

FINAL STATEMENT OF REASONS
(Update of Initial Statement of Reasons)

**NON-PARTICIPATING TOBACCO MANUFACTURERS
RESERVE FUND REGULATIONS**

I.
General Purpose of Regulations

On November 23, 1998, leading United States tobacco product manufacturers entered into a settlement agreement, entitled the Master Settlement Agreement (MSA), with the state through the California Attorney General. Under the MSA, the States, including California, released the participating tobacco manufacturers from all claims by the States for past conduct based on the sale, use, and marketing of tobacco products. They also released future monetary claims arising out of exposure to tobacco products, including future claims for reimbursement of healthcare costs allegedly associated with the use of or exposure to tobacco products.

In return, the Master Settlement Agreement obligates these tobacco product manufacturers to pay substantial sums “in perpetuity” to the State (tied in part to their volume of sales) and to significant conduct restrictions. Among the conduct restrictions are agreements (1) to refrain from targeting youth in the advertising and marketing of tobacco products; (2) to refrain from using cartoon characters to promote cigarette sales; (3) to limit tobacco brand-name sponsorships of athletic and other events; (4) to refrain from lobbying Congress to preempt or diminish the States’ rights under the MSA or to advocate that settlement proceeds under the MSA be used for programs other than those related to tobacco or health; (5) to dissolve the Tobacco Institute, the Council for Tobacco Research, and the Center for Indoor Air Research; and (6) to refrain from suppressing research relating to smoking and health and misrepresenting the dangers of using products.

The MSA permits other tobacco companies to participate in the benefits of the agreement as “Subsequent Participating Manufacturers.” If a subsequent Participating Manufacturer joined the MSA within 90 days of November 23, 1998, it is not required to make any payments under the Master Settlement Agreement unless its share of the national cigarette market exceeds the greater of its 1998 market share or 125% of its 1997 market share. Any payments that would be required would be tied to the Subsequent Participating Manufacturers’ share if the market.

As provided in the MSA, the Attorney General recommended, and the California Legislature adopted reserve fund requirements for tobacco product manufacturers which determine not to participate in the MSA (Calif. Health & Saf. Code, §§ 104555 - 104557). The reserve fund is to be used to pay any judgment or settlement in a lawsuit brought by the State of California to recover on a claim (of the kind released in the MSA) against a nonparticipating manufacturer. Otherwise, the escrow funds are returned to the nonparticipating manufacturer either annually to the extent that they exceed what the manufacturer would have paid had it participated in the MSA or completely after 25 years. In the interim, all interest earned on the reserve fund is paid to the manufacturer (Health & Saf. Code, § 104557(b)). In short, as stated in the statute, the Legislature intended to ensure that the State of California will be able to recover healthcare costs from a tobacco product manufacturer regardless of whether the manufacturer has signed onto the MSA. Health and Safety Code sections 104555 through 104557 essentially requires tobacco product manufacturers to provide a surety bond against future liability for tobacco-smoking related healthcare costs. This surety bond is imposed upon manufacturers which choose to avoid the conduct restrictions that would apply if they sign the MSA. Government Code sections 11110 - 11113 require the Attorney General to adopt regulations to provide forms for surety bonds, which are approved by the Attorney General as conforming with applicable law.

As recommended by the Attorney General, the Legislature determined, among other things, that it would be contrary to the policy of the State if tobacco product manufacturers which do not participate in the MSA and therefore do not obligate themselves to the MSA's payments and conduct restrictions, could use the resulting cost advantage to derive large, short-term profits in the years before liability may arise without ensuring that the State will have an eventual source of recovery from them. The Legislature also intended to prevent the unfair competition that would occur if some tobacco product manufacturers were avoided the costs of making settlement payments under the MSA to the disadvantage of tobacco product manufacturers that signed the MSA. The Legislature determined that it is in the interest of the state to require that these non-participating manufacturers establish a reserve fund to guarantee a source of recovery and to prevent those manufacturers from becoming judgment proof before liability may arise. As explained above, the reserve fund requirements operate essentially as a surety bond for the State of California for those future

liabilities. Health and Safety Code section 104557(c) authorizes the Attorney General to enforce compliance with Health and Safety Code sections 104555 through 104557. Government Code section 11110 - 11113 requires the Attorney General to adopt regulations to provide forms for surety bonds, which are approved by the Attorney General as conforming with applicable law. Consequently, Health and Safety Code section 104557 and Article 5, section 13 of the California Constitution and Government Code section 11110 - 11113 authorize the Attorney General to adopt regulations to make uniform and ensure adequate compliance with Health and Safety Code sections 10455 through 104557.

Health and Safety Code sections 10455 through 104557 provide that non-participating tobacco product manufacturers must establish reserve funds based upon their volume of cigarette sales in California. The reserve funds are to be deposited into escrow accounts. Every April 30th, the non-participating manufacturers must certify compliance with the reserve fund requirements to the Attorney General. The Attorney General is authorized to enforce compliance by non-participating tobacco product manufacturers with the reserve fund requirements. The primary purpose of the proposed regulations is to provide tobacco product manufacturers clear definitions, instructions, guidance and forms to comply with the requirement to establish a reserve fund for future tobacco-related illnesses and other potential liabilities. The regulations define the tobacco products that are subject to the reserve fund requirements, the confirmation of compliance and the reporting required, to allow monitoring and enforcement of compliance, the certification of compliance required along with the certification form, and the required escrow agreement terms, along with the agreement form. The proposed regulations are intended to make specific and clear what is required by Health and Safety Code sections 104555 through 104557 and to assist non-participating tobacco product manufacturers in complying with the reserve fund requirements and thereby prevent unfair competition by manufacturers which do not establish the required reserve fund, or join the MSA.

II.

Specific Purpose of Each Regulation

1. Proposed section 999.10.a explains the scope and purpose of the regulations. Proposed section 999.10b implements Health and Safety Code sections 104555 through 104557 by specifying

that a “cigarette” means the products described in section 104556(d) which are subject to the reserve fund requirements that require certification of compliance to the Attorney General, that “units sold” has the meaning based upon sections 104556(d) and (j), and that definitions for “distributor” (Rev. & Tax. Code, § 3011) and “wholesaler” (Rev. & Tax. Code, § 3016) are those in the specified sections of the Revenue and Taxation Code. In response to comments from members of the directly affected public, a definition of Non-participating tobacco product manufacturer has been added to clarify which companies are subject to the regulations. Also in response to comments, a definition of “Original participating manufacturer” has been added to explicate the formula provided in section 999.14.d.

Proposed section 999.10.c specifies the confirmation of compliance and the reporting required of tobacco product manufacturers, distributors and wholesalers to allow monitoring and enforcement of compliance to prevent unfair competition by manufacturers which fail to establish the required reserve fund. In response to comments from the affected public, section 999.10c has been revised to no longer require wholesalers and distributors to request written confirmation of compliance for every order or purchase of cigarettes. Instead, the tobacco product manufacturer is now required to provide written confirmation of compliance to wholesalers or distributors (section 999.10c(1) and (3)). Wholesalers and distributors are required only to request written confirmation of compliance by exception, that is, when the tobacco product manufacturer fails to provide it (section 999.10c(3)). Section 999.10c(3) not only serves the purpose of ensuring compliance with the statute, it also prevents non-complying tobacco product manufacturers from unfairly competing with manufacturers which make the reserve fund escrow deposits required by the statute. Finally, by this minimal monitoring for compliance by NPMs, wholesalers and distributors also protect themselves from suffering financial losses from purchasing or accepting orders for brands that are banned from sale in California by court order because the NPM did not comply with the NPM statute.

Finally, also in response to comments, section 999.10c has been amended to provide, in subparagraph (2), a new form [Acknowledgment of Receipt and Review of the Statute and Implementing Regulations form (form TOB.AOR-1) (“Acknowledgment of Receipt and Review form”)] to confirm compliance for a tobacco product manufacturer which is new to California. The

manufacturer must file the Acknowledgment of Receipt and Review form with the Attorney General. The endorsed copy of the Acknowledgment of Receipt and Review form constitutes the required written confirmation of compliance during the first year of sales in California.

2. Proposed section 999.11 specifies the certificate of compliance form which is to be used uniformly by non-participating tobacco product manufacturers, unless the manufacturer obtains the prior written approval of the Attorney General.

3. Proposed section 999.12 specifies the conditions for escrow agreements which are uniformly required of non-participating tobacco product manufacturers. This section is unchanged and remains as originally noticed to the public.

4. Proposed section 999.13 specifies the escrow agreement form to be used by non-participating tobacco product manufacturers, unless the manufacturer obtains the prior written approval of the Attorney General. In response to comments by the affected public, the original requirement in 999.13(3) that disputes be determined by the Independent Auditor appointed under the MSA has been deleted. Section 999.13 (3) now specifies that disputes are to be determined by a court of competent jurisdiction. The Escrow Agreement form, including sections 3, 4 and 5, has been amended to clarify some provisions and to be consistent with a model agreement developed by the National Association of Attorneys General. The new form includes new definitions for “Account,” “NPM Statutes,” and “Excess Amount,” which clarifies the directions for the Escrow Agent. Section 3(h) is clarified to specify that copies of the original notice, the escrow agreement, any instructions, and the amount of deposit are to be provided to the Attorney General and also to the Board of Equalization. Section 5 is clarified to specify that the Escrow Agent shall comply with instructions, if any, of only the Company with regard to investment of funds.

Finally, also in response to comments from the affected public, the escrow agreement has been modified to allow for release of escrow funds when the NPM signs the MSA and becomes a participating manufacturer. While the NPM statute does not authorize refunds or credits for overpayments that occurred because the NPM signs the MSA, a manufacturer which signs the MSA is no longer an NPM subject to the NPM statute. Moreover, in certain circumstances the MSA requires a company that becomes a subsequent participating manufacturer to make up their MSA payments. The release of the deposited funds to make up their MSA payments is consistent with the

legislative intent to prevent unfair competition through the NPM statute. By enacting the NPM statute, the legislature intended to create a level playing field for all tobacco product manufacturers selling tobacco products in California. The NPM statute requires tobacco product manufacturers either to become a participating manufacturer by signing the MSA and making payments under the MSA, or to make escrow deposits of approximately equivalent amounts as an NPM; Health and Safety Code section 104557(b)(2) provides that the escrow deposits of a non-participating manufacturer are to be no greater than the state's allocable share of the total payments that the NPM would have been required to make in that year under the MSA, had it been a participating manufacturer.

5. In response to comments, a new provision, section 999.14, has been added to provide a process and procedural guidelines for escrow release requests authorized in Health and Safety Code section 104557(b).

III.

Technical Studies Relied Upon

The Attorney General did not rely upon any technical, theoretical or empirical study, report or other similar document in proposing these regulations.

IV.

Alternatives to the Proposed Regulations

The Attorney General is authorized to enforce compliance by non-participating tobacco product manufacturers with the reserve fund requirements. Adoption of regulations to implement these requirements is necessary to specify uniform procedures and forms for establishment essentially of a "surety bond" against future liability for cigarette-smoking related healthcare costs. It is also necessary to make specific and clear what is deemed compliance by the Attorney General and to ensure adequate monitoring of compliance with the reserve fund requirements. In addition to providing clarity, the proposed regulations serve to make compliance easier and less costly for non-participating tobacco product manufacturers by specifying what is required and providing the necessary forms for their use. These regulations not only serve the purpose of ensuring compliance with the statute, they also prevent non-complying tobacco product manufacturers from unfairly competing with manufacturers who make the escrow deposits to create the reserve fund required by

the statute. Finally, by requiring written confirmation of compliance by NPMs to wholesalers and distributors, these regulations protect wholesalers and distributors from financial losses associated with purchasing or accepting orders for brands that are banned from sale in California by court order because the NPM did not comply with the NPM statute. There is no feasible alternative to the adoption of regulations to achieve these goals.

V.

Economic Impact on Business

Except as required by the Legislature in Health and Safety Code sections 104555-104557, these proposed regulations do not have any cost impact on non-participating tobacco product manufacturers.
