UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

UNITED STATES OF AMERICA, Plaintiff v. PHILIP MORRIS USA, INC., *et al*., Defendants.	Civil Action No: 99-2496 (GK) Next scheduled court appearance: NONE

NATIONAL ASSOCIATION OF CONVENIENCE STORES' SUBMISSION CONCERNING ORDER #1015'S POINT OF SALE DISPLAY REQUIREMENTS

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INTRODUCTION

Despite the D.C. Circuit vacating this Court's previous order, the Government and Plaintiff-Intervenors ask this Court to impose an order that both exceeds this Court's equitable powers and encroaches on the First and Fifth Amendment rights of non-party retailers.

The National Association of Convenience Stores ("NACS") seeks to provide the Court with an industry perspective on the issues and to help the Court understand how the Order will irreparably harm NACS' members. NACS respectfully submits this brief as a non-party at the request of the Court to describe the impact Order #1015's ("Order") Point of Sale Requirements will have on NACS members.

Founded in 1961, NACS is a non-profit trade association representing more than 2,100 retail and 1,500 supplier company members. NACS is the preeminent representative of the interests of convenience store operators. The convenience store industry in the United States, with over 145,000 stores, posted $190 billion in in-store sales (excluding motor fuel sales) in 2010, 39.8% were tobacco related. In 2009, NACS member in-store sales amounted to $182 billion. Tobacco products accounted for 39.8% of those sales.

STATEMENT OF FACTS

In the fall of 1999, the United States commenced this action against nine (9) cigarette manufacturers and two tobacco-related trade organizations. *See United States v. Phillip Morris USA, Inc*., 449 F. Supp. 2d 1, 26 (D.D.C. 2006). The eleven Defendants were: Philip Morris, R.J. Reynolds, Brown & Williamson, Lorillard, Liggett, American Tobacco Co., Philip Morris, B.A.T. Ind., BATCo, CTR, and TI. *Id.* at 31 n.4. Significantly, no retailer was named as a defendant, no retailer was found to be in privity with the defendants, and no evidence from retailers was presented at trial.

The Government's central allegation in this matter was that defendants had violated the Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. §§ 1961-1968 (2006). 449 F. Supp. 2d at 26-27. In particular, the Government asserted, among other contentions, the defendants fraudulently denied that smoking causes cancer and that nicotine is addictive. The Government also alleged that defendants had fraudulently marketed low tar and light cigarettes as less harmful than other cigarettes when in fact they are not. *Id.*

On August 17, 2006 this Court concluded the defendants had conspired to violate the substantive provisions of RICO. *Id.* Consequently, this Court entered the Order "to prevent and restrain any such violations of RICO in the future." *Id.* The Order, along with other injunctive relief, mandated that Defendants "require retailers who participate in [a Retail Merchandising Program] to display" corrective statements "in a position of prominent visibility," specifically on a "Countertop Display and Header Display at retail point-of-sale." 449 F. Supp. 2d at 939-40.

Paragraph 7(b) provides as follows:

> Each of the corrective statements approved pursuant to Section III(B)(¶5) of this Final Judgment and Remedial Order shall also be designed by Defendants for inclusion in a Countertop Display and Header Display at retail point-of-sale. Each Defendant that utilizes a Retail Merchandising Program shall require retailers who participate in such program to display each Countertop Display in a position of prominent visibility for the entire four month period, until it is replaced by a subsequent Countertop Display during the two-year duration set forth in Section III(B)(¶7)(a) of this Order. Each Defendant that utilizes a Retail Merchandising Program shall require retailers who participate in such program to display each Header Display in an equivalent position with any other brand advertising header for the entire period on the same schedule, whether monthly or quarterly, that any other brand advertising header is utilized. The Header Display shall be of at least equivalent size as any other brand advertising header or headers provided by Defendants.
>
> During the two year period set forth in Section III(B)(¶7)(a) of this Order, each Defendant shall include each of the five Court approved corrective statements in a Countertop Display and

> Header Display at least once. ***Each Defendant shall suspend from its Retail Merchandising Program for a period of one year any retailer that fails to comply with this provision.***

Id. (emphasis added). A display such as the one mandated by the Order is unprecedented in merchandising contracts entered into between manufacturers of tobacco products and retailers.

The Court imposed its Order without holding an evidentiary hearing to analyze the impact on non-party retailers. Retailers never had notice or an opportunity to present evidence to the Court regarding the Order's burden on their businesses. *See* Broviak Aff. ¶ 27 (Ex. B) Had they been given the opportunity, retailers would have offered evidence that they do not use countertop displays for tobacco products due to the heightened value of countertop space for selling high-profit items that consumers decide to buy on an impulse during their visits to the store. This Court issued the Order without evidence or analysis of, or seeming concern for, the adverse legal and practical effects it would have on non-party retailers including, in particular, NACS members. *See id.*

This Court's decision was appealed to the D.C. Circuit. On May 22, 2009, the D.C. Circuit vacated and remanded the Order as it pertains to point-of-sale displays, and instructed this Court to "make due provision for the rights of innocent third parties and clarify that the order, if reinstated in any form, does not require duplicative displays." *United States v. Phillip Morris USA, Inc.*, 566 F.3d 1095, 1150 (D.C. Cir. 2009). To address the D.C. Circuit's remand, this Court gave several organizations, including NACS, leave to file briefs regarding the legal and practical impact of point of sale displays. This Court has not, however, held an evidentiary hearing to address the legal and practical impact point of sale displays would have on non-parties.

If the Court reinstates this Order, it would have a profound and adverse effect on NACS member companies. The Order places convenience store owners, who did not participate in these proceedings, in an untenable position that is different from any other party affected by the Order. Retailers would be required to display a message (with which many of them affirmatively disagree) on their countertops and thereby lose the sales generated through the use of that space, or else be deprived of the benefits and revenue from their merchandising agreements with tobacco manufacturers. Further, the proposed message implicates retailers as having misled their customers thereby undermining customer good will and harming their businesses. Accordingly, the Court should not reinstate the Order.

The burdens imposed on retailers by this Order are substantial. The majority of NACS members have retail merchandising agreements with at least one cigarette manufacturer and many have more than one agreement. The retail merchandising agreements are contracts negotiated between the retailer and a specific cigarette manufacturer. In exchange for the retailer allowing tobacco companies to place advertising in certain parts of the store – but notably not on the countertop at the point of sale – the tobacco company will offer the retailer payments for the marketing and rebates on cigarette sales that are made at discounted prices. Those with merchandising agreements derive significant revenue from such agreements. *See* Broviak Aff. ¶ 6 (Ex. B); Richardson Aff. ¶ 10 (Ex. C); Paduano Aff. ¶ 7 (Ex. D). In the past twelve months, for example, Nice N Easy, an operator of 35 stores, has been reimbursed $445,000 in total through the buy-down provisions of its contracts with five tobacco manufacturers. Paduano Aff. ¶ 7 (Ex. D). Ricker Oil Company, with 50 stores, was reimbursed approximately $1,768,798 from buy down reimbursements with three tobacco manufacturers. Broviak Aff. ¶ 6 (Ex. B). E-Z Mart, an operator of over 300 stores, received approximately $6,563,343 from buy-down reimbursements with three tobacco manufacturers. Richardson Aff. ¶ 10 (Ex. C). The Order, however, requires retailers to have countertop and header displays in their stores communicating the "corrective statements," which seek to remedy ***defendants'*** conduct. Thus, retailers choosing to contract with tobacco manufacturers would have to place the corrective statements at valuable point of sale space or else be suspended for one year from their merchandising agreements. Without the rebates, retailers would not be able to offer competitive prices and that, in turn, would result in a loss of sales and a significant loss of revenue.

Complying with this Court's Order would lead to significant losses for retailers. The Order interferes with a retailer's countertop space -- the single most important marketing space within a convenience store. The countertop space at the point-of-sale is essential to the economic health of a convenience store. Retailers depend on this limited space for existing marketing and impulse sales. The countertop signs required by the Order are very large. They must be at least 30 inches high and 18 inches wide. NACS conservatively estimates that the loss of one square foot of countertop space could cost the industry $82 million in sales per year. *See* Beckwith Aff. ¶ 10 (Ex. A). Retailers will lose more than one square foot of countertop space if they are required to display signs of this size. Thus, the industry as a whole will lose a multiple of that $82 million figure. *See id.*

If the Court reinstates the Order, NACS members will lose substantial revenue regardless of what they choose to do. If NACS members comply with the Order, they will lose the use some of the most valuable marketing space in their stores and customer goodwill, resulting in reduced sales. If, on the other hand, NACS members elect not to accept this Court's imposed contract terms, then tobacco manufacturers will have to suspend retailers from their merchandising agreement programs for one year. This would deprive retailers of the substantial revenues they receive from such contracts and result in these retailers losing tobacco sales to competitors due to their practical inability to compete with stores that continue to receive buy-down payments.

Moreover, the Order affects NACS members in a way that is far different than any other non-party interest affected by the Order. Under the Order, tobacco manufacturers will have to ***purchase*** advertising space from media outlets, increasing advertising revenue for those outlets. Further, the media outlets are under no obligation to accept such ads. The Order does not impose penalties of, for example, the loss of advertising dollars on media outlets that refuse to accept the ads. These media outlets also do not face the prospect of running messages that are worded in a way that implicates them with wrongdoing. Customers are conditioned to seeing 3rd party ads in media outlets and understand the outlet is not the party delivering the message. That is not the case for signs displayed in a store – and the message proposed for these signs creates the impression that the store itself is the speaker. In contrast, tobacco manufacturers will not compensate NACS members for incorporating the mandates of the Order -- displaying corrective statements on countertops -- into merchandizing agreements. This is because this Court's Order prohibits any merchandizing agreements that do not require signs to be displayed on countertops. Retailers will instead be penalized if they refuse to display the court-ordered signs in places where tobacco advertising does not, by design, exist.

SUMMARY OF ARGUMENT

The Order runs afoul of traditional equitable principles. It impermissibly obligates retailers to display "corrective statements" and give up the use of the most valuable marketing space in the store -- the countertops at the point of sale. This requirement will substantially harm retailers, resulting in security risks and losses of significant revenue. Retailers must display "corrective statements" on their countertops despite the fact that they were neither party to the litigation nor given an opportunity to be heard. At no point did the Court adjudicate any retailer of wrongdoing.

Additionally, the Court's equitable powers do not extend to the retailers burdened by the Order. A Court's decree can only bind parties and those who are in privity with parties. Otherwise, courts could render broad decrees applicable to the world at large, displacing legislatures. In contrast to this foundational principle, the Order broadly binds any retailer that has a contract with these tobacco manufacturers. Consequently, this Court should amend the scope of the Order so that it does not place burdens on retailers.

In any event, courts of equity ordinarily apply their decrees prospectively. The Court's Order, as it stands now, will disrupt existing agreements. To the extent the Court upholds the order; it should only apply prospectively to agreements newly created in the future.

In addition to these equitable doctrines, reinstating the Order will violate retailers' constitutional right to due process. At no point during these proceedings have retailers had the opportunity to properly demonstrate how they are impacted by this Order. Anything short of a full evidentiary trial deprives the NACS and its members of due process.

Beyond this procedural defect, this Court's injunction compels retailers to display certain content -- the corrective statements -- with which they may not agree. In fact, many retailers do not agree with the corrective statements. The First Amendment does not permit the Court to force retailers to convey the ordered remedial message.

Finally, the Order substantively violates retailers' Fifth Amendment rights. A contract is a valid property interest; the Order interferes with retailers' existing contracts. Such interference is an impermissible taking without just compensation. In addition, if retailers do abide by the Court Order, they must relinquish control of countertop space at the point of sale to make way for a Court ordered notice without any compensation. The taking of valuable space at the point of sale without compensation is an impermissible taking.

Accordingly, the Court should not reinstate the Order, as it is an improper exercise of the Court's equitable powers and runs afoul of the Constitution.

ARGUMENT

A. THE ORDER IMPERMISSIBLY BURDENS RETAILERS

The D.C. Circuit remand is an acknowledgement of the significant and impermissible burden this Court's Order imposes on innocent third party retailers. *United States v. Phillip Morris USA, Inc*., 566 F.3d 1095, 1150 (D.C. Cir. 2009) (ordering the District Court to "make due provision for the rights of innocent third parties and clarify that the order, if reinstated in any form, does not require duplicative displays.") Rule 65(d)(2) provides that an injunction

> "binds only the following who receive actual notice of it by personal service or otherwise; (A) the parties; (B) the parties' officers, agents, servants, employees, and attorneys; and (C) other persons who are in active concert or participation with anyone described in Rule 65(d)(2)(A) or (B)."

Fed. R. Civ. P. 65(d).

Rule 65(d)(2) makes it clear that a non-party cannot be bound by an injunction unless it receives notice by personal service and is found to be in privity with the persons bound. *See Zenith Radio Corp v. Hazeltine Research Inc.*, 395 U.S. 100, 112 (1969)("a nonparty *with notice* cannot be held in contempt until shown to be in concert or participation. It was error to enter the injunction against Hazeltine, without having made this determination in a proceeding to which Hazeltine was a party") (emphasis added). It is not enough for this Court to name the retailers in the Order nor to give selected associations like NACS the opportunity to submit briefs. *See Kean v. Hurley*, 179 F.2d 888, 890 (8th Cir. 1950)("persons who are not parties to the injunction or in privity with them, and whose rights have not been adjudicated therein, are not bound by the decree and can not be held liable for acts done contrary thereto even though the decree assumes to bind them.") The Order violates the long-standing rule that Courts cannot bind a non-party by needlessly depriving retailers of the most valuable space within their stores, damaging the reputation of retailers, and undermining longstanding security practices.

1. The Order Deprives Convenience Stores of Their Ability to Utilize Valuable Space Within The Store

The Order's requirement that large signs be placed at the point of sale makes it impossible for retailers to utilize the most valuable space in the store. Convenience stores place some of their top selling items on the counter space at the point of sale. Products at the point of sale are primarily "impulse items," products customers decide to buy even though they did not plan to purchase such items before entering the store. *See* Broviak Aff. ¶ 18 (Ex. B). These items consist of a variety of "high-margin, high-impulse items" such as "gum, mints, and candy." Richardson Aff. ¶ 13 (Ex. C).

The Court ordered sign would deprive convenience stores of the ability to devote this space to "high-margin, high-impulse items." Ricker Oil Company, an owner of approximately 50 convenience stores, believes that if "Ricker were required to place large 18 x 30 inch signs on its counters, the company would be forced to move the highly profitable items currently displayed in those locations and would lose a significant volume of sales and profits. This would adversely impact Ricker's profits." Broviak Aff. ¶ 16 (Ex. B); *Id* at ¶ 19 ("The profits generated by impulse items displayed on counters are extremely important to Ricker's overall profitability. In 2010 Ricker's generated approximately $907,165 in revenue from the point of sale space"); *see also* Richardson Aff. ¶ 14 (Ex. C) ("This is prime real estate and the signage requirement contemplated by the Court *would take the economic value of the retail space away from E-Z Mart*") (emphasis added).

Contrary to the government's assertions, convenience store retailers do not allow tobacco companies free reign to place advertising throughout the store, especially in the limited space at the point of sale. *See* Photograph of E-Z Mart Store #101 Point of Sale (Ex. E) (highlighting the lack of space available at the point of sale at a typical convenience store). Nice N Easy Grocery Shoppes, an owner of 35 stores, E-Z Mart, an owner of over 300 stores, and Ricker's, an owner of 50 stores, all have contracts that do not contemplate allowing any tobacco advertising at the point of sale. *See* Richardson Aff. ¶ 14 (Ex. C) ("If asked, E-Z Mart would refuse to allow tobacco signage at the point of sale in its stores because that is the most valuable retail space in the stores"); Affidavit of Matthew Paduano ¶ 14 (Ex. D) ("The contracts do not require that Nice N Easy place signs at the point of sale."); Broviak Aff. ¶ 12 (Ex. B) ("We do not allow signs on or near the sales counter because this space is so valuable").

The average convenience store would certainly lose more than $2.50 a day in sales if they lost the ability to sell products at the point of sale. Ricker Oil Company estimates that each of their 50 stores generated approximately $49.70 of revenue a day from the point of sale. *See* Broviak Aff. ¶ 19 (Ex. B). Adhering to the Court's Order and placing the mandated sign at the point of sale would cost Ricker Oil Company convenience stores about *twenty times the amount estimated by the government*.

Tobacco companies, well aware of how valuable the point of sale is to a convenience store, rarely ask to place signage in that area and when they do such requests are refused. Richardson Aff. ¶ 10 (Ex. C) ("Tobacco manufactures have never asked us to include provisions in the contracts requiring us to place signs at the point of sale in E-Z Mart stores."); *Id.* at 11 ("It is my understanding that tobacco manufacturers have on occasion asked other stores to place signs at the point of sale, but that those stores have refused the requests.") The NACS and its members object to the Order for many of the same reasons they refuse to place tobacco advertising at the point of sale - it consumes tremendously valuable space that is best devoted to high-margin, high impulse items.

2. Alternatively, the Order Deprives Convenience Stores of the Essential Buy-Down Provisions in their Contracts

The Order places convenience stores at a competitive disadvantage by forcing them to either remove high-margin, high-impulse items from the point of sale to make space for a Court imposed message or be suspended from Retail Merchandising Programs, losing essential buy-down contract rights and advertising revenue.[1] A major component of all Retail Merchandising Programs is the buy-down provision. All Retail Merchandising Program contracts contain buy down provisions, whereby each tobacco manufacturer reimburses retailers for selling its cigarettes at discounted prices. *See* Richardson Aff. ¶ 6 (Ex. C).

Any store that decides to continue to use the counter space for high-margin, high-impulse items would have to forego revenue from advertising and reimbursements from buy-down agreements. The buy-down provisions are integral to the convenience store business. Cigarette sales typically constitute a large percentage of a store's revenue, 45% in the case of Ricker Oil Company. *See* Broviak Aff. ¶ 4 (Ex. B). Buy-down provisions are essential to the continued viability of a convenience store's cigarette sales. *See* Broviak Aff. ¶ 7 (Ex. B); Richardson Aff. ¶ 7 (Ex. C); Paduano Aff. ¶ 8 (Ex. D).

The government's argument that retailers that "choose to leave" the retail programs would be free to purchase cigarettes at prevailing market prices ignores the reality that many stores could not compete on their tobacco sales without the buy-downs provided for in their

[1] This choice is made more difficult by the many unanswered questions left by the Order regarding the precise standards to which retailer's signage must be held and the full range of consequences for those decisions. The unanswered questions compound the burden on retailers.

agreements. Stores that presently are less dependent on such sales (or less dependent on point of sale purchases) such as those with more space and a more diversified product offering may continue to operate with the strictures of the Order. Doing so could allow them to take significant tobacco market share from convenience stores and others that are forced to give up their agreements. This places many stores, whose viability depends on the revenue from the point of sale and from tobacco, at a competitive disadvantage against competitors who may be able to sell cigarettes at far lower prices. *See* Richardson Aff. ¶ 7.

The convenience store business model is dependent on the sale of high-margin, high-impulse items at the point of sale *as well as* competitive pricing on cigarettes. The Court's Order would force convenience stores to sacrifice an essential element of their business model for at least an entire year. The Government's assertion that the Order would cost convenience store owners an average $2.50 per day per store is absurd. Nice N Easy has received $445,000 dollars over the past 12 months just in reimbursements from the retail management program's buy-down provisions. Losses due to reduced tobacco sales alone (not counting the revenue from the agreements) could result in losses of $214.28 dollars per Nice N Easy store *per day*. Paduano Aff. ¶ 9 (Ex. D). This figure alone is nearly $30,000 more than the annual pre-tax profits of the average convenience store in the United States. NACS, *State of the Industry Annual Report 2009 Data* 54. That amount is also about *eighty-six times the amount estimated by the Government*. Pl's. Br. On Point of Sale at 12. In addition, the merchandising payments received by agreements are substantial and essential to their survival. See Broviak Aff. ¶ 10 (Ex. B) (In 2010, Ricker's received $123,220.17 in merchandising payments from Philip Morris; $84,229.59 from RJ. Reynolds; and $43,800.00 from Lorillard."); Richardson Aff. ¶ 9 (Ex. C) ("E-Z Mart receives merchandising payments of $356,443.18 from Altria, $164,472.56 from RJ Reynolds, and $55,775.00 from Lorillard.")

The losses incurred by convenience stores, which they will incur no matter how they choose to address the Order, are not marginal. On the contrary, these sums threaten the viability of many of these businesses.

3. The Order Creates Security Risks for Convenience Stores

The placement of a large 30 x 18 sign directly in front of store clerks will impair their vision, reducing their ability to detect and prevent robbery, shoplifting, gasoline theft[2], and other threats to themselves or customers. Convenience stores' tendency to operate with many cash transactions, extended hours, and low staffing mean that they pay particular attention to security and crime-prevention issues.

Store layout is a critical component of crime prevention in a convenience store.[3] One of the ways convenience stores use layout to enhance security and deter crime is to provide sales clerks with a clear line of sight to people filling up their cars with gas, shopping in the store and approaching the stores entrance. *See* Broviak Aff. ¶ 21 (Ex. B). Convenience stores typically ensure the clerk's line of sight by having counters, shelves, and floor displays that do not exceed 34 to 42 inches in height. *See* Broviak Aff. ¶ 22 (Ex. B); Richardson Aff. ¶ 22 (Ex. C). Placing an 18 x 30 sign on top of a counter that is already 36 or 42 inches high would prevent many store

[2] In 2009, gasoline theft cost the U.S. convenience store industry $89 million. *See* NACS, *Gasoline Theft at Convenience Stores, available at* http://www.nacsonline.com/NACS/News/FactSheets/Motor%20Fuels/Pages/GasolineTheftatConvenienceStores.aspx (last accessed May 6, 2011).

[3] *See* NACS, *Convenience Store Security and Safety*, *available at* http://www.nacsonline.com/NACS/Resources/Pages/ConvenienceStoreSecurityandSafety.aspx (last accessed May 11, 2011) (Recommending that convenience stores improve their security by "[r]emov[ing] signs from windows to provide clear lines of visibility to the cashier" and "[m]oving *displays that block visibility to the cashier from the outside*.") (emphasis added).

employees from having a full line of sight. *Id.* at 23 ("Requiring E-Z Mart to place large 18 x 30 inch signs on top of counters that are 36 inches in height would obscure clerk's sightlines. This would frustrate the security-related design features of E-Z Mart stores and could increase crimes inside and outside the stores-including shoplifting.").

The NACS has devoted substantial time and resources to identifying and implementing effective strategies for improving safety and security in stores.[4] This Order substantially undermines this work. For many years, NACS has taken the position that improving the visibility of the store clerk is an essential element of crime prevention in convenience stores.

Ordering the placement of a sign at the point of sale of the size contemplated by this Court contravenes the longstanding policy of NACS and most retailers of not impairing the clerk's ability to observe what is happening inside and outside the store. The Court's Order will end this policy and create new and unnecessary security risks in stores.

4. The Order Causes Undue Harm to the Reputation of Retailers

The Court Order forces non-party retailers to display a message in their stores they disagree with and one that will inevitably harm their reputation. *See* Broviak Aff. ¶ 25 (Ex. B) ("The required signs would give customers the false impression that Ricker's misled them and that Ricker's was required to apologize for misleading customers."); Richardson Aff. ¶ 19 (Ex. C) ("The signs proposed by the Court would make both smokers and non-smokers believe that E-Z Mart misled them. This would damage E-Z Mart's brand and make customers less likely to frequent our stores."); Paduano Aff. ¶ 19 (Ex. D) ("The messages on the signs contemplated by the Court's Order would be objectionable to me and to Nice N Easy. These messages would

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[4] NACS, *Security 2003*, *available at* http://www.nacsonline.com/NACS/News/FactSheets/IndustryIssues/Pages/Security.aspx (last accessed May 11, 2011) ("Robbery deterrence strategies that have been implemented include cash control and *visibility enhancements*, as well as employee training, which have been proven deterrents recommended safety experts.") (emphasis added).

make customers of Nice N Easy think the company misled them. Both smokers and non-smokers would get this impression. That would cause Nice N Easy to lose customers, lose customer good will, and would diminish the reputation of the company.")

The implication that retailers are at fault will injure the goodwill retailers have established with both smoking and non-smoking consumers. Paduano Aff. ¶ 19 (Ex. D); Richardson Aff. ¶ 19 (Ex. C) ("This would damage E-Z Mart's brand and make customers less likely to frequent our stores."); Broviak Aff. ¶ 28 (Ex. B) ("The result will be lost customers and lost sales for the company"). The Court's Order erroneously creates the impression that non-party retailers have deceived their customers. This message will cost retailers in the form of lost customers and sales.

B. THE ORDER EXCEEDS THE DISTRICT COURT'S EQUITABLE POWERS IN THAT IT BINDS NON-PARTIES AND ABROGATES CURRENT CONTRACTS

1. The Order Impermissibly Binds Non-Parties

The D.C. Circuit held that the Order, in its current state, does not "make due provision for the rights of innocent third parties." *United States v. Phillip Morris USA, Inc*., 566 F.3d 1095, 1150 (D.C. Cir. 2009). The D.C. Circuit's remand is a clear endorsement of the NACS' position that this Court exceeded its equitable powers by ordering the display of corrective communications by non-party retailers.

This Court's Order impermissibly binds retailers, who were never parties to this action. Moreover, the government has not taken the position, nor is there evidence in this case to suggest, that retailers act in concert with tobacco manufacturers. Accordingly, this Court's injunction must be reversed because it is impermissibly broad and affects the rights of non-parties that have not been subject to this Court's jurisdiction.

Courts in equity may only enjoin parties properly before them and those who are in privity with such parties. *Regal Knitwear Co.*, 324 U.S. at 13 ("The courts, nevertheless, may not grant an enforcement order or injunction so broad as to make punishable the conduct of persons who act independently and whose rights have not been adjudged according to law."); *Chase Nat'l Bank v. City of Norwalk, Ohio*, 291 U.S. 431, 436 (1934) (reversing an injunction "in so far as it enjoined 'all persons to whom notice of the order of injunction should come' . . . . The City alone was named as defendant. No person other than the City was served with process. None came otherwise before the court.") (*citation omitted*); *Kean* 179 F.2d at 890; *Alemite Mfg. Corp. v. Staff*, 42 F.2d 832, 832-33 (2d Cir. 1930) (Hand, J., writing) ("[N]o court can make a decree which will bind any one but a party; a court of equity is as much so limited as a court of law; it cannot lawfully enjoin the world at large . . . . It is not vested with sovereign powers to declare conduct unlawful; its jurisdiction is limited to those over whom it gets personal service, and who therefore can have their day in court.").[5]

Parties are in "privity" when a judgment involving one party may "justly be conclusive upon the others, although those others were not party to the lawsuit." *See Gill & Duffus Servs., Inc. v. Islam*, 675 F.2d 404, 405 (D.C. Cir. 1982) (citation omitted) (holding that part-time employee and employer were not in privity). This Court is bound by the traditional definition of privity: a non-party and party to an action are not in privity unless the non-party "claims an interest in the subject-matter affected by the judgment through or under one of the parties, i.e., either by inheritance, succession, or purchase." *Id.* at 406 (quoting Comment, *Privity and*

[5] These bedrock equitable principles are regularly adhered to by federal courts. *See, e.g., Blackard v. Memphis Area Med. Ctr. for Women, Inc.*, 262 F.3d 568, 574 (6th Cir. 2001); *Doctor's Assocs., Inc. v. Reinert & Duree, P.C.*, 191 F.3d 297, 302-03 (2d Cir. 1999); *Additive Controls & Measurement Sys., Inc. v. Flowdata, Inc.*, 154 F.3d 1345, 1351 (Fed. Cir. 1998); *Rockwell Graphic Sys., Inc. v. DEV Indus., Inc.*, 91 F.3d 914, 919 (7th Cir. 1996).

Mutuality in the Doctrine of Res Judicata, 35 Yale L.J. 607, 608 (1926)); *see also Ethnic Employees of Library of Cong. v. Boorstin*, 751 F.2d 1405, 1409 (D.C. Cir. 1985) (holding that individual members of an association were not in privity with the association; and thus, individual members were not precluded from bringing a new suit against the same party).

Neither the NACS nor its individual members satisfy the requirements to establish privity. Neither NACS nor its members are a party to this case. Further, there is no evidence whatsoever that NACS, or its individual members, have a claim in the judgment here through inheritance, succession, or purchase. Accordingly, NACS, and its members are not in privity with the Defendants. The lack of privity with the defendants precludes the equitable powers of the Court from extending to the NACS or its members.

2. This Court's Order is Unnecessarily Burdensome on Non-Parties

The Supreme Court has held that imposing broad remedial sanctions on non-parties similar to those found in the Order is an abuse of power. The Order includes its own enforcement mechanism -- if a retailer does not comply with the district court's requirements, a tobacco manufacturer must "suspend" a retailer from its Merchandising Program for one year. Such broad remedial sanctions have been found to be an abuse of discretion. *See Spallone v. United States*, 493 U.S. 265, 276 (1990) (finding a district court abused its discretion by imposing contempt sanctions on non-parties and violating the axiom that courts are obliged to use the "'least possible power adequate to the end proposed'" when selecting contempt sanctions) (citations omitted).

In addition to the self-executing enforcement, the Order requires retailers to surrender precious countertop space for the "corrective statements" or lose their Merchandising Program with tobacco manufacturers. Either alternative would result in retailers losing substantial revenue even though they have not been adjudicated of any wrongdoing and are not parties before this Court.

The government, and other supporters of appellees, may argue that the Order only binds the Defendants and how the Defendants interact with retailers -- in other words, retailers are free to act as they wish. This view ignores the breadth and reality of the Order. In addition to the self-enforcing "suspension provision" and the losses retailers will face by either complying with the Order or abandoning their merchandising programs, the Order binds retailers in other ways. By way of example, if a retailer agrees to participate in the Merchandising Program under the Order's ***imposed*** requirements, and then later on decides to stop displaying "corrective statements" in the designated areas, what would occur? The tobacco manufacturer would be required to suspend that retailer for a year. Would the retailer then be forced to return some of the revenues received pursuant to its merchandising agreement? The Order is silent on this point, but such a requirement would seem to be punitive for the non-party retailer.

At bottom, the Order leaves retailers with a Hobson's choice. Under either alternative, retailers will lose significant revenue. The Order imposes obligations on retailers with the threat of substantial financial penalties despite the fact that they are not parties before the Court, and have not had their rights adjudicated. Accordingly, the Court should abandon this aspect of the Order.

3. The District Court's Order Impermissibly Abrogates Current Contracts

The Court's Order violates the recognized principle that courts should apply their relief prospectively rather than retroactively. *See, e.g., United States v. Philip Morris USA, Inc.*, 396 F.3d 1190, 1197-98 (D.C. Cir. 2005). During the first interlocutory appeal, the D.C. Circuit considered the availability of disgorgement as an equitable remedy under RICO. *Id.* The Court explained that "Federal courts are courts of limited jurisdiction. They possess only that power authorized by Constitution and statute, which is not to be expanded by judicial decree." 396 F.3d at 1197 (*quoting Kokkonen v. Guardian Life Ins. Co. of Am.*, 511 U.S. 375, 377 (1994) (quotations omitted). The Court held that RICO only allows forward-looking remedies to prevent and restrain violations, and does not allow backward-looking remedies to prevent violations. 396 U.S. at 1198. Thus, forfeiture of ill-gotten gains from past conduct was not a permissible remedy. *Id*. at 1199-1200. This Court's Order has similarly violated these principles.

NACS has been unable to find a case in which a district court's injunction altered an existing contract when that contract was not before the court. Regardless, an equitable decree should only operate with prospective effect. *Cf. Leedom v. Int'l Bhd. Electrical Workers, Local Union No.* 108, 278 F.2d 237, 241 (D.C. Cir. 1960) ("[A]s a matter of equitable discretion, courts will apply a judgment overruling a prior decision only prospectively in order to avoid 'gross injustice.'") (citation omitted). Courts particularly adhere to this rule when the change in law will affect contracts, which were made in reliance upon the earlier rules. *See id.*

Retailers have existing contractual relationships with tobacco manufacturers for the marketing of tobacco products. To the extent this Court reinstates this Order, at a minimum, it should only be enforced prospectively. An equitable decree should not compel parties to an existing contract to alter an agreement that is not before the court. Equity protects a party's reliance; it does not retroactively impair it, save for unique circumstances. *See Leedom*, 278 F.2d at 241 (explaining that in their equitable discretion, courts apply rule changes prospectively in order to avoid a "gross injustice"). Therefore, to the extent the Order is applied at all, it should apply prospectively to future contracts and not alter, interfere with, or end existing agreements.

C. THE ORDER VIOLATES THE DUE PROCESS RIGHTS OF NACS MEMBERS

The most basic and fundamental requirements of due process provide that a party must be properly brought within a court's jurisdiction and given an opportunity to be heard. *See Mullane v. Cent. Hanover Bank & Trust Co.*, 339 U.S. 306, 313 (1950) ("[A]t a minimum [the Due Process Clause] require[s] that deprivation of life, liberty or property by adjudication be preceded by notice and opportunity for hearing appropriate to the nature of the case.").[6]

The D.C. Circuit has held that these notions of due process also apply to the remedies phase of proceedings. See *United States v. Microsoft Corp.*, 253 F.3d 34, 101 (D.C. Cir. 2001) ("Hence a remedies decree must be vacated whenever there is 'a bona fide disagreement concerning substantive items of relief which could be resolved only by trial.'") (citation omitted). The defendants named in this action were tobacco manufacturers and research organizations. Until this Court issued the Order, there was no indication whatsoever that this action implicated retailers' interests – let alone that they would be bound by a court decree. As non-parties, NACS members never recieved notice, and never had an opportunity to present evidence or defend themselves during the action.[7] Essentially, the Court is considering binding NACS members to an injunction when this Court did not adjudicate their actions or interests in

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[6] Even though these cases dealt with the due process clause of the Fourteenth Amendment, this Court has recognized that the protections offered are the same as those offered by the Fifth Amendment. *See, e.g., Washington Free Cmty., Inc. v. Wilson*, 484 F.2d 1078, 1079 n.2 (D.C. Cir. 1973) (holding that the Due Process Clause of the Fifth Amendment embodies the guarantees of the Equal Protection Clause of the Fourteenth Amendment as applied to the District of Columbia).

[7] Defendants-Appellants were similarly deprived of the opportunity to present such evidence. *See* Proof Brief of Defendants-Appellants at 134-36.

any way. Fundamental due process and fairness do not permit a court to affect substantially the rights of non-parties in this way. The D.C. Circuit has held that "[it] is a cardinal principle of our system of justice that factual disputes must be heard in open court and resolved through trial-like evidentiary proceedings." *Microsoft Corp*., 253 F.3d at 101. Neither the parties nor the impermissibly bound non-parties has been afforded an evidentiary hearing to dispute the factual basis underlying this Court's Order.[8] In *Microsoft Corp*., the D.C. Circuit found that the failure to hold a hearing prior to issuing an injunction was "[c]ontrary to the spirit which imbues our judicial tribunals prohibiting decision without hearing." *Id*. (quotation marks and citation omitted). This Court's actions mirror those of the court in *Microsoft Corp*. Accordingly, the Order should not be reinstated.

The Order will have real consequences for retailers. Regardless of what NACS members decide to do, they will lose substantial revenue. The bottom line is the Court's Order imposes large monetary penalties on retailers without the benefit of due process of law.

D. THE ORDER VIOLATES THE FREE SPEECH CLAUSE OF THE FIRST AMENDMENT

Injunctions are subject to even stricter analysis under the First Amendment than statutes or regulations. *See Madsen v. Women's Health Ctr., Inc.*, 512 U.S. 753, 765 (1994) (applying "a somewhat more stringent application of general First Amendment principles" to a content-neutral injunction). A fundamental protection of the First Amendment is that the government cannot compel individuals to express certain views -- otherwise known as "forced speech." *See United States v. United Foods, Inc.*, 533 U.S. 405, 410 (2001); *Wooley v. Maynard*, 430 U.S. 705, 714 (1977); *West Virginia Bd. of Ed. v. Barnette*, 319 U.S. 624, 642 (1943) ("If there is any fixed star in our constitutional constellation, it is that no official, high or petty, can prescribe

[8] Asking NACS to submit this brief does not cure this due process problem as NACS is not a party and has not had an opportunity to participate in a full evidentiary hearing.

what shall be orthodox in politics, nationalism, religion, or other matters of opinion or force citizens to confess by word or act their faith therein.").

The *Wooley* case is particularly relevant to the facts here. In *Wooley*, the Supreme Court considered whether a state may constitutionally enforce criminal sanctions against a person who covered the state motto "Live Free or Die" on a vehicle license plate. *Wooley*, 430 U.S. at 706-07. The Supreme Court held that a state cannot constitutionally require an individual "to participate in the dissemination of an ideological message by displaying it on his private property in a manner and for the express purpose that it be observed and read by the public." *Id.* at 713. The First Amendment protects an individual's right to speak freely and "to refrain from speaking at all." *Id.* at 714. The Court's order violates these essential tenets of the First Amendment.

The Order requires retailers to display "corrective statements," with which they may not agree. The purpose of these statements is to be observed and read by the public on private property, the convenience store's business. Indeed, if convenience store operators refuse to post the "corrective statements," then according to the Order, their merchandising agreements will be abrogated for a period of one year, and retailers will be deprived of the buy-down benefits and marketing revenues they bargained for in the merchandising agreements. The "corrective statements" are a state-sanctioned message (by way of court order) in an effort to affect the marketplace and consumers by mandating the communication of certain information. The First Amendment does not permit a court to compel non-parties to display such state sanctioned messages with which they might disagree.

Moreover, retailers' disagreement with the message required by the Order is not merely hypothetical. The Order seeks to force retailers to convey to customers a message that implicates retailers as having engaged in some wrongdoing. *See* Richardson Aff. ¶ 17 (Ex.C); Paduano Aff.

¶ 19 (Ex. D); Broviak Aff. ¶ 18 (Ex. B). No retailer has been adjudicated of any wrongdoing, yet they must display the "corrective statements" in the most prominent position in their stores. By forcing retailers to display the "corrective statements," there is a significant probability that customers will view retailers as wrongdoers, which would affect the retailers' goodwill.

Content-neutral injunctions such as the Order must adhere to the intermediate scrutiny standard. In applying a higher standard of scrutiny to a content-neutral injunction than what the Supreme Court would apply to a similar statute, the majority in *Madsen* justified the application of the intermediate scrutiny standard because of the differences between statutes and injunctions that Justice Scalia identified in his dissent. *See Madsen*, 512 U.S. at 766. While Justice Scalia would have applied a strict scrutiny standard, his dissent illustrates the dangers injunctions pose to First Amendment rights, and the majority agreed the case called for a higher standard than the simple time, place, manner analysis. *Id.* 764.

> The danger of content-based statutory restrictions upon speech is that they may be designed and used precisely to suppress the ideas in question rather than to achieve any other proper governmental aim. But that same danger exists with injunctions. Although a speech-restricting injunction may not attack content *as content* (in the present case, as I shall discuss, even that is not true), it lends itself just as readily to the targeted suppression of particular ideas. . . .
>
> The second reason speech-restricting injunctions are at least as deserving of strict scrutiny is obvious enough: They are the product of individual judges rather than of legislatures and often of judges who have been chagrined by prior disobedience of their orders. The right to free speech should not lightly be placed within the control of a single man or woman. And the third reason is that the injunction is a much more powerful weapon than a statute, and so should be subjected to greater safeguards. Normally, when injunctions are enforced through contempt proceedings, only the defense of factual innocence is available.

Madsen v. Women's Health Ctr., Inc., 512 U.S. 753, 792-93 (1994) (Scalia, J., dissenting).

This Order fails to meet the intermediate scrutiny standard. The injunction can only meet the intermediate scrutiny standard "if it advances important governmental interests unrelated to the suppression of free speech and does not burden substantially more speech than necessary to further those interests." *Turner Broadcasting System v. FCC*, 520 U.S. 180, 189 (1997). This Court's Order, which forces innocent non-parties to communicate a message that they do not agree with, does not satisfy the intermediate scrutiny standard. Further, this Court has not conducted an evidentiary hearing to ensure the Order "does not burden substantially more speech than necessary to further those interests."

This Court's order violates these First Amendment precepts, and accordingly, the Order should be overturned.

E. THIS ORDER RESULTS IN IMPERMISSIBLE TAKINGS OF RETAILERS' CONTRACT RIGHTS AND VALUABLE COUNTER SPACE WITHOUT JUST COMPENSATION

The Fifth Amendment commands that property cannot be taken without just compensation. U.S. Const. amend. V ("[n]or shall private property be taken for public use, without just compensation."). This Court's Order would both interfere with valid contracts between retailers and tobacco manufacturers and take away valuable space at the point of sale. Accordingly, unless the Order provides for just compensation, it is impermissible under the Fifth Amendment.

The judicial abrogation of a contract without just compensation is an unconstitutional taking. "Valid contracts are property, whether the obligor be a private individual, a municipality, a State, or the United States." *Lynch v. United States*, 292 U.S. 571, 579 (1934). In *Lynch*, Congress abrogated war risk insurance contracts that individuals had entered into with the United States. *Id*. The Supreme Court held that the government cannot annul contracts between an individual and the United States without just compensation, unless it is exercising a "federal police power or some other paramount power." 292 U.S. at 579.

It is well-established that "state action" can occur through judicial decrees. *See Shelley v. Kraemer*, 334 U.S. 1, 14 (1948) (explaining that in applying the Fourteenth Amendment to invalidate judicial enforcement of discriminatory private agreements, "a State may act through different agencies, --either by its legislative, its executive, or its judicial authorities . . . .") (quoting *Commonwealth of Virginia v. Rives*, 100 U.S. 313, 318 (1880)); *Cohen v. Cowles Media Co.*, 501 U.S. 663, 668 (1991) (holding that applying state rules of law in state courts in a way that restricts First Amendment rights constitutes "state action"). The Order at issue here interferes with vested contract rights. The interests at stake here are exactly the same as those that were at issue in *Lynch*. The only difference between *Lynch* and this case is that the "state action" is a judicial decree rather than an act of Congress. Under Supreme Court jurisprudence, the constitutional analysis is the same -- government action that abrogates existing contracts without just compensation is an unconstitutional taking.

The D.C. Circuit considered whether an injunction could constitute a taking in *National Wildlife Federation v. Burford*, 835 F.2d 305 (D.C. Cir. 1987). In *Burford*, however, the D.C. Circuit concluded there was no unconstitutional taking of property because, unlike the situation in this case, the injunction did not interfere with existing contractual rights.

In *Burford*, the National Wildlife Federation brought suit against the Department of Interior, challenging the conduct of its land withdrawal review program. The district court enjoined the Department from modifying, terminating, or revoking any restriction in effect on January 1, 1981 and enjoined the agency from taking any action that was inconsistent with those restrictions. Appellants argued that the injunction, in effect, improperly enjoined non-parties from exercising their property rights. The D.C. Circuit did not agree with the appellants in *Burford*; however, this case is materially different from *Burford*. That Court explained that, unlike the injunction *sub judice*, the injunction in *Burford* did not affect non-parties:

> The order does not deprive any person or entity who is not before the court of his property rights. The injunction does not invalidate existing mining claims or mineral leases. Indeed, the order explicitly allows holders of existing mining claims to continue to satisfy the legal requirements to preserve those claims. Mountain States complains that such claims and leases may be void *ab initio* if they were initiated before the land was lawfully available for entry. However, the injunction simply *suspends* the classification and withdrawal terminations under the Program; it does not reinstate the original withdrawals and classifications. Thus, the court's order does not upset these interests. Nor does it overturn completed sales or exchanges of previously withdrawn lands. The injunction addresses only the Department's ability to convey legal title to private persons in the future.

Id. at 315. The D.C. Circuit ultimately concluded that "[t]he injunctions only actual effect [in *Burford*] on third parties is lost or delayed opportunity to consummate transactions for the purchase or use of federal lands in the future. These interests, however, are not constitutionally protected property rights." *Id.*

This case is far different from *Burford*. First and foremost, the Court's injunction would apply with immediate effect. There is no limitation that it will enjoin future behavior or leave existing legal relationships alone. Second, the injunction interferes not with prospective economic development or opportunities, but with valid, existing contracts between retailers and tobacco manufacturers.

In addition, retailers that place the Court mandated sign at the point of sale in order to keep their Retail Merchandising Contract would lose valuable space and suffer an unconstitutional taking. The Supreme Court has held that where government requires an owner to suffer a permanent physical invasion of her property, however minor, it must provide just compensation. *See, Lorettto v. Telepromter Manhattan CATV Corp*., 458 U.S. 419 (2005)(state law requiring landlords to permit cable companies to install cable facilities in apartment buildings effected a taking).

The Order's requirement that large signs cover the point of sale counter space in retail locations is a regulatory taking as defined by *Penn Central Transp. Co. v. New York City*, 438 U.S. 104 (1978). The *Penn* Court set out four factors to guide an analysis into whether a taking occurred. The first is "the economic impact of the regulation on the claimant and, particularly, the extent to which the regulation has interfered with distinct investment-backed expectations." *Id.* The second factor is whether the taking of the property "can be characterized as a physical invasion by government" as opposed to "interference aris[ing] from some public program adjusting the benefits and burdens of economic life to promote the common good." *Id.* The third factor is whether the property interest is "sufficiently bound up with the reasonable expectations of the claimant to constitute "property" for Fifth Amendment purposes" *Id.* at 125. Finally, the Court will consider whether "a state tribunal reasonably concluded that "the health, safety, morals, or general welfare" would be promoted by prohibiting particular contemplated uses of land."

Applying the aforementioned factors to the present case demonstrates that the Order constitutes an impermissible taking. First, the economic impact from the mandated sign at the point of sale is substantial. Broviak Aff. ¶ 19 (Ex. B). Second, the Order requires the physical occupation of the point of sale space by a Court ordered sign, eliminating the retailer's ability to use the space to sell products in that space. The economic harm suffered by retailers is exacerbated by the fact that the store's business model is based on the assumption that healthy revenues will come from products displayed at the point of sale. The Order dramatically reduces the chances that a retailer will be able to make money on the store's operation because the portion of the store that generates the highest-value sales, the point of sale, would no longer be available. Third, it is reasonable for a retailer to expect to have a property interest in commercial real estate that they have leased or purchased specifically for the purpose of selling goods to customers with that space. Finally, the Order does not prohibit use of property in order to promote the "safety, morals, or general welfare." This Court has never found the sale of high-margin products at the point of sale to contravene safety, morals, or the general welfare, yet denies retailers the right to sell them in the Order. Indeed, this Order actually causes security issues for convenience stores by displacing long-standing security policies. Also, the contemplated signs are affirmatively misleading by sending the message that retailers engaged in wrongdoing. As such, the Order certainly does not meet the final prong of the *Penn Central* test.

Accordingly, the injunction substantially interferes with the legitimate property interests of non-parties without just compensation; hence, it is an unconstitutional taking.

CONCLUSION

For the foregoing reasons, NACS respectfully urges this Court not to reinstate Order #1015, which erroneously imposes substantial burdens on NACS's members.

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Respectfully submitted,

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