No. 15-1299

In the Supreme Court of the United States

R.J. REYNOLDS TOBACCO COMPANY, PHILIP MORRIS USA INC., COMMONWEALTH BRANDS, INC., ET AL.

v.

COMMONWEALTH OF PENNSYLVANIA BY KATHLEEN G. KANE, IN HER OFFICIAL CAPACITY AS ATTORNEY GENERAL OF THE COMMONWEALTH OF PENNSYLVANIA

On Petition For A Writ Of Certiorari To The Commonwealth Court Of Pennsylvania

REPLY TO BRIEF IN OPPOSITION

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RULE 29.6 STATEMENT

The Rule 29.6 statement included in the petition for a writ of certiorari remains accurate.

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Respondent does not seriously dispute that state high courts have split on the first question presented here: whether the FAA preempts state laws that impose non-FAA standards of judicial review for FAA-governed arbitrations. Nor does Respondent dispute the significance of this question given that most FAA arbitrations are reviewed in state court. Moreover, Respondent barely defends the holding below that state laws imposing non-FAA standards are not preempted. Thus, Respondent essentially concedes that that holding would warrant certiorari if it was the sole basis for the judgment below.

Respondent insists, however, that the decision below rests on two alternative holdings: (1) that the applicable state-law standard is identical to the FAA standard; and (2) that the parties contractually agreed to the state-law standard. But both of those determinations are also erroneous under the FAA, and neither one makes this a bad vehicle; if anything, by further misapplying the FAA, they make this an especially good vehicle to clarify the FAA's proper application.

More specifically, Respondent invokes the determination below that the "rationally derived" standard under Pennsylvania law is identical to the "essence" test under the FAA as construed in *Oxford Health Plans LLC v. Sutter*, 133 S. Ct. 2064 (2013). But that just begs the second question presented here. And Respondent ignores Petitioners' showing that certiorari is also warranted on it since *Oxford Health* forbids *any merits review* — even if limited to "irrational" errors — and allows vacatur only if the arbitrators acted *dishonestly* or *without jurisdiction*.

Respondent also invokes the determination below that the parties agreed on the judicial-review standard by incorporating state law in the MSA's general choice-of-law provision, not by incorporating the FAA in the MSA's specific arbitration provision. But Respondent mischaracterizes the actual holding below, which was that the alleged agreement *could not be* an alternative basis for the decision because "contracting parties are not free to impose their own standards of review on a court." Pet.App. 34a-35a. Moreover, Respondent largely ignores Petitioners' showing that the court's determination that the MSA incorporated the state standard is itself preempted by the FAA under *DIRECTV, Inc. v. Imburgia*, 136 S. Ct. 463 (2015), because the court discriminated against arbitration in adopting that erroneous interpretation. Respondent disregards the glaring defects in the interpretation, and Respondent's only defense of why the interpretation was not hostile to arbitration is to reprise the erroneous position that Pennsylvania's "irrationality" standard is as deferential as the FAA *Oxford Health* standard.

In sum, the decision below is riddled with cert-worthy errors under the FAA. It is also particularly important because it invalidated a multi-hundred-million-dollar award under the MSA, while casting a shadow over all future MSA arbitrations. Thus, whether this Court grants plenary review, summarily vacates and remands in light of *Oxford Health*, or at least GVRs in light of *Imburgia*, it should not allow the decision to stand.

I. RESPONDENT ESSENTIALLY CONCEDES THAT WHETHER THE FAA PREEMPTS STATE LAWS IMPOSING NON-FAA JUDICIAL-REVIEW STANDARDS IS A QUESTION THAT WARRANTS THIS COURT'S REVIEW

As Respondent acknowledges, the decision below includes a broad holding that the FAA does not preempt state laws imposing non-FAA judicial-review standards because such standards supposedly are "procedural" rules that do not frustrate the FAA's substantive enforcement of the arbitration agreement. Pet.App. 35a-36a; BIO 8-9. That holding gives rise to the first question presented here. Pet. i. Yet Respondent does not meaningfully dispute that the question is certworthy.

A. Notably, Respondent concedes that state high courts are divided on the preemptive effect of the FAA's judicial-review standard. It does not dispute that at least two (and arguably four) state high courts have held that the FAA review standard does not govern in state court. Pet. 16-17; BIO 18-21. And it admits that, by contrast, the Alabama Supreme Court has held that the FAA review standard governs in state court, unless the parties provide otherwise. Pet. 16-17; BIO 20-21. Moreover, Respondent admits that five additional state high courts have said the same as Alabama's court, and it fails in trying to distinguish those decisions:

First, although Respondent concedes that the Idaho Supreme Court has concluded that the FAA review standard governs in state court (Pet. 16), Respondent erroneously asserts that the conclusion was "not dispositive" there because the Idaho and FAA standards were indistinguishable. BIO 20-21.

In actuality, while the court noted that the standards "d[id] not vary significantly," its conclusion that "the federal act applies due to the interstate nature of the subject matter" was a holding *necessary to its disposition* that "a number of appellant's arguments directly focusing upon the Idaho act need not be decided." *Hecla Min. Co. v. Bunker Hill Co.*, 617 P.2d 861, 865 n.3 (Idaho 1980).

Second, Respondent misleadingly suggests that the Georgia Supreme Court's conclusion that the FAA vacatur standard applied (Pet. 16) was unreasoned because "[b]oth sides" agreed. BIO 19-20. Respondent cites the *lower-court opinion* without mentioning that it *refused* to apply the FAA vacatur standard *despite* the parties' agreement. *Hilton Constr. Co. v. Martin Mech. Contractors, Inc.*, 303 S.E.2d 119, 120-21 (Ga. Ct. App. 1983). The Georgia Supreme Court granted certiorari, analyzed the question *independently of the parties' agreement*, and held: "[s]ince the Federal Arbitration Act created a body of substantive federal law, if a state court has jurisdiction to vacate an award, federal law rather than state law governs the vacation of the award." *Hilton Constr. Co. v. Martin Mech. Contractors, Inc.*, 308 S.E.2d 830, 832 (Ga. 1983).

Third, Respondent also observes that the high courts of New York, South Dakota, and Nebraska applied the FAA vacatur standard without extensive analysis or evident dispute. BIO 19-20. But this does not undermine those courts' clear holdings that the FAA vacatur standard is "substantive" law that applies in state courts for arbitrations involving "interstate commerce." Pet. 16.

In sum, Petitioners' showing of either a 6-2 or 6-4 split remains untouched. Indeed, even if the New York, South Dakota, and Nebraska decisions were treated (incorrectly) as mere drive-by rulings, there still would be 3 state high courts (Alabama, Idaho, and Georgia) squarely on Petitioners' side of this well-developed conflict. That is more than sufficient to warrant certiorari, especially given the recognized importance of ensuring state-court compliance with the FAA. *Id.* 13.

B. Moreover, Respondent does not really defend the broad holding below that state laws can impose non-FAA review standards on FAA arbitrations. Although Respondent regurgitates the court's reasoning, it never disputes Petitioners' rejoinders.

For instance, Respondent reiterates that the FAA vacatur provision specifies a federal district court where review may be sought. BIO 17. But Respondent does not deny that this venue provision is permissive rather than restrictive and thus does not excuse state courts from applying the FAA vacatur standard. Pet. 20.

Likewise, Respondent reiterates that the FAA's substantive goal is to prevent hostile states from undercutting enforcement of arbitration agreements. BIO 18. But Respondent does not deny that barring state courts from nullifying arbitration agreements is meaningless unless state courts also are barred from second-guessing arbitration awards on the merits. Pet. 18-19. Nor does Respondent deny the significance of this question to the FAA's proper functioning, given that FAA-governed arbitration agreements are typically enforced in state court

rather than federal court because the FAA does not confer federal-court jurisdiction. *Id.* 19.

C. Rather than disputing the state-court split or defending the broad holding below that state law can *require* the application of *non-FAA* review standards to FAA arbitrations, Respondent persistently asserts the decision also rested on two alternative grounds: (1) that Pennsylvania's "rationally derived" standard is *identical* to the FAA standard; and (2) that the parties *agreed* to the state-law standard in the MSA. BIO 11, 12, 13, 14 n.1, 16, 18, 19, 21, 22, 23.

Respondent's refusal to independently address the broad holding below effectively concedes that the first question presented is certworthy in a case where it is properly presented. And Respondent errs in arguing that this is an inappropriate case, because the purported alternative holdings present no vehicle problem. If anything, they make the case more certworthy, as shown below.

II. RESPONDENT FLOUTS *OXFORD HEALTH* AND ILLUSTRATES THE NEED FOR THIS COURT TO REAFFIRM THAT THE FAA DOES NOT ALLOW REVIEWING THE MERITS OF ARBITRATION AWARDS IN ANY RESPECT

In defending the holding below that the FAA's *Oxford Health* standard is identical to Pennsylvania's "rationally derived" standard — which gives rise to the second question presented here — Respondent resorts to *ipse dixit* rather than legal analysis. It asserts that the standards are identical because the court below said so, while ignoring Petitioners' showing that the standards are fundamentally different.

A. Respondent emphasizes that the court below quoted *Oxford Health* and deemed its standard identical to the "not rationally derived" standard applied by Pennsylvania courts under the "contrary to law" ground for review in 42 Pa. C.S. § 7302(d)(2). BIO 7-8, 22-25. From that alone, Respondent contends that the court's application of *Oxford Health* is a "fact-bound" issue that "does not present a significant question of law." *Id.* 24.

But that contention is willfully blind to the significant legal question presented by the holding below: whether the FAA requires upholding the arbitrators' contractual interpretation *even if* a court concludes that it cannot be "rationally derived" from the contract. Pet. i. As Petitioners showed, the court below answered that question wrong: under the plain text of FAA § 10(a)(4) and the square holding of *Oxford Health*, courts cannot engage in *any* merits review, because arbitrators "exceed their powers" only if they act *without jurisdiction* or *dishonestly*, not if they interpret the contract *in good faith* yet make an (allegedly) irrational error. *Id.* 21-23.

Astonishingly, Respondent never acknowledges this showing, much less refutes it. BIO 22-25. Moreover, like the court below, Respondent ignores that neither *Oxford Health* nor the cases cited therein used the phrase "rationally derived" (or any variant). *Compare id.* 7, 9, 22-25, *with Oxford Health*, 133 S. Ct. at 2068-71. Respondent, like the court below, simply treats the "essence" test that *Oxford Health* adopted from labor arbitration law as identical to a "rationally derived" standard. *See id.* That is demonstrably wrong.

Oxford Health holds that an arbitrator's award fails to "'draw[ ] its essence from the contract'" "[o]nly if … [it] 'simply reflect[s] [his] own notions of [economic] justice.'" 133 S. Ct. at 2068 (quoting *United Paperworkers Int'l Union v. Misco, Inc.*, 484 U.S. 29, 38 (1987)). This requires the arbitrators to have dishonestly "abandoned their interpretive role," not just honestly "misinterpreted the contract" in an irrational way. *Id.* at 2070.

That fundamental distinction is underscored by this Court's labor-law cases applying the "essence" test. They hold that "[t]he courts … have no business weighing the merits of the [dispute]" or even "determining whether there is particular language in the [contract] which will support the claim." *Misco*, 484 U.S. at 37. An arbitrator acting within his jurisdiction thus cannot be reversed unless he fails to provide "his honest judgment." *Id.* at 38. Even where the contract has "plain language," arbitrators exceed their powers only if they intentionally "ignore" such language, not if they accidentally "misread" it. *Id.* Indeed, this Court *summarily reversed* the Ninth Circuit precisely because it misapplied the "essence" test by vacating arbitral findings as "irrational." *Major League Baseball Players Ass'n v. Garvey*, 532 U.S. 504, 510-11 & n.2 (2001) (per curiam).

B. This case illustrates the importance of the FAA's ban on merits review. Both Respondent and the court below use "irrationality" review as a means simply to substitute their preferred contract interpretations for the one adopted by an arbitral Panel of three former federal judges. Indeed, both of them accuse the Panel of "irrationality" even though

each of them urges a *different* and *erroneous* interpretation.

Respondent insists that the Panel's *pro rata* judgment-reduction ruling violates the MSA because § IX(d)(2) allegedly requires the NPM Adjustment shares of the States who "prove" their diligence to be reallocated to all States who do not "prove" their diligence. BIO 2, 5, 25, 27-28. But § IX(d)(2) does not contain the word "prove" (or any variant). It says only that the NPM Adjustment "shall apply" to all States "except" for States that "diligently enforced," and that the diligent States' shares are "reallocated" to the "other" non-diligent States. Pet.App. 214a-215a. It thus says nothing expressly about how reallocation operates where it is *unknown* whether or not a State is diligent, much less dictate that a State must be treated as non-diligent unless its diligence is "proven," let alone post-settlement.

In contrast, the court below *rejected "*arguments based on whose burden it was to prove diligence," and instead reasoned that "relief from the NPM Adjustment and Reallocation Provision depended on a determination of diligence." *Id.* 50a. Yet Petitioners showed that this interpretation also has no basis in § IX(d)(2), Pet. 24-26, and Respondent ignores that showing, BIO 25-28.

Ultimately, it is immaterial whether either Respondent, the court below, or the Panel was correct (though the Panel was). What matters under the FAA is that the interpretation adopted by Judge Mikva and the other arbitrators cannot be set aside on the merits using "irrationality" review. Otherwise, no FAA award would be safe from judicial second-guessing.

C. Respondent's refusal to respect *Oxford Health*'s prohibition on merits review underscores the need for this Court to grant the second question presented. Indeed, summary reversal is warranted, as in past cases of outright State defiance of the FAA. Pet. 32-33. That would be especially efficient here because it may well prompt the court below to reconsider its holding on the first question presented that state law may impose a non-FAA review standard on FAA arbitrations, since Respondent has now abandoned any real defense of that holding.

III. RESPONDENT CANNOT EVADE THIS COURT'S REVIEW BASED ON THE PARTIES' PURPORTED AGREEMENT TO THE STATE-LAW STANDARD

Finally, this Court should reject Respondent's attempt to manufacture a vehicle problem by asserting that (1) "the primary basis" of the decision below was that the parties had "agreed in the MSA to … state standards of review," and that (2) this "contract interpretation" is a "question of state law that is not appropriate for this Court's review." BIO 11. Neither assertion is correct.

A. To begin, Respondent mischaracterizes the decision below. It claims that the court's application of the state standard was "premised" on the "finding that the parties here *agreed*" to this standard in the MSA, and that the court merely held "in the alternative" that this standard would govern "even in the absence of [the alleged] agreement." *Id.* 12, 16. But the court *never held* that the alleged agreement was *itself a valid basis* to apply the state standard. Pet.App. 34a-35a. To the contrary, the court expressly held that *it must independently decide* the applicable standard because "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." *Id.*

Respondent, "remarkably, do[es] not even mention this key holding," BIO 12-13, which renders the alleged state-law agreement *irrelevant* to this Court's review of the questions *actually passed upon below*. As Petitioners noted (Pet 11 n.1, 30-31), because the sole ground invoked by the decision below — that the FAA standard does not preempt the state standard, without regard to any agreement by the parties, Pet.App. 34a-36a — is both certworthy and erroneous, this Court should either reverse it after plenary review or summarily vacate it in light of *Oxford Health*.[1]

B. Anyway, Respondent is also wrong that it would be inappropriate for this Court to review the state court's interpretation that the MSA agreed to the state standard. That erroneous interpretation — which flouts the MSA's express direction that "[t]he arbitration shall be governed by the [FAA]" and be "binding," Pet.App. 227a — discriminates against

[1] On remand from either disposition, the court below then can decide in the first instance whether the governing FAA standard could be displaced by the alleged state-law agreement. Although Respondent argues (BIO 14) that such an agreement must be given effect due to the FAA's policy of enforcing arbitration agreements by their terms, this Court rejected that precise argument in *Hall Street Associates, L.L.C. v. Mattel, Inc.*, 552 U.S. 576 (2008), which held that parties *cannot agree* to expand the FAA standard in federal court, but left the issue open for state court. *See id.* at 585-86, 590. At most, this is a potential issue on remand, not a reason to deny review now.

arbitration and thus is itself preempted by the FAA under this Court's decision in *Imburgia*. Pet. 31-32.

Respondent simply parrots the state court's determination that the arbitral standard of review is covered by the MSA's general choice-of-law provision incorporating state law, rather than by its specific arbitration provision incorporating the FAA. BIO 15-16. Respondent ignores Petitioners' showing that this determination contradicts the language of those provisions and this Court's decision in *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52, 63-64 (1995). Moreover, Respondent's only argument for why the court's bizarre interpretation does not reflect a preempted hostility to arbitration is to double down on the canard that Pennsylvania's "irrationality" standard is as deferential as the FAA *Oxford Health* standard. BIO 14 n.1.

Thus, under *Imburgia*, this Court could and should reject the state court's interpretation of the MSA if that were necessary to reach the certworthy questions presented on the FAA (though it is not, *supra* at 10-11). At a minimum, this Court should GVR in light of *Imburgia*, an intervening decision that could and should cause the state court to revisit its contract interpretation, thereby clearing the path for further review here as to the FAA's scope.

CONCLUSION

The decision below should not be allowed to stand, as it is riddled with certworthy errors and has massive financial and practical implications for the MSA parties. This Court should either grant plenary review, summarily vacate and remand in light of *Oxford Health*, or at least GVR in light of *Imburgia*.

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Respectfully submitted,

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