



# The Florida Senate

Issue Brief 2011-218

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Committee on Finance and Tax

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## TOBACCO SETTLEMENT AND NON-PARTICIPATING MANUFACTURERS ISSUE DESCRIPTION AND BACKGROUND

### Statement of the Issue

In 1995 the State of Florida sued several tobacco companies, asserting claims for, among other things, expenses allegedly arising from tobacco-related matters and injunctive relief concerning sales of cigarettes to minors. In 1996 Florida and four other states<sup>1</sup> entered into a settlement agreement with the Liggett and Brooke Group.<sup>2</sup> In 1997 the State of Florida settled its lawsuit with the “Big Four” tobacco companies: Phillip Morris, Inc. R.J. Reynolds Tobacco Company, Brown and Williamson Tobacco Corp., and Lorillard Tobacco Company. These companies agreed to make annual payments to the state in perpetuity, adjusted annually for inflation. The amount of the annual payments was based on Florida’s share (5.5 percent) of the total volume of U.S. cigarette sales at the time of the settlement, and the national market share of the settling manufacturers, which was calculated at 98.18 percent of U.S. volume in 1997.<sup>3</sup> (As provided by the settlement agreement, the annual payment is based on U.S. sales by the signatories to the agreement; not their sales in Florida.) The settlement also included a “most favored nation” provision, which provided the state with additional monies for a period of time if another state settled with the defendants on terms more favorable than Florida’s. Cigarette manufacturers other than the “Big Four” were not named in the state’s suit as defendants, or, in the case of Dosal Tobacco Corp., were subsequently dismissed from the lawsuit without prejudice.

In the years since the settlement agreement, the U.S. market share of the original participating cigarette manufacturers (OPMs) has fallen to 83.62 percent, significantly reducing Florida’s annual settlement payments. At the same time, Florida’s cigarette market has shifted toward non-participating manufacturers’ (NPMs) cigarettes, which have a competitive price advantage over those whose manufacturers make tobacco settlement payments.

### Discussion

In November 1998, the “Big Four” tobacco companies settled with 46 states, the District of Columbia, and five U.S. territories by entering into the Master Settlement Agreement (MSA). (The states of Mississippi, Minnesota, and Texas, like Florida, entered into individual settlements before the MSA.) Some but not all other cigarette manufacturers subsequently joined the MSA but have not settled with the State of Florida. These manufacturers are known as Subsequent Participating Manufacturers (SPMs). Manufacturers that have not joined the MSA or otherwise settled with a given state are known as Non-Participating Manufacturers (NPMs).

### Treatment of Non-Participating Manufacturers in the Master Settlement Agreement

The Master Settlement Agreement between the “Big Four” tobacco companies and the states, and the individual settlements they made with Mississippi, Minnesota, Florida, and Texas, could have created significant competitive disadvantages for these companies compared to other cigarette manufacturers. Incentives were provided for small manufacturers to participate in the MSA—they were protected from lawsuits by the MSA states and early signatories’ payments are based on the amount by which their market share exceeds their 1998

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<sup>1</sup> West Virginia, Mississippi, Massachusetts, and Louisiana

<sup>2</sup> “The Liggett and Brooke Group” or “Liggett” refers collectively to Liggett Group, Inc., Brooke Group, Ltd., and Liggett & Myers, Inc.

<sup>3</sup> Revenue Estimating Conference “Tobacco settlements Payments Forecast,” March 1, 2010

market share or 125 percent of their 1997 market share—and 58 manufacturers have subsequently joined the master settlement agreement. There are presently 51 active SPMs.<sup>4</sup> Unlike the states that joined the MSA, Florida never settled with any tobacco companies except the Big Four and Liggett. Florida does not receive a share of the payments made by the SPMs, even though the SPM payments are based on their total United States market share, including Florida sales.

### **Escrow Statutes and NPMs**

To offset the competitive advantage that would otherwise inure to NPMs, and recognizing that all cigarettes impose health care costs on the states, the 46 MSA states enacted escrow statutes as prescribed by the MSA.<sup>5</sup> The statutes require each NPM to make payments of 53 cents per pack sold into an escrow account.<sup>6</sup> These accounts earn interest that is payable to the NPMs, and they can recover their payments if there is no state judgment against the manufacturers within 25 years of deposit. (Virginia and North Carolina have enacted legislation that allows NPMs to choose to release escrow money to the state.)

### **Liggett's Role in the Tobacco Settlement**

On March 15, 1996, the states of Florida, West Virginia, Mississippi, Massachusetts, and Louisiana entered into a settlement (the "Initial Settlement") with Liggett and Brooke Group, pursuant to which Liggett agreed to make certain payments, comply with certain proposed regulations restricting the marketing and sale of cigarettes to minors and to offer certain cooperation in connection with the prosecution of such actions against other defendants, all according to the terms of the Initial Settlement.

On March 20th, 1997, eighteen states and Liggett and Brooke Group entered into a settlement (the "New Settlement"), pursuant to which Liggett agreed, among other things, to extend additional cooperation in connection with the prosecution of Attorneys General actions against other cigarette companies and the other states agreed to exercise their best efforts to ensure that the financial terms of any global settlement, legislative or otherwise, would be no more onerous on, or less favorable to, Liggett and Brooke Group than those set forth in any new agreement. The initial settling states and Liggett and Brooke Group decided to expand upon the Initial Settlement, through an Addendum to Settlement Agreement, to provide for additional cooperation by Liggett with the initial settling states and to provide Liggett with assurances that the initial settling states would seek to ensure that any global settlement provide for financial terms for Liggett that reflect appropriate recognition of Liggett's cooperative efforts.<sup>7</sup>

Because of these settlements, and the cooperation provided by Liggett in the states' subsequent negotiations and settlements with the "Big Four" cigarette companies, Liggett is not required to make payments under Florida's settlement with the "Big Four."

### **Florida's Tobacco Settlement and the Cigarette Market Today**

According to the Department of Professional Regulation's Division of Alcoholic Beverages and Tobacco, there were 46 licensed cigarette manufacturers or importers doing business in Florida in FY 2009-2010.<sup>8</sup> There are four Settling Manufacturers—Liggett Group, Lorillard Tobacco Company, Philip Morris, and RJ Reynolds Tobacco Company—whose shipments make up 78.6 percent of cigarette sales by volume. Of the non-settling manufacturers, 12 SPMs contribute 2.2 percent of total cigarette shipments while 30 NPMs make up 19.2 percent. One NPM—Dosal Tobacco Company of Miami, FL—accounts for 15.9 percent of Florida shipments, making it the 3rd-largest source of cigarettes manufactured in or shipped to Florida.

<sup>4</sup> [http://www.naag.org/backpages/naag/tobacco/msa/participating\\_manu/2010-07-27\\_PM\\_List.pdf/file\\_view](http://www.naag.org/backpages/naag/tobacco/msa/participating_manu/2010-07-27_PM_List.pdf/file_view)

<sup>5</sup> [http://www.naag.org/backpages/naag/tobacco/msa/exhbits/Exhibit%20T.pdf/file\\_view](http://www.naag.org/backpages/naag/tobacco/msa/exhbits/Exhibit%20T.pdf/file_view)

<sup>6</sup> This is the 2009 payment year rate as adjusted for inflation, based on Exhibit C of the Master Settlement Agreement and information provided by Rob Wilkey, Senior Legal Counsel, Commonwealth Brands, Inc. on November 2, 2010.

<sup>7</sup> <http://stic.neu.edu> August 30, 2010.

<sup>8</sup> <http://www.myfloridalicense.com/dbpr/abt/auditing/Wholesale/2010/June/documents/CigaretteShipmentsToFloridaforFY0910-JuneYearEnd.pdf>

The 3 remaining “Big Four” cigarette manufacturers (OPMs)—Lorillard Tobacco Company, Philip Morris, and RJ Reynolds Tobacco Company—that were parties to the 1997 settlement with the state make annual payments to the Tobacco Settlement Trust Fund. The FY 2009-10 payment was \$355.1 million, and in that year these manufacturers shipped 679,525,553 packs of cigarettes into the state. The average payment per pack is 52.3 cents. The total amount of the payment for any year is based on, among other factors, the national sales volume of the settling manufacturers. As these manufacturers’ market share decreases Florida’s payment also falls.

Cigarette manufacturers (SPMs) that were not in the group of original signatories but subsequently joined the master settlement agreement (MSA) with the 46 states, the District of Columbia, and 5 territories also make annual payments to the MSA based on national sales, including sales in Florida and other non-MSA states. According to Commonwealth Brands, Inc., that company’s MSA payment is approximately \$5 per carton on all U.S. sales, including those in non-MSA states. These manufacturers do not make payments to Florida, and there is no provision in their settlement agreement for a credit for payments to Florida or other non-MSA states. These manufacturers are making payments to Minnesota and Mississippi<sup>9</sup> although they receive no credit for these payments against their MSA payments.

According to representatives of Commonwealth Brands, Inc., the SPMs have been negotiating with the MSA states over the issue of providing a credit for payments by these companies to previously settled states, including Florida. A conceptual agreement was reached in 2008 for an amendment to the MSA to allow these credits, but the agreement is not effective until all states execute an amendment to the MSA. A possible impediment to such an amendment is that 21 states and territories and the District of Columbia have securitized some of their MSA payments, and 8 of the states believe that the three bond rating agencies must confirm that their bonds would not be downgraded if they sign off on an amendment to provide credits. Two agencies—Fitch and Standard & Poor’s—confirmed for one state (California) that such an amendment is not materially adverse to bondholder rights, but have not expressly approved an amendment to allow a credit for the previously settled states. Moody’s has not concurred on the position with respect to California.

Many cigarette manufacturers have not joined the MSA or otherwise entered into settlements with the non-MSA states. These non-participating manufacturers (NPMs) are subject to escrow statutes (as described above) in the MSA states and must pay fees in lieu of settlement payments in Minnesota and Mississippi, but are not subject to any compensating fee in Florida (or Texas). These manufacturers are also exempt from marketing restrictions that are part of the settlement agreement.

### **Potential Revenue Impact of a Fee in Lieu of Settlement Payments**

In 2004 bills were introduced in the Florida House of Representatives and Senate that would have imposed a fee of 2.5 cents per cigarette on each nonsettling manufacturer. SB 2112 was passed by the Senate (at a lower fee level) but its companion bill in the House, HB 405, was reported unfavorably by the House Committee on Business Regulation and the bill died. In 2009 the Senate Finance and Tax Committee held a workshop on the issue of NPM cigarettes but legislation was not introduced.

A fee that is imposed in lieu of settlement payments would provide additional revenue directly and indirectly. The direct revenue would come from fees collected from non-settling manufacturers for their Florida cigarette sales. The indirect revenue would come from higher settlement payments under the state’s settlement agreement as the market share of the OPMs increased, because NPM cigarettes would no longer have such a large price advantage.

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<sup>9</sup> Of the 4 states that are not signatories to the MSA—Florida, Mississippi, Minnesota, and Texas—Florida and Texas have not imposed a fee on the sale of cigarettes by NPMs. Minnesota imposed a fee of 1.75 cents per nonsettlement cigarette in 2003. Industry interests challenged this and other cigarette fees on various grounds. The Minnesota Supreme Court rejected these challenges, upholding the state’s power to impose the fees, and the United States Supreme Court declined to hear the cases. In 2009 Mississippi imposed a 1.25 cent per cigarette fee on nonsettling-manufacturer cigarettes that are sold, purchased or otherwise distributed in the state, including those sold, purchased, or otherwise distributed for sale outside the state.

Whether or not to include SPM cigarettes will be an important question in any discussion considering fee legislation. SPM representatives explain that since they make payments to the MSA based on all their U.S. sales, including Florida sales, they do not have a competitive price advantage and would be unfairly penalized by an additional fee imposed on these sales. On the other hand, SPM settlement payments do not benefit Florida and their sales do cause Florida's settlement payments to be reduced to the extent they reduce sales by the settling manufacturers.

Potential Revenue from a Fee in Lieu of Settlement Payments (assuming no decrease in sales of non-settling cigarettes)			
	Fee per pack	NPM & SPM	NPM only
Mississippi rate	\$0.25	\$45,375,212	\$39,233,536
Minnesota rate	\$0.35	\$63,525,297	\$54,926,950
Escrow Statute Rate	\$0.53	\$96,195,450	\$83,175,096
Effective OPM rate	\$0.52	\$94,641,753	\$81,831,697

The actual revenue impact of a fee that is imposed in lieu of settlement payments would differ from the potential revenue because NPM cigarette sales will decrease due to the increase in their price. This loss would be offset to some extent by the additional settlement payments from the state's settlement agreement. The Revenue Estimating Conference would determine the magnitude of these offsetting effects in its analysis of any proposed fee.