

STORAGE NAME: h1721s1.fs

DATE: April 3, 2000

**HOUSE OF REPRESENTATIVES
COMMITTEE ON
FINANCIAL SERVICES
ANALYSIS**

BILL #: CS/HB 1721

RELATING TO: Tobacco settlement proceeds

SPONSOR(S): Committee on Financial Services and Representative Lacasa

TIED BILL(S):

ORIGINATING COMMITTEE(S)/COMMITTEE(S) OF REFERENCE:

- (1) FINANCIAL SERVICES YEAS 10 NAYS 0
 - (2) GOVERNMENTAL RULES AND REGULATIONS
 - (3) FINANCE AND TAXATION
 - (4) GENERAL APPROPRIATIONS
 - (5)
-

I. SUMMARY:

In February, 1995, the State of Florida commenced a legal action against various tobacco manufacturers and other defendants, asserting various claims for monetary and injunctive relief on behalf of the State of Florida. On August 25, 1997, the State of Florida entered into a settlement agreement with several of the tobacco companies: Phillip Morris, Reynolds Tobacco, B&W American Brands, and Lorillard (the "Big Four").

To insure against the possibility of decreases in settlement payments due to adjustments for inflation, decreases in cigarette consumption, or tobacco company bankruptcy, the bill establishes the general authority and the legal structure under which the state may securitize the proceeds from the tobacco settlement. The bill creates the Tobacco Settlement Finance Corporation, a non-profit, public-benefits corporation, for the purpose of purchasing the state's rights, interest and title to future tobacco settlement payments. The corporation would be authorized to sell bonds, the principal and interest on which would be paid from tobacco settlement payments. The rate of interest on the bonds would be capped at 12 percent, and the bonds would not be deemed a debt or obligation of the state. Proceeds of the securitization would be deposited directly into the Lawton Chiles Endowment Fund.

The corporation would be governed by a board consisting of the Governor, the Treasurer, the Comptroller, and the Attorney General (or designees), until January 7, 2003, at which time the board would include the Chief Financial Officer or its designee, in place of the Treasurer and the Comptroller. The executive director of the State Board of Administration would serve as the chief executive officer of the corporation.

The Department of Banking and Finance would be authorized to act on behalf of the state to assist the corporation in the execution of its responsibilities, and would represent the state in signing all legal documents necessary to implement the financing.

Economic & Demographic Research stated that the fiscal impact of this bill is indeterminate and any future projection will depend on myriad factors, including the amount of the future settlement payments, the size of the bond issue and the structure of the bond securitization.

II. SUBSTANTIVE ANALYSIS:

A. DOES THE BILL SUPPORT THE FOLLOWING PRINCIPLES:

- 1. Less Government Yes No N/A
- 2. Lower Taxes Yes No N/A
- 3. Individual Freedom Yes No N/A
- 4. Personal Responsibility Yes No N/A
- 5. Family Empowerment Yes No N/A

B. PRESENT SITUATION:

In February, 1995, the State of Florida commenced a legal action against various tobacco manufacturers and other defendants, asserting various claims for monetary and injunctive relief on behalf of the State of Florida. On August 25, 1997, the State of Florida entered into a settlement agreement with several of the tobacco companies: Phillip Morris, Reynolds Tobacco, B&W American Brands, and Lorillard (the "Big Four"). These cigarette producers currently hold a market share of roughly 93 percent in the country. The remaining seven percent of market share is shared by various, smaller producers but they were not named in the state's suit as defendants and were, therefore, not parties to the settlement.

The tobacco settlement - financial obligations

The settlement documents (as amended)¹ clearly outline the Big Four's financial obligations to the state of Florida. Apart from other first year payments, Florida is to receive 5.5 percent of the following *unadjusted* amounts, in perpetuity:

<u>Year</u>	1999	2000	2001	2002	2003	thereafter
<u>Amount</u>	\$4.5B	\$5B	\$6.5B	\$6.5B	\$8B	\$8B

Currently, tobacco proceeds are placed in the Lawton Chiles Endowment Fund (the "endowment"), which was legislatively created in 1999. The fund is administered by the State Board of Administration. Portions of the non-recurring moneys received pursuant to the settlement are required to be deposited into this fund, and monies will be disbursed to tobacco funds in various departments depending on appropriations made by law. The State Board of Administration invests monies in the endowment in order to maximize rate of return earned by the state. Section 215.5601, F.S. Funds from the endowment will not be available for disbursement to state agencies until after July 1, 2000.

¹Florida negotiated a "Most Favored Nations" clause in the settlement which provided the state with additional monies for a period of time after Minnesota settled with the defendants on terms more favorable than Florida's.

After Florida's settlement, the Big Four settled lawsuits with Texas, Mississippi, and Minnesota (collectively, estimated to be worth between \$25 billion to \$40 billion over the next 25 years), and they (along with the other producers who hold the other seven percent market share) have settled with the remaining states in what has been termed the "Master Settlement Agreement" or "MSA". The unadjusted cost of the state settlements ranges between \$212 billion to \$246 billion over the next 25 years. The range is rather broad because these amounts are subject to numerous adjustments, from inflation to fluctuations in cigarette consumption and market share, therefore, the amount may increase due to inflation but may decrease if cigarette consumption decreases markedly. Other factors that may affect cigarette consumption includes general population growth, cigarette price increases, changes in disposable income, youth consumption, health warnings, smoking bans in public places, nicotine dependence, advertising restrictions, and smoking trends over time.²

Legal issues and conflicting signals

Notwithstanding the restrictions and covenants negotiated in the various settlements, a sharply divided U.S. Supreme Court ruled March 21, 2000, that the Food and Drug Administration lacks the power to regulate tobacco products. The 5-4 opinion states that the FDA overstepped its authority in 1996, when it issued unprecedented, sweeping regulations involving cigarettes and smokeless tobacco. The tobacco companies anticipate federal legislation introduced in 2001, that would shift jurisdiction for tobacco from Congress to the FDA.

According to information posted on R. J. Reynolds' website the states will be provided with up to \$246 billion over the next 25 years which can be used to design local solutions to address underage smoking and to enforce the settlement's new rules and restrictions on cigarette marketing.³ The Philip Morris website declares that

"...cigarettes are a legal product that many adults enjoy, notwithstanding the serious health issues surrounding smoking. Although it is appropriate for governments and health authorities to *encourage* people to avoid risky behaviors, we don't believe that they should *prohibit* adults from choosing to smoke. The decision as to whether or not to smoke should be left to individual adults (emphasis theirs)."⁴

Despite the MSA (or perhaps because of it) and other settlements' requirements to educate about the dangers of smoking, tobacco companies are still active in recruiting. According to a Chicago PRNewswire story dated March 24, 2000, Philip Morris recently launched a \$40 million advertising campaign called "Find your Voice" which portrays smoking as an alluring act of personal choice and is geared specifically towards women whose ethnicity is

²For instance, according to a report prepared by WEFA, Inc. (an international econometric and consulting firm), on behalf of the Westchester Tobacco Asset Securitization Corporation, dated December 15, 1999, adult consumption of cigarettes declined 0.65% annually for the period 1965 to 1981, 3.31% for the period 1981 to 1990, and 2.47% for the period 1991 to 1998. According to these trends, consumption could decline from the roughly 530 million cigarettes consumed in 1990, to under 200 million cigarettes for the year 2040.

³<http://www.rjrt.com/common/pages/IndexDefault.asp>

⁴http://www.philipmorris.com/tobacco_bus/tobacco_issues/index.html

Latina, African American and Asian American, which reportedly is a largely untapped demographic for smoking.

What the tobacco companies (and the settling state governments) cannot factor in at this time is the estimated cost of dozens of individual suits and one certified class action (*Engle v. R.J. Reynolds, et. al.*, in Dade County, Florida) that are currently pending around the country.⁵ While the tobacco settlement payments are to be made in perpetuity, there is concern by some that the companies may someday declare bankruptcy and default on their obligations.

Viability of the tobacco companies and the threat of bankruptcy

In a story dated March 26, 2000, the Associated Press reported that the National Association of Attorneys General retained a Los Angeles bankruptcy law firm to insure states receive a combined \$246 billion in tobacco settlements. According to the story, the nation's five biggest cigarette makers owe about \$10 billion this year, and also face a potentially record-setting punitive damages award in the *Engle* trial, which could wrap up as early as the first week in April. The tobacco industry fears an estimated 500,000 sick Florida smokers may be awarded \$300 billion.

According to comments by Salomon Smith Barney, tobacco industry credit fundamentals make bankruptcy of a major manufacturer unlikely due to the significant domestic demand for the addictive product, the profitability of the industry, and the ability of the industry to pass additional costs to consumers in the form of higher prices.⁶ In fact, in a series of scenarios presented by WEFA included within the SSB materials projected an industry settlement three times the size of the MSA (approximately \$700 billion) resulting in a cigarette price increase of more than 50 percent causing a consumption decline of more than 14 percent. WEFA concluded that even in those "extreme and unlikely conditions" consumption is still projected to generate sufficient tobacco settlement revenues to meet the planned principal amortization schedule. While it appears that the industry could shoulder a tremendous hit that is amortized and payed out over time, it is unknown how the industry would react to a \$300 billion jury award that was upheld on appeal and immediately payable.

Securitization of tobacco settlement proceeds

To hedge against the uncertain continuation of tobacco settlement payments as a result of a vagarious marketplace, ongoing litigation, and potential bankruptcies, New York securitized portions of tobacco settlement proceeds by issuing bonds through non-profit corporations three times, to date, with a fourth offering in the beginning stages. In New York, Medicaid payments are split equally between the state and its counties so the Master Settlement divided New York state's settlement "share" between the state and other political subdivisions, and then again according to population and medical reimbursement. New York City had pursued its own lawsuit against the tobacco companies so it, too, was included within the settlement for New York state.

⁵For instance, in early 1999, Philip Morris lost a case in California for \$51.5 million (including punitive damages of \$50 million) and a case in Oregon for \$80.3 million (including punitive damages of \$79.5 million). The punitive damages awards in those cases have been reduced to \$26.5 million and \$32 million, respectively, and are on appeal.

⁶Opinions in Tobacco Settlement Securitization, dated February 29, 2000, page 19.

The separate offerings were issued for Nassau County, Westchester County, and New York City. A fourth, for Erie County, is in the beginning stages. For New York City (offering \$709 million) and Nassau County (offering \$295 million), the non-profit corporations were set up according to New York's existing corporation statutes. For Westchester County (offering \$104 million), an existing law authorizing a non-profit corporation and subsidiaries to own and operate the Westchester Medical Center was used as general authority to proceed with bonding.

Committee staff communicated with the transaction counsel for the Westchester County offering⁷ who provided some insight into the time spent (over one year, beginning immediately after the Master Settlement was reached and signed) structuring the bond issue so that it was finally approved with a favorable rating by the bond rating agencies. According to counsel, the offering was structured similarly to a securitization of receivables from credit card accounts or mortgages, and was very successful. Counsel also opined that there is a market for these securities at this time, but the situation could change if more and more political subdivisions securitize their settlement funds, and/or if the tobacco companies take a major "hit" in a pending lawsuit, like *Engle*.

According to Bank of America, a proponent of securitization, other states considering this option include Alabama, Alaska, Colorado, Illinois, Indiana, Louisiana, Maine, New Mexico, Ohio, Oklahoma, South Carolina and Virginia. Salomon Smith Barney, another proponent, reports that the majority of states are interested and/or open to securitization, while Washington, Idaho, Montana, Wyoming, North Dakota, Minnesota, Indiana, Michigan, West Virginia, Maryland, New Hampshire, Maine and Mississippi are not interested.

Advantages and disadvantages of securitization

Generally, the advantages of securitization include transferring the risks associated with the receipt of future settlement payments to bond investors, and generating a large, up-front cash payment for a permanent trust fund or for new capital programs.

The disadvantages to securitization include having to discount the stream of future payments, and the implications for the state if there is a default on any bonds. Even though the bonding issues are not backed by the full faith and credit of the state, the bonds are still associated with the state, which creates a policy issue in the event of a default. This may have major implications for Florida because the Governmental Accounting Standards Board (GASB)⁸ requires that bonds of this type offered in the structure proposed by this bill must be reported as a "blended component unit" of the state and as a bond payable in the Annual Financial Report.

C. EFFECT OF PROPOSED CHANGES:

The bill establishes the general authority and the legal structure under which the state may securitize the proceeds from the tobacco settlement. The bill creates the Tobacco Settlement Finance Corporation, a non-profit, public-benefits corporation, for the purpose of purchasing the state's rights, interest and title to future tobacco settlement payments. The corporation would be authorized to sell bonds, the principal and interest on which would be

⁷Hawkins, Delafield & Wood, New York, New York.

⁸The GASB is a group of private CPAs that standardized bond reporting requirements for states and municipalities, adherence to which provides consistency and comfort to investors.

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paid from tobacco settlement payments. The rate of interest on the bonds would be capped at 12 percent, and the bonds would not be deemed a debt or obligation of the state.

The department is authorized to act on behalf of the state to assist the corporation in the execution of its responsibilities, and would represent the state in signing all legal documents necessary to implement the financing.

Proceeds of the securitization shall be deposited directly into the Lawton Chiles Endowment Fund.

See, Part II.D., SECTION BY SECTION ANALYSIS, for more detail.

D. SECTION-BY-SECTION ANALYSIS:

Section 1. Provides language for legislative intent.

Section 2. Creates s. 215.5600, F.S., providing definitions. This section also establishes the Tobacco Settlement Finance Corporation, a non-profit, public-benefits entity separate from the state. The purpose of the corporation is to purchase from the state its right, title and interest in and to any or all of the tobacco settlement agreement payments and will sell securities backed by the settlement payments. The proceeds from the bond sale will be used to pay the purchase price for the right to the payments. The rate of interest on the bonds would be capped at 12 percent.

The corporation will be governed by a board consisting of the Governor, the Treasurer, the Comptroller, and the Attorney General (or designees), until January 7, 2003, at which time the board will include the Chief Financial Officer or its designee, in place of the Treasurer and the Comptroller. The executive director of the State Board of Administration (SBA) will serve as the chief executive officer of the corporation. The board members cannot be sued for any actions taken by them in the performance of their duties under the act. The corporation may elect, appoint, or employ such officers, agents, or employees as the corporation deems advisable. The officers, agents, or employees may be officers, agents, or employees of the state, as was done for the Inland Protection Financing Corporation (ss. 376.3071, 376.3075, F.S.), and the Investment Fraud Restoration Financing Corporation (ss. 5217.1203, 517.1204, F.S.).

The corporation will be exempt from state and local taxation, and will not be deemed a special district for purposes of Chapter 189, F.S. (Special Districts), or a unit of government under Part III of Chapter 218, F.S. (Financial Matters Pertaining to Political Subdivisions). Neither the corporation, the purchase agreements entered into by the corporation, nor the bonds issued by the corporation, shall be subject to Chapter 120, F.S. (The Administrative Procedures Act), Part I of Chapter 287, F.S. (Procurement of Commodities, Insurance or Contractual Services), and ss. 215.57 through 215.83, F.S. (The State Bond Act within Chapter 215 - Financial Matters General Provisions). The corporation is authorized to validate any bonds issued pursuant to this act as provided by Chapter 75, F. S. The corporation may contract with the SBA to serve as trustee with respect to bonds issued, invest proceeds, or perform any other duty for the corporation as contracted. The Auditor General is authorized to conduct financial audits of the accounts and records of the corporation. The corporation would be required to use a competitive bidding process consistent with the rules adopted pursuant to the State Bond Act for the selection of service providers and underwriters.

The bonds are not to be construed in any manner as an obligation of the state or any of its agencies. The bonds can only be secured by payments received under the tobacco settlement agreement, and the corporation does not have the power to pledge the credit, the general revenues, or the taxing power of the state or of any political subdivision. The corporation is prohibited from filing for voluntary bankruptcy as long as it has outstanding obligations, however, if the tobacco payments stop for any reason and the bonds go into default the state will not be held accountable to the bondholders. The state does covenant, however, that it will do no thing to impair the creditworthiness of those securities. The bonds that the corporation is authorized to issue are not to exceed a term of 40 years.

The Department of Banking and Finance is authorized, on behalf of the state, to assist the corporation in the execution of its responsibilities, including entering into one or more purchase agreements to sell to the corporation any or all of the state's right, title and interest in and to the tobacco settlement agreement. The department is authorized to covenant to take whatever actions on behalf of the corporation or holders of the bonds to enforce the provisions of the tobacco settlement agreement, and any remedies or rights thereunder. This language, suggested by the Division of Bond Finance, is to help secure a beneficial rate from the bond rating agencies who look favorably on provisions which allow a proxy (in this case the department) to enforce the agreement. The state, although it has sold its rights, still has a compelling interest in the bond residuals to keep the payments forthcoming.

Section 3 amends s. 17.41, F.S., conforming it to the changes in light of section 2, above, and clarifying that monies received by the state pursuant to any *residual* interest retained in the tobacco settlement are to be deposited in the clearing trust fund. However, *proceeds* of the sale of the state's right to tobacco settlement payments are to be deposited directly into the Lawton Chiles Endowment Fund. The administrative requirement that the State Board of Administration serve as cash manager for the clearing fund is removed.

Section 4 amends s. 215.5601, F.S., conforming it to the changes in light of section 2, above, and changes references to future appropriations to the Lawton Chiles Endowment Fund so that the endowment will receive *at least* \$200 million per year, for three years beginning in fiscal year 2000-2001. Current law states that the fund shall receive \$200 million for those fiscal years.

Section 5. Provides this bill will take effect upon becoming a law.

III. FISCAL ANALYSIS & ECONOMIC IMPACT STATEMENT:

A. FISCAL IMPACT ON STATE GOVERNMENT:

1. Revenues:

According to Economic & Demographic Research the fiscal impact of this bill is indeterminate and will depend on the amount of the future settlement payments, the size of the bond issue and the structure of the bond securitization.

2. Expenditures:

See, Part III.A.1., above.

B. FISCAL IMPACT ON LOCAL GOVERNMENTS:

1. Revenues:

See, Part III.A.1., above.

2. Expenditures:

See, Part III.A.1., above.

C. DIRECT ECONOMIC IMPACT ON PRIVATE SECTOR:

The impact is indeterminate, and depends on the amount of the future settlement payments, the size of the bond issue and the structure of the bond securitization.

D. FISCAL COMMENTS:

N/A

IV. CONSEQUENCES OF ARTICLE VII, SECTION 18 OF THE FLORIDA CONSTITUTION:

A. APPLICABILITY OF THE MANDATES PROVISION:

This bill does not require counties or municipalities to spend funds or to take an action requiring the expenditure of funds.

B. REDUCTION OF REVENUE RAISING AUTHORITY:

The bill will not reduce the authority of counties and municipalities to raise revenues.

C. REDUCTION OF STATE TAX SHARED WITH COUNTIES AND MUNICIPALITIES:

This bill will not reduce the total aggregate percentage of a state tax shared with counties and municipalities to below February 1, 1989 levels.

V. COMMENTS:

A. CONSTITUTIONAL ISSUES:

The bonds would not be a debt or obligation of the state. If, after the securitization process, the tobacco payments stopped for any reason the bonds would simply go into default and there would be no recourse against the state by bond holders.

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B. RULE-MAKING AUTHORITY:

None is authorized under the bill.

C. OTHER COMMENTS:

None.

VI. AMENDMENTS OR COMMITTEE SUBSTITUTE CHANGES:

On April 3, 2000, the Committee on Financial Services adopted five amendments offered by the bill's sponsor, who requested the bill be made into a committee substitute. The original bill differs from the committee substitute in that the committee substitute version:

- Caps the maximum interest rate for the bonds at 12 percent;
- Replaces a broad exemption of the corporation from Chapter 215, F.S., with a narrowly defined exemption to include the provisions of the State Bond Act only;
- Requires that selection of certain professional service providers be made in a manner consistent with rules of the State Bond Act, through a competitive bidding process;
- Clarifies that the Auditor General may perform audits as deemed appropriate; and
- Authorizes the department to covenant to take whatever actions are necessary on behalf of the corporation or holders of the bonds issued by the corporation to enforce the provisions of the tobacco settlement agreement.

VII. SIGNATURES:

COMMITTEE ON FINANCIAL SERVICES:

Prepared by:

Staff Director:

Michael A. Kliner

Susan F. Cutchins