d at 237.

\(^{83}\) *Id.*
was brought home in a study conducted by the New York Department of Taxation and Finance (“the Department”), which found that “the volume of tax-exempt cigarettes sold on New York reservations in 1987-1988 would, if consumed exclusively by tax-immune Indians, correspond to a consumption rate 20 times higher than that of the average New York resident.”  

The Department estimated this tax evasion cost the state roughly $65 million annually. Confronted with this information about the extent of tax evasion within its borders, the Department undertook the difficult task of devising an enforcement system that would simultaneously prevent non-Indians from avoiding the tax, permit qualified tribe members to continue buying cigarettes tax-free, and impose only a minimal burden on the tribal retailers who were charged with collecting the tax from non-Indian purchasers.

In 1988, the Department promulgated regulations in furtherance of the state’s efforts to enforce its cigarette tax on Indian reservations. Under the 1988 regulations, the state-licensed agent-wholesalers who were generally charged with the duty of precollecting the excise tax by purchasing tax stamps from the state were not required to purchase the stamps on cigarettes intended for consumption by tribe members. The new regulations strictly regulated the sale of these unstamped (and therefore untaxed) cigarettes, however, and the wholesalers bore the brunt of these restrictions. For instance, wholesalers were required to verify that the tribal retailers to which the unstamped cigarettes were distributed possessed tax exemption certificates issued by the state; to keep records of tax exempt sales made to these retailers; to submit to the Department monthly reports of their unstamped cigarette sales; to continue precollecting taxes on the non-exempt, stamped cigarettes; and to obtain

---

84 See Milhelm, 512 U.S. at 65.
85 Oneida Nation of New York v. Cuomo 645 F.3d 154, 159 (2d Cir. 2011).
86 See id. at 235-36.
the Department’s approval concerning all deliveries of untaxed cigarettes to tribal retailers. In addition, wholesalers were limited as to the amount of cigarettes they could sell to tribal retailers. This quantity limitation was based upon the “probable demand” of the cigarettes on the particular reservation where the retailer operated. A reservation’s probable demand was calculated based upon evidence submitted by the tribe; if no evidence was submitted, the probable demand calculation was computed based upon the number of “enrolled members” in the affected tribe and their projected cigarette consumption.\textsuperscript{87} For example, if the Seneca Tribe were likely to consume 10,000 packs of cigarettes in one year, then, for that year, only 10,000 untaxed packs would be available for distribution to tribal retailers. The objective was to ensure there would be a sufficient supply of untaxed cigarettes available to tribe members, but that no excess would remain available to non-tribe members seeking to avoid the tax.\textsuperscript{88}

In 1994, the validity of New York’s “probable demand” regulations was tested before the United States Supreme Court in Department of Taxation & Finance of New York v. Milhelm Attea & Bros., Inc.\textsuperscript{89} Wholesalers, displeased with the strict limitations placed upon their sales to Indian tribes and tribal retailers, challenged the Department’s regulations on the basis that they were preempted by federal statutes governing trade with Indians.\textsuperscript{90} The Supreme Court rejected the

\textsuperscript{87} Records of previous sales to qualified Indian consumers, records relating to the average consumption of qualified Indian consumers on and near its reservation, tribal enrollment, and other statistical evidence contributed to probable demand calculations. Milhelm, 512 U.S. at 67 (citing 20 N.Y.C.R.R. § 336.7(d)(2)(i) (1992)). Alternatively, tribes could also enter in an agreement with the state regarding its probable demand quota.

\textsuperscript{88} Id.

\textsuperscript{89} See Milhelm, 512 U.S. 61.

\textsuperscript{90} The wholesalers alleged that New York’s regulatory scheme was preempted by the Indian trader statutes set forth in 25 U.S.C. §261 et seq. Id. 67-68. The wholesalers claimed that these statutes, as construed in Warren Trading Post Co. v. Arizona Tax
wholesalers’ preemption challenge, and explained that because the Court had previously ruled that “[s]tates may impose on reservation retailers minimal burdens reasonably tailored to the collection of valid taxes from non-Indians,” that “[i]t would be anomalous to hold that a State could impose tax collection and bookkeeping burdens on reservation retailers who are enrolled tribal retailers but not on wholesalers, who often are not. The Court approved New York’s probable demand mechanism as a “reasonably necessary method of preventing fraudulent transactions” that “polices against wholesale evasion of [New York’s] own valid taxes without unnecessarily intruding on core tribal interests.”

The Court qualified its approval only upon New York’s ability to calculate the “probable demand” among the various Indian reservations such that tribe members would be able to continue purchasing the cigarettes tax-free. Highlighting this point, the Court stated that “[i]f the Department’s probable demand calculations are adequate, tax-immune Indians will not have to pay New York cigarette taxes and neither wholesalers nor retailers will have to pre-collect taxes on cigarettes destined for their

Comm’n, 380 U.S. 685, 14 L. Ed. 2d 165, 85 S. Ct. 1242 (1965), deprived the States of all power to impose regulatory burdens on licensed Indian traders. Id.

In rejecting this argument, the Court conceded that while Warrant Trading Post did invalidate state regulation of Indian traders, its subsequent decisions (e.g., Moe and Colville) “undermined” that proposition. Id. at 71-72.

Id. at 73.

Id. at 75 (quoting Colville, 447 U.S. at 160, 162). The Court did, however, express concerns that, as a practical matter, the State could face serious issues in attempting to enforce the tax. Cayuga, 930 N.E. 2d at 236. For example, tribal immunity meant that Indian tribes could not be held liable for a tribal retailer’s refusal to comply with the State’s collection of the tax. Id. The State could, however, pursue enforcement through other means, such as entering into an agreement with the reservation to enforce the tax, or attempting to impose individual liability for nonpayment on uncooperative retailers. Id. at 237.
While *Moe* vested New York with the authority to impose its cigarette tax on Indian reservation sales made to non-tribe members, *Milhelm* essentially approved the enforcement mechanism proposed to actually collect the tax. The road to enforcement, however, was blocked off, literally, when more than one thousand Seneca protestors congregated on the New York Thruway to prevent state officials from entering tribal land to collect the tax. Violence ensued and at least a dozen state troopers were injured in the confrontation with protesters. This demonstration and the accompanying violence prompted New York Governor George Pataki to make a “political decision” to refrain from collecting its cigarette tax on Indian reservations. Speaking directly to the Seneca Indians and their supporters, Governor Pataki proclaimed, “It is your land. We respect your sovereignty and if the Legislature acts as I am requesting, you will have the right to sell . . . tax-free cigarettes free from interference.” In April 1998, New York formally repealed the Department’s 1988 “probable demand” regulations. In effect, despite § 471’s unequivocal mandate to

94 The *Milhelm* Court’s language implied that probable demand calculations would be proper if the calculations ensured that a sufficient quantity of untaxed cigarettes remained available to tax-exempt tribal members. *Milhelm*, 512 U.S. at 76.
95 *Cayuga*, 930 N.E.2d at 237.
96 The protestors were also challenging New York’s collection of gasoline taxes from reservation sales to non-tribal members. See Jonathan I. Sirois, *Remote Vendor Cigarette Sales, Tribal Sovereignty, and the Jenkins Act: Can I Get a Remedy?*, 42 DUQ. L. REV. 27, 61-62.
100 See Folser, *supra* note 101, at 709.
collect excise tax on all cigarettes other than where the State was “without power to impose such tax,” Governor Pataki decided, based on political considerations, not to impose the cigarette excise tax on tribal sales.

This policy of forbearance remained unchanged until 2003, when the New York State Legislature adopted Tax Law § 471-e.¹⁰¹ In its original form, § 471-e simply stated:

> Where a non-native American person purchases, for such person's own consumption, any cigarettes or other tobacco products on or originating from native American nation or tribe land recognized by the federal government and reservation land recognized as such by the state of New York, the commissioner shall promulgate rules and regulations necessary to implement the collection of sales and use taxes on such cigarettes or other tobacco products.¹⁰²

Shortly thereafter, the last sentence of § 471-e was amended to provide that the Commissioner of Taxation & Finance was also to promulgate rules and regulations necessary to implement the collection of excise taxes (as well as sales and use taxes) on reservation sales to non-tribe members. The Department failed to issue any rules or regulations as called for by the statute.¹⁰³

---

¹⁰¹ Id. at 238.
In 2005, § 471-e was again amended, this time in such a way that the legislature effectively adopted the Department’s previous “probable demand” regime (approved by the Supreme Court in *Milhelm*) as a means of curtailing tax-exempt cigarette sales by tribal retailers to non-tribe members. The 2005 amendments to § 471-e differed slightly from the Department’s 1988 regulations, however, in that the 2005 amendments provided for a “coupon” system whereby coupons were to be distributed to “Qualified Indians,” who would then present the coupons to tribal retailers upon purchasing cigarettes. The number of coupons distributed to each tribe was calculated based upon the “probable demand” of that particular tribe.

Despite the 2005 legislation amending § 471-e, in 2006 the Department indicated its intent to “continue its forbearance policy” and stated that it would not attempt to enforce the state’s cigarette excise tax on tribal lands. Tax Law § 471-e as enacted in 2003, and again when amended in 2005, called for the Department to promulgate implementing regulations. Nevertheless, the Department refused to do so. The Department also declined to undertake the “probable demand” calculations necessary to determine the quantity of tax exempt cigarettes that each tribe or nation was entitled to receive. With no method provided by the Department for actually applying § 471-e, tribal retailers successfully

---


105 Cayuga, 930 N.E. 2d at 254. When Governor Pataki refused to enforce the new regulations upon their effective date, March 1, 2006, state convenience stores immediately sued Pataki to enforce sections 471-e and 284-e of the tax law. John Milgrim, *Convenience Store Reps Sue Pataki*, *Ottaway New Service* (May 3, 2006), available at http://www.supportnativebusiness.com/ConvenienceStoreRepsSuePataki.pdf. Wholesalers known or believed to be supplying tribes with untaxed cigarettes were also named as defendants to the lawsuit. *Id.*

106 Cayuga, 930 N.E. 2d at 239.
obtained a declaratory judgment enjoining enforcement of the statute. In effect, the legislature enacted a statute calling for an end to tax exempt sales of cigarettes on tribal lands to non-tribe members, but the Department refused to promulgate regulations necessary to implement the statute. As a result, tribal retailers were released from any obligation to comply with the statutory excise tax collection obligation and untaxed cigarette sales continued unabated on tribal lands.¹⁰⁷

This state of affairs continued until June 21, 2010, when New York lawmakers again amended § 471-e, this time to increase the state’s cigarette excise tax from $2.75 per pack to $4.35. The 2010 amendments also allowed for tribes to opt out of the “coupon system” included in earlier versions of § 471-e. Rather than only using coupons to ensure tribe members could purchase cigarettes on their tribal lands tax free, the 2010 amendments provide that if a tribe elects not to use the coupon system, it will still be allowed to purchase tax-exempt cigarettes from “pre-approved” agents (often wholesalers) in a quantity equal to the tribe’s probable demand. This alternative to the coupon system is defined in the statute as the “prior approval system.” The 2010 amendments again called for the Department of Taxation & Finance to promulgate rules and regulations necessary to implement the coupon exemption system and the prior

¹⁰⁷ *Id.* In September 2008, District Attorneys of Seneca and Cayuga counties encouraged local law enforcement to enforce the state’s cigarette tax on tribal lands, notwithstanding the lack of Department enforcement guidelines. *Id.* at 240. The New York Court of Appeals disapproved of this ad hoc mechanism of enforcement recognizing the danger inherent in an enforcement scheme that had not been articulated by the Legislature or the Department of Taxation. *Id.* at 255 (reasoning that “taxpayers are not ordinarily required to guess what they need to do to comply with the tax law. It is generally up to the Legislature and the Department to articulate – before a transaction occurs – in what circumstances a tax is owed, who is obligated to collect it, how it should be calculated and when and how it must be paid.”).
Unlike in 2003 and 2005, however, this time, the Department adopted an emergency rule the day after the 2010 amendments became effective, providing for implementation of the statute. This long-overdue action on the part of the Department compelled the New York Court of Appeals to vacate the previously granted injunction against the enforcement of § 471-e and effectively allowed the state to begin collecting its cigarette excise tax on tribal lands.

Indian tribes across the state responded to the Court of Appeals’ ruling by filing claims for injunctive relief in the federal courts. In October 2010, the United State District Court for the Western District of New York denied the Seneca and Cayuga Nations’ request for injunctive relief. The court determined that the burden imposed upon Indian reservation retailers by the new amendments to Tax Law § 471 was reasonable and that the amendments did not unconstitutionally interfere with tribal sovereignty. The same court subsequently denied relief to the Unkechauge Nation and the Mohawk Tribe in a similar suit that followed the court’s earlier ruling. Meanwhile, the United States District Court for the Northern District of New York came to the opposite result and

---

109 Id.
110 Id. (“The prior preliminary injunctions were based on the Department’s failure to ensure that ‘any actions, rules and regulations necessary to implement’ Tax Law § 471-e were complete…Because those actions have been completed and rules and regulations have been promulgated by the Department to implement the amended version of Tax Law § 471-e, we conclude that the prior preliminary injunctions are no longer warranted.”).
112 Id.
granted the Oneida Nation’s request to enjoin the state’s cigarette excise tax collection on its tribal lands. The Northern District court focused upon the fact that the new coupon system required the tribe to prepay the cigarette excise tax on all cigarettes, including those destined for consumption by tribe members. The court noted that even if the tribe were reimbursed for the tax precollection costs in full, the tribe would still bear an out-of-pocket loss until the retail sales were made. This, according to the court, amounted to an impermissible interference with the tribe’s right to self-governance. The court also took a jab at the state’s vacillating cigarette excise tax collection policy, stating:

[T]he State’s policy of forbearance—not enforcing collection of tax on such sales—was its own choice and has been in effect for many years despite valid laws requiring such collection. The State has been depriving itself of these revenues for many years and cannot now use revenues as a “public interest weapon” to prevent injunctive relief where it is otherwise deserved.

The Second Circuit for the United States Court of Appeals consolidated the appeals from the conflicting district court decisions in an attempt to resolve the split among the lower courts and to clarify New York’s authority to enforce its cigarette tax in Indian country. The

115 Id.
116 Id.
117 Id.
118 Oneida Nation of New York v. Cuomo, 645 F.3d 154 (2nd cir. 2011).
tribes asserted that the precollection feature of the new amendments to § 471 imposed a direct tax on tribal retailers and unduly burdened tribal retailers; that it interfered with their right to self-governance; and that it interfered with the tribe members’ right to purchase cigarettes tax-free.119 In rendering its decision, the court traced the evolution of the state’s taxation authority in Indian country and contrasted a valid taxation regime, which is able to distinguish among Indian and non-Indian consumers in its application, with an impermissible regime that failed to draw this critical distinction.120 A valid taxation regime, according to the Second Circuit, places the burden, or “legal incidence,” of the tax on non-Indian consumers. The court noted with approval the “mandatory ‘pass through provisions’ that require wholesalers and retailers to pass on the tax to the consumer” in concluding that the state’s regime reflected the legislature’s intent to accomplish this objective.122 Moreover, the court described the “probable demand” system as “substantially similar to those of the 1988 version upheld against a preemption challenge in Milhelm Attea,” and concluded that, “to the extent the general features of the amended tax law’s quota and allocation schemes mirror those in the 1988 version, Milhelm Attea undermines the likelihood of Plaintiff’s success of this pre-enforcement challenge to the amended tax law’s validity.”123 The court acknowledged that the tribes’ challenges were not grounded in federal preemption (as were the tribes’ challenges in Milhelm Attea), but opined “Milhelm Attea’s reasoning is applicable here because federal preemption over the regulation of Indian tribes is closely related to federal recognition and protection of tribal sovereignty.”124

119 Id. at 163, 175.
120 Id. at 165.
121 The court distinguished what it termed a "legal burden," which described the party liable if the tax went unpaid, from the practical, economic burden that wholesalers alleged due to the onerous statutory restrictions. Id. at 168.
122 Id.
123 Id. at 170.
124 Id.
The court proceeded to examine and approve the “coupon” and “prior approval” mechanisms as set forth in the new amendments to § 471. With respect to the coupon system, the court rejected the tribes’ argument that the system would interfere with their right to self-governance, as the coupon system was, in fact, optional. The court further rejected the tribes’ contention that the prior approval system—a feature distinct from the state’s 1988 regulations—encouraged monopolistic behavior among wholesalers that could make it difficult, if not impossible, for some of the tribes to access tax-exempt cigarettes. The court declined to presume that this hypothetical would play out as contended by the tribes, and noted that, in any event, the Department possessed the ability to modify the prior approval system should this risk materialize. The Second Circuit ultimately held against the plaintiff tribes, vacating the Northern District’s ruling and affirming the two rulings of the Western District. In addition, the court vacated the stays preventing tax collection that had been issued by each of the district courts pending the outcome the appeal.

The Second Circuit’s ruling came more than three decades after the United States Supreme Court authorized the states to collect excise taxes on cigarette sold to non-Indians by tribal retailers. New York has finally adopted a collection regime recognized as legitimate and, perhaps more importantly, the Department has finally manifested a willingness to enforce it. These changes may come too late, though, as the historical failure to impose excise taxes on cigarettes the state was clearly authorized to tax could cost New York billions of dollars in MSA payments as a result of the NPM Adjustment.

\[125\] Id. at 171.
\[126\] Id. at 172-74.
\[127\] Id. at 174.
IV. FAILURE TO COLLECT EXCISE TAX AND DILIGENT ENFORCEMENT

A. New York’s Position on Diligent Enforcement and Reservation Sales

At the time The Brattle Group issued its “significant factor” decision in March 2006, the annual MSA payment from the Participating Manufacturers to the states was due just two weeks later. But with both a “Market Share Loss” and the “significant factor” determination now definitely established for the sales year 2003, several Participating Manufacturers took the position that they were immediately entitled to an NPM Adjustment for that year. In effect, these Participating Manufacturers contended that whether a state enacted and diligently enforced its Qualifying Statute amounted to an affirmative defense against the application of the NPM Adjustment, and that until arbitrators determined which states had diligently enforced their Qualifying Statutes the Participating Manufacturers were entitled to the full NPM Adjustment.

As might be expected, the states disagreed with this view and contended that the diligent enforcement determination constitutes a third pre-requisite (along with Market Share Loss and significant factor determination) to any NPM Adjustment. Given the opposing views on

---

128 Final Determination, supra note 17.

129 In fact, some Participating Manufacturers had argued that they were entitled to the NPM Adjustment even before The Brattle Group’s “significant factor” determination. See State of New York v. Philip Morris Inc., 8 N.Y.3d 574, 579 (2007) (explaining the basis for this position as a provision in the MSA which states that if any information is “missing” (such as the significant factor determination before The Brattle Group issued it, or, presumably, the diligent enforcement determination before the arbitration panel rules), the Independent Auditor under the MSA – the accounting firm charged with calculating payment amounts – “is to ‘employ an assumption as to the missing information producing the minimum amount that is likely to be due with respect to the payment in question’”).

130 With respect to whether or not the diligent enforcement determination is a prerequisite to application of the NPM Adjustment, in a section of the MSA entitled “Allocation among Settling States of NPM Adjustment for Original Participating Manufacturers, the
this issue, a number of Participating Manufacturers either withheld outright or paid into a disputed payment account their share of the 2003 NPM Adjustment when they made their annual MSA payment in April, 2006. Those companies that paid a portion of their 2006 annual MSA payment into the disputed payment account effectively put these funds into escrow until resolution of the diligent enforcement issue. The amount of MSA payments either withheld or paid into the dispute payment account in April 2006 totaled approximately $813 million.

In response, a number of states, including New York, filed declaratory judgment actions asking their state courts to find that the states had in fact diligently enforced their Qualifying Statutes and therefore were not subject to the NPM Adjustment. Confronted with declaratory judgment agreement provides that the NPM Adjustment “shall apply,” except if a state had a Qualifying Statute in effect and diligently enforced the provisions of the statute. See MSA § IX(d)(2). The MSA does not specifically address whether this amounts to an affirmative defense or a pre-condition to the application of the NPM Adjustment, but the “shall apply” language and the placement of the diligent enforcement issue in the allocation provision at least implies that it is an affirmative defense. Nevertheless, PriceWaterhouseCoopers, the “Independent Auditor” for the MSA (i.e., the third party charged with calculating the payments owed from the Participating Manufacturers to the states) continued to calculate the payment obligation of the Participating Manufacturers without an offset for the NPM Adjustment even after The Brattle Group’s “significant factor” determination.

132 See MSA § XI(d) (setting forth procedure for payment disputes).
133 See Final Determination, supra note 11 at p. 5. The total available NPM Adjustment for 2003 exceeded $1.1 billion, but rather than withholding or paying its share of the NPM Adjustment into the disputed payment account, Philip Morris paid its full annual payment amount to the states. Id. at 3.
actions in almost every state, the Participating Manufacturers responded by arguing that under the MSA’s dispute resolution provision the diligent enforcement issue was a matter for arbitration before a single arbitration panel rather than litigation in dozens of individual state courts. Ultimately, all but one state court agreed with the Participating Manufacturers’ position and ordered the parties to arbitrate the diligent enforcement issue. Since the arbitration process is not open to the public, information about the parties’ positions with respect to the diligent enforcement issue has been extremely limited. New York’s position with respect to its decision not to collect excise taxes (and therefore its failure to require escrow payments under its Qualifying Statute) on reservation sales to non-tribe members is publicly available, however, because the state laid out its position in the brief it filed in support of its motion for declaratory judgment after the Participating Manufacturers withheld a portion of the 2006 annual MSA payment.

In that brief, New York argued that the failure to collect escrow payments on NPM cigarettes sold on Indian reservations should have no effect on the diligent enforcement determination because these cigarettes were outside the scope of the Qualifying Statute. On this point, New York stated:

“Units sold,” upon which enforcement is based, is defined [in the MSA’s Model Statute and New York’s Qualifying Statute] as the number of cigarettes sold by the NPMs “as measured by excise
taxes collected by the state on packs . . . bearing the excise tax stamp of the state.” Thus, any cigarettes not “bearing the excise tax stamp of the state” and upon which excise taxes have not been “collected by the state,” do not constitute “units sold” and are not covered by either [New York’s Qualifying Statute] or the “diligent enforcement” obligation set forth in the MSA.

Since they are defined out of consideration by the provisions of the MSA and [New York’s Qualifying Statute], unstamped sales are completely irrelevant to the “diligent enforcement” analysis, and therefore are irrelevant to the application of the NPM Adjustment. 137

In effect, New York contended that because excise taxes are not collected on reservation sales, these cigarettes do not constitute “units sold” under that term’s definition in the MSA’s model Qualifying Statute. 138 As a result, escrow payments are not required on reservation sales of NPM cigarettes. This argument comports with a “plain reading” approach to the Qualifying Statute. It fails to account, however, for the authority under Supreme Court precedent and the mandate under Tax Law § 471 to impose the cigarette excise tax on cigarettes sold on Indian reservations to non-tribe members. Ultimately, New York’s argument promotes the position that the state’s executive branch may simply ignore a legislative mandate to impose a tax and may instead choose when, whether, and against whom it will apply the state’s cigarette excise tax.

137 NY Brief, supra note 30 at 22.
138 MSA Exhibit T, T-4.
B. Dissonance Between the Branches

As previously explained,\textsuperscript{139} since 1939 New York Tax Law § 471 has provided that “there is imposed and shall be paid a tax on all cigarettes possessed in the state by any person for sale, except that no tax shall be imposed on cigarettes sold under circumstances that this state is without power to impose such tax.”\textsuperscript{140} Despite (i) this express statutory mandate, (ii) the clear authority to impose excise taxes on reservation sales to non-tribe members under the U.S. Supreme Court’s 1977 \textit{Moe} decision, and (iii) approval by the Supreme Court in \textit{Milhelm} of New York’s proposed tax collection procedure on reservation sales to non-tribe members, New York only began collecting excise taxes on those sales in 2011, after the most recent amendments to Tax Law § 471-e. Prior to 2011, the New York Legislature made several legislative attempts to require the imposition of excise taxes on reservation sales to non-tribe members. New York’s governors and Department of Taxation & Finance, however, chose to ignore those legislative mandates and not impose excise taxes on any reservation sales (including sales to non-tribe members).\textsuperscript{141} Rather than impose the tax, the Department of Taxation & Finance for almost two decades maintained a policy of “forbearance,” effectively allowing tax-free sales of cigarettes on all tribal lands.

In light of the statutory and judicial history, New York’s current position that reservation sales have no bearing on the diligent enforcement issue rings hollow. In effect, New York argues that the executive branch has absolute discretion to decide what cigarettes it will tax, and any cigarettes it elects not to tax should have no bearing on the diligent enforcement determination. This ignores the direct legislative mandate in

\textsuperscript{139} See supra Section IV-A.
\textsuperscript{140} N.Y. Tax Law § 471(1).
\textsuperscript{141} See New York Association of Convenience Stores \textit{v.} Urbach, 275 A.D.2d 520 (N.Y. App. Div. 3d 2000) (explaining the “rational basis” for the state’s decision not to tax reservation sales).
§ 471 to impose excise taxes on all cigarettes other than those over which the state has no authority to tax. The state’s position also ignores the fact that in 2003 (the first year for which the NPM Adjustment is currently in dispute), the New York Legislature amended Tax Law § 471-e to state that the Commissioner of the Department of Taxation & Finance “shall promulgate rules and regulations necessary to implement the collection of sales, excise and use taxes” cigarettes sold on reservations to non-tribe members.”142 As already explained, however, the mandated regulations were never implemented due to the protests by members of Native American tribes and the Governor’s subsequent decision to continue the previous policy of forbearance.

Taken to its extreme, the state’s position (i) that no escrow payments are owed on any untaxed cigarettes and (ii) that the state’s executive branch (despite legislative mandates to the contrary) has discretion to decide what cigarettes to tax, completely undermines the deal struck in the MSA. Applying the state’s logic, for example, the Governor or the Department of Taxation & Finance could unilaterally decide that no excise taxes should be imposed on sales of any NPM cigarettes, whether or not those sales occur on Indian reservations. If this policy were adopted, according to the state’s position, no NPM sales would constitute “units sold” as defined in the Qualifying Statute and no escrow payments would be owed by any NPM. This would, of course, render the MSA’s diligent enforcement issue meaningless—a result clearly not anticipated by the parties.

New York’s position also contradicts the intention of the parties with respect to the purpose requiring NPMs to make escrow payments, as that purpose is expressed in the MSA’s Model Statute and in New York’s

142 N.Y. Tax Law § 471-e.
Qualifying Statute. New York’s Qualifying Statute adopts the Model Statute’s prefatory statement that “it would be contrary to public policy” to allow NPMs to “derive large, short-term profits” through the cost advantage they enjoy as a result of not joining the MSA. Permitting the state’s executive branch unilaterally to exempt some NPM sales from the Qualifying Statute’s escrow requirement undermines the very purposes behind the Qualifying Statute: (i) to level the playing field between Participating Manufacturers and NPMs and (ii) to provide a source of funds in the event that the state obtains a judgment against an NPM.

Thus, New York’s position with respect to Indian reservation sales to non-tribe members ignores the statutory mandate in § 471 that excise taxes be imposed on these sales, violates the separation of powers by allowing the executive branch to simply disregard repeated attempts by the legislature to require the collection of taxes on these sales, and fails to uphold stated purposes of the Qualifying Statute as expressed in the statute’s prefatory language. As a result, the arbitrators assessing whether New York diligently enforced its Qualifying Statute should consider the state’s failure to collect escrow payments on these sales in making their determination. All of which may lead the arbitrators to find that New York failed to diligently enforce its Qualifying Statue and ultimately may reduce the state’s MSA payments by billions of dollars under the NPM Adjustment.

V. LESSONS FROM THE MSA AND THE NPM ADJUSTMENT

Despite the somewhat singular nature of the MSA, lessons may be drawn from the agreement that have potential application to future major settlements, including the recently-announced settlement between the states and some of the nation’s largest mortgage servicers. These lessons include the benefit of simplicity, the advantage of precise drafting, and the

need for coordination (or at least communication) between various branches of state government.

A. Simplicity

The NPM Adjustment is anything but simple. There are two, or possibly three, requirements for the NPM Adjustment to apply (it is not clear whether the diligent enforcement determination is a prerequisite or an affirmative defense).\textsuperscript{144} Both the significant factor determination and the diligent enforcement determination require subjective interpretations of undefined terms. As a result, the Participating Manufacturers and the states are, in 2012, still disputing whether the 2003 NPM Adjustment should apply.

Since the significant factor determination in 2006, a substantial portion of the funds comprising the 2003 NPM Adjustment have been sitting in disputed payment accounts, serving neither the Participating Manufacturers nor the states.\textsuperscript{145} Moreover, the time and cost incurred by both sides to determine whether the NPM Adjustment should apply has been extensive. In addition to the scores of attorneys who participated in the resolution of the significant factor issue, almost every state filed a declaratory judgment motions after numerous Participating Manufacturers withheld a portion of their 2006 MSA payments following The Brattle Group’s significant factor determination. These motions resulted in litigation in almost every state over whether the diligent enforcement issue was subject to litigation in state court or arbitration before a single, nationwide panel.\textsuperscript{146} All state courts but one ultimately found arbitration

\textsuperscript{144} *Supra* note 132 and 133.
\textsuperscript{145} MSA Documents, *supra* note 134.
\textsuperscript{146} *See, e.g.*, State v. Philip Morris Inc., 869 N.E.2d 636 (N.Y. 2007); State v. Philip Morris USA, Inc., 666 S.E.2d 783 (N.C. Ct. App. 2008); Ieyoub v. Philip Morris USA,
to be the proper forum for the dispute. In many states, however, this issue was appealed up to the state’s court of final review. As a result, the dispute over the proper forum for determining whether states diligently enforced their Qualifying Statutes took years to resolve.

The complexity of the NPM Adjustment provision has also created a situation that could hardly have been anticipated at the time the settlement was reached, particularly for New York. How could the state have anticipated that the politically-motivated decision not to tax cigarettes sold on Indian reservations might cause it to lose several years’, and up to billions of dollars worth, of MSA payments? Thus, the first lesson from the NPM Adjustment experience is to simplify the terms of settlement agreements if at all possible. This allows states to understand the scope of their obligations and avoid the type of “surprise” that New York presently faces.

B. Precision

A second lesson from the MSA, and the NPM Adjustment in particular, is to define terms and allocate burdens expressly, rather than leaving that task to future decision-makers. Neither “significant factor” nor “diligent enforcement” is defined in the MSA. Perhaps this reflects an inability to reach agreement on their meanings at the time the parties entered into the MSA. But by not defining the terms in the agreement, the sides

---


149 MSA § IX(d)(1)(C); (2)(B).
ensured substantial uncertainty over the ultimate outcome of the NPM Adjustment proceeding, a proceeding that now has several billions of dollars at stake.

Had “significant factor” been defined in the MSA, The Brattle Group might have reached a different conclusion in determining the role the MSA played in the Participating Manufacturers’ loss of market share. Moreover, if the MSA had defined “diligent enforcement,” or at least if some type of safe harbor or general guidelines for meeting the standard of diligent enforcement had been provided in the MSA, the states could have substantially reduced the uncertainty they now face over whether they diligently enforced their Qualifying Statutes. That uncertainty may lead the states to settle the NPM Adjustment proceeding under unfavorable terms, rather than run the risk of losing their entire MSA payments for several years. Settlement discussions have reportedly been underway and a leaked draft settlement showed the states paying at least thirty cents on the dollar to settle the NPM Adjustment for years 2003-2010. Earlier media reports of an impending settlement were apparently overstated, though, as neither the states nor the Participating Manufacturers have confirmed that a settlement is impending.

In short, much of the uncertainty that currently surrounds the NPM Adjustment arbitration could have been avoided had the parties defined some of the key terms applicable to the adjustment. Future settlements should strive to minimize this type of uncertainty.

---

151 Principle Terms of a Comprehensive Settlement of the NPM Adjustment Dispute, available at http://64.38.12.138/docs/mou052511.pdf (memorandum of potential settlement, not yet agreed to by states or Participating Manufacturers).
152 David Kesmodel, States Near Tobacco Deal, WALL ST. J. (June 22, 2011).
C. Communication

A third lesson from the NPM Adjustment proceeding is that states must have better communication between branches of government and between departments within the same branch, particularly when so much is at stake, as in the case of the NPM Adjustment. At the time the MSA was signed by New York Attorney General Dennis Vacco in November 1998, it is unlikely he appreciated how the policy of forbearance adopted by Governor Pataki in 1997 and implemented by the Department of Taxation & Finance might affect the diligent enforcement determination or how that policy could ultimately result in the state losing billions of dollars of MSA payments. Better communication between the attorney general’s office and the Department might have surfaced this issue, or at least provided an opportunity to identify the potential problem.

In addition, the New York legislature’s enactment of § 471-e in 2003, specifying that the state’s cigarette excise tax applies to reservation sales made to non-tribe members, undercuts the state’s current position that it had no obligation to collect escrow on these sales because no excise tax was imposed on them. By 2003, the attorney general’s office should have been well aware of the potential risk posed by the failure to impose excise tax (and the concomitant failure to collect escrow payments) on reservation sales. The 1999-2002 years’ NPM Adjustment claims had already been settled, so the issues involved in the claims should have been known to the states and a subject of their attention. The enactment of § 471-e, followed by the Department’s decision to continue its policy of

153 N.Y. Tax Law § 471-e.
forbearance, not only failed to generate any additional tax revenue for the state, it also served to highlight the fact that the state could have collected excise (and escrow) on reservation sales but elected not to do so purely for political reasons. The result of all this is that a lack of communication between the legislature and the executive branch and between the attorney general and the Department of Taxation & Finance may now play a major role in the potential loss of billions of dollars of MSA payments for the state. That potential loss might have been avoided with better intra-governmental communications.

**CONCLUSION**

These lessons—to strive for simplicity, to expressly define terms and allocate burdens, and to coordinate actions between branches of government and departments within the same branch—constitute three major lessons from the NPM Adjustment proceeding. Our hope is that the states will consider these lessons when entering into future landmark settlements.