IN THE ARBITRATION UNDER CHAPTER ELEVEN
OF THE NORTH AMERICAN FREE TRADE AGREEMENT
AND THE UNCITRAL ARBITRATION RULES
BETWEEN

GRAND RIVER ENTERPRISES SIX NATIONS, LTD., JERRY MONTOUR, KENNETH HILL, AND ARTHUR MONTOUR, JR.

Claimants/Investors,

-and-

UNITED STATES OF AMERICA,

Respondent/Party.

STATEMENT OF DEFENSE
OF RESPONDENT UNITED STATES OF AMERICA
TO CLAIMANTS' ALLOCABLE SHARE CLAIM

Pursuant to Article 19 of the UNCITRAL Arbitration Rules and in accordance with the Tribunal's Letter dated September 21, 2006, respondent United States of America respectfully submits this Statement of Defense ("Allocable Share Defense") in response to the Statement of Claimants' Claims Arising Directly out of the Adoption and Implementation of the Allocable Share Amendments ("Allocable Share Claim").

I. PRELIMINARY STATEMENT

1. Claimants' claims are fatally defective, both on jurisdictional grounds and on the merits. Claimants' only remaining claim challenging the escrow statutes as originally enacted, concerning retail sales on-reservation to Native Americans ("on-reserve sales"), is based on the mistaken premise that imposition of escrow obligations on Grand River Enterprises Six Nations Ltd. ("Grand River") arising from such sales

violates U.S. law or the United States' other treaty obligations. With respect to claimant's claim challenging the amendments to the allocable share release provision under the escrow statutes (the "allocable share amendments"), by failing to identify any investment in the United States owned or controlled by Grand River or its shareholders, and by failing to demonstrate that the allocable share amendments "relate to" Arthur Montour or his alleged enterprises, claimants fail to meet fundamental jurisdictional requirements under NAFTA Article 1101(1). Moreover, claimants fail to articulate how the "withdrawal" of their "entitlement"[1] to a release of escrowed funds as calculated under the original allocable share release provision (rather than as calculated under the release provision as amended) violates the NAFTA. Claimants' claims should be dismissed in their entirety.

2. The Tribunal's July 20, 2006 Decision on Objections to Jurisdiction ("Decision") dismissed as time-barred under NAFTA Articles 1116(1) and 1117(1) claimants' claims of breach with respect to the Master Settlement Agreement ("MSA") and the escrow statutes as originally enacted, except to the extent such claims concern on-reserve sales. Nevertheless, in their Allocable Share Claim, claimants continue to argue that their "reasonable understanding" was that none of the states' escrow statutes applied to them, but rather that the ultimate retailer, and not the manufacturer, of

[1] Allocable Share Claim ¶ 101 (Nov. 6, 2006).

cigarettes should be held responsible for escrow payments.[2] As the Tribunal's Decision makes clear, these complaints are time-barred and have been dismissed.[3]

3. Claimants' claim with respect to on-reserve sales is practically non-existent, consisting of challenging the actions of two MSA states (Wisconsin and Oklahoma), with an oblique reference to the actions of a third state (Georgia), that are alleged to have included at least some on-reserve sales in their calculations of Grand River's escrow liability. Claimants' assertion that the inclusion of such on-reserve sales in computing Grand River's escrow liability violates NAFTA Chapter Eleven fails for several reasons.

4. As an initial matter, claimants fail to offer any details surrounding any such sales (such as the retail buyers and sellers involved) or the alleged inclusion of on-reserve sales in the calculation of Grand River's escrow obligations. Contrary to claimants' assertion, it is not the United States' burden to disprove any alleged wrongdoing but, rather, it is claimants' burden to offer evidence supporting its allegations.

5. In addition, claimants vaguely refer to sales "taking place" on reserve,[4] and a purported failure by certain states to distinguish between "on- and off-reserve sales."[5] In doing so, they rely on the Tribunal's statement in the Decision that on-reservation sales of tobacco products to members of federally-recognized Indian tribes

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[2] Allocable Share Claim at ¶ 33; *id.* ¶¶ 42-44. While reviving time-barred arguments, claimants at the same time contradict their time-barred claim by acknowledging that their off-reserve business was "profitable" under the original escrow statutes and that "there would be no reason to make a claim" for their off-reserve sales under those measures. *Id*. ¶ 79.

[3] Decision at ¶ 79 (term "manufacturer" under the escrow statutes "is defined in a manner that appears to clearly cover Claimant Grand River"); *id*. ¶ 83 (July 20, 2006).

[4] Allocable Share Claim ¶ 84.

[5] *Id.* ¶ 72.

"are generally exempt from regulation by the states within the United States as a matter of Federal law."[6] U.S. law does not prohibit the imposition of escrow obligations on Grand River arising from on-reserve sales of its products, particularly given that Grand River, which is the only claimant subject to escrow obligations, does not allege that it has any operations on any Indian reservation in the United States. Claimants therefore have failed to allege any U.S. action that would violate U.S. law, not to mention the provisions of NAFTA Chapter Eleven at issue in this arbitration.

6. With respect to claimants' remaining claim, under the allocable share amendments, claimants fail to articulate how a revised formula for calculating escrow payment releases under the escrow statutes violates the NAFTA. As discussed below, many tobacco product manufacturers that declined to join the MSA ("Non-Participating Manufacturers" or "NPMs"), including claimants, exploited the escrow release provision under the original escrow statutes by concentrating their sales in one, or only a few, MSA states, which resulted in large releases of NPM escrow payments. Such releases undermined the intent of the escrow statutes, *i.e.*, ensuring that settling states are able to enforce potential future judgments against NPMs for smoking-related costs incurred by the states' public health systems. In response, states enacted the allocable share amendments to foreclose NPMs from obtaining large releases by concentrating their sales in only a few MSA states. The elimination of such releases helps to keep state escrow accounts adequately funded for potential future judgments, as intended under the original escrow statutes. The "withdrawal" of what claimants contend was their so-called

[6] Decision ¶ 72. More specifically, U.S. law proscribes taxing sales on reserve only when those sales are made to members of the governing Indian tribe. Claimants' claim contains no allegations of such sales.

"entitlement"[7] to the release of escrow payments under the formula set out in the original escrow statutes in no way violated the United States' obligations under NAFTA Chapter Eleven.

7. Nor can the claim be salvaged by discovery. After unsuccessfully attempting to secure rounds of discovery before even stating a claim concerning the allocable share amendments, claimants continue to look to discovery as a potential crutch for their otherwise deficient claim. Claimants' attempts to shift their burden of proof to the United States to demonstrate that it acted in compliance with all legal obligations, and to launch a fishing expedition in an attempt to craft a claim, should not be countenanced.[8]

8. In a further attempt to rely on discovery to help formulate their claim, claimants purport to "reserve the right to amend or supplement" their claim pending "the outcome of the documentary discovery process."[9] Claimants, however, are not within their rights to unilaterally reserve the ability to amend their claim at a later date, and the Tribunal should deny any such attempt to further amend their claim.

9. In any event, no amount of discovery can overcome claimants' inability to meet jurisdictional requirements, in particular those set forth in NAFTA Article 1101(1). Claimants have shown no investment in the United States held by Grand River or its shareholders, Jerry Montour and Kenneth Hill, and the escrow statutes (either as originally enacted or as amended) do not "relate to" Arthur Montour Jr. or his companies,

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[7] Allocable Share Claim ¶ 101.

[8] *See id.* ¶ 84 (asserting that "the onus falls upon each MSA State" to demonstrate that its calculations of escrow obligations did not include on-reserve sales); *see also id.* ¶ 84 & n.15 (asserting that only the MSA States have "full knowledge of whether or how on-reserve sales have been treated," which, in claimants' view, provides them with a "reason to believe" that the MSA States "have likely included" on-reserve sales in their escrow calculations).

[9] Allocable Share Claim, Introduction at 2.

Native Tobacco Direct and Native Wholesale Supply, which are not cigarette manufacturers. Claimants' allegations that their "traditional trading rights" have been violated,[10] even if true, would not give rise to an investment claim cognizable under NAFTA Chapter Eleven. Claimants' repeated calls for discovery should not divert attention from their inability to meet fundamental jurisdictional requirements under the NAFTA. Nor does claimants' contention that they lack an effective remedy under U.S. law[11] -- even if true, which it is not -- provide a basis for jurisdiction where none would otherwise exist.

10. In this Allocable Share Defense, the United States responds only to assertions made in the Allocable Share Claim, and reserves and incorporates by reference all defenses set forth in its Statement of Defense dated August 29, 2005. For the reasons set forth herein and in the Statement of Defense, claimants' claims should be dismissed in their entirety.

II. STATEMENT OF FACTS

11. As set forth in the Statement of Defense, in 1998 the attorneys general of 46 states, the District of Columbia, Puerto Rico, and four United States territories signed the MSA with the nation's four largest tobacco manufacturers, requiring them to make annual payments to states in perpetuity as reimbursement for costs associated with treating smoking-related illnesses. In part as an incentive for other tobacco product manufacturers to join the MSA (which, upon joining, are referred to as "Subsequent Participating Manufacturers" or "SPMs"), the MSA provided that any manufacturer joining within 90 days of its signing (a "Grandfathered SPM") would be exempt from

[10] *Id.* at 1.

[11] Allocable Share Claim ¶¶ 29-31.

making any payments to the states unless its market share exceeded the greater of its 1998 market share or 125% of its 1997 market share (the "grandfathered amount").[12] If a Grandfathered SPM's market share does not exceed the grandfathered amount, then it is not required to make any payments under the MSA. SPMs that joined the MSA more than 90 days after its signing must make payments on all of their cigarette sales pursuant to the MSA's formula.

12. NPMs are subject to the requirements set forth in Exhibit T to the MSA, known as the "Model Statute." All MSA states have enacted escrow statutes that follow the form of the Model Statute. The escrow statutes require NPMs to deposit into escrow each year an amount per cigarette sold that is roughly equivalent to what the NPM would be required to pay as a participating manufacturer under the MSA, had the NPM joined the MSA. Payment obligations of NPMs under the escrow statutes and of SPMs under the MSA are based on the number of cigarettes sold in the U.S. market as measured by, respectively, state or federal excise taxes.[13] NPMs receive interest on funds in escrow as it is earned.[14] Funds revert to the NPM twenty-five years after they are placed into escrow, provided that the funds have not already been released to the depositor and the state has not sought to recover the funds to satisfy judgments or settlements of tobacco-related claims brought against the NPM by the state.[15]

13. Claimant Grand River manufactures cigarettes in Canada for subsequent sale by other entities in the United States, as well as for sale in Canada and other

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[12] MSA § IX(i)(1).

[13] *See id.* § II(z) ("market share" defined as a manufacturer's respective share of U.S. cigarette sales as measured by federal excise taxes); *id*. Exh. T at T-3, ¶ (j) ("units sold" defined as the number of cigarettes sold (directly or indirectly) by a manufacturer in the state as measured by state excise taxes).

[14] *Id.* at T-4, ¶ (b)(2).

[15] *Id.* at T-4, ¶ (b)(2)(C).

countries. It did not join the MSA and, therefore, is an NPM. Grand River did not manufacture cigarettes for sale in the United States until after the MSA went into effect,[16] and thus had no U.S. market share in 1998. Accordingly, because its grandfathered amount would have been zero, Grand River would have had to make payments pursuant to the MSA's formula for each cigarette that it sold (as measured by federal excise taxes), whether or not it joined the MSA within 90 days of its signing. And by not joining the MSA, Grand River remains subject to escrow obligations for each cigarette it sells (as measured by state excise taxes), as an NPM subject to the states' escrow statutes.

14. Payments by original participating manufacturers ("OPMs") and SPMs under the MSA are based on nationwide sales, while payments by NPMs under the escrow statutes are based on sales in a particular MSA state.[17] Payments made under the MSA are distributed among the MSA states according to fixed percentages, known as allocable shares, which are assigned to each state under the MSA.[18]

15. The escrow statutes were intended both to ensure that the settling states would be able to enforce potential future judgments against NPMs for smoking-related costs incurred by the states' public health systems and, in securing such funds, to impose escrow obligations on NPMs that, on a per-cigarette basis, were roughly equivalent to what the NPM would be required to pay as a participating manufacturer under the MSA.

16. To help accomplish these aims, the escrow statutes, as originally enacted, contained an escrow payment release provision, sometimes referred to as the "allocable share release" provision. This provision enabled NPMs to obtain a release from escrow

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[16] *See* Hearing on Jurisdiction, Transcript Vol. 2, at 588:11-15 (Mar. 24, 2006).

[17] *See* note 13, *supra.*

[18] *See* MSA Exh. A.

of any funds in excess of the amount that the particular MSA state would have received as its allocable share of the NPM's nationwide sales, had the NPM been an SPM under the MSA. An unforeseen and unintended consequence of this provision emerged, however, when certain NPMs, including Grand River, determined that if they concentrated their sales in a few states, they could obtain an immediate release of practically all of their escrowed funds. This result followed because of differences in the way MSA payments and escrow payments are calculated.

17. For example, an NPM that concentrated all of its U.S. sales in a state that had been allotted a two percent allocable share under the MSA would be required to leave in escrow an amount based on only two percent of those sales. The NPM could then obtain a release for any escrow payments made based on the remaining ninety-eight percent of its sales, virtually eliminating its escrow obligations under the escrow statutes. Thus, these NPMs were contributing to cigarette sales in a particular state, but were not contributing a proportional amount of funds to be held in escrow.

18. In response to the unintended consequences of the allocable share release provision, state legislatures passed the allocable share amendments, which revised the formula to be used for calculating allocable share release amounts. Under the revised formula, with respect to an NPM's sales in a particular state, the NPM could obtain a release only for amounts paid into escrow in excess of the amount that the NPM would otherwise have been obligated to pay as an SPM under the MSA for those sales.

19. The allocable share amendments were enacted by democratically-elected state governments through regular democratic processes, forming part of each state's

statutory code. Forty-four state legislatures have passed allocable share amendments to their escrow statutes.

20. Claimants now assert that the revisions to the release calculation formula under the escrow statutes violate NAFTA Chapter Eleven. This claim, along with claimants' other remaining claims, should be dismissed.

III. JURISDICTION

21. Among other jurisdictional bars set out in the Statement of Defense, claimants do not meet jurisdictional requirements under NAFTA Article 1101(1). NAFTA Article 1101, the scope and coverage provision, provides, in pertinent part, that the Chapter "applies to measures adopted or maintained by a Party relating to: (a) investors of another Party; (b) investments of investors of another Party in the territory of the Party[.]"

22. Claimants Grand River, Jerry Montour, and Kenneth Hill have not shown that they own or control, directly or indirectly, any investment in the United States. Rather, these claimants are involved in the business of manufacturing cigarettes in Canada for subsequent sale by other entities in the United States. None of these claimants has any ownership interest in any of the U.S. enterprises identified by claimants. None of these claimants qualifies as an investor that may submit a claim under NAFTA Chapter Eleven. The measures challenged by these claimants do not "relate to" them as investors or to any investments that they own or control in the United States. Consequently this Tribunal lacks jurisdiction over their claims.

23. The only claimant that allegedly has an investment in the United States is Arthur Montour Jr., who allegedly owns and controls Native Tobacco Direct Company and Native Wholesale Supply Company. The allocable share amendments, however, do

not "relate to" Arthur Montour Jr., whose companies are not subject to the revised release calculation formula under the amendments (just as they were not subject to the release calculation formula as originally enacted in the escrow statutes). Native Tobacco Direct and Native Wholesale Supply are cigarette distributors, not manufacturers. Escrow payment obligations under the escrow statutes do not apply to distributors, and thus the formula for calculating releases of such escrow payments – both as originally enacted and as amended – does not apply to distributors, including Native Tobacco Direct and Native Wholesale Supply. Under NAFTA Article 1101(1), there is no jurisdiction over claimants' claims.

IV. MERITS

A. Articles 1102 and 1103

24. In accordance with Article 1102 – the national treatment provision – each NAFTA Party is obligated to accord to investors of another Party (and their investments) "treatment no less favorable than that it accords, in like circumstances," to its own investors (and their investments) with respect to the "establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments."

25. Article 1103 – the most-favored-nation treatment provision – provides that the treatment accorded to another NAFTA Party's investors (and their investments) with respect to certain investment activities must be no less favorable than that accorded, in like circumstances, to the investors of any other Party or of a non-Party (and their investments).

26. Claimants' national treatment and most-favored-nation treatment claims fail because the allocable share amendments – like the other challenged measures – do not accord different treatment to investors or their investments on the basis of nationality. The allocable share amendments, like all state legislation implementing the MSA, distinguish among tobacco product manufacturers on the basis of their circumstances with respect to the MSA, *i.e.*, whether and at what time they joined the MSA, not on the basis of nationality.

27. Regardless of nationality, companies manufacturing cigarettes for the U.S. market are eligible to join the MSA. And regardless of nationality, cigarette manufacturers that did not join the MSA, *i.e*. NPMs, must make payments into escrow as set out in the escrow statutes, first as originally enacted and, later, as amended. In addition, manufacturers that joined the MSA are not "in like circumstances" with manufacturers that did not join the MSA.

28. Because claimants and their alleged investments have not been accorded treatment less favorable than any other investors or investments in like circumstances, their national treatment and most-favored-nation treatment claims are without merit. Claimants' Article 1102 and 1103 claims should therefore be dismissed.

B. Article 1105(1)

29. As set forth in the Statement of Defense, Article 1105(1) prescribes the customary international law minimum standard of treatment to be accorded to investments of investors of another NAFTA Party.[19] Claimants' Article 1105(1) claim fails because no rule of customary international law has been violated in this case.

[19] *See* Statement of Defense ¶ 109 (Aug. 29, 2005).

30. Claimants' allegation that the "withdrawal" of their alleged "entitlement" to escrow payment releases as calculated under the formula set out in the original escrow statutes is contrary to the minimum standard of treatment under customary international law and thus in violation of Article 1105(1) is without merit.[20] The allocable share amendments were intended to correct an unintended consequence of the escrow statutes, as originally enacted, *i.e*., the avoidance by NPMs of virtually all escrow obligations by concentrating sales in only a few MSA states. The decision by 44 state legislatures to correct this unintended consequence in no way contravenes the customary international law minimum standard of treatment.

31. Claimants' allegation that the allocable share amendments violate "the customary international law principle of good faith"[21] and the Jay Treaty's provisions regarding "interference" with the trade and commerce of the Six Nations,[22] is similarly without merit. As an initial matter, the United States denies that it has violated any of its obligations under any international treaty. In addition, as set forth in the Statement of Defense, claimants' reliance on the principle of good faith and purported rights under international agreements other than NAFTA Chapter Eleven cannot form the basis for a claim of breach of Article 1105(1).[23]

32. None of the United States actions at issue in this arbitration violate the customary international law minimum standard of treatment and claimants' Article 1105(1) claim should therefore be dismissed.

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[20] Allocable Share Claim ¶ 101.

[21] *Id.* ¶ 103.

[22] *Id*.

[23] *See* Statement of Defense ¶¶ 112, 114.

C. Article 1110

33. Article 1110 provides that "[n]o Party may directly or indirectly nationalize or expropriate an investment of an investor of another Party in its territory or take a measure tantamount to nationalization or expropriation of such an investment" except where certain conditions are met, including payment of compensation.

34. For the reasons set forth in the Statement of Defense, claimants' claim under Article 1110 fails on a number of grounds.[24] Foremost among them is the fact that none of the claimants has identified any investment in the United States that has allegedly been expropriated. As noted above, neither Grand River, nor Jerry Montour, nor Kenneth Hill own or control any investments in the United States. In addition, claimants' claim under the allocable share amendments includes no allegation that any investment owned or controlled by Arthur Montour or the enterprises he allegedly owns or controls has been expropriated.

35. Accordingly, claimants' Article 1110 claim should be dismissed.

36. For the avoidance of doubt, the United States denies each and every allegation of the Allocable Share Claim, as well as in claimants' original Statement of Claim, not specifically and unambiguously admitted in either this Allocable Share Defense or in its earlier Statement of Defense.

V. REMEDY SOUGHT

37. The United States requests that this Tribunal render an award in favor of the United States and against claimants, dismissing claimants' claims in their entirety and with prejudice. The United States further requests that, pursuant to Article 40 of the

[24] *See id.* ¶¶ 119-124.

UNCITRAL Arbitration Rules, claimants be required to bear all costs of the arbitration, including the United States' costs of legal assistance and representation.

Respectfully submitted,

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December 21, 2006