

Since the signing of the Master Settlement Agreement, MSA-related legislation has been enacted, often initiated by or with the strong support of the Attorneys General. Other legislative proposals, such as Tax and Credit proposals (described in more detail below), would violate the terms of the MSA and the Contracts Clause of the U.S. Constitution.

Model Escrow Statutes

Soon after signing the agreement, each of the 46 states that signed the MSA enacted the Model Escrow Statute (Exhibit T of the MSA), under which NPMs must pay into an escrow account a per pack deposit approximately equal to the per pack payment of a Subsequent Participating Manufacturer.

The escrow funds were established to ensure that funds are available to satisfy state claims, such as for health-care costs, in the event a state obtains a judgment at some point against an NPM, which has not settled with the state and has thus not been released from such claims. Under the Model Escrow Statute, funds that have remained in the escrow account for 25 years are released back to

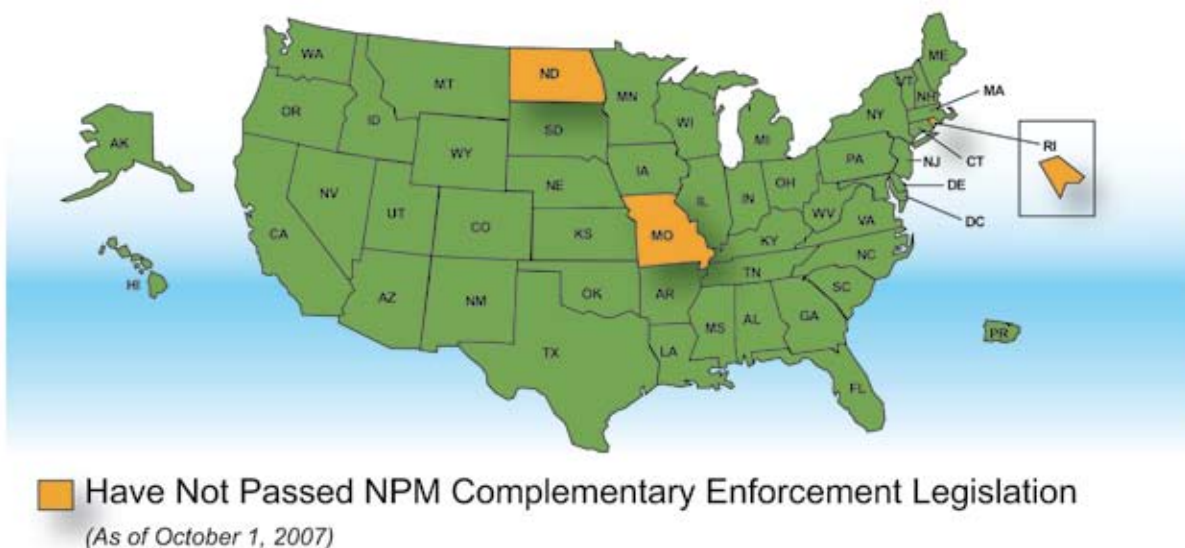
the NPM, and the NPM receives the interest as it is earned by its escrow deposits.

The model legislation, which was included in the MSA as Exhibit T, is discussed in more detail in the Non-Participating Manufacturers section of this guide.

Complementary Enforcement Legislation

In subsequent years, unintended issues arose with the Model Escrow Statutes. Consequently, the National Association of Attorneys General drafted Complementary Enforcement legislation that would provide the states with additional tools to enforce the escrow payment requirements of the Model Escrow Statutes. This legislation mandates a directory of all cigarette manufacturers (including the brands that they sell) that are signatories to the MSA or that are in full compliance with the Model Statutes. PM USA supports this legislation.

This legislation, or legislation containing different forms of some of these provisions, has been enacted in every state except Missouri, North Dakota, and Rhode Island (as of October 1, 2007).

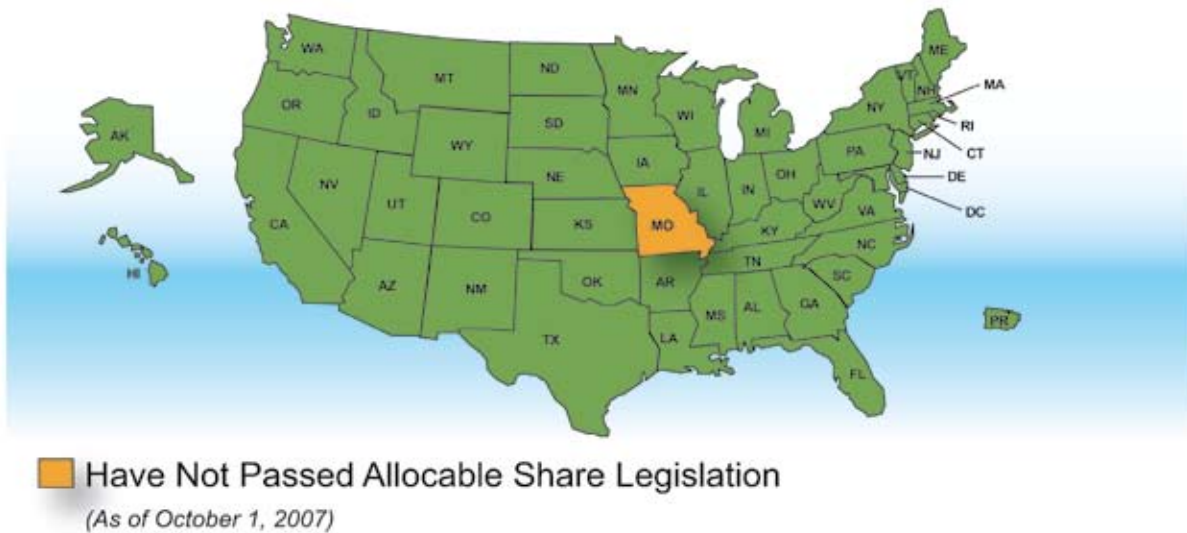


Allocable Share Legislation

NAAG's Allocable Share Amendment to the Model Escrow Statutes (supported by the Participating Manufacturers, including PM USA) closed a loophole in the Model Escrow Statute that allowed NPMs to obtain an early release of escrow deposits based on a state's share (so called "allocable share") of the overall national settlement fund that the MSA created. As a

result, this provision permitted some NPMs to avoid keeping significant amounts of money in escrow.

The NAAG and other state officials have worked to pass Allocable Share Amendments to the Escrow Statutes in order to permit the Escrow Statutes to function as intended. These amendments have been enacted in all MSA states except Missouri (as of October 1, 2007).



NPM Fee

Some states have considered legislation to impose a fee on NPMs. PM USA supports such fees in the previously settled states, which have not adopted the Model Escrow Statutes. Minnesota has enacted such a fee, while Florida, Mississippi and Texas have not yet done so.

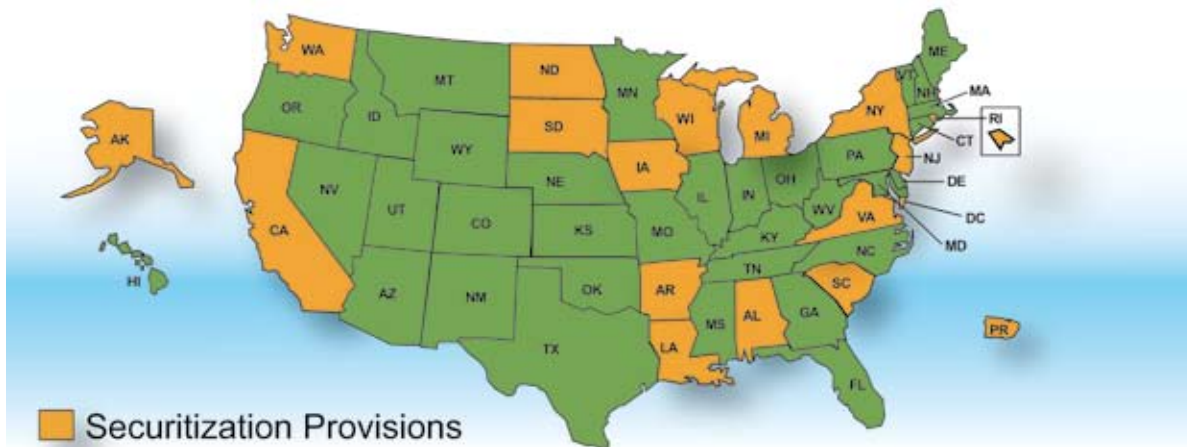
However, PM USA opposes NPM Fees in the 46 states that are parties to the MSA and where Model Escrow Statutes are in place. Alaska, Michigan and Utah currently have fees for NPMs.



Securitization

Some states and localities have enacted legislation to securitize their MSA payments. These laws allow the states to sell the right to future MSA payments to

investors for an up front payment. In other words, the states and localities receive income up front, instead of over time. At least 16 states have passed securitization provisions.



Source: Information provided to Altria Corporate Services, Inc. by Citibank, as of March 31, 2007.

Tax & Credit Proposals

“Tax & Credit” or similar proposals, which are supported by certain NPMs and the Council of Independent Tobacco Manufacturers of America (CITMA), would impose a tax on cigarettes based on a company’s sales in that particular state. Under some proposals, companies would be given a “credit” against the tax in the amount of its MSA payment made to that particular state, but the credit is incomplete and would increase the payment obligation of Participating Manufacturers.

PM USA opposes such proposals because they would:

- unfairly increase payment obligations of Participating Manufacturers;

- breach the contractual provisions of the MSA that specify the way that MSA payments are calculated and paid;
- violate the Contracts Clause of the U.S. Constitution, which bars a state from passing “any law impairing the obligations of contracts” into which it has entered; and
- jeopardize the MSA, thus placing a state’s finances at risk.

At least 12 states have considered Tax & Credit Proposals. To date, all have rejected them.

WHERE WE STAND ON...

Challenges to The MSA and the Allocable Share Amendment to the Model Escrow Statute

Philip Morris USA supports the efforts of the National Association of Attorneys General (NAAG) and other state officials to enact the so-called Allocable Share Amendment to the State Escrow Statutes. We believe that this legislation, which has already been enacted in 45 of the 46 states that entered into the MSA, is essential to permit the Escrow Statutes to function as intended.

There have been a number of challenges made to the MSA and the Allocable Share Amendment to the Model Escrow Statutes based on a variety of incorrect assertions. PM USA would like to take this opportunity to address a number of these claims.

Myth: The MSA is really a national tobacco tax in disguise and unfair to small manufacturers.

Non-Participating Manufacturers (NPMs) allege that they are being penalized for not joining the MSA. In an article in *Fortune Magazine* (Is the \$200 Billion Tobacco Deal Going Up in Smoke? March 7, 2005), NPMs claimed that the MSA and Escrow Statutes are unfair because, unlike the major tobacco companies that were originally sued by the states for their “long litany of sins,” NPMs on the other hand “haven’t done anything wrong.”

Facts: One of the fundamental purposes of the MSA was to resolve state claims for health-care reimbursement – not just for past costs, but for costs going forward in perpetuity.

Original Participating Manufacturers (OPMs) made

substantial initial up front payments to the states under the MSA totaling over \$10 billion dollars. In addition to these up front payments, the MSA also requires all Participating Manufacturers to make ongoing annual payments in perpetuity to the states to offset health-care costs.

Each of the 46 MSA states enacted the MSA’s Model Escrow Statute, which requires NPMs to pay into an escrow account a deposit approximately equal to the per-pack payment of a Subsequent Participating Manufacturer, or \$4.27 per carton in 2005. This amount is less than the total tobacco settlement-related payments (including settlement payments made to the four states who have separate settlement agreements) than are made by the OPMs. The escrow funds were established to ensure that funds are available to satisfy state claims, such as for health-care costs, in the event a state obtains a judgment at some point against the NPM, which has not settled with the state and thus has not been released from such claims. The escrow statute payments parallel only one portion of the payments made by MSA participants – namely the portion paid to compensate the states for health-care costs that may be attributable to current and future cigarette sales. Under the Escrow Statute, funds that have remained in the escrow account for 25 years are released back to the NPM, and the NPM receives annually the interest that is earned by the escrow fund.

So, far from being unfair to NPMs, the MSA gives them a big advantage: NPMs pay less money, NPMs are not bound by the unprecedented advertising and marketing restrictions under the MSA, and what money NPMs do pay may be refunded to them

after a period of time and provides them with interest annually.

Myth: The Allocable Share Amendment is unfair because escrow payments are not tax-deductible like MSA payments.

NPMs who want to keep the loophole in place argue that if they have to make their full escrow payments they will be disadvantaged because they won't be able to deduct them for federal and state income tax purposes, whereas Participating Manufacturers can deduct the payments they make under the MSA.

Facts: To the extent that an NPM prefers a tax deduction for these deposits, Professor Marvin Chirelstein of Columbia Law School testified in the Freedom Holdings case that an "NPM itself could structure the transaction (payment of escrow deposits) to provide for tax deductibility, if it wished to do so and the state agreed to accept a direct payment in lieu of the creation of an escrow account." In fact, recent legislation passed in Virginia and North Carolina expressly authorizes NPMs to assign their reversionary interest in the escrow deposits to the State for this reason.

Myth: Closing the Allocable Share "loophole" is a violation of the federal antitrust laws or the U.S. Constitution.

Facts: During the first few years after the MSA and Model Escrow Statutes' implementation, their opponents repeatedly argued in court that they violated various federal laws, including the antitrust laws and the U.S. Constitution. The MSA and the Model Escrow Statutes, however, withstood every form of attack that their opponents launched, and they were upheld by numerous courts, including three U.S. Courts of Appeals. Star Scientific, Inc. v. Beales, 278 F.3d 339, 356 (4th Cir. 2004); Mariana v. Fisher, 338 F.3d 189 (3rd Cir.

2003); Table Bluff Reservation v. Philip Morris, Inc., 256 F.3d 879 (9th Cir. 2001); A.D. Bedell Wholesale Co v. Philip Morris, Inc., 263 F.3d 239 (3d Cir. 2001); see also PTI, Inc. v. Philip Morris, Inc., 100 F. Supp. 2d 1179 (C.D. Cal. 2000); Forces Action Project LLC v. California, 2000 WL 20977 (N.D. Cal. 2000); Hise v. Philip Morris, Inc., 46 F. Supp. 2d 1201 (N.D. Okla. 1999).

NPMs sometimes claim that a decision in a case called Freedom Holdings holds that the MSA and Model Escrow Statutes violate the antitrust laws. That claim is not correct. The decision that the NPMs point to came at a preliminary stage of the litigation – whether the NPMs' complaint should be dismissed on its face – at which the court was required to simply accept the NPMs' allegations as true. Once Freedom Holdings proceeded to a stage at which the NPMs' had to prove their allegations, the court realized that the facts "tell a quite different story" than the NPMs did in their complaint, and denied their motion to enjoin enforcement of the MSA and New York's Escrow Statute. 2004 WL 2035334 (S.D.N.Y. Sept. 14, 2004). Other courts have simply rejected the initial decision in Freedom Holdings to allow such a complaint to proceed at all, even if the allegations could be proved. To the extent the Second Circuit's decision in Freedom Holdings held that the plaintiffs might even have stated a claim (assuming their untested factual allegations were true, which they are not), other courts have rejected that decision outright. See Sanders v. Brown, ___ F.3d ___, n.7 (9th Cir. Sept. 26, 2007). As the Sanders court recently held: "Sanders has failed to show that the MSA implementing statutes are *per se* illegal under the Sherman Act. Sanders has also failed to show that [the State of California or the manufacturers] are liable under either the Sherman Act or under California antitrust law. Sanders therefore has failed to state a claim entitling him to relief, and the district court properly dismissed his lawsuit."

Although the opinions upholding the MSA and Model Escrow Statutes do not rely on the existence of the Allocable Share loophole, NPMs have

attempted to use the Allocable Share Amendment to revive their baseless legal challenges. The courts have regularly rejected those efforts. In the last few years, federal courts in Arkansas, Kentucky, Oklahoma and Tennessee have affirmed the legality of the Allocable Share Amendment against antitrust and/or constitutional challenge. Grand River Enterprises Six Nations, Ltd. v. Beebe, No. 05-5051 (W.D. Ark. March 6, 2006); Xcaliber Int'l Ltd. v. Kline, 2006 WL 288705 (D. Kan. Feb. 7, 2006); S&M Brands, Inc. v. Summers, 2005 WL 2469658 (M.D. Tenn. Oct. 6, 2005), aff'd, 228 Fed. Appx. 560 (6th Cir. April 19, 2007); Tritent Int'l Corp. v. Kentucky, No. 3:04-67 (E.D. Ky. Sept. 8, 2005), aff'd, 467 F.3d 547 (6th Cir. Oct. 30, 2006); Xcaliber Int'l Ltd., LLC v. Edmondson, No. 04-0922, Order at 10 (N.D. Okla. May 20, 2005). The only ruling currently suspending enforcement of a State's Allocable Share Amendment is temporary and procedural in nature. In Freedom Holdings, the court temporarily suspended enforcement of the State's amendment against certain NPMs, but noted that the evidence on this point is "still preliminary" and has "not been subjected to testing." The court recognized that the State had not been given a "full opportunity" to rebut plaintiffs' evidence, and that the "State thus may yet defeat any requested permanent injunction." On a more complete record, the same court recently denied the relief to another NPM because the NPMs are unlikely to succeed on the merits. Grand River Enterprises Six Nations, Ltd. v. Beebe, 2006 WL 1517603 (S.D.N.Y. May 31, 2006), aff'd on other grounds, 481 F.3d 60 (2d Cir. March 6, 2007).

A separate constitutional challenge to the MSA and Escrow Statute was filed in a federal court by the Competitive Enterprise Institute in Louisiana, A.B. Coker Co. v. Foti, No. 05-1372 (W.D. La.). That complaint invokes some of the same provisions of the U.S. Constitution on which previous challengers have unsuccessfully relied, including the Compacts Clause, Due Process Clause and the Commerce Clause.

Myth: The MSA and Escrow Statutes are designed to allow the "major" cigarette companies to raise prices without fear of competition and preserve their market share.

Facts: In Xcaliber v. Edmondson, Judge Eagan's court decision stresses that, even after the Allocable Share Amendment, there is "no evidence" to support that allegation by the NPMs. The MSA doesn't insulate the big companies from competition. The facts – what has actually happened since the MSA was signed – bear this out. Competition in the U.S. cigarette market has intensified since the adoption of the MSA. Indeed, the Participating Manufacturers collectively had already lost over six percent of their 1997 market shares by the end of 2005, and the "major" companies had lost more than that.



Accordingly, Philip Morris USA will continue to support NAAG's efforts to eliminate the so-called "allocable share loophole." We believe that enactment of this legislation is a fair and effective way to preserve the important public health benefits of the MSA.

In addition to the Allocable Share Amendment, Philip Morris USA strongly supports Complementary Enforcement legislation drafted by NAAG that provides the states with additional tools to enforce the escrow payment requirements of the Model Escrow Statutes. This legislation requires, among other things, that each state maintain a directory of cigarette manufacturers and the brands they sell that are permitted to be sold in the state. A cigarette manufacturer must certify that it is a participating manufacturer or in compliance with a state's Model Escrow Statute before it and its brands will be listed in the directory.

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