



Tobacco Settlement Fund *The Master Settlement Agreement*

Through April 2017, Pennsylvania has received \$6.5 billion from the nation's major tobacco manufacturers since the 1998 Master Settlement Agreement between 46 states and those companies. All MSA payments are deposited into the Tobacco Settlement Fund, established by Act 77 of 2001, and are used to support health-related programs.

Pursuant to the agreement's non-participating manufacturers adjustment, tobacco companies have been withholding a portion of their payments. Recent litigation found that Pennsylvania did not diligently enforce the MSA's non-participating manufacturer provisions in 2003, resulting in a \$116 million payment reduction. The ongoing legal dispute over the adjustment may lead to reduced payments in future years.

Pennsylvania's MSA payments are annually appropriated to programs according to statutory funding formulas. The original funding formula, Act 77 of 2001, was replaced with formulas in the Fiscal Code.

This primer explains the Master Settlement Agreement, including responsibilities of the settling states, payments required of tobacco companies participating in the agreement, and litigation related to the non-participating manufacturers adjustment. A separate primer examines how Pennsylvania spends its share of the MSA payments, including a review of the statutory formula used to distribute the revenue and a description of the programs that receive funding.

MSA Overview

On Nov. 23, 1998, 46 states' attorneys general signed the Master Settlement Agreement with the nation's largest tobacco manufacturers. The four remaining states had previously settled with tobacco manufacturers in separate agreements.

The Master Settlement Agreement resolved lawsuits the attorneys general had filed against the tobacco industry, including claims to recover Medicaid costs associated with treating smoking-related illnesses, and protected the manufacturers from future state suits. In exchange, the tobacco companies agreed to make annual payments to the states in perpetuity. The companies also agreed to change their marketing and advertising practices, which were largely aimed at youth.

In addition to the original participating manufacturers, the MSA allowed other tobacco manufacturers to join the agreement. As of May 2017, 53 tobacco companies are MSA signatories and are the "participating manufacturers." Companies that have not signed the agreement are "non-participating manufacturers."

To ensure fair competition between participating and non-participating manufacturers, the MSA encourages states to enact legislation (the "qualifying statute") requiring nonparticipating manufacturers to pay a sum into an escrow account that is roughly equivalent to what they would pay had they joined the agreement.

- Pennsylvania enacted its qualifying statute, the **Tobacco Settlement Agreement Act**, in 2000. This act requires all tobacco manufacturers doing business in Pennsylvania to either become participating manufacturers in the MSA (adhering to its financial obligations) or place funds in a qualified escrow account so that non-participating manufacturers can pay future claims from suits brought by the commonwealth. The amount non-participating manufacturers must place in escrow is a per-unit fee on each cigarette sold in Pennsylvania (as measured by taxes collected by the commonwealth).
- In 2003, Gov. Rendell signed the **Tobacco Product Manufacturer Directory Act**, which provided a mechanism to strengthen the provisions in Pennsylvania’s qualifying statute. The act authorized the attorney general to publish and maintain a directory of all tobacco product manufacturers offering cigarettes for sale in Pennsylvania. To be in the directory, tobacco manufacturers must annually certify they are a participating manufacturer under the MSA or in full compliance with the Tobacco Settlement Agreement Act. Non-participating tobacco manufacturer certification must include a statement that the company executed a qualified escrow agreement approved by the attorney general and has established and continuously maintains an escrow fund.

This act made it unlawful to sell, distribute, possess or transport cigarettes of a manufacturer that is not listed in the directory. It is also unlawful for cigarette stamping agents to affix a tax stamp to cigarettes belonging to a tobacco product manufacturer or brand family that is not included in the directory. Cigarette stamping agents must report to the Department of Revenue the monthly total number of cigarettes sold by brand and make available to the department all invoices and documentation of sales of all nonparticipating manufacturers.

- In 2015, Gov. Wolf signed legislation amending the Tobacco Settlement Agreement Act and the Tobacco Product Manufacturer Directory Act to further ensure Pennsylvania is in full compliance with the MSA. Act 95 expanded the definition of “units sold” in the Tobacco Product Manufacturer Directory Act to include taxes on roll-your-own tobacco containers; this broadened the calculation for the number of individual cigarettes sold annually by the applicable tobacco product manufacturer. Similarly, Act 96 expanded the definition of “units sold” in the Tobacco Settlement Agreement Act to include taxes on roll-your-own tobacco containers and the taxes collected on cigarettes sold without a tax stamp – this served to broaden the calculation of the number of units sold annually in Pennsylvania for purposes of determining the amount non-participating manufacturers must place in escrow.

MSA Payments

The MSA requires tobacco companies to make three payments to the settling states: initial, annual and strategic contribution. These payments were originally estimated at \$205 billion through 2025 before taking into account the various allowable upward and downward adjustments. **The MSA places no restrictions or requirements on how states use their payments.**

- The original participating manufacturers were required to make five initial payments between 1998 and 2003. These “up-front” payments did not apply to subsequent participants in the agreement. The MSA committed the companies to make base (unadjusted) payments of \$12.7 billion.
- Annual payments began in 2000 and are to be made by April 15 each year in perpetuity. The base payment amounts listed in the agreement are \$3.9 billion in 2000, increasing to \$8 billion in 2018 and each year thereafter. These payments were projected to total \$183 billion through 2025.
- Ten strategic contribution payments were made each April, from 2008 through 2017, to compensate states for the time and finances invested in litigation leading to the settlement. The base amount was \$861 million per year, for a total of \$8.61 billion.

MSA payments are allocated to each state according to distribution formulas developed by the state attorneys general. The formula for distributing annual payments and initial payments is based on estimated tobacco-related Medicaid expenditures and the number of smokers in each state. The percentage allocation for each state is listed in Exhibit A of the agreement. The formula for distributing the strategic contribution payments reflects the effort made by each state toward the litigation or resolution of state tobacco lawsuits.

Table 1. MSA Payments to Settling States			
Payment Type	When Paid	Base (Unadjusted) Amount	Pennsylvania %
Annual	In perpetuity (due April 15)	\$3.940 billion in 2000 \$4.378 billion in 2001 \$5.691 billion in 2002 & 2003 \$7.004 billion in 2004-2007 \$7.143 billion in 2008-2017 \$8.004 billion in 2018 & thereafter	5.7468588%
Initial	5 payments, from 1998 through 2003	\$12.742 billion total, (amount increasing from \$2.4 billion for first payment to \$2.7 billion for final payment)	5.7468588%
Strategic Contribution	2008-2017 (due April 15)	\$8.61 billion total, (\$861 million per year)	3.2572691%

Table 1 summarizes the MSA payments to settling states, including the base payments in the agreement and Pennsylvania’s percentage share. The base payment amounts are subject to adjustments, reductions, and offsets specified in the agreement. Consequently, the exact amount a state receives in any given year is its base allocation net any adjustments, reductions and offsets.

Tobacco payments to states are affected by adjustments for inflation, cigarette sales and the change in participating manufacturers’ market share:

- **Inflation adjustment.** Annual payments are adjusted each year based on an inflation factor that is the greater of the percentage increase in the Consumer Price Index or three percent. The inflation adjustment also applied to the strategic contribution payments.
- **Volume-of-sales adjustment.** Annual payments are adjusted each year based on the number of cigarettes shipped within the United States by the participating tobacco manufacturers. Declining cigarette sales reduce payments to states, while rising sales increase the payments. This adjustment also applied to the initial payments made by tobacco companies and strategic contribution payments.
- **Non-Participating Manufacturer (NPM) adjustment.** The MSA allows participating manufacturers to reduce annual payments (as well as strategic contribution payments) to certain states when the companies lose a portion of their market share to non-participating manufacturers. The NPM adjustment may be applied to a calendar year in which three conditions are met: (1) the aggregate market share of participating manufacturers decreases more than 2 percent; (2) an independent economic consultant determines that the provisions of the MSA were a significant factor contributing to the market share loss; and (3) at least one state failed to “diligently enforce” its qualifying statute. If all three conditions are met, the adjustment is triggered and states that have not diligently enforced their qualifying statutes will have their payments reduced. In general, tobacco companies may reduce their aggregate state payments by three percent for each percent loss in market share over the two percent threshold. States that enacted qualifying statutes and diligently enforce their statutes are exempt from the NPM adjustment. **The MSA does not define what constitutes diligent enforcement.** Determination of a state’s diligence is made by an arbitration panel of three former federal judges.

Each year, PriceWaterhouseCoopers calculates the aggregate MSA payments due under the agreement, determines how the payments are allocated among the individual participating tobacco manufacturers, and authorizes the disbursement of payments to states in accordance with each states’ allocable share.

Participating manufacturers disputing a portion of their annual payments have three options to handle the disputed amounts. They can withhold the amount from their state payments, deposit the contested amount in to a disputed payments account, or pay the disputed amount to states subject to a “clawback” at some future date. States may try to regain their disputed payments by filing lawsuits in the courts or resolving the issue through arbitration.

Pennsylvania has received \$6.5 billion in payments through April 2017, and its payments have been less than the base amounts estimated in the MSA, reflecting the effect of an overall decrease in tobacco sales and the declining market share of manufacturers participating in the settlement. The combined impact of all adjustments has reduced state payments by approximately \$1.2 billion, or 15.7 percent, below the base amounts in the MSA.

Table 2 lists the yearly MSA payments received by Pennsylvania and deposited in the Tobacco Settlement Fund:

- 1999 through 2002 include the five initial payments required of the original tobacco manufacturers that signed the MSA. Pennsylvania received two payments in 2000.
- Annual payments began in 2000 and continue in perpetuity. Since 2006, tobacco companies have asserted they are entitled to the non-participating manufacturer adjustment and have been withholding a portion of their payments.¹ The increase in 2009 payments reflects \$31 million of prior year disputed payments released to Pennsylvania in 2009. The decline in 2014 payments reflects the impact of 2003 NPM litigation (discussed in the next section).
- 2008 through 2017 counted strategic contribution payments, which averaged about \$21 million annually.

NPM Litigation

The stakes are high for states failing to diligently enforce qualifying statutes that require non-participating manufacturers to make yearly escrow deposits. Under the terms of the MSA, states that diligently enforce their qualifying statutes are exempt from the NPM adjustment, leaving the non-diligent states to bear the full financial burden of the NPM penalty and risking the loss of an entire year of payments. The entire NPM penalty is allocated on a pro rata basis among the non-diligent states. The maximum penalty for any one state cannot exceed the amount of the state’s total MSA payments (the annual payment and strategic contribution payment) for that particular year.

Beginning with 2003, an independent economic consultant concluded the MSA was a “significant factor” in participating manufacturers losing market share to non-participating manufacturers. Because of this finding, participating manufacturers reduced payments to states and the withheld amounts were deposited into a disputed payments account until an arbitration panel could rule on whether states had diligently enforced their qualifying statutes. The 2003 arbitration process commenced in 2010 after a three-member panel was selected to resolve disputes over applying the NPM adjustment to reduce state payments.

In 2013, the arbitration panel ruled Pennsylvania was among six states that had not adequately enforced their qualifying statutes during 2003 and set the commonwealth’s share of the NPM penalty at \$242 million. Pennsylvania Attorney General Kathleen Kane appealed the panel’s decision to the Philadelphia County Court of Common Pleas. In 2014, the court ruled the arbitration panel had not appropriately calculated the NPM adjustment and reduced Pennsylvania’s NPM adjustment to \$116 million, recouping approximately \$126 million of the penalty ordered by the panel. The tobacco

Table 2. Pennsylvania MSA Payments

Year	Total Payments
1999	\$123,594,244
2000	\$452,285,185
2001	\$348,514,672
2002	\$410,916,875
2003	\$338,305,373
2004	\$361,264,628
2005	\$366,363,096
2006	\$335,196,245
2007	\$348,843,634
2008	\$382,002,877
2009	\$419,237,965
2010	\$349,843,211
2011	\$330,835,458
2012	\$337,362,909
2013	\$337,185,537
2014	\$203,595,041
2015	\$352,496,406
2016	\$339,110,711
2017	\$369,315,919

Source: National Association of Attorneys General

¹Because of the procedures required to complete a market analysis, a three-year lag exists between the year in which cigarette sales are made and the year in which disputed payments are withheld. For example, payments withheld in 2006 are based on the disputed amounts claimed by companies in 2003 pursuant to the NPM adjustment.

companies appealed the ruling to Commonwealth Court but the court upheld the lower court’s decision, allowing Pennsylvania to keep the \$126 million of recouped tobacco payments. The tobacco companies filed an appeal with the Pennsylvania Supreme Court challenging the Commonwealth Court decision, but the court rejected the appeal in 2015. The 2003 litigation finally ended October 2016 when the U.S. Supreme Court let the lower state court rulings stand, allowing Pennsylvania to keep the recouped money. A detailed timeline of the 2003 litigation is provided on page 6.

Participating manufacturers have continued to claim the NPM adjustment, withholding payments for 2004 and subsequent years. The potential aggregate NPM adjustments for 2004 through 2016 is \$11.1 billion. As shown in Table 3, the maximum potential adjustment exceeds \$1.1 billion for 2004, but drops significantly thereafter. The reduced size of the potential NPM adjustment reflects participating manufactures regaining some of the market share lost to non-participating manufacturers. The smaller market share losses coincide with states enacting complementary legislation that improved their qualifying statutes and facilitated enforcement of the escrow requirements for non-participating manufacturers.

The non-participating manufacturer disputes for 2004 through 2016 still need to be arbitrated. New arbitration panels will be constituted for each of these years. Pennsylvania's MSA payment will increase or decrease, at some future date, when the arbitration panels rule on the state's compliance in 2004 and each subsequent year. While the 2003 arbitration results do not create a legal precedent for the “diligence” findings of future panels, the court orders regarding the calculation of NPM penalties may be adopted by the new panels and provide some predictability. The next arbitration panel will be for 2004; its proceedings will likely take less time to complete than the 2003 proceedings.

(Dollars in Millions)

Table 3. Maximum Potential NPM Adjustments

2003	\$1,147.6	2010	\$872.5
2004	\$1,137.4	2011	\$727.7
2005	\$753.3	2012	\$797.2
2006	\$700.3	2013	\$822.3
2007	\$749.4	2014	\$825.0
2008	\$888.4	2015	\$895.5
2009	\$859.1	2016	\$901.4

Source: National Association of Attorneys General

Timeline for 2003 NPM Arbitration

The legal process for resolving the 2003 disputed payments spanned more than four years. The dispute was triggered in 2006 after an independent economic consultant concluded that, as a result of the MSA, participating tobacco manufacturers had lost market share to non-participating manufacturers.

- * In 2012, a three-member federal arbitration panel began state-specific hearings for the 35 states whose diligence in enforcing the MSA requirements during 2003 was challenged by participating manufacturers.
- * Between December 2012 and February 2013, 22 states reached a side settlement with the participating manufacturers that reduced their payments (for 2003 through 2012) and protected them from any further diligence tests through the 2012 payment year. Pennsylvania was among the 13 states that did not accept the manufacturers' settlement offer and proceeded with arbitration to determine whether it had diligently enforced the MSA.
- * In September 2013, the federal arbitration panel ruled that Pennsylvania and five other states had not adequately enforced the MSA requirements during 2003 and were subject to the NPM adjustment penalty. Pennsylvania's proportionate share of the NPM adjustment was \$242 million. In calculating the NPM adjustment for Pennsylvania, the arbitration panel treated the 22 settling states as "diligent" and divided the total adjustment only among the six losing states. Pennsylvania Attorney General Kane appealed the panel's decision, including its method for distributing the NPM adjustment, and hired outside counsel to assist.
- * In March 2014, the Philadelphia County Court of Common Pleas modified the arbiters' ruling. The court upheld the decision that Pennsylvania had not diligently enforced the MSA provisions, but also ruled that the panel had not appropriately applied the NPM adjustment when it decided to penalize only the six "non-diligent" non-settling states. Specifically, the court ruled that Pennsylvania's share of the NPM adjustment was excessive and that the 2003 NPM adjustment should have been divided among 26 states – including 20 of the 22 states that had reached a side settlement with the tobacco companies. The court ordered the tobacco companies to return more than \$120 million to Pennsylvania.
- * In April 2015, Commonwealth Court upheld the ruling that modified the arbitration panel's penalty and said the federal arbitration panel had improperly interpreted the MSA provisions when it treated the settling states as "diligent" even though they had not proved their diligence.
- * In December 2015, the Pennsylvania Supreme Court rejected an appeal by the tobacco manufacturers challenging the Commonwealth Court decision.
- * In October 2016, the United States Supreme Court refused to hear an appeal by the tobacco manufacturers; thus, letting stand the lower state court rulings.