

Update on the Tobacco Master Settlement Agreement and Its Impact on States

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Overview

In 1998, the Attorneys General of 46 states reached an agreement with the four largest U.S. tobacco companies to settle various lawsuits against the tobacco industry regarding the medical costs associated with treating tobacco-related illnesses; the four other states settled their tobacco cases separately. The agreement, known as the Tobacco Master Settlement Agreement (MSA), required the participating tobacco companies to pay approximately \$200 billion to states over the next 25 years to help cover healthcare costs associated with smoking. A number of states decided to securitize their tobacco settlement funds, meaning that states received an upfront, lump sum payment by selling bonds backed by the stream of settlement payments that would be received from tobacco companies. Recently, several issues have arisen regarding the MSA that have the potential to impact states. First, an arbitration ruling in September 2013 regarding the enforcement of tobacco laws will result in more tobacco funds for nine states, and reduced funds for six states. Secondly, concerns have been raised that future tobacco settlement payments could be lessened if tobacco consumption continues to fall. Many tobacco bonds, backed by the settlement payments, may face the possibility of default if tobacco consumption maintains its downward trend.

Background

States began to file numerous lawsuits against the tobacco industry in the 1990's. The premise behind the lawsuits was that states were facing increased Medicaid and other healthcare costs due to the harmful effects of tobacco products; additionally, it was alleged that the tobacco industry had engaged in a series of deceptive practices. Instead of defending each state lawsuit individually, major tobacco companies in the late 1990's began discussions regarding a joint settlement with the states. The discussions would eventually lead

to an agreement in 1998 known as the Tobacco Master Settlement Agreement (MSA). The MSA was agreed to by the four largest tobacco companies in the United States (Philip Morris, R.J. Reynolds, Lorillard, and Brown and Williamson) and the Attorneys General of 46 states as well as the District of Columbia, Puerto Rico, and the Virgin Islands; four states (Florida, Minnesota, Mississippi, and Texas) reached their own settlements with the tobacco industry prior to the MSA.

According to the [National Association of Attorneys General](#) (NAAG), the central purpose of the MSA was to reduce smoking, and in particular youth smoking. The agreement contained numerous restrictions on the advertising, marketing, and promotion of cigarettes. The MSA also required the four largest tobacco manufacturers to provide a large amount of funds to states to compensate for decades of healthcare costs related to treating tobacco induced illnesses. According to the [Campaign for Tobacco Free Kids](#), the MSA required the tobacco companies to pay states approximately \$195.9 billion from the time of the agreement through 2025. The payments are increased for inflation, but can be reduced if the participating tobacco companies market shares fall and/or if U.S. cigarette sales decrease. From 1998 through 2012, [states](#) received approximately \$107 billion from the tobacco industry. The MSA did not place any restrictions on how states spent the funds. In addition to spending the funds on programs designed to reduce the use of cigarettes and other tobacco products, states have spent the payments for other purposes including various healthcare programs and to help solve budget shortfalls.

Current Developments

Recent Legal Actions

On September 11, 2013, an arbitration panel issued a ruling regarding disputed funds associated with the

MSA. The MSA required states to collect escrow payments from tobacco companies that were not part of the MSA in order to help ensure that the companies that were part of the MSA did not lose market shares. The four tobacco companies that were part of the original MSA claimed that 15 states had not diligently enforced escrow requirements from tobacco companies that did not participate in the MSA and therefore did not fulfill their requirement to collect funds from these other tobacco companies. The arbitration panel ruled that nine states had enforced the requirements while six had not; several states that the arbitration panel ruled against have noted that they plan on appealing the ruling. The nine states (Colorado, Illinois, Iowa, Maine, New York, North Dakota, Ohio, Oregon, and Washington) that the arbitration panel ruled in favor of will receive disputed funds from the tobacco companies that were previously withheld. For example, it is [reported](#) that New York will receive \$92 million, Ohio \$35 million, and Washington state \$15 million. On the other hand, the six states (Indiana, Kentucky, Maryland, Missouri, New Mexico, and Pennsylvania) that the arbitration panel ruled against will receive approximately \$500 million less in MSA payments from tobacco manufacturers after they are subjected to a 50 to 60 percent reduction in the 2014 MSA payments, according to [Moody's Investors Services](#). It should be noted that the arbitration ruling only applied to states fulfilling requirements in 2003, while the question of whether states fulfilled their requirements from 2004 to 2012 is still in dispute.

Since the arbitration panel's decision, several states have spoken out regarding the ruling's impact:

- [Indiana](#) is expected to receive \$63 million less in tobacco funds in 2014. Its payments are expected to be reduced from \$131 million to \$68 million. The state can appeal the arbitration panel's ruling and a spokesman for the Indiana Attorney General noted that "legal action is likely to be taken soon." The chairman of the Senate Appropriations Committee noted that the ruling will not cause an immediate [budget](#) crisis, but that future similar rulings will likely need to be taken into consideration when negotiating future budgets. Additionally, a member of the House Ways and Means committee noted that the ruling will impact the state's ability to fund health programs.



- [Kentucky](#) anticipated receiving \$90 million in tobacco settlement funds next year, but is now uncertain how much it will receive. The executive director of the Governor's Office of Agricultural Policy reported that the state could receive anywhere from \$5 million to \$45 million next year, pending further court actions. A [spokeswoman](#) for the governor said that it remains uncertain if the settlement agreement will be reduced and that the state is formulating contingency plans.
- [Missouri](#) is expected to receive \$70 million less in tobacco funds in 2014, after having its payments reduced from \$130 million to \$60 million. The state budget director stated that "the \$35-million that comes out of those payments for early childhood programs will be safe, but some mandatory payments to Medicaid might have to come from General Revenue." The budget director also expressed concern that future rulings regarding 2004-2012 could have an impact on the budget. Following the arbitration panel's ruling, the Missouri [Department of Attorney General](#) once again called on the state legislature to pass legislation called the "Allocable Share Release", which 45 other states have previously passed. The Allocable Share Release is related to preventing non-participating manufacturers from avoiding their full escrow obligations by concentrating their sales in a few states.
- [New Mexico](#), which will receive \$39 million in tobacco payments this year, may receive up to \$25 million less next year according to their Legislative Finance Committee. The Senate Finance Committee Chairman said that he is concerned about both the reduced [payment](#) next year and the possibility of

smaller payments in subsequent years. Additionally, the [Finance and Administration Secretary](#) stated that the ruling will lead to less funding for the state lottery scholarship fund, tobacco prevention programs, cancer treatment, and early childhood intervention programs.

- [Pennsylvania](#), which annually receives approximately \$320 million in tobacco funds, may receive \$170 million less in 2014. The state budget secretary said that Pennsylvania will freeze discretionary funds from the settlement which will impact health research, uncompensated care to hospitals, and discretionary funds related to tobacco prevention and cessation programs. However, Department of Aging programs and mandated tobacco prevention programs will not be impacted. The state [Attorney General](#) also filed a motion asking for the arbitration panel's ruling to be overturned. In a statement, the Attorney General said that, "The arbitration panel's decision penalizes Pennsylvania for factors the panel clearly allowed for other states."

Tobacco Settlement Bonds

In addition to the arbitration panel's ruling regarding disputed MSA funds, another issue related to the MSA is the possibility of default of some tobacco settlement bonds. After agreeing to the MSA, a number of states decided to securitize their tobacco settlement funds. In this instance, the process of securitization entailed a state selling its right to receive future tobacco settlement payments in order to receive an up-front, lump sum payment. As a report from the [Connecticut General Assembly](#) noted, in most instances states sold their

tobacco settlement revenue stream to a separate entity established for the purpose of issuing tobacco bonds and paying the debt service on the bonds. Recently, concerns have been raised that reduced levels of smoking could impact tobacco settlement bonds. In a July 2012 report, [Moody's Investors Service](#) noted that declining rates of cigarette consumption pose a credit risk to tobacco settlements. This is mostly due to the volume adjustment component that was part of the MSA; under the agreement, cigarette companies have the ability to reduce payments if cigarette consumption falls below certain levels. In its report, Moody's found that if the decline in consumption continues at its current three to four percent pace, 74 percent of the aggregate outstanding balance of all the tobacco settlement bonds will default. It should be noted that Moody's did not predict a possible date of the defaults in its report.

Outlook

While the Tobacco Master Settlement Agreement (MSA) was reached fifteen years ago, it is important for states to continue to monitor new developments surrounding the MSA. Although the September 2013 arbitration panel's ruling only directly affected 15 states, several of those states may need to make spending adjustments and its impact could be more widespread in future rulings. The arbitration panel's ruling only applied to 2003, and payments from 2004 to 2012 are still in dispute. The possibility remains that new arbitration panels could reach a different conclusion on how states enforced the terms of the MSA. Also, states could be impacted by continued declining cigarette consumption, which may limit future healthcare costs, but also may lead to less tobacco settlement payments in the future as part of the agreed upon MSA.

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