

**Committee Name:**  
**Senate Committee –**  
**Judiciary, Corrections and Privacy**  
**(SC–JCP)**

**Appointments**

03hr\_SC–JCP\_Appt\_pt00

**Committee Hearings**

03hr\_SC–JCP\_CH\_pt00

**Committee Reports**

03hr\_SC–JCP\_CR\_pt00

**Clearinghouse Rules**

03hr\_SC–JCP\_CRule\_03–

**Executive Sessions**

03hr\_SC–JCP\_ES\_pt00

# Hearing Records

03hr\_ab0000

## 03hr\_sb0245

**Misc.**

03hr\_SC–JCP\_Misc\_pt00

**Record of Committee Proceedings**

03hr\_SC–JCP\_RCP\_pt00

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STATE OF WISCONSIN  
DEPARTMENT OF JUSTICE

SB 245  
?

PEGGY A. LAUTENSCHLAGER  
ATTORNEY GENERAL

Daniel P. Bach  
Deputy Attorney General

114 East, State Capitol  
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Madison, WI 53707-7857  
608/266-1221  
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June 23, 2003

The Honorable Mary Panzer  
Senate Majority Leader  
Room No. 211 South  
**HAND DELIVERED**

The Honorable John Gard  
Speaker of the State Assembly  
Room No. 211 West  
**HAND DELIVERED**

The Honorable John Erpenbach  
Senate Minority Leader  
Room No. 202 South  
**HAND DELIVERED**

The Honorable Jim Kreuser  
Assembly Minority Leader  
Room No. 201 West  
**HAND DELIVERED**

Re: Non-participating tobacco manufactures enforcement legislation

Dear Legislators:

I write to urge the quick passage of legislation drafted by the National Association of Attorneys General ("NAAG") for tobacco enforcement. Delay in passing this legislation in Wisconsin poses a serious and real threat to the state's tobacco revenue stream. Additionally, without this legislation, the state risks significant legal exposure to securitization bondholders and to manufacturers who are parties to the Master Settlement Agreement (MSA).

When the states signed on to the MSA with the leading tobacco manufacturers, they agreed to enact and diligently enforce a model statute requiring non-participating manufacturers (NPMs) to either join the MSA or to fund certain escrow accounts. The escrow accounts had two purposes: to even the playing field among all manufacturers, whether they made MSA payments or not; and to give the states a fund to draw from in the event they ever obtained a judgment for public health costs. Wisconsin enacted that legislation in 2000 at Wis. Stat. § 895.10.

Enforcement of the model statute is absolutely critical to the states' continued receipt of MSA payments. Under the MSA, participating manufacturers are entitled to a reduction in their payments if (1) their market share decreases due to their MSA obligations; and (2) a state has not "diligently enforced" the model statute. We believe it very likely that, given the huge financial incentive at stake, one or more participating manufacturers will claim this adjustment for sales in 2003 and after. The adjustment would be shared among all states that were adjudicated as "non-diligent." Although Wisconsin has securitized its stream of MSA payments, the State remains liable to the bondholders for the enforcement of the model statute.

In enforcing the model statute, the states have discovered several major hurdles to ensuring that non-participating manufacturers met their escrow obligations. Because the manufacturers could sell product for up to sixteen months before their escrow payment must be made, huge sales could accrue before the state could take action. Most of the non-participating manufacturers are located abroad, and locating and serving these companies has been a major challenge. Enforcing judgments in these countries is expensive or impracticable. As a result, many NPMs have sold millions of cigarettes, making no escrow obligations, before states could stop their sales. Such NPMs have been able to significantly underprice other manufacturers. NAAG estimates that the loss of MSA revenue due to NPM non-compliance as \$450 million for the April 2003 payment alone.

Further, one provision of the model statute has had an unintended effect: it has allowed NPMs to receive a refund of almost all of the payments they do make into an escrow account. If an NPM sells only in Wisconsin, it is entitled to a escrow refund of all but two percent of what it would have paid as a participant in the MSA. Certain NPMs have used this provision to target their sales in only a few states and to limit their escrow obligation to almost zero.

NAAG, with the assistance of a working group of assistant attorneys general and tax administrators from 37 states, created two pieces of legislation in order to create a regulatory, rather than litigation, focus. Under complementary legislation, no manufacturer may sell cigarettes until it has expressed its intent to sell the cigarettes in Wisconsin, set up an escrow account, and become compliant with all state obligations. It then is required to make escrow deposits on a quarterly basis. This proactive approach will more effectively and cheaply enforce the model statute and has been highly effective in the states where it has been enacted. That legislation, or an earlier version of it, has passed in 33 states and is pending in 6 more. Further, NPMs cannot reduce their escrow obligations by limiting their sales to a few states. They will owe the same obligation for a certain amount of sales whether the cigarettes are sold in one state, or twenty.

This legislation will assist the state in enforcing the model statute and ensure continued payments under the MSA. My office has participated in the review of draft legislation that would resolve this matter. I am aware of language that is currently available to resolve these concerns. I urge your quick consideration and approval of this legislation.

Thank you for your attention to this matter. As always, please feel free to call me with any questions or concerns you may have.

Very truly yours,



Peggy A. Lautenschlager  
Attorney General

PAL: vlv

SB 245

**Hogan, John**

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**From:** Rhodes-Engels, Judi  
**Sent:** Thursday, September 18, 2003 9:24 AM  
**To:** Hogan, John  
**Subject:** A0953

**AMENDMENT: WI has a blanket severability clause, so Bob Nelson, the drafter, did not feel it necessary to include it in the bill.**

**However the National Association of Attorney Generals (NAAG) has said other states who have not specifically included it have been in non-compliance and have had problems with lawsuits. So we are spelling it out. It really is purely technical.**

**Gundrum said they would introduce it as a committee amendment. Can we do the same?  
The stripes are on their way down.**



STATE OF WISCONSIN  
DEPARTMENT OF JUSTICE

PEGGY A. LAUTENSCHLAGER  
ATTORNEY GENERAL

Daniel P. Bach  
Deputy Attorney General

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P.O. Box 7857  
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TTY 1-800-947-3529

September 22, 2003

The Honorable Dave Zien, Chair  
Senate Committee on Judiciary, Privacy & Corrections  
The State Capitol  
Room No. 15 South  
**HAND DELIVERED**

The Honorable Mark Gundrum, Chair  
Assembly Committee on Judiciary  
Room No. 19 North  
**HAND DELIVERED**

Re: Senate Bill 245 & Assembly Bill 494  
Non-participating tobacco manufactures enforcement legislation

Dear Legislators:

I write to urge your quick passage of SB245 and AB494, model legislation drafted by the National Association of Attorneys General (NAAG). This legislation is essential to the continuation of the state's tobacco revenue stream. Without this legislation, the state risks significant legal exposure to securitization bondholders and to manufacturers that are parties to the Master Settlement Agreement (MSA). Failure to adopt this legislation, in its current form, may also result in the loss of millions of dollars to the state's bondholders and could ultimately eliminate the entire tobacco payments contemplated under the MSA.

Last June, I wrote to all legislative leaders urging the quick adoption of this legislation and highlighting the potential dangers of failing to do so. At the committees' hearing last week, Assistant Attorney General Charlotte Gibson presented you with detailed information showing that Wisconsin has already lost more than \$10 million in tobacco revenue for the coming year. Quite frankly, the state cannot afford the legal liability or financial exposure that failing to pass this legislation would create.

The model legislation contained in these two bills has been vetted with all necessary parties to the MSA over the last several months. Any change to the language presented here would almost certainly invalidate these extensive negotiations. The only opportunity to fulfill the state's due diligence enforcement obligations under the MSA and avoid excessive risks to our revenue stream is to pass SB245 and AB494 as they were presented to the committee. Any additional amendments to either bill, beyond the committee amendment currently pending, would negate all of the work leading up to this point and expose the state to great financial and legal risk.

When the states signed on to the MSA with the leading tobacco manufacturers, they agreed to enact and diligently enforce a model statute requiring non-participating manufacturers (NPMs) to either join the MSA or to fund certain escrow accounts. The escrow accounts had two purposes: to even the playing field among all manufacturers, whether they made MSA payments or not; and to give the states a fund to draw from in the event they ever obtained a judgment for public health costs. Wisconsin enacted that legislation in 2000 at Wis. Stat. § 895.10. Wisconsin remains obligated under the MSA to diligently enforce that statute, and we expect, given the financial incentives for participating manufacturers to do so, that multiple states will be sued regarding their enforcement for 2003 and beyond.

The legislation before you addresses several hurdles that the States have faced in enforcing the model statute. For the past several months, my office has been working closely with NAAG, Attorneys General in many other states, the participating manufacturers and other Wisconsin stakeholders to draft this legislation. Until the very day of the hearing, no concerns were ever raised with respect to this legislation.

As you know, however, a last-minute speaker, Tony Troy, appeared at the hearing to speak in opposition to two aspects of the legislation. I will address a few of the issues raised by his testimony here. I note, however, that the changes proposed by the last-minute opponent have little to do with the public policy of the proposals and everything to do with a timed effort to delay the State's enforcement.

At the hearing, Mr. Troy expressed several inaccurate statements. The most basic is that NPM compliance and sales have no effect on MSA payments. This is false. NPM sales affect MSA payments by reducing the Participating Manufacturers' market share, and thus required payments. Non-compliant NPM cigarettes, which cost a fraction of Participating Manufacturer cigarettes, erode that market share far more. Further, the NPM adjustment, which Mr. Troy claims has never been levied, has already been taken. Wisconsin has already lost millions of dollars due to NPM sales.

Another basic untruth was that NPM tobacco companies would be unfairly treated by this legislation. Nothing could be further from the truth. Under current law, a Participating Manufacturer pays \$15,689.85 for Wisconsin sales (about 31¢ per pack) per 1,000,000 sticks sold. The NPM places \$13,612.50 in escrow (about 27¢ per pack), but, if all its sales are in Wisconsin, currently receives a release of \$13,275.46. Only less than 2.5 percent of the original deposit - \$337.04 (about 0.7¢ per pack) - remains in escrow for the 25 years. This clearly subverts the purposes of the escrow statute and creates an unintended advantage for NPMs. The NPM enjoys a 50-fold cost advantage over the Participating Manufacturer and can easily undersell them. Further, if the State seeks to recover its public health costs relating to those 1 million sticks, only \$337—not even enough to cover the State's filing and service fees—is in the escrow account.

This loophole in current law has allowed non-compliant manufacturers with unpaid escrow in many states to "cure" their violation in a only few states, begin selling large quantities of cigarettes in those limited markets, and then to receive almost complete escrow refunds while their obligations in other states go unpaid. Mr. Troy has been unwilling to tell any State the names of his manufacturer clients. We do not know his clients, but they may well be among those scofflaws that have manipulated the cigarette market to circumvent the consequences of breaking the law in other states.

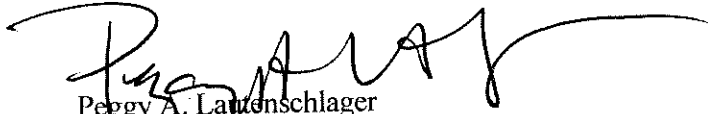
The model legislation before you levels the playing field for all manufacturers. It ensures that, in the event the State seeks to recover public health costs from an NPM, there is a meaningful fund available to pay a judgment. Under the example above, the legislation will simply require the NPM to leave the \$13,612.50 in the escrow account unless that amount exceeds what the NPM would have made as a PM in MSA payments. In this example, because the NPM already is escrowing less than what it would have paid as a PM, it would not be entitled to a refund.

Mr. Troy also told committee members that seventeen states had rejected the allocable share provisions contained in this bill. This statement was inaccurate and untrue. To date, seventeen states have approved the allocable share provisions of this bill. In only one state, Delaware, have these provisions been rejected. In that case, it is my understanding that the Attorney General was not directly involved in the negotiations or presentation of this legislation.

I hope that you will see beyond the last-minute attempts of opponents to this legislation and move quickly to adopt this legislation. This legislation is necessary to assist the state in enforcing the model statute and to ensure continued payments under the MSA.

Thank you for your attention to this matter. As always, please feel free to call me with any questions or concerns you may have.

Very truly yours,



Peggy A. Lattenschlager  
Attorney General

PAL: vlv



# STATE SENATOR DAVE ZIEN

ASSISTANT MAJORITY LEADER

CHAIRPERSON  
 COMMITTEE ON JUDICIARY, CORRECTIONS AND PRIVACY  
 VICE CHAIRPERSON  
 COMMITTEE ON HOMELAND SECURITY, VETERANS AND MILITARY AFFAIRS AND GOVERNMENT REFORM  
 MEMBER  
 COMMITTEE ON SENATE ORGANIZATION  
 COMMITTEE ON ENVIRONMENT AND NATURAL RESOURCES  
 COMMITTEE ON LABOR, SMALL BUSINESS DEVELOPMENT AND CONSUMER AFFAIRS  
 SENTENCING COMMISSION  
 COUNCIL ON TOURISM  
 JUDICIAL COUNCIL

## MEMORANDUM

TO: Senator Scott Fitzgerald, Member, Senate Committee on Judiciary, Corrections & Privacy

FR: Senator Dave Zien, Chair, Senate Committee on Judiciary, Corrections & Privacy

DT: September 24, 2003 (hand delivered 10:30am)

RE: Paper Ballot for SB245 (1 page)

Please consider the following bill and vote on the motion below. **Return this ballot to Senator Dave Zien, Room 15 South, no later than 12:00pm (noon) Thursday, September 25, 2003.** Committee members' ballots not received by the deadline will be marked as not voting.

### Senate Bill 245

Relating to: tobacco settlement agreement enforcement and providing penalties. (FE)

By Senators S. Fitzgerald, Kedzie, Lassa, Breske and Welch; cosponsored by Representatives Vrakas, Nischke, Jeskewitz, Rhoades, M. Lehman, Van Roy, Ladwig, Nass, Taylor, Bies and McCormick

Please consider the following motion:

- Moved by Senator Zien that SENATE BILL 245 be recommended for PASSAGE:

Aye  X  No \_\_\_\_\_

Signature  *Sen. Scott Fitzgerald (US)*   
 Senator Scott Fitzgerald







# STATE SENATOR DAVE ZIEN

ASSISTANT MAJORITY LEADER

CHAIRPERSON  
 COMMITTEE ON JUDICIARY, CORRECTIONS AND PRIVACY  
 VICE CHAIRPERSON  
 COMMITTEE ON HOMELAND SECURITY, VETERANS AND MILITARY AFFAIRS AND GOVERNMENT REFORM  
 MEMBER  
 COMMITTEE ON SENATE ORGANIZATION  
 COMMITTEE ON ENVIRONMENT AND NATURAL RESOURCES  
 COMMITTEE ON LABOR, SMALL BUSINESS DEVELOPMENT AND CONSUMER AFFAIRS  
 SENTENCING COMMISSION  
 COUNCIL ON TOURISM  
 JUDICIAL COUNCIL

## MEMORANDUM

TO: Senator Cathy Stepp, Member, Senate Committee on Judiciary,  
 Corrections & Privacy

FR: Senator Dave Zien, Chair, Senate Committee on Judiciary, Corrections  
 & Privacy

DT: September 24, 2003 (hand delivered 10:30am)

RE: Paper Ballot for SB245 (1 page)

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Please consider the following motion:

- Moved by Senator Zien that SENATE BILL 245 be recommended for PASSAGE:

Aye  No

Signature *Cathy Stepp*  
 Senator Cathy Stepp





# STATE SENATOR DAVE ZIEN

ASSISTANT MAJORITY LEADER

CHAIRPERSON  
 COMMITTEE ON JUDICIARY, CORRECTIONS AND PRIVACY  
 VICE CHAIRPERSON  
 COMMITTEE ON HOMELAND SECURITY, VETERANS AND MILITARY AFFAIRS AND GOVERNMENT REFORM  
 MEMBER  
 COMMITTEE ON SENATE ORGANIZATION  
 COMMITTEE ON ENVIRONMENT AND NATURAL RESOURCES  
 COMMITTEE ON LABOR, SMALL BUSINESS DEVELOPMENT AND CONSUMER AFFAIRS  
 SENTENCING COMMISSION  
 COUNCIL ON TOURISM  
 JUDICIAL COUNCIL

## MEMORANDUM

TO: Senator Gary George, Member, Senate Committee on Judiciary, Corrections & Privacy

FR: Senator Dave Zien, Chair, Senate Committee on Judiciary, Corrections & Privacy

DT: September 24, 2003 (hand delivered 10:30am)

RE: Paper Ballot for SB245 (1 page)

Please consider the following bill and vote on the motion below. **Return this ballot to Senator Dave Zien, Room 15 South, no later than 12:00pm (noon) Thursday, September 25, 2003.** Committee members' ballots not received by the deadline will be marked as not voting.

### Senate Bill 245

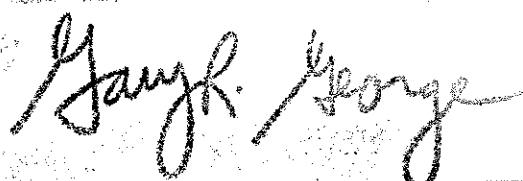
Relating to: tobacco settlement agreement enforcement and providing penalties. (FE)

By Senators S. Fitzgerald, Kedzie, Lassa, Breske and Welch; cosponsored by Representatives Vrakas, Nischke, Jeskewitz, Rhoades, M. Lehman, Van Roy, Ladwig, Nass, Taylor, Bies and McCormick

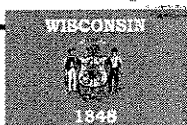
Please consider the following motion:

- Moved by Senator Zien that SENATE BILL 245 be recommended for PASSAGE:

Aye \_\_\_\_\_ No   X  

  
 \_\_\_\_\_  
 Senator Gary George

Signature





# STATE SENATOR DAVE ZIEN

ASSISTANT MAJORITY LEADER

**CHAIRPERSON**  
 COMMITTEE ON JUDICIARY, CORRECTIONS AND PRIVACY

**VICE CHAIRPERSON**  
 COMMITTEE ON HOMELAND SECURITY, VETERANS AND MILITARY AFFAIRS AND GOVERNMENT REFORM

**MEMBER**  
 COMMITTEE ON SENATE ORGANIZATION  
 COMMITTEE ON ENVIRONMENT AND NATURAL RESOURCES  
 COMMITTEE ON LABOR, SMALL BUSINESS DEVELOPMENT AND CONSUMER AFFAIRS  
 SENTENCING COMMISSION  
 COUNCIL ON TOURISM  
 JUDICIAL COUNCIL

## MEMORANDUM

TO: Senator Tim Carpenter, Member, Senate Committee on Judiciary, Corrections & Privacy

FR: Senator Dave Zien, Chair, Senate Committee on Judiciary, Corrections & Privacy

DT: September 24, 2003 (hand delivered 10:30am)

RE: Paper Ballot for SB245 (1 page)

Please consider the following bill and vote on the motion below. **Return this ballot to Senator Dave Zien, Room 15 South, no later than 12:00pm (noon) Thursday, September 25, 2003.** Committee members' ballots not received by the deadline will be marked as not voting.

### Senate Bill 245

Relating to: tobacco settlement agreement enforcement and providing penalties. (FE)

By Senators S. Fitzgerald, Kedzie, Lassa, Breske and Welch; cosponsored by Representatives Vrakas, Nischke, Jeskewitz, Rhoades, M. Lehman, Van Roy, Ladwig, Nass, Taylor, Bies and McCormick

Please consider the following motion:

- Moved by Senator Zien that SENATE BILL 245 be recommended for PASSAGE:

Aye           ✓           No                           

Signature           Tim Carpenter            
 Senator Tim Carpenter



NATIONAL ASSOCIATION OF ATTORNEYS GENERAL  
750 FIRST STREET NE · SUITE 1100  
WASHINGTON, DC 20002  
(202) 326-6057 (Tobacco Project) · (202) 408-8064 (Facsimile)  
<http://www.naag.org>

SB 245  
?

**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.

**Participating Manufacturers to the MSA:**

Alliance  
Brown & Williamson  
Caribbean-American Tobacco Corp.  
Chancellor Tobacco Company, PLC  
Commonwealth Brands, Inc.  
Compania Industrial Tabacos Monte Paz  
Cutting Edge Enterprises, Inc.  
Daughters and Ryan, Inc.  
Dhanraj International, Inc.  
Eastern Company SAE  
House of Prince A/S  
Imperial Tobacco Limited/ITL (USA)  
Limited  
Japan Tobacco International U.S.A., Inc.  
King Maker Marketing  
Konci G&D Management  
Kretek International  
Lane Limited  
Liberty Brands, LLC  
Liggett Group, Inc.  
Lignum-2, Inc.  
Lorillard Tobacco Co.  
LTD Corporation  
Mac Baren  
Pacific Stanford Manufacturing Corporation

Peter Stokkebye International A/S  
Philip Morris Incorporated, USA  
PLANTA  
Pöschl Tobak GmbH and Company KG  
Premier Marketing Incorporated  
P.T. Djarum  
R.J. Reynolds Tobacco Company  
Santa Fe Natural Tobacco Company, Inc.  
Sherman 1400 Broadway N.Y.C., Inc.  
SEITA  
Vectro Tobacco Inc. (formally The  
Medallion Company, Inc.)  
Tobacco & Candy International, Inc.  
Lane LTD (formally Tobacco Exporters  
International (USA) Ltd.)  
Top Tobacco, L.P.  
Vector Tobacco Inc.  
Virginia Carolina Corporation, Inc.  
Von Eicken Group (Tabak-Haus Dingelstadt  
Joh., Von Eicken, GMBH, and  
Charles Fairmorn)  
VIP Tobacco USA, LTD. (Formerly Winner  
Sales Company)  
Wind River Tobacco Company, LLC  
ZNF International, LLC



NATIONAL ASSOCIATION OF ATTORNEYS GENERAL  
750 FIRST STREET NE · SUITE 1100  
WASHINGTON, DC 20002  
(202) 326-6057 (Tobacco Project) · (202) 408-8064 (Facsimile)  
<http://www.naag.org>

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## 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 pay more per cigarette than Philip Morris or RJ Reynolds.*

**Fact:** The proposed legislation *limits* the payments an NPM makes to the amount that a Participating Manufacturer would have to make on a per-stick basis under the MSA.

*Myth: In the absence of the current release provision, an NPM would have to pay more than Philip Morris actually paid per-stick.*

**Fact:** By way of example, in the absence of any release, for sales in 2002 an NPM would have had to pay 1.53 cents per stick. For cigarettes sold in 2002 Philip Morris actually paid 2.0 cents per stick. (\$3.8 billion paid based on 189 billion sticks).

*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 pay 30 cents per pack. Others pay 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 imposed a huge cost on the state in health care costs. The tiny amount per stick that was left in escrow isn't anywhere close to the cost those cigarettes impose. The refund shortchanged the state. 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 payments. The loophole in the escrow statute operates to give only certain NPMs a windfall. This 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. That amounts to a significant 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: NPMs have a right to compete. The states are just trying to protect the majors.*

**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. NPMs don't make payments to the states and they don't observe the restrictions. NPMs have to make escrow payments but the states don't get those revenues. Under current law, some NPMs' escrow payments are both far less than the payments the Participating Manufacturers make to the states and also far less than the escrow payments of other NPMs. It's time to put a stop to this discrimination.

*Myth: The MSA was a scheme hatched by OPMs to protect themselves 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: 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. This makes sense because kids have less disposable income. The states should not be encouraging the sale of cheap cigarettes. The state's desire to curb youth smoking is an important objective.

#### **Participating Manufacturers to the MSA:**

Alliance	Peter Stokkebye International A/S
Brown & Williamson	Philip Morris Incorporated, USA
Caribbean-American Tobacco Corp.	PLANTA
Chancellor Tobacco Company, PLC	Pöschl Tobak Gmbh and Company KG
Commonwealth Brands, Inc.	Premier Marketing Incorporated
Compania Industrial Tabacos Monte Paz	P.T. Djarum
Cutting Edge Enterprises, Inc.	R.J. Reynolds Tobacco Company
Daughters and Ryan, Inc.	Santa Fe Natural Tobacco Company, Inc.
Dhanraj International, Inc.	Sherman 1400 Broadway N.Y.C., Inc.
Eastern Company SAE	SEITA
House of Prince A/S	Vectro Tobacco Inc. (formally The
Imperial Tobacco Limited/ITL (USA)	Medallion Company, Inc.)
Limited	Tobacco & Candy International, Inc.
Japan Tobacco International U.S.A., Inc.	Lane LTD (formally Tobacco Exporters
King Maker Marketing	International (USA) Ltd.)
Konci G&D Management	Top Tobacco, L.P.
Kretek International	Vector Tobacco Inc.
Lane Limited	Virginia Carolina Corporation, Inc.
Liberty Brands, LLC	Von Eicken Group (Tabak-Haus Dingelstadt
Liggett Group, Inc.	Joh., Von Eicken, GMBH, and
Lignum-2, Inc.	Charles Fairmorn)
Lorillard Tobacco Co.	VIP Tobacco USA, LTD. (Formerly Winner
LTD Corporation	Sales Company)
Mac Baren	Wind River Tobacco Company, LLC
Pacific Stanford Manufacturing Corporation	ZNF International, LLC

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## **WISCONSIN SENATE BILL 245 & ASSEMBLY BILL 494 HELPING THE ATTORNEY GENERAL PRESERVE THE MSA BY ENFORCING WISCONSIN'S ESCROW STATUTE**

Good morning. I'm Charlotte Gibson, the Assistant Attorney General responsible for enforcing and managing our tobacco law. I'm here to testify in support of SB 245 and AB 494. Thank you for providing the opportunity to testify and for considering this important legislation.

As many of you will remember, almost five years ago, Wisconsin and 45 other States signed the landmark Master Settlement Agreement, the MSA, with major tobacco manufacturers. Since that time, dozens of other tobacco manufacturers have signed on to the MSA, as well. Those companies are making payments to the States and complying with public health provisions.

Other cigarette manufacturers have not signed on to the MSA. At the time the States signed the MSA, they were concerned that such non-participating companies, called "NPMs," could significantly undersell participating companies. The States were also concerned that, if the States ever sought a judgment for public health costs against an NPM, the judgment would not be collectible. Thus, the States agreed to pass a model statute, codified here in Wisconsin at 895.10, which would require NPMs to put money into escrow for every package of cigarettes sold in the State. The amount of the escrow was to be similar to what the payment they would have made under the MSA, and it would be available to satisfy a judgment against them by a State.

The States also agreed under the MSA that the participating manufacturers could reduce their MSA payments if they lost significant market share to NPMs. Finally, the States agreed that, if they were found to be not diligently enforcing their model statutes, the participating manufacturers could reduce or withhold their payment altogether from those States.

Five years later, we have good news and bad news. The good news is that Wisconsin has low sales by NPMs – currently less than 1/7 of the average for a state our size. Further, we have relatively good compliance so far.

The bad news is that, nationwide, some NPMs are flouting our laws. Most of these companies are located abroad, and it is difficult and expensive to locate them and obtain a judgment when they do not comply. Further, other NPMs, while nominally complying with the letter of the law, are utilizing a loophole to receive almost all of their escrow payments back. Instead of paying an amount into escrow roughly equivalent to MSA payments, they are paying as little as 2 percent of that amount. Partly as a result of these tactics, the States' MSA payments are declining. Wisconsin is expected to lose over \$10 million in its MSA payment next year due to national rising NPM sales. Further, the States may be facing litigation from the participating manufacturers or, in States that have securitized, suits from bondholders.

The bills before you today address these problems. They enhance the Attorney General's ability to enforce our model statute by requiring tobacco companies to set up their escrow accounts prior to sale and to agree to local service. They strengthen the ability of the Attorney General and Department of Revenue to cease sales if escrow payments are not made.

They also close the loophole in the model statute. They allow escrow refunds only when an NPM can show that it escrowed more than it would have had to pay under the MSA for the number of cigarettes sold in Wisconsin.

The simple amendment to the bills before you modifies our statutes' default severability rule. The amendment makes clear that, should the change to the model statute ever be challenged successfully on constitutional grounds, that the model statute as originally enacted would remain in effect. This language assures that Wisconsin meets our MSA obligation regardless of any challenges NPMs might raise in litigation.

This legislation is part of a national effort by Attorneys General around the country. 38 other States have enhanced the ability of their Attorney General to enforce their Escrow Statute by enacting complementary legislation, including 28 that have passed the model complementary legislation in our bills. 17 States have closed the loophole in their Escrow Statutes by passing the allocable share amendment. Many other States are working to enact both parts of the legislation in the coming legislative session.

The Attorney General endorses this legislation as a key component in upholding our obligation to enforce the model statute. I urge you to join the many States that have already taken action and passed this legislation. We appreciate your taking the time to consider this important issue. I'd be happy to answer any questions that the Committee members have.