NAFTA/UNCITRAL ARBITRATION RULES PROCEEDING

\- x

In the Matter of Arbitration Between:

GRAND RIVER ENTERPRISES SIX NATIONS LTD., et al.,

Claimants/Investors,

and

UNITED STATES OF AMERICA,

Respondent/Party.

\- x Volume 1

HEARING ON THE MERITS

Monday, February 1, 2010

The World Bank
1818 H Street, N.W.
Conference Room MC 13-121
Washington, D.C.

The hearing in the above-entitled matter came on, pursuant to notice, at 9:10 a.m. before:

MR. FALI S. NARIMAN, President

PROF. JAMES ANAYA, Arbitrator

MR. JOHN R. CROOK, Arbitrator

Also Present:

MS. KATIA YANNACA-SMALL,
Secretary to the Tribunal

Court Reporters:

MR. DAVID A. KASDAN, RDR-CRR
Registered Diplomate Reporter
Certified Realtime Reporter
MR. JOHN PHELPS, RPR-CRR
Registered Professional Reporter
Certified Realtime Reporter
B&B Reporters
529 14th Street, S.E.
Washington, D.C. 20003
(202) 544-1903

APPEARANCES:

On behalf of the Claimants/Investors:

PROF. TODD WEILER
#19 - 2014 Valleyrun Blvd.
London, Ontario N6G 5N8
Canada
(613) 686-3636

MR. ROBERT J. LUDDY
Windels Marx Lane & Mittendorf, LLP
156 West 56th Street
New York, New York 10019
(212) 237-1114

MR. LEONARD VIOLI
Law Offices of Leonard Violi, LLC
910 East Boston Post Road
Mamaroneck, New York 1053
(914) 698-6200

MS. CHANTELL MACINNES MONTOUR
Inch Hammond Professional Corporation
1 King Street, West Suite 500
Hamilton, Ontario L8P 4XP
(905) 525-4481

On behalf of Grand River Enterprises Six Nations, Ltd.:

MR. STEVEN WILLIAMS

On behalf of the Wahta Mohawks:

PROF. MATTHEW FLETCHER

APPEARANCES: (Continued)

On behalf of the Respondent/Party:

MR. HAROLD HONGJU KOH
Legal Adviser
MR. JEFFREY D. KOVAR
Assistant Legal Adviser
MR. MARK E. FELDMAN
Chief, NAFTA/CAFTA-DR Arbitration Division
Office of International Claims and Investment Disputes
MS. ALICIA L. CATE
MS. DANIELLE M. MORRIS
MR. JEREMY SHARPE
MS. JENNIFER THORNTON
Attorney-Advisers,
Office of International Claims and Investment Disputes
Office of the Legal Adviser
U.S. Department of State
Suite 203, South Building
2430 E Street, N.W.
Washington, D.C. 20037-2800
(202) 776-8443

ALSO PRESENT:

On behalf of the United Mexican States:

SR. JOSÉ LUIS PAZ,
Head of Trade and NAFTA Office
SR. SALVADOR BEHAR,
Legal Counsel for International Trade
SRA. LAURA MARTINEZ
Embassy of Mexico
Secretaria de Economia
Trade and NAFTA Office
1911 Pennsylvania Avenue, N.W.
Washington, D.C. 20006
(202) 728-1707

On behalf of Canada:

MS. CHRISTINA BEHARRY
Department of Foreign Affairs and International Trade, Canada
Trade Law Bureau (JLT)
Lester B. Pearson Building
125 Sussex Drive
Ottawa, Ontario K1A 0G2
Canada
(613) 944-0027

MR. SEAN CLARK
Embassy of Canada

C O N T E N T S

OPENING STATEMENTS	PAGE
ON BEHALF OF THE CLAIMANTS:	
By Mr. Violi	17
By Mr. Weiler	95
ON BEHALF OF THE RESPONDENT:	
By Mr. Koh	117
By Mr. Kovar	142
By Mr. Feldman	198
WITNESSES:	
MICHAEL G. HERING	
Direct examination by Mr. Feldman	229
Cross-examination by Mr. Luddy	230

CONFIDENTIAL PORTIONS

NUMBER	PAGE
1.	21-35

P R O C E E D I N G S

PRESIDENT NARIMAN: Ladies and gentlemen, good morning. If we could start in a minute or two. If all of you are ready, if you could all be seated and we could know you are ready.

Mr. Weiler, are you ready?

MR. WEILER: Yes.

PRESIDENT NARIMAN: May we begin.

Just before the opening remarks, I would like to say that I have a personal apology for not turning up in June due to circumstances beyond my control, and they were circumstances beyond by control, and caused you a great deal of difficulty and discomfort for which I am truly sorry.

My co-Arbitrators were also very kind and said that we should continue on some other date, so thank you all for bearing with me.

There is just one preliminary remark, and that is, are there any witnesses in the room, and what is the position of the parties regarding witnesses? Because there are some proceedings where witnesses sit right through and there is no

09:10:29 objection, and others they don't. So, what is the agreement? Is there some agreement between you? Otherwise, the witnesses would have to be outside, except the witness who is called, the immediate next witness. Present witnesses.

MR. FELDMAN: Mr. President, the agreement is that witnesses can watch the opening arguments, but then cannot re-enter until they testify.

PRESIDENT NARIMAN: Okay. So, that's all right. That's all right by us. Yes.

Yes, who will begin?

MR. VIOLI: Mr. Chairman, Mr. Crook, Professor Anaya, on behalf of Claimant, we thank you for being here and listening to our case today and over the next few days.

I would like to start by introducing the members of the Claimants' legal counsel team as well as the Claimants themselves. I will thereafter defer to Mr. Weiler regarding some preliminary matters that the agenda provided for with respect to the procedure that we are going to follow over the next couple of days.

09:12:07 First, myself, Leonard Violi, on behalf of the Claimants; Mr. Weiler, Professor Weiler, to my right; to his right is Mr. Luddy. And to Mr. Luddy's right is Chantell McInnes Montour.

In the Claimants' table behind us is Catherine McInnes, appearing with the counsel's office of Ms. Montour; Mr. Jerry Montour, one of the Claimants in the case, and Blaine Commandant, Chief Commandant from the Wahta Nation.

Mr. "Sugar" Montour unfortunately had a fall, and--a serious fall and did some damage to his back, but he is making every effort to get here and should be here by midday; and Mr. Hill has been--the other individual Claimant in the case, should be here by the end of the day as well. He had some other pressing matters that required him not to be able to attend this morning.

Mr. Montour is also here on behalf of Grand River Enterprises Six Nations Limited, the corporate Investor Claimant of the case. He is the CEO of the company and is here in both his individual capacity and his representative capacity.

09:13:33 We also have here--Mr. Hill had presented--requested his son Joshua Hill to be here on his behalf, and he is sitting to the right of Chief Commandant.

With that, I would like to allow Mr. Weiler to proceed with some preliminary matters regarding procedure and submissions before the Tribunal.

Thank you.

MR. WEILER: I would like to thank the ICSID for putting the arrow to the button because I was about to have to press about five of them before I figured it out.

We have one preliminary matter to discuss. Claimants' counsel had made a request of Respondent's counsel to admit two documents which we believe should be admitted into the record. They are both decisions of the California State Court which were referred to in one of the affiant's statements, and these two decisions apply directly to NWS and GRE, and they essentially give the latest status of the law with regard to the statements that were made by that witness, the Attorney General.

09:15:09 So, just--and obviously the reason that they come now is because they weren't decided until January 20th.

Sorry, September and December, but I see received here.

So, after the close of the pleadings.

PRESIDENT NARIMAN: Mr. Feldman?

MR. FELDMAN: Yes, Mr. President. We would object to the admission of the documents as not in compliance with the Tribunal's June 2008 order which provided that any rebuttal evidence of the Claimants was to be submitted together with their Reply brief.

MR. LUDDY: Obviously the decisions were not available at the time of our Reply because they were rendered in September of '09 and December of '09, effectively. The result would be the absence of their admissions. Mr. Eckhart testified about judgments that have now been vacated, and Mr. Eckhart testifying about allegations against NWS that have now been rejected by a court in California.

ARBITRATOR CROOK: Is there a reason you

09:16:21 didn't petition for leave to file at the time you received these?

MR. LUDDY: Well, I mean, I guess our thinking on that was when we--in '09, when we had submitted the complaints when they were filed, Respondents objected to that procedure, and we were advised by the Tribunal at that time to make no further submissions.

In the case of these documents, obviously the witness had them promptly upon their issuance because he's a party to the case as counsel, and obviously the Respondent had them, and our position was that the most appropriate way to deal with it was to simply ask counsel's consent to their admission because, quite frankly, any other alternative just seems to be trying the case in an Alice in Wonderland type situation where a witness is testifying about things that are no longer the case.

PRESIDENT NARIMAN: But is this one document or several orders?

MR. LUDDY: Two documents, Your Honor.

09:17:25 PRESIDENT NARIMAN: They are both orders of courts?

MR. LUDDY: Correct.

PRESIDENT NARIMAN: Orders of courts?

MR. LUDDY: Decisions.

PRESIDENT NARIMAN: Decisions of courts?

MR. LUDDY: Correct.

PRESIDENT NARIMAN: What would be the objection, then, if it's October 2099? At the most you could have got it. If there was any inconvenience, then, of course, you may have to deal with it later and so on, but since we have a two week hearing, you can respond.

MR. FELDMAN: Thank you, Mr. President.

There are a number of recent decisions that have been issued in domestic courts of the United States which touch on issues very similar to those in the two California decisions. We have not attempted to put any of those recent decisions into the record because we are abiding by the terms of the Tribunal's June 2008 order.

PRESIDENT NARIMAN: Well, if we admit this, 09:18:09 then you will be entitled to put that in as well.

MR. LUDDY: And we would have no objection to Mr. Feldman--

PRESIDENT NARIMAN: Decisions of courts, then the Tribunal might be well instructed to take them under accord and deal with them during the argument as to how relevant they are or not relevant. That's what we think.

ARBITRATOR CROOK: Let me just ask, does either party anticipate that we will receive any new documents that are not in the record? Is this one incident or will there be others?

MR. LUDDY: We do not anticipate submitting additional documents, Mr. Crook.

PRESIDENT NARIMAN: Yeah, because we don't want them in driblets. If you have any, for God's sake put on record, subject to any objection.

MR. VIOLI: Mr. Chairman, there was a passage of a law in June of '09, but that's a law. It's not factual material. It's a law that was passed in June of '09 that we will make reference to.

09:19:18 PRESIDENT NARIMAN: That's fine.

ARBITRATOR CROOK: Could we have that now or today so that everyone can look at it and be familiar with it when you put it in?

MR. VIOLI: Sure. We will get it today.

MR. FELDMAN: Mr. President, in light of the Tribunal's admission of the two recent California decisions, we, in turn, would have a series of recent decisions issued after May of 2009--

PRESIDENT NARIMAN: Let's us have them at one go so that it's not in driblets again. Whether tomorrow or the day after, you can put them in.

MR. FELDMAN: Thank you.

PRESIDENT NARIMAN: And give notice to the other side so that they know what that you are intending.

MR. FELDMAN: Yes, thank you. We will.

MR. WEILER: Just to be clear, what the Claimants are consenting to are cases involving the Claimants. There are other cases that we also could bring in that have to do with the law generally, but

09:20:10 these two documents we give you have NWS and GRE on the title.

So, I would be a little concerned if we start creating new books of brief that just could be any case law. Alternatively, we could simply say whatever case law either party has, give it to the end of the week.

PRESIDENT NARIMAN: That's fine by us.

We can't shut out case law, for God's sake, I mean, whether it happens to be someone with--who is a party here or not here. If you think it's relevant, we will decide that later whether it's relevant or irrelevant.

How many decisions would you have?

MR. FELDMAN: Thank you. We will be quite selective. It will not be a large number.

PRESIDENT NARIMAN: Okay, that's fine.

MR. LUDDY: We will consult with counsel for Respondent on that.

PRESIDENT NARIMAN: Shall we say that by the weekend, by Friday, Thursday or Friday?

MR. FELDMAN: Yes, thank you.

09:21:01 PRESIDENT NARIMAN: So, the following week, there would be no further documents as far as possible, unless something erupts something. Okay.

Any more preliminaries? No?

MR. VIOLI: No.

SECRETARY YANNACA-SMALL: Yes. I just would like to make a request to both parties. As you know, this is an open hearing, and as I understand, there are confidential parts of your pleadings. So, when you are about to start on the confidential part, please say close and leave about 10, 15 seconds for the technician to switch off.

Thank you very much.

MR. VIOLI: Thank you, we will do it.

OPENING STATEMENT BY COUNSEL FOR CLAIMANTS

MR. VIOLI: Again, thank you, Mr. President and Members of the Tribunal.

I would like to begin today with the overview of Claimants' case, to proceed with some of the particulars on the facts with particular emphasis on Respondent's Rejoinder, which was filed without any rebuttal or further comment from

09:23:06 Claimants pursuant to the procedural order of the Tribunal.

My opening will be followed with a presentation by Mr. Weiler, Professor Weiler, on legal matters and application of the NAFTA to the facts of the case.

What we have, and as the Memorials and evidentiary materials demonstrate, are regulatory measures adopted by 46 states in connection with the tobacco Master Settlement Agreement of November 1998. Those measures have been adopted by all 46 signatory states to the Master Settlement Agreement, and only one of the states, Missouri, has not adopted one of the principle measures at issue. That's the Allocable Share Amendment. That is not in effect in Missouri.

The measures, as Claimants allege and have demonstrated, impose discriminatory payment burdens on Claimants in comparison to other investors in the United States in the free trade area. The measures expropriate Claimants' investments of tens of million of dollars, and they treat Claimants in the

09:24:34 investments unjustly, all in violation of NAFTA and applicable international law.

What we have seen over the past seven years, six or seven years since the Allocable Share Amendment, has been an undeniable effect on Claimants and their investments, and the effect of the measures are to impose an in rem ban--an embargo, if you will--on Claimants' trademark products, not just in personam these measures, they also apply to the products and to the assets and to the investments of the Claimants, effectively imposing a ban on them wherever the offending payments haven't been made or where the Claimants have refused to accept the discriminatory terms of compliance.

The damage to the Claimants and their investments is clear and can be measured by lost profits, fair Market Value of the investments affected and expropriates, or reliance damages.

At this point, I would like to show a nonpublic slide.

(End of open session. Confidential

09:25:49 business information redacted.)

09:25:52 CONFIDENTIAL SESSION

MR. VIOLI: We see here and in the materials that I have given each of the Tribunal Members a hard copy of the presentation, we have been able to quantify the effect of the measures on the market, and particularly the market in the sense of what's called "Non-Participating Manufacturers' market shares," and we have quantified it to the dollar and to the volume in the U.S. market, which is what appears on the screen now.

Beginning in 2003, when the states started to meet with the major tobacco companies, they hatched a plan to change what is called the allocable share release provisions of the Escrow Statutes. In doing so, they made reference to a number of points, a number of dollars, and certain market share figures, making specific reference to what is the loss to the states in dollars if they don't pass the Allocable Share Amendment? And the way to quantify that or determine that is by measuring what is the loss to the tobacco companies who are part of the Master Settlement Agreement.

09:27:35 MR. FELDMAN: I'm sorry, counsel, has this information been produced?

MR. VIOLI: Yes, this is all from the PwC documents. This is all-this is a composite, a synthesis of the documents that were produced by the Respondent in this case.

I can assure--let me just state for the record now so we don't have any further interruptions, if that's okay with the Tribunal, all the materials that are in the presentation come from the evidentiary materials produced in the case so far.

Thank you.

ARBITRATOR CROOK: Mr. Violi, just to be clear, I'm looking at your non-Participating Manufacturer shares table. I don't recall having seen that before. This is a computation that you have arrived at on the basis of data previously in the record?

MR. VIOLI: Yes. PricewaterhouseCoopers is the independent auditor for the MSA, Master Settlement Agreement, and PricewaterhouseCoopers

09:28:26 receives factual data regarding the market and the Participating Manufacturers.

ARBITRATOR CROOK: I understand that, but just the computation is something that is new that we have not seen previously; is that right?

MR. VIOLI: The computation is new, yes, Mr. Crook.

ARBITRATOR CROOK: Thank you.

MR. VIOLI: In taking those documents produced by Respondent in the case, and looking at the market share of the Non-Participating Manufacturers, of which Grand River Enterprises is included, we see that the Non-Participating Manufacturers' market share peaked in or about 2003, 2003-2004.

You then see a precipitous decline after 2004 in the market share of Non-Participating Manufacturers, including the off-reserve markets of the Claimants in this case. That follows directly from the adoption and subsequent to the adoption of the Allocable Share Amendments.

This is rather simple math, taking

09:29:35 what--using the baseline of 8.3 percent market share for NPMs, Non-Participating Manufacturers, which was roughly equivalent to the market share of the exempt and the nonexempt SPMs under the Master Settlement Agreement. We see that the--we can quantify the loss in market share by Non-Participating Manufacturers as roughly 3 percent, 2.7 percent, from 8.3 percent to 5.7, or thereabouts. But what's interesting is the number that the states received by adopting the Allocable Share Amendment.

In total to date, we have quantified the number that the states have received through this plan that they hatched with the major tobacco companies of a number of $662 million. The states alerted the tobacco companies in private, and among each other they discussed the fact that, as NPMs grow, Non-Participating Manufacturers grow or exist, their mere existence in the market causes the states to reduce or receive reduced MSA payments because the MSA is based principally on the profitability and the sales of its Participating Manufacturers, not their profit level, not on prices.

09:31:12 PRESIDENT NARIMAN: But for ASR? The last column.

MR. VIOLI: What we have, Mr. President, is at the time, just before the adoption of the Allocable Share Amendments, the Non-Participating Manufacturers were at a level of 8.6 percent, approximately.

PRESIDENT NARIMAN: And they remained that right through?

MR. VIOLI: They did not. They went down to 5.7 percent after the adoption of the Allocable Share Amendment.

The 8.3--these percentages are from Pricewaterhouse documents. What happened is after the adoption of the Allocable Share Amendment, there was a precipitous decline, 25 percent. If you went from 8 percent to roughly 5.7 percent, losing approximately two, two and a half percentage points, that is a quarter of your business, 25 percent of your business if you're NPMs.

So, they have lost 25 percent of their market share since the adoption of the Allocable

09:32:12 Share Amendment.

This statistic, Mr. President, is based on if they had remained at that level, if they had remained at 8.36 percent and the Allocable Share Amendments were not adopted.

There was a question whether they would continue to grow because, in fact, their growth was trajectory, as was the exempt SPMs, so what we did was take a conservative baseline and say let's just leave them at 8.63 percent and continue then but for the Allocable Share Amendments. So, what we tried to do was carry forward that percentage that existed prior, carry it forward to future years.

And to date, and these savings or earnings by the state are just through 2007. They have earned a total of $662 million extra, the states have, by reason of the Allocable Share Amendments.

Now, the reason why I point that out, and that number will grow to billions of dollars over the next few years. Why do I point that out? I point that out because that is what the states with the tobacco companies in private, although we don't

09:33:16 have all their documents of their meetings, that's what they set out to do by taking away the NPM market share, and that's what they have accomplished to date.

The number is there simply to show that our damage figures, what Grand River is coming here today and in the next week to seek is a fraction, a literal fraction, almost infinitesimal fraction of the total that the states sought by passing these measures. It's not unreasonable. And under the circumstances, if the states were going to set out to take away the market share of the NPMs like Grand River, take away their ability to compete, their ability to use their investments effectively, wisely, their ability to exploit their intellectual property, their trademarks, it's not unreasonable to compensate them for that expropriation and that discriminatory treatment.

The next measure, the next slide is also closed.

What we have is a 2003 memorandum on the screen--and it might be difficult to read it on the

09:34:32 screen, but we have it in the handouts--a 2003 memorandum by the National Association of Attorneys General regarding the Allocable Share Amendments and the regarding the phenomenon that I was explaining earlier. This document was not shared with the public. The matters that are discussed in here were discussed with the major tobacco companies, but they were not discussed with Grand River or the NPMs.

What we see here is a memo to all the states Attorneys General, from Attorney General Sorrell, who is Chairman of the Tobacco Committee. It says, and I quote, "Increasing sales by NPMs will sharply reduce the next scheduled payments to all states under the MSA and under the four separate state agreements."

I will move on.

Quote, "These results underscore the urgency of all states taking steps to deal with the proliferation of NPM sales, including enactment of complementary legislation and allocable share legislation, and consideration of other measures designed to serve the interests of the states in

09:35:37 avoiding reduction in tobacco settlement payments."

And then at the very end we see, "It should be stressed that NPM sales anywhere in the country hurt all states. All payment calculations are done on the basis of cigarette sales nationally. NPM sales in any state reduce payments to every other state."

And, finally, "All states have an interest in reducing NPM sales in every state."

PRESIDENT NARIMAN: What is the date of this?

MR. VIOLI: This is--I have the specific date. I believe it's April 2003. I can get you the exact date.

You see the moniker up at the top, Memorandum 03-111.

ARBITRATOR CROOK: Tab 11 in your binder?

MR. VIOLI: Yes, it's Tab 11 of the binder.

So, we see a plan, a design taking measures, the allocable share measures which are at issue in this case, and which we brought to the Tribunal's attention, in secret and in private, the

09:36:49 AGs candidly admitting that they have an interest in reducing NPM sales in every state.

Now, why reduce NPM sales in every state? Are NPMs a problem? Do they present a problem? Have they advertised in a way that the MSA manufacturers advertise and were accused of committing giving rise to the lawsuits against the major manufacturers? What have they done to deserve and receive such attention by the states?

Just prior to that memorandum in 2002, we see the National Association of Attorneys General pointing out that the reduction in payments to the states is not the fault of the NPMs, not caused by their culpable conduct or, more importantly, by any unparticipated consequence of the MSA and its measures. No loophole, no wrongful conduct, and that's admitted candidly in April 2002 in the slide that's up on the screen, where the National Association of Attorneys General was reporting, responding to a report by the Council of State Governments or legislators where they questioned the reduction in MSA payments, and I will again read

09:38:31 from the letter written on April 2nd of 2002.

Fourth, the report correctly notes the massive increase in the price of cigarettes since 1997. However, the report erroneously intimates that costs imposed by the MSA were the principal cause of the price increase. In fact, the major cigarette manufacturers raised prices by several multiples of their MSA costs. MSA costs have been about 30 cents per pack, or $3 per carton for the major manufacturers. As noted in the report, however, the price differential between OPM brands and those companies outside the agreement is far more, as much as $17 per carton. The price increase that created the market opportunity for NPMs is not attributable to the MSA, but rather to the decision by the OPMs to inflate per-pack profit margins at the cost of losing market share."

Report--the letter concludes--excuse me, further notes, "The report correctly notes that the market share of NPMs has risen. As noted previously, this increase is principally the result of price increases by the OPMs far in excess of the

09:39:39 costs imposed by the MSA and the decision by OPMs to widen their profit margins."

So, just prior to the memo, the call to arms as I would call it by the Attorneys General, saying we need to do whatever we need to do to stop NPM sales. They're hurting us. They're causing reductions in MSA payments. The same group of individuals, the same state officials candidly admit that the NPMs were not the cause, they're not the root of the problem. The MSZ costs are not the root of the problem. No mention of unanticipated consequences, unintended effects of the Allocable Share Amendment.

The price differential is noted right here. The price differential noted here has to do with the low price of NPMs because of the so-called "Allocable Share Amendments." No pointing a finger at NPMs, no mention of requiring a change in the law to take away their market share.

But the dilemma is this for the States--and some courts have said they have been snookered, the wool has been pulled over their eyes--the dilemma is

09:40:58 this: The MSA payments are based on sales volume of one group of competitors: The major manufacturers.

It's also based on market shares of the companies in the MSA. It's not based on their profit. So, when Philip Morris and the major manufacturers raised their prices to astronomical levels and sold fewer cigarettes at higher prices, their profits, of course, go through the roof, but that causes a reduction in payments. That causes a reduction in MSA payments because the MSA is not tied to the profitability of the MSA manufacturers.

So, the states in private, realizing this dilemma, say how do we deal with this? How do we deal with this? We have an Escrow Statute that's in effect that everybody wrote, some of the best and sharpest lawyers in the country, 46 states Attorneys General. We have this Escrow Statute that is supposed to neutralize costs, and candidly it admitted it has, but it's not good enough. It's not good enough because the MSA manufacturers figured out a way o get around it, to abuse the system.

So, instead of dealing with the

09:42:22 manufacturers who are at the cause of the problem, as mentioned in this letter, they decide to go to the small manufacturers like Claimants and NPMs and say let's squeeze them more. Let's affect their ability to compete more. Let's take their market share, squeeze every dollar out of the U.S. economy and make it come from sales by the MSA manufacturers. The way to do that is to put NPMs out of business or take their market share away. So now, we could go open.

(End of confidential session.)

09:43:01 OPEN SESSION

MR. VIOLI: Okay. Proceed? Thank you.

How do they achieve this effect of expropriation, discrimination, taking NPM market share away? They do it by that provision in the original Escrow Statute that provided for what were called Allocable Share Releases under the Escrow Statutes. NPM would put in so much dollars per schedule in the statute, and then it would be entitled to a rebate or return of the amount of money that exceeds the amount that that NPM would have paid to the state under the MSA or the state would have received under the MSA.

Now, the mechanics of how this works--I will try to explain it in bigger terms so that we can understand it in the concept of NAFTA and what is happening here. Prior to the measures at issue, this is what the free trade area looked like. We see it up on the screen. You will note the words Canada, United States, and Mexico are in gray, very subdued. They're not prominent in the free trade area. There is a highlighted, clearly defined

09:44:57 border around the North American continent. That is the North American free trade area.

The effect of the measures, however, is to redefine the borders. The effect of the measures is to put the borders back in to the free trade area, and what the measures do is they delineate--you see Alaska and highlight it in bold, and they re-establish the border around the United States. I didn't put Hawaii in there; I probably should have, sorry.

And you will note that the term or the words United States of America now appear in the bold--in the prior, they don't--and Canada and Mexico are subdued.

Now, how so? How did they redefine the borders? How did they change the free trade area again? They did so by now having measures in effect that say, if you are in the United States or your products are in the United States for which Federal excise tax was paid during the period 1997-1998, you will forever get an exemption and a subsidy which is currently worth about $400 million per year. You

09:46:13 can sell at one time it was 16 billion cigarettes, now it's 13 billion cigarettes, based on PwC, PricewaterhouseCoopers, numbers most recently produced in this action. You can sell 13 billion cigarettes in the United States without ever making a payment under the MSA. The value is roughly $400 million. 13 billion cigarettes is a fraction of what Claimants sold at the height of their market, at the height of their business under the old or the original measures that were in place.

So, this reintroduction, this abridgment of the free trade area is the means, is the conceptual way that the MSA States have employed to undertake this discrimination, take away the market share, and expropriate Claimants' investments.

What I would like to talk about now is what this proceeding is not about. We are not here today, this week, because of health initiatives, or health initiative concerns, or youth smoking, or a loophole that keeps prices low to price-sensitive consumers, including minors. Nor are we here because of a reduction in funds needed to meet

09:47:45 further claims for state healthcare costs. I can assure you if those laudatory goals were the reason we were here, we wouldn't be here. Grand River, through the Dreamcatcher Fund, has probably donated more to societal and healthcare issues and treatment issues than any manufacturer under the MSA. $12 million in its short existence per earnings likely to be a ratio greater than any other manufacturer.

Now, why is this proceeding not about these matters, healthcare, loophole, youth smoking? You don't need to look to me for that answer. You could look for the Respondent itself.

Now, what I'm about to explain is that, Claimants really don't have quarter with and don't raise issue with the Respondent per se, the United States. They do so because of vicarious attributes in the United States for each individual state under the MSA and under the NAFTA. Because what you will see is that Respondent itself has many things to say about the MSA, none of which are good. All that the MSA is ineffective, doesn't do its job. It's not

09:49:01 really accomplishing its goals or objectives.

So, in this proceeding, however, it seems everywhere else, every branch of the Federal Government--the executive, the legislature, and the Judiciary--has raised issue with the MSA, its shortcomings, its problems. Every branch, at every turn, every level, every opportunity. The Federal Government has chastised the MSA in this court and in this proceeding. The Federal Government takes a completely different view. It's what the states are doing. It's a plan from the playbook in the states. It's one thing to say in private because they do meet semi-annually.

MR. VIOLI: I have sent put the particular index numbers, Mr. Crook, because each one of these will be discussed or addressed in the cross-examinations or further testimony before the Tribunal, so as an Opening Statement, I generally would not include them as evidentiary materials.

But so, I was mentioning the playbook of the states. They meet with the Tobacco Companies or among themselves, confer, come up with a plan, hatch

09:52:11 a plan, put it into effect, have certain reasons for it, but in public they have a totally different explanation for the purpose and design of these measures.

So, and we will see that throughout the course of the proceedings, the various documents that contradict or provide a completely different interpretation and reason for certain actions undertaken by the states.

One example, Respondent's expert, Professor Gruber. Now, you may recall from the submissions, the evidentiary submissions, that the United States brought its own lawsuit against the tobacco companies, a Federal MSA type case. Not particularly pleased I guess with the MSA, it did its own thing.

That lawsuit resulted in several decisions. One of them was that there is no recoupment type of recovery for a sovereign because the sovereign must pay for health-related costs in treating indigent smokers. There are taxes for that. The harm is too remote. There are warnings, there is an assumption

09:53:31 of risks. There are a number of reasons why the courts have held, but they have all held that there is no such--there is no viable claim for recoupment. There is no MSA recoupment type pay for healthcare costs theory.

But the state--the Federal Government, excuse me, brought its lawsuit nonetheless, and it also alleged RICO violations, racketeering activity. In fact, all the other causes of action were thrown out by the courts when the Federal Government brought its case, MSA type claims, but they kept the RICO claims, spiking nicotine, advertising to youth, conspiring not to come out with a safer product, none of which, of course, Claimants are accused of or most of the manufacturers in the United States. Roughly four or five have been accused of that conduct. And that case is still proceeding, as a matter of fact, but a procedure on a RICO theory, not under MSA theory.

But in that case, Professor Gruber states, and I quote, "Testimony makes clear that the MSA has not been successful in reducing overall marketing

42

09:54:33 and promotion aimed at young people."

The USDA, another Federal Government agency, United States Department of Agriculture, in an October 2001 report also in the record, "Although consumption has declined, it has declined less than expected. Premium brands especially have shown a tenacious grasp on market share. The share of the market held by premium brands has continued to increase since the MSA was signed. Discounts and promotions have also enabled manufacturers to maintain market share for premium cigarettes." That's the USDA. Federal Government agency again.

New England Journal of Medicine, next slide, one of the most respected if not the most respected medical journal in the United States, noting in an Article 2002, "It has been suggested that the MSA is not living up to its promise. Despite the newly imposed marketing restrictions, the 24 percent increase in marketing expenditures by the tobacco industry in the year after settlement, to a total of 8.24 billion dollars, was the highest ever reported".

PAGE 43

43

09:55:44 Now, this is all at a time when the allocable share was in effect. Nothing to do with the allocable share. The major cigarette manufacturers, in fact, increased their marketing to make up for their MSA so-called "restrictions," and they increased it to a point of, I believe, $11 billion, as some of the documents in the record have demonstrated.

The Department of Justice, again, in that Federal proceeding, what do they have to say about the MSA and the so-called restrictions and youth smoking initiatives? "The defendants claim that the MSA fundamentally changed their marketing practices and effectively prevents and restrains them from marketing to youth."

Now, the defendants in that case are Philip Morris, R.J. Reynolds, the OPMs.

Again I quote, "But the evidentiary record before the court establishes that defendants have not changed their marketing practices since the effective date of the MSA in a way that reduces the youth appeal of their marketing."

PAGE 44

44

09:56:45 Finally, "Defendants have redoubled their efforts to reach teenagers and nonsmokers."

This is the same government that is litigating our case. How do they tell a Federal Court all of this and in the prior slides, but before the Tribunal? They want to paint a completely different picture and expect the Tribunal to accept that.

Again in that lawsuit by the Federal Government, "OPMs' experts failed to cite any evidence supporting a claim that raising prices on premium brands would cause youth to smoke generic brands. In fact, the evidence adduced at trial was overwhelmingly to the contrary."

NPM prices, the generic cigarettes, their lower costs had no effect on an attribution of youth smoking or increase of youth smoking in the United States. They have admitted it.

PRESIDENT NARIMAN: Mr. Violi, what was the purpose, according to you, what was the purpose of this stand taken by the United States Government in the case of U.S. NPMs, Philip Morris? What was the

PAGE 45

45

09:58:02 point that they were attempting to reach?

MR. VIOLI: The point was, Mr. President, was that the Federal Government, the people here, were not happy with the MSA. It wasn't doing its job. They brought their own lawsuit, RICO, racketeering, monitoring, youth, what's called look back provisions. The original MSA that was proposed in 2007 had youth look back provisions whereby if you did not reduce youth smoking by a certain year, you had to pay more money if you were a tobacco company. All of that was in an original agreement. In 2007 that was presented to the Federal Government. The Federal Government said no, it's not good enough. It's not doing its job. The FTC of the Federal Government said this could lead to an increase in prices three-fold, three times the MSA cost. One third will go to the states, two thirds will go in the tobacco companies' pocket.

What did the Federal Government do, Mr. President? They said, no, we will not pass this legislation. What did the states do? The states got back together with the Tobacco Companies and

09:59:06 with the lawyers representing the states who made $11 billion on these cases, lawyers who represented asbestos companies predominantly. Those were the individuals who were representing the states. Litigation of the MSA was not controlled so much by the states as it was these attorneys.

They regrouped and they said the Federal Government is not going to take this. They won't accept it. We will do it on our own, the states said. We will do it on our own. Forget the Federal Government. We will come up with our own MSA.

Fast-forward after the MSA. The Federal Government looks at it again and said it is not doing its job. It is not doing its job. Let's bring our own lawsuit, the Federal Government says, to correct it. Pick up where the states left off and do what the states were supposed to do but did not. That's why we had the Federal Government lawsuit. And it's still pending on RICO theories. The damages part of the Federal Government's case was thrown out. That's the part of the case that tried to make MSA claims, saying we paid for

10:00:03 healthcare costs. Federal Government tried to make that argument as well, but it was thrown out. What remained was the monitoring, the RICO, making the tobacco companies have to monitor, maybe pay for screening of tobacco smokers, programs, funding programs to stop youth smoking, advertising campaigns. That's principally what's left of the Federal Government's case right now.

Inequitable. It's more of an equitable type relief that the Federal Government is seeking. The damages are out.

As I mentioned before, in June of 2009, here we had the Federal legislature speaking. We have the courts, we have the Department of Justice, now we have the Legislative Branch.

In June of 2009, Congress, the Federal Congress, passed what is called the Family Smoking Prevention and Tobacco Control Act. And in that law, Preamble at 6, which is quoted here, the Federal Government, its legislature, stated, "Because past efforts to restrict advertising and marketing of tobacco products have failed adequately

10:01:20 to curb tobacco use by adolescents, comprehensive restrictions on the sale, promotion, and distribution of such products are needed."

At 15, "Advertising marketing, and promotion of tobacco products have been especially directed to attract young persons to use tobacco products, and these efforts have resulted in increased use of such products by youth. Past efforts to oversee these activities have been--have not been successful in adequately preventing such increased use."

Congress then states, children are more influenced by tobacco marketing than adults. More than 80 percent of youth smoke three heavily marketed brands, while only 54 percent of adults, 26 and older smoke the same brands.

Finally, Congress telling us exactly what I've been saying. In August 2006 a United States District Court judge found that the major United States cigarette companies dramatically increased their advertising and promotional spending in ways that encourage youth to start smoking subsequent to

10:02:18 the signing of the master Settlement Agreement in 1998. That's the decision of Judge Kessler, USA versus Philip Morris noted there. That's in a Federal act of Congress. There is no mention of an allocable share. There is no mention of the MSA doing--the MSA doing anything to really help youth smoking or these initiatives.

The Federal Government has candidly admitted that the MSA is not doing what it's supposed to. It's not accomplishing its objectives. So, the government, the Federal Government, passed the FSPTCA in June. No allocable share. There was a straight line application to every manufacturer equally under the FSPTCA. There are strict restrictions on youth advertising, marketing, so much so the query say that the MSA is no longer needed, but the point being that the Federal Government has admitted at every level, executive, legislative, judicial, that the MSA is not doing what it's supposed to do.

Now, the next slide, youth smoking is not implicated by the measures. Although you will see

10:03:39 the Respondent tried to argue that, you know, we need this allocable share amendment because of cheap cigarettes, it's bad for youth, and the Respondent points to a reduction in the rate of youth smoking since the adoption of the MSA. The responsibility points out that eighth graders, the incidents in the rate of smoking among eighth graders went down from 8.8 percent down to 4.0 percent. Twelfth graders went from 25 percent to 12 percent, and that's after the MSA. And they say that the MSA caused this reduction.

But if you look at the statistic, as Congress said the preference for three premium brands remained roughly at 80 percent, then there is no substitution. It's mathematically impossible for there to be a substitution of Claimants' products for those premium brand products that appeal to youth. There is no substitution.

In fact, as I highlighted in blue--search the record--there is not one piece of evidence suggesting that discount cigarettes stalled or prevented a reduction in youth smoking. In fact,

10:04:48 you see the statement by the Federal Government that the opposite occurred.

There is also, more importantly, no evidence anywhere in the record that a minor, that a child, either started smoking by consuming Seneca cigarettes, the lower cost Seneca cigarettes made by Claimants, or that a youth continued to smoke by substituting Seneca cigarettes for a higher price brand. There is no evidence. None. It's all a fabrication out of whole cloth by the Respondent.

The next slide is fairly telling. The middle line on the slide there, this is a chart, and I would like to focus on the consumption line there. From 1990, eight years before the MSA, to 2007, nine years after the MSA, it is virtually almost perfectly linear, 22.5 percent. If the MSA did what it was supposed to do or if its virtues as extolled by Respondent were truly realized, the line would look nothing like that. Post MSA we would see a serious and precipitous decline. In fact, it just continued the trend business as usual of approximately 22.5 percent reduction, and that's

10:06:20 just the way the market has been going since 1990, not because of the MSA.

And the statistic also that it's stark is over 80 percent of the youth still smoke only three brands. And those brands are made by the major manufacturers, not by Claimants or any NPM.

PRESIDENT NARIMAN: Excuse me, Mr. Violi, if you delete exports from this chart, what would it look like? If you only had cigarette production and domestic consumption for eight years before the MSA and eight years after, would it be somewhat the same, or would it be different?

MR. VIOLI: The export is for international markets. That's where--that's made in the United States and sold elsewhere.

PRESIDENT NARIMAN: I know, I know, that's why I'm asking you.

MR. VIOLI: The export--consumption would not change. It would stay the same. It's not a function of--they're not correlative. And I understand where you're--the consumption line or the factors, production is a function of demand, or

10:07:37 production is the function of domestic consumption, but not entirely.

So, you would not have--if you deleted the top line which is the production line, it would not affect--if you don't plot it is my point, it doesn't affect the middle line consumption.

PRESIDENT NARIMAN: That's all I wanted to know.

MR. VIOLI: But if you stop U.S. production, yes, then presumably prices would go up astronomically if there was no U.S. production.

ARBITRATOR ANAYA: This is just U.S. production?

MR. VIOLI: Yes, production in the United States, physically in the United States.

ARBITRATOR ANAYA: So, it wouldn't include Claimants?

MR. VIOLI: It would include Claimants--well, I don't know if it's based on trademark, Professor Anaya, or not. I think it's based on factories located in the United States. I don't know if--I don't think it's based on imports, 10:08:35 for example, by Native Wholesale Supply.

Now, we hear a lot about loopholes in Respondent's Memorials, but the loophole argument cannot withstand even minimum scrutiny.

The states created an annual subsidy and exemption in the exempt SPMs. They can sell over 13 billion cigarettes, five times Claimants' highest volume without paying a penny under these measures. They sell or they receive a 400 million-dollar exemption, a subsidy if you will, and they use the subsidies to price their products. Their products are in the deeply discounted area of the market. They're not in the high-priced areas that the states say need to be charged to stop youth smoking.

If a 400 million-dollar exemption, a 13 billion stick exemption does not constitute a loophole, then it cannot be seriously argued that Claimants were operating under a loophole under the original measures at issue. Where is the logic or the reason of giving a company or group of companies the ability to sell five times Claimants' market share, $400 million of subsidy at generic cheap

10:10:15 discount prices? They call them cheap discount prices. Where is the logic to avoiding youth smoking through higher prices through initiatives to stop smoking by increasing prices of all manufacturers, including NPMs? It's just not there. And it's not imposed on the exempt SPMs. If it was truly a matter of youth smoking and health initiatives, there would be no exemptions. There would be nobody operating at the low end of the market with a subsidy that grants them $400 million a year.

One of Respondent's last arguments, we find it to be meritless, and that was that the escrow deposits were not sufficient to meet the potential future claims for healthcare costs. The states are well aware of nondiscriminatory method and means of addressing healthcare costs. It's through taxes. Taxes apply equally across the board to every manufacturer or seller.

Oklahoma, for example, in a brief that's in the record, incurs $5 or they represented that they incurred $5.70 per carton in healthcare costs in the

10:11:23 State of Oklahoma. Tobacco tax is over $10 per carton in Oklahoma effective January 1st of 2005.

New York, in the record, stated that they incurred $600 million in healthcare costs attributable to tobacco. I should have said that earlier. Attributable to tobacco. $600 million New York spends on tobacco treatment. Its tax revenue for the bulletin provided is tax revenue on cigarettes, I may add, is $1.2 billion, double, double the alleged cost associated with smoking.

Now, the Respondent will say, well, there's a societal loss because people are out sick and employers have to pay, and there are health insurance companies. They pay the bulk, the lion's share of the healthcare costs, and that may be true, but that's not a reason to impose a discriminatory escrow burden or measure on Claimants in comparison to other competitors.

And I should add last year the Federal Government raised its federal excise tax from $3.90 a carton to over $10 a carton. There is a simple expedient to address the issues that Respondent is

10:12:34 putting forth before the Tribunal, and the states and the Federal Government has used them.

Continuing on this last argument by Respondent, it has been 10 years since the Escrow Statutes were first adopted. 10 years. No claim that the Claimants here have engaged in any culpable conduct giving rise to what's called the released claim under the MSA and Escrow Statutes. Every case as I mentioned before that has been decided on this issue has held there is no medical expense recoupment theory that exists against the Tobacco Product Manufacturer. Even when it commits RICO acts, we have the U.S. Department of Justice case against Philip Morris, where the whole case was thrown out except for the RICO case. Nothing to do with recoupment of health insurance or--excuse me, health costs.

We have health insurer, Blue Cross/Blue Shield in the record. We have pension benefits. They have all seen the tobacco companies saying we had to pay because you sold a product that harmed someone. All of those cases were thrown out.

10:13:42 Why, then, all the smoke and mirrors? Why does Respondent raise a loophole, public health. Claimants' sales really aren't on Reservation, and this is particularly an interesting argument, Respondent says, and you'll note it's mostly the damage theory, and I didn't want to get into it, but I wanted to bring this up. They say that Claimants' sales which take place on tribal land or reservation, Indian land in the United States really aren't on Reservation because they're sold to non-Reservation members who come on there.

Now, a New York tourist who goes to Paris and buys a bottle of wine and brings it back into New York, nobody is going to the Parisian seller and say, sorry, your sales weren't in New York. They weren't on French land. I mean, the argument defies logic. Sales aren't on Reservation.

And then Claimants say--Respondent says, for example, Claimants rely only on the trademark licensing agreement between Grand River and Native Tobacco Direct. That was the first agreement entered in March of 1999 between Grand River and

10:14:47 NTD, and Respondent says, now, that agreement, Claimants are putting that forth to demonstrate an integrated business between Grand River and NTD; right? But they don't rely on any agreement to establish an enterprise between Grand River and NWS? Nonsense. In 2000, NWS purchased and was assigned all the rights of NTD, including by express corporation Exhibit A to that agreement, they succeeded to that contract manufacturing and trademark licensing agreement. That agreement demonstrates a business association with NTD as much as it does NWS by way of the assignment.

PRESIDENT NARIMAN: Mr. Violi, just one second. I would like you to just say a few more words about Claimant sales really aren't on-Reservation. If you can just expound on that.

MR. VIOLI: Respondent says in its Memorials, Mr. President, that NWS, Grand River, the Seneca brand, when it's sold on an Indian Reservation, Indian land whether it's Seneca land in New York or Seneca-Cayuga land in Oklahoma or Paiute land in Nevada, that's really not on Reservation.

10:16:02 It's not on-Reservation because a non-Indian member, non-Native American can go on that land and they go on that land and they buy this product. We have gasoline, we have tobacco, we have--

ARBITRATOR ANAYA: Are you saying that Claimants do not--cigarettes are not sold off-Reservation?

MR. VIOLI: They are sold off Reservation.

ARBITRATOR ANAYA: That are sold?

MR. VIOLI: I'm talking about the particular argument where they try to refute the on-Reservation damage claim that Claimants are putting forth, and the reason why--

ARBITRATOR ANAYA: So, you're only addressing that?

MR. VIOLI: Yes.

ARBITRATOR ANAYA: You're not contesting that, in fact, cigarettes are sold off Reservation?

MR. VIOLI: They are indeed sold off Reservation.

ARBITRATOR ANAYA: To non-Indians?

MR. VIOLI: To Non-Indians, yes, and they

10:16:54 may be sold on-Reservation to non-Indians as well, Professor.

ARBITRATOR ANAYA: But we can't forget about the sales off Reservation.

MR. VIOLI: No, no.

What I'm pointing out, there's all these arguments that the Federal Government--the Respondent here is throwing at the Tribunal to obfuscate, to smoke-screen, literally, the issues.

And another example is a bit about Tobaccoville. They say that, you know, Claimants can't include--cannot exclude Tobaccoville from their alleged U.S. enterprise while at the same time including Grand River's cigarettes to Tobaccoville. But NAFTA does not require a Canadian investment to make every one of its dealers part of the investment enterprise. Tobaccoville pay royalties to these Claimants for those off-reservation sales. It's not an investor in Claimants' investment.

Another argument that the Respondent has made is that particularly troubling, is they say they doubt--Respondent doubts that Arthur Montour

10:18:03 holds the Seneca trademark beneficially for the Claimants and for that reason Respondent rejects that the trademark is an investment of any Claimant. That's at the Rejoinder page 22. Suggesting that if Mr. Montour, who owns a trademark through NWS does not hold it for all of them, he does not even have the asset, the investment of that trademark.

It's a non sequitur. Their conclusions are non sequiturs to the facts or the basis for the arguments.

Grand River owns a trademark right to the Seneca name and brand, and these right constitute an asset in which Grand River has invested heavily including in its preservation of protection. Respondent nowhere addresses the hundreds of thousands of dollars that Grand River has spent to protect and enforce its trademark rights against infringers in multiple U.S. court cases and proceedings in the United States. This is not a company that merely sells cigarettes. It has the trademark. It has the license. At Respondent's evidentiary materials in Tab 68, you will see this,

10:19:07 the breakdown of the cases in the matters, and the attorneys' fees that Grand River paid to protect the trademark in the United States.

Under the agreement that Grand River has with NWS, every cigarette sold in the United States must be manufactured by Grand River or with Grand River's permission. Grand River's contract with NWS is not merely a sale of goods contract. It has licensing of trademarks, intellectual property, clear rights of the United States and with respect to the United States market.

Now, that smoke and mirrors was mentioning before, it starts to become clear. We start cutting through what the Respondent is doing here. At the Rejoinder at Page 29, Respondent says Claimants simply provide no support for any "legitimate expectation that their on-reserve operations would be exempt from state regulation." On-reserve is where the sales actually take place on-reserve as opposed to off-reserve.

So, Respondent is saying, well, you don't have any expectation that those would be free from

10:20:16 regulation by the states under the MSA. They failed to address a New York lawsuit. New York sued NWS, Philip Morris, and all these companies because what happened was New York does not apply these measures, the Escrow Statutes, the allocable share, does not apply it on-Reservation. They acknowledge a public policy and certain rights of the Native Americans in New York to sell free of state taxation and regulation. They don't apply the MSA on tribal land in New York.

Philip Morris came knocking on New York's door and said, we want about a billion dollars back or whatever the number is, I don't know. We want the money back that we paid you, New York. New York said why? It's because our market share went down in the country. Okay. And you're not applying this MSA on tribal land. You're not applying it to the Indians, the Native Americans. You're not applying it. You're not diligently enforcing this law, New York; therefore, we want a reduction.

New York, said, you think so? Tell you what we are going to do. New York brings a lawsuit

10:21:31 against all the Tribes in New York, but names them as defendants nominally, meaning beneficially, and also sues Philip Morris in that lawsuit. It's in the record. New York wants a declaration that the MSA does not apply on tribal land. And they put in there, you can't tell us that we are supposed to apply this MSA on tribal lands. It's New York's public policy not to apply it on tribal land, sovereign Nations, they have sovereignty and authority to be regulated by themselves. The MSA does not apply to New York, it says; right?

So, for Claimant--for respondent to say that we have no legitimate expectation in the application of being free from the MSA with respect to on-reserve is--borders on bizarre.

PRESIDENT NARIMAN: What happened in this suit?

MR. VIOLI: What happened in the suit was that the judge, Mr. President, said that I can't decide that issue. Under the MSA, that issue goes to an arbitrator.

Now, what's interesting is that

10:22:36 when--Philip Morris didn't just knock on New York's door. It knocked on California's doors, knocked on all the state's doors and said, are you applying this correctly on-Reservation, on Indian land? Idaho, for example. And when they said no, we don't apply this on Indian land; therefore, we don't have to collect the money, we don't have to bother the Native Americans. We don't have the authority. When Philip Morris started doing that and saying we want our money back, 2 billion or whatever, all the states brought their own lawsuits against Philip Morris for a declaration to show that Claimants, that we are right, but the judges in all of those state court cases said, sorry, states, you made a deal with the devil, you got in bed with them, you have to go to arbitration. That's what the agreement says, and all the states washed their hands--state judges, they all washed their hands.

So, now they are involved in arbitration, Philip Morris and the OPMs, they're involved with arbitration with the states to decide that very issue, but we haven't been provided those materials,

10:23:40 we haven't in this proceeding. We don't know what the status is, what the--we don't even know who the arbitrators are.

ARBITRATOR ANAYA: This concerns retail sales on-Reservation?

MR. VIOLI: Yes, units sold.

ARBITRATOR ANAYA: Retail, so not sales to distributors to--not sales to distributors on-Reservation to then sell retail off Reservation?

MR. VIOLI: It could, Professor Anaya. I'm sorry, I was talking about Escrow Statute. The complementary legislation also--

ARBITRATOR ANAYA: I'm talking about, pardon me, this lawsuit against Philip Morris, the issue you're talking about here on the slide.

MR. VIOLI: Yes.

ARBITRATOR ANAYA: About legitimate expectations for on-reserve sales. Those on-reserve sales you're talking about that you say are exempt and that the New York Attorney General agrees should be exempt for an MSA, those are retail sales on-Reservation?

10:24:41 MR. VIOLI: They are retail sales, but I should mention when the Respondent speaks to the measures generally, no legitimate expectation because we have--

ARBITRATOR ANAYA: I understand that, but I want to know--

MR. VIOLI: The lawsuit, the lawsuit is--the lawsuit, although it doesn't specifically say it, the only way it applies on Reservation is if it's a what's called a unit sale, units sold under the Escrow Statute which is a retail transaction. It's a taxing retail transaction.

So, what happens is, if there is no tax collected on Native land, then there is no MSA obligation or escrow obligation on native land, so that's what New York was suing to have a declaration, declaratory judgment action.

The Idaho Attorney General memorandum that's in the record is equivocal at best. It never says the Escrow Statute, the complementary legislation, absolutely applies to Indian commerce.

The National Association of Attorneys

10:25:53 General early on after the Escrow Statute started coming into effect wrote a memo which we will see throughout the course of these proceedings. In that memo, the candid question was asked, for example, does this Escrow Statute apply to a manufacturer who is foreign, who has no jurisdiction? We don't have jurisdiction over. The answer was no, can't apply it to foreign manufacturer.

What about Indian Reservation sales where we don't collect the tax? It's not a unit sold. They said it. This is what's distinctive. It's not a unit sold; therefore, it doesn't apply.

But now, they're coming full circle.

All of these--and these are just a few. They acknowledge a legitimate expectation. How then does Respondent come before the Tribunal and say, Claimants simply provide no support for any legitimate expectation that their on-reserve operations would be exempt from state regulation?

So, now we come to the light.

So, why then has Respondent tried so hard to complicate and cloud the record and the issues

10:27:04 before the Tribunal? Why mention loophole and unanticipated consequences and unintended consequences, youth initiatives, and healthcare costs? The reason is that they refuse to treat squarely with the fundamental issue that's before the panel: Look to the entirety of the materials. We have a couple of trees, I believe, in this room.

Respondent never denies the following two critical points, which is really the crux of this proceeding: Exempt SPMs are afforded more favorable treatment than Claimants under the measures at issue, and that favorable treatment is in the form of an annual subsidy that currently amounts to nearly $400 million per year.

In the words of one of the favored manufacturers as well as the states and their representatives, the favored entities intend to use and capitalize on this favorable treatment which gives them a competitive advantage over their competitors such as Claimants.

These--the fact that these exempt SPMs, which is why we are here today--the fact that they

10:28:21 have that discriminatory and favorable treatment is admitted. It's admitted by the Respondent, or the states, I should say.

If you look at the Kentucky brief--there is a brief--let me give you a little background first, I don't want to jump into it. There's a company that tried to join the MSA, it's called General Tobacco, and it did join the MSA, and it received certain treatment when it joined the MSA. It was able to pay its back payments. It was able to pay its back payments over a certain period of time, and certain of its brands were maybe not acknowledged to be its brand, so it lowered its MSA payments.

But General Tobacco is not--is not an exempt SPM. It still has to pay more under the MSA than the exempt SPMs. So, General Tobacco enters the MSA, enters into an agreement with the MSA States, but who complains? Liggett, Commonwealth, the companies that have the exemptions which are at issue in this proceeding, the companies who have the favorable treatment. They complain vehemently. Tell the states you have violated the MSA.

10:29:56 Essentially we are the only ones who get an exemption in favorable treatment. We are the ones who got the benefit by joining early. Don't allow General Tobacco to come into this agreement with any kind of favorable treatment.

So, Liggett and those various companies bring a lawsuit or get involved in a lawsuit with the states, and it's launched in Kentucky. And Liggett--and the exempt SPMs come in and they say, you can't do this. You cannot give this favorable treatment to General Tobacco now joining the MSA. Can't do it. You have breached the MSA, MSA States.

What does the National Association of Attorneys General and the State of Kentucky Attorney General of Kentucky have to say about that? This is the states' own words in that brief which is in the record, "It is not difficult to understand why movants in that case the exempt SPMs"--I will use the words exempt SPMs in place of movants. "It is not difficult to understand why exempt SPMs seek as their primary remedy exclusion of an MSA competitor. As Grandfathered SPMs, they already enjoy terms much

10:31:26 more favorable than those imposed on General Tobacco, but apparently this is not good enough. Thus, for its 2005 sales, General Tobacco will owe MSA payments of approximately $4.20 per carton on all of its cigarette sales in the Commonwealth and elsewhere in the United States.

By contrast, exempt SPMs will owe MSA payments only on sales above their grandfathered shares. If its MSA payments obligation for 2004 sales is any guide, exempt SPM vector will likely not owe no MSA payments at all for 2005 sales, whereas the average payment by the other states, by the other manufacturers will range--excuse me, the other exempt SPMs will range between 70 cents--sorry, I'll do it again. If its MSA payment obligation for 2004 sales is any guide, exempt SPM vector will likely owe no MSA payments at all for 2005 sales, whereas the average payment by the other exempt SPMs will range between approximately 70 cents and $3 a carton.

Now, those numbers are tremendously larger, phenomenally larger than $4.20 per carton. Over a

10:32:43 dollar carton advantage, in some cases 350, another case. At a price point in the market where price is key.

The Attorney General and the National Association of Attorneys General, in their heading, they say millions--exempt SPMs already enjoy MSA payment terms that are far more favorable than those afforded General Tobacco.

The brief goes on to demonstrate how General Tobacco gave a security interest in its brands to join the MSA its trademark.

Here we have Respondent saying your trademark is not an asset. It's not an investment, it's not intangible property worth being considered, but the states are taking security interests in the companies who join the MSA, take security interests in their trademarks, as an asset. Has value, clearly again double-talk.

Finally, the brief mentions, each exempt SPM makes payments only on its sales above the grandfathered level, and each far less than $4.20 for each carton of cigarettes it sells. And some

10:34:08 like exempt SPM vector in 2004 made no MSA payments for the 2005 sales at all.

And when talking about the treatment that was given to General Tobacco when it tried to join, it did join the MSA, the Attorney General of Kentucky states, "The exempt SPMs, of course, will not agree to such similar payment provisions because they already enjoy far more favorable treatment under the MSA."

Vector Group, in its 10(k)--

PRESIDENT NARIMAN: One question, please.

MR. VIOLI: Yes.

PRESIDENT NARIMAN: You said here that two critical points, and I ask you about Point B, the words of one of the favored manufacturers as well as the states and their representatives, favored entities, intend to use and capitalize on this favorable treatment, which gives them a competitive advantage over their competitors.

Now, apart from the Claimants, who are the other competitors that you contemplate here?

MR. VIOLI: All the exempt SPMs under the

10:35:23 MSA. There are 15. One of them, the biggest, is called Liggett. The second is called Commonwealth. Those are the--those are the competitors. They're the exempt competitors, exempt SPMs, Subsequent Participating Manufacturers under the MSA. Those are the companies that joined the MSA and have a grandfather based on 125 percent of their 1997 market share--

ARBITRATOR ANAYA: They are the ones that get the favorable treatment. Who are their competitors?

PRESIDENT NARIMAN: Who are their competitors?

MR. VIOLI: Their competitors are--generally it's the--primarily it's the lower priced what's called third or fourth tier discount segment of the market.

ARBITRATOR ANAYA: Right, right. We understand that I think, but it's the Claimant--

MR. VIOLI: Claimants' arguments.

PRESIDENT NARIMAN: Who else? Apart from Claimant, who else? Are you the only ones?

10:36:17 MR. VIOLI: No. There are other Non-Participating Manufacturers.

ARBITRATOR ANAYA: And these are all the foreign, or no?

MR. VIOLI: Not all foreign.

ARBITRATOR ANAYA: Are most foreign?

MR. VIOLI: I believe most are foreign, but I can't say all.

ARBITRATOR ANAYA: How about this Tobacco Company in this case here?

MR. VIOLI: General Tobacco?

ARBITRATOR ANAYA: Yes.

MR. VIOLI: General Tobacco is actually an importer and located in Miami. It was--it joined on behalf of the Colombian manufacturer, Pro-Tobacco (ph.) in Colombia.

When you join the MSA, you have to get the manufacturer and enter into an exclusive licensing agreement.

PRESIDENT NARIMAN: My question was: Are you unique, according to you? I mean, is yours a unique case, the Claimants? That why when you

10:37:03 said--

MR. VIOLI: In some cases, yes, Mr. President, we are unique with respect to the on-reservation, but of all the competitors, there are other competitors that are in the same situation as Claimants.

PRESIDENT NARIMAN: And they are not on Indian Reservations?

MR. VIOLI: Some are. I know one may be an Indian manufacturer who is being prosecuted or--

PRESIDENT NARIMAN: But you reckon you are the one of the principal competitors?

MR. VIOLI: Yes, for certain. We are one of the principal SPMs in the United States market currently. Many of them went out of business. There were more, but they are out of business since the Allocable Share Amendment.

ARBITRATOR CROOK: Mr. Violi, now that we have thoroughly thrown you off your stride, I would like to focus on the light slide as well, and your Point A.

Certainly the emphasis in your presentation

10:37:58 here and the emphasis in Claimants' Reply was the focus on the treatment of exempt SPMs, and I don't want to box you in here, but it would be useful to the panel over time to clarify. Is that now the focus of your case? Are you focusing primarily on the treatment accorded to the exempt SPMs?

MR. VIOLI: That's how we would quantify it, and that's how it shows up in the economics. But certainly the OPMs pay less under the MSA. The OPMs, Philip Morris.

The issue is there is a reduction in sales in the United States. That reduction principally came out of OPM market share. There is a complex concept of what's called price elasticity, but OPMs, their premium brands compete even with discount brands at a certain price level and to a certain extent.

So, the treatment afforded OPMs also--they pay 12 percent less than under the MSA, but then they say that they pay to the four previously Settling States, so there is a mistreatment or an underpayment by them comparison to Claimants as

10:39:15 well.

But when you saw--the key is to look at the statistics. The statistics show that when the allocable share came into effect, the OPMs were harmed because their market share principally went to exempt SPMs. Right? So it's an expropriation for another private entity, I guess you would call it, public person to a private entity. So the states went through the adoption of the Allocable Share Amendment actually caused the reduction in NPM market share, and that market share shifted predominantly to the exempt SPMs.

So, it's a little complex, and I know you don't want to box me in, and I can assure you I'm not off-stride, but that's why I'm focusing on exempt SPMs because they're the ones who receive the principal, the lion's share, the most favorable treatment as the Kentucky Attorney General pointed out. The Kentucky Attorney General didn't point out OPMs at that point because he wasn't getting sued by the OPMs, he wasn't comparing the OPMs, but to some extent the OPMs who have entrenched market share,

10:40:18 the limitation on advertising has the effect of entrenching established brands in the market, but I would be getting beyond--certainly beyond that.

As far as--I mentioned what the states, at least the Attorney General and the National Association of Attorneys General wrote in that brief about how the exempt SPMs have favorable treatment. There is also Vector Group, which is the biggest exempt SPM. In their 10(k) which is in the record, their Annual Report that they filed--they're a public company--Liggett says that our strategy is to maximize shareholder value in the following ways. One of them is, "capitalize upon Liggett's cost advantage in the U.S. cigarette market due to the favorable treatment that it receives under the Settlement Agreements with the states Attorneys General and the Master Settlement Agreement."

Liggett also says we believe that Liggett has gained a sustainable cost advantage over its competitors through its various Settlement Agreements under the Master Settlement Agreement reached in November 1998, with the 46 State

10:41:39 Attorneys General.

Liggett must make settlement payments to the states. "Liggett, however, is not required to make any payments unless its market share exceeds approximately 1.65 percent of the U.S. cigarette market. Additionally, as a result of the medallion acquisition, Vector Tobacco likewise has no payment obligation unless its market share exceeds approximately 2.28 percent."

Business strategy, Liggett's business strategy is to capitalize upon its cost advantage in the United States cigarette market due to the favorable treatment Liggett receives under the settlement agreements.

Candid admission.

And this is the same exemption in different volumes that other exempt SPMs received under the MSA. Candid admission that they had a cost advantage over their competitors. Also an admission that they're going to capitalize on.

As I mentioned before, if they're not operating under a loophole, then Claimants weren't

10:42:42 operating under a loophole. If they could capitalize on their favorable treatment, Claimants should be able to capitalize on the Allocable Share Amendment.

So, how does Respondent deal with this critical point? Clear admissions throughout the record. Exempt SPMs have more favorable treatment under the MSA, that it could be capitalized. Respondent says essentially nothing.

Instead, in addition to the smoke and mirrors loophole, it says, while the Claimants' claim should be rejected, even if the exempt SPMs have that exemption that gives them an advantage, and they're taking market share away from the NPMs and the market share went from 8 percent to 5 percent of the NPMs and it pretty much went to the exempt SPMs. The Respondent says, that's fine. We could do that to the NPMs.

Why? In the case of Claimants, because discrimination is not nationality-based. Now, I will leave that for Professor Weiler dealing with NAFTA and particulars of international law in this

10:44:06 context, but that's one of their arguments.

And the second argument is that Claimants are not in like circumstances. They're not comparators with the favored Investors.

The like circumstances argument, however, is developed at the beginning of Respondent's case in their Counter-Memorial, and then it takes a complete odd circle in the Rejoinder. At Page 48 in the Rejoinder, the Respondent wants to argue, and does argue that Claimants have no claim because it's a law. We are dealing with a law of general application to everybody. It applies to everybody. And Claimants, you're in the same boat as any other manufacturer, including the exempt SPMs. All right.

So, you're in the same boat, so you were given the same choice to join the MSA just like everybody else; therefore, it's a law of general application.

Well, with all due respect, if the Claimants are in the same boat for purposes of general application of the law, then they're in the same boat for determining whether we are a like

10:45:17 comparator to the people who are treated favorably.

And there Claimant notes--Respondent notes that allegedly Claimants also failed to address the generally applicable nature of the Allocable Share Amendments, each Escrow Statute, both as originally enacted and as amended provides that any--and they emphasize any--cigarette manufacturer doing business in the state must either join MSA or make escrow payments. In that regard, the Escrow Statutes treat all cigarette manufacturers equally."

Again, if we are being treated the same way or being subject to the same law as our competitors, then we are like competitors to our competitors. And that's because, according to Respondent, you face a choice. But Respondent can't have it both ways. We cannot be like competitors because we face a choice that is presented to our competitors, but not like competitors when trying to analyze the effect of the choice or what is truly being offered. That's the equivalent of saying an NPM has a choice, joining an agreement or not joining an agreement. If it joins it, it will have to pay $5 a carton

10:46:41 while others only pay $2 per carton. If it doesn't join, it still has to pay $5, but it's the NPMs' choice. And the fact that it is given the opportunity to exercise this choice means that it's being treated the same as all other manufacturers. Nonsense. That was pure nonsense. It's not a meaningful choice at this point or it's a--it's not a nondiscriminatory choice.

And the reason that it's not discriminatory is because the others who obtained that choice or exercised--so-called exercised that choice were given these exemptions under the MSA that both the competitors themselves as well as the states acknowledge gave more favorable and gives more favorable treatment to.

One other argument that Respondent has made is that there is a reasonable basis for granting exemptions in exchange for maximizing participation in the MSA. That's at Page 6 of the Rejoinder.

So, according to the states and Respondent here, it's reasonable to give an exemption because we want to--we want people to join the MSA. We want

10:48:19 to promote participation in the MSA. The problem with that argument is that Grand River offered to join the MSA. Made only one request or a simple request. I shouldn't say one. It made others. But the critical request that Grand River made when it joined the MSA was treat us the same as our competitors. And that was rejected.

So, if the states really want to exchange participation in the MSA for terms of joining the MSA, we submit that they should do that on an equal basis, a nondiscriminatory basis. It hasn't been done so here.

PRESIDENT NARIMAN: One question Mr. Violi. What was the basis on which the Claimants were out of time or did not join the MSA for their own reasons? You had the choice. The Claimants had the choice, if you had known. Apparently you said you didn't know or something in your pleadings, but if you had known and you had joined in that right time, you would have gotten the same benefit.

MR. VIOLI: The benefit, however, was based on a market share that the states came up with.

10:49:44 They said, you can join--well, first of all, the time to get an exemption expired.

PRESIDENT NARIMAN: That's my point. The time expired because you say you didn't know about it.

MR. VIOLI: They only gave 90 days.

PRESIDENT NARIMAN: But if you knew about it, you would have got the same exemption.

MR. VIOLI: But they've put a--we would not have gotten the same exemption because it's not the least favorable treatment, and it's not--it's not--it gives a cost advantage to the Claimants' competitors that effectively renders them an inability to compile.

So, for example, when you give $400 million subsidy, and that's what this agreement does, gives a $400 million subsidy to the exempt SPMs, so Grand River has a choice. Join the MSA and pay $5 per carton when its competitors are paying $2 per carton; right? Or don't join the MSA and pay $2 per carton under the Allocable Share Release provision.

So the choice that Grand River faced at the

10:50:47 time, Mr. President, it exercised the meaningful choice and was so advised, was at a time when the measures allowed exempt SPMs to compete effectively, they gained 8 percent of the market, and it allowed the people who didn't join to compete effectively. They also went up by about 8 percent of the market. And there was parity: Liggett will pay $2 or the exempt SPMs will pay $2 under the MSA, you must pay two or more, whatever it is, depending on average. I think the national average was like 58 percent of the MSA payments. But that was the choice.

And you're right, and we exercised that choice, and we developed a business plan because of it. Invested heavily because of it. Entered into agreements, licensing agreements, because of it. All based on what were told our choice was, so we did not join the agreement. But we were able to effectively compete under the measures and the choice that was presented to us at that time. It's when they changed the measures. It's when they took away the release that now we have $2 for these favored companies under the MSA and $5 for us.

PRESIDENT NARIMAN: You mean the Allocable Share Amendment?

MR. VIOLI: Yes, that is what--we did make a choice, a meaningful, advised, but that was the crux of the problem.

ARBITRATOR CROOK: Two questions, please. When you said that you sought to join on the same basis, does that mean that you sought as well an exempted element of market share?

MR. VIOLI: What we did was--it was--I get a little more complex than that. What we did was the states wanted Grand River to pay I think it was close to a hundred million dollars in back MSA payments for brands that were not Grand River's brands. So, what we said was, look, these are not our brands. We don't own the trademark.

ARBITRATOR CROOK: You effectively want a treatment that reflected the equivalent--

MR. VIOLI: Or some kind of--we didn't want it to--we didn't want to include our--those other brands that they were tagging us with.

ARBITRATOR CROOK: Right.

MR. VIOLI: So, something that would have lessoned the burden and the effect, and we also asked that it be without prejudice to come before Your Honor and members of the panel.

ARBITRATOR CROOK: I understand.

And my second question, and this is not one where I expect an answer from you now, but I would be interested in the course of the proceedings and hearing from both sides their views on this. Now, you have made a great deal of the discriminatory preferential treatment accorded to the exempt SPMs here this morning and in your Reply. And my question is, I haven't really seen either party relate those arguments to the Tribunal's 2006 jurisdictional decision.

Now, you will recall there we were confronted with arguments, for example, that according the exempt SPMs preferential treatment was a NAFTA violation, and we held in Paragraph 103 of that decision that those claims were time-barred, at least as to a certain period, and I would be interested--this is--I don't want to ask you to do

it right now, but I would be very interested in hearing from both parties their views on the implications of Paragraph 103 of the jurisdictional decision.

MR. VIOLI: As we discussed it at the time, and we will certainly provide more over the course of the proceedings, but the damage was not sustained at that time, nor was the measure discriminatory at that time. In other words--

ARBITRATOR CROOK: But, Mr. Violi, you made the argument before us in 2005 that, as I recall, was very similar to the argument you're making right now.

MR. VIOLI: No, the allocable share has a distinct and definite different damage.

ARBITRATOR CROOK: No, sir, I'm referring here to the claim of preferential treatment to the exempt SPMs.

MR. VIOLI: Yes. It's preferential because of the allocable share. In other words, under the original measures, if the Claimants, and they did, restructure their business plan and concentrated

only a few states or have their sales of their product concentrated in a few states, their escrow burden, the burden, the payment burden of the measures, could equate to--could be brought down to a level at which they could compete with those who received an exemption, a subsidy under the MSA.

So, what we have is at that time the measures promoted parity. Query: Why make this law, give a refund or an allocable share? Why put it in the statute to begin with? They stated it was an unintended oversight or whatever, but we posit that it was intended. In fact, it promoted parity.

It is uncanny that the market shares of MPMs grew at the same rate and to the same level as exempt SPMs, roughly 8 or 9 percent, under the now allocable share system and under an exempt SPM system; right? When the allocable shares came into effect, that created the disparate treatment, the discriminatory treatment. It was at that point one received the subsidy, and the other not a rebate under the statute, and that's how we deal with it on the time issue.

10:56:42 One other last point deals with the investment, and Professor Weiler will talk more about that, but there is approximately $50 million in these Escrow Statutes in the United States for Seneca brand cigarettes and Grand River sales of cigarettes that were sold at this stage. $50 million. Respondent's expert, in his report, has called these a forced savings that we should accept as part of our portfolio. Again, telling us that we have $50 million that's required to promote business activity in the United States because you had to put that money in to continue to do business as a cost of doing business, telling us that we have a forced savings account, and it's part of our portfolio, asset portfolio in one sense, but then to tell us we don't have an investment in the United States in another defies logic and confounds me to this day how the Respondent could come before the Tribunal and completely dismiss our investments in the Territory of the United States.

That will end my introduction.

PRESIDENT NARIMAN: Thank you.

10:58:25 (Brief recess.)

PRESIDENT NARIMAN: Yes, Mr. Weiler.

MR. WEILER: We have eaten up a fair amount of our time, and I won't want to go too long, so what I'm going to do is leave my prepared notes and the presentation that I have for later as part of our 15 hours.

Just briefly, I would just like to say a few things about the NAFTA obligations at issue. I know you don't have them before you right now, so again we will go back to them in more detail. But I think it would be useful just to remind the Tribunal of what the obligations are.

The first one is Article 1102, which is national treatment; and Article 1103, which is most-favored-nation treatment. We put the two together because, in the context of this case, the only difference between national treatment and most-favored-nation treatment is whether they're comparing yourself to a foreign company such as Japan Tobacco (international) or a local company such as Liggett; but, otherwise, the comparison is

12:02:08 the same. For the most part, I think you will find everybody saying "national treatment" repeatedly, but we really do mean both of them.

Basically, a lot of tribunals have adopted, and a lot of others have adopted a basic three-prong test, which we think it would be useful for the Tribunal to also follow, if it so chooses.

The first step is to compare the players to basically--define the market: What are the competitors who are basically affected by the measure?

The next thing to do would be to ask: Well, what is the treatment? Is the treatment more or less favorable?

And then the final question would be to say, well, is there a justification or is there a reason why what appears on a prima facie basis to be less favorable treatment offered to a qualifying--well, not offered to a qualifying NAFTA Party--I had that backwards, David--you know what I'm saying--you will fix up.

(Technical pause.)

11:19:11 MR. WEILER: This brief intermission was brought to you by Mac and Apple, the makers of a better computer.

Article 1102, you find the comparators, you decide whether or not more favorable treatment is being offered than is being received by the Claimant, and then finally you look to see if there is any justification for that. There may be a prima facie breach that is asserted by the Claimant but it is still possible there is still an explanation that is not discriminatory or arbitrary.

Even though--and that applies even though in the NAFTA we don't have a general exceptions provision. It's well accepted that, nonetheless, this balancing provision is read into the provision.

It's important to note that if you look at the language, which we will get you the copies of later, when you look at language of Article 1102 or Article 1103, it does not say "discrimination" or "discriminate" anywhere. It talks about "more favorable treatment," and it talks about "treatment no less favorable." Doesn't say anything about

11:20:19 discrimination. These are equality provisions. They certainly do work to prevent discrimination but on the basis of effective equality of opportunity. So, that's why I prefer to call them "equality provisions" or "favorable treatment provisions."

That means, as NAFTA Tribunals have previously found, while intent to discriminate de jure is really great evidence that there probably is a breach of the national-treatment provision, it's not essential, it's not necessary. The question is, has more favorable treatment been offered to a competitor, and is there not a valid justification for it? Obviously, our argument will be that, in this case, the treatment of the SPMs was better than the treatment of the Claimants.

Now, I'm going to try to quickly answer Mr. Crook's question that again we probably can give in more detail later, about the choice, about the choice to which the Claimants were put. The choice was join or don't join. If you join, you get a grandfathering based on 1997-to-1998 market performance; and, if you don't join, you have to

11:21:44 restrict yourself to a limited number of markets in order to qualify for this relief under the Allocable Share Release mechanism. So, that was the original measure: Join or don't join, and there are actual examples. There is one example somewhere in the--there's a press story we included in one of the earlier productions which describes a fellow who actually was consulted, people flew out, and the lawyers flew out and said would you like to join, and he looked at it and said no, I don't want to join because I'm just in this state. I'm better off not joining because I can get the Allocable Share Release.

So, it was a decision that one could make at the time, but as a result of the time bar in this case, that choice isn't really relevant anymore. The choice that's relevant in our case is that the status quo was the measures here, you may--you have to--well, there is still a choice, but the choice has been changed. The choice now is, here's the measure. Either you join the MSA, and no, you're not going to get any break if you join the MSA

11:22:53 because we don't have to, it's not--you missed your 90 days, or you can have access to this Allocable Share Release mechanism. That was the status quo ante when the time bar was no longer in effect. You can join, but if you join, you only get the chance to do the Allocable Share Release mechanism. It's too late to get the grandfathering.

And they took that deal, and the Claimants did well with that deal, and it wasn't until the Allocable Share Release mechanism was yanked from these provisions that they had a problem, that they had a complaint.

Now, when it was yanked, though, when they took away that option, they tipped the table. It's no longer a level playing field. The funny thing is, the justification my friends have is they needed to do it to level the playing field.

We will go into that in more detail. I don't think that--common sense would suggest that's not the case. But that's the way the test worked, and that's why it is relevant to this Tribunal in keeping with the time bar.

11:24:03 This would be a good time, if you would like to ask that most-favored nation treatment question.

ARBITRATOR CROOK: Thank you, Professor Weiler. How do we address you? Professor Weiler?

I don't want to answer now, but I would be interested in hearing from both parties. You quoted to us sort of the Pope & Talbot test for analyzing whether there is a denial of MFN treatment. Respondents used a somewhat different test from UPS versus Canada. And not now but in due course, I would be interested in hearing from both parties whether there is really a difference. Is there some operational or legally significant difference in these two formulations of the test?

Thanks.

MR. WEILER: My short answer would be no, there isn't. I do recall. It's been probably a few months since I last looked at the UPS. As you know, I was involved in both of those cases.

What I take the majority in the UPS Case to have been saying is simply that, in the facts of

11:25:13 that case, it wasn't necessary to do the three-step analysis, that you got to the same result anyway. The one thing that the Tribunal wanted to make clear, and I actually agree with them on it is, that there is no automatic burden shift. That's what the UPS Tribunal seemed to be, if you will, up about or upset about. The idea was that the Claimant at that time was really pushing the idea that, once they made their prima facie case, the evidentiary burden as a legal matter shifted to the other side, and in fact, it doesn't. It's just a strategic burden. If I have proved my prima facie case, obviously it would behoove the Respondent to provide some evidence of justification, but it's not a legal burden shift, and I think that's really what they were answering when they tried to say, no, no, no, it's not about the three-part test as if it has--it's the same thing in a sense with the Salini test in ICSID jurisprudence. There aren't supposed to be tests. This is arbitration. This isn't Common Law, and I think that that's a reaction we saw on that Tribunal to the notion there was some

11:26:23 hard and fast rule of Common Law.

For now that's all I'm going to say about Article 1102 and Article 1103. As I said, I don't have much time, and I don't want to take much time.

The other obligation, the primary obligation here, is Article 1105, "the treatment in accordance with international law, including fair and equitable treatment and full protection and security" test or standard.

The binding interpretation issued by the three NAFTA Parties on July 31, 2001, confirms that this standard is not simply just a treaty standard, but is also required as a matter of customary international law. They feel bound by it, regardless of whether it was in the Treaty or not. There is a difference, though. The difference is if it were only a matter of customary international law, it would be necessary for the Claimants to have our friends in the corner there espouse the case for us because that's the remedy in customary international law. They put it in a treaty with binding investor-State arbitration because they

11:27:30 wanted Claimant to be able to do it themselves.

The important thing to note, though, as other tribunals have noted, and I will discuss this in more detail later, is that while the standard is definitely customary international law, that doesn't mean how we interpret the standard is a matter of only finding discrete rules of customary law that have somehow been breached by the current facts of the situation. Customary international law does evolve--it evolves pretty slowly, and it's going to be pretty difficult to find some of the more arcane applications of custom today.

On the other hand, though, there are some ways in which custom has evolved and is relevant. The point that I want to make, though, is that as a matter of treaty interpretation, the words say what they say. They are a standard of customary international law, but we still need to know what "fair and equitable treatment" means in this case. And it can't be a subjective exercise. It has to be an exercise that's grounded in some sort of objective reality. The way one does that is one

11:28:40 refers to available and applicable rules of international law in the circumstances.

So, in this case we have a few that we have cited, customary international law Rights of Indigenous Peoples. We think that that informs the interpretation. We think that treaties applicable specifically to the Haudenosaunee and the individual Nations of the Six Nations may be relevant in determining whether we have fair and equitable treatment met here; the doctrine of legitimate expectations, which is--seems to have become well established in the ICSID and ad hoc jurisprudence; the older doctrine of abuse of right, which is particularly understood in the investment context for civilized--I'm sorry, for civil law countries; and, finally, the doctrine of denial of justice.

We think all of these standards, as you see in our Memorials, we think they're all relevant in allowing the Tribunal to interpret fair and equitable treatment and full protection and security in context.

ARBITRATOR ANAYA: Excuse me.

11:29:46 MR. WEILER: Yes.

ARBITRATOR ANAYA: So you don't agree that relevant customary international law is limited to that concerning the treatment of aliens?

MR. WEILER: No. It's the treatment of these aliens.

ARBITRATOR ANAYA: Not the customary international law concerning treatment of aliens generally?

MR. WEILER: No. And tribunals have not--there is only one Tribunal that has actually followed that strict an approach, and it was the most recent. Every other Tribunal has looked at this, the most famous being the first. It had Sir Steffan, and it had Judge Schwebel, and it had Professor Crawford on it, and this was the Mondev versus USA case, and in that case they decided exactly what I suggested: They were all very happily relieved that the State of Mexico was now in agreement because previously it had not been in agreement with the proposition that these standards are required as a matter of custom.

11:30:47 But even if, for purposes of semantics, Professor Anaya, I were to agree to that particular language, that language isn't magic. It's really just saying customary international law treatment of aliens. Well, who are aliens? Foreign investors, foreign investors who have particular rights and interests depending on the context of the case.

ARBITRATOR ANAYA: In all fairness, I mean that is a term of art, isn't it? I mean, it's maybe not magic but...

MR. WEILER: Well, it's a term of art in the sense that it's an arcane--I would agree with you it's an arcane term of art, or an archaic term of art--hasn't been used in a long time.

ARBITRATOR ANAYA: But it refers to a specific body of customary international law.

MR. WEILER: It refers to a body of customary international law as of a period of time.

But as many tribunals have commented, customary international law does not stand static. It does not get frozen in amber. It moves forward and is informed by later cases.

11:31:47 So, yes, this was the standard they were talking about with would have applied in to 1920s and 1930s, but pretty much all doctrinal writers and all tribunals are in agreement that it didn't freeze in amber, to use the expression of one Tribunal, that, indeed, it has advanced. That's why it's an arcane or archaic standard if one interprets it to mean oh, no, we do mean if we throw you in jail like poor Mr. Neer and throw away the key--some of these really old, egregious cases. As a number of tribunals have said, what might have been egregious to a tribunal a hundred years ago would probably still be egregious today, that there's probably things that they didn't think were so bad for states to do that today we would not accept.

As a matter of fact, as I like to teach my students, human rights law and investor-State law are, if not siblings, cousins because they both flow from the protection of aliens, Diplomatic Protection. They both come from there. It's just that they diverged around the 1940s when different institutions were set up for them. But it's time to

11:33:05 bring them back together basically, and the WTO Appellate Body has certainly held the lead here in explaining that even though it's a lex specialis in terms of the dispute settlement, that, nonetheless, public international law norms that may be applicable in the circumstances should be considered.

I was going to mention it later, but I will mention it now since it seems appropriate. Article 1131 of the NAFTA, sub (1), authorizes this Tribunal to use the governing law to decide disputes, and it names the governing law as the NAFTA and applicable rules of international law. Pretty much every Tribunal has agreed that the applicable rules of international law include the customary international law rules of treaty interpretation which are represented in the Vienna Convention. The Vienna Convention, Article 31(3)(c), states that Treaty terms shall be read in context and in accordance with applicable rules of international law. And that's where the WTO, for example, panels have--and Appellate Body--have

11:34:18 looked to other areas of public international law and relied on them as necessary to interpret the terms before them. And I would submit that that's what this Tribunal should do, too.

The final item I wanted to mention, I didn't--lest you believe that we are quote-unquote giving up on Article 1110, we are not giving up on it. It's just that in this case, the distinction between Article 1105 and Article 1110--and I would submit in the doctrine the difference between the two provisions is largely evaporated and continuing to evaporate--the only difference between a breach of 1105 and a breach of 1110 is a matter of degree. It's all about impairment of the investment. If the impairment is substantial enough to be tantamount to a taking, we can call it 1110. But if it's less than that, we call it a breach of fair and equitable treatment, and that's why fair and equitable treatment indeed is referred to in the chapeau of 1110.

So, we would submit that we don't need to spend a lot of time back and forth on

11:35:29 angel-on-a-pinhead legal arguments concerning Article 1110 and expropriation and what it means in customary international law. The bottom line is whether there has been an impairment. If there has been an impairment, you can call 1105, you can call 1110, it doesn't matter because it's going to be measured the same way.

And with that, I'm going to wrap up and that way we can keep within our two hours, hopefully, and the presentation that I had for you, I will provide to you later when our 15 hours start.

Are there any more questions?

Yes.

ARBITRATOR CROOK: So, just to be clear on 1110, so, your argument is, and I understand what you're saying, but is your view that this is a tantamount to expropriation, or is your view that an expropriation, in fact, occurred?

MR. WEILER: This would be--this would be an indirect expropriation. Actually, the Pope & Talbot Tribunal and another one basically said "tantamount to" and "indirect" mean the same thing,

11:36:33 relying on their French and Spanish versions.

ARBITRATOR CROOK: Right. And others have taken a different view, as you know.

MR. WEILER: I actually prefer the notion that "tantamount to" and "indirect" mean the same thing.

ARBITRATOR CROOK: Okay. So your view is that there was in fact a taking by the or a--

MR. WEILER: An indirect taking.

ARBITRATOR CROOK: An indirect taking. Okay.

MR. WEILER: And it tied in three state--in the territories of three states.

PRESIDENT NARIMAN: Three or five?

MR. WEILER: There's actually three where they're out. I will go into it more later, but in Georgia, Oklahoma, and Arkansas.

ARBITRATOR CROOK: You'll explain that to us later.

MR. WEILER: Yes.

ARBITRATOR CROOK: So your view is that for 1110, what we have here is an indirect

11:37:07 expropriation.

MR. WEILER: Yes.

ARBITRATOR CROOK: Thank you.

MR. WEILER: And if you don't think that the impairment was substantial enough, call it 1105. Yes.

ARBITRATOR ANAYA: You are going to get into what these customary international law norms are--

MR. WEILER: Yes.

ARBITRATOR ANAYA: --at some point and how they're--

MR. WEILER: Definitely. We only have two hours here, but that's what I--

ARBITRATOR ANAYA: That's what I understand. I mean you seem to suggest that 1105, the fair and equitable treatment standard is basically just a human rights standard. Now we see human rights norms incorporated in there. So anytime--so now 1105 is basically about possible breaches of human rights.

MR. WEILER: It can be a breach of a human

11:37:48 rights norm if the human rights norm is applicable in context, whatever the given context may be. Let's say that it's an investor who has been deprived the access to counsel and that that affected their investment.

It would be very useful to refer to the UN Conventions that have to do with that provision, the political convention to start. I mean yes, so you can certainly refer to them. But as a matter of treaty interpretation, at the end of the day, what you have before you are those words, "treatment in accordance with international law, including fair and equitable treatment and full protection and security."

Another example that I could point you to where that has become--

ARBITRATOR ANAYA: No, I understand. I just wanted to make sure--

MR. WEILER: Well, I wanted to mention, there's something that's happened that has become confused in the law, I found. You can actually now find examples where some tribunals have said "fair

11:38:43 and equitable treatment" is the detrimental reliance standard, and you have other tribunals saying, actually, no, that's full protection and security. Professor Schreuer seems to think it's that way.

It doesn't really matter because in this provision we have both; we have an "and" between them, and the bottom line is we know they are a matter of custom. And if it's necessary and useful to refer to other norms, we can, but you're not finding a breach of these other treaties. It doesn't matter whether they were or weren't breached because you're not authorized to make that decision. That would be that Tribunal's right. But you are authorized to figure out what "fair and equitable treatment" means in the circumstances.

So, with that, I'll surrender the pulpit, which I think might be the appropriate word for it right now, and we can either begin with Respondent or, if you would like to take the break, we can do that, too.

PRESIDENT NARIMAN: I think it would be appropriate that we stick to the program and break

11:39:53 for lunch and back again at 12:15. 45 minutes, yes. Okay. 12:20, 12:25. About 25.

(Discussion off microphone.)

PRESIDENT NARIMAN: Okay. Would you like a shorter lunch break or a longer lunch break?

(Off microphone.)

PRESIDENT NARIMAN: What about you?

MR. FELDMAN: We would prefer to stick with the schedule of a 1:00 opening.

PRESIDENT NARIMAN: Okay, 1:00. All right. So your opening is at 1:00.

Thank you. So, 1:00. Thank you.

(Whereupon, at 11:40 a.m., the hearing was adjourned until 1:00 a.m., the same day.)

AFTERNOON SESSION

PRESIDENT NARIMAN: Okay, ladies and gentlemen. Welcome back.

We now have the Respondent's Opening Statement.

That's Mr. Koh.

OPENING STATEMENT BY COUNSEL FOR RESPONDENT/PARTY

MR. KOH: Good afternoon, Mr. Chairman, Professor Anaya, Mr. Crook, I'm Harold Hongju Koh. I'm the Legal Adviser of the United States Department of State. On behalf of the Respondent, United States of America, I'm pleased both to introduce our team and also before that the case that they will present.

This is the first NAFTA Chapter Eleven merits hearing during President Obama's administration. On behalf of President Obama and Secretary Clinton, I'm pleased to appear in this arbitral proceeding on behalf of the Legal Adviser's Office and its Office of International Claims and Investment Disputes.

My presence here underscores the commitment

01:01:45 of our administration to binding dispute and transparent international dispute resolution in investment treaties. The goal of NAFTA's investment chapter is to provide specific protections both to foreign investors and to their investments, protections that are critical both for the Investors and for the governments that must regulate in the public interest. And this is a commitment enshrined in the NAFTA and shared by each of our partnered governments: Mexico, Canada, and the United States who appear before Chapter Eleven tribunals like this one.

Let me say, Members of the Tribunal, we are very grateful to each of you for your hard work and commitment to this public process. By my presence, I'm committing to you that the United States will do its pat fully and fairly to present our case and to respond forthrightly to your questions. And in turn we ask you to adhere to the terms of the Treaty, to decide the case based solely on your jurisdiction, the law, and the facts.

Now, this morning, you heard a detailed

01:02:48 presentation from Claimants. That presentation will be responded to in a few moments by my colleague, Assistant Legal Adviser Jeffrey Kovar, who will make a detailed presentation of our responsive case.

My presentation will not get into the weeds for two simple reasons: First, because my job is to give you the big picture, and secondly because my colleagues are much better gardeners than I am.

But at the broadest level, this case concerns two questions which we ask you to keep in mind: First, whether the Canadian cigarette manufacturer and exporter Grand River has established an investment in the United States as defined by NAFTA Chapter Eleven; and, second, whether that "investment" and the investment of Claimant, Mr. Arthur Montour, who imports and distributes Grand River cigarettes, have been given treatment by the United States that violates our legal obligations under Chapter Eleven to accord national treatment, most-favored-nation treatment, the customary international law minimum standard of treatment, as well as the obligation not to

01:04:00 expropriate investments without payment of compensation.

We urge you, Members of the Tribunal, to answer both of these questions, whether there is an investment and whether there is a violation in the negative.

And in answering these questions, this Tribunal will place three distinct but overlapping roles: As a finder of fact, as a finder of law, and only, if necessary, as an assessor of monetary damages. And with respect to each of these, we submit, Claimants have a burden that they have failed to carry.

As a matter of fact, what will emerge from the whole of the evidence is not as Claimants allege, a picture of invidious discrimination by states bent upon destroying Claimants' tobacco business. Rather, what we will see is the creation of a necessary regime of state regulation designed to protect the public interest and the public health.

Now, remarkably, Claimants said that this

01:05:08 case is not about the public health. A case about cigarettes is not about the public health. That assertion is hard to understand.

For the public interest in this case could not be higher. What we are dealing with here is not what they would describe an evil effort to destroy their own market share, but rather a concerted and landmark efforts by the states of the United States to regulate the leading cause of preventable disease and the single most dangerous consumer product in the world today; namely, cigarettes. And without losing sight of this bigger picture, we will ask you to walk patiently with us through the history and design of this complex regulatory scheme, the MSA, the 1998 Master Settlement Agreement, and its related state measures.

And as you understand this regime, what you will see is that the Claimants are essentially asking this Tribunal to reward them for flouting a web of State statutes that were aimed at ensuring that their cigarettes will be priced at a level that reflects their true social costs.

01:06:22 Now, Claimants have questioned the public health rationale that supports the landmark Master Settlement Agreement, but as you're aware, in November of 1998, as part of the state Attorneys Generals' suit to recoup Medicaid-related costs, the Attorneys General of 46 of the American states settled their Medicaid lawsuits with the so-called "Majors," the four largest major U.S. tobacco companies. In exchange, the Majors agreed to end or curtail certain marketing practices and to make payments in perpetuity to exceed $200 billion by the year 2025. Under the MSA, the Majors agreed, among other things, to restrict their advertising sponsorship, lobbying, and litigation activities, particularly those marketing activities that targeted youth.

What Claimants are now asking this Tribunal to do is to substitute your judgment for that of the settling states with respect to two key features of the MSA regime, and you know them well.

First, the so-called "partial payment exemptions," also known as the grandfather shares;

01:07:39 second, the amendment of the Escrow Statutes known as the Allocable Share Amendments.

And let me say a word about each.

First, in 1998, the partial payment exemptions, the grandfathered shares, were offered to nonparticipating tobacco manufacturers on a onetime basis in order to maximize their participation in the Master Settlement Agreement. In exchange for signing the Master Settlement Agreement and receiving the partial payment exemption, the smaller manufacturers were at the same time required to submit to wide-ranging advertising and lobbying restrictions under the agreement.

The states used the grandfathered shares for a simple purpose: To induce established small market participants to join the MSA and to expand its coverage, and their plan succeeded. Indeed, following the 90-day window for obtaining a grandfathered share, the MSA conduct restrictions came to cover over 99 percent of the U.S. cigarette market. That is all of the U.S. market, but Grand

01:08:52 River simply was not part of either end of the grandfathered share bargain. On the one hand, it claims it should have received a grandfathered share in 1998, but it could not have because it was not exporting cigarettes to the U.S. at the time, and it had no market share.

On the other hand, Grand River chose not to sign the MSA once it started exporting to the U.S. It has not signed it ever since, and thus, it has not given up the other part of the bargain. It has never been subject to the reciprocal advertising and lobbying restrictions. This was their choice. As Mr. Violi conceded, Grand River made a choice not to participate. Their comparator, therefore, is other Non-Participating Manufacturers. It's not the exempt SPMs as they claim.

Now, Grand River, therefore, has no credible claim to any partial exemption or grandfathered shares comparable to the ones offered to other tobacco manufacturers by the settling states back in 1998. And even if Grand River were suddenly to sign the MSA today, it would still have

01:10:05 no legal claim under the NAFTA to the partial exemption for the simple reason that NAFTA Chapter Eleven imposed no obligation on States to freeze the regulatory regimes in perpetuity.

The second issue raised in this case is the allocable share amendments. The Claimants ask this Tribunal again to substitute its judgment for the settling states' complex policy decision to close a loophole that was found in the original Escrow Statutes by adopting the allocable share amendments.

Now, the Claimants have called it this morning yanking a release mechanism. They suggested in various ways it was an unjust subsidy. We prefer the term, which is what it was, closing a loophole. And closing the loophole has a particular purpose, as you will hear when you see the testimony of Professor Gruber. He said, what is undoubtedly clear is that, by closing the loophole, the MSA States reduced the possibility of increasing youth use of a lower priced NPM product. Closing the loophole reduced the possibility that more young people would use the lower priced products of the

01:11:32 Non-Participating Manufacturers.

Now, Claimants have just suggested that somehow these amendments fostered some kind of unjust enrichment. Mr. Crook asked whether, in fact, these amendments and issues regarding them are time-barred. Those are questions that we will answer during the course of our presentation, but let me say this: Under the original Escrow Statutes a non-Participating Manufacturer that concentrated its sales in one or a few states could receive a release of substantial portions of the escrow deposits it had made on cigarettes that it sold that year.

It soon became clear that this arrangement had a decidedly perverse effect. It was a loophole. Those manufacturers who did not participate in the Master Settlement Agreement but concentrated their selling in only a few states could concentrate the detrimental public health effects and costs of their product and still minimize their escrow contributions in those states. In one year, for example, Non-Participating Manufacturers obtained

01:12:46 the release of approximately 60 percent of their total escrow deposits, and it soon became apparent that if this was to continue, states would not have adequate funds available in the event of a future judgment or settlement against the manufacturers. That is what the Allocable Share Amendments were designed to do. They were not designed to damage Grand River. They were designed to create an escrow to achieve the purposes of the state regime.

Now, in this morning's presentation, you heard the argument that somehow the states ought to be able to impose taxes. We don't disagree that they can impose taxes, but the fact that the states can also tax doesn't mean that closing an escrow loophole was unreasonable. It does not mean it was discriminatory. It does not mean it was expropriatory. It does not mean it violated minimum standards of treatment of the law, and it does not mean that it violated the NAFTA.

Now, the goal here of these Allocable Share Amendments was so that the price of cigarettes would accurately reflect their true costs to society. The

01:14:00 states recognize that the perverse loophole ran directly contrary to the public interest, and so, in support of the public health goals of the MSA, they closed it.

And what we will show, Members of the Tribunal, is that these two actions offering grandfathered shares closing the escrow deposit loophole were reasonable regulatory steps with respect to both the grandfathered share and the Allocable Share Amendments. State regulatory agencies made sensible decisions. Those decisions sought to promote, they did promote their citizens public health and welfare.

The simple fact is these state regulatory decisions worked, and the question now is whether you, the Members of this Tribunal, ought to recalculate those complex state judgments.

Now, in the presentation you heard this morning, the Claimant said that somehow the MSA's provisions are not working perfectly. They went on to marshal evidence in criticism of the MSA. The question here, though, is not whether they worked

01:15:20 perfectly, but whether the Claimants have carried their burden of proving that they were discriminatory, expropriatory, or otherwise illegal under the NAFTA Chapter Eleven.

Now, they also have claimed that large manufacturers redoubled efforts to reach nonsmoking youth, even after the various steps were taken, but whether or not this is true, that's like saying that just because state regulatory measures didn't stop pollution that the Federal Government or other governments somehow owed money to smaller polluters simply as a way of giving them compensation.

NAFTA Chapter Eleven does not contemplate the Tribunal such as this one should undermine complex and balanced regulatory regimes or substitute your views on important policy issues for the considered views of governmental authorities who are plainly and effectively acting in the public interest. Those are the facts, and we will demonstrate them during these proceedings.

That brings me to your second role, the role of legal arguments. As a matter of law, by the

01:16:36 end of these proceedings, you will find that Claimants have not met their burden to establish any breach of any Chapter Eleven violation. What you will see is that the state tobacco laws that are applicable to Claimants are fully consistent with the protections that must be provided to all foreign investors and their investments under Chapter Eleven of the NAFTA.

Members of the Tribunal, this is a NAFTA case. As my colleagues will explain in considerable detail, contrary to the assertions of Claimants, Chapter Eleven did not vest this Tribunal with general jurisdiction to resolve any and all grievances that Claimants might assert against the U.S. under public international law. You sit here not as the Human Rights Council, and you sit here not as the Inter-American Court of Human Rights, although some of you are certainly qualified to sit on those bodies at the appropriate time and in the appropriate case.

But the question here about minimum standards of treatment is not the same as saying

01:17:43 that every body of human rights law or other law that's imaginable ought to be fed into the terms of this Treaty; and because Claimants cannot prove liability under the law that actually controls, their case should be dismissed.

Which brings me to the third role, a role you need not play, but if you do play it, you can sit not just as finder of fact, finder of law, but also as an assessor of damages to consider Claimants'Claimants' claim for monetary award. If you do play that role, please understand one thing: Claimants have asserted grave monetary losses. They have proven none of them. Indeed, the most striking thing about this morning's presentation, the dog that did not bark, was their failure even to allege this morning any damages.

But make no mistake. What they're asking you to do is to award them, depending on the calculation between $75 million or $268 million for their claim of losses--$75 million or $268 million--when they have, in fact, made no serious effort to carry their burden of

01:19:07 demonstrating genuine and concrete losses.

We will show this in great detail. You will see and hear many facts. What you will notice in particular is although Claimants claim future lost profits relying on limited and contradictory sales and costs data from the years 2006 and 2007, those losses are projected from entirely unreliable foundations. Claimants have not provided Audited Financial Statements from Grand River for those years. If you want 75 to 268 million, you ought to at least be able to document the losses in Audited Financial Statements.

And most obviously, Claimants attempt to pull a transparent bait and switch when. When they argue liability, they direct your attention to the activities of Grand River's on-Reservation distributor, Native Wholesale Supply. But when they move to their sweeping hundreds of millions of dollars of damages claims, suddenly they shift their focus to Grand River's off-Reservation distributor, Tobaccoville USA. The Claimants, we submit, simply cannot have it both ways. Claimants are entitled to

01:20:32 no relief for the simple reason they have demonstrated no liability and they have demonstrated no damages.

So, to divert the Tribunal from the weaknesses of their factual, legal, and damages case, the Claimants seek to paint this case throughout their papers as a case about discrimination based on their status as members of indigenous Tribes. Mr. Weiler said this morning we don't use the term discrimination. We use the term equality provisions. Equality provisions, he says, which are designed to prevent less favorable treatment, which sounds to me like discrimination.

And what they are claiming is they were discriminated against because the Settling States did not consult with private Canadian First Nations Investors before they adopted the measures challenged in this arbitration. The Claimants assert the failure to consult violated indigenous rights principles, which they claim were established as customary international law and peremptory norms of international law.

01:21:39 Now, Members of the Tribunal, as Legal Adviser, I am charged with upholding both the laws and Constitution and laws of the United States and U.S. obligations under international law. Each of those bodies of law, include, as you know, include the legal rights of persons to be free from racial discrimination. As an international lawyer, as a Professor, as a Dean, and a public servant, I have devoted most of my life, most of my career to the study and practice of human rights law, and that includes a deep commitment to the rights of indigenous persons. But you whatever you might hear, up close, it is clear that this case is not a case about human rights or indigenous law. Claimants have not shown that they suffered any form of invidious discrimination. The statutes they challenge are facially neutral. Those statutes do not distinguish in any way based on race or indigenous status. They've offered no evidence of animus by any State officials against either them or their investments based on race or indigenous status. Nor do they give any evidence that the

01:22:51 contested measures treated the investments of nonindigenous and indigenous tobacco manufacturers any differently from one another.

Now, notice, we are not saying that First Nations Tribes have not been discriminated against. The opposite. We understand and sympathize with the deeply felt historical grievances that Native Americans and Canadian First Nations have experienced. In November, President Obama gathered the opening of the Tribal Nations conference. He said to the tribes, we know the history we share; it's a history marked by violence, disease, and deprivation. That's a history we have got to acknowledge if we are to move forward.

But the hurt of these historical grievances does not suddenly give these Claimants' claim of discrimination here on these facts, much less a violation of the NAFTA. For even if the UN Convention for the Elimination of all Forms of Racial Discrimination, the CERD, could be applied to this proceeding, the Claimants don't make out the most elementary case under Article One, which

01:24:05 requires that an alleged mistreatment involve "a distinction based on race or ethnic origin which has the purpose or effect of nullifying or impairing the recognition, enjoyment, or exercise on an equal footing of human rights and Fundamental Freedoms."

And when the facts and the law are laid before you, you will see that the regulating states have not discriminated under the NAFTA, and they have treated Claimants no differently from the way they treat other cigarette manufacturers who are similarly situated.

What our case will show is that what Claimants are calling discrimination should really be called paying the true social costs of their dangerous product. Claimants'Claimants' status as members of indigenous groups did not confer upon them a right to continue to exploit a statutory loophole that had enabled them to pass along to others the social cost of their cigarettes.

And/nor have Claimants explained, nor could they explain how the norms they cite would require that they be compensated for the supposed legal

01:25:15 failure of the Settling States to consult with them before enacting measures that affect their business.

Notice how curious the Claimants'Claimants' argument is. They argue that under available principles of international law, before passing laws to protect their own general welfare and to protect the public health of their citizens, the states of the United States had a legal duty to consult with individual businessmen in Canada. But as this Tribunal well knows, even under the U.N. Declaration on the rights of indigenous peoples which the Claimants site, any such consultations occur between the states and their tribal representative institutions, not between states and individuals, not between states and businesses. To conduct vital aspects of tribal self-government, tribal authorities have to be able to speak and act on behalf of their group.

So, on examination, the principles of indigenous rights law actually cut not for but against Claimants'Claimants' argument. For this Tribunal to suggest that the United States has an

01:26:27 international law duty to consult with companies and individuals, not with the tribal authorities who represent them, would take the Tribunal well outside the scope of its NAFTA duties. It would distort indigenous law, and it would undermine the most basic mechanisms of tribal self-governance.

So, ironically, rather than being about discrimination, what this case is really about is misuse of indigenous status. Rather than operate their business under reasonable state regulations designed to protect the public health of consumers, Claimants have adopted a business strategy and tactics that frankly are designed to use indigenous connections to threaten the public health and then to shield themselves from legitimate laws and regulations.

So, in sum, Members of the Tribunal, this is an investment case. This is an investment case. It is not an indigenous case, and the law of indigenous peoples does not license Claimants'Claimants' improper use of indigenous status or license dangerous cigarette manufacturers

01:27:36 to exploit indigenous connections to jeopardize public health by shielding themselves from legitimate regulations.

And when you listen to the facts, when you listen to the law, when you hear the claim of damages over the next few weeks, a very consistent picture will emerge.

Now, the Claimants might like to divert your attention to exotic bodies of law, the 18th Century Jay Treaty, U.S. Federal Indian Law. I have to admit I enjoyed studying the Jay Treaty myself. It's not something that you do as an international lawyer every day, but if you fairly find the facts and apply the law that is actually relevant here, Chapter Eleven of the NAFTA, you will see Claimants have not proven an investment in the United States by Grand River. They have not proven discrimination of any kind. They have not proven any denial of justice or expropriation. They simply cannot make their case for liability or for damages on the facts or on the law, and this Tribunal should not accept Claimants'Claimants' invitation to reach out to

01:28:46 address broad-ranging grievances that are not before you and that are in no sense relevant to the investment provisions of the NAFTA that it is your duty to apply.

So, with that, Members of the Tribunal, let me now introduce our team. They will make in considerable detail presentations to support every element of the broader case I have just described. And before I turn the podium over to them, I would like to ask each to rise as I describe the role that they will play.

In a moment I will turn the podium over to Assistant Legal Adviser Jeffrey Kovar. He is the leader of our team, and he will be presenting to you in far greater detail the broad outlines of our case.

Following him in our opening argument will be the head of our State Department NAFTA team, Attorney Mark Feldman, who will present an overview of the Master Settlement Agreement and its related state measures that I've spoken about here so briefly.

01:29:52 And then, after the Claimants have presented their case, Mr. Feldman will return to address our jurisdictional defense under Article 1101, and he will be followed by Attorney Jeremy Sharpe, who will address Claimants'Claimants' failure to support their damages claim. He will point out, as I have just done, the total absence of damages or documented injuries.

And, next, we will demonstrate that there is no valid claim of liability under NAFTA Chapter Eleven. We will start with our Claimants'Claimants' expropriation claim.

First, Attorney Danielle Morris will address the factors of economic impact, character of the challenged measures.

Attorney Feldman will return to address Claimants'Claimants' alleged expectations with regard to their off-Reservation claim.

Jeff Kovar and Attorney Alicia Cate will then address Claimants'Claimants' alleged on-Reservation expectations with respect to both the Jay Treaty and the Federal Indian Law.

01:30:58 From that point forward, Attorney Jennifer Thornton and Jeff Kovar will answer Claimants' arguments regarding minimum standard of treatment in accordance with international law.

And finally, to complete our presentation, Alicia Cate will address the claims of violations of the national treatment and most favored Nation provisions of the NAFTA. She will at that time, Mr. Crook, answer your question about the difference in the standard between the Pope & Talbot Case and the UPS Canada case.

In sum, Members of the Tribunal, our team has prepared at length for this hearing. It very much looks forward to presenting our case to you. We are determined to demonstrate, and we will demonstrate over these next few days why Claimants'Claimants' case simply cannot stand.

Mr. Chairman, Professor Anaya, Mr. Crook, on behalf of my country, on behalf of our government, we thank you for your most careful attention.

PRESIDENT NARIMAN: Thank you.

01:32:24 MR. KOVAR: Mr. President, apparently there is a little bit of a technical problem with the feed for our slides, so if we could beg your indulgence for a couple of minutes while they fix that, then we can start the next part of the presentation. Thank you.

(Pause.)

MR. KOVAR: Mr. President, Members of the Tribunal, let me say it's an honor to appear before you today.

Claimants are Canadian tobacco manufacturers and exporters, Grand River Enterprises and their shareholders Jerry Montour and Kenneth Hill, and an importer and distributor, Mr. Arthur Montour, also I think, referred to today as Sugar Montour.

Claimants are responsible for selling, importing, and distributing billions of sticks of cigarettes each year in the United States. The heart of their argument is that they expect to be able to sell, import, and distribute these cigarettes, the most deadly addictive and

01:34:12 carcinogenic consumer product in the world free of state regulation.

Yet, when Claimants began exporting and distributing their cigarettes in the United States, it was already one of the most highly regulated markets for cigarette sales in the world. The web of state tobacco laws in the United States has been created in the public interest to reduce smoking and require the tobacco manufacturers provide funding to cover the social costs associated with their deadly products. Claimants have often evaded or refused to obey these state tobacco laws at issue here; namely, the Allocable Share Amendments and the complementary legislation.

And they have been subject to enforcement actions under those laws. Nevertheless, their sales are stronger than they have ever been.

Despite these facts, Claimants asked this Tribunal to award them a quarter of a billion dollars from the Government of the United States for damages allegedly suffered in violation of the NAFTA. To award Claimants damages here would

01:35:14 require that the U.S. taxpayers pay twice for the harm that the Claimants' addictive and carcinogenic cigarettes cause in the United States. In my presentation today and over the next 10 days, the United States will explain why under either the law or the facts Claimants have not made out a case under the NAFTA.

We will show that the Claimants' facts and figures underlying their story just don't add up. First, despite Claimants'Claimants' pleas about the destruction of their business, Seneca sales are stronger than ever.

Second, Claimants'Claimants' sales, importation, and distribution activities are occurring in significant part off-Reservation.

Third, Claimants' alleged on-Reservation market in the United States is largely a false front. This so-called "on-Reservation" market is overwhelmingly composed of customers who are not members of federally recognized Indian tribes and do not live on tribal lands. As a result, Claimants'Claimants' cigarette sales cause

01:36:16 significant off-Reservation effects in the various states.

Fourth, ClaimantsClaimants' Grand River, and Jerry Montour, and Kenneth Hill are Canadian exporters of cigarettes, who have no investment in the United States and do not meet the requirements of Article 1101.

These Claimants cannot have it both ways. They cannot insist before this Tribunal that they are engaged in a "vertical business association" with Claimant Arthur Montour and his solely owned company NWS, which is located in the United States and organized under the Seneca Business Code, while repeatedly swearing before U.S. courts that they only sell cigarettes in Canada, and they have no idea where they're going next.

Fifth, while Claimants place great emphasis on their so-called "on-Reservation activities when attempting to establish liability in this case, virtually their entire demand for damages concerns off-reservation sales. Moreover, those damage claims are completely unsupported. Claimants

01:37:20 present incomplete and misleading financial information, and they put forward damages theories that are built on presumptions about their brand value that are flatly inconsistent with their status, as I think what they called a fourth tier discount brand that competes almost exclusively on price.

Their experts' efforts to build a damages model on this basis are a failure.

Sixth, Claimants fail to make a case for violation of the national treatment or MFN provisions of Articles 1102 and 1103 because they fail to meet any of the three requisite elements of these claims. Treatment in like circumstances and that is less favorable by virtue of their nationality.

A failure to meet even one of these elements is sufficient grounds to dismiss the claims.

Comparison to grandfathered SPMs rather than NPMs simply makes no sense because Grand River was not in the U.S. market and was not able to take

01:38:22 advantage of the 90-day grandfather share in 1998.

Among other failures of proof, Claimants have utterly failed to allege much less prove any less favorable treatment by virtue of their nationality. As such, their Articles 1102 and 1103 claims should be dismissed.

Seventh, Claimants have no claim under the minimum-standard-of-treatment obligation in Article 1105(1). NAFTA Article 1105(1) requires the NAFTA Parties to provide investments of Investors those minimum protections guaranteed in the customary international law minimum standard of treatment. Claimants'Claimants' efforts to present Article 1105(1) as an open-ended Fair and Equitable Treatment provision under which the Tribunal is invited to conduct its own evaluation of U.S. domestic tobacco regulations and to range widely to apply certain international human rights and indigenous rights principles is flatly inconsistent with the legal provisions before this Tribunal.

The NAFTA Free Trade Commission has clearly stated in an interpretation that is binding on all

01:39:32 NAFTA Tribunals that Article 1105(1) guarantees only the customary international law minimum standard of treatment as applicable to investments.

Eight, Claimants'Claimants' effort to establish their case as one concerning discrimination against them on the basis of their indigenous status is--

ARBITRATOR ANAYA: So you disagree obviously or apparently with opposing counsel on the place of customary international law generally with regard to the minimum standard of treatment.

MR. KOVAR: We will address that in more detail, Professor Anaya. Our view is that the NAFTA Free Trade Commission has stated very clearly that the minimum-standard-of-treatment obligation under Article 1105(1) is the customary international law standard, and the burden on the Claimants is to establish that the standards that they are putting before you have been established under the customary international law minimum standard of treatment, and that's where we differ. It's not an open-ended invitation to bring in all customary international

01:40:49 law from all different areas of international law.

ARBITRATOR ANAYA: Just so I'm clear, we could pare this down to two levels of inquiry. One is what the scope is of of the relevant customary international law.

MR. KOVAR: Yes.

ARBITRATOR ANAYA: And you part company on that with opposing counsel.

MR. KOVAR: Yes.

ARBITRATOR ANAYA: They say it's any relevant customary international law including human rights law.

MR. KOVAR: That's right.

ARBITRATOR ANAYA: Another level is what is the content of that relevant customary international law?

MR. KOVAR: That's right. We differ on those.

Eight, Claimants'Claimants' effort to establish their case as one concerning discrimination against them on the basis of their indigenous status is, in all due respect, little

01:41:29 more than a facade. There is no evidence that the MSA States regulations treat Claimants in any way other than exactly like all other manufacturers that have opted not to join the MSA. Claimants cannot build a NAFTA claim on historical grievances that they may have with the United States.

Ninth, Claimants cannot make out a violation of Article 1105(1) based on the alleged violation of an international duty to consult and bargain with them before enacting the Allocable Share Amendments.

Tenth, Claimants' alleged expectations, whether they're based on assertions of U.S. Federal Indian Law or the Jay Treaty, are not justified, and they cannot support a claim that the minimum-standard-of-treatment obligation in Article 1105(1) has been violated.

11, Claimants have no denial-of-justice claim under Article 1105(1) because, as they admit, they have not exhausted their local remedies. There is no basis in Article 1105(1) or, in fact, for their claim that a denial of administrative and

01:42:36 regulatory due process has occurred.

12, Claimants' attacks on the state's MSA framework for regulating tobacco manufacturers in the U.S. market and ensuring that costs of future health damage are reflected in the current price of cigarettes in the U.S. market are disingenuous and cannot support an expropriation claim under Article 1110. Claimants would have the Tribunal believe that they have never engaged in any conduct that is worthy of regulation. But the sale of cigarettes alone merits regulation, given the dangerous nature of the product. Claimants demonstrate none of the elements for a claim of expropriation.

Finally, Claimants' ever shifting allegations and legal theories in this case do nothing but reveal the lack of factual and legal basis for their claims.

Now, I will take these points one by one.

As an initial matter, we find it extraordinary that the Claimants in this case demand well over a quarter of a billion dollars from U.S.

01:43:37 taxpayers when their exports of Seneca cigarettes to the United States are stronger than ever. As reported in March 2009, in the Buffalo New York, news, some industry executives believe the Seneca brand alone could push 10 billion cigarettes a year in volume. That would be 500 million packs of Seneca cigarettes each year. It must be remembered that these very Claimants previously alleged in this arbitration that the effect of compliance with the challenged measures is the complete destruction of the Investor's business and their investments. Indeed, nearly five years ago, Claimants made the following representation to this Tribunal: "There is a very good reason as to why the parties and Tribunal should move with great efficiency: Their investments are quickly dying because of the governmental conduct complained of in the Notice of Arbitration. In a nutshell, the Claimants may no longer be in business in the Territory of any of the 46 states in question, much less in the five states in which they have been able to remain operating if this arbitration was allowed to drag on for a number

01:44:46 of years".

Well, five years later, Claimants are most certainly still in business.

Claimants' pattern of alleging great harm to their cigarette business only to later reveal that Seneca sales are, in fact, thriving has continued through even their last pleading. It undermines their entire case. In their Memorial, Claimant sought so-called "on-Reservation damages in connection with sales in only four states: Arizona, California, Idaho, and Nevada. In their Reply, however, Claimants dropped California from their damages claim, acknowledging that Seneca sales in California have skyrocketed since 2004 and nearly doubled in 2008. Indeed, statistics maintained by U.S. customs and border protection show that the actual imports of Grand River cigarettes increased dramatically from 2007 to 2008, and through March 2009, which is the last statistics we were able to put in evidence in this Tribunal.

Imports were on track to exceed the 2008 level.

01:45:54 The sheer volume of Seneca sales undermines the core, indeed the fundamental premise of Claimants' on-Reservation claim. Claimants assert repeatedly that they had a expectation of freedom from state regulation of their so-called "on-Reservation" sales on the basis that those sales are made by Arthur Montour's solely owned company Native wholesale supply on a "Nation-to-Nation basis." The truth is, though, that Arthur Montour is fully aware that his company NWS is, in fact, conducting much of its importation, transportation, and distribution of Seneca cigarettes off Reservation and outside what is called Indian Country in U.S. law.

In addition--

ARBITRATOR ANAYA: Mr. Kovar, I'm pretty sure I understand what you think is the relevance of this point, but could you explain that to us, the relevance of this point you're making now of the off-Reservation effects of on-Reservation sales, the relevance of that to the NAFTA threshold that we need to--

01:46:59 MR. KOVAR: We will be developing that more, Professor Anaya, as we go along, but the Claimants use it in a number of different ways, but one way they use it is--

ARBITRATOR ANAYA: I see how they use it, but why are you making the point now?

MR. KOVAR: Well, we are countering it by saying that they couldn't have had an expectation that there would be no regulation of any of Mr. Montour's distribution activities because Mr. Montour's activities are not truly Nation-to-Nation. They actually have to move across great areas of the United States which are not Indian reservations, and as a result the states are permitted under Federal Indian Law to regulate those activities.

ARBITRATOR ANAYA: This goes to the Federal Indian Law issue?

MR. KOVAR: Yes, and we will be addressing that in some detail.

ARBITRATOR ANAYA: So, just so I'm clear, are you conceding that there is some kind of

01:47:55 distinction between off-Reservation versus on-Reservation scales?

MR. KOVAR: We will try to explain in some detail when we get to that part that--

ARBITRATOR ANAYA: I'm not saying it's necessarily a controlling distinction here, but there is some distinction that informs our analysis?

MR. KOVAR: There can be, yes, under Federal Indian Law, there is a distinction between when the states are permitted lawfully to regulate activities on-Reservation, and Ms. Cate, when she presents the Federal Indian Law section of our discussion, will go into that in great detail.

ARBITRATOR ANAYA: And that goes to the question of a legitimate expectation which, in turn, goes to the question of equitable or minimum standard of treatment?

MR. KOVAR: It's part of that. I mean, their question about legitimate expectations, their claim of legitimate expectations, in our view, is a claim that only arises under Article 1110, which is the expropriation chapter of the NAFTA.

01:49:04 But Claimants, as you heard this morning, also argue that legitimate expectations is part of the minimum standard of treatment analysis under Article 1105(1). We disagree with them on that point, and we will be also addressing that in much more detail when we come back to our more detailed presentations.

I hope that helps explain things.

PRESIDENT NARIMAN: I just to want take you back for a minute. You have given us a résumé of why you say that Seneca sales are stronger than ever before.

MR. KOVAR: Yes.

PRESIDENT NARIMAN: And you quote from various magazines and journals and so on.

Is this an admitted fact, or is this going to be proved? What's your case on this?

MR. KOVAR: Thank you, Mr. President. Unfortunately, I deleted two slides from this presentation because they are confidential, and we wanted to keep the opening arguments open, but one of the slides was from Claimants' expert,

01:50:07 Mr. Wilson, which showed that there were these enormous increases in sales in California, and the other slide that I was going to show you were the statistics from the customs and border protection agency in the United States, which show the dramatic increase in imports of Grand River cigarettes over the last few years.

I can describe it to you that way, but I can't show the numbers unless we turn off the feed, so we will do that when we come back to our more detailed presentations. I hope that's helpful.

In addition, Arthur Montour knows that his company NWS is serving an overwhelmingly off-Reservation market through its so-called "on-Reservation" sales. Again, as recently reported by the Buffalo News, Seneca cigarettes are available on hundreds of Internet Web sites, and much of the market for Seneca cigarettes exists in cyberspace.

A few examples illustrate this reality. As recently reported by the New York Times, fewer than 20,000 Indians live on-Reservation in New York, and last year more than 30 million cartons--that's

01:51:22 6 billion cigarettes with a retail value of nearly $2 billion--were sold on Indian lands. Those cigarettes amounted to nearly one third of all the cigarettes sold in the state of New York where cigarette excise taxes are the highest in the Nation.

The bulk of wholesale shipments to New York reservations last year went to two Tribes, the Possepatucks on Long Island and the Senecas of western New York.

The Claimants would have the Tribunal believe that Arthur Montour's company, NWS, is engaging in traditional Nation-to-Nation indigenous trade, but in reality NWS's market for Seneca cigarettes exists not on American Indian lands for Indian customers, but rather in the entire United States through Internet sales.

You can see on the screen, Mr. President and Members of the Tribunal, some screen shots from Internet sales portals from back in the spring.

Because Arthur Montour's importation and distribution activities occur primarily off

01:52:29 Reservation and have significant off-Reservation effects, Claimants hold no legitimate expectation of freedom from state regulation. Claimants Grand River, Jerry Montour, and Kenneth Hill fail to meet the requirements of Article 1101 because they have no investment in the United States. Claimants have offered a flurry of alternative facts and theories in an attempt to establish a vertically integrated association under the Seneca Business Code, but none of those theories can be reconciled with Grand River's own representations in U.S. court proceedings, which confirm that Grand River merely sells Seneca cigarettes to third-party distributors in Ontario, Canada, and retains no control over any subsequent distribution of those cigarettes.

As he stated in sworn testimony by the President of Grand River, Steve Williams, Grand River sells Seneca cigarettes to native wholesale supply in Tobaccoville at all times on an F.O.B. basis with title and risk of loss transferring to these third parties at Grand River's facility in Ohsweken, Canada.

01:53:42 Similarly, as stated by the President of Tobaccoville, Larry Phillips in sworn testimony in U.S. court proceedings, "GRE does not sell any cigarettes in the United States, and has no input into where sales are made, to whom, in what volumes, or the pricing."

The President of Grand River, Steve Williams, agrees. In his sworn testimony, observing that with respect to cigarettes sold by Grand River to Tobaccoville, Grand River never had any control about how or where these cigarettes were sold.

Claimants cannot have it both ways. Grand River's prior testimony sworn to on the pain of perjury before a court of law completely undermines Claimants' assertions in this arbitration. That Grand River and Arthur Montour executed joint sales strategy with Grand River and Arthur Montour having joint and several control over the Seneca trademark which Arthur holds for the benefit for Grand River.

In addition, Claimants' argument that a Grand River Native Wholesale Supply business association is constituted under the Seneca Nation

01:55:06 of Indians' Business Code is utterly without foundation, as Professor Goldberg observed. The Seneca Business Code does not even govern the establishment of business organizations under tribal law. Since the code does require a business operating on Seneca Nation Territory to procure a license, and Claimants' alleged association does not have one, Claimants make the extraordinary claim that the Business Code has an unwritten exception from licensing requirements for business associations between First Nation members where one member of the association is a member of the Seneca Nation.

By inventing such an exception, Claimants attempt to avoid regulation by the Seneca Nation just as they attempt to avoid regulation by the MSA States.

Even Mr. Schneider, the President of the Seneca nation stated recently, Seneca cigarettes are manufactured in Ontario, not in our territories. The Nation is in no way responsible for them or their contents. Thus, Claimants' bare allegations

01:56:08 of an investment by Grand River in the Territory of the United States are unsupported and flatly inconsistent with Grand River's sworn testimony in U.S. court proceedings. Nor do Claimants' alternatives--

ARBITRATOR ANAYA: Excuse me, are you going to get into this point some more later about the absence of any travel authority?

MR. KOVAR: Yes.

Nor do Claimants' alternative attempts to establish a Grand River investment in the United States related to a so-called inventory baseline of credit withstand scrutiny. The claims of Grand River and its shareholders Jerry Montour and Kenneth Hill should be dismissed for lack of jurisdiction.

Consistent with their failure to establish a failure of violation of NAFTA Chapter Eleven in this case, Claimants offer no credible support for their demand for hundreds of millions of dollars in damages. Indeed fundamental deficiencies run throughout Claimants' demand for damages. The demand should be rejected in its entirety.

01:57:10 Despite the extraordinary quantum of their demand, Claimants provide no audited Grand River Financial Statement after 2005 to establish their losses. Among the most important sources of financial data for any damages expert to review is a complete set of audited Financial Statements, including at a minimum statements for the years in which damages are being claimed. Yet Grand River presents no such evidence, even though they attempt to rely on sales and cost data from those missing years to project their lost future profits.

The sales and cost data they do rely on from those years is contradictory, it's uncorroborated, and it's otherwise unreliable.

PRESIDENT NARIMAN: Excuse me, Mr. Kovar, but is it your case that, despite being a corporation and a company governed by company law, there are no audited statements, Financial Statements? You have said Claimants do not provide, but I take it that company law here requires such statements to be filed with someone who is the registrar of companies and so on.

166

01:58:16 MR. KOVAR: Mr. President, they have not put into evidence in this proceeding after 2005 any Audited Financial Statements for Grand River Enterprises.

PRESIDENT NARIMAN: Is it not your suggestion that they have no audited Financial Statements?

MR. KOVAR: Well, not that we know. I would assume that our understanding from the evidence is that Grand River is incorporated in Canada and would have to comply with whatever laws there are in Canada.

PRESIDENT NARIMAN: And most laws, corporate laws, do have requirements that such annual Financial Statement, copies of them, be filed with the record of the company, Registrar or whatever that authority is.

MR. KOVAR: That's normal, yes, Mr. President. And NWS is incorporated in the Sack and Fox Nation in Oklahoma, and so their corporate requirements would be under the Sack and Fox Nation law.

167

01:59:06 PRESIDENT NARIMAN: But I'm talking of Canadian law which would be proximate to the laws here as well?

MR. KOVAR: Yes.

PRESIDENT NARIMAN: Thank you.

MR. KOVAR: Our expert, Navigant Consulting, has explained in some detail why the sales and cost data they do rely on instead of audited financial statement is unreliable.

Further weakening the reliability of the damages calculations put forward by Claimants' expert, Mr. Wilson, is a series of elementary errors that were contained in his First Report. Simply correcting for those basic errors, forced Mr. Wilson to slash Claimants' primary damages claim by over $100 million.

Moreover, even if they had presented accurate data, Claimants' entire brand impairment theory rests on the unsupported premise that the Seneca brand has value that is distinct from the underlying product; namely, discount cigarettes. As addressed by Navigant and as discussed in our

168

02:00:07 rejoined, this is not accurate. Claimants simply conflate the current income generating value of a product with the intrinsic value of a brand. Generic aspirin, for example, may generate millions of dollars in sales for its manufacturer, but it has by definition no brand value. Like generic products and unlike well established premium cigarette brands such as Marlboro or Camel, discount cigarettes have minimal brand loyalty, and they compete almost exclusively on price. Therefore, they have little or no brand value.

Claimants admit that small change in the price of their cigarettes can have an important effect on sales, which is not true of the premium brands. The actual value of the Seneca brand must, in fact, be demonstrated by evidence which Claimants have not done.

In addition, even assuming that the Seneca brand has significant value, the measure of that value cannot be established through lost profits but through the measures such as what a licensee would pay in royalties for the brand.

169

02:01:10 Furthermore, even in connection with their arguments about lost profits, Claimants fail to demonstrate that the challenged measures caused all of the lost profits they alleged. Claimants expressly recognize in their latest filing that a number of different factors can contribute to the level of consumption of tobacco products, but Claimants attribute 100 percent of lost profits to only one factor and that is the challenged measures in this arbitration. Claimants fail to address the very causation issues they highlighted in their latest written submission. Claimants' entire damages claim is Claimants' wholly unreliable and should be rejected.

Equally unsupported are Claimants' allegations of violations of the no less favorable treatment provisions of the NAFTA. With respect to the national treatment obligation under Article 1102, and the most-favored-nation treatment obligation under Article 1103, Claimants simply fail to allege any nationality-based discrimination at all, which is an essential element for any claim

02:02:11 under those provisions. The challenged Escrow Statutes present every tobacco manufacturer with the same choice, regardless of nationality: Either to sign the MSA as a subsequent Participating Manufacturer and accept the marketing and lobbying restrictions and payment obligations of membership, or remain a non-Participating Manufacturer that is free of those restrictions and obligations but require to make escrow deposits under the applicable Escrow Statute. There is not one piece of evidence that the laws treat foreign and domestic Non-Participating Manufacturers differently or that the impact of the rules differ according to the national origin of the manufacturers and sellers, the discrimination claims under Articles 1102 and Article 1103 should be dismissed.

Article 1105. Claimants offer the Tribunal a picture of the minimum-standard-of-treatment obligation in Article 1105(1) that bears no relationship to the obligations agreed upon by the three NAFTA Parties and subsequently clarified by them in a binding interpretation of the Free Trade

02:03:19 Commission. Article 1105(1) is not, as Claimants would assert, the basis for arbitral tribunals to conduct a broad-ranging review of domestic law and regulations. Nor does it call for Tribunals to substitute their sense of fairness and equity for that of domestic authorities. Rather, Article 1105(1) accords great deference to state regulation, setting out a strict and stringent customary international law standard the breach of which requires finding of wrongful conduct falling below that standard.

Claimants would have this Tribunal believe that Article 1105(1) empowers it to apply international law related to human rights and indigenous people in order to free Claimants from any regulatory restraint in selling their deadly and addictive carcinogenic product. But this case is not about the international law of human rights or the protection of indigenous rights, as Claimants would have you believe. NAFTA Chapter Eleven is an investment chapter, and Article 1105(1) of that chapter protects investment rights, not individual

02:04:32 rights.

That does not mean the individual rights of investors are s not protected in the United States--far from it--but Claimants have not shown that they have been subject to discrimination of any kind. The international law related to human rights and indigenous rights does not operate under Article 1105(1) as Claimants assert, to guarantee them minimum restraints and maximum profits for selling their deadly product.

Claimants' so-called discrimination claim under Article 1105(1) does not concern discrimination--

ARBITRATOR ANAYA: Are you saying that no human rights standards apply? I mean, let's say it's as deadly as you say product. I mean, you keep saying that, and it just makes me think, what if this weren't the same kind of product. Is it because it's a deadly product?

MR. KOVAR: No. It's not dependent on the type of product that's being sold.

ARBITRATOR ANAYA: All right. I just want

02:05:26 to be clear about that.

MR. KOVAR: We stress it--

ARBITRATOR ANAYA: I understand why you're stressing it because the other side makes certain arguments as well, but I just want to be clear on that. It's not because of the nature of the product that this analysis comes out as you say.

MR. KOVAR: No.

ARBITRATOR ANAYA: Are you saying that no human rights standards are relevant here? I'm not talking specifically about indigenous rights, but are you saying no human rights standards are relevant to the analysis under 1105(1)?

MR. KOVAR: Well, they're not relevant to this case, the case that the Claimants have presented.

ARBITRATOR ANAYA: But they could be relevant, if we're talking about this case, the treatment.

MR. KOVAR: They could be relevant--

(Overlapping conversation.)

ARBITRATOR ANAYA: They could be relevant

02:06:13 if we were talking about--if we can relate them to equitable treatment of Investors?

MR. KOVAR: They would be relevant if they were part of the customary international law minimum standard of treatment as applied to investments. If we look at the actual obligations of the United States under Article 1105(1), as they have been interpreted by the Free Trade Commission, we have to apply the customary international law minimum standard of treatment as it applies to investments.

ARBITRATOR ANAYA: I understand that, but what are those standards? I mean, you're saying you have to apply those, and I guess you're also saying they don't include human rights--

MR. KOVAR: Yes, and we will get into that in more detail. We will have a detailed presentation simply on Article 1105.

ARBITRATOR ANAYA: I'm confused. This was the third time we've touched on this. I thought this was the more detailed--

MR. KOVAR: We will get into it in more detail. I promise.

02:07:12 Yes, Mr. Crook?

ARBITRATOR CROOK: Just to be clear, Mr. Kovar, I mean I've always understood the customary minimum standard, for example, included denial of justice which I would think of as a human rights principle. Is that not right?

MR. KOVAR: Well, denial of justice, there's at least three standards that are always talked about in terms of minimum standard of treatment. One is denial of justice. One is--

ARBITRATOR CROOK: I'm just trying--I think we have got a certain confusion going on here about how we are using words, but isn't the debate not whether the customary standard incorporates human rights standards, but rather which ones?

MR. KOVAR: The question is which standards are incorporated in the minimum standard of treatment obligation, yes, I agree with that. Whether you characterize them as human rights standards or investment standards, in our view, is not the issue. The issue is the Claimants have to demonstrate what the standards are that have been

02:08:16 violated.

I don't know if that answers your question or not, but we will get into this in more detail, and we expect certainly that you will want to ask more questions.

PRESIDENT NARIMAN: Investment standards, to my mind, at least, speaking for myself, is not quite the same as human rights standards.

So, the question really is whether you would include human rights standards in a determination on a case-to-case basis, under Article 1105. That's the only point.

So, bear that in mind. I mean, don't answer it now, but when you make a detailed presentation, please do bear that in mind.

MR. KOVAR: We will. Thank you.

The fact that NAFTA Chapter Eleven is an investment chapter and that Article 1105(1) protects investment rights, not individual rights, doesn't mean the individual rights of Investors are not protected. The Claimants have not shown they have been subject to discrimination of any kind. The

02:09:24 international law related to human rights and indigenous rights does not operate under Article 1105(1) as Claimants assert to guarantee them minimum restraints and maximum profits.

Claimants' so-called "discrimination" claim under Article 1105(1) does not concern discrimination at all since Claimants can point to none. Rather, Claimants' alleged failure by the MSA States to affirmatively consult and bargain with Claimants prior to the adoption of the Allocable Share Amendments with the aim of granting Claimants a unique exception to the requirements of the law sets a principle that governments must bargain with private indigenous businessmen prior to taking regulatory action that might affect them simply doesn't exist in international law.

Claimants allege that such a consultation obligation is included within the Article 1105(1) minimum-standard-of-treatment obligation, but they point to no State practice or opinio juris to demonstrate its inclusion into the customary international law minimum standard provided in that

02:10:25 provision. There is simply no basis in the NAFTA or in international law for a duty to consult with the purpose of exempting Grand River from escrow deposit obligations under the amended Escrow Statutes.

Now, Claimants also allege that the MSA State actions have frustrated their legitimate expectations. Claimants allege they entered the U.S. tobacco market expecting to be free of state regulation with respect to their on-Reservation sales, and to receive large releases of escrow deposits in perpetuity with respect to their off-Reservation sales. The mere frustration of a Claimants' expectations does not give rise to claim under 1105(1) because Claimants fail to demonstrate such a principle is part of the customary international law minimum standard of treatment. An Investor's expectations, however, serve as one of several factors that international tribunals consider when determining whether a regulatory expropriation has occurred under Article 1110.

In any event, Claimants' alleged expectations in this matter are baseless.

02:11:31 Claimants allege that given their status as members of indigenous tribes, they held legitimate expectations that the importation, distribution, and sales of their cigarettes would be free of state regulation under Federal Indian Law and the 1794 Jay Treaty. Claimants misread the law. Under Federal Indian Law, as addressed by Professor Goldberg and as we will address in detail, Grand River's operations cannot be shielded from state regulation as purely on-Reservation activities. Grand River operates only on land that is located outside the United States, and it thus operates outside of Indian Country as that term is defined under U.S. Federal Indian Law.

Furthermore, because Claimants Grand River, Jerry Montour, and Kenneth Hill are not members of any federally recognized Tribe in the United States, they do not qualify as "Indians" under U.S. Federal Indian Law. As non-Indians conducting their manufacturing activities outside Indian Country, Grand River and its shareholders enjoy no protection from state regulation anywhere in the United States.

02:12:35 That's Grand River.

In addition, as it is addressed by Professor Goldberg, while Claimant Arthur Montour, the sole owner of NWS, is a member of a federally recognized Tribe in the United States, states do have authority under Federal Indian Law to regulate Native wholesale supplies' importation and distribution activities because those activities often occur in foreign trade zones and involve the transport of Seneca cigarettes across large areas of the United States outside Indian Country.

Moreover, Claimants' Indian customers could not possibly smoke the billions of cigarettes that Claimants sell in the United States. The sheer volume of Seneca cigarettes distributed by Arthur Montour's company and sold on scores of Internet Web sites confirms that the so-called on-Reservation sales of NWS are in fact largely serving an off-Reservation market and result in significant off-Reservation effects.

Concerning the Jay Treaty, Claimants make the astonishing claim that a provision that did not

02:13:36 allow their ancestors in 1794 to bring goods duty-free across the border in large baskets today gives them the right to import, distribute, and sell billions of cigarettes throughout the United States free from state regulation. With all due report, this is nonsense.

In any case, the duty exemption Claimants seek to rely on is no longer in force.

Claimants' alleged on-Reservation expectations under either U.S. Federal Indian Law or the Jay Treaty have no reasonable basis.

ARBITRATOR ANAYA: Just to be clear, you're going to get into this?

MR. KOVAR: Yes. We will address this in more detail as well during our 15 hours, yes.

Claimants'Claimants' alleged off-Reservation expectations are equally meritless. Specifically Claimants allege that the original Escrow Statutes included a promise of annual releases of escrow deposits for tobacco manufacturers that restricted their ambitions to maintaining a regional brand, as if somehow the MSA

02:14:36 States had invited NPMs to concentrate sales in certain states to minimize their escrow obligations. But as we addressed in our briefing and as we will address in this hearing in more detail, Claimants cannot transform what began as the clever loophole strategy of their legal and marketing teams into a prime goal of the original Escrow Statutes. In fact, the Escrow Statutes were intended to ensure that adequate funds would be escrowed to cover any future liabilities of NPMs for state tobacco-related health costs and that the price of all cigarettes in the market adequately internalize the future health costs of those deadly a detective and carcinogenic products. To have exempted so-called "regional NPMs" from most of their escrow obligations would have undermined the core purpose of the Escrow Statutes. For that reason, the Allocable Share Amendments were passed by MSA States to eliminate the loophole and restore the functioning of the MSA regime with respect to NPMs.

Claimants'Claimants' alleged off-Reservation expectations that large releases of

02:15:42 escrow deposits would remain available to so-called "regional NPMs" in perpetuity have no basis.

Claimants also raise a denial-of-justice claim under Article 1105(1) which fails because as they admit, they have not exhausted their local remedies. Indeed, Claimants further admit that they have no complaint with the U.S. justice system. Instead, their claim is for a denial of administrative and regulatory due process. According to Claimants, application of the challenged measures denies them justice because the original MSA agreement settled legal claims of fraud and conspiracy brought against the major Tobacco Companies, but those claims were never alleged against them. These arguments have no substance.

The Claimants ignore a fundamental fact. Unlike MSA payments made by Participating Manufacturers, an NPM retains ownership over its escrowed funds unless and until an MSA State is able to obtain a tobacco-related judgment against the NPM. If no MSA State brings a tobacco-related claim against Grand River, then Grand River has no risk of

02:16:50 losing ownership of its escrowed funds.

Moreover, as an NPM, Claimant Grand River is not subject to the MSA payment obligations, and the strict limitations on advertising and other conduct with which the Participating Manufacturers must comply. The NPM regime, which is distinct from but linked to the regime governing Participating Manufacturers is also fully justified by the most important state public health and welfare considerations. Nevertheless, even if this regulatory regime was not reasonable on its face and Claimants' characterizations of the MSA framework were accurate, these facts alone would not constitute a denial of justice under the customary international law minimum standard of treatment. Claimants must first exhaust their challenge to these measures in domestic courts before alleging that they deny them justice as a matter of international law. Claimants make no attempt to show remedies are not available in U.S. courts or would be futile. Their denial-of-justice claim is meritless.

02:18:02 Article 1110.

Claimants attack the character of the challenged measures throughout this arbitration. Their character, that is whether the measures are nondiscriminatory in nature and serve a legitimate public purpose is a key factor for determining whether a regulatory expropriation has occurred under Article 1110. The challenged state regulatory measures at issue in this case are measures to regulate tobacco. As we've said many times already, it's addictive, and it's carcinogenic, and it's a consumer project that every manufacturer and every tobacco merchant knows or they should know will endanger the health and the life of their customers.

There can be no question that the MSA regime serves critical public health interests of the MSA States and is implemented in a nondiscriminatory way. That regime includes the Allocable Share Amendments from manufacturers like Grand River that choose not to participate in the MSA, and complementary legislation to enforce the law with respect to both NPMs and the distributors

02:19:05 of their cigarettes.

The regime seeks to ensure that the price of all cigarettes in the market reflects their potential healthcare impact on their customers, and that sufficient funds will be available to MSA States for 25 years to satisfy any future tobacco-related judgments they may obtain against NPMs.

Unable to support their attack on the MSA regime, Claimants attempt to shift the burden to the United States, as we heard this morning. An entire section of Claimants' Reply Memorial, in fact, is entitled "Respondent fails to demonstrate the necessity of its measures." But recall it's the Claimants who bear the heavy burden of establishing that state regulation of the tobacco industry is discriminatory in violation of Article 1110, and the United States has--we have raised no necessity defense in response to these allegations.

It is beyond debate that states are accorded broad deference under international law when regulating in the public interest. The burden

02:20:06 is not on the United States to show that they are necessary or represent even the most effective regulatory approach.

Finally, Claimants complain that they have been subject to enforcement actions by the states. Claimants assert that this evidence--that this is evidence of a discriminatory intent aimed at destroying the value of their regional brand. However, Claimants' cigarettes that are brought into the states in violation of state complementary legislation are unlawful, and they're subject to seizure and fines. The fact that the states Attorneys General are serious about enforcing their laws adds nothing to Claimants' allegations of discrimination.

Now, Claimants argued this morning that in the Federal racketeering case against the major cigarette manufacturers, the RICO case, the U.S. Government denigrated the importance and the efficacy of the MSA. We will address this matter more fully in our later presentation by Ms. Morris. But we would note now that the defendants in the

02:21:12 RICO case argued that future-looking injunctive relief against them made no sense because the MSA completely and comprehensively precluded them from advertising and marketing in the ways they had in the past. In reply, the United States showed that the MSA did not prohibit all possible forms of cigarette company misbehavior, and that the state enforcement was limited by available resources. This does not mean, however, that the MSA was not effective or that it did not serve the public health. Clearly the states and Federal Government can still do more to reduce smoking and reduce tobacco sales by all manufacturers in the United States.

Claimants, who have not also demonstrated that their expectations have been frustrated or that they've suffered a taking of their investment establish no expropriation claim under Article 1110.

Claimants'Claimants' approach in this arbitration mirrors their approach to selling cigarettes in the U.S. market. Claimants challenge the authority of States to regulate their so-called

02:22:18 "Nation-to-Nation trade, but in reality those activities are not Nation-to-Nation at all. They occur in large part off-Reservation. And Claimants ultimately are serving an overwhelmingly off-Reservation market. Most of Claimants' market in the U.S. is actually persons living off Reservation who are not enrolled members of government recognized tribes and who purchase their cigarettes either from on-Reservation retailers or on Internet Web sites. In a similar fashion, in charging the United States with violating the NAFTA, Claimants invoke irrelevant, unproven, or incorrect principles and refuse to be constrained by the specific provisions of the Treaty on which they base their claim.

Moreover, they seek hundreds of millions of dollars in alleged damages but present no credible or consistent data or damages theory. It should be no surprise to the Tribunal that the Claimants have continued this approach, which was already on display in the jurisdictional rounds in this case of constantly shifting their claims and legal

02:23:15 arguments. Let us look briefly at how they have revised their arguments during the merits phase in an attempt to salvage a viable claim.

Five illustrations--five examples illustrate this point.

First, Claimants have reversed their position with respect to the harm allegedly caused by the original Escrow Statutes. At the beginning of this arbitration, when they were challenging the original Escrow Statutes, Claimants asserted that the Escrow Statutes were causing the complete destruction of their business. After that claim was dismissed on jurisdictional grounds, Claimants reformulated their contention to be that the original Escrow Statutes were entirely reasonable and permitted them to compete on an approximately equalized basis with the grandfathered SPMs. This is the claim you heard this morning. Thus, the original Escrow Statutes have abruptly changed in Claimants' case from measures that were destroying their business into measures that actually established a level playing field with grandfathered

02:24:10 SPMs.

Second, Claimants' demands with respect to the grandfather shares offered to tobacco manufacturers that joined the MSA within 90 days of its execution have shifted dramatically. In their Statement of Claim, Claimants argued that they were not privy to secret MSA negotiations and were never notified of the 90-day window for obtaining the grandfather shares. Claimant subsequently confirmed, however, that Grand River was not even exporting Seneca cigarettes to the U.S. market in 1998.

So, Claimants then revise their demand in their Memorial to assert not only that the grandfathered share was unreasonable and discriminatory, but that the NAFTA required the states to provide them as indigenous manufacturers with the comparable market share exemption in 2003.

Thus, Claimants ask the Tribunal to agree that they should receive a payment exemption comparable to that of the Grandfathered SPMs in perpetuity, but this would reward Claimants with a

02:25:13 substantial payment exemption for failing to sign the MSA until they had already built up a significant market share by avoiding MSA payments and making only minimal escrow payments. Nothing in NAFTA Article 1105(1) would suggest the Tribunal should substitute in this way its judgment for those of the States in a crucial state public health regime.

Third, regarding the relationship between Grand River and Arthur Montour's solely owned company NWS, Claimants initially maintain that Grand River and NWS's predecessor Native Tobacco Direct entered into a formal venture in 1999 by adopting a corporate structure and concluding written agreements in respect to the possession and use of intellectual property rights supporting their current and planned brands. Claimants even asserted the two companies served as corporate branches of some larger enterprise. But Claimants now say that the word "formal" was a typographical error and that the Grand River venture with Native Wholesale Supply is not something based on written agreements or

02:26:15 formal business charters, but rather on the Seneca Nation's Business Code.

Specifically, Claimants argue that the Grand River and NWS venture is, in fact, an association constituted under the Seneca Nation's Business Code because they--the two companies act in concert on Seneca Nation Territory. There is no more reference to corporate branches.

However, the Seneca Business Code has no provision for constituting associations or businesses of any kind what to do. Since the Claimants were actually operating a business venture together on Seneca Territory, they would need a business license, which they do not have. Claimants simply conjure up an unwritten provision of the code that they assert would exempt Claimants' association from that requirement. With all due respect, this kind of argument is simply fallacious.

Fourth, Claimants' allegations concerning the state markets that are relevant for their expropriation claim have shifted constantly throughout this case. As stated in their Statement

02:27:18 of Claim, Claimants allege that they have been completely excluded from the states of Virginia, Alabama, Kansas, Ohio, North Dakota, Wisconsin, and Michigan. Three years later in their Memorial, the relevant markets for their expropriation claim shifted abruptly. Now the relevant markets were five entirely different states, North Carolina, South Carolina, Oklahoma, Arkansas, and Georgia. Then eight months later with the filing of their Reply Memorial, the markets identified by Claimants appear to shift again.

In their Reply, Claimants' expropriation claim is now limited to only "three states." Where Claimants assert they have been substantially deprived of the benefits of the Seneca and Opal brands.

Today, Mr. Weiler suggested they may have a new list. However, Claimants fail to identify with precision which of the three states remain relevant for their expropriation claim.

Fifth, and finally, the denial-of-justice claim set forth in Claimants' Memorial bears little

02:28:23 resemblance to the denial-of-justice claim set forth in the Claimants' Reply. In their Memorial, Claimants emphasize their right to equal access to a host state's domestic courts in order to adjudicate claims concerning property rights of foreign investors and certainly before such property is confiscated. In their Reply, however, Claimants now assert that they have no complaint with the U.S. justice system, but rather are alleging that the denial of administrative and regulatory due process because they were never sued for the same things for which Liggett and the OPMs were sued.

Thus Claimants who have brought lawsuits in various state and Federal Courts across the United States recognize that it was frivolous to assert that they were denied access to U.S. courts by the challenged measures. Instead, now Claimants would have this Tribunal find that the states cannot regulate tobacco sales of NPMs like Grand River, including through the creation of an escrow obligation on the basis that they never sued them in the past.

02:29:27 Moreover, Claimants would say that it is inherently discriminatory to require escrow deposits to ensure the availability of assets in case of future lawsuits against manufacturers peddling a dangerous product. These allegations cannot credibly state the denial-of-justice claim under international law.

Let me now conclude by highlighting four final points, a few final points. This claim has been brought by a Canadian cigarette exporter and the owner of a U.S.-based cigarette importer and distributor whose cigarette sales are booming and would serve an overwhelmingly off-Reservation market throughout the United States. These businessmen attempt to rely on their status as members of Canadian First Nations to shield themselves from state regulation of the importation, distribution, and sales of Seneca cigarettes, billions of which they export every year. Such an attempt to avoid state regulation of the tobacco industry should not be countenanced.

Claimants' allegations in their most recent

02:30:27 submission of the existence of a business association under Seneca law cooked up an attempt to meet the jurisdictional requirements of this proceeding under Article 1101 are not only flatly inconsistent with sworn testimony by Grand River officials in other proceedings, but they're also inconsistent with their own earlier allegations in this arbitration. Claimants' damage model, which is premised on the purported value of the Seneca brand is also a concoction. It is inconsistent with Claimants' own characterization of Seneca cigarettes as a discount brand. In fact, I think we heard today a third or fourth tier discount brand that competes primarily only on price.

Claimants, who bear the burden of establishing the facts of their claims have presented supporting documentation that is vague, incomplete, contradictory, uncorroborated, and otherwise unreliable. In short, Claimants have failed to prove they have an investment in the United States under Article 1101. Claimants have failed to demonstrate any of the three elements

02:31:27 required under Articles 1102 and 1103 including the failure to even allege much less prove less favorable treatment by virtue of their nationality. Claimants have failed to prove a violation of the minimum standard of treatment under Article 1105(1) as interpreted by the NAFTA Free Trade Commission, and Claimants have failed to prove that their investment has been expropriated in violation of Article 1110. As such, no damages could possibly be owed here, and especially not on the basis of the severely unreliable evidence submitted in this case. Claimants' NAFTA Chapter Eleven claims should be dismissed in their entirety, and we would request full costs to be awarded to the United States under Article 40 of the UNCITRAL Arbitration Rules.

Thank you. I would now ask the Tribunal to invite Mr. Feldman to complete the U.S. Opening Statement by providing an overview of the MSA regime.

Perhaps, Ms. Small, you could let us know how much time we have left. Thank you.

SECRETARY YANNACA-SMALL: 3:14.

02:32:45 (Brief recess.)

PRESIDENT NARIMAN: Mr. Feldman, please.

MR. FELDMAN: Mr. President and Members of the Tribunal, it is an honor to appear before you today.

In the decision on jurisdiction in this matter, the Tribunal addressed the MSA regime in some detail. This week, the Tribunal will be hearing from, among other witnesses, representatives from offices of the Attorney General in several MSA States as well as a representative from the National Association of Attorneys General. Before hearing from those witnesses, we thought it would be helpful to provide an overview of the MSA regime, and in particular to highlight several aspects of that regime which are critically important for understanding the relevant facts in this case.

Those aspects include:

First, the distinctions between payment obligations under the MSA and escrow deposit obligations under the Escrow Statutes.

Second, the distinctions between the MSA

02:45:11 and the Escrow Statutes with respect to limitations on tobacco manufacturer conduct.

Third, the distinctions between the Escrow Statutes and complementary legislation with respect to the scope of regulated activity.

Fourth, the distinctions between manufacturers and distributors with respect to the applicability of deposit obligations under the Escrow Statutes.

Fifth, the calculation of deposit obligations under the Escrow Statutes.

And, sixth, the flaw in the Allocable Share Release provision of the original Escrow Statutes which required correction through the adoption of the Allocable Share Amendments.

As we have addressed in our written submissions, in the United States, much of the costs of treating cigarette-related diseases ultimately is borne by the states, which administer Medicaid and other health and welfare programs. Beginning in the mid 1990s, many states sued the major U.S. tobacco companies, seeking to recover costs they had

02:46:14 incurred in treating smoking-related illnesses as well as injunctive relief.

In those lawsuits, the states brought multiple causes of action which concerned both the conduct of tobacco manufacturers as well as the harmful nature of the cigarettes they produced. The lawsuit brought by the State of New York, for example, included multiple claims of fraud and misrepresentation, including allegations of "fraudulent, misleading, and deceptive statements and practices relating to the issue of smoking and health," as well as allegations that the defendants "conspired together for the purpose of fraudulently misleading the public."

The New York lawsuit also included claims concerning the harmful nature of the manufacturers' cigarette products including claims of strict liability, alleging that the companies manufactured, sold, and distributed tobacco products which "were likely to cause injury to persons who used them as intended."

Negligence: Alleging that, "it was

02:47:22 foreseeable by the defendants that certain New York residents who used their tobacco products would become ill and suffer injury, disease and sickness as a direct result of using the tobacco products as the tobacco companies intended."

And indemnity: Alleging the defendants breached duties to the public and to tobacco consumers, including "the duty not to place in the stream of commerce unreasonably dangerous tobacco products" and "the duty to make their products safe and nonaddictive."

The state lawsuits were settled by the MSA, which was entered into in November 1998 between 46 states, known as Settling States, and the four major U.S. tobacco companies. The objectives of the MSA were to resolve the Settling States' tobacco litigation while simultaneously addressing the states' strong public health concerns regarding tobacco use particularly with regard to underaged smoking. As stated in the recitals to the MSA, "the undersigned Settling State officials believe that entry into this agreement and uniform consent

02:48:26 decrees with the tobacco industry is necessary in order to further the Settling States' policies designed to reduce youth smoking, to promote the public health, and to secure monetary payments to the Settling States."

At the time the MSA was signed, the four Majors, referred to as Original Participating Manufacturers or OPMs, manufactured about 97 percent of all cigarettes sold in the United States.

The MSA included provisions addressing the remaining 3 percent of the U.S. cigarette market. Smaller cigarette manufacturers were permitted to sign on to the agreement as Subsequent Participating Manufacturers or SPMs and thereby obtain a broad release of tobacco-related claims from the Settling States.

In exchange for obtaining that release, SPMs are obligated to make annual payments to the Settling States in perpetuity and are subject to wide-ranging conduct restrictions. Those conduct restrictions include the following: No placement of tobacco brand names in movies or on television. No

02:49:29 placement of tobacco brand names on apparel or other merchandise. No use of cartoons in advertisements. No billboard advertising. No advertising at train stations, airports or other transit locations. No lobbying against potential future legislation on a variety of tobacco-related issues.

As an inducement for smaller manufacturers to sign the MSA and thus be subject to the MSA's conduct restriction, SPMs that signed the agreement within 90 days of its execution were granted a partial payment exemption or grandfather share. The SPMs that received partial exemptions, known as Grandfathered SPMs, are required to make payments for their cigarette sales in a given year only to the extent their respective market shares in that year exceed 100 percent of their 1998 market share or 125 percent of their 1997 market share, whichever is greater. Thus, those figures, 100 percent of a manufacturer's 1998 market share or 125 percent of the '97 market share, represent the grandfather share of each Grandfathered SPM.

15 SPMs signed the MSA within 90 days of

02:50:45 its execution and thereby received a grandfathered share. Through the inducement of the grandfathered shares, MSA States were able to increase participation in the MSA from over 97 percent of the U.S. cigarette market to 99 percent, thus following the 90-day offer of a grandfathered share, 99 percent of the U.S. cigarette market was represented by manufacturers that were subject to the conduct restrictions in the MSA.

Another 32 SPMs signed the MSA more than 90 days after its execution and thus do not receive a partial exemption from MSA payment obligations. Those SPMs are known as non-grandfathered SPMs. Non-Grandfathered SPMs include both U.S. and foreign cigarette manufacturers. Grandfathered SPMs likewise include both U.S. and foreign cigarette manufacturers.

OPMs and SPMs are known collectively as Participating Manufacturers. Under the MSA, Participating Manufacturers have agreed to make payments to the Settling States in perpetuity which by 2025 will exceed $200 billion.

02:52:02 Tobacco manufacturers are not required to sign the MSA. Those that do not are known as Non-Participating Manufacturers or NPMs. NPMs are not liable for payments under the MSA, nor are they subject to the MSA's restrictions on marketing and lobbying activities. The Settling States recognize that cigarettes manufactured by NPMs would also present multiple public health and fiscal issues for the states. In response to those issues, a Model Escrow Statute governing NPM sales was attached as Exhibit T to the MSA. The findings and purpose section of that model statute included the following points:

"Cigarette smoking presents serious public health concerns to the state and to the citizens of the state. The Surgeon General has determined that smoking causes lung cancer, heart disease, and other serious diseases, and that there are hundreds of thousands of tobacco-related deaths in the United States each year. These diseases most often do not appear until many years after the person in question begins smoking."

02:53:14 "Cigarette smoking also presents serious financial concerns for the state. Under certain healthcare program, the state may have a legal obligation to provide medical assistance to eligible persons for health conditions associated with cigarette smoking, and those persons may have a legal entitlement to receive such medical assistance."

"Under these programs, the state pays millions of dollars each year to provide medical assistance for these persons for health conditions associated with cigarette smoking."

"It is the policy of the state that financial burdens imposed on the state by cigarette smoking be borne by Tobacco Product Manufacturers rather than by the state, to the extent that such manufacturers either determine to enter into a settlement with the state or are found culpable by the courts."

"It would be contrary to the policy of the state if the Tobacco Product Manufacturers who determine not to enter into such a settlement"--

02:54:12 referring there to the MSA--"could use a resulting cost advantage to derive large, short-term profits in the years before liability may arise without ensuring that the state will have an eventual source of recovery from them if they are proven to have acted culpably."

"It is thus in the interest of the state to require that such manufacturers establish a reserve fund to guarantee a source of compensation and to prevent such manufacturers from deriving large, short-term profits and then becoming judgment proof before liability may arise."

Each of the 46 settles states has passed an Escrow Statute which follows the MSA's Model Escrow Statute. The escrow Statutes give each tobacco manufacturer the option either to sign the MSA as a Participating Manufacturer and therefore to be treated as an SPM or to remain a non-Participating Manufacturer and make deposits into an escrow fund.

In the event that Settling States are able to obtain future tobacco-related judgments against NPMs, the Escrow Statutes provide a source of

02:55:21 recovery for those states to satisfy such judgments. Under the Escrow Statutes, a Settling State can access escrow funds to satisfy any tobacco-related judgment that it obtains against an NPM so long as the judgment falls within the definition of "released claims" under the MSA.

The definition of "released claims" under the MSA is quite broad and includes, "claims directly or indirectly based on, arising out of, or in any way relate, in whole or in part, to, A) the use, sale, distribution, manufacture, development, advertising, marketing, or health effects of; B) the exposure to, or; or, C) research, statements or warnings regarding tobacco products. Thus, escrowed funds under the Escrow Statutes are available to the Settling States to satisfy any such tobacco-related claims against NPMs.

Deposit obligations under the Escrow Statutes are measured by the collection of state excise taxes, while payment obligations under the MSA are measured by the collection of Federal excise taxes. Specifically under the Escrow Statutes, an

02:56:40 NPM's escrow deposit obligation is based on the number of its units sold in a given state, and "units sold" is defined as the number of individual cigarettes sold in a given state as measured by the collection of state excise taxes on packs bearing a state excise tax stamp.

Cigarette sales which are not subject to state excise tax stamping requirements do not give rise to escrow deposit obligations under the Escrow Statutes.

Because cigarette sales must be subject to state exercise tax to give rise to deposit obligations under the Escrow Statutes, a cigarette manufacturer's escrow obligations in a particular MSA State are linked to that State's excise tax policy with respect to cigarettes. As addressed by Deputy Attorney General Brett DeLange in his second declaration in this case, in the State of Idaho, "There is no escrow obligation for cigarette sales to Idaho Indian Reservations where the purchaser is an enrolled tribal member or a business wholly owned and operated by an Idaho Indian tribal member."

02:57:56 No escrow obligation arises from such sales because, as addressed by Mr. DeLange, under an Idaho tax regulation, no state excise tax applies to such sales.

The State of New York similarly exempts on-Reservation sales from state excise tax as a matter of public policy. That state policy is discussed in a declaratory judgment complaint filed by the State of New York and included by Claimants as Exhibit 42 in their Core Bundle of documents. In that complaint, New York sought a declaratory judgment construing the meaning of "units sold" under the New York Escrow Statute to exclude cigarette sales for which excise taxes are not collected by New York as a matter of public policy.

In light of that state excise tax policy, on-Reservation sales of Seneca cigarettes in New York do not give rise to escrow obligations under the New York Escrow Statute.

For cigarette sales that are subject to state excise tax and thus subject to escrow deposit requirements under the Escrow Statutes, the per

02:58:56 cigarette escrow deposit obligation for NPMs for 2007 sales is approximately two-and-a-half cents per cigarette sold. That amount is roughly equivalent to the per cigarette payment obligations of OPMs and of SPMs for sales above any applicable grandfathered share under the MSA.

The only entity subject to deposit obligations under the Escrow Statutes are Tobacco Product Manufacturers as that term is defined under the statutes. A tobacco product manufacturer is defined as an entity that "manufactures cigarettes anywhere that the manufacturer intends to be sold in the United States. So long as a manufacturer intends for its cigarettes to be sold in the United States, only the manufacturer and not any U.S.-based importer, distributor, or reseller of the cigarettes qualifies as a Tobacco Product Manufacturer under the Escrow Statutes."

With respect to the deposit obligations that apply to Tobacco Product Manufacturers, there are several important differences between those deposit obligations and the payment obligations of

03:00:08 Participating Manufacturers under the MSA.

First, each Participating Manufacturer makes an annual payment to one central agent which then distributes the funds to the Settling States according to fixed percentages known as "allocable shares." A non-Participating Manufacturer, by contrast, makes annual deposits into multiple escrow accounts, each of which corresponds to a settling state in which the cigarettes are sold.

Second, a Participating Manufacturers' payments under the MSA are based on nationwide sales. The escrow deposits of a non-Participating Manufacturer by contrast are made on a state-by-state basis with each annual deposit corresponding to NPM sales in a particular settling state.

Third, Participating Manufacturers do not retain ownership over their MSA payments, and those payments are distributed directly to the Settling States. NPMs, however, do retain ownership over the funds they deposit into escrow.

In addition, NPMs are paid interest on

their deposited funds as that interest is earned.

The original Escrow Statutes included an allocable share release provision which was intended to ensure that an NPM's deposit obligations under the Escrow Statutes would not exceed what that manufacturer's MSA payment obligations would have been had the manufacturer been an SPM under the MSA. The allocable share provision enabled NPMs to obtain a release of escrow deposits in the event of such an imbalance between a manufacturer's escrow deposit obligations and hypothetical MSA payment obligations.

Although the Settling States did not realize it at the time, the formula for calculating the amount of the release under the Allocable Share Release provision was flawed. Specifically the formula compared an NPM's deposit obligations in a given state with the amount the state would have received as its allocable share of the manufacturers' nationwide payments had the manufacturer been an SPM under the MSA. Because each State's allocable share represents the state's

share of a manufacturer's nationwide sales, the Allocable Share Release provision operated as intended when NPM sold their cigarettes on a nationwide basis. But some NPMs discovered that they could exploit the formula by concentrating their sales in only a few MSA States.

As stated by the Tribunal in the Decision on Jurisdiction in this arbitration, "Each State's share of MSA funds is based on its proportionate share of national cigarette sales covered by the MSA regime. Thus, for example, a state with 1 percent of all national sales of covered cigarettes would receive 1 percent of all funds paid in by the Participating Manufacturers. If a NPM sold all of its cigarettes in that state, it would have to escrow there an amount roughly corresponding to the amount it would have paid to the national MSA fund were it a PM. However, pursuant to the allocable share provisions, it could then receive an immediate refund of 99 percent of the escrowed funds because the state would receive only 1 percent of the manufacturers' payments if it were a party to the

MSA.

NPM's exploiting the Allocable Share Release provision in this matter was able to obtain releases of escrow deposits on a massive scale. For NPM sales in 2003, NPMs obtained releases of well over half of the escrow funds they had deposited. Specifically, of 236 million in escrow deposits, 137 million was released back to NPMs. Such releases of escrowed funds undermined the core goals of the Escrow Statutes.

Released funds would no longer be available for Settling States to satisfy any future tobacco-related judgments against NPMs. The largest releases of escrowed funds were obtained by NPMs in the very states that had received the greatest concentration of harmful NPM cigarettes, and NPMs receiving large releases of escrowed funds were able to maintain lower prices for their cigarettes, driving up demand among price-sensitive consumer, including smokers under age 18.

Simply put, the flawed formula for calculating Allocable Share Releases under the

original Escrow Statutes had to be corrected. While this flaw seems obvious today, it was not obvious in 1998, when the MSA was signed. However, the flaw quickly became apparent in practice when NPMs adopted sales strategies to exploits it.

The Allocable Share Amendments corrected the flawed release mechanism by amending the formula for determining the amount of an NPMs' release. Rather than comparing an NPMs' escrow deposit obligations to the state's allocable share of the manufacturer's hypothetical MSA payments, the amended formula compares the NPMs' escrow deposit obligations in a given state with what the manufacturer would have had to pay for those sales under the MSA.

Under the release provision as amended by the Allocable Share Amendments, an NPM can no longer avoid escrow deposit obligations by concentrating sales in only one or a few MSA States.

There is another crucial aspect of the MSA regime applicable to NPMs that Claimants challenge, the enforcement provisions called "state

218

03:05:38 complementary legislation," which had been enacted by most Settling states. The state complementary legislation addressed difficulties that had been encountered by states when attempting to enforce NPM deposit obligations under the Escrow Statutes. In his first declaration, Mr. DeLange provided examples of the kinds of enforcement difficulties the State of Idaho had faced under the Idaho Escrow Statute. As stated by Mr. DeLange, "In 2001, Idaho sued Kisanlal Bastiram Sarda, a Tobacco Company located in India, for failure to comply with Idaho's MSA Act." They're referring to their Escrow Statute. "the state attempted service only to be rebuffed because of the Tobacco Company operated behind an armed compound and the process server was unable to penetrate the compound to effect service. This company never paid escrow on its cigarettes sold in Idaho."

As an additional example of the State of Idaho's enforcement difficulties under the Escrow Statutes, Mr. DeLange discussed the state's attempts to bring Grand River into compliance with its Escrow

219

03:06:46 Statute. With respect to Grand River's escrow obligations in Idaho, it is important to note once again that Idaho law exempts from state excise tax requirements cigarette sales to Idaho Indian reservations where the purchaser is an enrolled tribal member or a business wholly owned and operated by an Idaho Indian tribal member. And thus those sales do not give rise to escrow obligations under the Idaho Escrow Statute. But Grand River is subject to escrow obligations in Idaho for sales of Seneca cigarettes that occur off-Reservation and thus are subject to state excise tax.

With respect to Grand River's escrow obligations under the Idaho Escrow Statute, Mr. DeLange stated, "the State of Idaho sued Grand River in 2002 as a result of Grand River's violations of Idaho's MSA Act," again, Idaho's Escrow Statute.

"On September 5th, 2002, the Idaho District Court enjoined Grand River from selling any cigarettes in Idaho whether directly or through a distributor until Grand River takes steps to comply

220

03:07:50 with Idaho law, including establishing a qualified escrow fund and certifying its compliance to the Attorney General, neither of which Grand River has done."

Grand River is located in Canada and it has proven very difficult for the state to enforce or collect upon its judgment under the Idaho MSA Act. To date, Grand River is still in violation of the District Court's order.

Accordingly, the State of Idaho, like most Settling States, adopted complementary legislation to address such enforcement difficulties under the Escrow Statutes. The complementary legislation requires all cigarette manufacturers whose products are sold in a given state to file an annual certification with the State Attorney General and/or the State Revenue Department. In its certification, the cigarette manufacturer must attest that it is either, one, a Participating Manufacturer making payments under the MSA; or, two, a non-Participating Manufacturer making deposits under the applicable Escrow Statute.

221

03:08:49 The complementary legislation also requires the state to maintain a directory of Tobacco Product Manufacturers that are currently in compliance with either the MSA or the state Escrow Statute. Under the complementary legislation, if a manufacturer is not listed in the state directory, it is unlawful for any person to hold, own, possess, transport, import, or cause to be imported that manufacturer's cigarettes, where the person knows or should know that the cigarettes are intended for distribution or sale in violation of the statute.

Any person violating the complementary legislation is subject to civil penalties. The Escrow Statutes and complementary legislation differ in scope in several respects. Deposit obligations under the Escrow Statutes apply only to tobacco product manufacturers as that term is defined under the statutes.

Under the Escrow Statutes, a Tobacco Product Manufacturer includes any manufacturer regardless of their location that manufacturers cigarettes intended for sale in the United States.

03:09:56 A U.S. importer of cigarettes is not included in the definition of "Tobacco Product Manufacturer" under the Escrow Statutes so long as the manufacturer of the cigarettes intends for them to be sold in the United States.

The complementary legislation, by contrast, applies to any person who holds, owns, possesses, transport, imports, or causes to be imported cigarettes that the person knows or should know are intended for distribution or sale in violation of the statute.

Given the differences between the Escrow Statutes and complementary legislation with respect to the scope of activities being regulated, there are corresponding differences under those measures with respect to when regulation is triggered. Because escrow deposit requirements for manufacturers under the Escrow Statutes are tied to units sold, a deposit obligation is triggered upon the sale of cigarettes for which state excise taxes are collected. Under the complementary legislation, by contrast, regulation of any purchase is triggered

03:10:57 from the moment that person causes cigarettes to be introduced into a state, given that the complementary legislation applies not only to the sale of cigarettes, but also to their possession, importation, and transportation where the manufacturer of those cigarettes is not included on the applicable state directory.

Returning to the six key aspects which were identified at the outset of this presentation, I would provide the following summary: First, with respect to distinctions between MSA payment obligations and deposit obligations under the Escrow Statutes, NPMs retain ownership over their escrowed funds while Participating Manufacturers lose ownership of the funds they pay pursuant to the MSA.

Second, with respect to limitations on tobacco manufacturer conduct, the MSA imposes wide-ranging marketing and lobbying restrictions on Participating Manufacturers while the Escrow Statutes impose no such conduct limitations on NPMs.

Third, with respect to distinctions between the scope of regulated activity under the Escrow

03:12:01 Statutes and complementary legislation, escrow obligations arise from the sale of cigarettes in an MSA State, while the complementary legislation applies not only to the sale of non-compliance cigarettes, but also to their importation, transport, and possession.

Fourth, with respect to distinctions in the applicability of deposit obligations to manufacturers and distributors under the Escrow Statutes, only Tobacco Product Manufacturers as defined under the statutes are subject to deposit obligations under the Escrow Statutes. So long as the tobacco manufacturer intends for their cigarettes to be sold in the United States, only the manufacturer and not any U.S.-based importer, distributor or reseller qualifies as a tobacco product manufacturer under the Escrow Statute.

Fifth, the calculation of escrow obligations under the Escrow Statutes is determined by the number of cigarettes sold for which state excise tax has been collected. Sales of cigarettes which are not subject to state excise tax do not

03:13:03 give rise to escrow obligations.

Six, the flawed formula for calculating the amount of an NPMs' release under the original Escrow Statutes was corrected by the Allocable Share Amendments. The formula was based on a mistaken assumption that manufacturers sold cigarettes nationwide. NPMs exploited that flawed formula by concentrating their sales in only a few Settling States.

Under the amended release provision, an NPM can no longer obtain large releases of escrow deposits by concentrating its sales in only a few states. Thus, an NPMs' escrow obligations in each state now more accurately correspond to the NPM's sales of cigarettes in that state.

This overview of the MSA regime completes our opening argument in this matter. I would be happy to take any questions from the Tribunal concerning the regime either at this time or at a later stage in the proceeding.

PRESIDENT NARIMAN: Thank you.

ARBITRATOR CROOK: Thank you, Mr. Feldman.

03:14:06 And I would really address this to both parties and not to be addressed now but in your future discussions.

You say that the Allocable Share Amendments were the correction of a mistake. Claimants say the Allocable Share Amendments were the unreasonable revocation of a deal that was implicitly offered to them and that they accepted.

I'm not aware of a whole lot of contemporaneous evidence for either position in the records. So, as you discuss this, I would be interested in anything that either side could point us to that provides contemporaneous support for one view or the other as opposed to, you know, the declarations of one side or another that today here is how we saw it, but is there any contemporaneous evidence for either view in the record.

MR. FELDMAN: The evidence we have in the record, Professor Gruber addresses the release, and also there is the American Law Report on the MSA, which makes clear that the assumption was that manufacturers would operate on a nationwide basis.

03:15:18 In terms of evidence of it being a flaw, given that the states--given that the NPMs receiving the largest release were receiving that release from the very states in which--the very states that were receiving the largest influx of cigarettes, it's just so directly contrary to the core goals of the statute that it simply makes no sense to argue that any kind of flaw on that scale would have been anticipated because it undermines the entire purpose of the Escrow Statutes. All of the goals are undermined when you have these large releases, prices fall, and NPMs are able to enjoy a competitive advantage. It's just directly contrary to the entire scheme.

MR. VIOLI: Would you like a response from our side?

ARBITRATOR CROOK: In due course. I have a quick--

MR. VIOLI: I will give a short answer to it.

The Cigarette Manufacturing Agreement with Tobaccoville and the evidence showing that the sales

03:16:25 for Grand River going to a few states off-Reservation for purpose of the allocable share at the time when it learned of the allocable share provisions demonstrated that change in the business plan--

ARBITRATOR CROOK: I'm familiar with that, Mr. Violi. But what evidence do you have for your claim that you were essentially offered a deal and you accepted it? It's just the conduct you've just described?

MR. VIOLI: Right. It's the statutory compliance. We came into compliance.

ARBITRATOR CROOK: You came into compliance.

MR. VIOLI: Right.

ARBITRATOR CROOK: And that's your evidence that you were offered a deal.

MR. VIOLI: Not offered a deal. That was opposed--as opposed to joining the MSA. You had two choices.

ARBITRATOR CROOK: I understand, and you--but your pleadings are full of representations

03:17:02 that you were implicitly offered a deal and you took it.

MR. VIOLI: They never say we were offered a deal. They said we were faced with that set of circumstances, and it went into the expectations whether we thought the states would continue keeping that law in effect. Implicitly, we expected the law to be as if it was handed to us as we faced it at the time we came into compliance. But there was never a deal by the states coming to us and saying--no state has ever come to us and said, listen, this is what you have to do instead of joining the MSA, get Escrow Statute releases.

PRESIDENT NARIMAN: Okay. Thank you.

(Discussion off the record.)

MICHAEL G. HERING, RESPONDENT'S WITNESS, CALLED

DIRECT EXAMINATION

BY MR. FELDMAN:

Q. Mr. Hering, thank you for appearing here to testify. I will ask you a few questions, and then counsel for Claimants may wish to cross-examine you.

Would you state your full name for the

03:41:13 record.

A. My name is Michael Glenn Hering.

Q. Where do you currently work?

A. I am currently employed by the National Association of Attorneys General.

Q. And what is your position at NAAG?

A. My title is Deputy Chief Counsel for MSA Payments in the Tobacco Project of NAAG, as we call it.

Q. Were you asked to prepare a declaration in this matter?

A. Yes, I was.

Q. And what did you address in your declaration?

A. I addressed the Allocable Share Amendment.

Q. Okay. Thank you.

PRESIDENT NARIMAN: Yes.

CROSS-EXAMINATION

BY MR. LUDDY:

Q. Okay. Good afternoon, Mr. Hering.

Can you restate again your title.

A. My current title is Deputy Chief Counsel

03:42:00 for MSA Payments.

Q. And are you with NAAG or some group within NAAG?

A. I'm with NAAG, the National Association of Attorneys General. We have I suppose what might be called colloquially "divisions" within NAAG. However, we term them "projects," and the term I used was the "Tobacco Project."

Q. Tobacco Project.

And how does the Tobacco Project relate to the Tobacco Committee?

A. The Tobacco Committee, you're referring, I supposed, to the committee to which General Sorrell was the chair?

Q. Correct, correct.

A. Let me try to explain first of all what NAAG is because I think that background is necessary.

NAAG is an unincorporated association of the Attorneys General of the 50 United States, D.C., Puerto Rico, and for outlying territories. We call them all states for ease of reference, so that would

03:43:03 be 56 States' AGs.

PRESIDENT NARIMAN: N-A-A-G?

THE WITNESS: Correct.

It's an unfortunate acronym, but yes, that's what I'm saying. The National Association of Attorneys General, NAAG for short.

I am employed directly by NAAG. I report ultimately to our Chief Executive Officer, the Director of NAAG. His name is Jim McPherson.

NAAG has what I suppose in the private sector what would be considered a Board of Directors. That Board of Directors is known as the Executive Committee. It consists of 12 Attorneys General from the 56 states.

That is, as I say, the Executive Committee, and then there are a number of subject area committees: Antitrust, environment, consumer, and tobacco. And from time to time there are--there has been chairs, chairpersons, of the Tobacco Committee. At one time, General Sorrell was the Chair of the Tobacco Committee.

BY MR. LUDDY:

03:44:18 Q. Okay. And does the Tobacco Committee still exist?

A. Yes, it does.

Q. And who is presently the Chair?

A. Presently we have two co-chairs. They are Attorney General Martha Cokely from Massachusetts and Attorney General John Bruning from Nebraska.

Q. Okay. And you said in response, I think, to a question from Mr. Feldman that the purpose, as you understood it, of your declaration was to explain how the Allocable Share Amendments came about; correct?

A. I said it was addressing the Allocable Share Amendment, yes.

Q. I guess we could agree it's not a complete explanation of how the Allocable Share Amendments came about, is it?

A. I was referring to my answer to Mr. Feldman, but I can--I can and will explain that--

Q. Excuse me, that isn't my question. My question was: Can we agree that your declaration

03:45:18 does not provide a full explanation of how the Allocable Share Amendments came about?

A. Yes.

Q. That's a yes or no.

Thank you.

PRESIDENT NARIMAN: If you want to complete anything, please do. Don't let anybody stop you. If you want to complete it, you can.

THE WITNESS: Thank you. I would.

Yes, I would degree that my declaration, being as short as it was, is not a full and complete explanation of the Allocable Share Amendments and how they came about, but I would be happy to provide that, and I will.

The MSA, as you know, gives Participating Manufacturers--I'm sorry, Tobacco Product Manufacturers a choice of either becoming part of the MSA that is settling the states and become a Participating Manufacturer and making payments to the states and abiding by the public health restrictions under Section 3 of the MSA or remaining as a Non-Participating Manufacturers making payments

03:46:24 into escrow or, rather, deposits into escrow and not subjecting themselves to the public health restrictions contained in Section 3 of the MSA.

There was contained in the original Model T Escrow Statute, the statute that was enacted in each of the MSA Settling States, a provision regarding the release of escrows. The escrows, as you heard, were deposited and then could be released upon three conditions:

First, it was upon a judgment or settlement; that is, if the states obtained a judgment on a release claim against a company or if there is an intervening settlement. For instance, we do from time to time have Non-Participating Manufacturers who decide to become Participating Manufacturers. At the time they become Participating Manufacturers, they must deposit monies into--pay monies over to the states as part of that settlement. They can use the monies in the escrow account to satisfy those payments.

The third condition for release of the escrow accounts is after 25 years. Now, some of

03:47:39 you--I'm not sure this was addressed, but why 25 years? The reason for 25 years is because the harm we are talking about here, which, of course, is likely to be some form of cancer, has a latency period. There is a time before--from the time at which a person begins to smoke until the disease begins to show itself and the state incurs the associated costs. Therefore, the money remains in escrow for that period of time, should the state wish to bring an action to recover.

Then there is the third--in the statute it's actually the second condition for release, which is the Allocable Share Release provision, and this provision was meant to ensure that the nonparticipants never had to deposit more than they would had they been a Participating Manufacturer. The concern here was essentially a variation of the equal protection concern sometimes thought of as an unconstitutional conditions concern; that is, that we were concerned that, to become a Participating Manufacturer, one must give up certain rights that they might have under the First Amendment to

03:48:52 advertise and sell their cigarettes in a particular way. We did not want it to be said that companies would be able to--would be forced economically to have to give up those rights in order to reduce their payment obligation.

The problem was that, as has been said, the original provision had a flaw. Rather than comparing the amount to place into escrow against the amount that the company would have to--have had to pay as a Participating Manufacturer for the same cigarettes, it compared the amount placed into escrow versus what the state would receive. That wouldn't have made a difference had the NPMs in question been like the Original Participating Manufacturers, the large companies that were sued, selling in a great number of states because, to take advantage of the Allocable Share Release mechanism, you had to, number one, concentrate your sales in a particular state; and, number two, do it in a state with a low allocable share. There are states where the allocable shares are some 12 percent--New York and California--and to obtain an allocable share

03:50:14 release in those states would be difficult. In fact, no one has ever been able or no one has ever gotten an allocable share release in those states.

It became apparent after a number of years that, among other things, Non-Participating Manufacturers were exploiting the allocable share loophole to be able to sell their cigarettes in a small number of states, receive nearly an entire--the release of nearly their entire deposit made under the Escrow Statute, thereby defeating the purposes of--the original purposes of the Escrow Statute and undermining the Master Settlement Agreement as well.

The Allocable Share Release amendment was meant to address this problem.

BY MR. LUDDY:

Q. You have led well into my next question. Could you look at Page 4 of the Counter-Memorial which I have given you a copy of there, sir.

MR. LUDDY: Actually, I'm showing him briefly Respondent's Counter-Memorial, just to read a sentence.

03:51:31 PRESIDENT NARIMAN: Okay.

BY MR. LUDDY:

Q. The first full paragraph, there is a sentence that starts as follows: "But the allegation of such entitlement or specific commitment is unsupported by evidence and logically unsupportable, given that the continued avoidance of escrow obligations by NPMs would have undermined the very purpose of the original MSA-related measures: To ensure adequate funding sources for Settling States in the event that those states were able to obtain future tobacco-related judgments against NPMs."

Do you see that language?

A. Yes.

Q. Okay. And we heard similar explanations today from our friends as to the purpose of the Escrow Statutes, didn't we, during openings? You were here for those, weren't you, sir?

A. Yes.

Q. Is that the stated purpose here, adequate funding sources for Settling States in the event the

03:52:37 future tobacco-related judgments against NPMs, is that the only purpose of the original Escrow Statutes?

A. The purposes of the Escrow Statutes--that is, the Model T Escrow Statutes--are enumerated in the Preamble to the Model T statute, and I believe there is more than one. I believe Mr. Feldman reviewed them. It is--and this is going by my recollection since I do not have it in front of me--yes, one, to ensure the adequate funding sources for the Settling States; and, number two, to ensure that the companies not exploit--sell cigarettes in a--let me back up for a moment.

To ensure that a company not sell cigarettes and become judgment-proof before the time that a judgment can be obtained against a company, and I think that's more or less the same thing.

And, number three, I would say to create a level playing field between the NPMs and Participating Manufacturers.

Q. Is there any other purpose--is there any other reason that you could think of, any other

03:54:24 purpose that you could think of, for the Escrow Statutes?

A. I do not have the Model T in front of me.

Q. That's fine. Let me ask it to you differently.

What happens to a state under the MSA that doesn't enact an Escrow Statute? Or what could happen to a state under the MSA that does not enact an Escrow Statute?

A. Okay. The MSA contains an adjustment known as the "NPM adjustment." This adjustment is not automatic. It is potential. And the NPM adjustment has a number of conditions. The NPM adjustment is potential and sometimes large downward adjustment in the payments to the states. It comes into play when several conditions have been met, number one, when the shipments of the Original Participating Manufacturers are lower than they were in the base year, which is 1997, and those shipments have declined in every year. In fact, in the first 10 years that the MSA was in existence, sales of cigarettes have declined by nearly 25 percent over

03:55:58 all.

Number two, there must be a market share loss of the Participating Manufacturers; that is, Non-Participating Manufacturers must have more than 2 percent greater than--greater market share than the market share that they had in the base year.

And, number three, there must be a determination made by a firm, an economics firm, serving as a sort of arbitration panel that the MSA was a significant factor contributing to the market share loss in the year in question.

Once those conditions are met, an NPM adjustment can be had, except that the states can insulate themselves from an NPM adjustment by enacting and enforcing an Escrow Statute. This was agreed to by the parties--that is, the Participating Manufacturers--and the Settling States, and both of them had reasons to protect the gains of the MSA. At the time the MSA was made, the settlement was made, and within the 90 days thereafter where the first set of SPMs--that is, Subsequent Participating Manufacturers--joined the MSA, there were--there was

03:57:36 99.6 percent of the U.S. market under the MSA; that is, 99.6 percent of the U.S. market was a Participating Manufacturer in the MSA. That means that they were subject to the multiple public health restrictions that you've heard about. That is no more T-shirts with Marlboro on them, no more belt buckles, leather jackets, billboards, hats; no more Joe Camel; no more other cartoon advertising; no more marketing to youth in youth magazines. All of those public health restrictions came into play, and they applied to 99.6 percent of the U.S. market. Only less than one half of the U.S. market did not--was not subject to the public health restrictions of the MSA.

The states recognized that to impose a cost on the Participating Manufacturers and then to do nothing with the nonparticipants could very well result in the undermining of this great public health achievement. That is, if the Participating Manufacturers were paying $5 a carton, nearly $6 a carton now in 2010 and the nonparticipants were not obligated to either pay or abide by the public

03:59:05 health restrictions, we could in a short number of years have a situation where the nonparticipants comprised a great percentage of the U.S. market. And it might not be Joe Camel, but we might be looking at some new cartoon figure, new billboards from NPMs, new marketing to youth. All of the public health achievements of the MSA would seemingly be undermined and disappear within a short period of time.

Therefore, the states passed the Model T Escrow Statutes in an effort to ensure that Non-Participating Manufacturers, while they wouldn't have to abide by these public health restrictions, would at least be putting aside an amount of money that was roughly equal to but always less than no more than equal to what they would have to pay had they been a Participating Manufacturer. And by asking them or requiring them to put aside these monies ensured that they could not come into the U.S. market, sell a great number of cigarettes at a very large price advantage and become judgment-proof both for the time that liability was--

04:00:33 PRESIDENT NARIMAN: The question was not that. The question was: What if a state did not have such a statute? That was the question.

THE WITNESS: I'm sorry, I thought I got to it. Maybe it was buried in the question.

As I said, there was an NPM adjustment, and the NPM adjustment has a number of requirements. Those requirements have actually been met in each of the years since the MSA has been in effect. However, a state can insulate itself against an NPM adjustment by passing and enforcing a Model Escrow Statute. If a statute does pass--I'm sorry, if a state does pass and enforce a statute, it prevents the downward negative adjustment from being assessed against its payment.

BY MR. LUDDY:

Q. So, then, succinctly, if we could, do you agree that one of the purposes of the Escrow Statutes was for each state to try to prevent itself from losing MSA payments to an NPM adjustment?

A. I would agree that that was one of the reasons, although not the only that the states

246

04:01:45 passed the statute.

MR. LUDDY: For the record, I will indicate I didn't suggest that it was. Thank you.

BY MR. LUDDY:

Q. Can you look at the document to your far left.

MR. LUDDY: For the Tribunal, there is one of the two documents that I handed up previously.

BY MR. LUDDY:

Q. Can you identify this document, sir.

A. Yes. This is a memorandum that accompanied a resolution that was transmitted to the membership of NAAG--that is, the Attorneys General that comprise the membership of NAAG--and the document this memo accompanied was a resolution in support of the Allocable Share Amendment.

The brief background on this was I, as I have stated in my affidavit, had been, among other people at NAAG, providing testimony in a number of states in favor of the Allocable Share Amendment. My testimony was quite often opposed by a number of entities, including CITMA, the Council of

247

04:03:05 Independent Tobacco Manufacturers in America, and on occasion NPMs and on occasion other groups. One of the things these groups maintained occasionally was that NAAG--that is, NAAG proper meaning not my office but the membership, the 56 Attorneys Genera--did not support the Allocable Share Amendment. To ensure that there is no question as to the support of the Allocable Share Amendment by our membership, the 56 AGs, we sought and obtained a resolution in favor of the Allocable Share Amendment.

ARBITRATOR CROOK: Mr. Luddy, could you or Mr. Hering give us an indication of the approximate date of this. What we have here does not show a date.

MR. LUDDY: There is not a date on it. I will give Michael--I will suggest to Michael that at the end it says "17 states have already passed." So, judging from that, I was placing it sometime in '04ish.

THE WITNESS: I would agree it was '04ish. I could give you a more exact date.

248

04:04:11 MR. LUDDY: We will stipulate to '04ish. Sometimes precision has its place, though; right?

BY MR. LUDDY:

Q. Let me read to you the first sentence, Mr. Hering: "The attached resolution expressing support for state legislation amending the model Escrow Statutes enacted pursuant to the tobacco Master Settlement Agreement is designed to close a loophole in existing law that is costing the states many millions of dollars."

Do you see that?

A. Yes.

Q. And specifically I will draw your attention to the phrase "many millions of dollars."

What are the many millions of dollars that the resolution is referring to there?

A. I believe that this is referring to money lost by an increase in the volume adjustment--that is, a downward adjustment--in the Master Settlement Agreement because of the loss of volume by Participating Manufacturers to Non-Participating Manufacturers.

249

04:05:25 The volume adjustment was meant to compensate the Participating Manufacturers when they essentially--they did not sell cigarettes. Their volume decreased. There are essentially three major adjustments to the--any payment in a given year. The downward adjustment is a volume adjustment. The upward adjustment is the inflation adjustment, and then there are some other minor ones.

Participating Manufacturers may lose volume for two reasons. One is simply that they don't sell cigarettes any longer because consumption has gone down. And as I mentioned, in large part, I believe, because of the MSA, consumption has gone down, sales have gone down, nearly 25 percent in 10 years, which is something that the Attorneys General are very pleased with. And then there is the volume adjustment that may be attributable to sales made to Non-Participating Manufacturers instead of Participating Manufacturers.

In the time frame of 2002-2003, leading up to the time of this memo, which, as we agreed, is probably around 2004, there were great increases in

04:06:45 NPM sales that were fueled by two events, primarily, one of which was exploitation of the allocable share loophole. As my affidavit states, the--in 2003 alone, the releases of the monies into the allocable share--into the escrow deposit accounts were upwards of 58 percent; in other words, of the 100 percent that went it, over 58 came back, and that number is probably understated because a few states where there were--allocable share releases were given were not part of those figures, and I can tell you that I know that some of the companies in particular were getting releases of upwards of 90 percent individually. There were some that didn't get any release. There were many that didn't get any release.

The other thing that was going on that was fueling high NPM growth was simply scofflaws, companies that made it their business model to break the law.

MR. LUDDY: Excuse me. Is there any chance that we could--I'm all for a witness having a full opportunity to answer the question. Is there any

04:07:58 way that we can somehow, though, have him answer the question and then stop rather than go into different categories, different subject matters that I'm ultimately going to reach?

PRESIDENT NARIMAN: That depends upon the interview because normally the position is that you ask a question, he may say yes or no and then amplify if he wants to. And if he wants to amplify, that's his privilege because he's a witness. You can't prevent him from answering.

MR. LUDDY: I have given up on yes or no. Trust me. But an answer as opposed to an ad hominem speech on matters altogether unrelated to the question. It's just something I suggest we consider.

BY MR. LUDDY:

Q. Go ahead, Mr. Hering.

PRESIDENT NARIMAN: But you are finished, I take it?

THE WITNESS: I was wrapping up.

And so, coming back to the question of the memo, and I'm--the many millions of dollars each

04:08:59 year was the increase in NPM sales, as I say, fueled by two reasons: Scofflaw NPMs and the allocable share--exploitation of the allocable share loophole. This memo, as I explained earlier, is meant to deal with one of those issues: Exploitation of the allocable share loophole.

The sentence--the reason I brought up the other one is this memo does not distinguish between the two issues, and mathematically, with the data available, we are incapable of distinguishing as to how much of the NPM growth was fueled by NPMs simply not abiding by the Escrow Statute versus the Allocable Share Release loophole, and that's why I bring up the--both problems.

BY MR. LUDDY:

Q. Okay. Now, the next sentence says every state, including the four previously Settled States, suffers injury from this loophole.

Do you see that?

A. Yes.

Q. Now, the previously settled states, they do not have Escrow Statutes; correct?

04:10:14 A. That's correct.

Once again, this is referring to the volume adjustment. The previously settled states are paid in a way that is very similar to the MSA. However, they are only paid by the major Participating Manufacturers, the OPMs, of which at this time there were four: Philip Morris, Reynolds, B&W, and Lorillard.

And what's important to understand here, and I believe it was explained but I'll underscore it is that Participating Manufacturers pay based on their national sales; that is the amount that any one State receives, whether it be California, which is a participating MSA State or Florida, which is a nonparticipating state, will depend on the Participating Manufacturers' sales in all 50 states. Therefore, when a Participating Manufacturer loses sales to a non-Participating Manufacturer because that NPM is exploiting a loophole under the Allocable Share Amendment or is failing to abide by the law altogether, it affects the payments not only to the MSA States but also to the previously Settled

04:11:29 States.

Q. But that first paragraph, and specifically the many millions of dollars each year, that is not referring, sir, to Escrow Statutes released under the Allocable Share Release provision; correct? That's addressed in the next couple of paragraphs; correct?

A. I believe that's correct.

Q. Okay. And having foreshadowed, I will jump down to the third paragraph, midway through it talks about Escrow Statutes being also dealt with in the context of the Allocable Share Amendments; correct?

A. I've lost you on which paragraph we're talking about.

Q. It's the third paragraph.

A. The third full paragraph--

Q. Yes.

A. --starting: Each of the 52 Settling States?

Q. Yes.

A. Okay.

Q. And it points out that a loophole in the

04:12:20 statute, however, the Allocable Share Release permits some manufacturers to get back most of their deposit within a few days; right?

A. Yes.

Q. Okay. Now, NAAG, and I take it from your declaration, you personally were very active in trying to get the Allocable Share Amendment passed across the country; correct?

A. Yes.

Q. And the states, in terms of dollars and cents, putting aside the health-care issue for a moment, from NAAG's perspective, was it more important for the States to pass allocable share, the Allocable Share Amendments, to further protect their payments from the Participating Manufacturers or to make sure that they had sufficient security in the escrow accounts? Which was--which was a greater concern to NAAG and the Settling States?

A. Number one, I don't think we can put aside the public health issues because the MSA is--and I saw the presentation earlier today, but I would greatly disagree with it. The MSA is first and

04:13:45 foremost about public health.

And let me underscore this: That, as I have said more than once already, the MSA has resulted in great declines in the consumption of cigarettes, from over 480 billion in the year before the MSA began to down to 360, less than 360, I believe, or thereabouts in the most recent year, over a hundred billion cigarettes. And those are cigarettes, because they are not being sold, on which the states will never be paid. We will receive no MSA payments for cigarettes that are not sold.

However, as one of our member AGs has said, it's the best money we never got because we save more in avoiding the public health costs resulting from the death and disease than we lose in payments.

So, when you ask me how do I quantify the value of the Allocable Share Amendment versus ensuring whether we're receiving the payments versus the money in escrow, first of all, I think that both of those are public health goals, and I honestly have never considered that question before, and I

04:15:17 don't know that I could answer which one is superior. There--

Q. You know what, let's look at it and see if we can't quantify it right here.

Can you open to document number 11 in the core documents.

A. Is that this document?

Q. Well, it's one of those. It's the one that's got 11 tabs.

PRESIDENT NARIMAN: Respondent's?

MR. LUDDY: I'm sorry, Claimants'.

BY MR. LUDDY:

Q. Can you identify Claimants' Core Document 11, please, sir.

A. This is the September 12, 2003, memo from the Tobacco Committee chair, Attorney General Bill Sorrell, that was referred to in the opening by Mr. Violi.

Q. Okay. And the title of this document is: Alert, Reduced Tobacco Settlement Payments and Request for Important Information.

A. Yes.

04:16:42 Q. I'll read some. I may ask you to read some later, but I'm reading from the first paragraph, the last sentence or two, last two sentences: We anticipate that the total payments to Settling States on April 15, 2004, will be approximately 5.78 billion--with a B. It will be distributed amongst the states as shown at Tab A-1 attached hereto. Total payments to the previously settled states on December 31st, 2003, are expected to be about 1.1, and will be distributed amongst the states as shown at Tab A-2.

Next paragraph: These payments are net of reductions totaling about $2.5 billion caused by the volume adjustment applicable to all agreements. One of the principal contributors to this revenue loss is the accelerated increase in sales of cigarettes by NPMs.

And then your colleague--is Mark Greenwald still with NAAG?

A. No, he's left as Chief Counsel.

Q. Chief Counsel? He's chief--

A. He was Chief Counsel for the Tobacco

04:18:07 Project. He has resigned as Chief Counsel--

Q. Okay.

A. --and he is no longer with NAAG.

Q. Okay. At the time--I guess he was your colleague.

Were you here--were you at NAAG by this time? You were, right?

A. I was.

Q. So your then-colleague concludes that page with the sentence at the bottom, and if you could read that for me, please: These results...

A. (Reading) These results underscore the urgency of all States taking steps to deal with the proliferation of NPM sales, including enactment of the complementary legislation and allocable share legislation and consideration of other measures designed to serve the interests of the States in avoiding reductions in tobacco settlement payments.

Q. Okay. Now, you--in other words, Mr. Greenwald and Mr. Sorrell, who I think we identified earlier as the chair of the Tobacco Committee and at the time he was the Attorney

04:19:02 General from the State of...

A. And still is, for Vermont.

Q. Vermont. Thank you, sir.

They were encouraging all Attorneys General, Chief Deputies, and state tobacco contacts to press for Allocable Share Amendments on the basis of this memo because the states were losing a ton of money from the OPMs because of the increasing NPM sales; correct?

A. Only partially. The loss is from the Participating Manufacturers as a whole.

Q. I thought I said that. I'm sorry.

A. You said the OPMs.

Q. I'm sorry.

A. And as I explained earlier, the issue that we were trying--or issues that we were trying to deal with with complementary legislation and the Allocable Share Amendment were NPM growth fueled by, on the one hand, noncompliance with the statute; that is simply scofflaws, rogue NPMs that made it their business model to break the law. That was how they survived and grew.

04:20:11 And, number two, NPMs that exploited the Allocable Share Release mechanism.

And yes, we were urging states to adopt both the Allocable Share Amendment and complementary legislation.

Q. Turn to Page 2, please. The last sentence: "We estimate that of $2.5 billion lost to the states because of the volatile humanity adjustment, $600 million is the result not of the client and smoking, but rather of NPM sales displacing sales by Participating Manufacturers."

Correct? Did I read that accurately?

A. You read it accurately.

However, I'd like to explain that you seem to be saying that what I said earlier--this is in contrast to what I said earlier about not being able to quantify. And let me explain that what I was saying earlier was not that we couldn't necessarily quantify the diminution in the payments as a result of a decrease in consumption; that is the sale of cigarettes versus the diminution in payments as a result of the volume adjustment attributable to a

04:21:26 shift in market share from PMs to Non-Participating Manufacturers. What I was saying was that we could not necessarily quantify the diminution in payments under the volume adjustment as a result of NPM scofflaws; that is NPMs that did not abide by the statute alone versus NPMs exploiting the allocable share loophole.

I'd also like to point out the paragraph that comes just before the sentence that you read, that the reduction in settlement payments resulting from an overall reduction in cigarette consumption benefit the states because of the healthcare costs imposed by each cigarette exceed the settlement payments, which is what I was pointing out earlier.

PRESIDENT NARIMAN: Where is that?

THE WITNESS: It's on Page 2 of the memo in the beginning of the last full paragraph, starting "reductions."

PRESIDENT NARIMAN: "Reductions."

BY MR. LUDDY:

Q. Okay, so, we have $600,000 so far. And this is without--

04:22:32 A. 600 million.

Q. 600 million, right. Thanks. 600 million.

And we haven't even gotten to the NPM adjustment yet; right? In this memo.

A. That's right. The NPM adjustment is not 600 million.

Q. Right. I think down below there is a paragraph that your colleagues wrote: (Reading) In addition to these reductions to the volume adjustment, the increased--that's NPM--sales create exposure for a potential NPM adjustment for the Settling States. We believe that the potential NPM adjustment applicable to sales in 2003 may exceed $1 billion.

A. Yes.

Q. Right? Okay. That's 1.6 billion.

That was either exposed to loss under the NPM adjustment or done in 2003 because of the volume adjustment; correct?

THE WITNESS: That's correct. The NPM adjustment for 2003 was actually about 1.1, and it is--but once again, I'd like to point out that

04:23:42 whereas the volume adjustment is an automatic adjustment, it's a reduction in payments because sales are not being made by the Participating Manufacturers. The NPM adjustment is a potential negative adjustment. The 1.1 amount is something that we are actually currently engaged in arbitration with the Participating Manufacturers to determine whether it will apply or not.

Q. Right. It's still out there. The exposure still exists. This many years later; right?

A. Yes.

Q. So, is it fair to say NAAG was a little bit concerned about that $1 million back in 2003 when Allocable Share Amendments were being pushed?

A. 1 billion, yes.

Q. 1 billion, thank you.

All right. That was 1.6.

Now, if you could look at your declaration, which is 59 of the core documents. 59 of the core documents.

A. I have it.

Q. And in Paragraph 3, you indicate that in

04:25:04 2003, the same calendar year that was the subject of the numbers we've just been pursuing; correct?

A. Yes.

Q. In 2003, you report that (reading) NPMs deposited a total of approximately $236 million into escrow on account of sales made in the MSA Settling States. Approximately 137 million of these deposits were 58 percent of the original amount deposited was released back to NPMs through operation of the Allocable Share Release mechanism.

Do you see that?

A. Yes, I do.

Q. Okay. So, by amending allocable share--by pursuing the allocable share amendments, the states were looking to thwart the release of 137 million in 2003; right? Actually, in future years, but for purposes of order of magnitude is the nature of my inquiry; correct?

A. You are right. It is for future years. We were attempting to close the allocable share loophole which resulted in the release of, in this year, upwards of 58 percent of the amount of escrow

04:26:32 deposited.

Q. And you were also looking to reduce the states' exposure to reduced payments arising out of increasing NPM sales, and those possible reductions, as we just established from core document 12, for 2003 totals 1.6 billion; correct?

A. Well, again, I see where you're going, and I'm not sure that's a fair comparison.

Number one, the Allocable Share Amendment--I'm sorry, the NPM adjustment again is about 1.1 billion, and it is a potential downward adjustment. We are still litigating or arbitrating over it. We don't know whether it will apply. Yes, it was a concern.

Of the 600 million, the decline in smoking but the NPM sales, displacing NPM sales, if I could touch on that for a moment. Mr. Violi opened up with a slide, suggesting--I think it showed the NPM market share for a number of years, and it showed that it was a bit over 8 percent in 2004, which was, I believe--2003 and 2004 were essentially the height of NPM market share as measured under the MSA.

04:27:50 As I had said earlier, NPMs started out at less than one half of 1 percent in the year that the MSA began, rose to somewhere above 8 percent and then declined.

They declined in '04 to '05 by a little over 2 percent, and that decline in itself is almost exclusively the result of one Participating Manufacturer, General Tobacco, becoming a Participating Manufacturer. That is in '04. It was a non-Participating Manufacturer. Its market shares that year was about 1.9 percent, nearly 2 percent. And when it shifted from a NPM to a PM, naturally the NPM market share declined by at least 1.9 or nearly 2 percent.

So, some of that was something else, but most of it was General Tobacco. Then NPM market share declined slightly again I think in the next year, and then ticked back up the next two years.

So, aside from General Tobacco, NPM market share has been roughly flat or slightly increasing the last few years.

The reason I bring that up is, although

04:29:10 this memo quantifies the 600 million as the amount attributable to NPM sales displacing PM sales, it does not quantify how much of that NPM growth is attributable to the exploitation of the NPMs of the allocable share loophole and noncompliance with the Escrow Statutes versus simply competition in the marketplace, and I would say that that's not possible or at least beyond my professional capacity to estimate because I simply don't have the data. I don't think this memo was attributing all of the 600 million to NPM growth as a result of the Allocable Share Release mechanism.

Q. You know, you mentioned, when I compared the 1.6 billion that they might lose from the PMs, which, by the way, you were here for closings; right? I remember one of our friends mentioning a dog that doesn't bark.

Do you remember anybody from the State Department mentioning at all this morning in the context of the Escrow Statutes the fact that they exist as you acknowledge at least in part to protect the states' payments from the Participating

04:30:30 Manufacturers?

PRESIDENT NARIMAN: I'm sorry, I couldn't follow that question.

THE WITNESS: I think it was--

MR. LUDDY: I will withdraw it.

THE WITNESS: It was a reference to Sherlock Holmes.

PRESIDENT NARIMAN: Okay.

BY MR. LUDDY:

Q. Is that true?

A. Yes.

Q. I compared the 1.6 that they could lose from the NPMs with the 137, I think, that was released to them, and you suggested that at least with respect to the 1.1 billion, it is a potential loss; right?

Money that the states received from the PMs, where does that go? MSA payments?

A. Well, contrary to, I suppose, some perception that that's not part of my job description, it's not something I track.

Q. And I--you know what--and I'll--you can

270

answer it as you wish, but just so you know, I'm actually--I was looking just to see whether they get the money and they have control over the money--
A. Okay.
Q. --as opposed to the escrow accounts.
A. I see.
Q. Feel free.
A. Payment--I'll give you the relatively brief answer, which is that payments by the Participating Manufacturers are paid into a consolidated account held by Citibank and then distributed to the Settling States pursuant to a formula which is Exhibit A to the MSA which specifies the allocable share, which is where the name comes from for the release mechanism, of each MSA State. Again, California gets about 12 percent. New York gets about 12 percent. Many of the states get something along the lines of 1 percent or less or 2 percent. Every state that is a Participating Manufacturer gets a certain percentage, and those percentages are fixed under Exhibit A.
Q. The Escrow Statutes, on the contrary, do

271

not go into the general coffers of the States; correct?
A. That is correct. They are required under the statute to be held in a bank under--in escrow.
Q. So my comparison of 12 to 1, 1.6 billion to 137 million was even somewhat generous because the 137 million doesn't even go to the states. It goes in an escrow account available in the event of a future judgment against an NPM for health-related damages; correct?
A. Yes. It is in the nature of a bond in that sense to ensure that money is available in the event of a future judgment or settlement.
Q. And these Escrow Statutes were enacted what? 10 or 11 years ago, I guess, the first ones?
A. In 1999 and thereafter.
Q. And if we read an occasional newspaper, I think we can all agree: States are always looking for money; correct?
A. You're speaking very generally, yes.
Q. Particularly at this point in time we've just come out of the worst recession in 80 years by

272

most accounts. A number of states' budgets are in dire straits. They could use money if they could get their hands on it, couldn't they, Mr. Hering?
A. I'm sure some of them could.
Q. Tell me how many states have actually sued an NPM to collect a nickel out of the Escrow Statutes to date.
A. I'm not aware that any have.
Q. And I assume--
A. And let me just elaborate--
Q. I assume that applies to GRE, too, and then you can answer--Claimants.
A. Okay, it does apply to GRE, but let me back up briefly there. When you say--I just want to be clear that there are three reasons the states might--there might be a case or a suit against an NPM. You're referring to one of them, and that is a claim brought against an NPM for public health reasons, a claim, a released claim under the terms of the MSA. That is a claim that the cigarettes of the NPM have caused harm and the NPM is responsible for them under a torte theory or other theory of

273

law.
There are other reasons to sue an NPM, and one of them, and this is one that GRE has been subject of many lawsuits, is a suit brought against the company for noncompliance with the Escrow Statute, and I know that there are--I don't know precisely the amount and the number of judgments against GRE, but there have been a great number of lawsuits brought against GRE, and not GRE alone, many, many other scofflaw NPMs that have sold secrets and not deposit the escrow and have resulted in judgments. I think there are at least a dozen judgments against GRE and many other judgments, dozens and dozens.
PRESIDENT NARIMAN: Jerry?
THE WITNESS: GRE is the company in Canada owned by Jerry Montour, yes. I was saying "GRE," not "Jerry."
PRESIDENT NARIMAN: I thought you were saying "Jerry."
THE WITNESS: No, I'm sorry. I was saying--I was using shorthand for Grand River

274

04:36:08 Enterprises: GRE.

PRESIDENT NARIMAN: Not Mr. Montour?

THE WITNESS: Correct. Not Mr. Montour.

PRESIDENT NARIMAN: Okay.

BY MR. LUDDY:

Q. Was there something else on that?

A. No.

Q. Look at Page 3 of the Counter-Memorial, if you would, please. It's the document to your far left.

This is Counter-Memorial of Respondent United States of America.

Page 3, the middle paragraph starting "furthermore." I'll read the last sentence: "The escrow obligations were intended to ensure that an adequate source of funds would be available to the Settling States to satisfy any potential future tobacco-related judgments that the Settling States may obtain against Tobacco Product Manufacturers that had not signed the MSA, known as Non-Participating Manufacturers or NPMs."

Those dollars that have been deposited can

275

04:37:24 only be sought in an action by the states to recover tobacco-related judgments arising out of healthcare; is that not correct?

A. A released claim as that is defined in the MSA.

I should mention, the released claim is defined in both the MSA and, I believe, the Model Escrow Statute, so I think it's identical, and it's a fairly broad definition. I think that the U.S. in their Counter-Memorial was trying to simplify it somewhat, but yes, that's the gist.

Q. Now, who's responsible within the states for working on these claims? I mean, we're 11, 12 years out.

A. Yes.

Q. Who's working on these claims to come after GRE or somebody else for all these dollars that the states think they may ultimately be entitled to 25 years ago but have decided not to go after yet?

A. It would be the State Attorneys General, the ones for which I work. And yes, there have been no suits brought, and we are now 11 years out.

276

04:38:39 However, as I said, there are 25 years before the first year is released.

I mean, just to be clear, at 25 years, it's not as if the whole bundle comes out, if the company has been depositing each year. It's simply on year 25 the first year comes out, year 26 the second year, and on a rolling basis and so on.

And yes, if we don't bring an action or obtain a settlement upon a release claim, those monies will come out, but we are not at 25 years yet.

Q. There is a--are you familiar with the GRE Working Group?

A. Yes.

Q. And who comprises that group?

A. Our working groups are whomever chooses to be part of it.

I--let me try to elaborate.

I work for, as I've explained, the 56 Attorneys General of the 50 United States, D.C., Puerto Rico, and the Territories. On any given day, and working with people from across the country, in

277

04:39:51 the South Pacific, in Guam and the Northern Mariana Islands, Hawaii, Alaska, et cetera, on any number of issues as they relate to tobacco and the Master Settlement Agreement. And as you can imagine, because we are spread literally across the globe, we work very often by conference call, by e-mail and the like, and there may be issues that interest certain states and don't interest others. There may be issues that are of interest to all States; however, it's not necessary that all States become involved. It's simply a division of labor or of interest.

And we have dozens of working groups on any one issue. They are formed ad hoc. Simply the idea is we have something we need to look at. We need to make a recommendation. We need to do something more specific, and we ask who would like to volunteer to serve on a Working Group to address this issue. At that point, we hold generally a series of conference calls. It could be one that our work might be done or they can be ongoing.

Q. Who is on the GRE Working Group?

04:41:16 A. Honestly, I have no idea at this point.

Q. Are you?

A. Ex officio. I'm--it's my job to be a part of or cover nearly every Working Group that NAAG has. I say "nearly" because my--I am one of currently five attorneys at NAAG who work exclusively on tobacco, and then we have some that work on a part-time basis on tobacco.

So, one of us is part of, again, ex officio, and it may be on one day it's me, on one day it's somebody else, essentially covering conference calls on any number of working groups at NAAG.

Q. Look at Page 7 of the Counter-Memorial, if you would. This talks about the MSA suits, or I should say the suits that gave rise to the MSA, and it recounts or records some of the various causes of action that were pled. The first batch is largely strict liability torte-type theories, and then the next sentence lists a number of more exotic claims--well, exotic might be overstating it--but claims that involve specific conduct by a Tobacco

04:42:58 Company as opposed to merely product-related claims.

Do you know if the GRE Working Group is looking into see whether GRE has--whether there is any evidence of GRE committing--and I'm going to read some of them off--fraud, deceptive trade practices, conspiracy, racketeering, unlawful marketing to minors, antitrust violations? Any of those? Have you seen any evidence of that with respect to GRE?

A. Well, first of all, I'd like to say I'm an attorney working for the Settling States, and as to my communications with my clients, that's not something here I'm here to testify about, but to--

MR. FELDMAN: If I may.

THE WITNESS: Yes.

MR. FELDMAN: Just two points. One, I believe the question is quite beyond the scope of Mr. Hering's statement. And two, it does seem to be touching on privilege issues that Mr. Hering is addressing.

PRESIDENT NARIMAN: He could take care of himself just fine.

04:44:23 MR. FELDMAN: I'm just making an observation.

PRESIDENT NARIMAN: He's quite competent.

MR. LUDDY: Fair enough. It was also compound and then some. So maybe I'm doing myself a favor. Thank you, sir.

BY MR. LUDDY:

Q. Has anyone uncovered any evidence in connection with GRE's sale of cigarettes concerning fraud, deception, misrepresentation, conspiracy, racketeering, unlawful marketing to minors, antitrust violations--all of the types of things that were pled in the MSA cases against the Majors? That type of conduct. Do you have any evidence of that?

A. And again, I'm not going to get into the communications with my clients, but speaking of what I personally know, in general, no, not the sorts of behaviors attributable to the Majors. I am aware, however, that GRE uses some methods of advertising that would, for example, potentially be banned. I don't know enough to know whether they would be

04:45:37 under the MSA, the Seneca Sam and Seneca Girls among them.

Q. Is it whatever marketing is precluded under the MSA also now precluded under the new legislation from this other?

A. The FDA?

Q. Yes.

A. No. They're not entirely identical, and they can't be because the U.S. Supreme Court has held that certain practices that are now prohibited under the MSA are constitutionally protected under the First Amendment to the United States Constitution as business speech; and, therefore, the FDA cannot--they cannot regulate business speech. They cannot restrict it, and although the companies can voluntarily submit themselves to such restriction, so they're not identical.

Q. But you're not in a position to offer an opinion that any of their advertising is, in fact, violative of what would be in the terms of the MSA?

A. I do not know enough about their advertising and marketing practices to offer that

04:46:49 opinion, no.

Q. Now, this whole concept of suits by states or governmental agencies to recover health care costs from tobacco companies, has any state ever taken one of those suits to judgment and won? To judgment as opposed to settlement.

A. Yes. Well, just by way of background, the way the MSA came about, in part, was through lawsuits brought by the United States individually against the tobacco industry. They began with the suit by Attorney General Mike Moore of Mississippi in 1994, and suits from other states followed.

The first four states that brought their suits to trial settled. In one case, I believe, on the eve of judgment, on the eve of going to the jury and the court. Minnesota, I believe, settled. So, that didn't go to judgment.

Shortly thereafter, there were the other three previously Settled States, which was Mississippi, Florida, Texas and Minnesota, and each of those settled, again having been brought to trial.

04:48:16 And it appeared perhaps again the companies might engage in a serial process of settling each case before it came to judgment. However, they were interested in doing a deal that would cover all the rest of the states rather than engaging in negotiations with each state as they came along, and that ultimately resulted in the MSA, and that is why, no, none of those cases resulted in judgment.

Q. So, no state has ever actually won on those claims; correct? By "won," I say got a judgment.

A. To my knowledge, no, none of them have gotten judgments.

Q. And after the MSA--and these are the cases--these are the theories that we are talking about--would be the subject of any claim by the states against the escrow deposits; correct?

A. Well, I think you have left some out. I think there are the traditional torte-type claims. Strict liability. It's not as if GRE's cigarettes, Senecas, are any less addictive, any less harmful than Marlboros, any less deadly.

Q. Yeah--I'm sorry, but the MSA cases included

04:49:35 strict liability theories on a subrogation basis against the major tobaccos, and those cases were settled.

A. Okay. Maybe I misunderstood your question, if it was a question.

Q. Yeah.

A. My point being--

Q. I'm not talking about a consumer claim. I'm talking about a state coming after GRE to try to get the escrow deposits released.

A. Okay. I will back up and ask what was your question.

Q. I think I may have forgotten my question.

Has any state won a judgment for healthcare costs against the tobacco companies?

A. No, and I think what bothered me about your question was you said "these claims," and I wanted to point out that there are other claims that could be brought, namely along the lines of torte claims strict liability, other than the ones you highlighted earlier. That's why I pointed that out.

Q. Yeah, but nobody has won on the strict

04:50:38 liability or torte claims either; correct?

A. Correct.

Q. Okay. And since this--since the MSA, did the Federal Government pursue subrogation-type claims of the type comparable to those that had been pursued by the states?

A. I assume you're referring to the U.S. versus Philip Morris case that resulted in the RICO judgment.

Q. Correct.

But those--there was no--none of the strict liability case theories prevailed, did they?

A. You know, I'm not familiar enough with that decision to opine.

Q. Let's go back to tab--your resolution, Michael--Mr. Hering.

A. Can you remind me where it was?

Q. Left-hand again.

A. Which tab?

Q. That's it actually.

Q. The resolution.

A. Sorry.

286

04:51:53 (Question from Arbitrator Crook off microphone.)

MR. LUDDY: Yes.

BY MR. LUDDY:

Q. Okay. Fourth paragraph: "The escrow deposit was designed to approximate the first cigarette payment a company would have to make if it were participating--if it were a Participating Manufacturer under the MSA but it has failed to do so because of the Allocable Share Release." That's the first sentence in Paragraph 4.

A. Yes.

Q. Do you see that?

A. Yes.

Q. Now, that sentence is not true, of course, when you consider the exempt SPMs, isn't it?

A. Yes, that's correct.

If I could provide a little bit of background--

Q. Before you do that, who was this intended for? Legislatures; right?

A. No. This was intended for our membership,

287

04:52:53 the Attorneys General.

Q. The Attorneys General.

A. It was a memorandum again transmitting the resolution to our membership, which are the 56 AGs, and the resolution was a resolution of the body of NAAG, meaning the 56 AGs, in support of the Allocable Share Amendment. That resolution did, in fact, pass. NAAG--and again, the reason for having a resolution was simply to counter the argument that was being made by opponents to the legislation in the hearings that I on occasion was testifying at.

I mean, by way of further background, we had a former AG that had been hired by the opposition, CITMA, who knew, of course, our parliamentary rules, I suppose, and decided to make a point of the fact that we did not have a resolution in favor of the allocable share, and therefore it must mean that we must be against it. It was not true. However, the easiest way to counter his argument was to pass a resolution.

As far as the--your calling them the exempt NPMs, we tend to call them the Grandfathered NPMs.

288

04:54:12 Q. I will adopt your terminology.

A. Okay. Thank you.

As we said earlier, the Grandfathered NPMs were made an offer at the beginning of the MSA. That is, if you were to join within 90 days, the market share that you had in '97 or '98, 125 percent of '97 or '98, would be, as we would say, "grandfathered." That is, you would not pay on all your sales up to that market share.

It's important to note that it's a share, not an exact number of cigarettes. And since the overall market has been shrinking--in fact, I said it's down about 25 percent--a number of cigaretts protected by that share has shrunk accordingly. All told, the 15 SPMs have about a 3.65 percent grandfathered share because that's what their share was in the base years. And that 3.65 is now protecting fewer cigarettes than it did. They have increased their market share well beyond 3.65.

In fact, in 2008, I looked at the figures over--I think it was 62 percent approximately of the sales made by SPMs were made either by

289

04:55:33 non-Grandfathered SPMs paying full freight on their cigarettes sold or by Grandfathered SPMs in excess of their grandfathered share, again paying full freight on their sales.

So, yes, this would not apply to the sales made by a Grandfathered SPM prior to the point at which it reached its grandfathered share limit.

Q. So, the sentence is wrong; right?

A. I wouldn't agree with that.

Q. You mentioned the 3.65.

A. 3.65.

Q. That number is locked in, but because of the inflation adjustment, the value of that exemption has increased dramatically, hasn't it?

A. It's increased. However, I think the figures I saw earlier in Mr. Violi's presentation are a little bit high. I think it's closer to 340 million than it is to 400 million.

And, in fact, there are, I think, last I looked, three Grandfathered SPMs that don't even reach their grandfathered share. In fact, one of them seems to have withdrawn from the U.S. market

04:56:40 altogether at least temporarily perhaps, so the value is--I mean, the max value would be 340 if all of them were selling to that, but since they're--not all of them are selling to their grandfathered share, the actual realized value is less.

Q. I hate to disappoint you, but I'm going to let you argue with Mr. Violi directly about this point.

A. All right.

Q. The--look at the--

ARBITRATOR CROOK: Sorry to interrupt you. I just wanted to clarify one thing. I had not understood that the grandfathered--SPM share was a percentage of market. I think it was a number of units, but it is generally agreed that it is a percentage?

MR. LUDDY: 100 percent agree with you, as a percent. As a result it will depend on any given year the size of the overall market. But the dollar amount goes up 3 percent in the year every year because of the inflation adjustments. I think we will probably hear some more about that with

04:57:49 Professor Gruber.

BY MR. LUDDY:

Q. The bottom paragraph of that page, the companies--I will read this: "Companies that concentrate their sales in only a few states are able to get releases of more than 95 percent of their escrow deposits. While technically proper, such releases defeat the purpose of the Escrow Statutes that undermine the MSA."

Do you see that?

A. Yes.

Q. Now, did you draft this?

A. I believe I assisted.

Q. While technically proper.

A. That's why we--that's why we call it a loophole. If it weren't proper, it wouldn't be a loophole. It would be illegal.

Q. Well, instead of technically proper, you could have also said "while entirely proper"; correct?

A. No, because it's a loophole. It defeats the purpose of the statute.

04:58:55 Q. But certainly nothing that the NPMs themselves were doing was anything other than entirely proper; correct?

A. I'm not suggesting that the NPM is taking advantage of the allocable share or violating the law. I'm suggesting they were exploiting a loophole, an unintended loophole, in the statute.

Q. Everyone uses--you always use the term "exploit" as to many of your colleagues. Do you mean that in a pejorative sense, or is that just--I mean, seriously, were they doing anything wrong or not?

A. Yes, some were.

Q. No, just with respect to concentration of sales.

A. Well, this is--yes, and perhaps I could explain. This gets a little bit into the complications of the MSA, but you perhaps realize the way the math works out is again the best way to maximize your release is if you concentrate your sales in the fewest states possible. Ideally one state. If you are an NPM and you can concentrate

05:00:01 your sales in one state that has, say, a 1 percent allocable share, you can obtain an immediate release of 99 percent of your escrow deposit. Instead of depositing $5 a carton, you're depositing, I don't know, a few cents a carton.

And some NPMs exploited this loophole by legitimately contracting their sales perhaps to a few states. However, there were some that deliberately attempted to artificially concentrate their sales by channeling their sales through companies that they had set up, saying that, okay, even though cigarrets are coming out of one manufacturer, one factory, I am going to set up--and there is one company I could think of that's a perfect example. They started setting up ABC companies. I think it was Atlanta, Birmingham, some--I can't remember what C was, but they went on, and they said, "Okay, this company Cig-Tec Atlanta is going to sell in this state or these three states. Cig-Tec Birmingham is going to sell in these three states. Cig-Tec is going to sell in these three," and then pretended that they were, in

294

05:01:23 fact, separate companies in order to maximum their sales in as few states as possible, obtain the maximum release and exploit the loophole.

Among other things, making sure that after the Allocable Share Release mechanism, it doesn't matter how many you sell or where you sell. You pay the same number per carton, whether you sell in 50 states or one state, whether you concentrate in one or spread it all out.

And again, as was pointed out--I mean, the great irony--and I know the panel asked why do we know this is a loophole, because it defeats the entire purpose of the statute. The great irony is that if you exploit it in the--to the maximum and sell your cigarettes in just one state, the harm that--the cigarettes that cause the disease, the cancer, the death, all the harm is concentrated in is that one state. However, in that instance, the state has the least amount in escrow, essentially is a bond to protect it, whereas if that harm is spread out, potentially there is no release.

And companies like Cig-Tec--and that is

295

05:02:42 just one example--did this. To a certain extent GRE did this as well, although I realize it was in part facilitated by the states. I say that because Tobaccoville, the importer of GRE's cigarettes, was recognized by some of the states as the Tobacco Product Manufacturer of the Seneca brand for a period of time.

And because it was Tobaccoville rather than GRE that was recognized as a Tobacco Product Manufacturer, when they were looking at the comparison, which would have been how much money, say, South Carolina would receive had Tobaccoville been a Participating Manufacturer, not all of GRE's sales were included in what would have been the payment to South Carolina; only the imports made through Tobaccoville. All of--and the cigarettes on which Federal excise tax is paid would be subject to payment under the MSA had GRE been considered the manufacturer rather than Tobaccoville, and the Allocable Share Release would have been much lower in South Carolina, if there would have been one at all.

296

05:04:02 I doubt very much, in fact, that any of those states--in any of those states mathematically there could have been an allocable share release today because GRE sells too many cigarettes in this country now to make it a mathematical possibility.

Q. When you were looking at allocable share release in the context of GRE, at some stage you you were also including on-reserve sticks, were you not?

A. Yes, I was because, as I explained, when you become--and I will say this takes a while to understand--when you become a Participating Manufacturer under the MSA, you make payments based on your sales in all 50 United States. It doesn't matter where they occur. You could be a small PM that sells in a handful of states, in Hawaii where no cigarettes are sold, you are still going to get a piece of that payment made into the Citibank escrow account. They will get their allocable share.

And your payments under the MSA are measured based on cigarette sales on which FET, Federal excise tax, is paid. I believe if they're not doing it, I think it's a violation of Federal

297

05:05:18 law, but I believe that all GRE's cigarettes that are sold both on-Reservation and off- are incurred FET; that is, the cigarettes that are imported and sold through Tobaccoville pay FET, Federal excise tax, and the cigarettes imported by Mr. Montour under Native Wholesale Supply also pay FET when they are imported. And were GRE to be a Participating Manufacturer, they would make payments under the MSA on all of their FET sales. So, yes, their sales made on-reserve.

Q. Last paragraph of the same resolution, your memo transmitting resolution, the sentence that reads as follows: "NPMs are able to use the unintended price advantage conferred by this loophole to gain market share, taking sales from Participating Manufacturers."

Do you see that sentence?

A. No, I'm sorry. I must have lost you. Where is it?

Q. Last sentence on the first page, big paragraph.

I will read it again: "NPMs are able to

05:06:41 use the unintended price advantage conferred by this loophole to gain market share, taking sales from Participating Manufacturers.

A. Yes, I see it.

Q. Now, keep that sentence in the back of your mind, or wherever else you see fit, and go to Core Document 12, Claimants' Core Document 12, and I will ask you if you identify or recognize this document.

A. Yes, I do. I think--I think this was the other document. I think it was in Mr. Violi's opening. I may be wrong. Sorry.

This was a document sent to Parris Glendening, the President of the Council of State Governments.

Q. And at that point, he was Governor of Maryland or something?

A. I believe he was the Governor of Maryland, that's correct.

And the Council of State Governments, I believe, I don't know a whole lot about them, but I know roughly the equivalent to NAAG for governors instead AGs.

05:08:02 Q. Since you have some familiarity with it at least, maybe we could noncontroversially identify it as a letter from NAAG. I guess they were responding to a report that the Council of State Governments had issued with respect to the MSA and payments under it; is that fair? I'm looking for something fair, not unfair.

A. I note this was before my time at NAAG, but yes, I think that's right.

Q. Okay. I'm going to draw your attention to Page 3. This is a lengthy paragraph, but it's important, so I will read it. It's the third full paragraph. It commences with the term--the word "fourth."

"Fourth, the report correctly notes that--the massive increase in the price of cigarettes since 1997. However, the report erroneously intimates that the costs imposed by the MSA with were the principal cause of the price increase. In fact, the major cigarette manufacturers raised prices by several multiples of their MSA costs. MSA costs have been about 30 cents

05:09:35 per pack or $3 per carton for the major manufacturers. As noted in the report, however, the price differential between OPM brands and those of companies outside the agreement is far more--as much as $17 per carton. The price increase that created the market opportunity for NPMs is not attributable to the MSA but rather to the decision of the OPMs to inflate per-pack profit margins at the cost of losing market share."

Do you see that?

A. Yes.

Q. Okay. Now, turn to the next page, Page 4. Again, the third full paragraph. I will just read the first few sentences, and you could supplement if fairness requires it, Mr. Hering:

"The report correctly notes that the market share of NPMs has risen. As noted previously, this increase is principally the result of price increases by the OPMs far in excess of the costs imposed by the MSA and the decision by OPMs to widen their profit margins."

Okay.

05:11:07 A. Yes.

Q. Now, this was dated April 2002, and it was signed by Mr. Sorrell, who we have previously agreed or determined was at the time chair of the Tobacco Committee; right?

A. Yes, that's correct.

Q. And if you look at the memorandum transmitting the resolution, you will see in the first paragraph that it has been approved by the Tobacco Committee; correct? The attached resolution at least, presumably.

A. Yes.

Q. Okay. So, in Core Document 12, we have Mr. Sorrell--

MR. FELDMAN: Counsel, was there a question?

MR. LUDDY: Yes.

BY MR. LUDDY:

Q. In Core Document 12, we have Mr. Sorrell reporting that the NPMs' market share was attributable to the OPMs' drastically raising costs and widening their profit margins.

302

05:12:27 A different reason was given in this memo, wasn't it, sir?
A. Yes, and I think there is--first of all, let me say that I think both things are true. Again, I remember that the NPM market share grew from less than one half of 1 percent up to a height of some 8 percent in '03 and '04, and then it has declined somewhat and hovered 5 or 6 percent since that time.
Certainly, I think we have never said that there is one reason that NPM market share has grown, and I think that you will find that in many instances we have said exactly what Core Document 12, the letter to Parris Glendening, says, which is that one of the causes of NPM growth was increases in prices by the OPMs well in excess of the cost of the MSA.
However, as I have said earlier, one of the other reasons was exploitation of the allocable share loophole. Another reason was the failure to follow the NPM statutes.
And I would note that the date of this--and

303

05:13:46 again this was before I joined NAAG and was employed by them, but the date of this particular letter is April of 2002. Our payments--and I don't think this was discussed--the way our payments work is we would--we would--we are paid in arrears on April 15th of the following year. For Americans it's easier to remember because it's tax day.
So, on April 5th, we would not have yet received our payment for 2001. And remember that the MSA began in '99, so we're only talking about our third payment. We only had two payment cycles by the time this memo was written.
The exploitation of the allocable share loophole was not something that occurred at the very beginning. It took a while for NPMs to learn how this worked, to discover it, and then to exploit it. It didn't happen in Year 1. It built over time. And then it diminished over time as the statutes were passed because the statutes weren't all passed in a single year. It took several years for them to pass. In the case of some states it took a long time, and we still have one state that has not

304

05:15:06 passed the Allocable Share Amendment, Missouri. The interests there have managed to defeat it, although I have been out to Missouri three times to testify.
So, I realize that you're trying to point out an inconsistency here. I do not think it's inconsistent. I think, as I say, both things are true, and this memo--I'm sorry, this letter does not highlight the allocable share because it may not have been a kind of front burner issue at that time.
I would also like to point out that the second reason echos what I said earlier, which is that the report correctly states that the principal cause of downward adjustments in MSA payments has been the decline in the national cigarette consumption from the base year of '97. However, the negotiators of the agreement would have applauded the decline in consumption that has occurred. At the time the agreement was reached, the AGs who negotiated it affirmatively stated that reductions in cigarette consumption were a goal of the agreement and that the states would gladly accept lower revenues resulting from such declines.

305

05:16:09 Q. First of all, don't the spreadsheets with respect to what the anticipated payments are in April come out in January-February? I mean, you don't just get a check in the mail for a billion and a half dollars?
A. Yes, that's correct. They would have come out in March. They would have come out in late March.
Q. So, they would have been available when you wrote the letter; correct?
A. You are correct.
Q. Secondly, when the OPMs signed the MSA agreement that had the NPM adjustment agreement in it, isn't it true that they knew they could jack up their prices as high as Mr. Sorrell says without fear ultimately from NPM competition because the states were going to have to deal with the NPMs themselves?
A. I don't know what was in their head, the OPMs.
Q. Well, could it make sense looking back on it? Because what happened? They jacked up their

306

05:17:12 prices by two or three times, depending on which economists you listened to, two or three times as much they had to to cover the MSA payments, so their prices went up, their profits went through the roof, their margins on each pack increased, and as a result they created an opening in the market below them for NPM and SPM; correct?

A. I don't disagree with what you said. This is probably a better question for an economist like Dr. Gruber, but as I've said, we never--I think we've always maintained that part of the loss of market share from OPMs, as you point out, to both SPMs, which grew in market share although not as dramatically as the NPMs, and to the NPMs was the result of the price increase. I don't disagree with that.

Q. Okay. We don't disagree on that, and then to just play out the last leg of the stool, they raised their price, increased their margins, NPMs and SPMs came in, and then at least as to the NPMs, what happened? What did the states do? They passed...

307

05:18:22 A. You're suggesting that the allocable share was passed as a result of this. I do not think that the OPMs had it in mind that they would force a defective statute upon the states and then later exploit it through prices advantages and then somehow convince or force the states to pass a fix to it. I find that hard to believe.

Q. But they did always know that the states had a vested interest in tamping down NPM competition, correct, because of the NPM adjustment.

A. As I explained earlier, I think that both the states and the OPMs or the PMs in general had an interest in enacting and enforcing an NPM Escrow Statute. The PMs, the Participating Manufacturers, that is, for the reasons of competition, and the states because they wished to preserve the public health gains of the MSA.

Now, if I could just go back to what you were suggesting earlier for just a moment, I think that if I could, and I was not in the room, of course, when this was negotiated, but remember that what we have said is that the unintended--the reason

308

05:19:50 that this was unintended is because folks had in mind a Participating Manufacturer or a Tobacco Product Manufacturer that sold nationwide because, of course, if a company sold nationwide there would be no release, and I find it quite natural that given that the companies that were in the room negotiating this were companies like Philip Morris, Lorillard, B and W, RJR, that sold a national basis, they failed to see the loophole in the statute because naturally they assumed that the sales would be made as they made sales across the country.

So, it doesn't surprise me in the least.

I know as it was said in the opening, it may seem obvious now, it seems obvious to everyone in this room I'm sure, but at the time I think the negotiators had in mind companies cast in their own image.

Q. But the Lorillards, the RJRs, the PMs of the world, they obviously sell on a national scale. But I mean just as a practical matter, I mean at the time the MSA was executed, the Majors had what? 97, give or take, percent of the market?

309

05:21:00 A. Give or take.

Q. I won't hold you to that, if you don't hold me.

The last two or three percent was divvied up between a number of very small companies; correct?

A. Well, you may recall that it was approximately 97 percent to the OPMs. Then there is the 3 percent or so, and the 3.65 I think is an overstatement because of the 125 percent.

Q. Right.

A. But the 15 companies that joined with about--about 3 percent of the market, and then we are talking about less than one half of 1 percent that was the NPMs, how many NPMs that were in the market at that time, I couldn't tell you.

Q. But none of them sold on a national scale, though, did they?

A. I don't know, but you're probably right.

Q. One second.

(Pause.)

Q. Again, looking at the differences between

310

05:22:12 Mr. Sorrell's explanation for the rise of the NPMs and NAAG's resolutions explanation--strike that.

Attorneys General are political animals; right? I mean, they are either elected or political; right?

A. They are mainly elected and in some instances appointed, yes.

Q. And when they're appointed, they're appointed by other politicians; right?

A. I believe that's correct. It's sometimes the Governor, it's sometimes the Supreme Court of the state in question. It's sometimes members of the state Assembly or Congress.

Q. And you personally have been involved in the legislative process in a score or more of states on this issue in particular and just generally involved in the political issues that face Attorneys General for the last however many years you have been at NAAG; right?

A. I have been involved certainly in the legislative process.

When you say the political issues, not so

311

05:23:30 much. NAAG is in purpose and design and, in fact, a nonpartisan organization. I served all the AGs regardless of their party affiliation.

Q. And I make have misspoke. I didn't mean red state blue state political in that sense. I meant more in the legislative process and what flies and what doesn't.

Based upon your experience in the legislature, how well received do you think it would have been by a legislature for you to come in and say we need Allocable Share Amendment because Philip Morris jacked up their prices to get higher profit margins, and we have got to get rid of the NPMs? Is that a good--that a palatable political argument?

A. No.

Q. More palatable is, we have got to get allocable share appeal because these guys are exploiting an unfair cost advantage, and we have got to put them out; right?

A. It's more palatable. It's also the truth.

Q. Well, I mean, you're not denigrating Mr. Sorrell's statement. That was also the truth;

312

05:24:41 correct?

A. Again, I think it is the truth. I think it was done--again, I was not around when this was written. I think it was written before the Allocable Share Release became a real issue.

Q. Now, you never--you never--you said that that has been said before, and on that I have personally never seen it, but it was certainly was never said in any legislative proceedings, wasn't it, Mr. Sorrell's statement that the rise of the NPM shares was attributable to the profit taking and price gouging by the OPMs?

A. It may have been, but not--I'm not suggesting it was in conjunction with the testimony that I made, but it may have been in another context.

Q. You never testified to that, did you?

A. Not in relation to the allocable share, no.

Q. In fact, haven't the AGs always been sensitive to either the legislature or the media or to citizenry generally seeing them as a little bit too close or cozy with the major tobacco

313

05:25:56 manufacturers?

A. Yes.

Q. Because it feeds a sense that you're going after the little guy; right?

A. No, more a sense that we are in bed with the tobacco companies, which I think some reporters have suggested.

Q. Well, in some respect they are; right? The states are in bed with the major tobacco companies, aren't they?

A. No, I would disagree with that statement.

As I've said, and I've pointed out in several instances, we have done our very best to enforce against the companies to ensure against perhaps or the state's greater interest in terms of payments that the sales go down. We have done nothing but enforce both the payment provisions and the public health.

I haven't mentioned those, but if I could just a moment mention that we do--I am the Deputy Chief Counsel for payments. We also have a Deputy Chief Counsel for public health, and we focus as

05:27:01 much on public health as on payments in terms of enforcing the Section 3 restrictions against the banned uses of advertising and marketing. And, of course, the end result of most of those actions is lower sales. We have brought cases against the Majors for--and it's almost always the Majors, not always, it's sometimes SPMs, but for advertising in magazines known to have a high youth readership. We brought it for marketing of what is known as prep products, potentially reduced exposure products, without proper scientific evidence of these actually are reduced exposure products.

We have most recently I think one of the cases we brought was a case against RJR for advertising with cartoons in Rolling Stone magazine, and another one that was recent was a case brought against an SPM, Shermans, for selling brand name merchandise; that is, merchandise meaning clothing, trinkets, ashtrays, things like that emblazoned with their logo on it, which is also banned under the MSA.

We do all of those thing, and we wouldn't

05:28:16 do those if we were trying to maximize sales and thereby payments under the MSA.

Q. But as between the OPMs and the NPMs, if someone has got to have a particular market share, the states have a vested interest, do they not, in the OPMs having a market share rather than the NPMs because of the NPM adjustment in the MSA?

A. Well, actually, I would say that if you're asking me if somebody was going to sell a cigarette whether it should be a PM or NPM, and you said OPMs, I'll just say PMs. Of course, we would rather have it be sold by a PM that is subject to the health restrictions and making payments to the states. I'm not suggesting that that is not the case. However, none of our--all of the efforts that you have focused on here were not engaged against NPMs making their full escrow payments. They were engaged, the complementary as I think I've explained was aimed at NPM scofflaws, those companies not able to sell, and without making deposits into escrow and often located in a place where it was impossible to enforce, impossible to even serve as you saw from

05:29:37 the excerpt from Brett DeLange's affidavit, and then the NPMs that were exploiting the allocable share loophole and thereby not making full deposits.

Q. And I know you want to go back to the healthcare aspects, and I get it, but my question is whether independent of the healthcare aspects, just on the dollars, do states have a vested interest in NPMs not taking market share from the PMs because of the NPM adjustment.

A. Okay. Well, again, I don't think you can divorce the public health--

Q. If you can't answer that question, that's fine.

A. I will attempt to answer it, but I don't think you can divorce them. I think they are part and parcel of the MSA. And, in fact, I mean I haven't said this before, I don't think I have, but the MSA addresses public health in four different ways. I mean, one of them is the payments. The payments themselves are a public health measure because higher payments means lower consumption.

Number two are the public health

05:30:40 restrictions contained Section 3 of the MSA.

Number three is the creation of the Legacy Foundation, the American Legacy Foundation, which hasn't been mentioned yet, but one of the features of the MSA was creation and funding of a nonprofit organization that is a dedicated to, and I will quote, I believe their purpose. Dedicated to a world where youth reject tobacco and everybody can quit. That is their mission.

And then fourth is the source of funds that is used, although I will admit not as much as we would by the states for antitobacco programs and the like.

So, the public health is integral to the MSA, but certainly payments are part of it too.

And as I've just explained, they are part of the public health, and--I'm trying to get back to your question. As I explained earlier, yes, between a PM making payments subject to the public health restrictions and an NPM, the states would have an interest in having a PM making payments and subject to the public health restrictions--

05:31:59 Q. Okay. What if an OPM--

PRESIDENT NARIMAN: At some point of time we stop, but convenient time. If you want to carry on.

MR. LUDDY: Just two minutes. Subject to his answers. My questions would be two minutes.

PRESIDENT NARIMAN: Yes.

BY MR. LUDDY:

Q. If an NPM was abiding by all the public health requirements of the MSA, just like a PM was, an OPM was specifically? The state would still have a vested interest on the basis of the economics, pure dollars, and I don't mean to denigrate the public health issue, but I'm separating for a moment, and assuming an NPM is doing everything that an OPM is doing. The states still have a vested interest because of the NPM adjustment proceeding in seeing those sticks be sold by an OPM rather than an NPM; correct?

A. Well, if you're talking about money, again, OPM, SPM, it doesn't really matter. The SPMs and OPMs make payments to the states, and if it's made

05:33:08 by an NPM rather than a PM, payments are not made.

Q. Well, and if they're stealing market shares, if they're displacing market share from the OPMs, it's not only the payments aren't being made by the NPMs, but that could set up an adjustment under the NPM adjustment that reduces the money you get from the OPMs; right?

A. Yes, there is a automatic--there is a reduction because the cigarette is not being sold by a Participating Manufacturer, and there is at least the potential of an NPM adjustment.

Q. So, I think the end of that was, if I give you a standing statement on the healthcare issue for purposes of that question, I think the answer was yes; correct?

This is probably--I will withdraw that question.

This is probably a convenient time as we could get.

PRESIDENT NARIMAN: Roughly, how long do you think it will take you?

MR. LUDDY: I didn't think I'd be this

05:34:13 long.

Less than an hour.

PRESIDENT NARIMAN: Okay. So we meet tomorrow at 9:00. Same time.

Your evidence is not over, Mr. Hering.

THE WITNESS: I understand.

(Whereupon, at 5:34 p.m., the hearing was adjourned until 9:00 a.m., the following day.)

CERTIFICATE OF REPORTER

I, David A. Kasdan, RDR-CRR, Court Reporter, do hereby certify that the foregoing proceedings were stenographically recorded by me and thereafter reduced to typewritten form by computer-assisted transcription under my direction and supervision; and that the foregoing transcript is a true and accurate record of the proceedings.

I further certify that I am neither counsel for, related to, nor employed by any of the parties to this action in this proceeding, nor financially or otherwise interested in the outcome of this litigation.

____

DAVID A. KASDAN