CASE NO. 09-30985

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

S&M BRANDS, INC., MARK HEACOCK, and TOBACCO DISCOUNT HOUSE #1, INC.,
PLAINTIFFS-APPELLANTS
V.
JAMES "Buddy" CALDWELL, in his official capacity as Attorney General of Louisiana
DEFENDANT - APPELLEE

APPEAL FROM THE U.S. DISTRICT COURT
FOR THE WESTERN DISTRICT OF LOUISIANA
CIVIL ACTION NO. 05-1372

REPLY BRIEF OF APPELLANTS

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SUMMARY OF ARGUMENT

This case raises two categories of challenges to the MSA. First, there are substantive objections under the Constitution and federal law; second, there is the overarching procedural objection that the MSA did not receive the congressional approval required under the Compact Clause. There is an important relationship between those two categories. The Compact Clause applies to agreements that have the *potential* to encroach upon federal authority or upon state rights and interests. If the Compact Clause is to have any independent meaning, as it must, then the category of *potential* encroachments that trigger it must be broader than the category of *actual* violations of other constitutional or statutory requirements. Potential encroachments lie in between clearly lawful and clearly unlawful conduct. Actions by individual States falling between those boundaries are often upheld based on strong federalism presumptions in favor of the States. But in the multistate context, the reverse occurs, and such actions trigger the Compact Clause. Thus, in considering the substantive claims raised in this case, this Court should strike down or uphold the MSA and its statutes if a violation is clearly proven or disproven. But if the violation lies in between such poles, that alone triggers the Compact Clause.

Turning to the particular claims presented, defendant-appellee ignores, and thus effectively concedes, that the MSA is an anticompetitive agreement between tobacco companies, between the Settling States, and between and among those two groups. Defendant likewise ignores, and hence concedes, that many States, including Louisiana, were coerced into joining the MSA and that his agent, NAAG, admits that NPMs are worse off for not having joined the MSA. Those concessions alone are more than sufficient to demonstrate that the MSA is an agreement subject to the Compact Clause; an agreement among competitors constituting a *per se* antitrust violation; and, together with its implementing legislation, a coercive imposition of unconstitutional and unlawful conditions.

Plaintiffs' First Amendment claim was more than adequately raised in the Complaint and subsequent pleadings. Extensive evidence and admissions establish that the MSA and its implementing legislation impose significant burdens on and deny valuable benefits to NPMs due to their refusal to waive their First Amendment rights by joining the MSA.

The MSA and its statutes likewise conflict with the FCLAA both by directly restricting cigarette advertising and by imposing burdens on and denying benefits to NPMs who refuse to restrict advertising by joining the

MSA. Such advertising restrictions are not voluntary given their incorporation into consent decrees and the coercion to join the MSA.

Plaintiffs' antitrust claim also was more than adequately raised in the Complaint and subsequent pleadings. Defendant's exclusive reliance on *Parker* state-action immunity is misplaced: States may not immunize agreements among competitors that constitute *per se* antitrust violations by simply joining or authorizing such agreements. *Parker v. Brown*, 317 U.S. 341, 351-52 (1943). Furthermore, *Parker* immunity has no application to multistate agreements concerning interstate commerce and has never been so applied by the Supreme Court.

Defendant largely ignores the direct imposition of extraterritorial fees and restrictions by the MSA, irrelevantly focusing on the Escrow Statute alone. Uncertainty whether the MSA's extraterritorial restrictions can, as a practical matter, be enforced by the States does not make them constitutional.

Finally, defendant misinterprets and ignores Supreme Court Compact Clause precedent, proffering an interpretation of that Clause that would render it a nullity. The Compact Clause applies to agreements involving even "potential" encroachment on federal authority or sister-state interests and sovereignty, not merely agreements violating other constitutional or

statutory provisions. While strong federalism presumptions insulate many potentially unconstitutional or preempted individual-state actions, the opposite federalism concerns apply under the Compact Clause, triggering the obligation to seek congressional review when such actions involve agreements among several States.

The MSA is subject to the Compact Clause because it raises *at least* "potential" encroachments on federal authority and state rights and interests. Consent for the MSA as a whole cannot be implied from the narrow language and history of the Medicaid Amendment and is firmly rebutted by well-established rules limiting implied congressional ratification.

ARGUMENT

I. THE MSA AND ITS STATUTES VIOLATE THE FIRST AMENDMENT.

Defendant does not dispute the First Amendment legal standards applicable to this case; that the MSA restricts protected speech; or that it would be an unconstitutional condition for the MSA and its statutes to burden or deny benefits to NPMs for failure to accept the MSA's speech restrictions. Opening Br. 22-24.

Defendant instead argues the claim was not properly raised; NPMs are no worse off for refusing to accept the MSA's speech restrictions; and that

such restrictions are voluntary. Appellee Br. 18-22. Each argument is flawed.

A. The First Amendment Claim Was Adequately Raised.

As defendant concedes, paragraphs 61-65 of the Complaint specifically allege that the MSA and its implementing statutes violate the First Amendment as one reason why the Compact Clause applies. Appellee Br. 18-19. Numerous additional allegations in the Complaint, as well as subsequent pleadings, also raise the First Amendment claim and the facts supporting it.[1] The district court recognized as much when it rejected the Magistrate's recommendation to dismiss.[2]

Notice pleading does not require plaintiffs to set forth every potential legal theory in their complaint, only facts that can "support relief on *any* possible theory." *Cinel v. Connick*, 15 F.3d 1338, 1341 (5th Cir. 1994) (emphasis added). The facts pled in the Complaint and briefed below are more than sufficient to satisfy that standard.

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[1] Complaint ¶¶ 5, 10, 30; 53, 61, 63, 65 [R23, R25, R30, R40, R42-43]; *cf*. ¶ 75 (FCLAA-related factual allegations sufficient to state a First Amendment claim) [R46]; Plaintiffs' Opp. to Motion to Dismiss 24-26 [R343-45]; Objections to Magistrate's Report 2-6 [R671-75]; Plaintiffs' Mem. in Support of Sum. Judgment 29-31[R2100-02]; Plaintiffs' Opp. to Sum. Judgment 23-24 [R1524-25].

[2] Mem. Ruling 3 (Nov. 9, 2006) (denying defendant's "motion to dismiss plaintiffs' claims pursuant to," *inter alia*, "the … First Amendment"). [R724] Defendant erroneously claims, at 19, that the "court" below recognized the failure to raise the First Amendment claim, citing only the Magistrate's Report, which was *rejected* by the court.

Cutrera v. *Board of Supervisors of Louisiana State University*, 429 F.3d 108 (5th Cir. 2005), is not to the contrary. *Cutrera* held that a "claim which is not raised in the complaint, but rather, is raised *only in response* to a motion for summary judgment is not properly before the court." *Id*. at 113 (emphasis added) (citation omitted). Here, by contrast, the First Amendment claim was not raised "*only*" in response to a motion for summary judgment, but also in the Complaint, in plaintiffs' motion for summary judgment, *and* in response to motions to dismiss.[3]

Finally, even assuming, *arguendo*, the failure to preserve a *separate* First Amendment claim, the First Amendment violation still supports a Compact Clause claim. Regardless whether such a claim would be "academic" or redundant alongside a separate First Amendment claim, Appellee Br. 39-40, the supposed absence of a separate claim eliminates the redundancy and makes consideration of the First Amendment a necessary step in analyzing the Compact Clause claim.

[3] It is doubtful whether *Cutrera* is even good law given its conflict with *Ganther v. Ingle*, 75 F.3d 207, 211-12 (5th Cir. 1996). *See Elliott v. Quintana*, 336 Fed. Appx. 405, 406 (5th Cir. 2009) ("Our authorities are split on whether the district court had to construe the inclusion of new arguments in the summary judgment motion as a motion to amend the pleadings.") (comparing *Cutrera* with *Ganther*). "'In the event of conflicting panel opinions from this court, the earlier one controls.'" *Texaco, Inc. v. Louisiana Land & Exploration Co.*, 995 F.2d 43, 44 (5th Cir. 1993) (citation omitted).

B. NPMs Are Severely Burdened and Denied Significant Benefits for Having Refused to Waive their First Amendment Rights.

Conceding the legal standards for unconstitutional conditions, defendant only raises a factual dispute regarding whether NPMs are burdened or denied benefits for not having accepted the MSA's speech restrictions. The district court did not address that factual dispute and, in any event, the evidence is overwhelming that NPMs both suffer greater burdens and are denied benefits relative to PMs.

Initially, defendant ignores numerous admissions by its agent NAAG and in its own briefs from an MSA arbitration proceeding, and the precipitous decline of NPMs in Louisiana, which establish to a near certainty that NPMs are worse off than PMs. Opening Br. 8, 10-15. NPMs, and particularly those such as S&M that would have been eligible for the MSA's grandfather exemption but receive no such escrow exemption, pay more per-pack than OPMs and grandfathered SPMs; suffer greater administrative burdens and expenses; face overwhelming marketing disadvantages due to the abusive threat of meritless yet burdensome litigation against them and their customers; and are denied the benefit of settling such threatened liability except on condition of waiving their First Amendment rights. Opening Br. 8-14.

Defendant's comparison, at 10, 12-13, 21, of NPM payments to *non*-grandfathered SPM payments simply ignores the grandfather-clause benefits denied to NPMs and the competitive burden they suffer relative to grandfathered SPMs. Although NPMs and *non*-grandfathered SPMs make nominally similar payments, NPMs pay far more than grandfathered SPMs.[4] Plaintiff S&M would have been eligible for a significant grandfather exemption (at least a million cartons annually, Gee Decl. 3 [Sealed Doc. 114]), but its escrow payments are not reduced accordingly.

Defendant's suggestion, at 13 n.13, that grandfathered SPMs have the same *marginal* costs as NPMs on cigarettes sold above their grandfathered levels is both misleading and irrelevant. Even assuming uniform pricing based on the marginal cost of the *last* cigarette sold, as opposed to based on their average cost for total sales, grandfathered SPMs earn an additional $0.52/pack profit on grandfathered sales, covering their fixed costs in a fraction of the time, providing greater resources for investment and marketing, and yielding far higher profits. It is frivolous to suggest that such

[4] Under defendant's own calculations, the facial amounts paid by NPMs and non-grandfathered SPMs differed by less than half a cent per pack. Appellee Br. 8-9 n.7 (*citing* Gruber Report [R1773-75] showing minimal difference for 2007 and 2008). A grandfathered SPM with a market share at or below its grandfathered share pays nothing, and with a market share of twice its grandfathered share pays only *half* as much as an NPM making comparable sales. Gruber Decl. 5 (grandfathered SPM payment calculated based on current market share minus base (grandfathered) share). [R1773] MSA payments for OPMs also were far less than NPM payments. Appellee Br. 4-5.

SPMs lack a competitive advantage over NPMs.[5] S&M thus has been denied a benefit and suffers a competitive burden for not having promptly waived its First Amendment rights.

Second, defendant's comparison of NPMs to non-grandfathered SPMs ignores the other burdens imposed on NPMs.[6] Defendant does not dispute that SPMs routinely fail to make or simply defer their payments without penalty and at nominal interest rates, receiving what amount to below-market loans that effectively reduce the present value of SPM obligations. Opening Br. 11. NPMs are denied such benefits, causing their escrow

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[5] Defendant's criticism, at 13 n.13, of our citation to both sides' experts, Opening Br. 10 n.12, is misplaced. Defense expert Gruber first argued that NPM costs were similar to aggregate OPM costs (including non-MSA state payments), Gruber Decl. 12. [R1780], and *then* said that grandfathered SPMs have an advantage over OPMs. The relative advantage of grandfathered SPMs obviously is commutative. And plaintiffs certainly disputed the other aspects of Gruber's marginal cost theory. Plaintiffs' Reply in Support of Sum. Judgment 3 n.11 (Gruber incorrectly excluded SPM sales below grandfathered levels) [R1907]; *see also* Response by Settling States to the Firm's Initial Written Questions 29 (Dec. 16, 2006) (noting that correct marginal cost calculation must include zero-cost SPM sales below grandfathered levels) [Sealed Doc. 96, attach. 7]; Gruber Dep. 139 (conceding that average cost determines long-run survival and that SPMs can have lower average costs) [R1139]. Contrary to defendant's suggestion, plaintiff's expert Bulow found higher NPM marginal costs relative to *both* Louisiana's allocable share of MSA costs *and* nationwide MSA costs, *i.e.*, full MSA payments. Bulow Rep. 54 (addressing marginal costs of PMs from the "moneys paid to the sum total of all MSA jurisdiction") [R1105]; *id*. at 55 (Chart showing higher NPM marginal costs even in 2003, before most States increased escrow charges) [Sealed Doc. No. 96, attach. 3].

[6] Contrary to defendant's assertion, at 11, interest on escrow deposits is virtually nil. Bank statements of NPM (showing miniscule interest and offsetting monthly fees) [R1678-81]; Model Escrow Agreement (restricting investments (§ 5), authorizing extravagant fees (§§ 6 and 9)) [R1682-97]. And NAAG does not view NPM administrative burdens as minimal. Opening Br. 13-14; *see also Taoh v. Freeh*, 27 F.3d 635 (D.C. Cir. 1994) (unquantified burden on speech from time-consuming application violated First Amendment).

payments to have a higher present cost than deferred SPM payments.[7] NAAG also admits that NPMs face severe marketing and distribution burdens from not being part of the MSA. Opening Br. 12-13. Defendant's suggestion, at 14, that such burdens are the ordinary cost of not settling their potential liability ignores that NPMs are denied the ability to settle that risk except on condition of waiving First Amendment rights having nothing to do with such potential liability. *Cf. New York Times v. Sullivan*, 376 U.S. 254, 277 (1964) ("The fear of damage awards … may be markedly more inhibiting [of speech] than the fear of prosecution"); *White v. Lee*, 227 F.3d 1214, 1228-29 (9th Cir. 2000) (investigation and threatened suit to coerce speech-restrictive settlement violates First Amendment).[8]

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[7] Defendant also ignores his admission that escrow deposits effectively produce a negative interest rate spread for NPMs that reduces the present value of their reversionary interests, even under optimistic assumptions, to only $0.20/dollar if returned in 20 years (and $0.14/dollar if returned in 25 years). Opening Br. 8-9 n.8. Less optimistic interest assumptions reduce the present value of such reversionary interests virtually to zero.

Of course, nobody actually believes that the escrow deposits will be returned without a fight (the cost of which would exceed their value). If there were any realistic prospect of the escrow deposits being returned, defendant argues they would not be tax deductible. Response of Settling States to Firm's Initial Questions at 62 ("The Internal Revenue Code provides that conditional payments that may be returned are generally not deductible business expenses. Thus, NPM escrow payments should not be deductible unless an NPM irrevocably waives any right to return of the escrow payment in the future.") [Sealed Doc. 96, attach. 7]; NAAG, Why Join the MSA at 3 ("payments under the MSA may be tax deductible and payments by an NPM may not. On an after-tax basis, it may be significantly more economical for a company to be an SPM") [R1057]. The real present cost of escrow payments would then dwarf their reversionary value and exceed the costs of non-grandfathered SPMs.

[8] Additionally, the escrow obligation discriminates against NPMs in that PMs are more likely to face liability for fraud (not released by the MSA, *see* MSA § II(kk)), yet are not

Third, defendant's claim that the amended Escrow Statute ensures equal payments between NPMs and non-grandfathered SPMs is contrary to the empirical evidence. MSA participants have previously received, and are currently negotiating, so-called NPM adjustments that reduce their MSA payments for previous years. Defendant does not dispute that NPMs were denied equivalent refunds, notwithstanding that the pre-amendment Escrow Statute similarly limited allocable-share escrow payments to an SPM's allocable-share of MSA payments. *See* Appellee Br. 9 n.9, 14 n.14; Levin Dep. 185-92 [Sealed Doc. 96, Attach. 4].[9] While the amended Escrow Statute eliminates Louisiana's allocable share of MSA payments as both the basis for escrow payments and the measure of the escrow-payment cap, the *relative* relationship between NPM and SPM payments remains the same as before. Defendant offers no reason why the only empirical evidence – showing that NPM adjustments are denied to NPMs – should be ignored.

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required to post what amounts to a bond for such potential liability. *Compare* Enright Dep. 38-39 (currently no claims against NPMs that could be satisfied from escrow funds) [R1547-48] *with United States v. Philip Morris*, 566 F.3d 1095, 1133-34 (D.C. Cir. 2009) (continuing fraud by the Majors post-MSA); *see also* [R1002 n.52] (discriminatory NPM taxes). NPMs also face state discrimination in suits against them by third parties, facing excessive appeals bonds and punitive damages while PMs are exempt from such risks. *See* LA. REV. STAT. § 39:98.6 (exempting PMs from burdensome appeals bonds); *Brown & Williamson Corp. v. Gault*, 627 S.E.2d 549, 550-54 (Ga. 2006) (plaintiff could not seek punitive damages against PM because MSA eliminated state interest in punishment).

[9] Refunds were denied because NPM adjustments are settled for multiple years, not broken down per pack or carton, and hence not readily translated into equivalent escrow refunds. Levin Dep. 187-88. [Sealed Doc. 96, attach. 4]

Furthermore, the burden of obtaining any refunds rests with individual NPMs, and the transaction costs of seeking a refund (including costs to the escrow agent for legal advice and the cost of litigating the inevitable denial of a refund) will almost invariably exceed the potential refund given the limited market shares of individual NPMs.[10]

Finally, if there were any doubt about the relative benefits and burdens of joining and not joining the MSA, the overwhelming decline of NPMs in Louisiana, particularly after the ASR amendment, confirms that NPM face greater burdens than SPMs.

Defendant's citation, at 20-21, to *S&M Brands, Inc. v. Summers*, 393 F.Supp.2d 604, 637-38 (M.D. Tenn. 2005), *aff'd*, 228 Fed. Appx. 560 (6th Cir. 2007), and *KT&G Corp. v. Attorney General of the State of Oklahoma*, 535 F.3d 1114, 1135 (10th Cir. 2008) for the proposition that NPMs "are no worse off financially" than they would be under the MSA adds nothing to their argument. The *S&M* case from Tennessee was dismissed on the pleadings without development of the extensive facts in this case. And the court's bald assertion that plaintiffs were no worse off improperly contradicted the factual allegation it cited earlier that NPMs are indeed

[10] SPMs, by contrast, can free ride on the efforts of the Majors seeking an NPM adjustment that would apply to all PMs. The much larger market shares of the Majors means the value of the adjustment far exceeds the transaction costs of obtaining it.

worse off than SPMs, even with identical nominal payments, because they could not deduct their payments. 393 F.Supp.2d at 631, 638.[11] *KT&G* likewise addressed only a motion to dismiss, relied on the erroneous factual conclusions of *S&M*, noted that plaintiffs there only challenged the Allocable Share Amendment, "expressly do not challenge" the MSA, and "do not allege that they are worse off doing business as NPMs" than under the MSA. 535 F.3d at 1133-35. Plaintiffs in this case offer well-developed facts and make the precise allegations and challenges lacking in *KT&G*.

II. THE MSA AND ITS STATUTES ARE PREEMPTED BY THE FCLAA.

Defendant does not deny that a State may indirectly "impose[]" restrictions on cigarette advertising by penalizing such advertising or conditioning a benefit on waiving the right to advertise. Opening Br. 26-29. Instead, defendant, at 22-23, primarily repeats his factual claim that NPMs are no worse off than SPMs, which is wrong for the reasons given *supra* at 7-13. The FCLAA preempts such unlawful conditions on advertising, as well as the direct advertising restrictions imposed by the MSA itself.

Defendant's related argument, at 23, that the MSA's restrictions are "voluntary," rather than "imposed under state law," is wrong for the reasons

[11] Defendant, at 20-21, chides plaintiffs for not citing this erroneous district court case, but does not argue preclusion, and did not so argue below.

given in the Opening Brief, at 27 n.22, 28-29.[12] Defendant does dispute that agreements enforced by consent decrees, or coerced by threatened penalties or denial of benefits, are subject to preemption.[13]

III. THE MSA AND ITS STATUTES VIOLATE THE ANTITRUST LAWS.

The MSA is an agreement among, *inter alia*, tobacco companies in *per se* violation of the Sherman Act. Joining and enforcing that illegal agreement are not sovereign state acts entitled to *Parker* immunity.

A. The Antitrust Claim Was Adequately Raised Below.

Defendant's assertion, at 24-25, that the antitrust claim was not adequately raised is mistaken for the same reasons given in connection with the First Amendment claim. *Supra* 5-6. Antitrust violations were alleged in numerous paragraphs of the Complaint and in subsequent briefing.[14] This

[12] Plaintiff Heacock, a smoker and potential recipient of advertising, has standing to challenge the MSA's advertising and speech restrictions regardless whether PMs were forced to waive their rights to bring such challenges. *Virginia State Bd. of Pharmacy v. Virginia Citizens Consumer Counsel*, 425 U.S. 748, 756-57 (1976) (potential recipients have standing to challenge advertising restrictions).

[13] Defendant's citation, at 23-24, to the district court decisions in *Grand River v. Pryor*, *PTI* and *Omaha Tribe* ignores the Opening Brief, at 29-30. The Second Circuit's unexplained disposition of an FCLAA claim in *Grand River Enterprises Six Nations Ltd. v. Pryor*, 425 F.3d 158, 175 (2d Cir. 2005), *cert. denied*, 549 U.S. 951 (2006), adds nothing, and the Second Circuit in the same case found the MSA to be sufficiently regulatory for purposes of reviving a dormant Commerce Clause claim. *Id*. at 173. It necessarily follows that the MSA is sufficiently regulatory for purposes of affirmative preemption.

[14] Complaint ¶¶ 7, 34-35, 61-62 [R24, R32, R42]; Plaintiffs' Opp. to Motion to Dismiss 16-21 [R335-40]; Plaintiffs' Mem. in Support of Sum. Judgment 23-27 [R2094-98]; Plaintiffs Opp. to Motion for Sum. Judgment 17-22 [R1518-23].

case is again readily distinguishable from the *Cutrera* case. *See also O'Hara v. General Motors Corp.*, 508 F.3d 753, 763 (5th Cir. 2007) (reversing district court's rejection of claim where "it was adequately disclosed in O'Hara's expert reports"); Bulow Expert Report 3, 8, 31, 41-42, 61, 64, 66 (discussing antitrust violation) [Sealed Doc. 96, attach. 3].

B. State-Action Immunity Does Not Insulate the MSA and Its Statutes.

Defendant does not dispute that the MSA is an agreement among competitors to divide markets and stabilize prices in *per se* violation of the Sherman Act. Opening Br. 30-34. Defendant only asserts state-action immunity under *Parker* and its progeny. Appellee Br. 26-31. State-action immunity is a disfavored repeal-by-implication and should be narrowly construed. No Supreme Court case has ever applied such immunity to a multi-state agreement, much less an agreement also between and among private companies. Opening Br. 34-40.

Defendant does not even attempt to deny that the federalism concerns underlying *Parker* and its progeny do not apply, and in fact cut the other way, here. Because *Parker* immunity is a product of judicial construction contrary to the actual language of the Sherman Act, and no Supreme Court case has ever extended such immunity this far, this Court certainly is not bound by cases involving individual States acting exclusively within their

own borders. State-action immunity is entirely inappropriate as applied to multi-state conduct for the reasons given in the Opening Brief and all but ignored by Appellee.

Defendant's claim, at 26-28, that a State is not a "person" under the Sherman Act misses the point.

First, the *prohibition* in the Sherman Act, 15 U.S.C. § 1, does not refer to "persons" at all, but rather declares that "[e]very contract, combination …, or conspiracy in restraint of trade" is "illegal." It is the agreement that is the object of the statutory prohibition, not the participants. To be sure, the statute goes on to provide criminal *punishment* for "[e]very person" who engages in such conduct, but this suit seeks neither punishment nor damages, merely a declaration of illegality and an injunction. *Parker* immunity from such remedies is not a function of the statutory language, merely a product of judicial construction based on federalism concerns. Nothing in *Parker* requires that extra-statutory limitation to be *extended* to the very different circumstances here. Such extensions are strongly disfavored, and there is no federalism justification for taking that step here.

Second, *Parker* itself recognizes that certain conduct by a State is not entitled to immunity. A State is not immune when it becomes a "participant in a private agreement or combination by others for restraint of trade," or

seeks to "give immunity to those who violate the Sherman Act by authorizing them to violate it, or by declaring that their action is lawful." 317 U.S. at 351-52. Indeed, *Parker* expressly contrasted the "act of government" at issue there from the situation here, where Louisiana and other States have entered into an "agreement or contract" or a "conspiracy in restraint of trade." *Id*. at 352.

As explained in our Opening Brief, at 31, 36, the MSA is far more than just an agreement between States to adopt anticompetitive laws – it is also an agreement *among* the tobacco companies themselves to divide costs, restrict advertising, and divide markets. That agreement on its face is *per se* illegal, and having the States "participa[te] in such private agreement or combination," 317 U.S. at 351, does not confer immunity on the MSA or on enforcement statutes the States were thereafter coerced into enacting. Such conduct is forbidden by the Sherman Act or, at best, constitutes a hybrid restraint. *See Freedom Holdings, Inc. v. Spitzer*, 357 F.3d 205, 224 (2d Cir. 2004) (MSA "by any definition a 'contract' that the [Majors] jointly negotiated among themselves … and with the states" and was joined by other manufacturers). It is certainly *not* a purely sovereign act entitled to automatic immunity, and defendant does not even pretend the MSA and its statutes could survive the *Midcal* test for hybrid restraints.

Defendant's reliance on *Hoover v. Ronwin*, 466 U.S. 558, 569 (1984), is misplaced. *Hoover* included only the conduct of the legislature or the "legislative" activities of the judiciary in its catalog of immune sovereign acts. *Id*. at 568. The signing of the MSA by Louisiana's Attorney General was the "conduct of a nonsovereign state representative," not the State itself, *id*. at 569, and is not entitled to any automatic immunity. Furthermore, joining, authorizing, and enforcing private agreements to restrain trade are not "sovereign" acts, even when undertaken by the legislature, particularly when done under coercion. The immunity described in *Hoover* simply does not apply to this case.[15] The executive and judicial acts of the state Attorney General and the courts, and the coerced enforcement measures enacted by the legislature, are precisely the type of conduct that *Parker* distinguished from sovereign "acts of government" for purposes of immunity.

IV. THE MSA REGULATES EXTRATERRITORIAL ACTIVITY.

Although the MSA directly restricts nationwide speech and petitioning activity and imposes extraterritorial fees on PM cigarette sales. Opening Br. 41-42, defendant largely ignores those actions and irrelevantly

[15] *Rice v. Norman Williams Co.*, 458 U.S. 654, 658 n.4, 661 (1982), similarly does not apply in that it describes strict standards applicable to facial challenges, not fully developed as-applied challenges such as the one here. *Compare United States* v. *Concentrated Phosphate Exp. Ass'n*, 393 U.S. 199, 208 (1968) (considering the "economic realities of the relevant transactions" in an as-applied case).

focuses on the geographic limits of escrow charges. Defendant's cases from other circuits similarly ignore the MSA's extraterritoriality and address only escrow payments. *Grand River Enterprises Six Nations, Ltd. v. Beebe*, 574 F.3d 929, 943-44 (8th Cir. 2009) (Allocable Share Amendment); *KT&G*, 535 F.3d at 1143-46 (same); *Star Scientific, Inc. v. Beales*, 278 F.3d 339, 356-57 (4th Cir. 2002) (Escrow Statute), *cert. denied*, 537 U.S. 818 (2002). Unlike the Escrow Statute or the Allocable Share Amendment, the MSA directly regulates speech and cigarette sales beyond the borders of Louisiana and other MSA States. *Cf. State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408, 420 (2003) (rejecting punitive damages for conduct in other States); *BMW of North America, Inc. v. Gore*, 517 U.S. 559, 572 n.17 (1996) (state sovereignty and comity preclude sanctions for conduct in other States; State attempting to alter defendant's "nationwide policy … infring[es] on the policy choices of other States").

As the Second Circuit has recognized, "[i]f a manufacturer joins the MSA as an SPM, the amount it pays as part of the settlement is tied directly to the manufacturer's *national* market share." *Grand River v. Pryor*, 425 F.3d at 171 (emphasis in original). Both the national MSA payments and the relation thereto of escrow payments led the court to reverse and remand a

dismissal of a Commerce Clause claim. *Id*. at 173.[16] Although the district court on remand still denied a preliminary injunction, it considered only the commerce effects of escrow payments alone, not the direct extraterritorial fees and regulations imposed by the MSA. *Grand River Enterprises Six Nations, Ltd. v. Pryor*, 2006 WL 1517603, at *9 (S.D.N.Y 2006), *aff'd*, 481 F.3d 60 (2d Cir. 2007).

Regarding the MSA itself, defendant, at 36-37, merely repeats his FCLAA argument that the MSA is voluntary, not regulatory. That argument is disposed of above, *supra* 14, and in our Opening Brief, at 27 n.22, 28-29.

Defendant's suggestion, at 37, that there is no practical means of enforcing the MSA outside its member-States' territory is both specious and irrelevant. MSA charges for sales in non-MSA States are applied by the Independent Auditor, enforced by binding arbitration, and do not depend on individual state enforcement. MSA § XI(c). Speech restrictions affecting national media can be enforced in any MSA State yet restrict speech nationwide. Various States and D.C. could attempt to enforce restrictions on national lobbying and petitioning. Any practical difficulties in enforcing the MSA's extraterritorial regulations do not make them constitutional.

[16] Contrary to defendant's claim, at 33, plaintiffs accurately described the Second Circuit as *reversing a dismissal* of a Commerce Clause claim, not ruling on the ultimate merits, Opening Br. 42.

V. THE MSA VIOLATES THE COMPACT CLAUSE.

For a select class of multi-state actions, the Compact Clause reverses the general presumptions of our federal system. Rather than leave in place the usual buffers and leeway for individual-state action, the Compact Clause requires States to seek affirmative congressional approval for agreements that even potentially encroach upon federal authority or sister-state rights and interests. Opening Brief 6, 42-46. The strong federalism presumptions that save individual-state enactments from potentially significant, though less-than-definitive, preemption or constitutional challenges do not apply to multi-state agreements. For such agreements, even *potential* encroachments of federal authority or state interests and sovereignty trigger the Compact Clause's default rule of invalidity absent approval. State authority cannot be presumed from mere congressional acquiescence; the burden of obtaining affirmative approval shifts to the compacting States. For the Compact Clause to have any meaning, consistent with Supreme Court precedent, the class of state agreements that trigger the Clause must be *broader* than the class of state actions that would otherwise be preempted or violate some other constitutional provision. Defendant's excessively narrow approach to

the Compact Clause, at 38-47, misreads Supreme Court precedent and would leave the Compact Clause a redundant nullity.[17]

Defendant's discussion, at 37-39, of *United States Steel Corp. v. Multistate Tax Commission*, 434 U.S. 452 (1978) ("*MTC*"), wholly ignores the Supreme Court's emphasis in that case on potential encroachment and enhanced political power, as well as the numerous material differences between this case and that one, described in our Opening Brief, at 53. The "advisory" nature of the tax rules produced under the MTC, the lack of "delegation of sovereign power" to the Commission, the States' retention of "complete control over all legislation and administrative action" regarding taxes, the unhindered freedom of States to enter or "withdraw from" the compact and "to reject, disregard, amend or modify any rules" of the Commission, the absence of conduct by the compact that would "redound to the benefit of any particular group of States or to the harm of others," and the lack of suggestion that any of the tax approaches at issue even "touches upon constitutional strictures" all played a significant role in the Court's

[17] Defendant's straw-man suggestion, at 41, that plaintiffs would apply the Compact Clause to *all* interstate agreements is simply false; we follow the Supreme Court in limiting the Clause to agreements involving potential encroachments. Where no potential encroachments exist no Compact Clause approval is required. But such *potential* encroachments are not limited to *actual* violations of the Constitution or federal law; they also include those doubtful actions that nonetheless might survive in the single-state context due to the favorable federalism presumptions that are not applicable in the Compact Clause context.

conclusion that the compact posed no threat to federal authority or state rights and interests. 434 U.S. at 457, 473-74, 477-78. The MSA is the complete opposite of the MTC in each of those particulars.

Defendant's citation, at 39-40, to the Supreme Court's recognition in *Northeast Bancorp v. Board of Governors of the Federal Reserve System*, 472 U.S. 159, 176 (1985), that conduct conflicting with federal statutes is preempted and "therefore any Compact Clause argument would be academic" does not support *limiting* the Compact Clause to such "academic" circumstances. *Northeast Bancorp* found specific congressional consent for the state conduct at issue. It is hardly surprising, then, for it to find that statutes "which comply with" such authorization "cannot possibly infringe federal supremacy." *Id*. The Compact Clause indeed has little further application once Congress has given its consent, and additional challenges must rest on other grounds. But that obvious conclusion does not render *potential* encroachments on federal authority irrelevant where, as here, no such consent has been given.[18]

[18] *Northeast Bancorp* also noted considerable doubt as to whether there was an "agreement amounting to a compact" at all, noting the absence of the "classic indicia of a compact": there was no "joint organization or body" to regulate or for other purposes; each State was "free to modify or repeal its law unilaterally"; and there was no requirement of reciprocal restrictions by participating States. 472 U.S. at 175. Each of those "classic indicia" of a compact is present in the MSA.

A. The MSA Is Subject to the Compact Clause.

The MSA's encroachment on federal authority, constraints on member States, and regulation of interstate activities are more than sufficient to trigger the Compact Clause. Opening Br. 47-54. If the MSA does not require congressional approval, nothing does.

In restricting speech, petitioning, and cigarette advertising, and penalizing companies that fail to join such restrictions, the MSA at least potentially encroaches on federal supremacy and our federal structure as reflected in the First Amendment and FCLAA. Defendant, at 44-46, simply disputes that actual First Amendment violations or preemption exist, a claim that turns entirely on its dubious characterization of the MSA as non-regulatory. Given the consent decrees enforcing the MSA and the coercion to join it, such an argument is plausible, if at all, only under a strong presumption in favor of state law and against preemption. Given that no such presumption applies to multistate agreements, the argument at best raises some *potential doubt* as to constitutionality and preemption. Furthermore, regardless whether the speech and petitioning restrictions might be viewed as voluntary, they still deprive Congress of the independent and honest views of the PMs and the Settling States, all of whom have agreed not to challenge or subvert the MSA. That certainly *encroaches* upon

congressional power. Any doubts or disagreements on these types of issues must, under the Compact Clause, be resolved by Congress, not by court-made presumptions in favor of the States.

The MSA likewise encroaches on federal supremacy in that it runs afoul of the express text of the Sherman Act, regardless whether courts have imputed a counter-textual immunity based on federalism concerns in the single-state context. The *Parker* immunity claimed by defendant is solely a function of federalism presumptions, not of the statute itself. *Supra* 15-16. Again, whether such non-textual immunity should be extended in the multi-state context to a textually forbidden agreement must, under the Compact Clause, be submitted to Congress, not resolved by the courts based on inapposite presumptions.

The MSA's extraterritorial regulations and fees directly encroach on both federal authority and sister-state sovereignty and interests. Defendant's repeated claim, at 46, that sister-state *interests* are irrelevant under the Compact Clause ignores the encroachments on state *sovereignty* from extraterritorial conduct and ignores Supreme Court precedent to the contrary. Opening Br. 42, 44.[19] The encroachments on sister States in this

[19] That the four non-MSA States have not complained about MSA speech and advertising restrictions or fees imposed on sales in their States hardly immunizes such extraterritorial conduct. Furthermore, Louisiana and other States that ultimately joined the MSA *did*

case are not merely incidental "economic pressure" from intra-state conduct in other States, *MTC*, 434 U.S. at 478, but rather the result of the direct imposition of extraterritorial fees and regulations on interstate activity.[20]

B. The MSA Did Not Receive Congressional Approval.

As an agreement subject to the Compact Clause, the MSA required, but did not receive, congressional approval. Defendant offers nothing to rebut the strong presumption against implied congressional approval of interstate compacts, the particular presumption against implying substantive action from appropriations bills, and the absence of an express grant of approval in the Medicaid Amendment or of any implication from that Amendment beyond its limited purpose of disclaiming federal recoupment rights under the Medicaid laws. Opening Br. 54-60.

Defendant's citation, at 47, to previous Supreme Court cases finding approval ignores the stark differences between those cases and the present case and the far weaker implications of the Medicaid Amendment. Opening

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complain about the MSA's nationwide cigarette levies forcing them to pass legislation required by the MSA. *See* Opening Br. 7; William Pryor, *A Comparison of Abuses and Reforms of Class Actions and Multigovernment Lawsuits*, 74 TULANE L. REV. 1885, 1911 (2000) (settlement pressured even States opposed to the tobacco lawsuits because "if a state refused to participate in the settlement, the smokers of that state nevertheless would pay higher prices to fund payments to other states").

[20] Defendant's claim, at 40, that each State could have settled separately under the same terms as in the MSA has already been debunked in our Opening Brief, at 54, and defendant merely repeats the erroneous conclusions of *Star Scientific*. Individual States could not possibly have adopted many of the restrictive provisions of the MSA.

Br. 59-60. Any implication of approval from such amendment certainly is not "necessar[y]" and is far from "clear and satisfactory." *Virginia v. West Virginia*, 78 U.S. 39, 60 (1871). The only necessary implication from the amendment is that the *Medicaid* rules "shall not apply" to MSA funds, not that the MSA is immune from all other constitutional or statutory limits.[21]

Defendant's suggestion, at 49-50 that even appropriations bills may amend substantive law, while true, ignores that they are presumed not to do so. While the Medicaid Amendment thus plainly and expressly altered the substance of Medicaid recoupment rules, the amendment remains less subject to expansion by implication precisely because of the presumption regarding appropriations bills. Defendant's attempt, at 51, to distinguish the appropriations-bill cases as not involving interstate compacts is vacuous, particularly given the *stronger* presumption against approval of compacts. Similarly, the mere *mention* of the MSA (as part of the collective reference to a larger group of tobacco settlements) does not distinguish cases rejecting implied ratification of other programs. Indeed, in *TVA v. Hill*, 437 U.S. 153, 189-92 (1978), the Court resoundingly rejected implied ratification from

[21] Defendant's reliance, at 48-49, on the Conference Report discussing the amendment is particularly misleading. The only litigation the conferees recognized was that "absent Congressional action, the issue of the Federal share of funds recovered under such settlements or judgments would be subject to litigation over the next several years," and that was the *only* litigation-based uncertainty they sought to avoid. H.R. CONF. REP. 106-143, 1999 WL 303282, *55 (May 14, 1999).

appropriations provisions, notwithstanding that the Committee Reports there expressly referred to the potential illegality that was supposedly ratified. The Medicaid Amendment and Conference Report, by contrast, make no mention of the Compact Clause or other legal challenges to the MSA. *See also In re Endo*, 323 U.S. 283, 303 n.24 (1944) (no ratification despite evidence and testimony before Congress of the challenged regulations; "appropriation must plainly show a purpose to bestow the precise authority which is claimed").

Regarding whether the Tobacco Control Act, specifically eschewing consent to anticompetitive tobacco compacts, makes the implication of consent less plausible, defendant begs the question by arguing, at 51-52, that the MSA is not such a compact. But the MSA's control over commerce in cigarettes and its promotion of price-fixing and regimentation suggest that it is such a compact. That the Act merely denies that *it* provides consent for such compacts still makes it less plausible that Congress casually implied consent in *other* acts absent express enactment of such consent.

Finally, regarding the use of state law in cases applying the MSA making it implausible that the MSA is a federally-approved compact (which would constitute federal law), defendant, at 52, points to the MSA's choice-of-law provision and notes that federal law can incorporate state substantive

rules. Of course, even where federal law adopts a state rule of decision, such rule then *becomes* federal law and claims based on such rules arise under federal law. But in *United States v. Philip Morris*, 316 F.Supp.2d 6, 11 (D.D.C. 2004), the federal court agreed with the United States that the court had "no jurisdiction to enforce the MSA," negating any suggestion that state-law rules governing the MSA had been adopted as federal law.

In the end, the Medicaid Amendment did not specifically consent to the MSA as a compact, addresses only the narrow question of how to apply the Medicaid rules, and does not overcome the many presumptions or satisfy the high bar of providing a clear and necessary implication of consent for purposes of the Compact Clause.

CONCLUSION

This Court should reverse the order below, grant summary judgment for plaintiffs, and enjoin the MSA and Louisiana's Escrow Statute. In the alternative, this Court should remand this case for trial.

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE

Undersigned counsel certifies that this Reply Brief for Appellants complies with the type-volume limitation of Rule 32 of the Federal Rules of Appellate Procedures. This brief, excluding those portions specified in the Rule, contains 6988 words in proportionally spaced font.

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