No. 09-911

IN THE

Supreme Court of the United States

R.J. REYNOLDS TOBACCO COMPANY, *ET AL.*,

Petitioners,

v.

STATE OF MONTANA *EX REL.* STEVE BULLOCK,

Respondent.

On Petition for Writ of Certiorari to the Supreme Court of Montana

REPLY TO BRIEF IN OPPOSITION

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ARGUMENT

Montana opposes certiorari on three grounds. *First*, Montana argues that the interpretation of an arbitration provision is *solely* a matter of state law, and that the petition accordingly does not present a substantial federal question. *See* Opp. 10-16. *Second*, Montana argues that the Montana Supreme Court properly held that the nationwide tobacco Master Settlement Agreement (MSA) does not require arbitration of a dispute over "diligent enforcement," even though the courts of all 47 other States and Territories to have considered the issue have concluded just the opposite. *See id.* at 17-27. And *third*, Montana argues that the issues presented by this petition are not sufficiently important to warrant this Court's review. *See id.* at 27-32. As explained below, Montana is wrong on all three scores.

A. The FAA Creates Substantive Federal Arbitration Law, So The Interpretation Of An Arbitration Provision Is Not Solely A Matter Of State Law.

Montana first argues that "whether the parties agreed to arbitrate diligent enforcement is a matter of state contract, not federal arbitration, law." Opp. 10. Thus, according to Montana, this case does not implicate federal law—specifically, the Federal Arbitration Act (FAA), 9 U.S.C. § 1 *et seq.*—at all.

Montana is clearly wrong. As explained in the petition, it has been settled for almost half a century that the FAA establishes *substantive* federal arbitration law, *see, e.g.*, *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 402-04 (1967), and that this law governs in both federal and state

courts, *see, e.g. Southland Corp. v. Keating*, 465 U.S. 1, 10-16 (1984); *see generally* Pet. 15. That substantive law addresses, among other things, whether the parties agreed to arbitrate a given dispute; indeed, this Court recently reaffirmed that "the central or 'primary' purpose of the FAA is to ensure that 'private agreements to arbitrate are enforced according to their terms.'" *Stolt-Nielsen S.A. v. AnimalFeeds Int'l Corp.*, 130 S. Ct. __, __ (U.S. Apr. 27, 2010) (Slip op. 18) (quoting *Volt Info. Scis., Inc. v. Board of Trs. of Leland Stanford Jr. Univ.*, 489 U.S. 468, 479 (1989)).

Needless to say, the federal substantive right to enforce arbitration agreements according to their terms would be illusory if the interpretation of those agreements were *solely* a matter of state law. If that were so, state courts would be free (as the Montana Supreme Court did here) to defeat the federal right at will by invoking state law. Indeed, the federal substantive presumption in favor of arbitration (which Montana grudgingly acknowledges, *see* Opp. 11 (citing *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52, 62 (1995)), would make no sense if the interpretation of an arbitration provision were *solely* a matter of state law.

That is why this Court has taken pains to emphasize that "the interpretation of an arbitration agreement is *generally* a matter of state law," as opposed to *exclusively* a matter of state law. *Stolt-Nielsen*, 130 S. Ct. at __ (Slip op. 17) (emphasis added); *see also Volt*, 489 U.S. at 474. While state law generally provides the background rules for interpreting an arbitration agreement, *federal* arbitration law "imposes certain rules of

fundamental importance" on the application of state law—including the rule that courts must "'give effect to the contractual rights and expectations of the parties.'" *Stolt-Nielsen*, 130 S. Ct. at __ (Slip op. 17, 18) (quoting *Volt*, 489 U.S. at 479); *see also id.* at __ (Slip op. 20) ("the purpose of the exercise" under the FAA is "to give effect to the intent of the parties").[1]

Thus, where, as here, courts refuse to "give effect" to the plain terms of an arbitration agreement, they violate the parties' *federal* arbitration rights. *See id.* at __ (Slip op. 18); *Southland*, 465 U.S. at 13-14. A state court cannot, consistent with the FAA, invoke state law to hold that an arbitration agreement does not mean what it clearly says. And a state court cannot evade review under the FAA by insisting that it is merely applying state law. *See, e.g., Buckeye Check Cashing, Inc. v. Cardegna*, 546 U.S. 440, 446 (2006).[2]

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[1] As discussed below, while petitioners believe that the better course would be for this Court to resolve this case definitively itself, an alternative course would be to grant the petition, vacate the decision below, and remand in light of *Stolt-Nielsen*.

[2] There is nothing novel or unusual in this hybrid regime of federal and state law. For example, while state law generally governs the interpretation of contracts, the question whether a particular application of state law violates federal rights protected by the Contract Clause, U.S. Const. art. I § 10, raises a question of federal law. *See, e.g., General Motors Corp. v. Romein*, 503 U.S. 181, 187 (1992). Similarly, while state law generally governs the definition of property rights, the question whether a particular application of state law violates federal rights protected by the Takings Clause, U.S. Const. amend. V, also raises a question of federal law. *See, e.g., Lucas v. South Carolina Coastal Council*, 505 U.S. 1003, 1031-32 (1992).

Montana nonetheless insists that "this case is on all fours with *Volt*," and that "*Volt* controls this case." Opp. 13-14. But *Volt* reaffirms the *federal* right to have arbitration agreements enforced "according to their terms." 489 U.S. at 478, 479. The state court in *Volt* did just that, *see id.*; the state court here did not. In addition, *Volt* confirms that the interpretation of an arbitration agreement is *not* solely a matter of state law, but that "due regard must be given to the federal policy favoring arbitration, and ambiguities as to the scope of the arbitration clause itself resolved in favor of arbitration." *Id.* at 476.

Indeed, if Montana were correct that "[r]esolution of th[e] threshold issue of the parties' intent [to arbitrate] is a matter of state, not federal, law," Opp. 12, this Court's recent decision in *Stolt-Nielsen* would be inexplicable. The Court there held, as a matter of *federal* substantive law under the FAA, that silence on the issue of class arbitration cannot be construed as consent to class arbitration. *See* 130 S. Ct. at __-__ (Slip op. 20-23). By contrast, under Montana's view, a state court would be free under state law to construe silence on the issue of class arbitration as consent to class arbitration, and *Stolt-Nielsen* would be a nullity.

Finally, Montana argues that the parties here contracted away their federal arbitration rights by agreeing in the MSA that "'[t]his Agreement ... shall be governed by the laws of the relevant Settling State.'" Opp. 13 (quoting MSA § XVIII(n)). As an initial matter, that argument ignores the MSA's arbitration clause, which specifies that arbitration "shall be governed by the United States Federal

Arbitration Act." MSA § XI(c), Pet. 7. In any event, a garden-variety contractual choice-of-law provision is not a waiver of federal arbitration rights. Were that so, the FAA would be essentially meaningless, since almost every contract includes a choice-of-law provision. Not surprisingly, therefore, this Court has consistently applied the FAA to contracts with provisions specifying that they are governed by a particular State's law. *See, e.g., Preston v. Ferrer*, 552 U.S. 346, 360-63 (2008); *Mastrobuono*, 514 U.S. at 63-64.

B. The Montana Supreme Court Violated The FAA By Refusing To Enforce The MSA's Arbitration Provision According To Its Terms.

Montana next strives to attach a fig leaf of respectability to the Montana Supreme Court's decision, contrary to the courts of the other 47 States and Territories that have addressed the issue, that a dispute over "diligent enforcement" does not fall within the MSA's arbitration provision. *See* Opp. 17-27. This effort too is unavailing.

At the broadest level, Montana asserts that the Montana Supreme Court could not have violated the FAA because nothing in the majority opinion expressly "*disavows* any federal policy or law." *Id.* at 18 (emphasis added); *see also id.* at 19-20, 21, 22. But it is hardly surprising that the Montana Supreme Court did not acknowledge that it was flouting federal arbitration law; courts rarely, if ever, acknowledge that they are flouting the law. Needless to say, the court "need not have said" that it was flouting federal law "to make it so." *Stolt-Nielsen*, 130 S. Ct. at __ n.7 (Slip op. 11 n.7).

On the merits, Montana has remarkably little to say. It simply repeats the Montana Supreme Court's manifestly erroneous assertion that a dispute over the Independent Auditor's presumption of "diligent enforcement" is not a dispute "'arising out of or relating to ... any determinations made by[] the Independent Auditor.'" Opp. 22-24 (quoting MSA § XI(c)). As every other court to address the issue has recognized, a legal presumption of diligent enforcement *is* a determination of diligent enforcement made on a categorical, as opposed to individualized, basis. *See, e.g.*, *Alabama v. Lorillard Tobacco Co.*, 1 So.3d 1, 11 (Ala. 2008); *New Hampshire v. Philip Morris USA, Inc.*, 927 A.2d 503, 510 (N.H. 2007); *North Dakota v. Philip Morris, Inc.*, 732 N.W.2d 720, 729 (N.D. 2007); *cf. American Hosp. Ass'n v. NLRB*, 499 U.S. 606, 611-12 (1991). At the very least, a presumption of diligent enforcement "relate[s] to" the Independent Auditor's determination not to apply the NPM Adjustment; after all, that presumption was the very *basis* of that determination. *See* Pet. 24 (citing cases).

And Montana does not even *try* to defend the Montana Supreme Court's decision to excise from the MSA's arbitration provision language requiring arbitration of, "without limitation, any dispute concerning the operation or application of any of the adjustments, reductions, offsets, carry-forwards and allocations described in subsection IX(j) or subsection XI(i)." Pet. App. 16-17a (quoting MSA § XI(c), Pet. 7). Rather, Montana simply repeats the Montana Supreme Court's Orwellian assertion that "reading the contract as a whole" requires reading this phrase out of the contract entirely, because it would "nullify the limiting words 'calculations

performed by, or any determinations made by, the Independent Auditor.'" Opp. 8 n.4 (quoting Pet. App. 16a). The parties included this language to underscore their intent to subject *all* disputes "concerning the operation or application" of the NPM Adjustment (set forth in MSA § IX(j), *see* Pet. 7) to binding nationwide arbitration. *See id.* at 25 (citing cases). By excising this language from the arbitration provision, the state court violated the FAA. *Cf. Stolt-Nielsen*, 130 S. Ct. at __-__ (Slip op. 17-23).

Montana's reliance on the MSA's provisions giving state courts "'exclusive jurisdiction for the purposes of implementing and enforcing this Agreement,'" Opp. 2, 4, 24, 32 (quoting MSA § VII(a)(2)), and authorizing the parties to sue in state court to enforce their rights under the MSA (or seek a declaration of those rights), *see* Opp. 2, 5, 24-25 (citing MSA § VII(c)), is equally unavailing. By their plain terms, both those provisions apply "*except* as provided in subsection[] ... XI(c)," the MSA's arbitration provision. MSA §§ VII(a)(3), VII(c)(1) (emphasis added). That limitation is not surprising: the arbitration provision would be meaningless if the parties were free to litigate disputes within its scope in state court. By agreeing that they could *enforce* their rights under the MSA in state court, the parties did not *relinquish* any such rights, including the right to arbitrate certain disputes under the FAA. *See, e.g.*, *Nevada v. Philip Morris USA*, 199 P.3d 828, 833-34 (Nev. 2009); *Alabama*, 1 So.3d at 7-8 & n.7; *New Mexico v. American Tobacco Co.*, 194 P.3d 749, 752 (N.M. Ct. App. 2008); *Nebraska v. R.J. Reynolds Tobacco Co.*, 746 N.W.2d 672, 679-80 (Neb. 2008); *Massachusetts v. Philip Morris Inc.*, 864 N.E.2d 505,

512, 513-14 (Mass. 2007); *North Dakota*, 732 N.W.2d at 727.

Montana also errs by arguing that the Independent Auditor itself stated that it was "not qualified to make the legal determination as to whether any particular Settling State has 'diligently enforced' its Qualifying Statute." Opp. 4 (internal quotation omitted); *see also id.* at 23. As Montana acknowledges in a footnote, the Independent Auditor said that in a "preliminary" letter, and "removed that language" (after petitioners objected) from the final letter. Opp. 4-5 n.3. Indeed, the Independent Auditor itself referred the parties' dispute over the denial of the 2003 NPM Adjustment, based on the presumption of diligent enforcement, to arbitration. In any event, the Independent Auditor's assessment of its own competence has no bearing on the scope of the MSA's arbitration provision. Because a presumption of diligent enforcement is a determination of diligent enforcement, or at least related to such a determination, or at least related to the NPM Adjustment set forth in MSA § IX(j), this argument is a red herring. *See, e.g.*, *Maryland v. Philip Morris Inc.*, 944 A.2d 1167, 1178 n.14 (Md. Ct. Spec. App.), *cert. denied*, 949 A.2d 653 (Md. 2008); *Massachusetts*, 864 N.E.2d at 510 n.7.

Montana also errs by dismissing as irrelevant the decisions of other state courts holding that a dispute over diligent enforcement falls squarely within the scope of the MSA's arbitration provision. *See* Opp. 24-27. That otherwise unbroken line of authority underscores the central point of the petition: the Montana Supreme Court's contrary conclusion represents a failure to enforce the MSA's arbitration

provision according to its plain terms, which in turn represents a denial of the parties' federal arbitration rights. *See, e.g.*, *West Virginia v. American Tobacco Co.*, 681 S.E.2d 96, 112 (W. Va. 2009) ("plain and unambiguous terms"); *Nevada*, 199 P.3d at 833 ("clear language"); *Alabama*, 1 So.3d at 8 ("clear and unambiguous language"); *Illinois v. Lorillard Tobacco Co.*, 865 N.E.2d 546, 554 (Ill. App. Ct.) ("plain and unambiguous language"), *appeal denied*, 875 N.E.2d 1119 (Ill. 2007); *Louisiana v. Philip Morris, USA, Inc.*, 982 So.2d 296, 300 (La. Ct. App.) ("clear and explicit language"), *writ denied*, 992 So.2d 942 (La. 2008); *New York v. Philip Morris Inc.*, 838 N.Y.S.2d 460, 463 (2007) ("plain language"); *North Dakota*, 732 N.W.2d at 731 ("plain and unambiguous language").

This case thus presents the federal issue in the starkest possible manner: it is unlikely that this Court will soon again see an arbitration provision that has been uniformly construed by the courts of 47 States to encompass a particular dispute only to have the 48th State reach the opposite conclusion. If ever there were a case in which it is clear that a state court has denied the substantive federal right to enforce an arbitration provision according to its plain terms, *see, e.g.*, *Stolt-Nielsen*, 130 S. Ct. at __ (Slip op. 18), this is it.

C. This Petition Warrants This Court's Review.

Finally, Montana argues that this petition is not worthy of this Court's review. *See* Opp. 27-32. Again, that argument is incorrect.

Montana first argues that "the question presented is limited and case-specific." Opp. 27. But

that argument is based on the erroneous premise that the issue presented here is "a matter of Montana law," *id.* at 28, which it is not. Indeed, the fact that Montana feels free to argue that the interpretation of an arbitration provision is *solely* a matter of *state* law, notwithstanding this Court's ongoing reaffirmation of the *federal* substantive right to enforce arbitration agreements according to their terms, *see, e.g.*, *Stolt-Nielsen*, 130 S. Ct. at __ (Slip op. 18), only underscores the need for this Court's review.

Montana also argues that the decision below is of little practical effect, because no other state court has refused to enforce the MSA's arbitration provision, Montana is too small to matter, and the Montana courts may reach the right decision on the merits. *See* Opp. 31. But none of these arguments addresses the problem of how to implement the nationwide MSA if Montana courts and nationwide arbitrators apply different standards for diligent enforcement, or how to implement the MSA in the future if state courts may disregard the MSA's arbitration provision with impunity. This is, after all, a "landmark" agreement, *Lorillard Tobacco Co. v. Reilly*, 533 U.S. 525, 533 (2001), with profound implications for the national economy and state budgets. It is hard to imagine a case where the need for national uniformity, and the countervailing pull toward parochialism, is more evident. There is a *Federal* Arbitration Act for a reason, *see, e.g.*, *Southland*, 465 U.S. at 13-14, and the Montana Supreme Court has made a mockery of all the other state courts that dutifully enforced the MSA's arbitration provision over the opposition of their States. *See* Pet. 19-23.

Montana also denies that its Supreme Court is waging a "war against arbitration," citing a single case in which that court (by a divided vote) enforced arbitration by applying the federal substantive rule of severability established in *Buckeye*, 546 U.S. at 443-45, and *Prima Paint*, 388 U.S. at 402-04. *See* Opp. 29. But one decision clearly compelled by federal law hardly overcomes a notorious record of hostility to federal arbitration rights. *See* Pet. 29-32 & nn.2, 3. Indeed, the decision below, rendered after the courts of 47 other States and Territories read the MSA to require arbitration, provides ample evidence that the "war against arbitration" in Montana is far from over. *See, e.g.*, Scott J. Burnham, *The War Against Arbitration in Montana*, 66 Mont. L. Rev. 139, 178 (2005).

Because the decision below cannot be reconciled with the federal arbitration rights reaffirmed most recently in *Stolt-Nielsen*, this Court may wish to consider granting the petition, vacating the Montana Supreme Court's decision, and remanding the case in light of *Stolt-Nielsen*. Petitioners submit, however, that the better course would be for this Court to grant the petition and resolve this dispute definitively, either by plenary consideration or summary reversal. Nothing in the decision below, the Montana Supreme Court's prior arbitration cases, or Montana's response to the petition suggests that petitioners have any possibility of vindicating their federal arbitration rights absent such resolution by this Court. *Cf. Doctor's Assocs., Inc. v. Casarotto*, 517 U.S. 681 (1996).

CONCLUSION

For the foregoing reasons, and those set forth in the petition, this Court should grant the petition.

Respectfully submitted,

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