

**OFFICE OF THE ATTORNEY GENERAL'S  
SUMMARY OF THE TOBACCO MASTER SETTLEMENT AGREEMENT**

**PREPARED FOR THE TOBACCO SETTLEMENT REVENUE OVERSIGHT  
COMMITTEE**

➤ **Origins of the Master Settlement Agreement**

- In 1994 the Mississippi Attorney General sued what were then the four largest tobacco companies in the United States for the health care costs associated with the sale and use of their products. Eventually all 50 States filed similar suits.
- Texas, Florida, Mississippi and Minnesota reached individual settlements with the major tobacco companies. The other 46 States reached a joint settlement with the tobacco companies in November 1998 resulting in the Tobacco Master Settlement Agreement (MSA).
- At the time, four major tobacco companies controlled over 97% of the nationwide cigarette market. These are the Original Participating Manufacturers (OPMs).
- Later, approximately 40 additional tobacco companies joined the Master Settlement Agreement. These are the Subsequent Participating Manufacturers, (SPMs). The OPMs and SPMs are jointly referred to as Participating Manufacturers (PMs).
- Tobacco manufacturers that have not joined the MSA are called Non-Participating Manufacturers (NPMs).
- Currently, 18 PMs and 13 NPMs are certified to do business in New Mexico. PMs continue to dominate the cigarette market in New Mexico. The largest tobacco manufacturer, Philip Morris (now known as Altria) by itself controls more than 41% of the total cigarette market (PM and NPM combined) in New Mexico, as measured by 2012 sales.

➤ **Relevant Terms of the Master Settlement Agreement**

- In signing the Master Settlement Agreement, Participating Manufacturers agreed to the following, among other obligations:

- To substantially limit advertising, promotion, marketing and packaging of cigarettes, including a ban on “targeting youth,” limitations on tobacco brand name sponsorships and merchandise.
- To make payments of about 50 cents per pack to the States in perpetuity. These payments serve the important purpose of providing partial reimbursement to each State for the health care costs caused by the use of tobacco products sold by the PMs in that State.
- In signing the Master Settlement Agreement, each signing State agreed to the following:
  - To enact a statute requiring escrow payments to be deposited for the sale of certain tobacco products by NPMs (the major tobacco companies’ competitors). If a State enacts the model statute proposed by the PMs and attached as an exhibit to the MSA, that State is deemed to have a “Qualifying Statute.” ***The MSA and model statute provide that only cigarettes or other tobacco products on which state excise tax is due are subject to the escrow deposit requirement.***
    - The escrow deposits are ***not*** payments made to the States. Rather, from the point of view of the States, the escrow deposits provide a potential source of recovery on any judgment that the States might obtain against an NPM for the health care costs caused by the use of that company’s tobacco products.
    - From the point of view of the PMs, the escrow deposits made by the NPMs neutralize the competitive advantage NPMs might otherwise have due to MSA payments.
  - To “diligently enforce” that Qualifying Statute. The term “diligently enforce” is not defined by the MSA. The meaning of that term is at the center of a contentious, expensive and to date unresolved dispute between States and the PMs.
- Under the MSA, a State can be forced to refund all or part the annual payment it received from the PMs if that State failed to

“diligently enforce” its escrow statute. In the language of the MSA, this offset is called the “NPM Adjustment.”

➤ **Payment Calculations**

- Under the MSA, a third-party auditor (the Independent Auditor) calculates and determines all payments that the PMs owe to the States under the MSA.
- Any dispute arising out of or relating to “calculations performed” or “determinations made” by the Independent Auditor is submitted to binding arbitration.
- Each year, New Mexico receives an MSA Payment according to our “Allocable Share” of the MSA payments, based on the percentage of nationwide PM cigarette sales made into New Mexico at the time the MSA was signed. New Mexico’s Allocable Share of the MSA Payment is 0.5963897%. The total PM payment to the States averages between \$6 and \$7 billion per year.
- Because New Mexico took an active role in the initial 1996 litigation and subsequent settlement, we also get an extra payment from a “Strategic Contribution Fund.”

➤ **MSA Payments New Mexico Has Received to Date**

1999	\$27,551,232.86
2000	\$34,311,719.72
2001	\$36,223,772.73
2002	\$41,311,954.56
2003	\$34,194,961.33
2004	\$37,488,987.12
2005	\$38,009,047.30
2006	\$34,785,540.19
2007	\$35,919,658.40
2008	\$44,863,501.60
2009	\$45,621,859.28
2010	\$40,949,708.41
2011	\$38,565,431.91
2012	\$39,320,878.43
2013	\$39,303,326.53

**Total paid to NM as of 5-2-2013**

**\$571,656,947.37**

- Note: 2009 was the first year that the largest PM, Philip Morris, chose to withhold funds due to its claimed NPM Adjustment (see below). These monies are placed in an escrow account rather than distributed to the States as MSA payments.

➤ **The NPM Adjustment**

- The PMs were concerned that their annual payment obligation to the States under the Master Settlement Agreement would diminish their historical 97%+ control of the cigarette market.
- To protect themselves against market loss, the PMs included a provision in the MSA where they would be entitled to a refund if four conditions were met:
  1. The PMs lost over 2% in market share in any given year from their market share in 1998 and
  2. An independent economics firm determines, in a non-appealable proceeding, that the MSA was a “significant factor” in the PMs’ market share loss.

If the first two factors are met, the PMs get an NPM Adjustment, unless a State meets the next two factors:

3. The State had a Qualifying Statute in place during the year in question and
4. The State “diligently enforced” that statute.

➤ **Allocation of NPM Adjustment**

- A State’s entire annual payment conceivably could be at risk depending on which other States’ annual payments are also subject to the NPM Adjustment. Thus, assuming
  - A \$1.5 billion NPM Adjustment, and
  - 15 States are found not to have diligently enforced,
  - Those 15 States must together pay the \$1.5 billion, based on each State’s market share, up to the State’s full payment for the challenged year (2003).
  - ***New Mexico’s potential exposure ranges from zero (if we are determined to have “diligently enforced” in 2003)***

***up to \$35 million (our entire 2003 payment). The exact amount of our exposure in the event of an adverse decision is unknown because it depends on the number of other States found non-diligent and the Allocable Shares of those States.***

- If a PM wants to challenge the amount of their annual MSA payment due on account of a claimed NPM Adjustment, it can withhold the funds, place the funds in a Disputed Payment Account, or pay the States the full amount subject to resolution of the dispute. In recent years, most PMs are choosing to place disputed funds into the Disputed Payment Account and therefore New Mexico and the other States' annual payments are significantly less than they would have been otherwise.

➤ **Overview of MSA-Related Legislation in New Mexico**

- In 1999, New Mexico enacted the model statute verbatim. NMSA 1978 §§ 6-4-12 and 6-4-13. The PMs agreed in 1999 that New Mexico had a Qualifying Statute. (Beginning in 2006, the PMs have challenged New Mexico on the ground that it no longer has a Qualifying Statute). In our escrow statute enacted in 1999, as in the model statute attached as an exhibit to the MSA, escrow must be deposited on NPM "units sold," which were explicitly defined as only those cigarettes or other tobacco product on which state excise tax is due.
- In 2003 and 2004, the Legislature passed additional legislation not specifically required by the MSA, including Complementary Legislation, NMSA 1978 §§ 6-4-14 through 6-4-24, and the Allocable Share Release Amendment, NMSA 1978, § 6-4-13. These statutes provide the Attorney General's Office with stronger enforcement tools.
- In 2006, the Cigarette Tax Act, NMSA 1978, § 7-12-5, was amended to require stamps on both excise tax-paid tobacco products and tax-exempt products. The Legislature added a section to the Cigarette Tax Act providing explicitly that "an exempt stamp is not an excise stamp, for purposes of "units sold" under the Tobacco Escrow Act (Section 6-4-12(j)). Although this amendment is consistent with New Mexico's escrow statute, the PMs assert that due to this change in language, New Mexico lacks a Qualifying Statute from 2006 forward.

- In 2009, the PMs challenged New Mexico’s diligence in part on the ground that it was not requiring escrow on tribal sales (which the MSA does not actually require). Although the MSA does not require escrow deposits on cigarettes exempt from state excise tax, such as sales on tribal lands, to protect against the risk of an adverse decision on that issue the Legislature passed a statute under which New Mexico going forward would require escrow on all cigarette sales, whether tax-exempt or tax-due.
- In 2010, the Legislature revised the Cigarette Tax Act to create a tribal tax credit stamp, permitting tribes to charge a 75 cent tax on all sales to non-tribal members, if they certified with the Department of Taxation and Revenue. The bill did not explicitly add the tax credit stamp as a “unit sold” under the Escrow Act. It changed the language in the Cigarette Tax Act to state that neither exempt stamps nor tribal tax credit stamps are excise stamps for purposes of the “units sold” definition.
- Since the 2010 change, NPMs have refused to make escrow payments on their sales on tribal lands. The Attorney General’s Office has made a claim for these payments, which total over \$12 million. The NPMs responded by filing a declaratory action in state court. The Attorney General’s Office is now defending this suit and the 2009 Legislation.
- The Attorney General’s Office proposed legislation in 2011 and 2012 to clarify that a tribal tax-credit stamp is an exempt stamp, and thus, escrow is due on those sales – although such a change is *not* required by the MSA. Senate Bills 397(2011) and 225 (2012), which passed both chambers by a comfortable margin, would have clarified New Mexico’s authority to require escrow deposits on all sales that have a tribal stamp, excise stamp or an exempt stamp. Governor Martinez vetoed both bills. In 2013, similar legislation (Senate Bill 516) passed the Judiciary Committee but died in the Finance Committee.

➤ **2003 NPM Adjustment Arbitration**

- The PMs claim that they are entitled to an NPM Adjustment for every year from 2003 to the present.
- All MSA States except Montana have been ordered by their state courts to attend national arbitration to litigate the 2003 NPM Adjustment.

- The arbitration panel adjudicating the 2003 NPM Adjustment dispute heard testimony on issues common to all contested States at a hearing in April 2012. Between April 2012 and June 2013, the arbitration panel heard individual state cases.
- The panel imposed the burden of proof on the States – that is, the States must show that they “diligently enforced” their escrow statutes.
- New Mexico’s state-specific hearing was held in Chicago in March 2013. New Mexico and the PMs were each allotted eleven hours to present their cases, although the arbitration panel shortened that time slightly during the hearing. New Mexico called five fact witnesses, including current employees of Taxation and Revenue and current and former employees of the Attorney General’s Office, to establish New Mexico’s diligence in requiring NPMs to deposit escrow in 2003 for “units sold” in 2002. New Mexico also called two expert witnesses, one who testified about methodological errors in the PMs’ accounting and economics analysis, and one who testified about the basis in history, law and policy for New Mexico’s tax-exempt treatment of tobacco sales on tribal lands.
- To date the arbitration panel has not issued orders regarding New Mexico’s or any other State’s diligence. The panel has indicated that decisions will issue as early as the end of June 2013 or sometime thereafter.
- New Mexico expects the 2003 arbitration to cost about \$500,000 in litigation expenses, including travel to hearings, transcripts, expert witnesses and document production costs. The Attorney General’s Office has not received a specific allocation of funds from the Legislature for the full costs associated with these disputes.

➤ **Issues at Stake in the 2003 NPM Adjustment Arbitration**

- What is the meaning of “diligent enforcement”?;
- Will the standard take into account the volume of applicable NPM sales in each particular State, i.e. the scale of the enforcement issue?
- Will the panel accept the PMs’ argument that diligence requires performance of a mandatory checklist of actions?

- Will enforcement efforts of one State become the “gold standard” for all States?
- Will the States be able to rely on other States’ efforts or NAAG’s enforcement efforts done on behalf of all States?
- Does the term “units sold” mean what the MSA and escrow statute say it means by their plain language, or will it be reinterpreted according to the PMs’ preference?

➤ **Partial Settlement of 2003-2014 NPM Adjustment Disputes**

- In 2012, a group of seven States (not including New Mexico) and the PMs secretly negotiated a proposal to settle disputes over the NPM Adjustment for years 2003-2014. The proposal would roughly split the value of the NPM Adjustment for those years between the signing States and the PMs. The settlement would also require those States to significantly expand the scope of their enforcement obligations beyond the terms of the MSA. The heightened enforcement standards would take effect immediately.
- Specifically, the settlement would obligate signing States to require escrow deposits for virtually all tobacco sales made into the state, regardless of whether those sales were subject to state excise tax or tax-exempt. In other words, the settlement would dramatically alter the definition of “units sold,” those cigarettes or other tobacco products on which escrow is due. Such a change would require enactment of legislation similar to the bills that the Legislature passed in 2011 and 2012 which were vetoed by Governor Martinez, and the 2013 bill that the Senate considered.
- In addition to tribal sales, the settlement would also make the States responsible for requiring escrow on all sales that each State “reasonably could have known about.” Although this term is not defined in the settlement it at least suggests that cigarette sales need not be reported to be subject to escrow.
- Significantly, the settlement would not resolve the NPM Adjustment dispute permanently. Rather, signing States would obtain a partial payment of their allocable share of the

NPM Adjustment for years 2003-12, and beginning with year 2013 would be subject to a new, more onerous NPM Adjustment.

- A minority of States (about 45% as measured by Allocable Share) signed the settlement agreement with the PMs. Most of those states did so before their state-specific arbitration hearings were held.
- The Attorney General determined that the substantial new enforcement requirements imposed by the settlement agreement would place New Mexico at great risk of losing its MSA payments going forward. Thus, settlement under the terms presented was not feasible.

➤ **Illustrative Enforcement Efforts**

- The Attorney General's Office since 2003 has maintained a directory of compliant tobacco products on its web page. Since 2008 significant improvements have been made to the directory so that it is updated by this office immediately as changes are required, allowing for improved accuracy. The directory can be viewed by accessing [www.nmag.gov](http://www.nmag.gov) and then selecting "Tobacco Manufacturers Information." In addition, all of the Attorney General Office's required forms for PMs, NPMs and distributors to file are available to download from our website.
- This office continues to audit every licensed cigarette distributor's monthly report. This encompasses the audit and review of approximately 480 returns annually. From these reports we are able to determine brand, manufacturer, retailer and tax status of all compliant brands sold in New Mexico.
- It is our continued goal to provide consistent and timely responses to questions posed by distributors and manufacturers consistent with New Mexico law. We have very positive feedback from these efforts.
- Since 2003, this office has significantly reduced the number of non-compliant NPM sales made in New Mexico through distributors. (Non-compliant sales are those cigarettes that are not listed on our directory and therefore considered contraband).

- Also since 2003, the Attorney General's Office has filed 15 enforcement actions against manufacturers of non-compliant brands and has obtained judgments totaling approximately \$3.9 million. Collection is frequently impossible due to the fact that some NPMs are no longer in business and often are based in foreign countries that do not recognize judgments from courts in the United States. The Attorney General's Office has settled or is in the process of settling three of these actions.
- The Attorney General's Office has been sued by five NPMs as a result of the Attorney General demanding that those companies deposit escrow for their tribal tax-credit sales. The Attorney General's Office is also defending a suit by an NPM which sought listing on the office's directory of approved tobacco manufacturers but was rejected because the company was selling illegal product in New Mexico and has otherwise failed to comply with New Mexico's tobacco statutes and regulations.