

An Overview of
The Tobacco Master Settlement Agreement
And Resulting State Concerns

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This overview of the Master Settlement Agreement, commonly referred to as the MSA, and the resulting state concerns is intended to address and clarify common misconceptions about the MSA to members of the Missouri General Assembly and the Missouri Press core. The overview will address and attempt to explain in layman terms one of the most complicated settlement agreements ever created.

Issues addressed by this overview:

- The basics of The Master Settlement Agreement
- The Qualifying Statute
- MSA Complimentary Legislation
- MSA Allocable Share Release Repeal Legislation

State Concerns addressed by this overview:

- The Non-Participating Manufacturer Adjustments
- How the NPM Adjustment affects tobacco settlement payments to the state

The Master Settlement Agreement:

On November 23, 1998, forty-six States¹, six United States Territories², and the four largest cigarette manufacturers³ entered into an agreement to settle litigation. The resulting agreement would be forever known as, the “Tobacco Master Settlement Agreement,” or as commonly known, the “MSA.” The agreement settled lawsuits brought by the states against the five largest tobacco companies⁴ in the United States at the time and sets out the terms, penalties and compensation for the settlement.

The states, referred to as the settling states, agreed to:

- Drop their lawsuits against the cigarette manufacturers;
- Grant the cigarette manufacturers immunity from future litigation;
- Pass and “diligently enforce” a “Qualifying Statute”⁵ that is designed to impose financial and reporting burdens on cigarette manufacturers that do not join the MSA; and,
- Arbitrate, rather than litigate, future MSA related disputes.

The Original Participating Manufacturers and Subsequent Participating Manufacturers, referred to as the PMs, agreed to:

- Cease targeted advertising to youth- no more Joe Camel, cigarette samples, etc.;
- Dissolve the “Tobacco Institute,” an information and lobbying consortium funded by the major cigarette manufacturers responsible for much of the misinformation regarding the health risks related to smoking;
- Restrict advertising to Point of Sale only - no more NASCAR or Rodeo sponsorships; and,
- Make annual payments to the states based on annual unit sales.

As stated above, there are two classes of cigarette manufacturers participating in the MSA - Original PMs (OPMs) and Subsequent PMs (SPMs). The OPMs were the four companies that initiated the MSA with the states. The SPMs joined the agreement subsequent to the MSA’s execution.

SMPs that signed onto the MSA within 60-days of its execution agree to abide by the MSA’s provisions, but don’t make payments to the settling states until they have sold the equivalent of their 1998 total sales, or 125% of their total cigarette sales in 1997, whichever is higher. This sweetener is referred to as the “grandfather exemption” and applies every year. Some SPMs use the exemption to boost sales, preferring to make MSA payments, albeit at a drastically reduced rate in comparison to what the OPMs are required to pay.

¹The states include all but Texas, Florida, Mississippi and Minnesota.

²The settling territories included in the settling states are District of Columbia, Puerto Rico, American Samoa, Guam, Virgin Islands and N. Mariana Islands.

³The four largest cigarette manufacturers were RJ Reynolds (dba Reynolds American), Philip Morris (dba Altria), Brown & Williamson (merged with RJ Reynolds in 2004), and Lorillard.

⁴Liggett & Myers Tobacco Company (dba Liggett Group) was party to the states lawsuits against the major US cigarette manufacturers. They joined the MSA as a Subsequent Participating Manufacturer.

⁵“Exhibit T - The Model Statute” - Source: Master Settlement Agreement Exhibits.

There is a final class of cigarette manufacturers, the Non-Participating Manufacturers (NPMs) that are not a party to the MSA, but are directly affected by the MSA. Most of these manufacturers were not in existence when the MSA was developed and executed. The NPM's can only join the MSA if all MSA PMs approve, and if they have been in business during any period before joining, the NPM must make payments equal to what they would have paid had they been a member. Since the PMs have always been able to pass the costs of the MSA onto their customers, this provision acts as a deterrent to NPMs joining.

This is not to say the NPMs get a free pass, quite the contrary. The MSA required the states to enact and keep in force a "Qualifying Statute"⁶ that requires the NPMs to make annual escrow payments in the states where they sell cigarettes in lieu of joining the MSA. Cigarette sales by an NPM within a state are precluded until the NPM registers with the states Attorney General's Office and provides information outlined by law on bank accounts, escrow funds and sales. Non-compliance by an NPM is a violation of the state law and subject to the full force of prosecution by the states Attorney General. In addition, failure to comply will make the NPM ineligible to sell in the state.

The Qualifying Statute:

As part of state finality, to get the annual stream of MSA payments started and to protect the PMs from price competition from the NPMs, each settling state was required to pass a "Qualifying Statute." Sometimes referred to as the "escrow statute," this qualifying statute requires cigarette manufacturers to either become an MSA participating manufacturer, or escrow money based on annual unit sales within the state.

Most of the settling states enacted this statute within the first year of the MSAs signing as a part of state finality and to get the MSA tobacco payment spigot flowing. Price competition was not a major concern for the states when the MSA was executed as the PMs controlled virtually 100% of the American tobacco market in 1998. The state of Missouri enacted the qualifying statute in 1999⁷.

At this point we note the extreme measures the MSA required the states to take to insure state law placed market restrictions on the PM's Competitors. The Attorney General enters settlement agreements during the normal course of litigation all of the time and has never before had the enactment of legislation as a qualifying requirement.

The escrow requirement under the qualifying statute requires the NPMs to escrow money under the semblance of paying a future settlement or judgment brought by the state for product misrepresentation, but in fact causes the NPMs to artificially increase their cigarette brand prices in order to make the annual escrow payment.

In this light, the qualifying statute has more to do with market share and price protection for the PMs than it does with state finality in litigation. This market share obsession is the focus of subsequent state legislation proposed by the MSA participants since 2003, and the focus of further discussion in this overview.

It is important to note than the NPMs get none of the benefits of the MSA and specifically have no immunity from lawsuits.

⁶ "Exhibit T - The Model Statute" - Source: Master Settlement Agreement Exhibits.

⁷ Sections 196.1000 to 196.1003 - Missouri Revised Statutes.

To address the point as to why the state would enact the qualifying statute, we turn to the MSA, pages 63-64, Section IX- Payments, d, (D), (2), (B) for the answer. This section of the MSA states:

“(B) A Settling State’s Allocated Payment shall not be subject to an NPM Adjustment: (i) if such Settling State continuously had a Qualifying Statute (as defined in subsection (2)(E) below) in full force and effect during the entire calendar year immediately preceding the year in which the payment in question is due, and diligently enforced the provisions of such statute during such entire calendar year; or (ii) is such Settling State enacted the Model Statute (as defined in subsection (2)(E) below) for the first time during the calendar year immediately preceding the year in which the payment in question is due, continuously had the Model Statute in full force and effect during the last six months of the calendar year, and diligently enforced the provisions of such statute during the period in which it was in full force and effect.” (underlined for emphasis)

This passage clearly delineates the conditions under which an NPM adjustment can be applied and is construed as a protecting measure against the PMs reducing payments under the NPM Adjustment clause of the MSA. So long as the state has the qualifying statute in force (Missouri’s Qualifying Statute was enacted and has been in force since 1999), and the escrow provisions of the qualifying statute are “diligently enforced” by the Attorney General, an NPM adjustment cannot be applied to the payments Missouri receives.

MSA Complimentary and Allocable Share Release Repeal Legislation:

In September 2003, a group representing the settling states and the PM’s met to discuss and develop measures *“to deal with the proliferation of NPM sales.”*⁸ This working group was charged with coming up with solutions to further protect the market share of the PMs by imposing new restrictions on the NPMs. Three potential actions were presented:

- Impose a *special state excise tax* only upon NPM cigarette brands equal to 100% of the payment per pack calculation under the MSA;
- Impose *Complimentary Legislation*, additional statutory registration and reporting requirements with penalties upon the NPMs; and,
- Repeal the provision contained within the Qualifying Statute that allows the release of money placed in escrow that exceeds what an NPM would have owed the state had they been an MSA PM. This is referred to as *MSA Allocable Share Release Repeal*.

A Special State Excise Tax was the easiest way to negate the NPM’s price advantage and protect the PM’s market share. The tax would raise NPM cigarette prices in the same manner that the MSA surcharge does and close the gap created by the PM’s price increases.

However a special state excise tax on one group of cigarette manufacturers may not have been constitutional or politically palatable to the Attorneys General. It would also be static and would result in price variances causing the states to continually have to increase the tax to keep pace with increased MSA payment requirements and increases in the PMs price increases.

⁸“September 12, 2003 Confidential Memorandum” - Source: Statesonthetake.com website

A special state excise tax would have caused a particular problem in Missouri, as voters had just turned down a cigarette excise tax increase (2002) and Missouri law (Hancock amendment) requires tax increase proposals exceeding a certain threshold to be approved by Missouri voters.

MSA Complimentary Legislation to impose additional statutory requirements on the NPMs was also proposed by this group. This legislation would not directly negate the price advantages the NPMs enjoyed, but it would give the AGs the ability to go after non-compliant NPMs in state courts and eliminate them from competing with the PMs. During the first four years of the MSA a number of foreign manufactured “burner brands” entered the market. These manufacturers would certify compliance to a state and then fold up shop before the escrow payment date and disappear into the night without making the required escrow payment.

The changes proposed by the complimentary legislation would require NPMs to submit to state court jurisdiction and maintain a registered agent for service of process in the state as a condition of doing business in the state. The changes also required the NPM to submit detailed information regarding manufacturing, escrow payments and bank accounts.

Finally the Complimentary Legislation required the state to establish and maintain a list of cigarette manufacturers and brands that were compliant barring the sales of cigarettes that were not on the list and imposing fines on distributors and retailers selling brands that are not on the compliant list. This legislation is sometimes referred to as “the toolbox” as it gives the AG’s additional tools to police the NPMs. The state of Missouri enacted the MSA Complimentary Statute in 2010⁹

MSA Allocable Share Release Repeal Legislation is designed to negate pricing advantages gained by the NPMs from the MSA. As originally passed in all MSA jurisdictions the qualifying statute contained four release provisions. Money can only be released from escrow:

- To pay a settlement or judgment to a settling state;
- To the extent the money deposited in escrow exceeds what the NPM would have been required to pay the state had they been a PM under the MSA based on the state allocable share percentage;
- To release any accrued interest on the escrow to the NPM; and,
- To release all escrow to the NPM each year after 25 - years if no claim, judgment or settlement results.

Proposed as an amendment to the settling states qualifying statute, repealing the provision that allows a release of money in escrow in excess of what is due the settling states based on it’s allocable share percentage tilts the playing field in the PM’s favor. This is accomplished by requiring the NPMs to maintain 100% of the national per pack MSA payment in escrow rather than the allocable share percentage of the national per pack MSA payment which is considerably less. This escrow release change requires the NPMs to significantly increase prices over market to meet the increase in escrow demand and thus severely damages the NPM’s ability to compete against the PMs.

⁹ Sections 196.1020 to 196.1035--- Missouri Revised Statutes.

While having nothing to do with enforcement of the qualifying statute, this change coupled with the Complimentary Legislation accomplishes the goals set by the group of AGs and PMs back in 2003. These changes achieve the objective of negating competition from the NPMs without the political fall-out that a special excise tax on NPM cigarette brands would have caused.

The NPM Adjustment:

The MSA affords the PM's multiple adjustments and offsets when determining payments to the settling states. One of these adjustments is called the NPM Adjustment and is designed to reduce the PM's tobacco payments to the settling states when the PMs lose market share in any year subsequent to signing onto the MSA.

There is a three-pronged test for determining whether an NPM Adjustment is warranted. The PMs have to prove:

- That they lost more than 2% of the market share they collectively controlled in 1997;
- The restrictions and provisions of the MSA were a "significant factor" causing the market share loss; and,
- At least some of the settling states didn't have the MSA Qualifying Statute in place, or did not "diligently enforce" the Statute.

The first two steps in determining an NPM Adjustment, calculating a market share loss and whether the MSA was a significant factor, are performed by the MSA's independent auditor and are statistical in nature. The third step in determining an NPM Adjustment, whether the settling states "diligently enforced" the Qualifying Statute, is less scientific and more subjective.

Since every state has the presumption that their laws will be enforced, the decision to grant an NPM Adjustment will hinge on how diligent a state was in enforcing the escrow provisions of the qualifying statute. If a settling state diligently enforced the law, then no NPM Adjustment can be applied. However, if a settling state failed to "diligently enforce" the law, then the NPM Adjustment can be applied to reduce payments to that settling state.

It is here where the determination of "diligent enforcement" takes a turn towards individualism. Each state has to prove diligent enforcement and can be sanctioned individually. That is to say that some states can be found to have diligently enforced the law and other can be found to have failed to diligently enforce the law. It is important to note that the determination of market share loss and whether the MSA was a significant factor is a collective decision. Whether a state diligently enforced the law is an individual settling state decision.

NPM Adjustment Arbitration:

In 2006, the PMs began withholding MSA payments to the settling states for market share losses in 2003-2005. The PMs claimed they lost market share to the NPMs due to the financial disadvantages imposed upon them by the MSA. The PMs also assert that the settling states have not diligently enforced the escrow provisions of the Qualifying Statute.

Recall, earlier discussion about enacting the Qualifying Statute and the MSAs assurance that any state that enacts and keeps the statute in force and diligently enforces the statute is immune from the adjustment being claimed by the PMs¹⁰. This is an important fact and the crux of the states argument against an NPM Adjustment as all settling states have the qualifying statute in place and believe it has been diligently enforced.

The facts: The MSA's "Independent Auditor" has found that the PMs had a market share loss exceeding 2% for 2003. An economic consult also determined that the provisions of the MSA, provisions that all of the PMs agreed too back in 1998, were a significant factor in the loss despite the fact that the PMs raised the prices of their cigarette brands well in excess of the amount needed to cover MSA payments to the settling states¹¹.

It is important to note that the Independent Auditor did not determine whether the settling states diligently enforced the Statute and did not apply an NPM Adjustment for 2003. It is equally important to note that the consulting group used an extremely "low threshold for determining whether or not the MSA was a significant factor"... [and] "it is clear that the major reason the main MSA cigarette companies lost market share to the NPMs since 1997 was because in 1998 they raised their cigarette prices by far more than was needed to cover their MSA related costs, thereby making it easy for NPMs to compete on a price basis and take away market share."¹²

The NPM Adjustment determination process: In an attempt to avoid the NPM adjustment being applied, the settling states ran to their respective state courts and filed for declaratory judgments to determine the meaning of "diligent enforcement." However most of these suits were set aside because the MSA specifies arbitration, not litigation, for settling disputes between the PM's and the settling states.

Forced into arbitration over the NPM Adjustment by the PMs, each state must present evidence of enforcement before a three-judge arbitration panel charged with determining the meaning of diligent enforcement and whether the settling states are in compliance. Since the only legislative requirement under the MSA was the enactment and diligent enforcement of the MSA Qualifying Statute, it stands to reason that the additional legislative actions sought by the PM's to further hamper the NPMs will have little effect on the arbitrations outcome.

The stakes are high in that the reduction sought by the PMs for 2013, is a little more than \$1.1 billion. Missouri Attorney General Chris Koster expects a decision by the fall of 2013, and believes he has presented a case for diligent enforcement of the escrow provisions of the MSA law. However, any future loss of MSA payment revenues based on the states lack of diligent enforcement will most certainly be the responsibility of Missouri's Attorney General.

¹⁰Section IX - Payments - Pages 63---64, Paragraph d, (D), (2), (B) of the MSA.

¹¹Cigarette Company MSA Payment Withholdings - The NPM Adjustment & How States Can Fight Back - Source: Campaign for Tobacco Free Kids Publication.

¹²Cigarette Company MSA Payment Withholdings - The NPM Adjustment & How States Can Fight Back - Source: Campaign for Tobacco Free Kids Publication.

How The NPM Adjustment Affects Tobacco Settlement Payments To The States:

The NPM Adjustment dispute currently being arbitrated is for cigarette sales made during 2003 and is estimated by the MSA independent auditor at approximately \$1.1 billion. The MSA requires all PMs to make their annual MSA payment in April of the year immediately following the year of sales. So, the NPM Adjustment currently under dispute will impact MSA payments made to the settling states in 2004.

Since 2006, several PMs have reduced their MSA payments to the settling states by either withholding a portion of their MSA payments or placing a portion into a “disputed payment account.” Since there is no true public accounting of the MSA payments withheld by the PMs, it is hard to determine what immediate impact, if any, a ruling against the settling states will have.

The best information available at present on the PMs withholdings comes from the *Campaign for Tobacco Free Kids* website. They estimate that the PMs withheld over \$3 billion in MSA payments for 2003 to 2007. The Table below approximates MSA payment withholdings by the PMs for these years:

Table 1: MSA Payment Withholdings per NPM Adjustment Claim by the PM's				
2003	2004	2005	2006	2007
\$813 million	\$699 million	\$536 million	\$522 million	\$597 million

If the arbitration panel determines that during 2003, a settling state had the “Qualifying Statute” in full force and effect and “diligently enforced” the escrow provisions of the Statute, its share of MSA revenues for that year cannot be subject to an NPM Adjustment¹³. However, if a finding that a settling state did not diligently enforce the Statute is returned, then any MSA payment credits awarded the PMs could be used to offset MSA payments to the settling states in future years after deducting the amount withheld from the states in that year.

There is still much uncertainty regarding the direction the arbitrations will take. What is certain is the MSA gives the PMs the ability to withhold MSA payments from the settling states and force the settling states into arbitration, rather than litigations to prove diligent enforcement of the law. This is one of the great mysteries of the MSA, why a state would submit to arbitration rather than exercise its legal right to litigate such matters.

The state of Missouri has received nearly \$2 billion in tobacco settlement payments under the MSA since 2001¹⁴. Missouri is entitled to 2.2746011%¹⁵ of all payments made under the MSA. This percentage is the states “allocation percentage,” commonly referred to as the states “allocable share” and is set by the MSA.

Of the \$2 billion received by the state, \$142,981,163.73¹⁶ was paid in 2004 for cigarette sales during 2003. That’s the year currently subject to the arbitrations. Of the \$813 million being withheld by the PMs, Missouri will be entitled to over \$18 million if the arbitration

¹³ Section IX - Payments - Pages 63---64, Paragraph d, (D), (2), (B) of the MSA.

¹⁴ “MSA payments to states: Inception thru 2012” - Source: National Association of Attorneys General website.

¹⁵ “Exhibit A - State Allocation Percentages” - Source: Master Settlement Agreement Exhibits.

¹⁶ “MSA payments to states: Inception thru 2012” - Source: National Association of Attorneys General website.

panel finds that the state diligently enforced the law. Conversely, if Missouri loses the arbitration and the loss is divided equally among the settling states, Missouri could lose a little over \$6.5 million in future MSA payments¹⁷. Again, there is no way of knowing the outcome or impact at this point in the arbitration.

The provision General Koster seeks serves only one purpose, to fix the price of the NPM's cigarette brands at 100% of the national per pack settlement cost. How this legislation is necessary to protect the state from NPM Adjustments or hinders enforcement is baffling and the subject of much debate in the state of Missouri. However, one thing is certain:

If the panel determines the state did not diligently enforce the escrow provisions of the Qualifying Statute during 2003, it won't be because the legislature didn't act, it will be because the Attorney General failed to diligently enforce the law.

¹⁷ \$1.1 billion, less \$813 million in withholdings equals \$287 million, times Missouri's allocable share percentage of .0227%.