State of Hawaii

Department of the Attorney General

REPORT ON THE STATE'S COMPLIANCE WITH THE TOBACCO MASTER SETTLEMENT AGREEMENT

Submitted to
The Twenty-Second State Legislature
Regular Session of 2004

66471_7.DOC

TABLE OF CONTENTS

INTRODUCTION

Section 70 of Act 200, Session Laws of Hawaii 2003, requires the Department of the Attorney General with the assistance and cooperation of the Department of Health to provide a detailed report to the Legislature no later than twenty days prior to the convening of the regular session of 2004 on the State's compliance with the Tobacco Master Settlement Agreement (MSA) that will include, but not be limited to, the effect on the MSA resulting from the diversion of funds in the initial allocation to the multitude of programs that are being included each year through various provisions.

In this report, discussion of the impact of the diversion of MSA funds to the multitude of programs that are being included each year through various provisions, as well as comment on any effect on the MSA itself, was prepared by the Department of Health. The parts of this report that address the on-going diligent enforcement activities designed to ensure that the State continues to receive the full measure of its MSA payments were prepared by the Department of the Attorney General.

A. Background

On November 23, 1998, leading United States tobacco manufacturers, entered into a settlement agreement, entitled the Tobacco Master Settlement Agreement (MSA), with forty-six states, including Hawaii. In consideration for a release of past, present, and certain future claims against them, the MSA obligates these manufacturers to pay substantial sums to the settling states (tied in part to the volume of tobacco product sales). The Attorney General of each state is responsible for enforcing the provisions of the MSA. The MSA places no restriction on how states spend the settlement moneys. Under the MSA, the forty-six participating states, the District of Columbia, and Puerto Rico, the Virgin Islands, and the other territories receive payments from the tobacco companies in perpetuity. These payments are subject to certain adjustments, reductions, and offsets that apply to each year's payments starting in 2000. These adjustments include an inflation adjustment, cigarette sales volume adjustment, a non-participating manufacturer (NPM) adjustment, and an adjustment for the payments to the four non-settling states amongst others.

B. State Allocation of Settlement Funds[1]

In 1999, the Legislature enacted Act 304[2] and stated in section 1 as follows:

> The purpose of this Act is to establish the Hawaii tobacco settlement special fund with the moneys received from the settlement from a class action lawsuit against the tobacco companies. The fund will serve as a medium for a public-private partnership to:

---

[1] See National Conference of State Legislatures, State Management and Allocation of Tobacco Settlement Revenue 2003, for an expanded discussion of the use of MSA payments by the various states.

[2] Codified as chapter 328L, Hawaii Revised Statutes.

(1) Reduce tobacco consumption in Hawaii;
(2) Control and prevent chronic diseases where tobacco is a risk factor;
(3) Promote healthy lifestyles through better nutrition and improved physical activity; and
(4) Promote children's health.

The fund shall serve as a mechanism to maximize financial resources for tobacco prevention and control, health promotion and disease prevention programs, children's health programs, and to serve as a long-term source of stable funding for prevention-oriented public health efforts.

An emergency and budget reserve account is established to provide the State with a financial reserve to be used when there is an emergency or economic downturn.

With this stated purpose, the 1999 Legislature established the Hawaii Tobacco Settlement Special Fund and determined that the tobacco settlement moneys were to be deposited and appropriated as follows:

- Forty percent into the Emergency and Budget Reserve Fund[3];
- Thirty-five percent to the Department of Health[4]; and
- Twenty-five percent to the Hawaii Tobacco Prevention and Control Trust Fund[5].

During the 2001 legislative regular session[6], moneys from the MSA settlement were specifically allocated for use by the Department of the Attorney General for the purpose of enforcing the MSA, chapter 675 ("Tobacco Liability Act"), Hawaii Revised Statutes ("HRS chapter 675"), and any other statutes or programs relating to the MSA. Accordingly, the Department of the Attorney General became eligible to receive up to $350,000 each fiscal year for the purpose of MSA enforcement activities.

Following the events of September 11, 2001, during the Third Special Session of the 2001 Legislature, the Legislature determined that it was necessary that the allocation of funds from the MSA be reconstituted as follows[7]:

---

3 Section 328L-3, Hawaii Revised Statutes.
4 Section 328L-4, Hawaii Revised Statutes.
5 Section 328L-5, Hawaii Revised Statutes.
6 Act 270, Session Laws of Hawaii 2001.
7 The first $350,000 of MSA payments received each fiscal year continues to be earmarked for MSA Enforcement activities by the Department of the Attorney General.

- Twenty-four and one-half percent shall be appropriated into the Emergency and Budget Reserve Fund under section 328L-3, Hawaii Revised Statutes;
- Thirty-five percent shall be appropriated to the Department for purposes of section 328L-4, Hawaii Revised Statutes;
- Twelve and one-half percent shall be appropriated into the Hawaii Tobacco Prevention and Control Trust Fund under section 328L-5, Hawaii Revised Statutes; and
- Twenty-eight percent shall be appropriated into the University revenue undertakings fund created in section 306-10, Hawaii Revised Statutes, to be applied solely to the payments of principal and interest on, and to generate required coverage, if any, for, revenue bonds issued by the Board of Regents of the University of Hawaii to finance the cost of construction of a University Health and Wellness Center, including a new medical school facility, to be situated on the Island of Oahu .

In 2003, the Legislature appropriated $50.3 million out of the Hawaii Tobacco Settlement Special Fund for allocations in fiscal year 2003-204 as required by section 328L-2(b), Hawaii Revised Statutes. This allocation mirrored the fiscal year 2002-2003 appropriations. The allocations are as follows:

- $12.4 million to the Emergency and Budget Reserve Fund.
- $6.3 million to the Tobacco Prevention and Control Trust Fund.
- $17.5 million to the Department of Health.
- $14.1 million for debt service on revenue bonds to build the University of Hawaii's new medical center.

While the basic distribution of the funds from the MSA did not change, executive and legislative actions affected the use and availability of the settlement moneys. Budget provisos directed the Department of Health to replace $10.5 million in general funds for the fiscal biennium with the same amount of tobacco settlement funds to support the Healthy Start home visit program. This supplanting of $5.3 million in fiscal year 2003-2004 and $5.2 million in fiscal year 2004-2005 has resulted in a forty-three percent budget cut for the Healthy Hawaii Initiative. A one-time appropriation in fiscal year 2002-2003 from the Hawaii Tobacco Settlement Special Fund children's health insurance sub-account to cover a general Medicaid shortfall resulted in a now perpetual shortfall for the children's health insurance programs administered by the Department of Human Services.

In addition, the Legislature repealed the exemption from administrative service fees that several special funds had enjoyed. This has resulted in a $2.5 million expense for the Hawaii Tobacco Settlement Special Fund consisting of central service expenses and pro rata departmental administrative expenses. The five percent central service fee is imposed on the entire Hawaii Tobacco

Settlement Special Fund (TSSF). The departmental administrative expense fee is assessed on all expenditures from the TSSF. Every transfer of funds from the "master" TSSF into "sub-accounts" are considered expenditures and are subject to this latter assessment.

Furthermore, $1.9 million of interest earned by the Hawaii Tobacco Settlement Special Fund was transferred to the State's general fund. Beginning in fiscal year 2005-2006, the University of Hawaii sub-account will not have sufficient cash to pay the debt service. The State's "rainy day" money is penalized by both assessments. The assessments further erode the Department of Health's ability to fund its nationally recognized prevention program, the Healthy Hawaii Initiative, bringing the Initiative's total budget cut to forty-eight percent. The assessments divert needed funds from the Hawaii Tobacco Prevention and Control Trust Fund. The aforementioned diversion of tobacco settlement money does not affect the MSA itself at this point in time. The diversions, however, do violate the intent of the MSA, and potentially invite future federal legislation directing the use of tobacco settlement funds.[8] The impact of these diversions is more fully discussed in a separate report to the Legislature by the Department of Health.[9]

B. MSA Payments[10]

MSA Payments include two types of payments:

--Initial Payments: These initial payments are payments to be received annually beginning January 10, 1999 through January 10, 2003. **The last initial payment was received on January 10, 2003.**

1999	2000	2001	2002	2003	SUBTOTAL
$15,161,138.18	$12,943,949.44	$11,659,558.77	$12,400,716.54	$12,864,378.74	$65,029,741.67

8 In May 1999, Congress moved to resolve the uncertainty over whether the federal government might lay claim to a portion of the settlement moneys as federal payments for purposes of Medicaid. In 2001 and 2003 the United States General Accounting Office issued reports to members of Congress including the Honorable John McCain, Ranking Minority Member, Committee on Commerce, Science, and Transportation U. S. Senate, the subject of which was the States' Use of Master Settlement Agreement Payments. Senator McCain has been quoted in the media as expressing his intent to hold hearings on the use of the settlement moneys as a go-to slush fund as opposed to being used for the purpose of tobacco education and treatment.

9 Section 21 of Act 200, Session Laws of Hawaii 2003, requires the Department of Health to prepare an annual report to the Legislature.

10 Beginning April 15, 2008, Hawaii will receive, in addition to the annual payment, moneys from the Strategic Contribution Fund. It is anticipated that Hawaii's share will amount to an additional $20,358,508.46 per year through April 15, 2017. This allocation was based on a formula, developed by state's attorneys general, that reflected the individual contribution made by a state toward resolution of the state lawsuits against the tobacco manufacturers. The Strategic Contribution Fund will be funded at $86.1 billion by the tobacco manufacturers.

--Annual Payments: These annual payments are payments to be received beginning April 15, 2000 and on April 15 of each year thereafter in perpetuity.

1999	2000	2001	2002	2003	SUBTOTAL
N/A	$22,115,441.28	$24,490,518.00	$31,351,126.11	$30,782,721.48	$109,802,776.29
					$174,832,571.96

C. Duties of the Attorney General and State's Tobacco Liability Act

In conjunction with the MSA, the Attorney General of Hawaii is tasked with enforcing the State's Tobacco Liability Act (TLA), HRS chapter 675.

The purpose of the TLA is to hold tobacco product manufacturers accountable for the harm caused by the sale of cigarettes to citizens of the State. As stated in the preamble to HRS chapter 675:

> It is the policy of the State that financial burdens imposed on the State by cigarette smoking be borne by tobacco product manufacturers rather than the State to the extent that such manufacturers either determine to enter into a settlement with the State or are found culpable by the courts . . . . It would be contrary to the policy of the State if tobacco product manufacturers who determine not to enter into such a settlement with the State could use a resulting cost advantage to derive large, short-term profits . . . . It is thus in the interest of the State to require that such manufacturers establish a reserve fund to guarantee a source of compensation and to prevent such manufacturers from deriving large, short-term profits and then becoming judgment-proof before liability may arise[11].

Enforcement of the MSA and HRS Chapter 675[12]

A crucial relationship exists between the MSA and the TLA. The MSA and TLA represent affirmative steps toward holding tobacco manufacturers responsible for the many financial burdens imposed on the State. HRS chapter 675 requires any tobacco product manufacturer selling cigarettes to consumers within the State (whether directly or through a distributor, retailer or similar intermediary or intermediaries) to either become a participating manufacturer and generally perform its financial obligations under the MSA or place funds into an escrow account to establish a reserve fund to guarantee a

[11] Section 675-1, Hawaii Revised Statutes.

[12] It should be noted that during the 2003 Legislative Session two pieces of legislation were introduced and passed (Act 77 and Act 177, Session Laws of Hawaii 2003) that will facilitate the Attorney General's on-going diligent enforcement efforts.

source of compensation to the State should such tobacco product manufacturers be found culpable by the courts.

With regard to the enforcement of the MSA and HRS chapter 675, the Unit has identified twenty-six non-participating manufacturers. A non-participating manufacturer (NPM) is a tobacco product manufacturer who has not entered into the tobacco master settlement agreement, whose product is being sold in the State. In order to identify such NPMs, it was necessary for the Unit to develop a system that would:

(1) Identify NPMs and their products,
(2) Gather and track information on NPM product,
(3) Notify NPMs of their obligations under HRS chapter 675. The Unit accomplished this task by mailing 670 letters to tobacco product manufacturers (worldwide) advising them of the requirements of HRS chapter 675 and related statutes.
(4) Follow through with assistance to effectuate compliance.

How was this accomplished? Armed with a list of wholesalers and distributors the Unit created a reporting form, mailed the form to the wholesalers and distributors, and started to gather information based on responses and invoices submitted to the Unit by the wholesalers and distributors. Based on the information contained in the invoices the Unit compiled a list of NPM manufacturers and cigarette brands and being sold in Hawaii. The Unit's list was supplemented by information from Alaska and other states that were willing to share their lists of NPMs and brands. In addition, the Unit will continue to actively investigate and identify brands of cigarettes that are on store shelves in an attempt to identify all of the NPMs who have cigarettes for sale in Hawaii.

Ferreting out individual manufacturers and their respective brands is a time consuming process. Once an NPM is identified as having sales within the State, a notice is sent to the NPM. When an NPM's sales data are accumulated, a formal demand is sent to the NPM for each year in which it had sales in Hawaii. One obstacle to enforcement efforts are cigarettes ordered and imported into the State by entities other than known wholesalers and distributors. For example, cigarettes are often ordered by consumers or retail stores via the Internet, phone, or by mail order. Retail inspections are the key to uncovering Internet, phone order, or mail order shipments. In conversations with storeowners the Unit has learned of another enforcement barrier: peddlers are offering cigarettes bought at military bases to merchants for resale.[13] These two types of cigarette sales are significant because the NPM sales and untaxed cigarette sales affect the amount of moneys available for disbursement under the MSA. An NPM who elects not to join the MSA and who does not comply with the escrow requirements of HRS chapter 675 enjoys a price advantage over other compliant tobacco manufacturers. This price advantage has the potential of luring consumers away, thus affecting the market share of the participating manufacturers. The sale of cigarettes by NPMs is not an academic issue. In the recent disbursement of settlement moneys the states' allocations were reduced due

---

13 In the 2001 regular session, the Attorney General successfully testified in favor of legislation that further clarified the prohibition against the resale of military cigarettes.

to an increase in NPM market share.

It should be noted that the MSA requires the State to "diligently enforce" the requirements of the "model statute" (codified as HRS chapter 675 (TLA)). Failure to "diligently enforce" the TLA may result in a state losing a significant portion of its MSA payments. "Diligent enforcement" in the context of MSA enforcement has not been clearly defined. However, we believe that "diligent enforcement" includes:

(A) Identification of the NPMs and the number of NPM cigarettes sold in the State,
(B) Notification to the NPMs of their obligations to establish and fund an escrow in accordance with HRS chapter 675, and
(C) The filing of complaints in court seeking compliance with the HRS chapter 675.

MSA Enforcement Activities[14] in Calendar Year 1999

- 1999 NPM sales totaled 3,845,053 cigarettes.

- In 1999 the Unit identified twenty NPMs who sold cigarettes in the State. Twelve of those NPMs have opened escrow accounts and two have subsequently joined the MSA. HRS chapter 675 requires NPMs selling cigarettes (directly or indirectly) to consumers within the State to either join the MSA or place funds into an escrow account to establish a reserve fund to guarantee a source of compensation to the State in the event of future claims.

- The Unit initiated lawsuits against six NPMs for NPM sales in 1999 seeking compliance with HRS chapter 675.

- Of the six NPMs who are non-compliant, three should have placed amounts in escrow of less than $75.

- While the overall NPM compliance rate for 1999 is 70 percent, the fourteen who have opened escrow accounts represent 96.3 percent of the NPM product sold in the State.

- Star Tobacco, the largest NPM, has funded an escrow account for 1999.

MSA Enforcement Activities in Calendar Year 2000

- 2000 NPM sales totaled 4,944,524 cigarettes.

---

[14] As the information becomes available the Unit continues to accumulate and update data on past and current NPM activity.

- The Unit identified twenty-six NPMs who sold cigarettes in the State. Of those twenty-six NPMs, sixteen have opened escrow accounts and one has joined the MSA.

- The Unit initiated lawsuits against eight NPMs for NPM sales in 2000 seeking compliance with HRS chapter 675.

- The Unit is working toward resolution of the issue with one NPM.

- Of the nine NPMs who are non-compliant, five should have placed in escrow amounts of less than $75.

- While the overall compliance rate for 2000 is 65 percent, the seventeen who have opened escrow accounts represent 95.6 percent of the NPM product sold in the State.

- Star Tobacco, the largest NPM, has funded an escrow account for 2000.

MSA Enforcement Activities in Calendar Year 2001

- 2001 NPM sales totaled 8,989,179 cigarettes.

- The Unit identified twenty-three NPMs who sold cigarettes in the State. Of those twenty-three NPMs, sixteen have opened escrow accounts.

- The Unit initiated lawsuits against six NPMs for NPM sales in 2001 seeking compliance with HRS chapter 675. The Unit is accumulating additional data on the remaining NPM in anticipation of litigation.

- Of the seven NPMs who are non-compliant, four should have placed in escrow an amount of less than $75.

- While the overall compliance rate for 2001 is 70 percent, the sixteen NPMs who have opened escrow accounts represent 89.3 percent of the NPM product sold in the State.

- Star Tobacco, the largest NPM, has funded an escrow account for 2001.

MSA Enforcement Activities in Calendar Year 2002

- 2002 NPM sales totaled 11,405,531 cigarettes.

- The Unit identified twenty NPMs who sold cigarettes in the State. Of those twenty NPMs thirteen have opened escrow accounts.

- The Unit initiated lawsuits against four NPMs for NPM sales in 2002 seeking compliance with HRS chapter 675. The Unit is accumulating additional data on the remaining NPMs in anticipation of litigation.

- Of the seven NPMs who are non-compliant, three should have placed in escrow an amount of less than $75.

- While the overall compliance rate for 2002 is 65 percent, the thirteen NPMs who have opened escrow accounts represent 88.5 percent of the NPM product sold in the State.

- Star Tobacco, the largest NPM, in prior years had no activity in the State for 2002.

MSA Enforcement Activities in Calendar Year 2003

- Lawsuits were filed against sixteen NPMs for prior years non-compliance with HRS chapter 675. Lawsuits were launched against cigarette manufacturers located in China, Greece, India, and Italy seeking compliance with HRS chapter 675.

- Settlement was reached with one NPM once the State initiated a lawsuit. Settlement discussions continue with other non-compliant NPMs.

- Three non-compliant NPMs joined the MSA.

- Default judgments are being sought as appropriate.

- The Unit is in the process of accumulating data on twenty NPMs.

- 441 notifications were sent worldwide notifying tobacco manufacturers and others of the certification requirements of Act 77, Session Laws of Hawaii 2003.

- The Unit created a Directory of MSA-compliant cigarettes in accordance with the requirements of Act 77, Session Laws of Hawaii 2003.

CONCLUSION

Because of the historic nature, size, and intent of the tobacco settlement the opportunities and potential for using these funds for prevention-oriented public health programs is staggering. States that have had well-funded tobacco prevention and control programs in place for ten years now provide irrefutable evidence that each dollar spent on prevention yields a three dollar savings in health care costs.[15] As a result of the State's economic struggles, tough budgetary decisions have been made, resulting in MSA funds being diverted from a variety of programs to cover budget shortfalls. As the Legislature seeks funding for on-going and new programs one can expect an increasing demand to use MSA funds to shore up shortages in revenue and to minimize the effects of budget cuts. What cannot be lost in dealing with these very important issues is that tobacco settlement money is "soft" money, and its continued availability is not guaranteed by the MSA. Experience has shown us that MSA revenue to the State has been twelve percent to fifteen percent below projections. Finally, significantly less MSA settlement money will be available in 2004 simply because there will no longer be a payment in January from the tobacco manufacturers.

---

[15] See Campaign for Tobacco-Free Kids Fact Sheet *Comprehensive Statewide Tobacco Prevention Programs Save Money* (January 16, 2003), and other related fact sheets.