

NONPARTICIPATING CIGARETTE MANUFACTURERS ESCROW

Senate Bill 781 as passed by the Senate
Sponsor: Sen. Buzz Thomas

Senate Committee: Finance
House Committee: Tax Policy

First Analysis (12-17-03)

THE APPARENT PROBLEM:

On December 7, 1998, the Ingham County Circuit Court entered a final judgment in *Kelley ex rel. Michigan v. Philip Morris, Inc. et al.*, a civil suit brought by then-Attorney General Frank Kelley on behalf of the state against various tobacco companies, distributors, and retailers. The circuit court's final judgment incorporated the Master Settlement Agreement (MSA), which had been reached two weeks earlier between the attorneys general from 46 states, including Michigan, and the five major cigarette companies - i.e. Philip Morris, R.J. Reynolds, Brown and Williamson, Lorillard, and Liggett and Myers. The MSA refers to the jurisdictions that signed the agreement before or on the date of its executing as "settling states". These "settling states" include all of the states, except for Florida, Minnesota, Mississippi, and Texas, which had settled their suits independently, plus the District of Columbia, Puerto Rico, Guam, the Virgin Island, American Samoa, and the Northern Marianas. The MSA refers to the five tobacco companies as "original participating manufacturers" (OPMs). The MSA also allowed other tobacco companies to join the MSA at a later date. Those that chose to join are known as "subsequent participating manufacturers" (SPMs). Those tobacco companies that have chosen not to join the MSA are known as "nonparticipating manufacturers" (NPMs).

The MSA required settling states to drop lawsuits brought against the tobacco companies for their past conduct. The MSA also precludes the settling states and local governments within the states from bringing suits for a broad range of future conduct by the tobacco manufacturers, retailers, and distributors. In exchange for this immunity and certain other concessions, the tobacco companies agree to abide by certain restrictions on advertising, marketing, and promotion of cigarettes. Perhaps most important of all, the participating manufacturers agreed to pay the settling states in perpetuity, with total payments through 2025 estimated at \$206 billion.

Generally speaking, the payments are paid by each participating manufacturer based on national market share. From the total amount paid, each settling state is entitled to an amount based upon estimates of the number of smokers in the state and the state's tobacco-related Medicaid expenditures. However, the MSA provides that the amounts paid to each state are subject to several adjustment factors, including inflation, volume of sales, and federal tobacco-related legislation adjustments. A state's estimated payment is known as its "allocable share," and Michigan allocable share is approximately 4.35 percent of the settlement payments.

The MSA was cognizant of the fact that the original participating manufacturers did not fully account for the entire cigarette market (though they held a 97.5 share of the market) and the fact that OPMs really had no interest in being held accountable for the actions of the remaining 2.5 percent of the market. Thus, the MSA included a nonparticipating manufacturer adjustment and the model statute. The nonparticipating manufacturer adjustment allows the OPMs to reduce their payments if their combined market share drops two percent or more from the 1997 level and if an independent research firm determines that the MSA was a significant factor in the loss of market share. To forestall the possibility that the states' settlement revenue would be decreased simply because NPMs had increased their market share because of the MSA itself, the MSA provided financial protection for states adopting and enforcing certain "qualifying statutes" in the event that the NPM adjustment was triggered. In order to qualify for such protection, a state had to either draft its own qualifying statute following the terms of the MSA or adopt the model statute contained in the MSA as "Exhibit T." The model statute, where adopted, basically requires a tobacco manufacturer that directly or indirectly sells cigarettes to consumers in a settling state to either become a participant to the MSA and perform its financial obligations under the agreement or put into escrow

specific dollar amounts based on the number of cigarettes its sells to cover any smoking-related claims against the manufacturer. Michigan adopted the model statute with the enactment of Public Act 244 of 1999, with some differences unrelated to the issue at hand.

Public Act 244 specifies that the amount a NPM has to put in escrow is \$0.0167539 per cigarette (33.5 cents per pack) for each year from 2003 through 2006, and \$0.0188482 per cigarette (37.7 cents per pack) for 2007 and every year thereafter (a lesser amount per cigarette was also paid through 20003), with the amounts adjusted for inflation. The act further specifies that interest or other appreciation on funds in escrow can only go to the tobacco product manufacturer, and the funds can only be released for one of three reasons. First, funds can be released to pay a judgment or settlement on any released claim brought against the manufacturer by the state or any releasing party located or residing in the state. Second, funds remaining in escrow 25 years after the date they were placed in escrow are released to the manufacturer. Finally, to the extent that a manufacturer establishes that it had put in escrow in a particular year an amount that is greater than the state's allocable share of the total payments that the manufacturer would have had to make under the MSA if it were a participating manufacturer, any amount in excess is released from escrow and reverts back to the manufacturer.

This last provision is the subject of contention here in Michigan, and in many states throughout the U.S. As stated earlier, each participating manufacturer pays an amount to the settling states equal to its relative market share, with Michigan receiving its "allocable share" of about 4.35 percent of that amount. For instance, R.J. Reynolds (an OPM) pays an amount based on its national market share, and Michigan receives roughly 4.35 percent of that amount. This is how a NPM would determine the amount it would have paid if it were a (subsequent) participating manufacturer. On a national scale, an NPM may hold a small very share of the market (and individually, they do), but regionally or on a state-by-state basis the NPM may hold a larger share of the market. However, while it pays in escrow an amount based on units sold, it is refunded an amount that exceeds the amount of Michigan's allocable share of the amount it would have paid had it been a participant to the MSA. Thus, this so-called "allocable share cap" allows for NPMs to have virtually all of their escrow payments refunded back to them, which some believe undermines the intent of the original provision. It is asserted that many nonparticipating manufacturers take advantage of this

"loophole" by concentrating their sales within a limited region, thereby allowing them to gain market share by offering substantially cheaper cigarettes. Legislation has been introduced to correct the loophole.

THE CONTENT OF THE BILL:

Senate Bill 781 would amend Public Act 244 of 1999 (MCL 445.2052), which implements provisions of the tobacco master settlement agreement, to revise the refund provisions regarding escrow payments of nonparticipating manufacturers. The bill is identical to House Bill 5222, introduced by Representative William O'Neil. That bill passed the House 88-16 on November 12.

Under Public Act 244, a nonparticipating manufacturer must place in an escrow fund, by April 15 each year, amounts specified in the act. The amount to be placed in escrow is determined pursuant to a formula prescribed by Sections IX(i)(2) and IX(i)(3) of the master settlement agreement. The nonparticipating manufacturer receives interest and other appreciation on the funds, but the funds themselves may be released from escrow only under circumstances specified in the act. Under one condition, if it is established that the amount a nonparticipating manufacturer is required to place into escrow in a particular year is greater than "the state's allocable share of the total payments that such a manufacturer would have been required to make under the master settlement agreement (as determined pursuant to Section IX(i)(2) . . . and before any of the adjustments or offsets described in Section IX(i)(3) . . . other than the inflation adjustment) had it been a participating manufacturer", then the excess is returned.

Senate Bill 781 would revise the escrow determination provision to read: "to the extent that a tobacco manufacturer establishes that the amount it was required to place into escrow on account of units sold in the state in a particular year was greater than the master settlement agreement payments, as determined pursuant to Section IX(i) of that agreement including after final determination of all adjustments, that [the] manufacturer would have been required to make on account of such units sold had it been a participating manufacturer", the excess would be returned. (This means apparently that, under the bill, all of Section IX(i), instead of only Sections IX(i)(2) and IX(i)(3), would be used to determine the escrow amount. Also Section IX details how payments are calculated and made by subsequent participating manufacturers - see "Background Information" for a description).

Under the bill, if a court found the new language added by the bill and quoted above unconstitutional, then the subdivision being amended would return to its original condition. Further, the bill would specify that if the act or any portion of the bill's provisions were held unconstitutional by a court of competent jurisdiction, the remaining portions of the act would continue in full force and effect.

BACKGROUND INFORMATION:

According to the National Association of Attorneys General (NAAG), approximately 17 other states have enacted legislation identical to that of Senate Bill 781. These states include neighboring Ohio (see the state's enacted budget bill for the 2003-2005 biennium, Am. Sub. HB 95), Indiana (see Public Law 252-2003), and Illinois (see House Bill 276/Public Act 93-0446). Other states include Alabama, California, Hawaii, Iowa, Louisiana, Maine, Montana, New York, Oklahoma, Oregon, Vermont, Washington, and West Virginia.

FISCAL IMPLICATIONS:

The House Fiscal Agency notes that the bill would not directly impact state revenue, though it would help preserve the approximately \$300 million the state receives from the tobacco settlement. (HFA analysis 12-16-03)

ARGUMENTS:

For:

Proponents of the Senate Bill 781 argue that it is necessary to close a "loophole" contained in the model statute and Public Act 244. The MSA and Public Act 244 unintentionally favor nonparticipating manufacturers over participating manufacturers. The reason is quite simple: nonparticipating manufacturers are able to keep their prices well below those of participating manufacturers, because NPMs, by and large, are not subject to the MSA and its financial obligations. The disparate treatment between participating manufacturers and nonparticipating manufacturers has resulted in a marked increase in market share for NPMs, as NPMs apparently have certain price advantages.

This situation was to have been avoided through the enactment of the model statute. Indeed, the model statute (though not Public Act 244) contains a statement of finding and purpose that, "[i]t would be contrary to the policy of the State if tobacco product manufacturers who determine not to enter into [the

MSA] could use a resulting cost advantage to derive large, short-term profits in the years before liability may arise without ensuring that the State will have an eventual source of recovery from them if they are proven to have acted culpably. It is thus in the interest of the State to require that such manufacturers establish a reserve fund to guarantee a source of compensation and to prevent such manufacturers from deriving large, short-term profits and then becoming judgment-proof before liability may arise."

The problem is that most nonparticipating manufacturers only sell their products on a regional basis. Thus, it is not surprising to see a NPM have a small national market share, but have a major presence in one or two states. The problem, then, is the fact that a NPM is refunded practically all of its escrow payments for a given year, because of the "allocable share" cap contained in the model statute and Public Act 244. This is because in terms of determining payments, participating members and nonparticipating members are treated the same, though they don't operate in the same manner, economically speaking.

In terms of the actual MSA payments, Michigan receives roughly 4.35 percent of the total, based on its cigarette sales. Participating manufacturers pay their required MSA payment based on *national* market share into escrow with the appropriate account being credited the appropriate amount. Here, it doesn't matter that one company pays less and another pays more than it should to Michigan because that money is essentially lumped together and Michigan receives (roughly) the proper amount (its allocable share) based on national market share. The NPM escrow payment works in a similar manner. The NPM pays an amount in escrow based on cigarette sales in the state, with the amount exceeding the state's allocable share (which is, again, based on national sales) being refunded to the NPM. This works well, in theory, if NPMs operated nationally and had similar market data as participating members, but the problem is that many NPMs operate only in select states and they are treated as if they had a national presence (where each settling state receives its allocable share). But, since they only operate in a select number of states, they pay all of their escrow payments to those states, and those payments greatly exceed the state's allocable share, if that NPM were a participant in the MSA. For instance, assume that NPM, Inc. sells cigarettes only in Michigan. So, 100 percent of its required escrow payment goes to Michigan. However, if NPM, Inc. was a participating member, roughly 4.35 percent of its MSA payment (which is comparable to

its escrow payment) would go to Michigan. Thus, it would be refunded roughly 95 percent of its escrow payment. [Although the calculations are different, the payments required under the MSA and the model statute/P.A. 244 are apparently similar.]

Now, rather than capping the escrow payment at the state's allocable share (meaning, as the act states, that the excess amount is refunded) the bill provides that the escrow payment would be capped at the amount of the MSA payments that the NPM would have been required to make on account of its sales in Michigan had it been a participant to the MSA. This provides a more direct connection to escrow payment and sales. By making this change, the "loophole" is apparently closed.

Closing this loophole has three consequences. First, it reaffirms the intent of the model statute and P.A. 244, which is to avoid providing NPMs with certain economic advantages. Now, NPMs could take advantage of the loophole, receive large portions of the escrow payments back, and use that additional money to keep the costs of their cigarettes down. Second, the loophole presents a problem with the amount of funding in escrow. One of the reasons for the enactment of the model statute and Public Act 244 was to establish a source of funding for any claims or judgments, should the state successfully sue a nonparticipating manufacturer at a later date. However, the current provisions effectively only require nonparticipating manufacturers to place a relatively small amount in escrow, thus leaving a substantial liability. If the state successfully sues a nonparticipating member, the amount in escrow will, in all likelihood, be woefully inadequate. Also, it has been suggested that the low cigarette prices offered by NPMs could entice (or certainly not dissuade) minors from attempting to purchase cigarettes. If, through the enactment of the equity assessment and the "allocable share" amendment, NPMs are required to raise their prices to cover their additional costs, then the allure of cheap cigarettes is no longer there, and children are (in one regard) turned off to smoking.

Against:

Opponents of the bill note that though there has been no finding that the MSA disadvantages OPMs, there exists a remedy contained in the MSA itself, should the OPMs believe that they are losing market share because of the constraints of the agreement. The annual payments are subject to a non-participating manufacturer adjustment, which only applies those settling states that have not enacted the model statute or a "qualifying statute." The adjustment is as follows: if in any year the total aggregate market

share of the OPMs decreases more than two percent from their total aggregate 1997 market share, and an economic consulting firm determines that the provisions of the MSA were a significant factor in their market share loss, payments to the states may be reduced on that loss.

POSITIONS:

[Note: Positions are based on information provided to the House Committee on Tax Policy on 11-5-03 regarding House Bill 5222.]

The Department of Treasury indicated that it supports the bill. (11-5-03)

The Department of Attorney General indicated that it supports the bill. (11-5-03)

The Michigan Grocers Association indicated that it supports the bill. (11-5-03)

The Michigan Distributors and Vendors Association indicated that it supports the bill. (11-5-03)

R.J. Reynolds indicated that it supports the bill. (11-5-03)

Commonwealth Brands, Inc. indicated that it supports the bill. (11-5-03)

Altria (Phillip Morris) indicated that it supports the bill. (11-5-03)

Lorillard Tobacco indicated that it supports the bill. (11-5-03)

Liggett Group Inc. indicated that it supports the bill. (11-5-03)

Top Tobacco L.P. indicated that it supports the bill. (11-5-03)

Japan Tobacco indicated that it supports the bill. (11-5-03)

The Council of Independent Tobacco Manufacturers indicated that it opposes the bill. (11-5-03)

Analyst: M. Wolf

■ This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.