United States Court of Appeals for the Fifth Circuit

United States Court of Appeals
Fifth Circuit
FILED
September 1, 2026
Lyle W. Cayce
Clerk

No. 25-40233

State of Texas,

Plaintiff—Appellee,

versus

R. J. Reynolds Tobacco Company,

Defendant—Appellant,

versus

Philip Morris, Incorporated,

Defendant—Appellant/Appellee.

Appeal from the United States District Court
for the Eastern District of Texas
USDC No. 5:96-CV-91

Before Richman, Southwick, and Oldham, *Circuit Judges*.

Per Curiam:*

In 1998, the State of Texas reached a settlement agreement with several tobacco companies to address Texas's smoking-related healthcare costs. Pursuant to that agreement, the tobacco companies make annual payments to Texas. A 2018 change to the maximum federal corporate income tax rate triggered a dispute about how those payments are calculated. Texas and the tobacco companies filed cross-motions urging their respective readings of the agreement. The district court granted Texas's motion, concluding that the agreement was unambiguous. It then allocated additional liability for several years of underpayment between the tobacco companies. We reverse and remand.

I

Despite the three-decade history of this litigation, the dispute presented in this appeal is narrow: what tax rate applies to the calculation of Base Net Operating Profit? This requires the construction of subparagraphs (B)(ii) and (C) of Appendix A of the 2001 Stipulation of Amendment (the "2001 Amendment") to the 1998 Settlement Agreement.

The 2001 Amendment governs the calculation of the tobacco companies' annual settlement payments. This is not the parties' first dispute over this issue. The language we are construing today was intended to resolve "certain disputes [arising] between the parties concerning the meaning of the term 'net operating profits' as used in Appendix A" of the 1998 Agreement. The disputes persist.

* This opinion is not designated for publication. *See* 5th Cir. R. 47.5.

A

The calculation of the tobacco companies' annual payment to Texas begins with the Base Payment: 7.25% of $8 billion, for each year after 2003.[1] That sum is then adjusted to account for volume of cigarette sales.[2] The agreement contemplated two scenarios: one in which volume of cigarette sales increased relative to 1997, and one in which they decreased relative to 1997. Sales of cigarettes by volume have declined precipitously since these agreements were inked. Therefore, we are today construing Subparagraph (B) of the 2001 Amendment, which governs the scenario in which "the Actual Volume is less than the Base [1997] Volume [of cigarette sales]."

Subparagraph (B)(i) provides that if sales volume decreased, the base payment would likewise decrease. Subparagraph (B)(ii) sets forth the Profit Adjustment Calculation. It states that if decreased sales volume led to a decrease in base payment, but the tobacco companies' operating profits from domestic sales of cigarettes increased, then the base payment would decrease *by less*.[3] The agreement accordingly provided for the possibility that volume of cigarettes sold would decrease, but that those sales would become more

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[1] *See* 2001 Amendment, ¶ 7 ("[I]t shall severally cause to be paid . . . its share of 7.25% of the following amounts (in billions) . . .").

[2] *See* 2001 Amendment, ¶ 7 ("Such payments will also be decreased or increased . . . in accordance with the formula for adjustment of payments set forth in Appendix A hereto.").

[3] *See* 2001 Amendment, Appendix A, Subparagraph (B)(ii) ("[I]f a reduction of the Applicable Base Payment results from the application of subparagraph (B)(i) [governing reduction in base payment derived from reduction in sales volume], but the Settling Defendants' aggregate net operating profits from domestic sales of Cigarettes for the Applicable Year . . . is greater that the Settling Defendants' aggregate net operating profits from domestic sales of cigarettes in 1997 . . . then *the amount by which the Applicable Base Payment is reduced by the application of subparagraph (B)(i) shall be reduced* (but not below zero) by 7.25% of 25% of such increase in profits.").

profitable for the tobacco companies. Texas negotiated for a slice of that increased profit. Subparagraph (B)(ii) reads as follows:

> [I]f a reduction of the Applicable Base Payment results from the application of subparagraph (B)(i) of this Appendix, but the Settling Defendants' aggregate net operating profits from domestic sales of Cigarettes for the Applicable Year (the "Actual Net Operating Profit") is greater than the Settling Defendants' aggregate net operating profits from domestic sales of Cigarettes in 1997 (the "Base Net Operating Profit") (such Base Net Operating Profit being adjusted upward by the greater of the rate of 3% per annum or the actual total percent change in the Consumer Price Index, in either instance for the period between January 1, 1998 and the date on which the payment at issue is made), then the amount by which the Applicable Base Payment is reduced by the application of subparagraph (B)(i) shall be reduced (but not below zero) by 7.25% of 25% of such increase in such profits. For purposes of this Appendix, the term "net operating profits" shall mean: (1) operating income before goodwill amortization, trademark amortization, minority interest, net interest expense, non-operating income and expense, general corporate expenses and income taxes, and excluding extraordinary items and the cumulative effect of changes in method of accounting; but (notwithstanding any of the foregoing) not excluding charges or expenses incurred or accrued in connection with any settlement of a tobacco and health case (including, but not limited to, "up-front" settlement payments), restructuring related charges, discontinued operations and casualty losses; (all as reported to the United States Securities and Exchange Commission ("SEC") for the Applicable Year (either independently by the Settling Defendant or as part of consolidated financial statements reported to the SEC by an affiliate of such settling defendant) or, in the case of a Settling Defendant that does not report such information to the SEC, as reported in financial statements prepared in accordance with

> U.S. generally accepted accounting principles and audited by a nationally recognized accounting firm); minus (2) the amount determined by clause (1) above multiplied by a percentage equal to the sum of (a) the maximum marginal federal income rate (such rate being 35% as of May 1, 2001) in effect on December 31 of the Applicable Year, plus (b) 4.472 percentage points. Notwithstanding the foregoing, the Settling Defendants' aggregate total amount of restructuring charges, restructuring related charges and discontinued operations included for purposes of clause (1) of the preceding sentence shall not in any Applicable Year exceed the Annual Restructuring Cap (as defined and provided in paragraph (D) below). Applying the foregoing definition, the Settling Defendants' aggregate net operating profits from domestic sales of Cigarettes in 1997 were $3,115,100,000. The determination of the Settling Defendants' aggregate net operating profits from domestic sales of Cigarettes shall be derived using the same methodology as was employed in deriving such Settling Defendants' aggregate net operating profits from domestic sales of Cigarettes in 1997. Any increase in an Applicable Base Payment pursuant to this subparagraph (B)(ii) shall be payable within 120 days after the date that the payment at issue was required to be made.

The 2001 Amendment then defines "Applicable Year" in Subparagraph (C):

> "Applicable Year" means (i) with respect to the payments made pursuant to paragraph 7 of the [2001] Amendment, the calendar year ending on the date on which the payment at issue is due, regardless of when such payment is made; and (ii) with respect to all other payments made pursuant to this . . . Amendment, the calendar year immediately preceding the year in which the payment at issue is due, regardless of when such payment is made.

The parties dispute whether Base Net Operating Profit is fixed save for the inflation adjustment, or whether it must change with changes in the maximum federal corporate income tax rate. Because the Profit Adjustment Calculation requires comparing Actual Net Operating Profit and Base Net Operating Profit, applying one tax rate to the calculation of one figure and a different one to the calculation of the other triggers significant changes in the tobacco companies' liability.

B

The construction of the agreement is governed by Texas law. "The construction of an unambiguous contract is a question of law for the court, which we may consider under a de novo standard of review."[4] "When construing a contract, the court's primary concern is to give effect to the written expression of the parties' intent."[5] "In other words, it is the objective intent of the parties, not their subjective intent, that must be ascertained."[6] To ascertain this objective intent, courts use "long-established rules of construction."[7] For instance, a court reads all parts of a contract together to ascertain the parties' agreement.[8] It considers the contract as a whole.[9] Each part of the contract should be given effect.[10] No phrase, sentence, or section may be isolated from its setting and considered

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[4] *Tawes v. Barnes*, 340 S.W.3d 419, 425 (Tex. 2011).

[5] *Forbau v. Aetna Life Ins. Co.*, 876 S.W.2d 132, 133 (Tex. 1994).

[6] 14 TEX. JUR. 3D *Contracts* § 228.

[7] *Id.*

[8] *Forbau*, 876 S.W.2d at 133.

[9] *Id.*

[10] *Id.*

apart from other provisions.[11] "Extrinsic evidence may . . . be admissible to give the words of a contract a meaning consistent with that to which they are reasonably susceptible, *i.e.*, to 'interpret' contractual terms."[12] "If the contract language is not fairly susceptible of more than one legal meaning or construction, however, extrinsic evidence is inadmissible to contradict or vary the meaning of the explicit language of the parties' written agreement."[13]

C

Performing the profit adjustment in Subparagraph (B)(ii) requires comparing Base Net Operating Profit with Actual Net Operating Profit. Each is a synthetic measure that measures profits derived from the sale of cigarettes. Base Net Operating Profit is a synthetic measure of profits derived from the sale of cigarettes in 1997, the Base Year. Actual Net Operating Profit is a synthetic measure of profits derived from the sale of cigarettes in the Applicable Year, the year a settlement payment comes due. For the years in which cigarette sales by volume have fallen, but Actual Net Operating Profit exceed Base Net Operating Profit, the tobacco companies' payments to Texas are adjusted to account for the increased profit. This section of the agreement provides a lengthy formula for calculating "net

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[11] *Id.* at 134.

[12] *Nat'l Union Fire Ins. Co. of Pittsburgh v. CBI Indus., Inc.*, 907 S.W.2d 517, 521 (Tex. 1995).

[13] *Id.*

operating profits" and contemplates that both Base and Actual Net Operating Profit will be calculated using the same formula.[14]

Texas argues—and the district court concluded—that the agreement fixed Base Net Operating Profit at $3.115 billion for all time, subject only to adjustment for inflation.[15] The tobacco companies argue that Base Net Operating Profit changes with the maximum federal corporate income tax rate in a given Applicable Year. They contend it *was* $3.115 billion (excepting the inflation adjustment) for many years, but that changed in 2018 when the maximum federal corporate income tax rate was reduced from 35% to 21%.

We begin with the definition of "Applicable Year." The payments at issue in this appeal are those "Annual Payments" made pursuant to paragraph 7 of the 2001 Amendment. They are therefore governed by subsection (i) of Paragraph (C) of Appendix A, which provides that "'Applicable Year' means . . . with respect to the payments made pursuant to paragraph 7 of the [2001] Amendment, the calendar year ending on the date on which the payment at issue is due . . . ." For a payment due in 2026, the Applicable Year for the Profit Adjustment Calculation would be 2026.

We then return to Subparagraph (B)(ii) of the 2001 Amendment, which calculates "net operating profits." It begins with "operating income," which Black's Law Dictionary defines as "[f]or business-tax

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[14] *See* 2001 Amendment, Appendix A, Subparagraph (B)(ii) ("The determination of the Settling Defendants' aggregate net operating profits from domestic sales of cigarettes shall be derived using the same methodology as was employed in deriving such Settling Defendants' aggregate net operating profits from domestic sales of Cigarettes in 1997.").

[15] *See* 2001 Amendment, Appendix A, Subparagraph (B)(ii) ("Applying the foregoing definition, the Settling Defendants' aggregate net operating profits from domestic sales of Cigarettes in 1997 were $3,115,100,000.").

purposes, earnings from the normal operations or activities of a business."[16] However, the Amendment provides a bespoke definition of operating income. It specifies several items that should not be deemed part of operating income: "goodwill amortization, trademark amortization, minority interest, net interest expense, non-operating income and expense, general corporate expenses and income taxes, and excluding extraordinary items and the cumulative effect of changes in method of accounting . . . ." It then specifies several settlement-related costs that should *not* be excluded from the calculation of operating income: "but (notwithstanding any of the foregoing) not excluding charges or expenses incurred or accrued in connection with any settlement of a tobacco and health case (including, but not limited to, 'up-front' settlement payments), restructuring charges, restructuring related charges, discontinued operations and casualty losses . . . ." These settlement-related expenses are "as reported to the United States Securities and Exchange Commission ('SEC') for the Applicable Year."

The formula then commands that operating income be multiplied by "a percentage equal to the sum of (a) the maximum marginal federal corporate income tax rate . . . in effect on December 31 of the Applicable Year, plus (b) 4.472 percentage points." The number that results is subtracted from operating income. The outcome of the operation is "net operating profits."

$$Net\ Operating\ Profits =$$

$$Operating\ Income - (Operating\ Income * (Max\ Marginal\ Federal\ Corporate\ Income\ Tax\ Rate\ in\ the\ Applicable\ Year +\ 4.472\%)).$$

The net operating profits calculation uses "Applicable Year" in two places. Operating income includes certain expenses stemming from the

[16] *Operating Income*, BLACK'S LAW DICTIONARY 910 (12th ed. 2024).

settlement, "all as reported to the [SEC] for the Applicable Year." The tax rate calculation incorporates "the maximum marginal federal corporate income tax rate . . . in effect on December 31 of the Applicable Year."

D

Texas law gives effect to defined terms in contracts.[17] The tobacco companies argue that giving effect to the definition of Applicable Year requires applying the maximum federal corporate income tax rate in effect on December 31 of the year the payment comes due to the calculation of "net operating profits."[18] For payments that come due in 2026, then, the tax rate calculation would use "the maximum marginal federal corporate income tax rate . . . in effect on December 31 of [2026]." Because both Base and Actual Net Operating Profit are sub-types of "net operating profits," this would require that both Base and Actual Net Operating Profit be calculated each year with the current year's maximum federal corporate income tax rate.

We agree. In addition to faithfully applying the 2001 Amendment's definition of "Applicable Year," this reading accords with the commercial

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[17] 14 TEX. JUR. 3D *Contracts* § 246 ("If there is a stipulation by the parties as to the meaning of a word, that meaning will prevail over the ordinary definition of the term, and the courts have no authority to ascribe a different meaning to it."); *see, e.g.*, *Provident Life and Accident Ins. Co. v. Knott*, 128 S.W.3d 211, 219 (Tex. 2003) ("When terms are defined in an insurance policy, those definitions control the interpretation of the policy. Reliance on defined terms in insurance policies to construe those contracts is necessary to determine the intent of the parties and integral to the application of basic principles of contract interpretation to insurance policies." (internal citations omitted)).

[18] *See* 2001 Amendment, Appendix A, Subparagraph (C) ("'Applicable Year' means . . . with respect to the payments made pursuant to paragraph 7 of the Stipulation of Amendment, the calendar year ending on the date on which the payment at issue is due . . . .").

logic of the agreement.[19] The tobacco companies' effective tax rate fluctuates wildly from year to year. By comparison, healthcare costs attributable to smoking are relatively stable.[20] The formula strips out *actual* tax costs,[21] instead applying a negotiated percentage reduction of "a percentage equal to the sum of (a) the maximum marginal federal corporate income tax rate . . . in effect on December 31 of the Applicable Year, plus (b) 4.472 percentage points." This has the effect of insulating the Profit Adjustment calculation from variation unrelated to the operating profits derived from cigarettes. It would be reasonable to conclude that the parties intended the 1997 base-year operating profits to serve as a baseline for comparison of the companies' operating profits from sales of cigarettes in future years. Applying different tax rates to the calculation of Base and Actual Net Operating Profit would tend to make the tobacco companies' liability turn on the fortuity of changes in the corporate income tax rate, rather than the operating profits from their cigarette businesses.

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[19] *See Hou. Expl. Co. v. Wellington Underwriting Agencies, Ltd.*, 352 S.W.3d 462, 469 (Tex. 2011) ("The [parol evidence] rule does not prohibit consideration of surrounding circumstances that inform, rather than vary from or contradict, the contract text. Those circumstances include . . . 'the commercial or other setting in which the contract was negotiated and other objectively determinable factors that give a context to the transaction between the parties.'" (quoting 11 RICHARD A. LORD, WILLISTON ON CONTRACTS § 32.7 (4th ed. 1999)).

[20] U. S. DEP'T OF HEALTH AND HUM. SERVS., THE HEALTH CONSEQUENCES OF SMOKING—50 YEARS OF PROGRESS: A REPORT OF THE SURGEON GENERAL 672 (2014) ("[S]moking-attributable medical expenditures were estimated to be $75.5 billion for 1998 . . . and $96 billion for 2004.").

[21] *See* 2001 Amendment, Appendix A, Subparagraph (B)(ii) ("operating income before . . . general corporate expenses and income taxes . . .").

E

Texas resists this reading of the agreement on two grounds. First, it contends that—as the district court concluded—an illustrative figure in the agreement fixed Base Net Operating Profit at $3.115 billion for all time: "Applying the foregoing definition, the Settling Defendants' aggregate net operating profits from domestic sales of cigarettes in 1997 were $3,115,100,000."

We disagree. The $3.115 billion figure was described as an "appl[ication of] the foregoing definition," and the foregoing definition calls for the application of the tax rate from the Applicable Year. In performing the illustrative calculation, the agreement referred to the tax rate in effect *in 2001*[22]—the year the Amendment was signed—rather than the tax rate in effect in 1997. While the tax rate in effect in 2001 was the same as was in effect in 1997, the agreement's recitation of the tax rate in effect "as of May 1, 2001"—approximately a month prior to its execution—suggests that the parties intended net operating profit be calculated with the tax rate of the Applicable Year. Additionally, the sentence that follows states that the "determination of the Settling Defendants' aggregate net operating profits from domestic sales of Cigarettes shall be derived using the same methodology as was employed in deriving such Settling Defendants' aggregate net operating profits from domestic sales of Cigarettes in 1997." The agreement describes the $3.115 billion figure as "aggregate net operating

[22] *See* 2001 Amendment, Appendix A, Subparagraph (B)(ii) (". . . (2) the amount determined by clause (1) above multiplied by a percentage equal to the sum of (a) the maximum marginal federal corporate income tax rate (*such rate being 35% as of May 1, 2001*) in effect on December 31 of the Applicable Year . . ." (emphasis added)).

profits from domestic sales of Cigarettes in 1997," rather than the defined term "Base Net Operating Profit."

Texas also contends that applying the definition of "Applicable Year" consistently across the agreement creates an absurdity. In addition to its use in the tax rate calculation, "Applicable Year" is used in the Amendment's bespoke definition of operating income. Texas's reading would apply the modifier containing "Applicable Year"[23] across each component of the definition of operating income. It observes that—when applied to the calculation of Base Net Operating Profit in 2026—this would require that *every component* of operating income be "as reported to the [SEC]" for 2026. The result would be a figure that has nothing to do with profits derived from sale of cigarettes in 1997, which Base Net Operating Profit is designed to measure.

We disagree with this reading. When interpreting contracts, Texas courts presume that "modifiers are intended to refer to the words closest to them in the sentence."[24] The modifier "all as reported to the [SEC] for the Applicable Year" immediately follows the agreement's enumeration of specific settlement-related expenses that may be accounted for in operating income: "'up-front' settlement payments[], restructuring charges, restructuring related charges, [and] discontinued operations and casualty

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[23] *See* 2001 Amendment, Appendix A, Subparagraph (B)(ii) ("all as reported to the United States Securities and Exchange Commission ('SEC') for the Applicable Year . . .").

[24] *Samano v. Sun Oil Co.*, 621 S.W.2d 580, 581-82 (Tex. 1981); *see Certain Underwriters at Lloyd's of Lond. Subscribing to Pol'y No.: FINFR0901509 v. Cardtronics, Inc.*, 438 S.W.3d 770 (Tex. App.—Houston [1st Dist.] 2014, no pet.) ("Under the 'last antecedent' doctrine, a canon of contract and statutory construction, 'relative and qualifying words, phrases and clauses are to be applied to the words or phrases immediately preceding, and not to be construed as extending to or including others more remote.'" (quoting *Montanye v. Transamerica Ins. Co.*, 638 S.W.2d 518, 521 (Tex. App.—Houston [1st Dist.] 1982, no writ))).

losses . . . ." Therefore, it modifies only those enumerated expenses—and not other components of operating income, which precede the enumerated expenses related to the Settlement Agreement.

Thus understood, the use of "Applicable Year" in the definition of operating income does not create an absurdity. The agreement contemplates ongoing expenses stemming from the settlements. The impetus for the 2001 Amendment was a dispute over whether those expenses should be included in operating income, and how they should be calculated. The agreement resolved that dispute by requiring that they be included (albeit with a cap)[25] and that they be calculated for settlement payment purposes the same way they are calculated for SEC reporting purposes: "all as reported to the [SEC] for the Applicable Year." This keeps the parties honest. It would be improper for a publicly traded company to distort the calculation of "discontinued operations and casualty losses" to the detriment of a contractual counterparty. It would be hazardous to do the same before the SEC.[26]

"[A] contract is ambiguous only when the application of pertinent rules of interpretation to the face of the instrument leaves it genuinely uncertain which one of two or more meanings is the proper meaning."[27] After applying the pertinent rules of construction, we conclude that the agreement requires the calculation of Base Net Operating Profit with the tax rate in the Applicable Year: "the calendar year ending on the date on which

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[25] *See* 2001 Amendment, Appendix A, Subparagraph (D)(ii) ("in no event shall the Settling Defendants' aggregate total amount of Restructuring Charges . . . exceed the Annual Restructuring Cap for the Applicable Year . . .").

[26] *See generally* 15 U.S.C. § 78m.

[27] *Universal C.I.T. Credit Corp. v. Daniel*, 243 S.W.2d 154, 157 (Tex. 1951).

the payment at issue is due . . . ." [28] We accordingly reverse the district court's finding of liability.

II

Because we reverse the district court's finding of liability, we do not reach the cross-appeal concerning the district court's allocation of that liability between the tobacco companies or the propriety of pre-judgment interest.

* * *

We REVERSE and REMAND.

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[28] *See* 2001 Amendment, Appendix A, Subparagraph (C) ("'Applicable Year' means (i) with respect to the payments made pursuant to paragraph 7 of the Stipulation of Amendment, the calendar year ending on the date on which the payment at issue is due, regardless of when such payment is made . . . .").