

Certification and Escrow Requirements Associated With the Tobacco Master Settlement Agreement



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Kentucky Legislative Research Commission

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Foreword

The General Assembly during the 2009 Regular Session enacted Senate Bill 48 that instructed staff of the Legislative Research Commission to review the certification and escrow process associated with the Tobacco Master Settlement Agreement. The bill also instructed staff to review the related impacts on participating manufacturers, nonparticipating manufacturers, stamping agents, distributors, and retailers.

As part of the study, staff collected and analyzed data and reports from a number of sources, including the National Association of Attorneys General, resources within the Legislative Research Commission, and language of the Tobacco Master Settlement Agreement.

Staff would like to acknowledge the staff of the Office of the Attorney General and the Department of Revenue for their cooperation and assistance.

Robert Sherman
Director

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Frankfort, Kentucky
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Summary

Kentucky joined the Tobacco Master Settlement Agreement (MSA) in November 1998. The Master Settlement Agreement is a contract among 46 states, five US territories, the District of Columbia, and the major US cigarette manufacturers that settled a number of lawsuits in which the states sought to recover the public health care costs associated with smoking. The agreement places certain marketing and advertising restrictions on the cigarette manufacturers and provides the framework for, and binds the manufacturers to, annual payments to the states in perpetuity.

Under terms of the MSA, states were encouraged to adopt a model statute that requires cigarette manufacturers that did not sign the MSA—nonparticipating manufacturers or NPMs—to make escrow deposits based on the amount of cigarettes they sell in Kentucky. In 2000, the General Assembly passed the model statute. In 2003, it also adopted statutory provisions requiring the Office of the Attorney General to establish a directory of NPMs that are certified as being in compliance with the model statute. In 2009, the General Assembly enacted Senate Bill 48 that established additional provisions regarding the responsibilities of cigarette stamping agents, distributors, and retailers when a removal notice has been filed indicating an NPM would be removed from the directory.

Included within SB 48 was a directive to the Legislative Research Commission to review the certification and escrow process and the related impacts on participating manufacturers (PMs), nonparticipating manufacturers, stamping agents, distributors, and retailers. Staff reviewed relevant provisions of the MSA, budget documents, presentations to the legislature, government and industry reports, and background information prepared by the LRC to provide a description of the Master Settlement Agreement and related legislation that has been adopted by the General Assembly. Specific emphasis was placed on the certification and escrow requirements contained within current statutes and how this process relates to the enforcement of the MSA and the level of payments received annually by the state. LRC staff also interviewed Office of the Attorney General and Department of Revenue staff to gain a better understanding of the certification, escrow, and compliance process. Staff also collected data pertaining to escrow amounts and certifications by year.

Provisions of the MSA provide for three types of payments to be made to the states. These payments are subject to certain adjustments, and each state's MSA payment allocation is specified within the agreement. In 2000, the General Assembly passed enabling legislation that established the programs that were to be funded by Kentucky's MSA dollars. MSA payments are initially placed in the Tobacco Settlement Agreement Fund and then distributed to the Rural Development, Early Childhood Development, and Health Care Improvement Funds. Since 2000, Kentucky has received almost \$1.3 billion in MSA payments.

Kentucky's model statute requires nonparticipating manufacturers to either become a participating manufacturer (sign the MSA) or to make escrow deposits based on the amount of cigarettes they sell in Kentucky. Nonparticipating manufacturers are required to deposit escrow and must certify to the attorney general they have complied with the model statute. The attorney

general maintains a directory of the NPMs that are in compliance with the model statute, and the Department of Revenue publishes a directory of the certified NPMs on its website.

Noncompliant manufacturers are subject to removal from the directory. Noncompliant NPMs are first sent a notice of removal, and the notice is also posted on the Department of Revenue's website. Thirty days after a removal notice is posted, a noncompliant NPM is removed from the directory.

Removal notices are filed when a participating manufacturer does not meet its MSA commitments or when an NPM fails to deposit escrow. Since the implementation of the directory in Kentucky, there have been 95 removal notices filed, resulting in 56 NPMs and 17 PMs being removed from the directory.

Under provisions of the model statute, NPMs that do not deposit escrow are subject to civil action on behalf of the state by the attorney general. The Office of the Attorney General has filed complaints against 69 different tobacco product manufacturers. Most of the complaints were filed against NPMs that violated the escrow provisions of the model statute and have resulted in a default judgment being obtained by the state.

SB 48 established a process for notifying retailers when a removal notice has been filed, established a grace period during which retailers can sell their inventory of noncompliant NPM cigarettes, requires stamping agents and distributors to send a list of the retailers notified to the Department of Revenue, and prohibits stamping agents from purchasing noncompliant NPM cigarettes after a removal notice has been filed.

Department of Revenue staff indicated that removal notices are electronically transmitted to stamping agents and distributors on the day notices are received and that the department has been receiving lists of retailers that have been notified from the stamping agents and distributors. Also, LRC staff were able to reconcile data that indicated that every required removal notice has been filed. LRC staff also verified that each removal notice is publically available.

Since the passage of SB 48, there have been nine NPMs removed from the directory. These NPMs owed escrow on 2.4 million packs, which represents less than one-half of 1 percent of the Kentucky cigarette market. Data provided by the Department of Revenue indicated that since the passage of SB 48, 15 inspections had been conducted, and noncompliant NPM cigarettes were found at three locations resulting in the seizure of 1,119 packs.

States were encouraged to pass a model statute to avoid having their MSA payments subject to the NPM adjustment provision. This provision allows PMs to reduce their payments if they experience a market share loss of more than 2 percent. States that diligently enforce their model statutes are not subject to the NPM adjustment; however, what constitutes diligent enforcement is not specified in the MSA. As a result, a portion of MSA payments has not been distributed to the states but has been placed into a disputed account. In total, almost \$6.3 billion in MSA payments are at risk while the settling parties begin an arbitration process in hopes of settling the NPM adjustment dispute.

While the NPM adjustment dispute is unresolved, the direct impact on Kentucky has been a reduction in MSA payments. Because the NPM adjustment dispute is directly related to enforcement of the model statute and other MSA-related statutes, it is important to recognize the potential implications that could arise if changes are made to these statutes.

When the NPM adjustment issue is resolved, the states that are found to have diligently enforced their model statutes will receive disbursements from the NPM disputed payment account. If Kentucky is viewed as not having diligently enforced its model statute, the state's MSA payments would be negatively affected.

Chapter 1

Background

The Tobacco Master Settlement Agreement (MSA) is a contract among the settling parties relating to the health care costs of treating smokers.

The Tobacco Master Settlement Agreement (MSA) went into effect in November 1998. The MSA is a contract between 46 states (including Kentucky), the District of Columbia, Puerto Rico, four US territories, and the major US cigarette manufacturers to recover the public health care costs of treating smokers. The contract imposes certain requirements on the settling parties, imposes marketing and advertising restrictions on the cigarette manufacturers, and provides for payments to be made to the settling states by the cigarette manufacturers.

The four major cigarette manufactures that initially signed the agreement are known as the original participating manufacturers. Cigarette manufacturers that joined the MSA after the initial signing are known as subsequent participating manufacturers. Collectively, the original and subsequent participating manufacturers are known as participating manufacturers (PMs). Cigarette manufacturers that have not signed the MSA are known as nonparticipating manufacturers (NPMs).

Origin of This Study

States were encouraged to adopt a model statute requiring nonparticipating cigarette manufacturers (NPMs) to deposit escrow based on their cigarette sales.

Under terms of the MSA, states were encouraged to adopt a model statute in order to receive payments under the agreement. Kentucky's model statute, KRS 131.600 and 131.602, requires NPMs to establish and make deposits into an escrow account based on the amount of cigarettes sold in Kentucky.

HB 390 created a directory of the NPMs that are in compliance with Kentucky's model statute. Noncompliant NPMs are given 30 days to comply with the model statute escrow provision.

Subsequent legislation, codified in KRS 131.604 to 131.630, established a directory of the NPMs certified as being in compliance with the model statute. Noncompliant NPMs (those that fail to make deposits into an escrow account) are notified by the Office of the Attorney General and are given 30 days to comply with the escrow provisions. At the time of notification, the attorney general files a removal notice in the directory that is maintained by the Department of Revenue. On the effective date of removal (30 days after notification), the noncompliant NPM is removed from the directory. After an NPM has been removed from the directory, a cigarette stamping agent is prohibited from affixing a cigarette tax stamp to noncompliant NPM cigarettes (NPM

cigarettes that are no longer listed on the directory), and from selling noncompliant NPM cigarettes in Kentucky.

Further modifications to the escrow requirements were instituted by House Bill 97 that was enacted in 2004. HB 97, known as allocable share release legislation, changed a provision in Kentucky's model statute regarding the release of money that had been deposited into escrow.

SB 48 required stamping agents and distributors to notify their retail customers when an NPM has been removed from the directory. Upon removal, a retailer has 60 days to sell cigarettes from a noncompliant NPM.

In 2009, Senate Bill 48 established additional provisions regarding the responsibilities of cigarette stamping agents, distributors, and retailers when a removal notice has been filed to the directory. Under SB 48, stamping agents and distributors are required to notify their retail customers each time a removal notice has been filed to the directory, indicating an NPM has fallen out of compliance. Stamping agents and distributors must provide the list of retailers notified to the Department of Revenue. SB 48 also prohibits a stamping agent or distributor from purchasing cigarettes from an NPM when a removal notice has been filed by the attorney general. Provisions in SB 48 included language permitting the retailer 60 days from the effective date of the removal notice to sell the noncompliant cigarettes that are in its inventory.

SB 48 instructed the Legislative Research Commission to review the certification and escrow process and the related impacts on participating manufacturers, nonparticipating manufacturers, stamping agents, distributors, and retailers.

Description of the Study

How the Study Was Conducted

In conducting this study, staff reviewed data and reports from a number of different sources. Background information regarding the MSA was obtained from various government reports, the National Association of Attorneys General, LRC, and the MSA. The relevant statutory provisions pertaining to the model legislation, escrow provisions, and other MSA-related legislation were obtained from the Kentucky Revised Statutes. LRC staff also interviewed staff of the Office of the Attorney General and the Department of Revenue in order to gain a better understanding from those directly involved in the certification, escrow, and compliance process.

Organization of the Report

The remainder of Chapter 1 describes how MSA payments are calculated, outlines the MSA payment allocations by state, and provides an example of how MSA payments are determined.

Chapter 2 reviews the provisions of the model statute and highlights the legislative actions that have taken place since Kentucky signed the MSA.

Chapter 3 provides an in-depth review of the certification and escrow process, including the statutory changes that were adopted with the passage of SB 48.

Chapter 4 contains a summary and analysis of the number of NPMs required to deposit escrow, the amount of escrow deposited each year, and the number of NPM cigarettes sold in Kentucky. Additional information included in Chapter 4 is a review of the removal notices served; a summary of judgments and collection activities; and a discussion of the interrelationship between MSA payments, the model statute, and the NPM adjustment factor.

Introduction

Kentucky, along with 45 other states, signed the MSA in November 1998. The remaining states settled individually prior to the MSA.

On November 23, 1998, 46 states (including Kentucky), Puerto Rico, four US territories, and the District of Columbia signed an agreement with the major cigarette manufacturers to settle a number of lawsuits in which the states sought to recover the public health care costs associated with smoking.

Prior to the signing of the MSA, there had been a number of lawsuits filed on behalf of states and legislation introduced at the federal level that addressed the issue of smoking-related health care costs. Florida, Minnesota, Mississippi, and Texas signed individual settlements with the major US cigarette manufacturers prior to the signing of the MSA and are, therefore, not parties to the MSA.

The MSA is a contract that places certain restrictions on cigarette manufacturers, provides an incentive for states to adopt a model statute, and requires certain payments to be made to the states.

The agreement, known as the Master Settlement Agreement, between the major cigarette manufacturers and the 46 states is a contract that places certain marketing and advertising restrictions on the cigarette manufacturers, encourages states to adopt model legislation, and provides the framework for and binds the manufacturers to annual payments to the states in perpetuity. Annual base payments to the states—prior to adjustments outlined

in the agreement—were estimated to total more than \$226 billion over the first 25 years.¹

MSA Payment Methodology and Amounts

States receive three types of payments under the MSA: Initial, Annual, and Strategic Contribution Fund.

Provisions of the MSA stipulated three types of payments to the states and provided funds for other initiatives, such as the American Legacy Foundation and the National Public Education Fund, and for administrative costs of the National Association of Attorneys General.

Table 1.1 outlines the three types of payments states receive. Table 1.2 summarizes the amount of base payments (payment amounts prior to adjustments) through 2025, and Figure 1.A displays the amount of total MSA base payments through 2025.

The initial payments are paid to the states over a 5-year period beginning in 1998. Annual payments are paid to the states in perpetuity. Strategic Contribution Fund payments are paid annually over a 10-year period beginning in 2008.

The initial, annual, and Strategic Contribution Fund payments are the three types of payments states receive under the MSA (see Table 1.1). The initial payments are paid over a 5-year period beginning in 1998, with payments being made in January each year. The annual payments are distributed to the states on April 15 and are designated to be paid in perpetuity. The initial and annual payments are subject to certain adjustments outlined in the MSA and are distributed to the states based on the allocation percentages established in the MSA. Ten annual Strategic Contribution Fund payments will be made to the states each April beginning in 2008 and will continue each April through 2017. The state allocation percentages for the Strategic Contribution Fund payments differ from the allocation percentages for the initial and annual payments and are discussed later in this chapter.

Table 1.1
State MSA Payments

Type of Payment	Payment Date	Payment Determination
Initial (5-year period)	January 10; (1998; 2000-2003)	Set base amount, less adjustments, distributed to states by allocation percentage
Annual (In perpetuity)	April 15; (Began 2000)	Set base amount, less adjustments, distributed to states by allocation percentage
Strategic Contribution Fund (10-year period)	April 15; (2008-2017)	Set base amount (\$861 million, less adjustments)

Source: United States.

¹ A separate agreement, known as the Phase II Agreement, was signed by tobacco-growing states and the major cigarette companies to compensate tobacco farmers and quota holders for expected losses associated with implementation of the MSA.

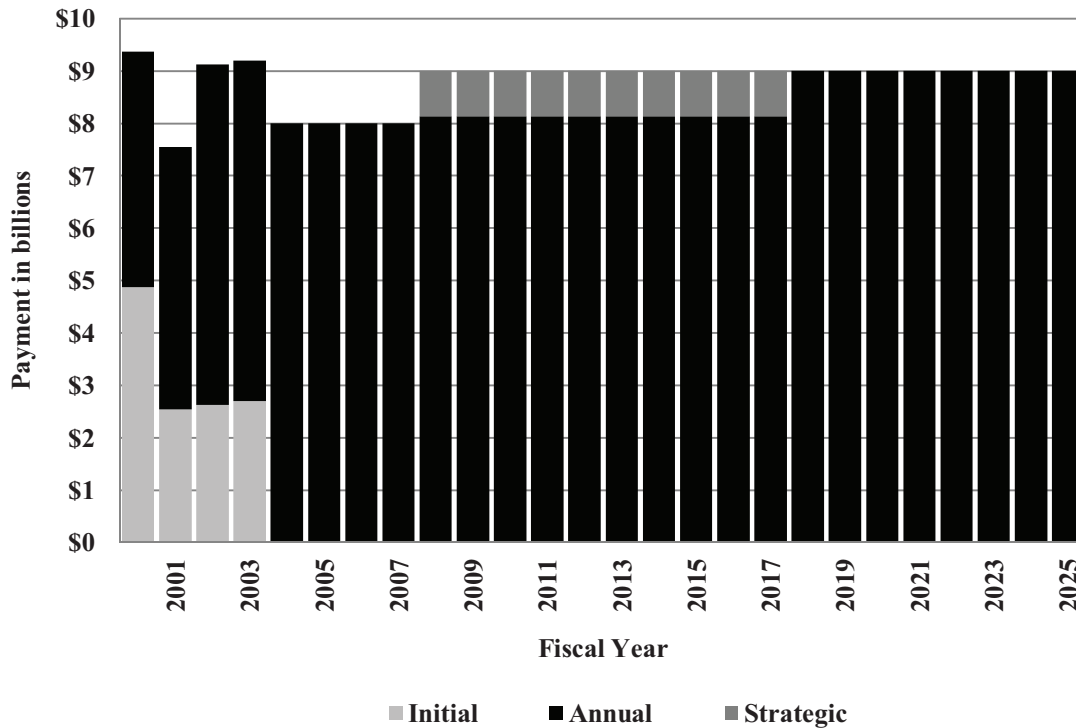
Table 1.2
MSA Base Payments Through 2025

Calendar Years	Initial Payments (in billions)	Annual Payments (in billions)	Strategic Contribution Fund Payments (in millions)
1998	\$2.40		
2000	\$2.47	\$4.50	
2001	\$2.55	\$5.00	
2002	\$2.62	\$6.50	
2003	\$2.70	\$6.50	
2004-2007		\$8.00	
2008-2017		\$8.14	\$861
2018-2025		\$9.00	

Note: Base payments differ from actual payments due to adjustment factors contained in the MSA.

Source: United States.

Figure 1.A
MSA Base Payments



Source: United States.

Each state's share of MSA payments is based on the allocation percentage established in the MSA.

The initial and annual base payments are distributed to states based on the allocation percentages established in the MSA. The MSA payments were designed in part to compensate the states for smoking-related public health care costs. Three state-specific factors were used to determine each state's allocation percentage:

- Smoking prevalence
- Population
- Medicaid expenditures

State allocation percentages were a result of negotiations between the settling parties. Factors considered during the negotiations included smoking prevalence, population, and Medicaid expenditures.

At the onset of negotiations between the settling parties, equal weight was given to Medicaid-related and non-Medicaid-related smoking costs in establishing the state allocation percentages. The final state allocation percentages contained within the MSA were a result of negotiations between the settling states and the four tobacco manufacturers that signed the original agreement. There was no set formula used to determine the state allocation percentages, rather these percentages roughly reflect each state's population-weighted smoking prevalence, combined with each state's relative share of Medicaid costs. As a result, the state allocation percentages are partially influenced by population (meaning payments are not proportional to population) and were not based on cigarette sales in each state. Table 1.3 displays the MSA state allocation percentages. Under the provisions of the MSA, Kentucky's allocation is 1.76 percent.

Table 1.3
MSA State Allocation Percentages

State	Percent	State	Percent
Alabama	1.6130800	Nebraska	0.5949833
Alaska	0.3414187	Nevada	0.6099351
Arizona	1.4738845	New Hampshire	0.6659340
Arkansas	0.8280661	New Jersey	3.8669963
California	12.7639554	New Mexico	0.5963897
Colorado	1.3708614	New York	12.7620310
Connecticut	1.8565373	North Carolina	2.3322850
Delaware	0.3954695	North Dakota	0.3660138
Georgia	2.4544575	Ohio	5.0375098
Hawaii	0.6018650	Oklahoma	1.0361370
Idaho	0.3632632	Oregon	1.1476582
Illinois	4.6542472	Pennsylvania	5.7468588
Indiana	2.0398033	Rhode Island	0.7189054
Iowa	0.8696670	South Carolina	1.1763519
Kansas	0.8336712	South Dakota	0.3489458
Kentucky	1.7611586	Tennessee	2.4408945
Louisiana	2.2553531	Utah	0.4448869
Maine	0.7693505	Vermont	0.4111851
Maryland	2.2604570	Virginia	2.0447451
Massachusetts	4.0389790	Washington	2.0532582
Michigan	4.3519476	West Virginia	0.8864604
Missouri	2.2746011	Wisconsin	2.0720390
Montana	0.4247591	Wyoming	0.2483449

Source: Master Settlement Agreement, Exhibit A.

MSA payments are subject to certain adjustments prior to distribution to the states.

The initial and annual base payments are adjusted for several factors prior to distribution to the states. Three adjustment factors that impact MSA payments are listed below.

- Volume Adjustment
- Inflation Adjustment
- Previously Settled States (PSS) Adjustment

The initial payments are subject only to the volume adjustment. The annual payment is subject to all three adjustment factors listed above. The volume adjustment is determined by changes in the amount of cigarettes shipped by the participating manufacturers relative to the shipment amount in 1997. The inflation adjustment is based on the Consumer Price Index (CPI) and is equal to

3 percent or the percentage increase in the CPI, whichever is greater. The previously settled states adjustment is an adjustment that reduces payments to the settling states by the combined allocation percentage to Florida, Minnesota, Mississippi, and Texas. The PSS adjustment is 12.45 percent for payments through 2006; 12.24 percent for payments from 2007-2017; and 11.07 percent for payments in 2018 and thereafter.

The MSA inflation and volume adjustments are applied cumulatively, which results in a compounding effect.

MSA provisions specify the order in which each adjustment factor is applied to the base payments. The inflation factor is applied first, followed by the volume adjustment, and then the previously settled states adjustment. The inflation and volume factors are applied annually on a cumulative basis, which results in a compounding effect. For example, if the inflation rate—the change in the CPI—in payment years 1 and 2 is equal to 3 percent each year, the MSA inflation adjustment factor in payment year 1 would be 1.03 and in payment year 2 would be 1.0609 (1.03 x 1.03). Table 1.4 provides an example of the 2009 MSA payments made to Kentucky from the participating manufacturers.

Table 1.4
Example MSA Calculation: 2009 Annual Payment

Annual Base Payment	\$8,139,000,000
Multiplied by Cumulative Inflation Adjustment	<u>1.3720212</u>
Equals: Inflation Adjusted Amount	\$11,166,880,547
Multiplied by Cumulative Volume Adjustment	63.8425472%
Multiplied by PSS Adjustment	87.7626244%
Multiplied by Kentucky's Allocation Percentage	<u>1.7611586%</u>
Equals Kentucky's MSA Adjusted Payment	\$110,192,020

Source: Staff calculation.

The state allocation percentages for Strategic Contribution Fund payments differ from the allocation percentages for the two other types of MSA payments.

Table 1.1 listed a third type of MSA payment: Strategic Contribution Fund (SCF) payments. These payments (\$861 million annually) will be made over the 10-year period from 2008-2017 and are subject to the volume and inflation adjustments. Unlike the initial and annual payments, the SCF payments are not distributed to states based on the allocation percentages listed in Table 1.3. Rather, the state allocation rates for the SCF payments were determined by a board of former state attorneys general, with the goal that each state's SCF allocation percentage would reflect the

relative contribution each state made to the final settlement. Table 1.5 displays the base SCF payment amounts by state.²

Table 1.5
Strategic Contribution Fund Allocation Percentages

State	Percentage	State	Percentage
Alabama	0.8	Nevada	1.0
Alaska	1.7	New Hampshire	0.9
Arizona	3.1	New Jersey	2.8
Arkansas	0.8	New Mexico	1.0
California	5.2	New York	5.5
Colorado	2.4	North Carolina	1.9
Connecticut	3.3	North Dakota	1.7
Delaware	0.8	Ohio	2.8
Georgia	0.9	Oklahoma	3.1
Hawaii	2.4	Oregon	2.4
Idaho	0.8	Pennsylvania	3.3
Illinois	2.7	Rhode Island	1.1
Indiana	2.6	South Carolina	1.3
Iowa	2.7	South Dakota	0.8
Kansas	1.9	Tennessee	0.8
Kentucky	0.8	Utah	1.8
Louisiana	2.6	Vermont	1.8
Maine	1.3	Virginia	0.8
Maryland	3.3	Washington	5.8
Massachusetts	4.8	West Virginia	2.3
Michigan	2.6	Wisconsin	2.6
Missouri	1.6	Wyoming	0.8
Montana	1.0	D.C. and US Territories	3.1
Nebraska	0.8		

Note: Percentages are rounded.

Source: United States.

Kentucky has received almost \$1.3 billion in MSA payments since 2000.

Over a decade has passed since Kentucky received its first payment under the MSA. Table 1.6 provides an annual summary of MSA payments received by Kentucky by fiscal year. The amounts received have varied, ranging from a low of \$103 million in FY 2006, to a high of \$142.3 million in FY 2000. In total, Kentucky has received almost \$1.3 billion in MSA payments.

² Kentucky was one of the last states to sign the MSA; therefore, Kentucky's allocation from the Strategic Contribution Fund (0.7549361 percent) is small when compared to other states.

Table 1.6
Kentucky MSA Payments
(in millions)

FY 2000	\$142.3
FY 2001	\$105.7
FY 2002	\$132.8
FY 2003	\$130.8
FY 2004	\$109.5
FY 2005	\$112.2
FY 2006	\$103.0
FY 2007	\$107.8
FY 2008	\$115.1
FY 2009	\$126.5
FY 2010	\$105.5
Total	\$1,291.3

Source: Governor's Office of Economic Analysis.

Chapter 2

Legislation Related to the Master Settlement Agreement

The General Assembly established a tobacco settlement account in 1998 to receive funds in anticipation of a national tobacco settlement agreement.

During the 1998 Regular Session, the Kentucky General Assembly included in the budget bill—HB 321—language that established a tobacco settlement account in the state treasury to hold any funds received from a national tobacco settlement agreement or any similar federal legislation until the General Assembly could appropriate the funds. Also, under the General Provisions section of HB 321, the General Assembly indicated that the “highest priority for distributing any funds from this account shall be for tobacco farmers and tobacco-impacted communities and health-related areas.”

2000 General Assembly Regular Session

Kentucky received its first MSA payment in 2000. The 2000 General Assembly adopted seven bills that established the programs and appropriations regarding the allocation of MSA dollars.

The MSA was signed in November 1998, and Kentucky started receiving MSA payments in January 2000. During the 2000 Regular Session, the General Assembly adopted HB 385, the model statute, and passed a number of other bills establishing the structure, programs, and legislative directives regarding how MSA dollars were to be spent.

The bills summarized below are those that passed during the 2000 Regular Session that are related to the MSA.

HB 385

HB 385 established Kentucky's model statute that contains the escrow requirements for NPMs.

HB 385 is the MSA model statute each state was encouraged to pass before it could begin receiving MSA payments. The model statute requires nonparticipating manufacturers to pay an escrow amount for each cigarette sold in Kentucky. HB 385, along with HB 390 that passed in 2003 and is known as complementary legislation, form the key provisions for the escrow and certification process within Kentucky and are discussed in detail later in the report.

HB 583

MSA payments are initially placed into the Tobacco Settlement Agreement Fund and then distributed among the Rural Development Fund, the Early Childhood Development Fund, and the Health Care Improvement Fund.

HB 583 created the Tobacco Settlement Agreement Fund (TSAF) as a permanent fund within the state treasury. MSA payments placed in the TSAF are divided into three funds. These three funds, along with the percentage received from the TSAF, are listed below.

- Rural Development Fund (50 percent)
- Early Childhood Development Fund (25 percent)
- Health Care Improvement Fund (25 percent)

This enabling legislation recognized the statutory establishment of a separate board or authority to oversee initiatives funded from each of the three respective funds, required strategic plans, and instituted reporting and auditing requirements for each board and authority. HB 583 also created the Lung Cancer Research Fund and required that money from the Health Care Improvement Fund would support the operations of the Lung Cancer Research Project, which is a research consortium between the University of Kentucky and the University of Louisville.

HB 611

HB 611 was the enabling legislation establishing how money in the Rural Development Fund could be used for agricultural initiatives. Money in the Rural Development Fund is split among a state account and the counties account.

HB 611 directed how money deposited in the Rural Development Fund could be used for different agricultural initiatives and established the provisions concerning oversight of the money in the fund. Money in the Rural Development Fund was divided into a state account (65 percent) and a counties account (35 percent).¹ The Agricultural Development Board created within the bill was granted responsibility for distribution of money in the state account. Funds placed in the counties account was further divided among Kentucky counties by a three-part formula based on each county's tobacco quota, number of farms growing tobacco, and the percent of total county income derived from tobacco production. Counties were directed to establish agricultural development councils to distribute money placed in the counties accounts.

¹ HB 611 included an appropriation of \$40 million, prior to calculating the distribution to the state and counties accounts, to ensure Phase II payees received \$114 million annually. These funds were transferred to the Kentucky Tobacco Settlement Corporation. In subsequent years, Phase II funds exceeded \$114 million. In 2004, the National Tobacco Buyout Program replaced the Phase II program, thereby eliminating the need for Rural Development Funds to subsidize Phase II payments.

HB 706

HB 706 created the Early Childhood Development Authority and created the programs first identified by the Governor's 1999 Early Childhood Task Force as being important to early childhood development.

The Early Childhood Development Authority was created under HB 706. The authority was given the ability to make expenditures from the Early Childhood Development Fund in accordance with priorities established within the bill. Overall, HB 706 was designed to provide the structure and programs relating to the initiatives identified by the Governor's 1999 Early Childhood Task Force as being important to early childhood development. The bill created a number of different councils, such as Community Early Childhood, Healthy Babies Work Group, Early Childhood Business, Early Childhood Professional Development, and Early Intervention, designed to provide input to the Early Childhood Development Authority regarding program priorities. Programs that have been funded through this initiative include hearing and vision screening; immunizations for low-income children; a scholarship program for students specializing in early childhood development; folic acid and substance abuse treatment for pregnant women; the STARS program that ranks childcare providers; and the HANDS program, which is a voluntary home visitation program for at-risk parents during pregnancy through the child's third birthday.

HB 517

HB 517 created Kentucky Access, a high-risk insurance pool, along with the Kentucky Health Care Improvement Fund. Money in the Kentucky Health Care Improvement Fund is divided among Kentucky Access, the Lung Cancer Research program, and programs to discourage substance abuse.

HB 517 established the Kentucky Health Care Improvement Authority to oversee and direct money placed in the Health Care Improvement Fund established under HB 583, which also passed in 2000. HB 517 created the Kentucky Access insurance program, an insurance pool for high-risk individuals that is partially funded with MSA dollars. Moreover, the bill required the Health Care Improvement Fund money to be divided among the Kentucky Access Program (70 percent); the Lung Cancer Research Program (20 percent) created under HB 583; and programs designed to discourage the use of harmful substances by minors, such as the Kentucky Agency for Substance Abuse Policy.

HB 593

HB 593 created an advisory board to monitor the advertising and marketing restrictions imposed on cigarette manufacturers.

The MSA imposes certain advertising and marketing restrictions on the cigarette manufacturers that signed the agreement. HB 593 created a six-member Compliance Advisory Board to monitor these restrictions. Membership is composed of the attorney general, the secretary of Cabinet for Health and Family Services, the commissioner of agriculture, the secretary of the Public Protection and Regulation Cabinet, and two citizens appointed by the attorney general. The Office of the Attorney General, working

with the Compliance Advisory Board, is responsible for identifying and reporting possible violations of the MSA to the appropriate tobacco manufacturer.

HB 502

HB 502 was the first budget bill passed after the adoption of the MSA.

HB 502 was the first biennial budget bill passed after the adoption of the MSA and contained appropriations for legislative initiatives that were to be funded by MSA payments during FY 2001 and FY 2002. Appropriations were made to each of the three funds—Rural Development, Early Childhood, and Health Care Improvement—and to specific programs within each fund, such as Kentucky Access, Lung Cancer Research, Universal Newborn Screening, Early Childhood Scholarship Program, and state and county agricultural programs.

MSA payments received prior to fiscal year 2001 were split equally among the “Bucks for Brains” program and the Rural Development Fund. Beginning with FY 2001, MSA payments have followed statutory formulas.

HB 502 also included language to address the MSA payments that were received prior to the start of the 2000-2002 biennial budget. HB 321 from the 1998 Regular Session had placed these payments into a tobacco settlement account, where they remained unappropriated. HB 502 Part XI appropriated one-half of MSA payments received prior to FY 2001 to the Endowment Program of the Research Challenge and Regional University Excellence Trust Funds, commonly referred to as the “Bucks for Brains” program. The remaining MSA funds received prior to FY 2001 were appropriated to the Rural Development Fund.²

Post 2000: MSA-related Legislation

Model Statute, Complementary, and Allocable Share Release Legislation

The model statute, complementary legislation, and allocable share release legislation contain the key provisions for Kentucky’s escrow and certification process.

The 2000 General Assembly enacted HB 385 that contained the MSA model statute. The model statute established escrow provisions whereby NPMs are required to deposit into escrow a certain amount for each cigarette sold in Kentucky.

In 2003 the General Assembly enacted HB 390, known as complementary legislation, that required the establishment of a directory of the NPMs that have been certified as being in compliance with the escrow provisions of the model statute. In

² FY 2000 MSA payments were estimated to be \$137.8 million. The Rural Development Fund was appropriated 50 percent (\$68.9 million); however, HB 611 committed \$40 million of this appropriation to the Phase II Supplemental Program.

2004, HB 97, the allocable share release legislation, modified the model statute regarding the release of escrow paid by NPMs.

These three pieces of legislation contain the key provisions for the escrow and certification process within Kentucky, and are described in detail below.

Model Statute (2000 HB 385)

Cigarette manufacturers that want to sell in Kentucky must either join the MSA or pay escrow on each cigarette sold in the state.

The model statute adopted by the General Assembly placed certain requirements on tobacco manufacturers that choose to sell cigarettes within the state. Manufacturers that want to sell cigarettes in Kentucky are required to do one of the following:

- Become a participating manufacturer under terms of the MSA (sign the MSA); or
- Establish an escrow fund and pay a certain amount per unit (cigarette) sold in Kentucky.

The amount of escrow required per cigarette was established in the MSA and is adjusted annually for inflation.

The escrow amount per unit sold was established within the MSA. Similar to the MSA payments made to the state, escrow amounts are adjusted annually for inflation. The escrow provisions contained in the model statute are listed in Table 2.1.

**Table 2.1
Escrow Amounts Required by the Model Statute**

Calendar Year Sales	Amount Per Unit Sold
2000	\$0.0104712
2001 and 2002	\$0.0136125
2003 through 2006	\$0.0167539
2007 and thereafter	\$0.0188482

Note: These are base escrow amounts prior to the inflation adjustment.
Source: Master Settlement Agreement, Exhibit T.

NPMs must certify to the attorney general that they have complied with Kentucky’s model statute.

Nonparticipating manufacturers must certify to the attorney general that they have complied with provisions of the model statute by depositing escrow based on their Kentucky cigarettes sales. NPMs that escrow receive any interest or appreciation on the escrow amount.

NPM escrow funds may be released under certain conditions.

The model statute also contained provisions for the release of escrow funds. Nonparticipating manufacturers can have their escrow released under three conditions:

- Payment of a judgment or settlement brought against the manufacturer by the state

- If the amount a nonparticipating manufacturer escrows in any year is greater than Kentucky's allocable share of the MSA payment the nonparticipating manufacturer would have been required to pay had it been a participating manufacturer
- After 25 years

NPM escrow dollars represent a source of funds if a judgment or settlement occurs against these manufacturers in the future.

The model statute serves two primary purposes. First, since NPMs do not make MSA payments and have not been released from any claims the state may make in the future, if a settling state decides to sue an NPM, the escrow amounts required under the model statute will be a source of funds for any judgment or settlement that might occur.

The model statute was intended to address the price differential that could exist among participating manufacturers (PMs) and NPMs.

Second, the model statute was also intended to address the price differential that could exist among participating manufacturers and nonparticipating manufacturers. When the PMs signed the MSA and agreed to pay the states, they raised their prices in order to fund the MSA payments. The model statute, by requiring NPMs to escrow an amount roughly equivalent to MSA payments, imposes a similar impact on both types of manufacturers.

Complementary Legislation (2003 HB 390)

Once the MSA was signed and the model statute adopted, states began to put in place a certification process for the NPMs that were required to establish escrow. The first full year in which the model statute applied was calendar year 2001, with escrow required by April 15, 2002. As states began to implement and monitor the compliance of the model statutes, a number of issues relating to enforcement appeared in the initial years of the MSA.

For example, the model statute allowed NPMs to sell cigarettes in the state for 16 months before they had to deposit escrow. Therefore, NPMs could operate for 16 months and then not deposit escrow before the attorney general could start civil proceedings against them. While states actively pursued and obtained judgments against noncompliant manufacturers, often these manufacturers were located outside the US (The Battle Group). As a result, the Office of the Attorney General noted that in a number of cases, it was difficult to serve notice and collect judgment amounts from these manufacturers. Also, given the lag time between sales in a state and certification of escrow, this created an incentive for cigarette manufacturers to form and sell cigarettes for 16 months then cease operations. In other instances, manufacturers operated continuously until being identified as noncompliant.

States moved quickly to enhance the effectiveness of and compliance with the model statute. The National Association of Attorneys General developed model legislation to promote enhanced compliance and enforcement of the model statute.

As a result of these early experiences, states moved quickly to enhance the effectiveness of, and compliance with, the model statute. By January 2003, more than 15 states had adopted some form of legislation designed to complement the enforcement of the model statute. As these additional compliance efforts grew, the National Association of Attorneys General created a Complementary Legislation Working Group. This group developed model legislation and recommended that the settling states adopt similar legislation to promote enhanced compliance and enforcement of the model statute.

In 2003, the General Assembly passed complementary legislation based on the model template developed by the National Association of Attorneys General.

During the 2003 Regular Session, the General Assembly passed HB 390 that was based on the model template recommended by the National Association of Attorneys General. HB 390 placed additional conditions on NPMs and required certain actions on the part of the Office of the Attorney General, the Department of Revenue, and cigarette stamping agents and distributors.

HB 390 requires NPMs to provide a list of all brand families sold in Kentucky.

HB 390 requires NPMs to

- provide a list of all brand families and the number of units sold in Kentucky and to provide notification to the attorney general of any changes;
- identify the financial institution where escrow has been established and to document the amount escrowed, any withdrawals, and transfers; and
- provide certification of registration to do business in Kentucky or indicate a resident agent for service of process.

HB 390 requires the attorney general to develop a directory of compliant NPMs and to share this information with the Department of Revenue.

HB 390 requires the attorney general to

- develop and maintain a directory of cigarettes that are permitted to be sold and stamped in the state and to make the directory available to the Department of Revenue for publication on its website;
- remove or exclude from the directory any NPM that has not been certified, has failed to pay sufficient escrow, or has failed to satisfy an outstanding judgment; and
- give 30 days' notice to an NPM prior to removal from the directory.

HB 390 requires Department of Revenue to notify stamping agents and distributors of any changes to the directory.

HB 390 requires the Department of Revenue to

- update the directory as information is received from the attorney general; and
- notify each stamping agent and distributor of changes to the directory.

HB 390 also

- makes it unlawful for stamping agents or distributors to stamp, sell, distribute, hold, own, possess, transport, or import cigarettes not included in the directory.
- identifies as contraband stamped packs of NPM cigarettes that have been removed or excluded from the directory.
- allows the Department of Revenue to suspend the sale of stamps to stamping agents and to revoke or suspend their licenses if they fail to comply with HB 390.
- requires stamping agents to document on a monthly basis the number of cigarettes stamped by brand family.

Allocable Share Release Legislation (2004 HB 97)

The model statute listed three circumstances in which a nonparticipating manufacturer could be released from escrow requirements. One of those circumstances released escrow based on Kentucky's MSA payment share. Specifically, the original language in the model statute adopted by Kentucky included the following

To the extent that a tobacco product manufacturer establishes that the amount it was required to place into escrow in a particular year was greater than Kentucky's allocable share of the total payments that such manufacturer would have been required to make in that year under the master settlement agreement, as determined pursuant to section IX(i)(2) of the master settlement agreement, and before any of the adjustments or offsets described in section IX(i)(3) of that agreement other than the inflation agreement, had it been a participating manufacturer, the excess shall be released from escrow and revert back to such tobacco product manufacturer (KRS 131.602(2)(b)).

Originally, the model statute allowed the release of escrow based on Kentucky's allocable share of the amount an NPM would have paid under the MSA.

As originally constructed, the model statute allowed the release of escrow based on Kentucky's share of the amount the manufacturer would have been obligated to pay had it signed the MSA. For example, if a manufacturer sold 100 million cigarettes in Kentucky and the escrow was \$0.0168 per cigarette, then the manufacturer would be required to place \$1.68 million in escrow. However, under the allocable share release, the amount of escrow for this manufacturer would be capped at 1.76 percent (Kentucky's allocable share). Therefore, the manufacturer would escrow \$1.68 million on the escrow due date and then file for a release the same day and recover all the escrow but \$29,587 (meaning 1.76 percent times \$1.68 million).

The idea behind the allocable share provision was to release escrow payments—but only to the extent such payments exceeded the amount the manufacturer would have paid had it signed the MSA—and to ensure that each manufacturer required to escrow would pay a comparable amount per cigarette in comparison to the payment per cigarette required under the MSA. By creating different financial requirements for PMs and NPMs, the original language in the model statute fell short of imposing similar financial conditions on each type of cigarette manufacturer and resulted in a loss of funds for future judgments.

HB 97 amended the model statute provision regarding the release of escrow. Escrow is now released only to the extent the escrow amount paid on account of cigarettes sold in Kentucky exceeds the amount of payments that would have been required under the MSA on the same number of cigarettes.

To address the allocable share release, the 2004 General Assembly passed HB 97 that amended the model statute. The bill changed the allocable share release so that NPMs would have escrow released, only to the extent the escrow amount paid on units sold in the state exceeds the amount of payments on such units the manufacturer would have been required to make under the MSA. HB 97 also allows the attorney general to require NPMs to escrow on a quarterly basis rather than on an annual basis.

Chapter 3

Certification and Escrow Process and SB 48

Before selling cigarettes in Kentucky, a cigarette manufacturer must file a certification form with the attorney general.

Before selling cigarettes in Kentucky, each tobacco product manufacturer must file a certification form with the attorney general. As part of this initial certification process, the tobacco manufacturer must provide company contact information and indicate whether it is a participating manufacturer or a nonparticipating manufacturer. Each tobacco manufacturer must provide a complete list of all brand families and brand names of cigarettes it sells. A nonparticipating manufacturer must provide contact information of its registered agent in Kentucky, if it has appointed one, for service of process.

When this initial certification has been completed, the tobacco manufacturer may begin selling its product in Kentucky. A participating manufacturer must update its certification annually with current contact information and a list of brand families and must file a supplemental certificate giving 30 days' notice regarding any changes to its brand families. A nonparticipating manufacturer is subject to the same provisions as a PM and must comply with additional requirements after attaining initial certification in order to be recertified.

NPMs must certify to the attorney general that they have deposited the correct escrow amount based on their Kentucky sales.

To comply with the model statute, NPMs are required to deposit escrow based on the number cigarettes they sell in Kentucky and to certify to the attorney general that they are in compliance with the model statute. While the model statute specifies that escrow payments are due on April 15 following the previous years' calendar sales, subsequent legislation (HB 97, enacted in 2004) gave the attorney general the ability to promulgate administrative regulations to require quarterly escrow during the year in which sales are made.

Escrow deposits may be required on either a quarterly or an annual basis.

Regulations currently in place set out the criteria in which the attorney general may require quarterly escrow and certification for NPMs. Quarterly escrow deposits may be required if an NPM meets any of the following criteria:

- New NPM – no previous escrow established or funded
- No escrow deposit for more than a year
- Incomplete or untimely escrow deposits
- Failure to pay any judgment or civil penalty
- Sales exceeding 125,000 packs per quarter

Quarterly escrow may also be required if the attorney general has reasonable cause to believe the nonparticipating manufacturer may not make its annual escrow payment.

NPMs that fail to deposit escrow in a timely manner are subject to civil action by the attorney general.

Certification requirements are the same for nonparticipating manufacturers regardless of whether they are required to make quarterly or annual escrow payments. The difference in quarterly and annual escrow relates to the date when escrow is required and when certification must be received by the attorney general. Nonparticipating manufacturers depositing escrow on a quarterly basis have 30 days following the end of a calendar quarter to deposit escrow. Within 10 days of the deposit due date, they must submit their certifications to the attorney general. Nonparticipating manufacturers allowed to deposit escrow on an annual basis must do so by April 15 following the calendar year in which cigarette sales were made. These NPMs then have 15 days in which to certify to the attorney general they are in compliance with the provisions of Kentucky's model statute.

A nonparticipating manufacturer that fails to deposit escrow on the due date and file its certification with the attorney general is subject to civil action by the attorney general and is subject to penalties. Penalties that may be imposed by the court range from 5 percent of the escrow amount for each day violated to 300 percent of the escrow amount that was improperly withheld. Manufacturers that knowingly violate the escrow provisions twice can be prohibited from selling cigarettes in Kentucky for a period not to exceed 2 years.

Verification that escrow amounts are correct is accomplished by comparing the amount of escrow deposited with information on cigarette sales captured on the Monthly Report of Cigarette Wholesalers and with information obtained by the attorney general from each financial institution that holds escrow.

Verification that escrow deposits are correct is accomplished by comparing information from the Monthly Report of Cigarette Wholesalers with escrow information captured on the certification forms. On the Department of Revenue's Monthly Report of Cigarette Wholesaler form, stamping agents are required to report the number of NPM cigarettes, by brand family, stamped each month. This information is forwarded to the attorney general and reconciled with the reported NPM escrow deposits to verify these deposits reflect the number of Kentucky sales—the number of packs stamped—during the escrow period. Also, the attorney general receives from each financial institution, documentation regarding escrow deposits, withdrawals, and transfers for each certified NPM.

Examples of the quarterly and annual certification forms are provided in Appendix A. Information contained on the certification

form provided by the NPM to the attorney general include the following items:

- A list of all brand families and units sold in Kentucky during previous period (by year or quarter) and the current period
- A list of any brand family sold in Kentucky during the previous period that is no longer being sold as of certification date
- Information relating to the escrow fund, including contact information of the financial institution where the escrow fund has been established; the account or subaccount number for Kentucky; and the amount of escrow and date of each deposit, transfer, or withdrawal

An NPM also must file a supplemental certificate 30 days prior to any addition or modification to its brand families.

As part of the complementary legislation passed during the 2003 Regular Session, the attorney general is required to develop a directory of the participating and nonparticipating manufacturers, along with their respective brand families that have been certified as being compliant with the model statute. The directory is then made available to the Department of Revenue and is published on its website.

The attorney general may remove from the directory an NPM that fails to deposit escrow but must give the NPM 30 days' notice.

When an NPM has been placed on the directory, if that manufacturer fails to continue to provide the required information for certification, fails to fully pay its escrow amount, or has an outstanding judgment that has not been fully satisfied, the Office of the Attorney General may remove the NPM from the directory. Before removal, the attorney general is required to give the NPM 30 days' notice of its intended action and will post the removal notice along with the effective date in the directory.

Notices of removal are posted on the Department of Revenue's website. The department is required to notify stamping agents and distributors when changes are made to the directory.

As certifications are received during the year—either 15 days after the annual escrow due date or 10 days after the quarterly escrow due date—the attorney general forwards this information to the Department of Revenue. The department then makes the appropriate changes to the directory, and an updated directory is published. Each time the directory is updated, the Department of Revenue is required to notify stamping agents and distributors of additions to and removals from the directory.

SB 48

During the 2009 Regular Session, several issues arose concerning the sales of NPM cigarettes.

During the 2009 Regular Session, representatives involved with cigarette stamping, distributing, and retail sales identified several issues with respect to sales of NPM cigarettes in Kentucky.

Retailers indicated that neither the Department of Revenue nor the company they purchase cigarettes from were required to notify them regarding changes to the directory. Therefore, retailers indicated they had to frequently consult the directory to make sure their cigarette inventories were composed of brands from compliant manufacturers.

Another concern expressed by retailers, stamping agents, and distributors was the timeframe concerning when a brand may be included on the directory and then subsequently removed. While the manufacturer is given 30 days' notice before the effective date of removal, its products remain on the directory until the effective date of removal. In practice, a brand would be listed on the directory one day (even though a removal notice had been filed) and not the next day (the effective date of removal); therefore, making the brand contraband. As a result, those involved in marketing cigarettes were concerned with having inventory without notification of impending decertification and without having a sufficient amount of time in which to sell the existing inventory.

SB 48 established a process for notifying retailers when an NPM has been removed from the directory and specified a time period in which retailers could sell their inventory of affected cigarettes.

To address these concerns, SB 48 establishes a process for notifying retailers when a removal notice has been filed; specifies the time in which retailers have to sell their inventory of affected cigarettes; prohibits certain actions by stamping agents; and establishes the conditions under which the affected cigarettes are contraband, which would make them subject to seizure and destruction.

Stamping agents and distributors must notify their retail customers when they receive a removal notice from the Department of Revenue and must provide to the department a list of the retailers notified.

Under the provisions of SB 48, when the stamping agents and distributors receive a removal notice from the Department of Revenue, they are required to send a copy of the removal notice to each of their retail customers within 7 days and must provide to the department a list of retail customers that were sent a copy of the removal notice. Also, when the removal notice is posted in the directory, a stamping agent or distributor is prohibited from purchasing cigarettes from the affected NPM.

Moreover, legislation adopted as part of the complementary act specified that upon the effective date of the removal notice, it would be unlawful for a stamping agent or distributor to affix tax stamps to the affected cigarettes, or to sell, distribute, acquire, transport, or import the affected cigarettes; and designated stamped

cigarettes that are not listed on the directory as contraband and subject to seizure and destruction.¹

Under SB 48, retailers are permitted a 60-day grace period from the effective date of a removal notice to sell the affected cigarettes. After this grace period, the affected cigarettes are contraband and subject to seizure and destruction by the Department of Revenue.

SB 48 placed additional requirements on retailers once a removal notice has been filed and they have received notification from their stamping agent or distributor. Each removal notice contains an effective date which is the day the NPM and their brand families will be removed from the directory. Retailers are permitted a 60-day period from the effective date of the removal notice to sell the affected cigarettes. After this grace period, SB 48 made it unlawful for the retailer to sell the affected cigarettes, and designated the affected cigarettes as contraband; therefore, being subject to seizure and destruction by the Department of Revenue.

Provisions of SB 48 indicate the owner—retailer, stamping agent, or distributor—of the cigarettes that have been seized by the Department of Revenue will be given notice of the date and number of cigarettes seized, will be allowed up to 20 days to file a protest with the department, and may appeal to the Kentucky Board of Tax Appeals. After the 20-day period, if a protest has not been filed, contraband cigarettes held will be destroyed.

¹ After the effective date of the removal notice, stamping agents and distributors are allowed to possess unstamped containers of the affected cigarettes, if the cigarettes are designated for delivery or for sale in another state.

Chapter 4

Data and Analysis

Tobacco Product Manufacturers Directory

There are 27 PMs and 28 NPMs on Kentucky's 2010 Tobacco Products Manufacturers Directory.

The Department of Revenue's website contains a directory of tobacco manufacturers that currently meet the certification and escrow requirements in Kentucky. Included in the 2010 directory are 27 participating manufacturers and 28 nonparticipating manufacturers. Table 4.1 displays the 2010 Tobacco Product Manufacturers directory as of September 30, 2010.

Of the participating manufacturers on the directory, the original participating manufacturers possess the largest market share. The 24 other participating manufacturers on the directory are subsequent participating manufacturers that signed the MSA after November 1998. PMs are not required to deposit escrow but instead make payments to the states under the MSA.

Of the 27 participating manufacturers, three are major manufacturers that originally signed the MSA. These three manufacturers produce and sell most of the cigarettes in the US and Kentucky.¹ The remaining 24 manufacturers are subsequent participating manufacturers (SPMs) that signed the MSA after November 1998. Unlike nonparticipating manufacturers, participating manufacturers are not required to deposit escrow based on their Kentucky sales but must provide information to the attorney general to continue to be certified and must make payments under the MSA.

¹ R.J. Reynolds and Brown & Williamson merged to form Reynolds American Incorporated after the signing of the MSA. As a result, there are now three original participating manufacturers.

Table 4.1
2010 Kentucky Certified Tobacco Product Manufacturers
(as of September 30, 2010)

Nonparticipating Manufacturers	Participating Manufacturers
Alternative Brands	Commonwealth Brands, Inc.
American Cigarette Company, Inc.	Daughters & Ryan, Inc.
Phoenix Industria e Comercio de Tabacos Ltda.	Dhanraj International, Inc.
Cabrofriense Industria Comercio De Cigarros Ltda.	Farmers Tobacco Co. of Cynthiana
Cheyenne International, LLC	General Jack's, Inc.
Compania Tabacalera International S.A.	Japan Tobacco International
Direct Buy tobacco	King Maker Marketing
Dosal Tobacco Corporation	Lane Limited
Firebird Manufacturing, LLC	Liggett Group, Inc.
Grand Tobacco Company, Ltd.	Lignum-2, Inc.
House of Windsor, Inc.	Lorillard Tobacco Company
Inter-Continental Trading, USA, Inc.	Monte Paz Compania, Industrial DE Tabaco
King Mountain Tobacco Company, Inc.	NASCO Products, Inc.
Korea Tobacco & Ginseng Corp. (KT & G Corp.)	Peter Stokkebye TobaksFabrik
M & R Holding, Inc.	Philip Morris, USA Inc.
National Tobacco Company, L.P.	Premier Manufacturing
Native Trading Associates	PT Djarum
People's True Taste, Inc.	R.J. Reynolds Tobacco Company
Rouseco, Inc.	Sante Fe Natural Tobacco
RSB Tobacco	Sherman's 1400 Broadway N.Y.C., Inc.
S & M Brands, Inc.	Tabacalera Del Este (Tabesa)
Seneca Manufacturing Company	Top Tobacco, L.P.
Skookum Creek Tobacco	US Flue-Cured Tobacco Growers, Inc.
Smokin Joes	Vector Tobacco, Inc.
Tantus Tobacco, LLC	Virginia Carolina Corporation
Tobaccoville USA, Inc.	Von Eicken Group
Truth and Liberty Manufacturing	Wind River Tobacco Company, LLC
Virginia Brands LLC	

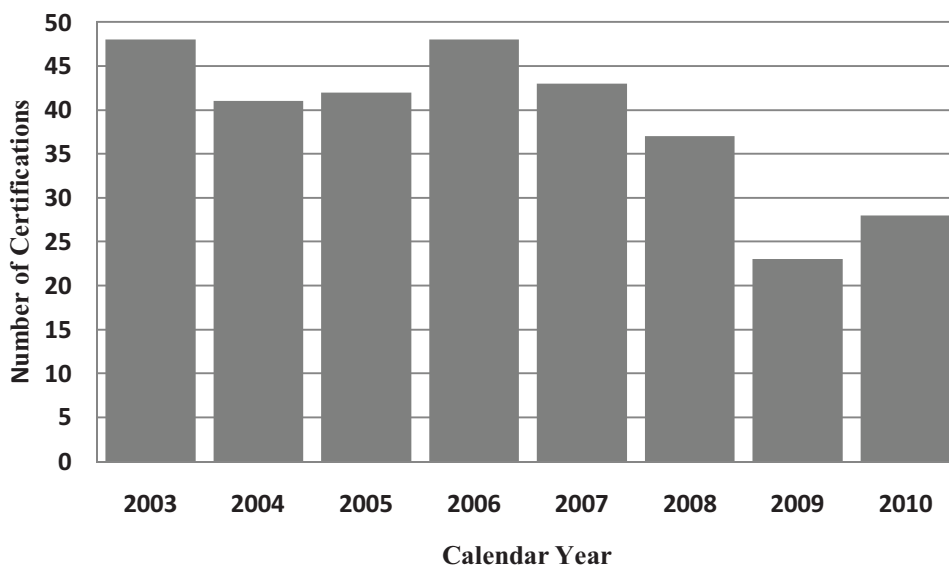
Source: Commonwealth of Kentucky.

Number of NPM Certifications, Number of NPMs That Owe Escrow, and Number of NPMs Depositing Escrow

The number of certified NPMs has ranged from 48 in 2003 to 23 in 2009. Overall, the number of certified NPMs has fallen since 2003.

Figure 4.A displays the number of certified NPMs since 2003. While variable from year to year, the number of certified NPMs has not exceeded 48 in any particular year. The number of certifications declined in the 2 years after complementary legislation was passed in 2003 but rebounded soon thereafter. From 2006 until 2009, the number of certified NPMs steadily declined. The most recent data indicate that certifications have risen relative to 2009. Overall, the number of certified NPMs has fallen since the implementation of the certification process.

Figure 4.A
Number of NPM Certifications



Source: Office of the Attorney General.

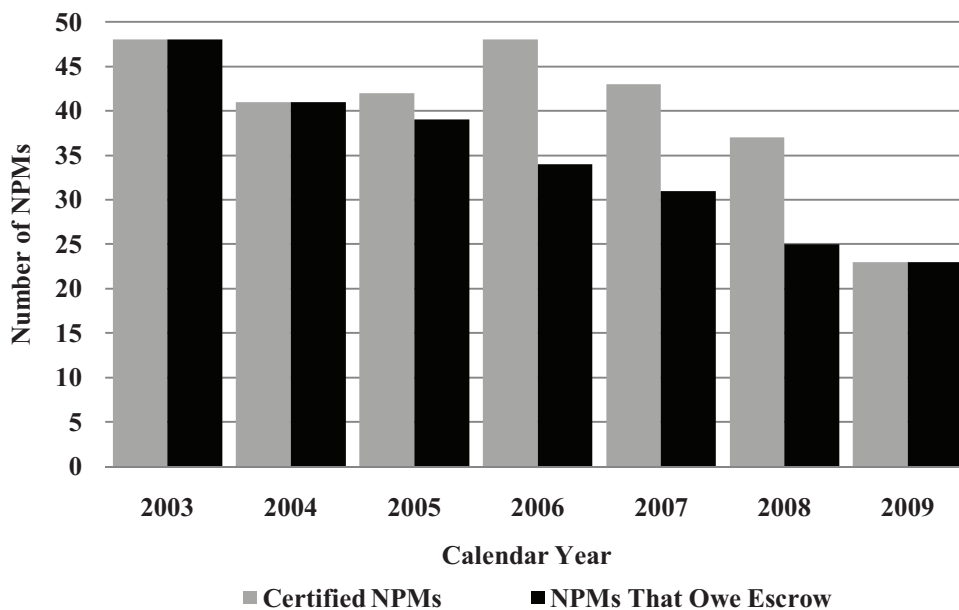
The number of certified NPMs is less than the number of NPMs that owe escrow because some NPMs are certified but have no cigarette sales in Kentucky.

Figure 4.B compares the number of certified NPMs to the number of certified NPMs that owe escrow. In each year, the number of certified NPMs that owe escrow is less than the number of certified NPMs. The difference between these two measures is directly related to NPMs attaining certification yet having no sales in the Kentucky market. NPMs without Kentucky sales are not required to deposit escrow, leading to the difference in the number of NPMs certified and NPMs certified that owe escrow.

The number of NPMs required to escrow has fallen each year since 2003—declining by 52 percent.

The data in Figure 4.B indicate that since the inception of the certification process, the number of certified NPMs that owe escrow has fallen from 48 in 2003 to 23 in 2009—a net reduction of 25 NPMs. On a percentage basis, the number of certified NPMs with sales in Kentucky has decreased by 52 percent since 2003.

Figure 4.B
Number of Certified NPMs and Number of Certified NPMs That Owe Escrow



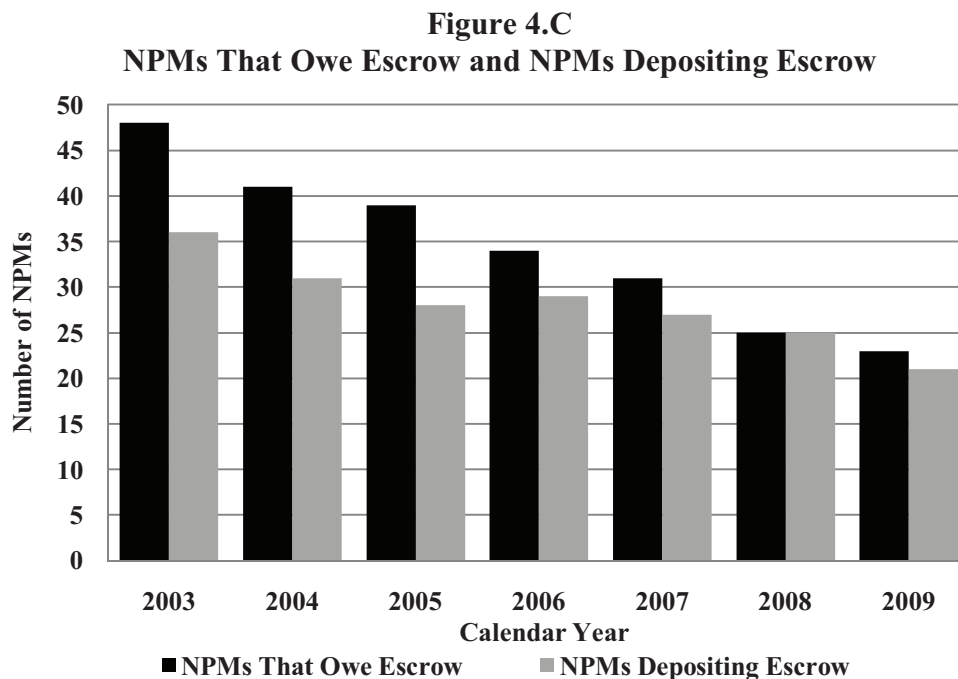
Source: Office of the Attorney General.

After the end of each escrow period, the attorney general collects information from the Department of Revenue regarding the number of NPMs that owe escrow and compares this information with the number of NPMs that deposit escrow based on certifications received. Figure 4.C displays the number of NPMs that owe escrow and compares this data with the number of NPMs that deposit escrow.

Each year since 2003, there have been NPMs that have failed to deposit escrow, leading to a difference in the number of NPMs that owe escrow and the number of NPMs that deposit escrow.

In any year, the number of NPMs depositing escrow will not exceed the number of NPMs that owe escrow. As shown in Figure 4.C (and in Figure 4.B), the number of NPMs that owe escrow has steadily declined since 2003. As a result, the number of NPMs that have deposited escrow has declined yearly, with the exception of 2006.

The number of NPMs that have deposited escrow has fallen from 36 in 2003 to 21 in 2009—a net loss of 15 NPMs (42 percent).



Source: Office of the Attorney General.

The difference in the number of NPMs that owe escrow and the number of NPMs that deposited escrow has gotten smaller over time.

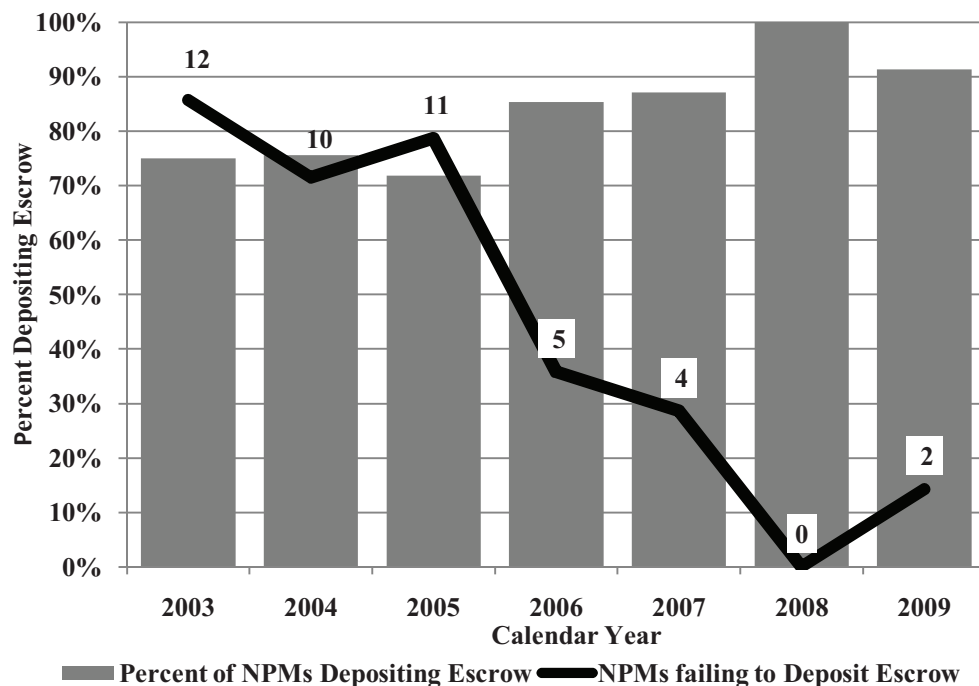
The 7 years of data presented in Figure 4.C compare the difference between NPMs that owed escrow and those that deposited escrow on an annual basis and show how this difference has changed over time. With the exception of 2008, in each year, there have been NPMs that owed escrow that did not deposit escrow; however, the difference in these two measures has grown smaller over time. Nonparticipating manufacturers that owe but do not deposit escrow are deemed noncompliant with Kentucky's certification and escrow process, resulting in a notice of removal being filed in the directory for the cigarettes manufactured and sold in Kentucky by these NPMs.

There are a number of different ways to examine the difference between the number of NPMs that owe escrow and the number of NPMs that deposit escrow. Figure 4.D displays the difference and compares these two measures in two ways. The line in Figure 4.D shows the number of NPMs that did not deposit escrow each year. Over the past 7 years, the number of NPMs that failed to escrow has been trending downward. In 2003, there were 12 NPMs that failed to deposit escrow. In 4 of the next 5 years, the number of NPMs that failed to deposit escrow declined, and by 2008 all NPMs that owed escrow deposited escrow. The most recent data indicate there were two NPMs in 2009 that owed escrow but failed to deposit money into their escrow accounts.

The percentage of NPMs depositing escrow has grown since 2003. Over the past 6 years, 82 percent of the NPMs that owed escrow complied with the model statute.

The bars in Figure 4.D represent the NPMs that deposited escrow as a percentage of NPMs that owed escrow. The percentage of NPMs that deposited escrow has ranged from a low of 71.8 percent in 2005 to 100 percent in 2008. From 2003 to 2009, 82 percent of the NPMs that owed escrow complied with the model statute and deposited escrow. Overall, while there has been variation in this measure, the trend has been positive, indicating that a greater percentage of NPMs have deposited escrow.

Figure 4.D
NPMs That Failed To Escrow and the Percentage of NPMs Depositing Escrow



Source: Office of the Attorney General.

Amount of Escrow Owed and Deposited

Because cigarette sales vary by NPM, it is important to examine changes in the number of NPMs certified and the dollar amount of escrow deposited.

In Figures 4.A-4.D, the analysis focused on the number of NPMs certified, the number of NPMs that owed escrow, the number of NPMs that deposited escrow, and the number that failed to deposit escrow. Because Kentucky cigarette sales vary by NPM and by year, the dollar amount of escrow payments will vary depending on which NPMs deposit escrow. For example, if an NPM sells 1 million packs annually and does not deposit escrow, the impact on the amount of escrow owed and escrow deposited will differ when compared to an NPM with 100,000 in annual pack sales. For this reason, it is important to examine changes in certifications and escrow not just in terms of the number of NPMs but also based on the dollar amount of escrow deposited.

The amount of escrow required per cigarette has increased every year because of provisions of the model statute. NPM sales grew prior to the establishment of the directory but have since declined.

Table 4.2 contains data on the amount of escrow required per cigarette, the number of packs for which escrow was required, the total amount of escrow owed, and the total amount of escrow deposited. Because of the provisions of the model statute, the amount of escrow per cigarette has increased every year since 2001.² The amount of escrowed packs represents the amount of NPM sales in Kentucky. Prior to the establishment of the tobacco product manufacturer's directory, NPM sales grew rapidly from year to year. After the directory was established and allocable share release legislation was passed, NPM sales declined from 141.4 million packs in 2003 to 25.7 million packs in 2009.

Table 4.2
Kentucky Escrow History

Calendar Year	Escrow per Cigarette	Escrowed Packs (NPM Sales) (millions)	Escrow Owed (millions)	Escrow Deposited (millions)
2001	\$0.0111506	23.8	\$5.3	\$5.3
2002	\$0.0149306	82.0	\$24.5	\$18.4
2003	\$0.0153785	141.4	\$43.5	\$40.2
2004	\$0.0194953	61.6	\$24.0	\$7.0
2005	\$0.0201300	52.7	\$21.2	\$3.7
2006	\$0.0207309	31.1	\$12.9	\$3.5
2007	\$0.0251069	22.1	\$11.1	\$5.7
2008	\$0.0258601	14.7	\$7.6	\$6.7
2009	\$0.0266359	25.7	\$13.7	\$9.8

Note: There are 20 cigarettes in a pack.

Source: Office of the Attorney General and staff calculations.

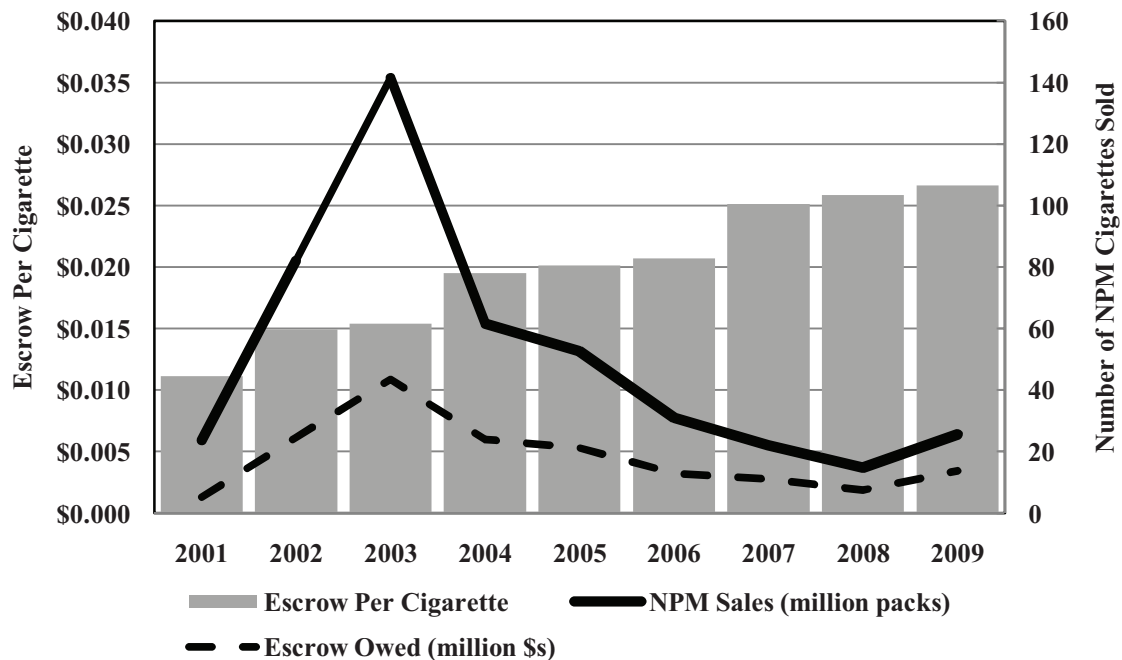
Changes in the amount of escrow owed are directly related to the percent change in the amount of escrow required and the percent change in NPM sales.

The amount of escrow owed in any particular year is directly related to the escrow per cigarette and NPM sales. Figure 4.E displays the escrow per cigarette, NPM sales, and the amount of escrow owed from 2001 through 2009. Escrow per cigarette has increased each year, while the amount of NPM sales has varied, increasing rapidly from 2001 to 2003, then declining thereafter with the exception of 2009. The amount of escrow owed is directly related to the percent change in the escrow per cigarette and NPM sales. For example, if the percent change in the escrow per cigarette and NPM sales are both positive, then the amount of escrow owed will increase when compared to the previous year. In

² The model statute sets the base escrow amount per cigarette required annually, which is then adjusted for inflation in accordance with the MSA. Subsequently, the escrow amount per cigarette increases each year because of higher base amounts in the model statute and the inflation adjustment calculation.

those instances when the percent change in one measure is negative while the percent change in the other measure is positive, the impact on the amount of escrow owed will be the net of those effects.

Figure 4.E
Escrow Per Cigarette, NPM Sales, and Escrow Owed



Source: Office of the Attorney General and staff calculations.

Substantial declines in NPM sales have overshadowed increases in the escrow per cigarette. As a result, the amount of escrow owed has closely tracked NPM sales.

The data in Figure 4.E indicate the amount of escrow owed increased as NPM sales and the escrow per cigarette increased. After 2003, the escrow per cigarette continued to increase, while NPM sales fell. Because the percent decline in NPM sales was larger than the percent increase in the escrow per cigarette, changes in the amount of escrow owed after 2003 closely track NPM sales. Therefore, increases in the escrow per cigarette have impacted the amount of escrow owed, but substantial declines in NPM sales have overshadowed this effect.

Changes in the amount of escrow owed and escrow deposited have mirrored each other. However, the magnitude of decline in escrow deposited from 2003 to 2006 was almost two times the decline in the amount of escrow owed.

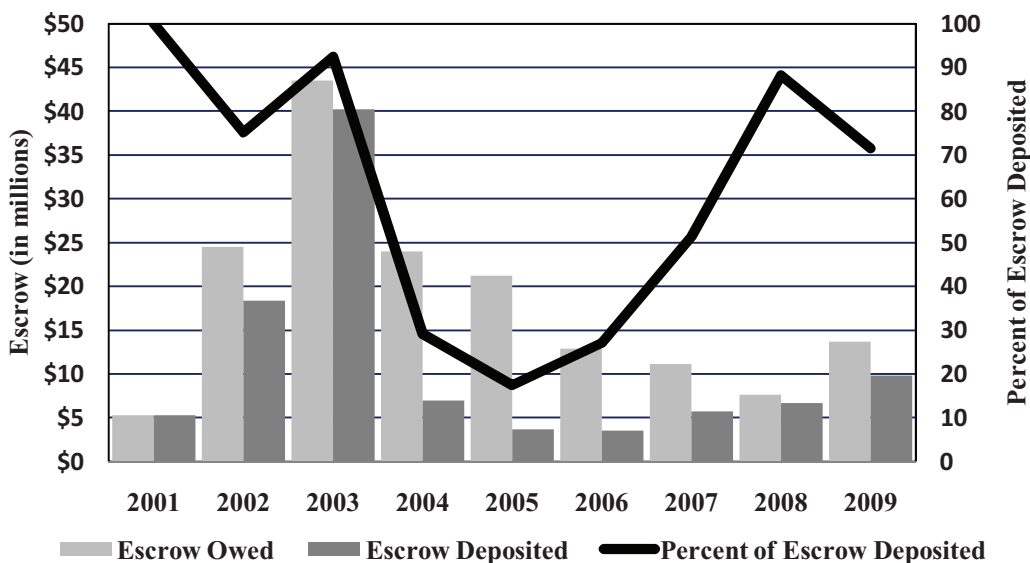
Figure 4.F displays data regarding the amount of escrow owed, escrow deposited, and the percent of escrow deposited. Changes in the amount of escrow owed and the amount of escrow deposited have generally mirrored each other. With the exception of 2007 and 2008, escrow deposited has moved in tandem with escrow owed.

Beginning in 2003, the percentage of escrow deposited declined significantly, followed by substantial improvement after 2005.

The difference between escrow owed and escrow deposited lies in the magnitude of the changes from year to year. After 2003, the amount of escrow owed and escrow deposited declined for a number of years. However, the magnitude of the decline in escrow deposited was almost two times the decline in the amount of escrow owed.

The relationship between escrow deposited and escrow owed is captured by the line in Figure 4.F, which reflects the percentage of escrow that has been deposited. The percent of escrow deposited fell rapidly from 2003 to 2005. However, after 2005, the percentage of escrow deposited has improved steadily.

Figure 4.F
Escrow Owed, Escrow Deposited, Percentage of Escrow Deposited



Source: Office of the Attorney General and staff calculations.

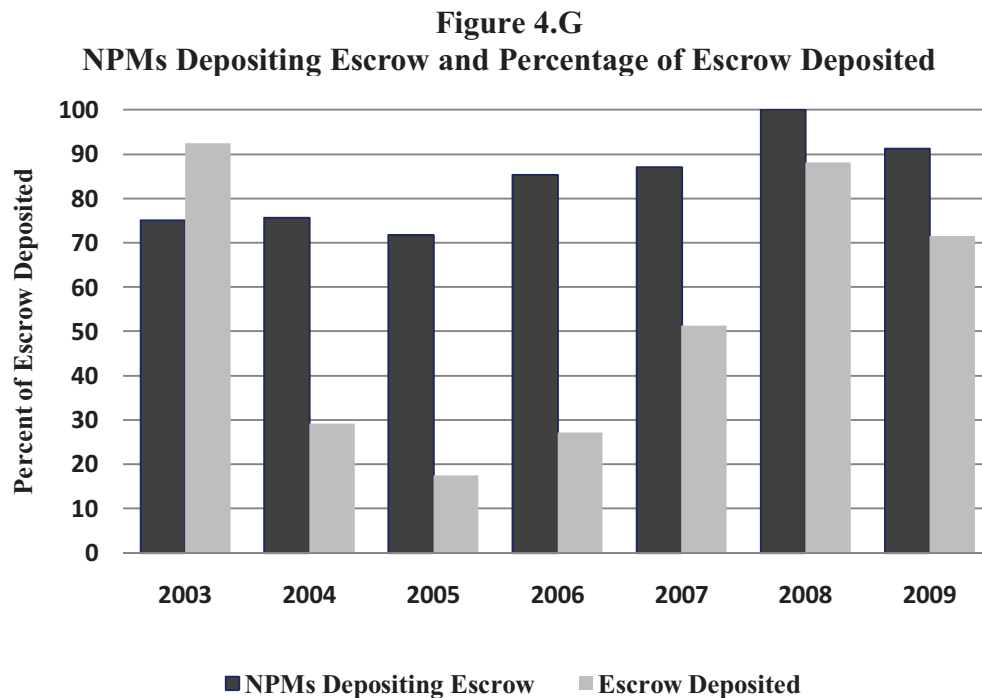
Changes in the percentage of NPMs depositing escrow will likely differ from changes in the percentage of escrow deposited.

The amount of escrow owed and escrow deposited varies by NPM because each NPM has a different cigarette sales volume. Because of this factor, the trend in the percentage of NPMs that deposit escrow will likely differ when compared to the percentage of escrow deposited.

The trend in the percentage of NPMs depositing escrow has been positive, while changes in the percentage of escrow deposited has varied, first declining, then rising.

Figure 4.G displays the percentage of NPMs depositing escrow and the percentage of escrow deposited. The trend in the percentage of NPMs depositing escrow has been positive overall. Comparatively, the percentage of escrow deposited declined substantially from 2003 to 2005 but rebounded sharply over the past 4 years. The divergence between the percentage of NPMs that deposit escrow and the percentage of escrow deposited is directly related to those

instances when NPMs that deposited escrow had lower Kentucky sales volume relative to the average NPM.



Source: Office of the Attorney General and staff calculations.

Allocable Share Release: Escrow Deposited and Escrow Released

Allocable share release legislation changed the calculation regarding the extent in which escrow could be released.

Prior to the passage of the allocable share release legislation, NPMs that met certain conditions could be released from a portion of their escrow requirements. As originally constructed, the model statute provided for escrow deposited by an NPM to be released based on the amount in which the escrow was greater than Kentucky's allocable share (1.76 percent) an NPM would have paid under the MSA.

The original language in the model statute capped escrow payments at a level below the amount an NPM would have paid under the MSA.

The idea behind the allocable share release was to release escrow payments—but only to the extent such payments exceeded the amount the manufacturer would have paid had it signed the MSA—and to ensure that each manufacturer required to escrow would pay a comparable amount per cigarette in comparison to the payment per cigarette required under the MSA. However, the original language in the model statute capped escrow payments at a level below the amount the NPM would have paid had it been a PM because the escrow release was based on a state's allocable share and not on the amount of NPM sales in the state. The result

was fewer escrow dollars for future judgments and different per-pack payment amounts for PMs and NPMs.

HB 97 changed the escrow release provisions of the model statute.

To address the allocable share release provisions of the model statute, the 2004 General Assembly passed HB 97 that amended the statutory provisions pertaining to the release of escrow. The bill changed the allocable share release so that NPMs would have escrow released but only to the extent the escrow amount paid on the number of cigarettes sold in the state exceeds the amount of payments on the number of cigarettes the NPM would have been required to make under the MSA. The implication is that after the passage of HB 97, the statutory provision for an escrow release was preserved, but the calculation of the release was modified.

From 2001 to 2004, 28 percent of the NPMs that deposited escrow received a partial release. The amount of escrow released over this 4-year period was \$59 million, or more than 83 percent of the escrow deposited.

Table 4.3 contains data relating to the amount of escrow deposited, the amount of escrow released, and the number of NPMs affected prior to and after the passage of HB 97. From 2001 to 2004, there were 39 NPMs that received a partial release of their escrow, representing 28.5 percent of the NPMs that deposited escrow during this period. The amount of escrow released was \$59 million, or more than 83 percent of the escrow deposits for the 4-year period. The net escrow amount was \$11.9 million, which is a little under 17 percent of the amount of escrow deposited from 2001 through 2004.

After the passage of HB 97, no escrow dollars have been released. Since 2001, \$100.3 million has been escrowed, of which \$59 million was released, leaving a net escrow amount of \$41.3 million.

Since the passage of HB 97 in 2004, no escrow dollars have been released because the amount of escrow paid by each NPM has been less than the amount each NPM would have been paid under the MSA. Since 2001, there has been \$100.3 million in escrow deposits made, of which \$59 million was released back to the NPMs making the deposits, leaving a net escrow amount of \$41.3 million.

Table 4.3
Historical Escrow Data

Calendar Year	# NPMs Depositing	Escrow Deposited (millions)	# NPMs Released	Percent	Escrow Released (millions)	Percent	Net Escrow (millions)
2001	24	\$5.3	8	33.3	\$2.1	39.6	\$3.2
2002	46	\$18.4	16	34.8	\$15.9	86.4	\$2.5
2003	36	\$40.2	18	22.2	\$35.7	88.8	\$4.5
2004	31	\$7.0	7	22.6	\$5.3	75.7	\$1.7
Sub total	137	\$70.9	39	28.5	\$59.0	83.2	\$11.9
2005	28	\$3.7	0		\$0		\$3.7
2006	29	\$3.5	0		\$0		\$3.5
2007	27	\$5.7	0		\$0		\$5.7
2008	25	\$6.7	0		\$0		\$6.7
2009	21	\$9.8	0		\$0		\$9.8
Total	267	\$100.3			\$59.0		\$41.3

Source: Office of the Attorney General.

Notices of Removal

If an NPM fails to deposit escrow, a notice of removal is filed in the directory indicating the effective date the NPM will be removed. Removal notices are also filed when a PM does not meet its MSA commitments.

If a nonparticipating manufacturer fails to deposit escrow, a notice of removal is filed in the directory identifying the NPM and the effective date when the NPM will be removed. A removal notice can also be filed if the NPM fails to file its certification with the attorney general, if an NPM requests to be removed from the directory, when an NPM requests that certain brands be removed, and for other issues besides noncompliance. Removal notices are also filed in those cases where a participating manufacturer does not meet its MSA commitments or does not file its certification with the attorney general.

Since 2004, there have been 95 removal notices filed: 71 NPMs and 24 subsequent participating manufacturers (SPMs).

Table 4.4 lists the number of removal notices by year based on the effective date of the notice. Total removals are further divided into two categories based on the number of NPM removal notices and PM removal notices. Since 2004, there have been 95 removal notices filed: 71 NPMs and 24 SPMs.³

³ Appendix B contains a list of the notices of removals, by effective date, since 2004.

Table 4.4
Notices of Removal

Effective Date	Removal Notices Filed	NPM Notices	PM Notices
2004	11	10	1
2005	17	14	3
2006	18	11	7
2007	8	8	0
2008	28	16	12
2009	7	7	0
2010	6	5	1
Total	95	71	24

Source: Commonwealth of Kentucky.

Nonparticipating Manufacturers

Sixty-one different NPMs have received removal notices.

Since the inception of the tobacco products manufacturer's directory, there have been 90 NPMs that have been certified to sell cigarettes in Kentucky. Of these 90 NPMs, 28 are currently certified to operate in Kentucky (see Table 4.1) and one certified NPM has signed the MSA, thus becoming an SPM. The remaining 61 NPMs were at one time certified but are no longer included in the directory.

Seventy-one removal notices have been filed, 10 of which were filed for NPMs that had received previous removal notices.

Table 4.4 indicates there were 71 notices of removal filed since 2004 relating to NPMs. Eight NPMs have failed to deposit escrow in a timely manner on multiple occasions, resulting in more than one removal notice being filed for each of these NPMs. After accounting for the multiple removal notices, there were 61 NPMs that received removal notices.

An NPM may receive a removal notice but deposit escrow within 30 days and retain certification. This is the reason the number of NPMs receiving removal notices differs from the number of NPMs decertified (removed from the directory).

When a notice of removal is filed, the NPM has 30 days to deposit escrow. At the end of the 30-day period, if escrow has been deposited, the NPM retains certification; if escrow has not been deposited, the NPM is decertified for noncompliance with the model statute. An NPM could receive a removal notice then deposit escrow and retain certification. Therefore, the number of NPMs receiving removal notices may not equal the number of NPMs decertified because some NPMs may deposit escrow after the notices have been filed.

Overall, 56 NPMs have been removed from the directory based on the number of removal notices filed.

In comparing the certified NPMs in Table 4.1 to the notices of removal data in Appendix B, there are five certified NPMs that received notices of removal and then deposited the required escrow amount. As a result, once adjustments are made for multiple notices being filed for the same NPM, and for those NPMs that

received removal notices and then deposited escrow, there were 56 NPMs removed from the directory.

Participating Manufacturers

PMs must comply with MSA payment provisions to continue to be certified and remain on the directory. Because original participating manufacturers have continually complied with the MSA, changes in the number of certified PMs are solely related to changes in the number of certified SPMs.

Of the 56 SPMs that have signed the MSA, 24 are currently on the directory and 17 have been removed based on the removal notices filed.

Of the 90 NPMs that have been certified, 28 are currently on the directory, 56 were removed after notices of removal had been filed, and 5 were removed for some other reason.

Of the 56 SPMs that signed the MSA, 24 are currently certified, 17 have been removed after a notice of removal had been filed, and the remaining 15 were never certified.

Although PMs are not required to deposit escrow under the model statute, they are required to provide information to the attorney general and must comply with the payment provisions of the MSA. Each of the three original participating manufacturers have complied with provisions of the MSA and have been certified each year to sell their products in Kentucky; therefore, changes in the number of certified PMs are solely related to changes in the number of certified subsequent participating manufacturers.

There have been 56 SPMs that have signed the MSA since its passage in November 1998. Currently, there are 24 SPMs certified to operate in Kentucky (see Table 4.1). The remaining 32 SPMs have either been removed from the directory or have never been certified to operate in the state. Since 2004, there have been 24 notices of removal filed relating to SPMs (see Table 4.4). Three SPMs had multiple removal notices filed; therefore, 21 different SPMs have received notices of removal. Of these 21, 4 are currently certified and 17 have been removed from the directory.

Table 4.5 reconciles the information regarding the total number of NPMs and SPMs, the number currently certified, and the number of removal notices filed. Data provided by the Attorney General's Office, coupled with the current directory and historical removal notices, indicate there have been 90 NPMs that have been certified to operate in Kentucky. Twenty-eight of these NPMs are currently certified, and one NPM has become an SPM. Fifty-six NPMs were removed from the directory as indicated by a notice of removal being filed. The remaining five NPMs were removed from the directory as a result of some issue besides noncompliance and without a removal notice being filed. For example, there have been certified NPMs that have requested to be removed from the directory.

Currently, there are 24 SPMs certified in Kentucky. Removal notices filed since 2004 indicate that 17 SPMs have been removed from the directory. In comparing the SPMs that have signed the MSA to Kentucky's current directory and the removal notices filed, there were 15 SPMs that did not have notices of removal filed and were not currently certified. These 15 SPMs represent those that signed the MSA but never filed for certification in Kentucky. These three categories of SPMs—certified, removed,

never certified—when added together equal the total number of SPMs that have signed the MSA.

**Table 4.5
Historical NPM and SPM Classification**

Classification	Number of NPMs	Number of SPMs
Currently Certified	28	24
NPM to SPM	1	
Removed (Notice Filed)	56	17
Removed (Other)/Never Certified	5	15
Total	90	56

Source: Commonwealth of Kentucky; and Office of the Attorney General and author’s calculations.

Complaints, Default Judgments, and Penalties

NPMs that do not deposit escrow are subject to civil action on behalf of the state by the attorney general.

Under provisions of the model statute, NPMs that do not deposit escrow in a timely manner are subject to certain actions by the attorney general. Statutory provisions allow the attorney general to bring civil action on behalf of the state against tobacco product manufacturers that fail to deposit escrow and provide for certain penalties to be paid by the manufacturer (KRS 131.602 (3)).

A nonparticipating manufacturer that fails to deposit escrow on the due date is allowed a grace period of 15 days to deposit escrow. At the end of the grace period, if the NPM has not deposited escrow, a notice of removal is sent to the NPM and posted on the Department of Revenue’s website indicating the effective date in which the NPM will be removed from Kentucky’s tobacco products manufacturer’s directory. Following these actions, if the NPM has not placed the required funds into escrow, the attorney general may bring a civil action against the NPM for noncompliance.

Each instance in which an NPM fails to deposit escrow is a separate violation of the model statute. Penalties for noncompliance range from 5 percent of unpaid escrow per day to 300 percent of the unpaid escrow.

Each instance in which an NPM fails to deposit escrow constitutes a separate violation of the model statute. If the court finds an NPM has violated the model statute, a civil penalty may be imposed. The penalty cannot exceed 5 percent of the unpaid escrow amount for each day of the violation, and the total penalty amount cannot exceed 100 percent of the unpaid escrow. If the court finds a knowing violation has occurred, the allowable civil penalty is higher. In these cases, the penalty may be up to 15 percent of the unpaid escrow per day but cannot exceed 300 percent of the unpaid escrow.

In addition to the penalties provided in the model statute, the state may recover funds relating to litigation as outlined under the provisions of KRS 131.626. This statute allows the state to recover the costs of enforcement actions including investigation costs, fees for expert witnesses, filing costs, and reasonable attorney fees.

The Office of the Attorney General has filed complaints against 69 different tobacco product manufacturers. The majority of these complaints were filed against NPMs.

Since the adoption of the model statute in 2000, the Attorney General has filed complaints against 69 different tobacco product manufacturers.⁴ Fifty-nine of the tobacco product manufacturers affected were NPMs that violated the escrow provisions of the model statute. Complaints were also filed against 10 SPMs because of their failure to comply with the payment provisions of the MSA. In addition to the 69 tobacco companies that had complaints filed against them, the state has received payments—without having to file complaints—from 15 tobacco product manufacturers for violations of the model statute. Overall, the state has either filed complaints against or received payments from 84 tobacco product manufacturers—73 NPMs and 11 SPMs—relating to enforcing the model statute.

More than 54 percent of the NPMs that violated the escrow provisions of the model statute have done so multiple times.

Overall, a total of 102 complaints have been filed against 59 NPMs for escrow violations relating to the model statute. Thirty-two of these 59 NPMs have failed to deposit escrow in more than one year, which means that more than half of the NPMs that violated the escrow provisions have done so multiple times. Because these NPMs have had multiple complaints filed against them, the total number of complaints exceeds the number of NPMs that have had a complaint filed against them.

Out of the 102 complaints filed by the state against NPMs, 91 resulted in default judgments for the state.

The disposition of the complaints that have been filed against NPMs has typically resulted in a default judgment. Table 4.6 displays the number of default judgments from 2002 to 2009 and shows that the number of default judgments has varied by year. Out of the 102 complaints filed, 91 default judgments have been obtained by the state. In terms of the number of NPMs impacted, the state has obtained default judgments against 50 of the 59 NPMs that have had complaints filed against them.⁵

⁴ A lawsuit begins when a complaint is filed with the court indicating the legal and factual basis for seeking damages from the entity subject to such action.

⁵ The remaining 11 complaints filed against the other nine NPMs were either settled resulting in a payment to the state; remain outstanding; or involve an NPM that has dissolved, gone bankrupt, or is in bankruptcy.

**Table 4.6
NPM Default Judgments**

Year	Number of Default Judgments
2002	18
2003	11
2004	14
2005	7
2006	17
2007	7
2008	10
2009	7
Total	91

Source: Office of the Attorney General.

All required removal notices had been filed and were publically available.

LRC staff reviewed information pertaining to notices of removal and Kentucky’s tobacco products manufacturer’s directory on the Department of Revenue’s Website. Notices of removal were listed for each year along with a current directory. The Office of the Attorney General also provided to staff a master list of the NPMs that had been certified since the creation of the directory. By comparing the two sets of information, staff determined that all required removal notices had been filed and were publically available.

Department of Revenue staff indicated that removal notices are electronically transmitted to all stamping agents and distributors on the day the notices are received.

When an NPM is removed from the directory, the Department of Revenue is responsible for notifying each stamping agent and distributor of the removal. Information obtained in interviews with Department of Revenue staff indicated that on the day the department receives information about which NPM should be removed, the directory is updated, and each stamping agent and distributor is notified electronically on that day regarding the removal.⁶

Department of Revenue staff indicated that they receive lists of retail customers that have been notified from stamping agents and distributors.

Provisions within SB 48 specify that within a week of receiving notification from the Department of Revenue, each stamping agent or distributor must send each of their retail customers a copy of the removal notice and forward to the department a copy of the retail customers that have been notified. Department staff indicated that since the passage of SB 48, the department has been receiving lists of the retail customers notified within the 7-day period. The department contacted those stamping agents and distributors that

⁶ All stamping agents and distributors are notified of the NPM removal even though some of stamping agents and distributors may not handle the particular cigarettes manufactured by the NPM being removed.

did not send lists, and department staff reported then receiving the lists. Department staff also noted that when performing field audits to monitor compliance with cigarette stamping and MSA enforcement, most retailers were aware of the availability of the directory and were receiving notification of NPM removals.

Another provision of SB 48 prohibits stamping agents and distributors from purchasing cigarettes from an NPM after a removal notice has been filed for that NPM. Existing statutory language makes it unlawful for a stamping agent or distributor to affix a cigarette tax stamp to any cigarettes manufactured by an NPM that has been removed from the directory. These two provisions, along with notification from the department, help to ensure that stamping agents and distributors receive timely notice of NPMs that have received a removal notice, require them to cease purchases of these products, and provide a 30-day window in order to sell the cigarettes that are likely to be removed from the directory.

SB 48 stipulates that retailers should receive a copy of each removal notice from their stamping agent or distributor within 7 days after the agent or distributor has been notified by the department. SB 48 also provides for a 60-day period, beginning on the effective date of the removal notice, in which the retailer can sell cigarettes from a manufacturer that has been removed from the directory. In essence, the retailer has 90 days from the date a notice of removal has been filed to sell any cigarettes from a manufacturer that is likely to be removed from the directory.

Data provided by the Department of Revenue indicated that since the passage of SB 48, 15 inspections had been conducted. Noncompliant NPM cigarettes were found at three locations resulting in the seizure of 1,119 packs.

Each month, the department receives from stamping agents a Monthly Report of Cigarette Wholesalers that includes the number of NPM cigarettes by brand family that have been stamped and a summary of the month's transactions, such as inventory levels, purchases, sales, and packs stamped. With this information and the field audits, the department can track purchases of cigarettes and stamping activity related to NPM cigarettes and compliance with the provisions of SB 48. Along with the information provided by stamping agents and distributors regarding retailers that have been notified of the removal of NPMs cigarettes from the directory, the department has information that allows it to identify locations where noncompliant NPM cigarettes may be located.

As part of its field audit process, the department checks retail locations to monitor tax and MSA compliance, including whether noncompliant NPM cigarettes are available after the 60-day grace period. Data provided by the department indicate that since the

passage of SB 48, 15 inspections had been conducted. During these inspections, the department found noncompliant NPM cigarettes at three retail locations and seized 1,119 packs.

Since the passage of SB 48, there have been nine NPMs removed from the directory that owed escrow on approximately 2.4 million packs. The cigarette sales by the NPMs that have been removed since the passage of SB 48 is less than one half of 1 percent of the Kentucky cigarette market.

The potential impact from an NPM being removed from the directory is directly related to level of cigarette sales for that particular NPM. Since the passage of SB 48, there have been nine NPMs removed from the directory. Data provided by the Office of the Attorney General indicated these NPMs owed escrow on approximately 2.4 million packs. Currently, approximately 478 million packs are sold in Kentucky annually; therefore, relative to the market as a whole, removals after the passage of SB 48 represent less than one-half of 1 percent of the Kentucky cigarette market.⁷

Interrelationship Between MSA Payments, the Model Statute, and the NPM Adjustment

States that signed the MSA were encouraged to pass the model statute. The potential benefits of doing so were the accumulation of escrow funds that could be used to pay future claims against NPMs, the establishment of similar financial requirements for PMs and NPMs and the potential to avoid having MSA payments being subject to the NPM adjustment provision.

The NPM adjustment provision allows PMs to reduce their MSA payments if they experience a market share loss of more than 2 percent. The adjustment is punitive: triple the market share loss over 2 percent.

The NPM provision contained in the MSA allows PMs to reduce their payments if they experience market share losses of more than 2 percent relative to their 1997 market share and if the MSA was a significant factor that led to the market share losses. The reduction in MSA payments caused by the NPM adjustment is punitive in that the net market share loss above 2 percent is tripled. For example, if the market share loss is 8 percent, the net market share loss would be equal to 6 percent. As a result, under the NPM adjustment provision, PMs could reduce their payments by 18 percent.

States that diligently enforce their model statutes are not subject to the NPM adjustment; however, what constitutes diligent enforcement is not specified in the MSA. As a result, a portion of MSA payments have not been distributed to the states but have been placed into a disputed account.

Under the MSA, states that pass model statutes and diligently enforce their provisions are not subject to the NPM adjustment. However, what constitutes diligent enforcement is not specified in the MSA. Subsequent actions taken by the PMs and the lengthy process of determining if the MSA was a significant factor in the loss of market share and of determining which states diligently enforced their model statutes has led to a portion of the states' MSA payments being withheld and placed into a disputed account.

⁷ This does not imply that retailers lost one-half of 1 percent of their cigarette sales, rather these sales were likely shifted to another compliant brand.

Almost \$6.3 billion in MSA payments are at risk because of the NPM adjustment. Currently, the settling parties have begun an arbitration process to settle this dispute.

The NPM adjustment is not allocated to each state based on that state's allocable share. The NPM adjustment is suppose to be applied only to those states that have not diligently enforced the model statute. In effect, a state could lose 100 percent of its MSA payment because of the NPM adjustment.

The impact on Kentucky from the NPM dispute has been a reduction in MSA payments.

Because of the link between enforcement of the model statute and the NPM adjustment factor, actions that may be viewed as negatively impacting Kentucky's diligent enforcement have the potential to significantly impact Kentucky's MSA payments.

Table 4.7 lists the amount of the potential NPM adjustment for each sales year that is currently in dispute. In total, almost \$6.3 billion in MSA payments are at risk because of the NPM adjustment. Currently, the settling parties have begun an arbitration process to settle this dispute.

A unique feature of the NPM adjustment is how it is applied to MSA payments made to the states. This adjustment is not allocated to the states based on each state's allocable payment share. Rather, the NPM adjustment will be applied only to those states that have not diligently enforced the provisions of the model statute. In essence, if a state is found not to have diligently enforced the model statute, it could lose 100 percent of its annual MSA payment.

While MSA payments are subject to the inflation, volume, and previous settled states adjustment factors, Kentucky's MSA payments have also been affected by the NPM adjustment factor that is currently in dispute. Kentucky's MSA payments have been reduced as a result of MSA payments being placed into an NPM disputed account. Once a partial or final resolution of the NPM adjustment issue is reached, the states that are found to have diligently enforced their model statutes will receive disbursements from the NPM disputed payment account. The ultimate resolution of this issue may positively or negatively affect Kentucky's future MSA payments.

Because the NPM adjustment dispute is directly related to enforcement of the model statute and other MSA-related statutes, it is important to recognize the potential implications that could arise if changes are made to these statutes. There is a link between enforcement of the model statute and the NPM adjustment factor. Actions that may be viewed as negatively impacting Kentucky's diligent enforcement have the potential to significantly impact Kentucky's MSA payments. Previously, the General Assembly recognized the interrelationship between the model statute and MSA payments. As part of complementary legislation that passed in 2003, HB 390 included the following:

...violations of the model statute threaten the integrity of the MSA, the fiscal soundness of the state, and the public health. The Legislature finds that enacting procedural enhancements will aid enforcement of the model act and thereby safeguard the MSA, the fiscal soundness of the state, and the public health.

Table 4.7
Potential NPM Adjustment Amounts

Calendar Year	Potential NPM Adjustment
2003	\$1,147,566,065
2004	\$1,137,395,925
2005	\$753,345,638
2006	\$703,720,207
2007	\$794,539,422
2008	\$918,904,595
2009	\$842,713,743
Total	\$6,298,185,595

Source: National Association of Attorneys General.

Works Cited

The Battle Group. *Final Determination pursuant to NPM Procedures Agreement § 19 in the 2003 NPM Adjustment Proceeding pursuant to Master Settlement Agreement §IX(d)(1)(C)*. March 27, 2006.

Commonwealth of Kentucky. Department of Revenue. <<http://revenue.ky.gov/business/Tobaccotax.html>> (accessed Oct. 15, 2010).

National Association of Attorneys General. <http://www.naag.org/backpages/naag/tobacc/msa-payment-info/2010-04-27_Tobacco_Product_Manufacturers_Market_Shares_and_Potential_NPM_Adjsutment_Amount.pdf/file_view> (accessed Oct. 19, 2010).

United States. General Accounting Office. Tobacco Settlement: States' Use of Master Settlement Agreement Payments. GAO-010-851. June 2001.

2010 Kentucky Annual Certificate of Nonparticipating Tobacco Product Manufacturer Compliance

Part 1: Manufacturer's Identification

- 1. Name:
2. Street address:
3. City, state, country, ZIP:
4. Telephone number:
5. Electronic mail address:

Part 2: Liability Year (Sales year)

6. The liability year for this certificate is: 2009

Part 3: Units Sold

- 7. Number of individual cigarettes and RYO sold by the manufacturer identified above during the liability quarter subject to Kentucky excise tax as follows (by brand; nine hundredths (.09) of an ounce of RYO tobacco counts as 1 stick):
1) 2) 3)
4) 5) 6)

Total sticks: 7)

Part 4: Deposit Amount

For the liability year 2007 and after, the base rate per cigarette is 0.0188482

- 8. The appropriate rate for the liability year as adjusted for inflation* is: 8. \$0.0266359
9. Multiply Line 8 by total of Part 3, Line 7, and write the amount here
(Total Escrow Deposit due for the quarter): 9.

Note: Attach a copy of your receipt or other proof of deposit from your financial institution as well as a copy of the escrow agreement between you and the institution if you have not previously provided one or if it has been amended.

Part 5: Financial institution

- 10. Name:
11. Street address:
12. City, state, country, ZIP:
13. Escrow account number
14. Total amount held in this account after current deposit: \$
15. Escrow agent:
16. Phone Number:

Part 6: Authorized Signature

Under penalties of perjury, I state that, to the best of my knowledge, all of the information contained in this certificate is true and accurate. This document must be signed and dated by an authorized notary public.

Sworn to and subscribed before me this ___ day of ___, 20__

Print the name of authorized agent Title

Signature of Notary Public

Signature of authorized agent Date

City / State:
My commission expires / /

* The cumulative inflation adjustment is calculated pursuant to Exhibit C of the MSA.

This form is due April 30, 2010 and may be sent to: Kentucky Office of Attorney General, 700 Capitol Avenue, Suite 118, Frankfort, KY 40601, (Attention: Michael Plumley, Assistant Attorney General).

2010 Kentucky Quarterly Certificate of Nonparticipating Tobacco Product Manufacturer Compliance

Part 1: Manufacturer's Identification

- 1. Name:
2. Street address:
3. City, state, country, ZIP:
4. Telephone number:
5. Electronic mail address:

Part 2: Liability Year/Quarter (Sales quarter)

6. The liability year for this certificate is: 2010, Q

Part 3: Units Sold

7. Number of individual cigarettes and RYO sold by the manufacturer identified above during the liability quarter subject to Kentucky excise tax as follows (by brand; nine hundredths (.09) of an ounce of RYO tobacco counts as 1 stick):

- 1) 2) 3)
4) 5) 6)

Total sticks: 7)

Part 4: Deposit Amount

For the liability year 2007 and after, the base rate per cigarette is 0.0188482

- 8. The appropriate rate for the liability year as adjusted for inflation* is: 8. \$0.0274350
9. Multiply Line 8 by total of Part 3, Line 7, and write the amount here
(Total Escrow Deposit due for the quarter): 9.
Note: Attach a copy of your receipt or other proof of deposit from your financial institution as well as a copy of the escrow agreement between you and the institution if you have not previously provided one or if it has been amended.

Part 5: Financial institution

- 10. Name:
11. Street address:
12. City, state, country, ZIP:
13. Escrow account number
14. Total amount held in this account after current deposit: \$
15. Escrow agent:
16. Phone Number:

Part 6: Authorized Signature

Under penalties of perjury, I state that, to the best of my knowledge, all of the information contained in this certificate is true and accurate. This document must be signed and dated by an authorized notary public.

Sworn to and subscribed before me this ___ day of ___, 20__

Print the name of authorized agent Title

Signature of Notary Public

Signature of authorized agent Date

City / State:
My commission expires / /

* The cumulative inflation adjustment is calculated pursuant to Exhibit C of the MSA.

Quarterly deposits are due 30 days after the end of the calendar quarter. This form is due 10 days after the deposit due date and may be sent to: Kentucky Office of Attorney General, 700 Capitol Avenue, Suite 118, Frankfort, KY 40601, (Attention: Michael Plumley, Assistant Attorney General).

Appendix B

Notice of Removals Kentucky Tobacco Manufacturers Directory

(Participating Manufacturers are listed in italics)
(Manufacturers in bold are currently certified)

2004	Effective Date
Phoenix Industria e Comercio de Tabacos, Ltda	September 23, 2004
<i>Argenship Paraguay S.A.</i>	July 21, 2004
<i>Blend Commercial Exportada Ltda</i>	June 1, 2004
<i>CigTec Tobacco, LLC</i>	June 1, 2004
<i>Diamond Bay Tobacco, Inc</i>	July 15, 2004
<i>Jasperland S.A.</i>	June 13, 2004
<i>Kaiser, S.A.</i>	July 23, 2004
<i>Makedonija Tabak</i>	June 1, 2004
<i>Ridgeway Brands Manufacturing</i>	November 8, 2004
<i>Unex, S.A.</i>	July 22, 2004
<i>Alliance Tobacco</i>	June 10, 2004
2005	Effective Date
<i>Centurion Industria e Comercio de Cigarros Ltda</i>	July 15, 2005
<i>China Tobacco Co., Anyang Factory</i>	June 3, 2005
<i>Cibahia Tabacos Especiales Limitada</i>	June 3, 2005
<i>Claymore Group of America Corp.</i>	June 3, 2005
<i>Coastal Trading Group & Imports, Inc.</i>	June 3, 2005
<i>Dos Santos, S.A.</i>	June 3, 2005
<i>Havana Tobacco Exporters, Inc.</i>	June 3, 2005
<i>Parker Tobacco Company Pvt. Limited</i>	September 9, 2005
<i>Samurai Industria e Comercio de Cigarros Ltda.</i>	June 3, 2005
<i>Sideral S.A.</i>	July 15, 2005
<i>Sudamax Industria e Comercio de Cigarros Ltda</i>	July 15, 2005
<i>Tabacalera Honnington</i>	November 5, 2005
<i>Tapti Tobacco Products Pvt. Ltd.</i>	June 3, 2005
<i>Tobacco Resource SDN BHD</i>	August 12, 2005
<i>Anderson Tobacco Company</i>	June 12, 2005
<i>International Tobacco Group (Las Vegas)</i>	December 14, 2005
<i>Planta of Berlin</i>	June 9, 2005
2006	Effective Date
<i>M/s. Dhanraj International</i>	June 1, 2006
<i>Cia Sulamericana de Tabacos</i>	May 25, 2006
<i>Guiyang Cigarette Factory</i>	June 11, 2006

Karelia Tobacco Company, Inc.	June 2, 2006
Keblon, S.A.	June 9, 2006
Pacific Tobacco, Inc.	February 1, 2006
Patriot Tobacco Company	June 11, 2006
Prime Mover Manufacturing	June 9, 2006
Procesadora Nacional Cigarella, S.A.	June 11, 2006
Seneca-Cayuga Tobacco Company	June 11, 2006
Soex India Pvt., Ltd.	February 25, 2006
Tabacalera Exportadora, S.A.	February 25, 2006
<i>Bekenton, S.A.</i>	<i>June 30, 2006</i>
<i>Canary Islands Cigar Company</i>	<i>June 11, 2006</i>
<i>Chancellor Tobacco Company, PLC</i>	<i>June 11, 2006</i>
<i>Pacific Stanford Manufacturing Corporation</i>	<i>August 17, 2006</i>
<i>Seita</i>	<i>June 11, 2006</i>
<i>VIP Tobacco USA, Ltd.</i>	<i>June 11, 2006</i>

2007**Effective Date**

Dos Santos, S.A.	June 11, 2007
Guiyang Cigarette Factory	April 2, 2007
Jai Ambe Cigarettes Pvt. Ltd	May 24, 2007
Patriot Tobacco Company	April 12, 2007
Star Scientific, Inc.	July 31, 2007
Tabacalera Nazionale	April 2, 2007
Tabacalera Regional, S.A.	August 17, 2007
YTC US, LLC	May 23, 2007

2008**Effective Date**

American Cigarette Company	July 9, 2008
Cabofriense Industrial Comercio De Cigarros, Ltda.	July 6, 2008
Dosal Tobacco Corporation	June 5, 2008
Phoenix Industria E Comercio Tabacos	June 8, 2008
Virginia Brands, LLC	June 2, 2008
<i>M/s. Dhanraj International</i>	<i>June 1, 2008</i>
<i>Monte Paz</i>	<i>July 6, 2008</i>
<i>Virginia Carolina Corp.</i>	<i>July 9, 2008</i>
C.L.P., Incorporated	June 2, 2008
Concord Tobacco International Fze.,	May 15, 2008
Jai Ambe Cigarettes, Pvt., Ltd.,	August 8, 2008
Maddi Lakshmaiah 7 Co. Ltd.,	May 30, 2008
Prime Time International Company	June 3, 2008
Procesadora Nacional Cigarella, S.A.	July 27, 2008
Seneca Cayuga Tribal Tobacco Corp.	July 9, 2008
Silver Eagle Manufacturing Corp.	June 28, 2008
Smokin Joes	June 5, 2008
Sovereign Tobacco Company	July 9, 2008

VCT Tobacco	July 9, 2008
<i>Carribbean American Tobacco Corp</i>	<i>July 9, 2008</i>
<i>Chancellor Tobacco Co., U.K., Ltd.,</i>	<i>July 9, 2008</i>
<i>Cutting Edge Enterprises, Inc.</i>	<i>July 9, 2008</i>
<i>Farmers Tobacco Company of Cythiana, Inc.</i>	<i>June 5, 2008</i>
<i>General Tobacco</i>	<i>July 9, 2008</i>
<i>House of Prince A/S</i>	<i>May 30, 2008</i>
<i>Konci G & D Management Group, USA., Inc.</i>	<i>July 9, 2008</i>
<i>Liberty Brands, LLC</i>	<i>April, 3, 2008</i>
<i>MacBaren Tobacco Company, Inc.</i>	<i>July 9, 2008</i>

2009	Effective Date
American Cigarette Company	January 15, 2010
ITW Manufacturing, Ltd.	January 18, 2010
Jai Ambe Cigarettes Pvt. Ltd.	August 14, 2009
Procesadora Nacional Cigarella, S.A.	October 16, 2009
Richardson and Richardson	June 1, 2009
Colossus Manufacturing Co. /Falcon Distributing, Inc.	February 13, 2009
Universal Tobacco, S.A.	May 16, 2009

2010	Effective Date
Carolina Tobacco Company	May 15, 2010
Charlestown Tobacco Corporation	September 25, 2010
International Masis Tabac, LLC	September 17, 2010
PT. Gudang Garam Tbk.	July 1, 2010
Tantus Tobacco LLC	March 19, 2010
<i>General Tobacco</i>	<i>February 22, 2010</i>

Source: Commonwealth.

