IN THE COMMONWEALTH COURT OF PENNSYLVANIA

Commonwealth of Pennsylvania by Kathleen G. Kane, in her official Capacity as Attorney General of the Commonwealth of Pennsylvania	:	
v.	:	No. 803 C.D. 2014
Philip Morris USA, Inc., R.J. Reynolds Tobacco Company, Lorillard Tobacco Company, Liggett Group LLC, Commonwealth Brands, Inc., Daughters and Ryan, Inc., Farmer's Tobacco Company of Cynthiana, Inc., House of Prince A/S, Sherman 1400 Broadway N.Y.C. Inc., King Maker Marketing, Inc., Top Tobacco, L.P., Japan Tobacco International U.S.A., Inc., Kretek International, Inc., Peter Stokkebye Tobaksfabrik A/S, P.T. Djarum, Santa Fe Natural Tobacco Company, Inc., Von Eicken Group	:	
Appeal of: R.J. Reynolds Tobacco Company, Philip Morris USA, Inc. and Lorillard Tobacco Company	:	
Commonwealth of Pennsylvania by Kathleen G. Kane, in her official Capacity as Attorney General of the Commonwealth of Pennsylvania	:	
v.	:	No. 804 C.D. 2014 Argued: February 11, 2015
Philip Morris USA, Inc., R.J. Reynolds Tobacco Company, Lorillard Tobacco Company, Liggett Group Inc., Commonwealth Brands, Inc., Daughters and Ryan, Inc.,	:	

Farmers Tobacco Company of Cynthiana, Inc., House of Prince A/S, Sherman 1400 Broadway N.Y.C. Inc., King Maker Marketing, Inc., Top Tobacco, L.P., Japan Tobacco International U.S.A., Inc., Kretek International, Inc., Peter Stokkebye Tobaksfabrik A/S, P.T. Djarum, Santa Fe Natural Tobacco Company, Inc.,Von Eicken Group	:
Appeal of: Commonwealth Brands, Inc., Daughters and Ryan, Inc., House of Prince A/S, Liggett Group Inc., Sherman 1400 Broadway N.Y.C. Inc., King Maker Marketing, Inc., Top Tobacco, L.P., Japan Tobacco International U.S.A., Inc., Kretek International, Inc., Peter Stokkebye Tobaksfabrik A/S, P.T. Djarum, Santa Fe Natural Tobacco Company, Inc., Von Eicken Group, and Farmers Tobacco Company of Cynthiana, Inc.	:

BEFORE: HONORABLE DAN PELLEGRINI, President Judge
HONORABLE ROBERT SIMPSON, Judge
HONORABLE MARY HANNAH LEAVITT, Judge
HONORABLE P. KEVIN BROBSON, Judge
HONORABLE ANNE E. COVEY, Judge

OPINION BY
JUDGE SIMPSON **FILED: April 10, 2015**

In this appeal, Appellants, who are the participating tobacco manufacturers (PMs)[1] to the 1998 Master Settlement Agreement (MSA), ask

[1] PMs comprise two groups of tobacco manufacturers: Original Participating Manufacturers (OPMs) and Subsequent Participating Manufacturers (SPMs). OPMs were the original tobacco companies to settle the claims filed against them by the states and enter the

(Footnote continued on next page…)

whether the Court of Common Pleas of Philadelphia County[2] (trial court) erred by modifying an arbitration panel's award. PMs assert the trial court: applied the wrong standard of review; exceeded the strict limits on its authority under any standard of review; and, improperly interfered with the panel's rational contract interpretation. We affirm.

I. Background
A. MSA

In 1998, 52 states and territories (Settling States), including Pennsylvania, entered the MSA with PMs. The MSA settled litigation against the tobacco industry for recovery of the Settling States' tobacco-related health-care costs. The tobacco manufacturers that did not participate in the MSA are known as nonparticipating manufacturers (NPMs).

(continued…)

Master Settlement Agreement (MSA). OPMs include Philip Morris USA, Inc., R.J. Reynolds Tobacco Company, and Lorillard Tobacco Company.

SPMs were not named in the original suit, and they entered the MSA at a later date. SPMs include Liggett Group LLC, Commonwealth Brands, Inc., Daughters and Ryan, Inc., Farmer's Tobacco Company of Cynthiana, Inc., House of Prince a/s, Sherman 1400 Broadway N.Y.C., Inc., King Maker Marketing, Inc., Top Tobacco, L.P., Japan Tobacco International U.S.A., Inc., Kretek International, Inc., Peter Stokkebye Tobaksfabrik a/s, P.T. Djarum, Santa Fe Natural Tobacco Company, Inc., and Von Eicken Group.

OPMs filed the appeal at No. 803 C.D. 2014; SPMs filed the appeal at No. 804 C.D. 2014. This Court granted SPMs' uncontested motion to consolidate the appeals. Commonwealth Ct. Order, 7/22/2014. OPMs and SPMs filed separate briefs.

[2] The Honorable Patricia A. McInerney presided.

1. MSA Payment

Pursuant to the MSA, PMs agreed, among other things, to make annual payments to the Settling States in perpetuity in a base amount that totals billions of dollars every year in exchange for release from civil liability. PMs do not make the payments directly to the Settling States; rather, PMs make a single, aggregate payment (MSA Payment) to an independent auditor in an amount calculated and determined by the auditor. The auditor then allocates the MSA Payment among the Settling States by making a single, annual payment (Allocated Payment) in an amount based on the States' pre-set "allocable share" percentage. Pennsylvania's allocable share of every MSA Payment is 5.75%. The MSA Payment for 2003 is approximately $6.435 billion; Pennsylvania's Allocated Payment is approximately $370 million.

2. NPM Adjustment

The annual MSA Payment is subject to a downward adjustment known as the NPM Adjustment if it is determined that PMs lost market share to the NPMs as a result of PMs' compliance with the MSA. The NPM Adjustment is divided among all of the Settling States, according to each State's allocable share, in each year where the NPM Adjustment applies. Section IX(d)(1) of the MSA. The NPM Adjustment "shall apply to the Allocated Payments of all Settling States" unless the State meets the diligence exception. Section IX(d)(2)(A) of the MSA. A non-diligent State's potential NPM Adjustment is capped at the amount of its Allocated Payment.

3. Diligence Exception

The MSA provides an exception to the NPM Adjustment. Specifically, Settling States may avoid the NPM Adjustment if, during the year at

issue, they "diligently enforced" a "qualifying statute," which "effectively and fully neutralizes the cost disadvantages that [PMs] experience vis-à-vis [NPMs] within such Settling State as a result of the provisions of [the MSA]." Sections IX(d)(2)(B), (E) of the MSA. Settling States are not required to enact or diligently enforce a qualifying statute, but if they want the benefit of the "diligence exception," they must do both. The exception gives states an incentive to protect the market dominance of PMs, because otherwise the states will receive fewer funds. If the Settling State satisfies the diligence exception requirement, its Allocated Payment is not subject to reduction.

The trial court and some of the parties refer to application of the diligence exception to the NPM Adjustment as the "first tier" adjustment. The final arbitration awards primarily addressed the diligence exception.

4. Reallocation Provision

Under the diligence exception, a diligent Settling State is spared an NPM Adjustment to its Allocated Payment. However, under the MSA's Reallocation Provision, the amount of the NPM Adjustment that would have otherwise applied to that diligent Settling State's Allocated Payment is "reallocated among all [non-diligent] Settling States *pro rata* in proportion to their respective Allocable Shares ...." Section IX(d)(2)(C) of the MSA.

Generally, as the number of diligent states increase, the burden on non-diligent states increases. This is because an increase in the number of diligent states means that there is more adjustment reallocated among a smaller group.

The trial court and some of the parties refer to the application of the Reallocation Provision as the "second tier" of the NPM Adjustment. The Reallocation Provision is central to the preliminary Partial Settlement Award discussed below. It is also crucial to the current appeal.

B. 2003 NPM Adjustment Dispute and Arbitration

1. Dispute

Despite the enactment of qualifying statutes by all Settling States, PMs experienced market share loss to NPMs attributable to their compliance with the MSA. The NPM Adjustments for 1999-2002 were resolved by settlement as to all Settling States, but the NPM Adjustment for 2003 (and subsequent years) was not. PMs requested that the auditor apply the total 2003 NPM Adjustment of $1,147,566,064.87 as a credit against their MSA Payment. The Settling States opposed the request and asked that the auditor presume diligent enforcement determinations for the Settling States. The auditor did not apply the NPM Adjustment because the Settling States' diligent enforcement was not yet determined.

2. Road to Arbitration

Given the impasse, PMs requested arbitration of the dispute pursuant to the MSA, which provides:

> Any dispute, controversy or claim arising out of or relating to calculations performed by, or any determinations made by, the Independent Auditor (including without limitation, any dispute concerning ... application of any of the adjustments) ... shall be submitted to binding arbitration before a panel of three neutral arbitrators, each of whom shall be a former Article III federal judge. Each of the two sides to the

> dispute shall select one arbitrator. The two arbitrators so selected shall select the third arbitrator. ...

Section XI(c) of the MSA. The last clause provides: "The arbitration shall be governed by the United States Arbitration Act." Id.

Pennsylvania and other Settling States refused to submit their disputes to arbitration and instead sought relief in their respective state courts. For instance, Pennsylvania filed a motion in the trial court seeking a declaration that it diligently enforced its qualifying statute in 2003 and that the auditor properly determined the 2003 NPM Adjustment should not be applied. In response, PMs filed a motion to compel arbitration, which the trial court granted.

3. Agreement Regarding Arbitration

The courts of every Settling State, but Montana, similarly ordered arbitration of the 2003 NPM Adjustment dispute. The parties then entered an Agreement Regarding Arbitration. The parties formed a panel to arbitrate the dispute, which consisted of three retired federal judges: the Honorable Abner J. Mikva (selected by the Settling States); the Honorable William G. Bassler (selected by PMs), and the Honorable Fern M. Smith (selected by the other two panel members).

The panel ruled on various threshold issues and set the ground rules for arbitration. Significantly, the panel determined each contested Settling State would bear the burden of proving it diligently enforced its qualifying statute at an evidentiary hearing. The panel rejected the Settling States' contention that they should be presumed diligent. The panel set a deadline of November 3, 2011, for

PMs to contest the diligence of the States and a deadline of December 5, 2011, for the States to contest the diligence of other States. If any Settling State's diligence was not contested by any party after the conclusion of discovery and deadlines set to contest the issue, the State would be deemed to have diligently enforced its qualifying statute.

Initially, PMs challenged the diligence of every Settling State. But, after discovery, PMs contested the diligence of just 35 Settling States, including Pennsylvania. In May 2012, the panel began hearings for the 35 Settling States whose diligence was contested. In November 2012, a hearing for Pennsylvania was held.

4. Partial Settlement – Term Sheet

As the national arbitration slowly progressed, a subset of Settling States entered into settlement negotiations with PMs. As a result, PMs and 19 of the Settling States entered into a term sheet agreement (Term Sheet) in November 2012, after the expiration of the contest deadlines.

The Term Sheet resolved the 2003-2012 NPM Adjustments and streamlined the process for post-2012 Adjustments. The other Settling States were invited to join the settlement and three more did. Of these 22 States (Term Sheet States), PMs contested the diligence of 20.[3] The 22 Term Sheet States represented

[3] The two uncontested states that joined the Term Sheet settlement were New Jersey and Wyoming.

approximately 46 percent of the allocable share of the NPM Adjustment. See Reproduced Record (R.R.) at 159a, 776a-777a.

Under the Term Sheet, each of the Term Sheet States agreed to a reduction of their Allocated Payment. The Term Sheet did not address the Reallocation Provision or consider how the settlement would affect the 30 Settling States that did not sign the Term Sheet (Non-Term Sheet States).

Pennsylvania and other Non-Term Sheet States objected to the Term Sheet based on their concern it would, among other things, alter the terms of the MSA and increase their reallocated share of the NPM Adjustment.

5. Arbitration Panel's Decisions
a) Partial Settlement and Award

In January 2013, PMs and Term Sheet States filed a Proposed Stipulated Partial Award with the panel. Borrowing from judgment reduction doctrines, the Term Sheet signatories proposed alternative methodologies for how the MSA's Reallocation Provision would be applied in light of the settlement.

The panel accepted briefs and held a hearing on the proposed award. Afterwards, the panel entered a Stipulated Partial Settlement and Award (Partial Settlement Award). The panel determined the MSA did not directly speak to the issue of how the Reallocation Provision would be applied when some states settle and others do not. The panel looked to post-settlement judgment reduction law, namely *pro rata*, *proportionate fault*, and *pro tanto* methodologies, to interpret the contract provision. R.R. at 464a.

The panel explained under *pro rata*, the court divides the amount of the total judgment by the number of settling and non-settling defendants, regardless of each defendant's culpability. The non-settling defendant's liability is reduced not by a specific dollar amount, but by the percentage of liability that is allocated by the factfinder to the settling defendant. With proportionate fault, after a partial settlement and trial of the non-settling defendants, the jury determines the relative culpability of all the defendants and the non-settling defendant pays a commensurate percentage of the total judgment. Finally, under *pro tanto,* the court reduces the non-settling defendant's liability for the judgment against him by the amount previously paid by the settling defendants, without regard to proportionate fault. Id.

Ultimately, the panel adopted the *pro rata* methodology. The panel directed the auditor to treat the Term Sheet States as "diligent." This direction had two effects. First, the Term Sheet States were not subject to the 2003 NPM Adjustment. Second, the Term Sheet States were not included in the pool of states for the Reallocation Provision; therefore, that pool was reduced in size. To account for the Term Sheet States removal from the reallocation pool, the panel instructed a *pro rata* reduction, under which the dollar amount of the 2003 NPM Adjustment would be reduced by a percentage equal to the aggregate allocable shares of the Term Sheet States, i.e., 46 percent.

It is useful to observe that, at this point, no determination had been made about the "diligence" of the Non-Term Sheet States. Therefore, it is unclear the extent to which the panel, or any of the parties, understood the practical effect

of the Partial Settlement Award. This is especially true as it concerns the "second tier" adjustments related to the Reallocation Provision.

b) Final Award (Non-Diligence Determination)

Thereafter, panel hearings continued to determine the diligence of the remaining 15 contested Non-Term Sheet States. In September 2013, the panel entered Final Awards. The panel found Pennsylvania and five other Settling States were not diligent; nine were diligent.

6. Motion to Modify or Vacate

In November 2013, the Commonwealth filed a motion with the trial court to modify or vacate the Final Award and the Partial Settlement Award. The Commonwealth argued the proper standard of review was prescribed by Pennsylvania law, not the Federal Arbitration Act[4] (FAA). It asserted Pennsylvania's Uniform Arbitration Act[5] (UAA) standard of review applied, in particular, Section 7302(d)(2) of the UAA, 42 Pa. C.S. §7302(d)(2).

Under this standard, the Commonwealth advanced the Partial Settlement Award must be vacated because it is irrational and contrary to the law. The Commonwealth argued the MSA explicitly provides the NPM Adjustment shall apply to all states unless those states diligently enforced the qualifying statute. The panel treated the Term Sheet States as diligent when they did not prove their diligence. The panel had no right to depart from the MSA's clear

[4] 9 U.S.C. §§1-307.

[5] 42 Pa. C.S. §§7301-7320.

language and fashion its own award. By treating the Term Sheet States as diligent, the panel's award requires the Commonwealth to bear more than its fair share of the reallocation of 2003 NPM Adjustment.

In addition, the Commonwealth contested the panel's determination that Pennsylvania was not diligent in enforcing its qualifying statute in the Final Award.

PMs countered the proper standard of review is governed by the FAA as agreed to by the parties in the MSA. The FAA standard of review is very narrow and does not permit a merits review for errors of law. Under the FAA, the court must determine whether the award can be rationally derived from the MSA.

PMs asserted the Partial Settlement Award is rationally derived from the MSA where the MSA did not directly speak to the process used to calculate the reallocable share of the NPM Adjustment when only some Settling States settle diligent enforcement and others do not. Notwithstanding, under any standard of review, the court cannot second-guess the merits of the panel's reasonable contractual interpretation of how to apply the NPM Adjustment and Reallocation Provision after a partial settlement.

In addition, PMs asserted the Final Award must be upheld because the evidence clearly showed that Pennsylvania did not diligently enforce its qualifying statute.

7. Trial Court's Decision

The trial court held a hearing in March 2014. It determined the base amount of Allocated Payment owed to Pennsylvania for 2003 is $369,807,760.89. If the Final Award is upheld, Pennsylvania's Allocated Payment would be reduced by $116,457,190.73, for a total amount payable of $253,350,570.16. If the Final Award and Partial Settlement Award are both upheld, Pennsylvania's reduction would be $242,309,663.54, leaving a total amount payable of $127,498,097.35. Tr. Ct., Slip Op., 4/10/14, at 22 & Attachment 1 (Diagram).

a) Standard of Review

As for the appropriate standard of review, the trial court determined review is governed by the standards set forth in the UAA. The trial court explained the MSA does not expressly adopt FAA's standards of review. Although Section XI(c) of the MSA provides "[t]he arbitration shall be governed by the United States Arbitration Act," "this section only speaks to how the arbitration was to be conducted, it does not speak to what standards of review should be applied in post-arbitration proceedings." Tr. Ct., Slip. Op., at 26. That question is answered by other sections of the MSA. Specifically, Section XVIII(n) of the MSA provides Settling States "shall be governed by the laws of the relevant Settling State, without regard to the conflict of law rules of such Settling State." Id. (quoting Section XVIII(n) of the MSA). In addition, Sections II(p) and VII(a) of the MSA provide it is "the respective court of each Settling State" that has exclusive jurisdiction over disputes arising out of the MSA. Id. Thus, Sections II(p), VII(a), and XVIII(n) of the MSA dictate it is the law of the Settling State that provides the standards of review for post-arbitration proceedings in state court. Id.

Even if the MSA called for review governed by the FAA, the trial court held review would still be governed by the standards set forth in the UAA. Relying on Trombetta v. Raymond James Financial Services, Inc., 907 A.2d 550 (Pa. Super. 2006), the trial court explained contracting parties are not free to impose their own standards of review on a court. Moreover, "[t]he FAA standards do not apply to a state trial court's review over an arbitration award created and enforced under the FAA." Tr. Ct., Slip Op., at 24-25 (quoting Trombetta, 907 A.2d at 569).

Under the UAA, the trial court determined the appropriate standard of review is set forth in the UAA's statutory arbitration provisions, specifically, Sections 7302(d)(2) and 7314, 42 Pa. C.S. §§7302(d)(2) and 7314. Section 7302(d)(2) provides that when "[t]he Commonwealth government submits a controversy to arbitration[,] ... a court in reviewing an arbitration award ... shall ... modify or correct the award where the award is contrary to law and is such that had it been a verdict of a jury the court would have entered a different judgment or a judgment notwithstanding the verdict [(J.N.O.V.)]." 42 Pa. C.S. §7302(d)(2). Section 7314 provides a court must vacate a statutory arbitration award where the "arbitrators exceeded their powers" or refused to hear material evidence. 42 Pa. C.S. §7314(a)(1)(iii)-(iv). The trial court determined Section 7302(d)(2) is the same as the "essence test" standard applicable to collective bargaining agreements and equally applicable here. Under this approach, an arbitrator's interpretation of the contract must be upheld if it is a reasonable one. Thus, the trial court determined the appropriate review is limited to whether the panel's

award can in any rational way be derived from the MSA after viewing the evidence in the light most favorable to PMs.

To the extent PMs argued the FAA preempted the standards of review under the UAA, the trial court disagreed. The trial court explained the FAA does not expressly preempt state arbitration laws. There is no federal policy favoring arbitration under a certain set of procedural rules. Moreover, the trial court reasoned the UAA standards do not provide for *de novo* review, rather essence review. Although state law may be preempted to the extent it conflicts with federal law, the standards of review under the UAA are very limited and do not stand as an obstacle to the accomplishment and execution of the full purpose and objectives of Congress. Thus, the trial court applied the UAA's statutory standard of review when addressing Commonwealth's motions to modify or vacate the Final Award and the Partial Settlement Award.

b) Final Award - Upheld

Applying the UAA statutory standard of review to the Final Award, the trial court determined the panel's conclusion that Pennsylvania was not diligent in enforcing its qualifying statute can be rationally derived from the MSA. The trial court reasoned the panel did not apply an incorrect definition of "diligence" in reaching its decision. The panel properly considered relevant evidence in a rational, consistent, and non-arbitrary manner. The panel's determination of Pennsylvania's non-diligence was not against the weight of evidence. Thus, the trial court declined to vacate the final award.

c) Partial Settlement Award - Modified

With regard to the Partial Settlement Award, the trial court determined the panel had jurisdiction to decide how the 2003 NPM Adjustment should be reallocated among the non-diligent, Non-Term Sheet States.

However, the trial court determined the panel's interpretation and adoption of the "*pro rata*" reallocation method cannot be rationally derived from the MSA and "amounts to an error of law as it violates the unambiguous language of [S]ection IX(d)(2), which provides the NPM Adjustment 'shall apply' to 'all' Settling States unless they prove their diligence." Tr. Ct., Slip Op., at 41. Central to the trial court's decision was its determination that the language of the MSA was unambiguous and therefore not subject to interpretation based on outside resources. Id. at 46-47. The trial court opined:

> [U]nder the plain language of the MSA, the default rule is a Settling State is treated as subject to the NPM Adjustment. And in order to earn an exemption, the State must show it 'diligently enforced' its qualifying statute during the year in question; no exceptions.

Id. at 47-48.

The trial court explained the NPM Adjustment is allocated using a two-tiered process. Under Section IX(d)(2) of the MSA, if a Settling State does not prove its diligence, it is subject to an initial reduction of its Allocated Payment equal to its allocable share of the total NPM Adjustment amount (first tier). That same Settling State is then subject to an additional reduction based on the allocable shares of any diligent Settling States whose shares are "reallocated among all [non-

diligent] Settling States *pro rata* in proportion to their respective Allocable Shares" (second tier). Tr. Ct., Slip. Op., at 49 (quoting Section IX(d)(2)(C) of MSA).

The trial court determined the panel exceeded its authority and irrationally interpreted the MSA when it applied the *pro rata* reallocation method instead of the unambiguous language of the MSA. The trial court explained the MSA's two-tiered allocation provision makes it impossible to coherently apply a generalized *pro rata* judgment reduction to this case. Id. Moreover, the adoption of the *pro rata* methodology violated Section XVIII(j) of the MSA, which prohibits amendments to the MSA that are not signed by all Settling States "affected" by such amendment. Tr. Ct., Slip. Op., at 50.

The trial court concluded the only way for the Partial Settlement Award not to affect Pennsylvania's rights – and amount to an unauthorized amendment of the MSA – is to treat the 20 Term Sheet States as non-diligent when calculating the non-diligent State's second tier share of the NPM Adjustment. The trial court rejected PMs' argument that some of the Term Sheet States may have been found diligent as irrelevant because they did not prove diligence as required by the MSA, choosing instead to settle. As 20 contested Term Sheet States did not prove diligence, they cannot be exempted from the NPM Adjustment calculation.

Thus, the trial court modified the Partial Settlement Award by ordering the auditor to treat the 20 Term Sheet States as non-diligent when calculating Pennsylvania's share of the NPM Adjustment for 2003. In so doing,

the trial court reduced Pennsylvania's NPM Adjustment from $242,309,663.54 to $116,457,190.73. Tr. Ct., Slip Op., at 45 & Attachment 1 (Diagram).

8. Appeal

From this decision, PMs appealed to this Court. In addition to the briefs submitted by the parties, the Court received amici curiae briefs from the Pennsylvania Cancer Alliance[6] and the Hospital and Healthsystem Association of Pennsylvania[7] in support of the Commonwealth's position.

II. Issues

On appeal,[8] PMs contend the trial court applied the wrong standard of review. Notwithstanding, under *any* standard of review, PMs argue the Partial Settlement Award must be upheld because the panel rationally interpreted the MSA.

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[6] The Pennsylvania Cancer Alliance is comprised of Pennsylvania's leading cancer centers, which depend on funding for cancer research from Pennsylvania's Allocated Payment.

[7] The Hospital and Healthsystem Association of Pennsylvania is the principal trade association for Pennsylvania's healthcare institutions, representing over 240 hospitals and health systems, affiliated physicians, nursing homes, home health agencies and other healthcare providers, which depend on funding from Pennsylvania's Allocated Payment, to pay for uncompensated care provided to uninsured and underinsured patients.

[8] In reviewing a trial court's decision to affirm, modify or vacate an arbitration award arising from a written contract and involving only questions of law, our standard of review is *de novo*, and our scope of review is plenary. Bucks Orthopaedic Surgery Assocs., P.C. v. Ruth, 925 A.2d 868 (Pa. Super. 2007).

The Final Award (non-diligence determination) and the jurisdiction of the arbitrators to enter the preliminary Partial Settlement Award are not contested here.

III. Discussion
A. Standard of Review
1. Contentions

PMs argue the trial court erred by determining judicial review of the award is governed by the standard in Section 7302(d)(2) the UAA. According to PMs, the narrow standard of judicial review set forth in the FAA controls. Pursuant to Section 10(a) of the FAA, an arbitration award may be vacated where the arbitrators engaged in misconduct or exceeded their authority. That standard forecloses a court from reviewing the merits of the arbitrator's contract interpretation for an error of law. An arbitration award that even arguably construes or applies the contract must stand, regardless of a court's view of its merits. The parties bargained for the arbitrator's construction of the agreement, not for the court's.

Further, PMs assert the FAA is the appropriate standard because the parties agreed to this standard. The MSA expressly specifies that "[t]he arbitration shall be governed by the United States Federal Arbitration Act." Section XI(c) of the MSA. PMs contend the parties did not intend for the arbitration standards of each Settling State to govern, choosing instead the uniform standard of the FAA. The need for a single uniform set of rules guiding arbitration is particularly important where the disposition of one Settling State's payment-related dispute may affect another State.

In addition, PMs maintain the FAA preempts the UAA insofar as the UAA applies a broader review, and Trombetta does not hold otherwise. The FAA preempts any state law that undermines the goals and policies of the FAA or is otherwise "hostile to arbitration." Review under Section 7302(d)(2), which permits vacatur if the award is contrary to the law, is fundamentally inconsistent with the national arbitration policy of the FAA and would subvert its central purposes. Even the trial court recognized the parties could not agree to an expansive *de novo* review because that would undercut the FAA's national policy against cumbersome and time consuming judicial review process. Yet, the trial court conducted an expansive review and second guessed the panel's interpretation of the MSA.

PMs contend Trombetta does not control. In Trombetta, the Superior Court held the FAA standard of review did not preempt Pennsylvania's *common law* standard of review in Section 7341 of the Judicial Code, 42 Pa. C.S. §7341, because the two sections were "on par," and applying the common-law standard would "facilitate rather than impede the goals of the FAA." 907 A.2d at 569. The same cannot be said of the *statutory* standard of Section 7302(d)(2) because it is significantly different from the FAA standard in that it permits vacatur "where the award is contrary to the law." The Superior Court held the parties could not agree to a *broader* standard of review than was allowed under the equivalent standards applicable under the UAA and FAA.

Unlike in Trombetta, the parties here agreed to the FAA standard *itself*, which is narrower than the UAA standard invoked by the trial court, not to

the broader standard of review under Section 7302(d)(2). Even if on point, Trombetta was decided before Oxford Health Plans LLC v. Sutter, __ U.S. __, 133 S.Ct. 2064 (2013), and Hall Street Associates, LLC v. Mattel, 552 U.S. 576 (2008). These cases declared the FAA reflects a national policy favoring limited judicial review of arbitration awards and compels the conclusion the FAA preempts application of broader standards of review. Oxford Health; Hall Street.

Alternatively, PMs add, if the UAA governs review, the common-law standard in Section 7341 of the Judicial Code, 42 Pa. C.S. §7341, or the general statutory law standard in Section 7314 of the UAA, 42 Pa. C.S. §7314, control as opposed to the special statutory standard in Section 7302(d)(2) of the UAA. Unlike Section 7302(d)(2), neither Section 7341 nor 7314 permits a merits review of a panel's decision.

Pursuant to Section 7302(a) of the UAA, arbitration must proceed under the common law arbitration unless "the agreement to arbitrate is in writing and expressly provides for arbitration pursuant to this subchapter or any other similar statute." 42 Pa. C.S. §7302(a). The MSA does not provide for statutory arbitration under the UAA. The FAA is not a "similar statute" to Section 7302(d)(2) of the UAA. In addition, Pennsylvania did not "submit" the case to arbitration but was compelled to arbitrate after seeking merits review in the trial court. 42 Pa. C.S. §7302(d)(2)(i). Therefore, PMs argue, by default, review is under the common law arbitration of Section 7341.

Under both Section 7341 of the Judicial Code and Section 7314 of the UAA, arbitrators are the final judges of both law and fact, and an arbitration award is not subject to a reversal on appeal for a mistake of either. Moreover, even under the special standard of review in Section 7302(d)(2), an arbitration award can be vacated or modified only if the panel acted "irrationally." Thus, none of the UAA standards authorized the trial court to conduct a merits review.

The Commonwealth counters the UAA provides the appropriate standard of review. Specifically, Section 7302(d)(2) of the UAA provides: "where the award is contrary to the law and is such that had it been a verdict of a jury the court would have entered a different judgment or a judgment notwithstanding the verdict." 42 Pa. C.S. §7302(d)(2) (emphasis added). In other words, Pennsylvania courts have explicit authority to correct an "error of law" in an arbitration award, including an arbitrator's failure to follow a contract's unambiguous language. "Under both the 'essence test' and 'error of law' review standards, the rule is the same: When a court is examining whether a ruling complies with the clear and unambiguous language of a contract, a contrary 'interpretation' will be rejected without any deference." Appellee's Br. at 45.

Although the MSA requires that the arbitration itself be conducted in accord with the FAA, review is under state law. Pursuant to the MSA, the parties agreed that judicial review of MSA disputes would take place in state court and would be resolved under state law. Sections II(p), VII(a) & XVIII(n) of the MSA.

Notwithstanding, the UAA standard applies regardless of whether the parties agreed to FAA review in the MSA. The Commonwealth maintains such a stipulation in the MSA is unenforceable. Relying on Trombetta, the Commonwealth posits the FAA standards do not apply to a state trial court's review over an arbitration award "created and enforced under the FAA." 907 A.2d at 569.

Contrary to the PMs' assertions, the FAA does not preempt the UAA. The FAA standard speaks only to actions in federal court and does not preempt state law in state court actions. 9 U.S.C. §10; see Trombetta. The UAA's standard of review does not stand as an obstacle to the national policy against cumbersome and time-consuming judicial review process. Trombetta.

2. Analysis

We begin our discussion by summarizing the various standards of review advocated by the parties. Then we address whether the trial court applied the proper standard.

a) Federal Law - FAA

First, under federal law, the FAA governs the standards by which federal courts may review arbitration decisions. 9 U.S.C. §10. Under Section 10(a) of the FAA, vacatur is permitted only:

> (1) where the award was procured by corruption, fraud, or undue means;
> (2) where there was evident partiality or corruption in the arbitrators, or either of them;
> (3) where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause

> shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced; or (4) where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.

9 U.S.C. §10(a) (emphasis added).

In determining whether arbitrators "exceeded their powers," a court must examine whether the award draws its "essence from the contract." Oxford Health, __U.S. at __, 133 S.Ct. at 2068 (emphasis added). That is, a court must determine whether the award can be "rationally derived" from the agreement between the parties. Ario v. Underwriting Members of Syndicate 53 at Lloyds for 1998 Year of Account, 618 F.3d 277, 295 (3d Cir. 2010).

The essence test doctrine is not derived from the FAA; rather, it has its origins in United Steelworkers v. Enterprise Wheel and Car Corporation, 363 U.S. 593 (1960). There, the United States Supreme Court opined:

> [A]n arbitrator is confined to interpretation and application of the collective bargaining agreement; he does not sit to dispense his own brand of industrial justice. He may of course look for guidance from many sources, yet his award is legitimate only so long as it draws its essence from the collective bargaining agreement.

Id. at 597.

Under this narrow standard, a court "may not overrule an arbitrator simply because [it] disagree[s] .... [T]here must be absolutely no support at all in

the record justifying the arbitrator's determinations for a court to deny enforcement of an award." Ario, 618 F.3d at 295-96 (quoting United Transp. Union Local 1589 v. Suburban Transit Corp., 51 F.3d 376, 379 (3d Cir.1995)). Indeed, an arbitration award that even arguably construes or applies the contract must stand, regardless of a court's view of its merits. Oxford Health; accord Enter. Wheel. "So long as the arbitrator was 'arguably construing' the contract ... a court may not correct his mistakes ... however good, bad, or ugly" they may be. Oxford Health, __ U.S. at __, 133 S. Ct. at 2070-2071 (quoting Enter. Wheel, 363 U.S. at 599).

Despite this deferential approach, the courts are not required to merely "rubber stamp" the interpretation and decisions of the arbitrators. Matteson v. Ryder Sys. Inc., 99 F.3d 108, 113 (3d Cir. 1996). "[I]f 'the arbitrator act[s] outside the scope of his contractually delegated authority'—issuing an award that 'simply reflect[s] [his] own notions of [economic] justice' rather than 'draw[ing] its essence from the contract'" a court may overturn his determination. Oxford Health, 133 S. Ct. at 2068 (quoting E. Assoc. Coal Corp. v. Mine Workers, 531 U.S. 57, 62 (2000)).

The role of the courts is to ascertain "whether the parties ... got what they bargained for, namely an arbitrator who would first provide an interpretation of the contract that was rationally based on the language of the agreement, and second would produce a rational award." Brentwood Med. Assocs. v. United Mine Workers of Am., 396 F.3d 237, 242 (3d Cir. 2005).

b) Pennsylvania Law

Turning to Pennsylvania law, Sections 7301 through 7320 of the UAA regulate statutory arbitration, while Sections 7341 and 7342 of the Judicial Code regulate common law arbitration in state courts. Section 7302(a) provides arbitration must proceed under common law arbitration unless "the agreement to arbitrate is in writing and expressly provides for arbitration pursuant to this subchapter or any other similar statute." 42 Pa. C.S. §7302(a). Absent an express agreement by the parties that calls for the application of the UAA's statutory provisions, an agreement to arbitrate is presumed at common law. Id.; Bridges PBT v. Chatta, 821 A.2d 590 (Pa. Super. 2003).

(1) Statutory Arbitration
(a) Section 7302(d)(2) of the UAA

Section 7302(d)(2) of the UAA provides that when "[t]he Commonwealth government submits a controversy to arbitration[,] ... a court in reviewing an arbitration award ... shall ... modify or correct the award where the award is contrary to law and is such that had it been a verdict of a jury the court would have entered a different judgment or a judgment notwithstanding the verdict [(J.N.O.V.)]." 42 Pa. C.S. §7302(d)(2). The Courts of this Commonwealth consistently hold that the J.N.O.V. standard of review is the same as the "essence test." Mifflinburg Area Educ. Ass'n ex rel. Ulrich v. Mifflinburg Area Sch. Dist., 724 A.2d 339 (Pa. 1999); Cnty. of Centre v. Musser, 548 A.2d 1194 (Pa. 1988); Cmty. Coll. of Beaver Cnty. v. Soc'y of the Faculty (PSEA/NEA), 375 A.2d 1267 (Pa. 1977); Tunkhannock Area Sch. Dist. v. Tunkhannock Area Educ. Ass'n, 992 A.2d 956 (Pa. Cmwlth. 2010); Greater Nanticoke Area Sch. Dist. v. Greater Nanticoke Area Ed. Assoc., 760 A.2d 1214 (Pa. Cmwlth. 2000).

More particularly, in the seminal case of Beaver County, the Pennsylvania Supreme Court equated the J.N.O.V. standard of review with the "essence test" formulated by the United States Supreme Court in the Steelworkers trilogy.[9] The Court in Beaver County opined:

> [W]here a task of an arbitrator ... has been to determine the intention of the contracting parties as evidenced by their collective bargaining agreement and the circumstances surrounding its execution, then the arbitrator's award is based on a resolution of a question of fact and is to be respected by the judiciary if the interpretation can in any rational way be derived from the agreement, viewed in light of its language, its context, and any other indicia of the parties' intention .... [Under] this approach ... the arbitrator's interpretation of the contract must be upheld if it is a reasonable one.

375 A.2d at 1275 (internal quotations and citations omitted) (emphasis added).

In Beaver County, the Supreme Court rejected the employer's argument that the J.N.O.V. standard provides for a closer or different scrutiny of arbitration awards than the federal standard announced in Enterprise Wheel. Id. Although Beaver County involved the statutory precursor to the UAA,[10] both provisions included the J.N.O.V. standard.

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[9] The Steelworkers' trilogy refers to three federal labor decisions decided on the same day: United Steelworkers v. American Manufacturing Co., 363 U.S. 564 (1960); United Steelworkers v. Warrior & Gulf Navigation Co., 363 U.S. 574 (1960); and Steelworkers v. Enterprise Wheel & Car Corp., 363 U.S. 593 (1960).

[10] Arbitration Act of 1927, Act of April 25, 1927, P.L. 381, No. 248, as amended, 5 P.S. §161-179, repealed by the Act of October 5, 1980, P.L. 693, and replaced by the UAA. Pursuant to former Section 11(d) of the Arbitration Act of 1927, 5 P.S. §171(d), a court shall vacate an award "[w]here the award is against the law, and is such that it had been the verdict of

(Footnote continued on next page…)

Under the essence test, the court must accord great deference to an arbitrator's contract interpretation. State Sys. of Higher Ed. (Cheyney Univ.) v. State Coll. Univ. Prof'l Ass'n (PSEA-NEA), 743 A.2d 405 (Pa. 1999). The interpretation may be set aside only where it is so indisputably contrary to the contract that it cannot rationally be derived from the agreement. Id. The court must make the distinction between an irrational award and one that merely chooses between differing interpretations of contract language. Id. An arbitrator's award must be upheld if it represents a reasonable interpretation of the parties' agreement. Id. In other words, "a court will only vacate an arbitrator's award where the award indisputably and genuinely is without foundation in, or fails to logically flow from, the collective bargaining agreement." Greater Nanticoke, 760 A.2d at 1217.

An arbitrator is not confined to the express terms of the agreement. Id. As with the federal standard, an arbitrator may look for guidance from external sources. Danville Area Sch. Dist. v. Danville Area Educ. Ass'n PSEA/NEA, 754 A.2d 1255 (Pa. 2000); Beaver Cnty.; Greater Nanticoke. However, where the contract language is truly susceptible to only one meaning, and thus unambiguous, the arbitrator may not deem it to mean something else. Delaware Cnty. v. Delaware Cnty. Prison Emps. Indep. Union., 713 A.2d 1135 (Pa. 1998); Greater Nanticoke. Indeed, "where the contractual language is clear and unambiguous as a matter of law, a contrary 'interpretation' cannot be said to rationally or logically be derived from the CBA." Greater Nanticoke, 760 A.2d at 1220.

(continued…)

the jury of the court would have entered different or other judgment notwithstanding the verdict."

"[O]nly where there is a manifest disregard of the agreement, totally unsupported by principles of contract construction ... may a reviewing court disturb the award." S. Butler Cnty. Sch. Dist. v. S. Butler Cnty. Ed. Support Pers. Ass'n, PSEA/NEA, 696 A.2d 932, 934 (Pa. Cmwlth. 1997) (quoting Teamsters Local Union No. 77 v. Pa. Tpk. Comm'n, 331 A.2d 588, 590 (Pa. Cmwlth. 1975)).

Although cases applying the essence test primarily deal with the arbitration of collective bargaining agreements in the labor context, we agree with the trial court that the application of essence test is equally applicable to arbitration awards involving other contractual agreements, such as the MSA. See Beaver Cnty. Arbitration is "designed to provide an expeditious and inexpensive method of resolving disputes with the further winning attribute of helping to ease congested court calendars ...." Allstate Ins. Co. v. Fioravanti, 299 A.2d 585, 589 (Pa. 1973). By circumscribing a court's review of arbitration awards, the essence test furthers this policy. See Enter. Wheel; Beaver Cnty.

(b) Section 7314 of UAA

Next, Section 7314 sets forth the general circumstances for vacatur under statutory arbitration. Specifically, Section 7314 provides:

> [T]he court shall vacate an award where:
> (i) the court would vacate the award under section 7341 (relating to common law arbitration) if this subchapter were not applicable;
> (ii) there was evident partiality by an arbitrator appointed as a neutral or corruption or misconduct in any of the arbitrators prejudicing the rights of any party;
> (iii) the arbitrators exceeded their powers;
> (iv) the arbitrators refused to postpone the hearing upon good cause being shown therefor or refused to hear

> evidence material to the controversy or otherwise so conducted the hearing, contrary to the provisions of section 7307 (relating to hearing before arbitrators), as to prejudice substantially the rights of a party; or
> (v) there was no agreement to arbitrate and the issue of the existence of an agreement to arbitrate was not adversely determined in proceedings under section 7304 (relating to court proceedings to compel or stay arbitration) and the applicant-party raised the issue of the existence of an agreement to arbitrate at the hearing.

42 Pa. C.S. §7314 (emphasis added).

Again, under this standard, in determining whether the arbitrator exceeded his powers, the court must look to whether the award draws its essence from the contract. Mun. Emps. Org. of Penn Hills v. Mun. of Penn Hills, 92 A.3d 865 (Pa. Cmwlth. 2014); City of Phila. v. Fraternal Order of Police, Lodge No. 5, 720 A.2d 811 (Pa. Cmwlth. 1998).

(2) Common Law Arbitration

Finally, the common law arbitration review standard is very limited. Gargano v. Terminix Int'l Co., L.P., 784 A.2d 188 (Pa. Super. 2001). Section 7341 of the Judicial Code codifies the common law standard:

> The award of an arbitrator in a nonjudicial arbitration which is not subject to Subchapter A (relating to statutory arbitration) or a similar statute regulating nonjudicial arbitration proceedings is binding and may not be vacated or modified unless it is clearly shown that a party was denied a hearing or that fraud, misconduct, corruption or other irregularity caused the rendition of an unjust, inequitable or unconscionable award.

42 Pa. C.S. §7341 (emphasis added).

An "irregularity refers to the process employed in reaching the result of the arbitration, not to the result itself." Jefferson Woodlands Partners, L.P. v. Jefferson Hills Borough, 881 A.2d 44, 48 (Pa. Cmwlth. 2005) (quoting Gargano, 784 A.2d at 193). "It is well-settled that a common law arbitration award is not reviewable on the basis of an error of law or fact." Id.

However, "the arbitrator's authority is restricted to the powers the parties have granted [him] in the arbitration agreement." Gargano, 784 A.2d at 194. A common law arbitration award "may ... be corrected if the arbitrator exceeds the scope of his authority." Jefferson Woodlands, 881 A.2d at 48-49 (citing Gargano). In addition, an award may be vacated where the irregularity "imports such bad faith, ignorance of the law and indifference to the justice of the result." Allstate Ins., 299 A.2d at 589.

c) Applicable Standard

With these standards of review in mind, we determine the appropriate standard applicable here. We begin by examining the terms of the MSA. See 42 Pa. C.S. §7302(a).

The MSA provides: "The arbitration shall be governed by the United States Arbitration Act." Section XI(c) of the MSA. However, the MSA contains choice of law provisions. Specifically, Section XVIII(n) of the MSA provides Settling States "shall be governed by the laws of the relevant Settling State, without regard to the conflict of law rules of such Settling State." In addition, Sections II(p) and VII(a) of the MSA provide it is "the respective court of each

Settling State" that has "exclusive jurisdiction" over disputes arising out of the MSA. Although Section XI(c) requires that the arbitration itself be conducted in accordance with the FAA, Sections II(p), VII(a), and XVIII(n) dictate it is the law of the Settling State that provides the standards of review for post-arbitration proceedings in state court. Thus, the parties indicated their choice to apply state enforcement mechanisms as opposed to those found within the FAA.

Even if the parties designated the FAA review standard in the MSA, the trial court properly determined review is governed by state law. The FAA applies to proceedings in United States district courts, not state courts. 9 U.S.C. §10; see Trombetta. "[T]he FAA standards of review do not apply to a state trial court's review over an arbitration award created and enforced under the FAA." Trombetta, 907 A.2d at 569. Beyond designating whether statutory or common law arbitration applies, "contracting parties are not free to impose their own standards of review on a court and parties to an arbitration agreement receive no support for doing so under the guise of arbitration, thereby putting those agreements in a superior position." Id.

Insofar as PMs argue the FAA preempts state review standards, we disagree. "The FAA contains no express pre-emptive provision, nor does it reflect a congressional intent to occupy the entire field of arbitration." Volt Info. Sci., Inc. v. Bd. of Trs. of the Leland Stanford Jr. Univ., 489 U.S. 468, 477 (1989) (citations omitted); accord Moscatiello v. Hilliard, 939 A.2d 325 (Pa. 2007). "There is no federal policy favoring arbitration under a certain set of procedural rules; the federal policy is simply to ensure the enforceability, according to their terms, of private agreements to arbitrate." Volt, 489 U.S. at 476.

In fact, "[t]he FAA is not the only way into court for parties wanting review of arbitration awards: they may contemplate enforcement under state statutory or common law, for example, where judicial review of different scope is arguable." Hall Street, 552 U.S. at 590. "However, state law may nonetheless be pre-empted to the extent that it conflicts with federal law; that is, to the extent that it 'stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.'" Trombetta, 907 A.2d at 564 (quoting Volt, 489 at 477).

In Trombetta, the Superior Court concluded the standards of review set forth in the UAA are not preempted by the standards of review outlined in the FAA. The Court explained preemption only applies where a state's action substantively affects the enforceability of the arbitration agreement. Preemption "will not be used to eviscerate state procedural arbitration when such rules have no effect on the enforceability of the underlying agreement." 907 A.2d at 567. Thus, the Court held:

> [T]he FAA standards of review cannot pre-empt the Pennsylvania standards of review for arbitration awards unless the Pennsylvania standards of review frustrate the underlying objectives of the FAA, as standards of review are an inherently procedural mechanism used to facilitate judicial resolution of controversies after the underlying arbitration agreement already has been enforced in accordance with the FAA.

Trombetta, 907 A.2d at 568.

Contrary to PMs' assertions, Pennsylvania's statutory and common law standards do not frustrate the underlying objectives of the FAA; instead, they promote the goals of enforcing arbitration agreements. Trombetta. In fact, the standards of review are quite "similar." Id. at 565 n.9. As discussed above, the FAA standard and the UAA statutory standard both require an arbitration award be upheld if the award draws its essence from the contract. Oxford Health; Mifflinburg; Beaver Cnty. Pennsylvania's common law standards of review, which are even stricter, "are on par with those outlined in FAA §10, and promote the goals of enforcing arbitration agreements and placing arbitration agreements 'upon the same footing as contracts.'" Trombetta, 907 A.2d at 569 (quoting Volt, 489 U.S. at 478). Thus, there is no basis for preemption.

The question remaining is whether, under state law, an arbitration agreement is subject to the broader statutory arbitration principles or to the narrower standard under the common law. This depends on whether the parties' agreement expressly provides for arbitration under the UAA or a "similar statute." 42 Pa. C.S. §7302(a). Although the parties agreed to arbitrate disputes under the FAA, they did not expressly agree to UAA statutory arbitration. The question then is whether the FAA is a "similar statute."

As discussed above, both the FAA standard and the UAA statutory standard require "essence test" review derived from federal decisional law. Oxford Health; Beaver Cnty.; see Mifflinburg; Greater Nanticoke. Under either standard, the award may be vacated if the arbitrator's interpretation cannot be rationally derived from the contract. Ario; Mifflinburg. Neither standard permits review on

the merits. See Enter. Wheel; Beaver Cnty. Although the statutory provisions are not identical, they are sufficiently "similar" triggering application of the UAA special statutory standard. We therefore conclude the trial court did not err by applying the UAA's statutory arbitration provision, and it properly reviewed the arbitration award under the essence test.

d) Review Under Any Standard

Although the parties spend a great deal of effort advocating the various standards of review, it makes little difference in this case. Under either the FAA or the UAA's statutory provisions, the award may be modified or vacated under the essence test, as formulated in Enterprise Wheel, if the award is not rationally derived from the agreement. Ario; Mifflinburg. Under all standards, even the narrowest common law standard, the award may be vacated or corrected where the arbitrators exceed the scope of their authority. 9 U.S.C. §10; 42 Pa. C.S. §7314; see Beaver Cnty; Jefferson Woodlands. The unifying factor among every standard of review is that a reviewing court cannot address the merits for an error of law or fact. With these fundamental tenets in mind, we examine the panel's Partial Settlement Award and the trial court's modification of it.

B. Modification of Partial Settlement Award

1. Contentions

PMs maintain that, under any standard, the trial court's modification of the Partial Settlement Award was improper. PMs assert the panel's interpretation of the MSA was rationally derived from the MSA. The panel rationally concluded the MSA did not directly address how to apply the NPM Adjustment and Reallocation Provision where some states settle and some do not.

The MSA provides only diligent states are exempt from the NPM Adjustment, and that their shares are reallocated to the non-diligent states. It does not address what happens when some states settle, so that there is no determination as to their diligence.

According to PMs, the panel rationally interpreted the MSA to address the effect of a partial settlement. The panel appropriately looked to extrinsic tools of interpretation, specifically judgment-reduction doctrines. Judgment-reduction doctrines specifically deal with situations where multiple defendants have a shared potential liability, and some defendants settle and some do not. Ultimately, the panel applied a *pro rata* reduction to the NPM Adjustment. This method gave Non-Term Sheet States a substantial reduction of $528 million, which amounted to a $128 million reduction for Pennsylvania.

Further, PMs claim the panel rationally rejected the Commonwealth's contention that all contested Term Sheet States (20 of the 22) must be treated as non-diligent. As the panel explained, this contention was not supported by the MSA and was contrary to judgment-reduction law. Also, there was no factual basis for determining those states were not diligent. Moreover, such an interpretation would place Pennsylvania in a better position than if there had been no settlement.

In opposition, the Commonwealth, supported by Amici, respond the trial court acted well within its power to modify the Partial Settlement Award because the panel deviated from the plain language of the MSA, imposed its own

notion of economic justice, and violated the Commonwealth's contractual right to its annual Allocated Payment under any standard of review.

The MSA's lack of a provision addressing a partial settlement did not render the MSA ambiguous or authorize the panel to deviate from the MSA's clear language. The MSA requires an annual payment of funds, and it specifies the exclusive limited grounds for reducing that payment. Specifically, a Settling State can receive its full Allocated Payment if it affirmatively proves that it "diligently enforced" its qualifying statute or all other parties agree that it did. Section IX(d)(2) of the MSA. Contrary to PMs' position, this is not a question of "differing interpretations of contract language" as the MSA is clear. Appellee's Br. at 26 (quoting OPMs' Br. at 23). There is no ambiguity. Only diligent states are exempt from the NPM Adjustment. No State can shift its share of NPM Adjustment to any other State unless it diligently enforced its qualifying statute or all parties agreed that it did.

In addition, Section XVIII(j) of the MSA provides the MSA can only be amended by agreement of "all" parties "affected by the amendment." "The terms of any such amendment shall not be enforceable in any Settling State that is not a signatory to such amendment." Section XVIII(j) of the MSA.

PMs contested the diligence of 20 of the 22 Term Sheet States. By entering the Term Sheet agreement, these 20 States settled without ever proving their diligence. Having never proved their diligence, the Commonwealth argues they are not exempt from the calculation of the NPM Adjustment pursuant to the

clear terms of the MSA. By allowing states that did not prove their diligence to shift their NPM Adjustment responsibility to other states, the panel deviated from the clear language of the MSA. In the process, the panel amended the terms to the MSA. There is no question that Pennsylvania is "affected" by the Partial Settlement Award because it removed 20 states from the pool of 26 states facing reallocation responsibilities. The Commonwealth never agreed to be responsible for another state's share of the NPM Adjustment unless that State was diligent.

Moreover, the Commonwealth contends the panel's adoption of the *pro rata* reallocation method cannot rationally be derived from the MSA. The *pro rata* judgment reduction method has absolutely no application to the Commonwealth's contractual right to its Allocated Payment. Judgment reduction doctrines are applicable to tort or breach of contract cases where each defendant is jointly and severally liable for the entirety of the damages. This is not a tort action, and there was no breach of contract. Moreover, the Settling States are not jointly and severally liable for any "damages." In fact, there is no liability, rather only a right to a contracted payment and agreed-upon rules for when that payment may be reduced. Unlike in tort or breach of contract cases, there is no "liability" for the "whole" NPM Adjustment as the potential NPM Adjustment reduction is capped at the amount of the Settling State's Allocated Payment for that year. The panel's application of the *pro rata* judgment reduction was not drawn from the essence of the MSA, and it went well beyond the scope of the panel's authority under the MSA. Thus, the trial court correctly held "there was no basis for the Panel to consider 'standard' judgment reduction methods" in this case. Tr. Ct., Slip Op., at 49.

Finally, the Commonwealth asserts PMs already collected the Term Sheet States' share of the NPM Adjustment through Term Sheet settlement, and they may not "double-dip" from the Non-Term Sheet States. Appellee's Br. at 41. Under the MSA, there are two tiers to the NPM Adjustment attributable to a non-diligent state: (1) the State's original allocable share of the NPM Adjustment, sometimes referred to as its base share, which is based on its MSA allocation; plus (2) the State's reallocation share, which covers the shares attributable to the diligent states that are reallocated among non-diligent states. Although the panel reduced the NPM Adjustment by the Term Sheet States' allocable base share under the first tier, it did not account for their share of the second tier liability.

Moreover, the Term Sheet extinguished the potential NPM Adjustment responsibilities (both tiers) between the Term Sheet States and PMs for 2003 through 2012. In other words, PMs surrendered any additional monies as part of the Term Sheet settlement. Because the Term Sheet States' responsibilities are extinguished, PMs cannot shift that responsibility and try to collect the amount from the Non-Term Sheet States.

In reply, PMs aver the Commonwealth's application of the two-tier approach in determining the NPM Adjustment is misleading. There is a single NPM Adjustment amount, split among potentially liable parties based on their conduct, i.e., their non-diligence.

PMs further respond the MSA is ambiguous and requires interpretation because it does not address what happens when a State's diligence is

unknown because it settled. Contrary to the Commonwealth's position, there is no default rule in the MSA that a Settling State must be treated as non-diligent when its diligence is unknown. In fact, the MSA does not even mention burdens of proof regarding diligence. The panel in assigning this burden to the Settling States applied the well-established principle in contract cases that the party seeking the benefit of an exception in a contract must prove it.

Moreover, the MSA contains no language displacing judgment-reduction law or contract law. The Commonwealth does not dispute arbitrators may consider relevant law in interpreting contracts to clarify ambiguous contract language. Judgment-reduction law is applicable in contract cases. The Commonwealth's claim that this methodology only applies where defendants are jointly and severally liable and does not apply to disputes involving agreed-upon contract rules is unavailing. Non-diligent States are collectively liable for the NPM Adjustment. The judgment-reduction laws address the situation where, as here, multiple parties have shared liability. Under the *pro rata* method, rationally applied by the panel, none of the Term Sheet States' 46% allocable share would be reallocated to the Non-Term Sheet States, and none of the Non-Term Sheet States' 54% allocable share would be reallocated to the Term Sheet States.

Finally, PMs reassert the trial court was not authorized to substitute its judgment for the panel's contract interpretation. To conclude, as the trial court did, that the Term Sheets States were not diligent for purposes of calculating the NPM Adjustment improperly gives a windfall to Pennsylvania. PMs provided the Non-Term Sheet States with a $528 million judgment reduction of the 2003 NPM

Adjustment, even though PMs received only a $243 million settlement from the Term Sheet States. Far from double-dipping, PMs sacrificed almost $300 million of their potential 2003 NPM Adjustment.

Thus, PMs claim the panel's refusal to treat all the contested Term Sheet States as non-diligent and its adoption of the *pro rata* method were entirely rational. On this basis, the Partial Settlement Award cannot be disturbed, under Section 7302(d)(2) of the UAA or any standard of review.

2. Analysis

Under any standard of review, the trial court properly modified the Partial Settlement Award because the panel exceeded its authority under the MSA. We begin our discussion by examining the MSA.

The MSA provides the NPM Adjustment "shall apply to the Allocated Payments of all Settling States." Section IX(d)(2)(A) of the MSA (emphasis added). The MSA provides the exclusive mechanism by which a Settling State can avoid the NPM Adjustment and shift its share. Specifically, "[a] Settling State's Allocated Payment shall not be subject to an NPM Adjustment: (i) if such Settling State continuously had a Qualifying Statute ... in full force and effect during the entire calendar year immediately preceding the year in which the payment in question is due, and diligently enforced the provisions of such statute during such entire calendar year ...." Section IX(d)(2)(B) of the MSA (emphasis added). If a Settling State satisfies the requirement of diligent enforcement, its Allocated Payment is not subject to reduction.

If a State does not adopt or does not diligently enforce a qualifying statute, its Allocated Payment is subject to reduction. "The aggregate amount of the NPM Adjustments that would have applied to the Allocated Payments of those Settling States that are not subject to an NPM Adjustment pursuant to subsection (2)(B) shall be reallocated among all other Settling States *pro rata* in proportion to their respective Allocable Shares ..., and such other Settling States' Allocated Payments shall be further reduced accordingly." Section IX(d)(2)(C) of the MSA (emphasis added).

In essence, the MSA created two categories for Settling States with regard to the NPM Adjustment: States that are diligent and those that are not. Settling States that do not satisfy the conditions of the diligent enforcement bear both (1) their Allocable Share of the NPM Adjustment (first tier), and (2) their proportional share of the aggregate NPM Adjustment reallocated from those States found diligent (second tier).

The MSA also addressed how the agreement could be amended. Specifically, the MSA can only be amended by agreement of "all" parties "affected by the amendment." Section XVIII(j) of the MSA. "The terms of any such amendment shall not be enforceable in any Settling State that is not a signatory to such amendment." Id.

However, the MSA did not address the effect of a partial settlement on the reallocation, which led to the parties' dispute. Under the MSA, the panel

was authorized to resolve the dispute as it related to the calculations of the NPM Adjustment. See Section XI(c) of the MSA.

In its preliminary rulings, the panel determined each contested Settling State would bear the burden of proving it diligently enforced its qualifying statute at an evidentiary hearing. Panel Order, 1/19/2011, at 14; R.R. at 222a. If a State was not contested by any party after the conclusion of discovery and deadlines set to contest the issue, the State would be deemed diligent. Panel Order, 7/1/2011, at 17-18; R.R. at 268a-69a. After discovery, PMs contested the diligence of 35 Settling States, including 20 of the 22 Term Sheet States. The panel rejected the Settling States' contention that they should be presumed diligent, directing that they must prove diligence. Panel Order, 5/23/11, at 6; R.R. at 230a. Yet, in its Partial Settlement Award, the panel treated all Term Sheet States as diligent for purposes of reallocation, even though 20 Term Sheet States did not show diligence. Panel's Stip. Partial Settlement & Award, 3/12/13, at 10; R.R. at 463a.

In reaching its decision, the panel determined the lack of a provision dealing with the effect of a partial settlement on the Reallocation Provision rendered the MSA ambiguous. Under the guise of contract interpretation, the panel looked outside the confines of the MSA, and the panel turned to judgment reduction methodologies to resolve the "ambiguity."

Ultimately, the panel held *pro rata* "reduction is appropriate and adequate under the MSA and governing law. Where multiple parties have a potential shared contractual obligation and some of them settle and some do not,

the non-settling parties cannot necessarily block the settlement, but may be entitled to a judgment reduction." Panel's Stip. Partial Settlement & Award, 3/12/13, at 10; R.R. at 464a. It continued: "Where non-settling defendants are given the protection of the applicable judgment-reduction method required under the contract and law, they are not prejudiced by the partial settlement." Id.

> The panel explained that the MSA provisions:
>
> > use the specific term '*pro rata*,' stating that the shares of diligent States are to be 'reallocated among all other Settling States *pro rata* in proportion to their respective Allocable Shares.' MSA § IX(d)(2)(C); *see also* MSA §IX(d)(2)(D) ('*pro rata* in proportion to their respective Allocable Shares'). More fundamentally, the MSA also provides that the reallocation is not done on a relative fault basis. The amount of a diligent State's share that is reallocated is its *pro rata* share of the whole, not an amount derived from its particular fault level. Likewise, the amount of reallocated share that a non-diligent State receives is derived from its *pro rata* share of the liable States, not its fault level. If the reallocation of diligent States shares is done on a *pro rata* basis in this way, the Panel reads the MSA as likewise meaning that a judgment reduction arising from some States' settlement of the diligent enforcement issue should be *pro rata* as well.

Id. at 11; R.R. at 465a (emphasis omitted).

Applying the *pro rata* reduction to the reallocation, the panel reduced the NPM Adjustment by the Term Sheet States' allocable shares and reallocated the adjusted amount among all Non-Term Sheet States that did not diligently enforce a qualifying statute during 2003. Id. It further directed the auditor to

"treat the [Term Sheet] [S]tates as not subject to the 2003 NPM Adjustment for purposes of Section IX(d)(2)(B)-(C) of the MSA" even though their diligence was unknown. Id. at 9; R.R. at 463a.

Although it is well-established that contract interpretation is left to the arbitrator, not the courts, as discussed above, the arbitrator's authority is not without some limit. An arbitrator that interprets unambiguous language in any way different from its plain meaning amends or alters the agreement and acts without authority. See Delaware Cnty.; Greater Nanticoke. The intent of the parties to a contract "is deemed to be embodied in 'what the agreement manifestly expressed, not what the parties may have silently intended.'" Greater Nanticoke, 760 A.2d at 1219 (quoting Delaware Cnty., 713 A.2d at 1138). Even in the arbitration setting, "when the words [of a contract] are clear and unambiguous[,] the intent is to be gleaned exclusively from the express language of the agreement." Id. (quoting Delaware Cnty., 713 A.2d at 1137).

Although the MSA does not address the effect of a partial settlement on the reallocation, it is not ambiguous. The MSA clearly sets forth the conditions under which the parties agreed a state's NPM Adjustment responsibility would shift to another state – only if the State diligently enforced its qualifying statute. Section IX(d)(2)(B) of the MSA. It also specified how the MSA could be amended. Section XVIII(j) of the MSA. These provisions are not susceptible to different constructions.

Yet, under the panel's "interpretation," it disregarded these terms and created a new term as to when a Settling State would not be responsible for its NPM Adjustment – when it settles its diligence contest. Since it is unknown whether 20 Term Sheet States were, in fact, diligent, there was no basis for removing them from the reallocation pool. In this regard, the panel's decision departs from the MSA, as well as from its initial ruling regarding burden of proof. By treating the Term Sheet States as diligent and allowing them to shift their share of the reallocation, the panel departed from the MSA's clear terms and "amended" the MSA without agreement of "all" parties "affected by the amendment." In so doing, the panel acted without authority. See Delaware Cnty.; Greater Nanticoke.

In addition, the process employed by the panel in reaching its result far exceeded the scope of its authority as bestowed by the MSA. By applying the *pro rata* reduction of the reallocation amount, the panel supplied its own formula for reallocation, not embraced by the MSA. Although arbitrators may consult external sources in interpreting a contract, Greater Nanticoke, there was no basis for the panel's adoption and application of judgment reduction methodology. The irrationality is that such methodologies are premised on joint tortfeasors and the ability of a plaintiff to recover the *entire* amount from a single defendant pursuant to the doctrine of joint and several liability. See Baker v. ACandS, 755 A.2d 664 (Pa. 2000). If a joint torfeasor pays "more than its proportionate share of the verdict," it may sue the nonpaying defendants for contribution. Id. at 669; see 42 Pa. C.S. §§8324 and 8327.

Under the MSA, the non-diligent States are not "jointly and severally liable" for the NPM Adjustment. Rather, a State's allocation of the NPM Adjustment is capped at the amount of the Settling State's Allocated Payment for that year. Section IX(d)(2)(D) of the MSA. Moreover, non-diligent States have no right of recourse against the Term Sheet States for failing to pay their proportionate share.

The MSA uses the term "*pro rata*" to distribute reallocated portions of the NPM Adjustment among all States that have not been found diligent according to a set rate. Section IX(d)(2)(C) of the MSA. The term does not, however, embrace judgment reduction doctrine. More importantly, the "*pro rata*" language in the Reallocation Provision does not excuse any State from the reallocation pool. To the contrary, the Reallocation Provision applies to "all" States unless those States were diligent. By fashioning its own formula not derived from the terms of the MSA, the panel again exceeded the scope of its authority.

Similarly, we reject PMs' arguments based on whose burden it was to prove diligence. Regardless of who bore the burden, relief from the NPM Adjustment and Reallocation Provision depended on a determination of diligence. In the absence of such a determination, no relief was available to any State under the clear language of the MSA. Thus, regardless of who bore the burden of proof, the Partial Award's direction to treat the Term Sheet States as diligent was in excess of the panel's powers.

The irrationality of the Partial Award is further illustrated by the disproportionate reallocation of the NPM Adjustment. Under the MSA, each non-diligent Settling State both bears its original share of the NPM Adjustment (first tier) and an additional share reallocated from diligent States (second tier). Although the *pro rata* offset removed the Term Sheet States aggregate allocable share of the NPM Adjustment from the reallocation pool, it also removed the Term Sheet States from the pool of States available to bear the reallocated amounts. This caused the Non-Term Sheet States found not to be diligent (including Pennsylvania) to pay more than they agreed to pay under the MSA.

More particularly, the NPM Adjustment for 2003 was $1,147,566,064.87. The panel reduced the total NPM Adjustment by 46% ($528,631,663.47), which represented the potential allocable shares of the 22 Term Sheet States. The NPM Adjustment, after the *pro rata* reduction, was $618,934,401.40 (=$1,147,566,064.87 - $528,631,663.47).

By removing 20 Term Sheet States from the reallocation pool, the panel divided the NPM Adjustment among the 6 non-diligent states based on a percentage attributable to their coordinating reallocation share.[11] Under this

[11] The breakdown is as follows:

State	MSA Allocation	Reallocation Share
Indiana	2.0398033%	13.8958103%
Kentucky	1.7611586%	11.9975910%
Maryland	2.2604570%	15.3989758%
Missouri	2.2746011%	15.4953300%
New Mexico	0.5963897%	4.0628026%

(Footnote continued on next page…)

formula, the panel determined Pennsylvania's proportionate share was $242,309,663.54 (=$618,934,401.40 x 39.15%).

In contrast, the trial court, based on the express terms of the MSA, determined "all" States must bear the NPM Adjustment unless they are diligent. Tr. Ct., Slip Op., at 41 (quoting Section IX(d)(2) of the MSA). As 20 States chose to settle rather than defend their diligence, the trial court treated them as non-diligent and included them in the reallocation pool. The trial court divided the total NPM Adjustment ($1,147,566,064.87), without any *pro rata* judgment reduction, among 26 States, not 6, according to a percentage attributable to their proportionate allocable share.[12] Under this calculation, the trial court determined

(continued…)

Pennsylvania	**5.7468588%**	**39.1494903%**
	14.6792685%	100%

[12] The breakdown is as follows:

State	**MSA Allocation**	**Reallocation Share**
Alabama	1.6161308%	2.8538727%
Arizona	1.4738845%	2.6026846%
Arkansas	0.8280661%	1.4622549%
California	12.7639554%	22.5394526%
Connecticut	1.8565373%	3.2783987%
D.C.	0.6071183%	1.0720904%
Georgia	2.4544575%	4.3342465%
Indiana	2.0398033%	3.6020221%
Kansas	0.8336712%	1.4721528%
Kentucky	1.7611586%	3.1099725%
Louisiana	2.2553531%	3.9826545%
Maryland	2.260457%	3.9916673%
Michigan	4.3519476%	7.6849623%
Missouri	2.2746011%	4.0166439%

(Footnote continued on next page…)

Pennsylvania's share of the NPM Adjustment is $116,457,190.73 (=$1,147,566,064.87 x 10.15%).

Contrary to the panel's declaration that the Term Sheet and Partial Settlement Award do not materially prejudice or adversely affect Non-Term Sheet States, R.R. at 466a, the panel's award caused Pennsylvania to bear a much greater portion of the 2003 NPM Adjustment than it should under terms of the MSA. Although the panel had jurisdiction over the dispute, it was not authorized to disregard MSA language or fashion a new remedy based on its own notions of economic justice. That is not what the parties bargained for. Rather, the parties bargained for the panel's construction of the MSA itself, i.e., a rational interpretation of the contract language. See Brentwood. The panel was obliged to apply the MSA as written without imposing additional terms that modify or limit what the parties expressed. Delaware Cnty.

(continued…)

Nebraska	0.5949833%	1.0506616%
Nevada	0.6099351%	1.0770645%
New Hampshire	0.665934%	1.1759511%
New Mexico	0.5963897%	1.0531451%
North Carolina	2.332285%	4.118506%
Oklahoma	1.036137%	1.8296805%
Pennsylvania	**5.7468588%**	**10.1481905%**
South Carolina	1.1763519%	2.0772815%
Tennessee	2.4408945%	4.310296%
Virginia	2.0447451%	3.6107487%
West Virginia	0.8864604%	1.5653715%
Puerto Rico	1.1212774%	1.9800272%
	56.629394%	100%

Because the panel's interpretation deviates from the MSA's express terms and disregards the intent of the parties regarding how the reallocation would be shared, the trial court properly determined the award does not draw its essence from the agreement. Moreover, the panel's departure from the contract language itself and the application of a judgment reduction offset constituted an irregularity under common law arbitration. Under any standard of review, we conclude the respected panel exceeded its powers, warranting modification.

The trial court's modification takes into consideration the express terms of the MSA and is rationally derived the MSA. Thus, we affirm the trial court's modification of the Partial Settlement Award.

IV. Conclusion

In conclusion, the trial court properly applied essence test review pursuant to Section 7302(d)(2) of the UAA and decisional law. Under this review, the trial court concluded the panel's Partial Settlement Award did not draw its essence from the MSA because the panel departed from the MSA's clear and unambiguous language regarding reallocation. By fashioning its own award that deviated from the contract terms, the panel did not enforce the terms of the MSA. Rather, the panel fashioned a new contract for the parties under the guise of contract interpretation. Therefore, under any standard of review, we conclude the panel exceeded its powers by acting beyond the material terms of the MSA, from which its authority was derived. The trial court properly modified the award in accordance with the MSA's express terms.

Accordingly, we affirm.

ROBERT SIMPSON, Judge

Judges Leadbetter and Cohn Jubelirer did not participate in the decision in this case.

IN THE COMMONWEALTH COURT OF PENNSYLVANIA

Commonwealth of Pennsylvania by Kathleen G. Kane, in her official Capacity as Attorney General of the Commonwealth of Pennsylvania	:	
v.	:	No. 803 C.D. 2014
Philip Morris USA, Inc., R.J. Reynolds Tobacco Company, Lorillard Tobacco Company, Liggett Group LLC, Commonwealth Brands, Inc., Daughters and Ryan, Inc., Farmer's Tobacco Company of Cynthiana, Inc., House of Prince A/S, Sherman 1400 Broadway N.Y.C. Inc., King Maker Marketing, Inc., Top Tobacco, L.P., Japan Tobacco International U.S.A., Inc., Kretek International, Inc., Peter Stokkebye Tobaksfabrik A/S, P.T. Djarum, Santa Fe Natural Tobacco Company, Inc., Von Eicken Group	:	
Appeal of: R.J. Reynolds Tobacco Company, Philip Morris USA, Inc. and Lorillard Tobacco Company	:	
Commonwealth of Pennsylvania by Kathleen G. Kane, in her official Capacity as Attorney General of the Commonwealth of Pennsylvania	:	
v.	:	No. 804 C.D. 2014
Philip Morris USA, Inc., R.J. Reynolds Tobacco Company, Lorillard Tobacco Company, Liggett Group Inc., Commonwealth Brands, Inc., Daughters and Ryan, Inc.,	:	

Farmers Tobacco Company of Cynthiana, Inc., House of Prince A/S, Sherman 1400 Broadway N.Y.C. Inc., King Maker Marketing, Inc., Top Tobacco, L.P., Japan Tobacco International U.S.A., Inc., Kretek International, Inc., Peter Stokkebye Tobaksfabrik A/S, P.T. Djarum, Santa Fe Natural Tobacco Company, Inc.,Von Eicken Group	:
Appeal of: Commonwealth Brands, Inc., Daughters and Ryan, Inc., House of Prince A/S, Liggett Group Inc., Sherman 1400 Broadway N.Y.C. Inc., King Maker Marketing, Inc., Top Tobacco, L.P., Japan Tobacco International U.S.A., Inc., Kretek International, Inc., Peter Stokkebye Tobaksfabrik A/S, P.T. Djarum, Santa Fe Natural Tobacco Company, Inc., Von Eicken Group, and Farmers Tobacco Company of Cynthiana, Inc.	:

O R D E R

AND NOW, this 10th day of April, 2015, the order of the Court of Common Pleas of Philadelphia County is **AFFIRMED**.

ROBERT SIMPSON, Judge