

HB

503

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FILE

Alaska State Legislature

House Finance Committee



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SPONSOR STATEMENT

HOUSE BILL 503: *An Act relating to the tobacco product Master Settlement Agreement; and providing for an effective date.*

In 1998, 46 states entered into the Master Settlement Agreement (MSA) with leading cigarette manufacturers resolving dozens of lawsuits. The state Attorney Generals realized, however, that the objectives of the agreement could be thwarted by non-participating cigarette manufacturers (NPMs). The NPMs are not bound by the marketing and other restrictions contained in the tobacco settlement agreement. Nor are they obligated to make payments to the states in satisfaction of health care cost related claims.

appended

To help ensure that funds would be available to the states to satisfy potential future legal claims, the MSA signatory states enacted legislation called "Model Statutes" because the model form agreed upon was annexed as an exhibit to the MSA. These model state statutes require cigarette and roll your own tobacco manufacturers to either join the MSA or make refundable deposits based on the number of cigarettes sold in the state into a qualified escrow account, which must be established with commercial lending institutions. Enactment and enforcement of the model statutes helps ensure that funds will be available should the state need to bring suit against the NPMs in the future.

House Bill 503 closes a loophole in the model statutes that costs states a significant amount in MSA payments every year. This loophole has enabled some NPMs to avoid making escrow payments under the states' model escrow statutes. A provision of the model escrow statute permits an NPM to obtain a release of funds from escrow "to the extent that a tobacco product manufacturer establishes that the amount it was required to place into escrow in a particular year was greater than the state's allocable share of the total payments that such manufacturer would have been required to make in that year under the Master Settlement Agreement ...had it been a participating manufacturer under the MSA...." Experience in several states has shown that this provision enables NPMs that concentrate their sales in a single state or a few states to obtain early releases of the great majority of their escrow deposits. This outcome was never contemplated and threatens to undermine the effectiveness of the Model Escrow statutes, Escrow funds so minimized are not adequate to provide security to the states nor do they prevent unfair profit taking.

RESOLUTION SUPPORTING ALLOCABLE SHARE LEGISLATION

WHEREAS, Cigarette smoking presents serious public health concerns to the States, requires the States to spend billions of dollars for the treatment of health conditions resulting from Cigarette smoking, and imposes substantial additional costs on the States, many of which costs occur years after the Cigarettes are sold; and

WHEREAS, 46 States, the District of Columbia, the Commonwealth of Puerto Rico, and four United States territories ("the Settling States") and more than 40 Cigarette manufacturers are parties to the tobacco Master Settlement Agreement of 1998 ("the MSA") under which Cigarette manufacturers who are parties to the MSA have agreed to significant limitations on the advertising, promotion, and marketing of Cigarettes and agreed to make substantial payments to the States in exchange for a release from liability for certain claims of the States related to Cigarette smoking; and

WHEREAS, in connection with the MSA the Settling States have enacted statutes that require Cigarette manufacturers who do not become parties to the MSA ("Non-Participating Manufacturers" or "NPMs") to make payments into an escrow fund of a specified amount for each of its Cigarettes sold in the State; and

WHEREAS, the Escrow Statute is designed to ensure that a Settling State that obtains a judgment against an NPM for the costs imposed by sales of the NPM's Cigarettes will have an Escrow Fund available against which to satisfy a judgment; and

WHEREAS, in the absence of a significant escrow fund, companies that choose not to enter into the MSA and are not subject to its restrictions on advertising and promotion would be able to sell cigarettes without making any provision for the costs imposed on the State by the sales of their cigarettes; and

WHEREAS, the existing escrow statutes as originally enacted by the Settling States contain language that inadvertently permits NPMs that concentrate their sales in only a few states to avoid the large majority of their obligation to keep funds in escrow and thereby confers on those companies an unfair competitive advantage over both Participating Manufacturers and over other NPMs; and

WHEREAS, as a result of this language several NPMs have enjoyed an unintended competitive advantage over the more than 40 companies that have chosen to join the Master Settlement Agreement and have thereby expanded their sales at the expense of those companies; and

WHEREAS, permitting NPMs to make sales in any State without requiring them to keep significant escrow funds on deposit jeopardizes the health care objectives and MSA payments of all States; and

WHEREAS, the availability of low-priced cigarettes made possible by the

deficiencies in the existing escrow statutes has reduced the effectiveness of State programs to discourage youth smoking; and

WHEREAS, a large number of States, recognizing the deficiency in the existing escrow statutes, jointly developed proposed legislation (the "Allocable Share legislation," attached as Tab A hereto) designed to eliminate this inadvertent deficiency and to serve the purposes for which the escrow statute was originally designed; and

WHEREAS, the Tobacco Committee of the National Association of Attorneys General considered and endorsed enactment of the Allocable Share legislation; and

WHEREAS, seventeen States have already enacted the Allocable Share legislation and the legislation is under consideration in other jurisdictions;

NOW, THEREFORE, be it resolved that the National Association of Attorneys General:

1. Reaffirms the principle that the purpose of the escrow statute is to preserve the public health gains of the MSA by ensuring that all Cigarette manufacturers selling Cigarettes in a State must either join the MSA, restrict their advertising and promotion, and make MSA payments to compensate the State for the costs imposed on the State by cigarette smoking or establish and maintain an escrow fund sufficient to ensure that significant funds will be available in the event that the State obtains a judgment for such costs; and
2. Recognizes that the existing escrow statutes as originally drafted and enacted do not always accomplish this objective; and
3. Endorses the enactment of the Allocable Share Amendment in each Settling State in order that this objective be accomplished; and
4. Directs the Executive Director to communicate this resolution to interested parties; and
5. Directs the Tobacco Project to provide support to attorneys general for the enactment of the legislation.

THE
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DOCUMENT(S)
ARE
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CHANGES TO THE ALLOCABLE SHARE PROVISION
OF THE MODEL ESCROW STATUTE

INTRODUCTION AND ANALYSIS

WHY IS THIS LEGISLATION IMPORTANT?

Enactment of the proposed change to the Model Act is necessary to avoid hundreds of millions of dollars in losses to the States' tobacco payments under the MSA. The proposed change is also important to ensure that the central public health purposes of the MSA are met. The Model Escrow Statute was enacted to ensure that Settling States would receive the benefits of the MSA and that companies that refused to enter into the MSA would not thereby be able to profit unfairly from such refusal. Some companies that neither make MSA payments to the States nor observe any of the public health restrictions in the MSA are profiting from a loophole in the current law that allows them to avoid any significant responsibility under the State's Model Escrow Statute. This amendment is designed to ensure that the Model Escrow Statutes operate evenhandedly as originally intended, thereby advancing the legitimate health and safety goals contemplated by the MSA.

WHAT IS THE MSA AND WHAT DOES IT PROVIDE?

The MSA was executed on November 23, 1998 by 52 Settling States with the major tobacco companies and numerous smaller manufacturers (collectively known as "Participating Manufacturers" or "PMs"). The MSA provides that in exchange for the agreement of the PMs to make specified payments to the Settling States -- estimated to exceed \$200 billion through 2025 -- and their agreement to abide by extensive public health restrictions on the advertising, promotion and marketing of cigarettes, the Settling States agreed to release the PMs from claims by the States. Tobacco Product Manufacturers that did not sign the MSA ("Non-Participating Manufacturers" or "NPMs") were not released from potential State claims and did not undertake any of the payment obligations or agree to abide by the public health restrictions.

The parties to the MSA also proposed a "Model Statute" designed to prevent NPMs from taking advantage of the fact that they do not make payments under the MSA and are not bound by the public health, advertising and other MSA restrictions. The Model Statute requires all NPMs whose cigarettes are sold in a State to establish and annually fund a qualified escrow account in an amount determined by the sales volume in the State. Funds deposited in the escrow account are released to the NPM after 25 years if not used before then to pay a judgment in favor of the State against the NPM. All Settling States enacted a Model Escrow Statute.

WHAT ARE THE PURPOSES OF THE MODEL ESCROW STATUTE?

In the MSA the States released their claims against companies that joined the MSA and that thereby agreed to make MSA payments and abide by the public health provisions of the MSA. As noted, companies that chose not to join the MSA were not released from claims by the States. They do not make MSA payments and they are not required to abide by the public health provisions of the MSA.

There was a concern, however, that NPMs could sell cigarettes in the States, take advantage of the fact that they did not have to bear the cost of making MSA payments or abide by the public health provisions of the MSA, yet be unable to satisfy judgments that the States might eventually obtain for the costs imposed as a result of these sales. The Model Escrow Statute is designed to ensure that there will be a fund available to satisfy State claims in the event the State obtains a judgment against an NPM. In addition, under the MSA, Settling States that enact and "diligently enforce" a Model Escrow Statute are not subject to certain potential downward adjustments to their MSA payments.

HOW DOES THE MODEL ESCROW STATUTE WORK?

The Model Escrow Statute requires an NPM to make escrow deposits on its cigarettes sold in a Settling State at a set figure per cigarette sold (about 1.5¢ 2002 sales). Deposits remain the property of the NPM and the NPM earns currently-payable interest. Principal must remain in escrow for twenty-five years to be available to meet potential State claims. In order to fairly estimate the sum necessary to satisfy any potential judgment a State may obtain, the NPM escrow obligation is calculated to approximate the MSA payment on a per-cigarette basis (and does so almost precisely).

HOW HAVE THE PURPOSES OF THE MODEL ESCROW STATUTE BEEN SUBVERTED BY THE CURRENT ALLOCABLE SHARE RELEASE PROVISION?

A provision of the Model Escrow Statute permits an NPM to obtain a release of funds from escrow "to the extent that a tobacco product manufacturer establishes that the amount it was required to place into escrow in a particular year was greater than the State's allocable share of the total payments that such manufacturer would have been required to make in that year under the Master Settlement Agreement ... had it been a Participating Manufacturer under the MSA...." Experience in several states has shown that this provision enables NPMs that concentrate their sales in a single state or a few states to obtain early releases of the great majority of their escrow deposits. This outcome was never contemplated and threatens to undermine the effectiveness of the Model Escrow Statutes. Escrow funds so minimized are not adequate to provide security to the States nor do they prevent unfair profit taking.

HOW DOES THE CURRENT ALLOCABLE SHARE RELEASE PROVISION SUBVERT THE PURPOSES OF THE MODEL STATUTE?

Participating Manufacturers under the MSA make payments to the States based on their nationwide sales. The States share in the payments in accordance with fixed percentages, known as Allocable Shares. By contrast, under each State's Model Statute, NPMs make payments only on their cigarettes sold in that State. The payments are designed to be the same as the payments that would be made on an equivalent number of cigarettes under the MSA if the NPM had become a Participating Manufacturer. The loophole that this legislation seeks to close gives some NPMs an immediate release of nearly all of those payments.

By way of example, consider an NPM that makes all its sales -- 100 million cigarettes -- in a state whose allocable share of MSA payments is two percent. Under the current statute, that NPM would be entitled to an immediate release of that portion of its escrow deposit that exceeds what would have been the State's allocable share of the NPM's total MSA payment had it been an MSA participant. Under this example, because the NPM makes all its sales in a single State and because the escrow deposit per cigarette and the MSA payment per cigarette are approximately the same, the NPM's (hypothetical) total MSA payment is the same as its escrow deposit. However, because the State's allocable share of the total MSA payment is only two percent, under current law the NPM would be

entitled to a release of 98 percent of its Escrow deposit. In other words, although the NPM sold 100 million cigarettes in the State, the amount it would have to leave in escrow would be based on only 2 million cigarettes. Accordingly, some NPMs that sell large numbers of cigarettes in a given State are not being required to keep significant funds in escrow in that State despite the volume of cigarette sales that continue to impose substantial health and other costs on that State. This outcome frustrates the fundamental objective of the Model Escrow Statute.

As the example demonstrates, the current provision permits an NPM that has geographically concentrated sales to obtain a refund of the vast majority of its escrow deposits. This allows the NPM to significantly lower the cost of its cigarettes, because the NPM is not escrowing its full share of the future healthcare burden that its product imposes on the State. In lowering the cost, the NPM presents a product that is very attractive to kids, whose cigarette usage is sensitive to price.

HOW DOES THE PROPOSED AMENDMENT REMEDY THE PROBLEM?

The proposed amendment to the Model Escrow Statute eliminates the unintended consequence of the original language that has compromised the law's effectiveness. The amendment is necessary to accomplish the fundamental purpose of the law: to ensure that every NPM is required to post escrows for sales of its cigarettes in the State that provide a meaningful fund from which the State can recover damages in the event it obtains a judgment against the NPM.

This first part of the amendment would limit releases from escrow accounts to any amounts paid into escrow in excess of the MSA payments **that the NPM would have been required to make as a PM on account of cigarettes sold in the State for a particular year.** Thus, under the amendment the MSA payments relevant to release would not be limited to a State's allocable share of the NPM's (hypothetical) total MSA payments, but rather would be the NPM's MSA payments on the same number of cigarettes as are sold in the State. In other words, under the above example where the NPM sells 100 million cigarettes in a State, the NPM under the amendment would be entitled to a release only to the extent that its escrow payment exceeded what would have been its MSA payment on these 100 million cigarettes.

WEREN'T STATES TOLD THEY WERE NOT SUPPOSED TO AMEND THE MODEL STATUTE?

All States have Model Statutes. Their payments are potentially subject to reduction if Participating Manufacturers establish that the statute has been amended in a way that disqualifies them from being Model Statutes. All the Original Participating Manufacturers and all the major Subsequent Participating Manufacturers have signed letters of assurance declaring that the proposed amendment will not affect the status of the Model Statute. Thus, a State that enacts the amendment will continue to have the protection afforded by having a Model Statute. In fact, the amendment strengthens the Model Escrow Statute by eliminating the unintended consequence that confers an unfair competitive advantage on some NPMs.

The amendment is consistent with the purposes of the Model Escrow Statute: it sharply reduces the ability of an NPM to minimize its payments by concentrating its sales in one or two states and it sharply reduces the unintended disparity created by the current Model Escrow Statute.

WHAT HAPPENS IF THE AMENDMENT IS CHALLENGED AS UNCONSTITUTIONAL?

There is no significant risk of the proposed amendment being held unconstitutional. The Model Escrow Statute, or versions identical to it in other states, has been challenged and consistently been upheld as a valid enactment. For example, in Star Scientific Inc. v. Beales, 278 F.3d 339 (4th Cir.), cert. denied, 123 S.Ct. 93 (2002), the Fourth Circuit Court of Appeals held that Virginia's statute was constitutional under the Equal Protection, Due Process, and Commerce Clauses. In none of the lawsuits has a court suggested that the aspect of the statute that the proposed legislation would amend is necessary to its constitutionality.

Moreover, in the unlikely event the amendment were challenged and struck down as unconstitutional, there exists a "back-up provision" which eliminates the paragraph dealing with the allocable share release in its entirety. Should the Model Escrow Statute thereafter be held unconstitutional due to the ABSENCE of the allocable share release paragraph, then the original Model Escrow Statute language would be restored. As a result, in the extremely unlikely event that BOTH alternative changes (i.e., eliminating the loophole, and eliminating the release paragraph altogether) are held unconstitutional, the Statute would be restored to its original constitutionally upheld position. This "revival" provision is a general rule that exists in every state – namely if an unconstitutional amendment is passed, the law is restored to its prior condition. (Think of it this way: If you amend your assault statute, and the amendment is held to be unconstitutional, assault doesn't suddenly become legal. Rather, the law is restored to its original position, because the unconstitutional change is deemed to be a nullity.)

WILL PASSAGE OF THE AMENDMENT PUT AT RISK MY STATE'S MSA PAYMENTS?

NO. Passing the amendment will NOT jeopardize a State's MSA payments. The only parties that could make such a challenge are parties to the MSA. The parties that make the preponderance of the payments have signed letters of assurance that the amendment will not affect the salutary effect of the Model Escrow Statutes. Companies that want to maintain an unfair competitive advantage may try to scare States with misinformation so that they can continue to profit by exploiting the loophole in the current statute. States that enact the amendment will ensure that NPMs who sell in their States make escrow deposits as originally intended.

HOW WILL THIS AMENDMENT PROTECT PUBLIC HEALTH?

Studies have repeatedly demonstrated that cheap cigarettes are favored by kids, who tend to be more price-sensitive than adults. By ensuring that NPM cigarette prices include some of the cost burden imposed on the State, this amendment will maintain the price of NPM cigarettes at a higher level and help discourage another generation of minors from becoming addicted to cigarettes.

WILL THE PROPOSAL HAVE A FISCAL IMPACT?

The proposed amendment would likely be "revenue neutral." Escrow deposits do not constitute state revenues; they remain the property of the NPM. However, the legislation would likely result in a reduction in the administrative costs of enforcing the Model Escrow Statute because there would be fewer requests for releases from escrow for the State to process. Moreover, should the State obtain a judgment against an NPM to recover the health care costs imposed on the State by the NPM's products, the proposed legislation would enhance the State's ability to recover that judgment.

Chapter 45.53. CIGARETTE SALES

Sec. 45.53.010. Tobacco product Master Settlement Agreement recognized.

The Master Settlement Agreement entered into by certain United States tobacco product manufacturers and the state, and related documents, for settlement of claims raised in *State of Alaska v. Philip Morris, Incorporated*, and approved by the Alaska Superior Court on February 9, 1999, are recognized.

Sec. 45.53.020. Requirements.

(a) Any tobacco product manufacturer selling cigarettes to consumers within the state, whether directly or through a distributor, retailer, or similar intermediary or intermediaries, after June 4, 1999, shall do one of the following:

(1) become a participating manufacturer, as that term is defined in sec. II(jj) of the Master Settlement Agreement, and generally perform its financial obligations under the Master Settlement Agreement; or

(2) place into a qualified escrow fund by April 15 of the year following each listed calendar year the following amounts, as such amounts are adjusted for inflation:

(A) for 1999, \$.0094241 per unit sold on or after June 4, 1999, but before January 1, 2000;

(B) for 2000, \$.0104712 per unit sold during that year;

(C) for each of 2001 and 2002, \$.0136125 per unit sold during the year in question;

(D) for each of 2003 through 2006, \$.0167539 per unit sold during the year in question;

(E) for each of 2007 and each year thereafter, \$.0188482 per unit sold during the year in question.

(b) A tobacco product manufacturer that places money into escrow under (a)(2) of this section is entitled to receive the interest or other appreciation on such money as earned. Such money itself shall be released from escrow only under the following circumstances:

(1) to pay a judgment or settlement on a released claim brought against such tobacco product manufacturer by this state or a releasing party located or residing in this state; the funds shall be released from escrow under this paragraph in the order in which they were placed into escrow and

only to the extent and at the time necessary to make payments required under the judgment or settlement;

(2) to the extent that the tobacco product manufacturer establishes that the amount that it was required to place into escrow in a particular year was greater than the state's allocable share of the total payments that the manufacturer would have been required to make in that year under the Master Settlement Agreement had it been a participating manufacturer, as such payments are determined under sec. IX(i)(2) of the Master Settlement Agreement and before any of the adjustments or offsets described in sec. IX(i)(3) of that agreement other than the inflation adjustment, the excess shall be released from escrow and revert back to that tobacco product manufacturer; or

(3) to the extent not released from escrow under (1) or (2) of this subsection, funds placed into escrow shall be released from escrow and revert back to the tobacco product manufacturer 25 years after the date on which they were placed into escrow.

(c) To be a qualified escrow fund under this section, the

(1) fund must be an escrow fund governed by an escrow arrangement with a federally or state chartered financial institution having no affiliation with a tobacco product manufacturer and having assets of at least \$1,000,000,000; and

(2) escrow arrangements described in (1) of this subsection must

(A) require that the financial institution hold the principal of the escrow fund for the benefit of releasing parties; and

(B) prohibit the tobacco product manufacturer that places money into the escrow fund from using, accessing, or directing the use of the principal of the fund except as consistent with this section.

Sec. 45.53.030. Regulations.

The commissioner of revenue shall adopt regulations under AS 44.62 (Administrative Procedure Act) necessary to ascertain the amount of excise tax paid on the cigarettes of a tobacco product manufacturer for each year for which the manufacturer is required to place money into a qualified escrow fund under AS 45.53.020 .

Sec. 45.53.040. Certification of compliance; civil actions.

(a) A tobacco product manufacturer that elects to comply with AS 45.53.020 by placing money into escrow under that section shall annually, at

the time of compliance, certify to the commissioner of revenue that it is in compliance with AS 45.53.020 .

(b) If the commissioner of revenue does not timely receive a certification of compliance from a tobacco product manufacturer as required by (a) of this section, the commissioner shall notify the attorney general. The attorney general shall require the manufacturer, within 15 days, to place into a qualified escrow fund the money necessary to bring the manufacturer into compliance with AS 45.53.020 . The attorney general may bring a civil action on behalf of the state against a tobacco product manufacturer that fails to place into a qualified escrow fund the money necessary to bring the manufacturer into compliance with AS 45.53.020 . The court, upon a finding of a tobacco product manufacturer's

(1) violation of AS 45.53.020 , shall require the manufacturer, within 15 days, to place into a qualified escrow fund the money necessary to bring the manufacturer into compliance with AS 45.53.020 and may impose a civil penalty, in an amount not to exceed five percent of the amount improperly withheld from escrow, for each day of the violation; the total amount of the penalty under this paragraph may not exceed 100 percent of the original amount improperly withheld from escrow;

(2) knowing violation of AS 45.53.020 , shall require the manufacturer, within 15 days, to place into a qualified escrow fund the money necessary to bring the manufacturer into compliance with AS 45.53.020 and may impose a civil penalty, in an amount not to exceed 15 percent of the amount improperly withheld from escrow, for each day of the violation; the total amount of the penalty under this paragraph may not exceed 300 percent of the original amount improperly withheld from escrow; and

(3) second knowing violation of AS 45.53.020 , shall require the manufacturer, within 15 days, to place into a qualified escrow fund the money necessary to bring the manufacturer into compliance with AS 45.53.020, and may impose a monetary penalty as described in (2) of this subsection, and shall prohibit the manufacturer from selling cigarettes to consumers within the state, whether directly or through a distributor, retailer, or similar intermediary, for a period not to exceed two years.

(c) In addition to the civil penalties described in (b) of this section, the court may award the state full reasonable attorney fees and costs if the state prevails in a civil action brought under (b) of this section.

(d) Each failure to make an annual placement of money into a qualified escrow fund as required by AS 45.53.020 is a separate violation for the purposes of this section.

Sec. 45.53.100. Definitions.

In this chapter,

(1) "adjusted for inflation" means increased in accordance with the formula for inflation adjustment set out in Exhibit C to the Master Settlement Agreement;

(2) "affiliate" means a person who directly or indirectly owns or controls, is owned or controlled by, or is under common ownership or control with, another person; in this paragraph,

(A) "owns," "is owned," and "ownership" mean ownership of an equity interest, or the equivalent thereof, of 10 percent or more;

(B) "person" means an individual, a partnership, a committee, an association, a corporation, or any other organization or group of persons;

(3) "allocable share" means allocable share as that term is defined in the Master Settlement Agreement;

(4) "cigarette"

(A) means any product that contains nicotine, is intended to be burned or heated under ordinary conditions of use, and consists of or contains

(i) any roll of tobacco wrapped in paper or in any substance not containing tobacco;

(ii) tobacco, in any form, that is functional in the product, which, because of its appearance, the type of tobacco used in the filler, or its packaging and labeling is likely to be offered to, or purchased by, consumers as a cigarette; or

(iii) any roll of tobacco wrapped in any substance containing tobacco which, because of its appearance, the type of tobacco used in the filler, or its packaging and labeling, is likely to be offered to, or purchased by, consumers as a cigarette described in (i) of this subparagraph;

(B) includes "roll-your-own"; for purposes of this subparagraph,

(i) 0.09 ounces of "roll-your-own" tobacco constitutes one individual "cigarette;"

(ii) "roll-your-own" includes any tobacco that, because of its appearance, type, packaging, or labeling is suitable for use and likely to be offered to, or purchased by, consumers as tobacco for making cigarettes;

(5) "Master Settlement Agreement" means the settlement agreement and related documents described in AS 45.53.010 ;

(6) "original participating manufacturer" means "original participating manufacturer" as that term is defined in the Master Settlement Agreement;

(7) "qualified escrow fund" means a fund described in AS 45.53.020(c);

(8) "released claims" means "released claims" as that term is defined in the Master Settlement Agreement;

(9) "releasing parties" means "releasing parties" as that term is defined in the Master Settlement Agreement;

(10) "tobacco product manufacturer"

(A) means an entity that, on or after June 4, 1999, directly, and not exclusively through an affiliate,

(i) manufactures cigarettes anywhere that such manufacturer intends to be sold in the United States, including cigarettes intended to be sold in the United States through an importer; provided, however, that an entity that manufactures cigarettes that it intends to be sold in the United States shall not be considered to be a tobacco product manufacturer under this clause (i) if, first, such cigarettes are sold in the United States exclusively through an importer that is an original participating manufacturer, as that term is defined in the Master Settlement Agreement, that will be responsible for the payments under the Master Settlement Agreement with respect to such cigarettes as a result of the provisions of sec. II(11m) of the Master Settlement Agreement and that pays the taxes specified in sec. II(z) of the Master Settlement Agreement, and, second, the manufacturer of such cigarettes does not market or advertise such cigarettes in the United States;

(ii) is the first purchaser anywhere for resale in the United States of cigarettes manufactured anywhere that the manufacturer does not intend to be sold in the United States; or

(iii) becomes a successor of an entity described in (i) or (ii) of this subparagraph;

(B) does not include an affiliate of an entity described in (A) of this paragraph unless the affiliate itself meets the standards set out in any of (A)(i) - (iii) of this paragraph;

(11) "units sold" means the number of individual cigarettes sold in the state by the applicable tobacco product manufacturer, whether directly or

through a distributor, retailer, or similar intermediary or intermediaries, during the year in question, as measured by excise taxes collected by the state on packs or "roll-your-own" tobacco containers.

THE ALLOCABLE SHARE AMENDMENT GETTING THE FACTS

- Myth:* The proposed legislation is a violation of the deal the States made with the tobacco manufacturers when the MSA was negotiated. The deal then was that a manufacturer could come into the agreement or else abide by the Model Statute. We chose to abide by the model statute and we have done so. Now the rules are changing.
- Fact:** The only agreement the States entered into was the Tobacco Master Settlement Agreement (MSA). The States entered into no agreement with companies that refused to join the MSA. While the Settling States have passed statutes that apply to companies that refused to join the MSA, States were not required to do so nor did this constitute any agreement with NPMs. Moreover, it is within the province of the State legislatures to amend a State statute if it believes it is warranted.
- Myth:* If this legislation is passed, an NPM would have to escrow more per cigarette than Philip Morris or RJ Reynolds has to pay.
- Fact:** The proposed legislation *limits* the escrow contributions an NPM makes. An NPM will never be required to deposit into the escrow account any more on a per-cigarette basis than Participating Manufacturers pay to the States under the MSA.
- Myth:* In the absence of the current release provision, an NPM would have to escrow more than Philip Morris actually paid per-stick.
- Fact:** Even without a release, NPMs contribute much less in escrow than Philip Morris pays. By way of example, in the absence of any release, for sales in 2002 an NPM would have had to contribute 1.53 cents per stick to escrow. For cigarettes sold in 2002 Philip Morris actually paid 2.0 cents per stick. (\$3.8 billion paid on 189 billion sticks). Philip Morris also made substantial payments to the American Legacy Foundation and the four Previously Settling States.
- Myth:* Participating Manufacturers who sell a disproportionate percentage of their cigarettes in a few states may pay less per cigarette than an NPM escrows.
- Fact:** MSA payments by Participating Manufacturers are calculated on a national basis. A Participating Manufacturer makes the same payment no matter what State or States the cigarettes are sold in. The number of cigarettes sold in an individual State is irrelevant to the calculation of its payment. Under the MSA a State receives its allocable share of the total payments no matter how many or how few cigarettes a Participating Manufacturer happens to sell in that State.
- Myth:* This legislation is unfair to small companies.

Fact: Many small companies are either Participating Manufacturers (there are over 40 Participating Manufacturers and some of them are small family-owned businesses) or NPMs with widely dispersed sales. The current statute allows some companies—those with sales concentrated in a few states — to avoid making the necessary deposits into escrow so that a fund would be available to satisfy State claims in the event the State obtains a judgment against an NPM. Additionally, the current statute allows only certain NPMs to compete unfairly with NPMs that have widely dispersed sales.

Myth: *The legislation tries to punish small companies for competing effectively with Philip Morris and the other OPMs.*

Fact: The legislation merely imposes requirements that are evenhanded. Under existing law, some NPMs escrow 30 cents per pack. Others escrow 3 cents per pack. That distinction gives some NPMs an advantage that is unfair. A lot of their sales growth came because they have had that unfair advantage, not because they make a superior product.

Myth: *"I have a client who made an escrow deposit of \$10.6 million in a state but was entitled under the existing statute to get \$10.1 million back. If my client had to pay \$10.6 million rather than \$500,000 in escrow payments, they would be out of business."*

Fact: In order to sell enough cigarettes to have an obligation of \$10.6 million, an NPM had to sell 700 million cigarettes. Those 700 million cigarettes will eventually impose a large cost on the State and its taxpayers in health care costs. The tiny amount per stick that was left in escrow does not come close to the cost those cigarettes will impose. The refund left the State and its taxpayers unable to recover their costs. Moreover, the only reason this company could sell 700 million cigarettes was that it had an unfair price advantage over companies who were either making MSA payments or were paying the full amount of escrow deposits. The loophole in the escrow statute operates to give only certain NPMs a windfall. This unfair result was not intended by the Escrow Statutes and those NPMs don't have the right to enjoy that windfall indefinitely.

Myth: *Companies that take advantage of this legislation are not hurting the States.*

Fact: NPMs were not released from claims by the States and are not required to abide by the public health provisions of the MSA. Additionally, NPMs do **NOT** pay anything to the States. However, the States lose potential MSA revenue every time a smoker chooses to buy a pack of NPM cigarettes. In 2002, the States lost \$450 million in revenue because of NPM sales.¹ That amounts to a significant

¹ Payments to the Settling States from the four largest companies alone for sales were reduced by \$2.3 billion in 2002 because of the reduction in volume sold by those companies. Shipments by those companies fell by 111 billion cigarettes from the base year of 1997. Reductions in cigarettes consumed nationally since the base year accounted for about 75 billion cigarettes, but sales by NPMs increased by at least 22 billion cigarettes. Thus, a

loss in every Settling State. (See Table 1). States have no obligation to continue conferring unfair advantages on companies whose sales cost them revenues. States that fail to enact this legislation are sacrificing state revenue.

Myth: The legislation will cost States money.

Fact: The legislation will save the States money. The legislation costs nothing to implement and will lessen the administrative burden on State Attorneys General and Revenue offices. In addition, once a critical mass of states enact the legislation, the decline in MSA revenue due to the loophole in the Escrow Statutes will stop, and states should recapture some of the MSA revenue that has been lost. To the extent that a state loses any tax revenue on reduced cigarette sales – and this is not likely to happen in any but a handful of states – the small loss in tax revenue would be overwhelmed by the gains in MSA revenue.

Myth: NPMs have a right to compete. The States are just trying to protect the major tobacco companies.

Fact: Companies that joined the MSA not only make payments to the states, but they also have to observe restrictions on advertising, marketing and promotion of their cigarettes.

Companies that chose not to join the MSA were not released from claims by the States. NPMs do NOT make MSA payments, are NOT required to abide by the public health provisions of the MSA and DO use marketing and advertising channels forbidden to Participating Manufacturers.

There is a real difference between the marketing policies of NPMs and those permitted by the MSA. One NPM recently distributed free packs of cigarettes at a convenience store directly across the street from an elementary school and advertised free samples on a van. NPMs engage in outdoor advertising and some host on-line catalogs of brand-name merchandise. Advertising and distributing cigarettes in all these fashions are not permitted by MSA companies and such activities violate the intent of the MSA concerning youth targeting.

In addition, NPMs have to make escrow contributions but the states do NOT get those revenues. NPMs retain ownership of their escrow funds and NPMs collect the interest. In contrast, payments by the Participating Manufacturers under the MSA are paid directly to the States. Under current law, some NPMs' escrow contributions are both far less than the payments the Participating Manufacturers make to the states and also far less than the escrow contributions of other NPMs. It's time to put a stop to this discrimination.

minimum of 20 percent of the payment lost to the Volume Adjustment is the result of increased NPM sales. The States are at further risk if, in addition to the Volume Adjustment, a Non-Participating Manufacturer Adjustment is imposed.

Myth: The MSA was a scheme hatched by OPMs to protect them from competition. Companies that joined the MSA as SPMs had to agree to restrict their output. Now they are trying to eliminate competition from NPMs.

Fact: The year before the MSA was signed companies that became SPMs sold 12 billion cigarettes. In 2002 SPMs sold 30 billion cigarettes. They did not restrict their output. They have greatly expanded it. Participating Manufacturers also face competition from NPMs. NPMs have a right to sell their cigarettes but they don't have a right to do so on terms that unfairly discriminate against other companies and fail to provide security to the states for the costs their cigarettes impose on the states.

Myth: The legislation would put NPMs out of business.

Fact: Many NPMs do not take advantage of the loophole and are not at risk by this legislation. The legislation would help ensure that NPMs price their products to reflect their escrow payments as participating manufacturers must price their products to reflect their MSA payments.

Myth: The legislation would retroactively require NPMs to make up for refunds received in earlier years.

Fact: The legislation would apply *only* to requests for release of escrow made after the effective date of the legislation.

Myth: The Allocable Share Amendment is not supported by NAAG.

Fact: The proposed Allocable Share Amendment is supported by the members of NAAG. It was developed by the members of NAAG in consultation with the NAAG Tobacco Project as is the normal process for developing model state legislation affecting the MSA. The NAAG Tobacco Committee has considered and approved the model Allocable Share Amendment.

Myth: NPMs don't market to kids.

Fact: Cheap cigarettes appeal to kids. Studies show there is a greater elasticity of demand for kids than for adult smokers.² This makes sense because kids have less disposable income. The states should not be encouraging the sale of cheap cigarettes. Moreover, NPMs continue to use marketing and advertising channels directed at youth that are forbidden to Participating Manufacturers. The state's desire to curb youth smoking is an important objective.

² See, e.g., Chaloupka, Frank. Macro-Social Influences: The Effects of Prices and Tobacco-Control Policies on the Demand for Tobacco Products, *Nicotine & Tobacco Research*, vol. 1, Supplement 1, September 1, 1999 and sources cited therein.

Participating Manufacturers to the MSA that have executed assurances and support the Allocable Share legislation:

Brown & Williamson
Caribbean-American Tobacco
Chancellor Tobacco Company
Commonwealth Brands, Inc.
Monte Paz
Daughters & Ryan, Inc.
Dhanraj Imports, Inc.
Eastern Company S.A.E.
Imperial Tobacco Limited/ITL
King Maker Marketing
Konci G&D Management Group

Kretek International
Lane Limited
Ligget Group, Inc.
Lignum-2, Inc.
Lorillard Tobacco Company
Mac Baren Tobacco Company
Peter Stokkebye International
Philip Morris Incorporated
Planta Tabak-manufaktur GmbH.
Premier Manufacturing Inc
P.T. Djarum

R.J. Reynolds Tobacco
Santa Fe Natural Tobacco
Sherman 1400 Broadway
Top Tobacco, LP
Vector Tobacco, Inc.
Virginia Carolina Corporation,
Von Eicken Group
Wind River Tobacco Company,
Winner Sales Company

**Estimated Reduction in State MSA Payments
Caused by Increased NPM Sales – 2002 Sales**

Table 1

STATE	\$450 Million	State's Allocable Share (Exhibit A - MSA)
Alabama	\$7,272,588.60	1.62%
Alaska	\$1,536,384.15	0.34%
Arizona	\$6,632,480.25	1.47%
Arkansas	\$3,726,297.45	0.83%
California	\$57,437,799.30	12.76%
Colorado	\$6,168,876.30	1.37%
Connecticut	\$8,354,417.85	1.86%
Delaware	\$1,779,612.75	0.40%
D.C.	\$2,732,032.35	0.61%
Georgia	\$11,045,058.75	2.45%
Hawaii	\$2,708,392.50	0.60%
Idaho	\$1,634,684.40	0.36%
Illinois	\$20,944,112.40	4.65%
Indiana	\$9,179,114.85	2.04%
Iowa	\$3,913,501.50	0.87%
Kansas	\$3,751,520.40	0.83%
Kentucky	\$7,925,213.70	1.76%
Louisiana	\$10,149,088.95	2.26%
Maine	\$3,462,077.25	0.77%
Maryland	\$10,172,056.50	2.26%
Massachusetts	\$18,175,405.50	4.04%
Michigan	\$19,583,764.20	4.35%
Missouri	\$10,235,704.95	2.27%
Montana	\$1,911,415.95	0.42%
Nebraska	\$2,677,424.85	0.59%
Nevada	\$2,744,707.95	0.61%
New Hampshire	\$2,996,703.00	0.67%
New Jersey	\$17,401,483.35	3.87%
New Mexico	\$2,683,753.65	0.60%
New York	\$57,429,139.50	12.76%
North Carolina	\$10,495,282.50	2.33%
North Dakota	\$1,647,062.10	0.37%
Ohio	\$22,668,794.10	5.04%
Oklahoma	\$4,662,616.50	1.04%
Oregon	\$5,164,461.90	1.15%
Pennsylvania	\$25,860,864.60	5.75%
Rhode Island	\$3,235,074.30	0.72%
South Carolina	\$5,293,583.55	1.18%
South Dakota	\$1,570,256.10	0.35%
Tennessee	\$10,984,025.25	2.44%
Utah	\$2,001,991.05	0.44%
Vermont	\$1,850,332.95	0.41%
Virginia	\$9,201,352.95	2.04%
Washington	\$9,239,661.90	2.05%
West Virginia	\$3,989,071.80	0.89%
Wisconsin	\$9,314,175.50	2.07%
Wyoming	\$1,117,552.05	0.25%
American Samoa	\$68,476.50	0.02%
N. Mariana Island	\$37,969.20	0.01%
Guam	\$98,716.95	0.02%
U.S. Virgin Island	\$78,116.85	0.02%
Puerto Rico	\$5,045,748.30	1.12%

FISCAL NOTE

STATE OF ALASKA
2004 LEGISLATIVE SESSION

Fiscal Note Number: _____
Bill Version: HB 503
() Publish Date: 2/16/04

Revision Date/Time (Note if correction): _____ Dept. Affected: Revenue
Title Tobacco Master Settlement Agreement RDU Revenue Programs & Services
Component Tax Division
Sponsor House Finance
Requester House Finance Component No. 2476

Expenditures/Revenues (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below.

OPERATING EXPENDITURES	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010
Personal Services						
Travel						
Contractual						
Supplies						
Equipment						
Land & Structures						
Grants & Claims						
Miscellaneous						
TOTAL OPERATING	0.0	0.0	0.0	0.0	0.0	0.0

CAPITAL EXPENDITURES						
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CHANGE IN REVENUES ()						
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FUND SOURCE (Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 GF						
1005 GF/Program Receipts						
1037 GF/Mental Health						
Other (Specify Type--Do not abbreviate)						
TOTAL	0.0	0.0	0.0	0.0	0.0	0.0

Estimate of any current year (FY2004) cost: 0.0
Check this box (X) if funding for this bill is included in the Governor's FY 2005 budget proposal:

POSITIONS

Full-time						
Part-time						
Temporary						

ANALYSIS: (Attach a separate page if necessary)

Tobacco Master Settlement Agreement - Bill Analysis

This bill, based on a model developed by the National Association of Attorneys General in cooperation with a working group of participating states, is designed to preserve, to the fullest extent possible, the revenue stream under the tobacco product Master Settlement Agreement (MSA) and AS 45.53. One of the provisions of the MSA required states to enact legislation that would "level the playing field" for non-participating tobacco manufacturers by requiring them to deposit money into escrow for every cigarette they sell in the state. Nonparticipating manufacturers have discovered a "loophole" that allows them to remove escrow payments from individual state escrow accounts which has given them a competitive advantage over those manufacturers that signed the MSA. This bill is intended to close the "loophole" and ensure a "level playing field" as originally intended by AS 45.53

Prepared by: Johanna Bales Phone 269-6628
Division Tax Division Date/Time 2/24/04 4:39 PM
Approved by: Steve Porter, Deputy Commissioner Date 2/24/2004
Agency Department of Revenue

Alaska State Legislature

House Finance Committee



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SECTIONAL ANALYSIS

HOUSE BILL 503: *An Act relating to the tobacco product Master Settlement Agreement; and providing for an effective date.*

Section 1: Amends AS 45.53.020(b)(2), Requirements. Language clarifies that a non-participating tobacco manufacturer in the Master Settlement Agreement must deposit money into escrow for every cigarette they sell in the state. Removes a loophole that allowed NPMs to remove escrow payments from individual state accounts. Currently, an NPM is supposed to deposit only a percentage of its cigarette sales into escrow.

Section 2: Repeals and reenacts AS 45.53.020(b), Requirements. Provisional language if a court finds section 1 of this legislation unconstitutional. States that funds placed into escrow may only be released to pay a judgment or settlement on a released claim or after 25 years after the date on which funds were placed into escrow.

Section 3: Repeals and reenacts AS 45.53.020(b), Requirements. Provisional language if a court finds section 1 and/or section 2 of this legislation unconstitutional. Reverts to original language found in current statute, AS 45.53.020(b).

Section 4: Conditional effective date. Section 2 takes effect only if section 1 of this bill is found to be unconstitutional. If section 2 is found to be unconstitutional, then section 3 takes effect.

Section 5: Section 1 effective date of July 1, 2004

Section 6: Section 2 takes effect on the day after the date of a final order or decision by a court if section 1 is found to be unconstitutional.

Section 7: Section 3 takes effect on the day after the date of a final order or decision by a court if section 2 is found to be unconstitutional.

2-25-04
law

**NPM Escrow Release Calculations
for hypothetical non participating manufacturer
Cheap Smokes, Inc.**

Cheap Smokes' national cigarette sales	100,000,000
Approx. MSA Contr./cigarette	\$0.02
"As if" MSA Contribution	\$2,000,000
Alaska MSA Allocable Share Percentage	0.003414187
AK allocable share of Cheap Smokes' "as if" MSA payment	\$6,828.37
Cheap Smokes' sales in AK	1,000,000
Approx. Escrow Deposit/cigarette	\$0.02
Escrow Deposit Requirement	\$20,000
Current Law:	
Escrow Release Threshold	\$6,828.37
Escrow Release Amount	\$13,171.63
Amount Left in Escrow	\$6,828.37
Effective Amount Deposited/Cigarette	\$0.0068
HB 503 Proposal, Section 1:	
Escrow Release Threshold	\$20,000
Escrow Release Amount	\$0.00
Amount Left in Escrow	\$20,000
Effective Amount Deposited/Cigarette	\$0.02
HB 503 Proposal, Section 2:	
Escrow Release Threshold	none
HB 503 Proposal, Section 3:	same as current law

prepared by AAG Mike Barnhill, Alaska Department of Law, 2/25/04
HB 503