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Tobacco-Settlement: Reorganization (Title XII)

Tob-set - reorganization (Title XII)

Summary of Policy Choices and Changes in McCain Non-consent Model

Set forth below is a summary of and a guide to the primary changes that will need to be made to the McCain bill in order to permit it to operate effectively on the assumption that the tobacco companies will not consent. The list looks longer than it is and it will not be difficult to make changes to separate out the provisions that pertain to what the bill refers to as "partici[ating manufacturers" so that all of the consensual provisions appear in a single stand-alone title. However, it is important to emphasize that the current McCain bill does not fully resolve many significant policy issues in a coherent fashion and thus that a reformulation of that bill along the lines that we have proposed will also have to resolve these issues.

The memorandum sets forth the issues raised by our redrafting in two parts. The first part addresses the issues that are raised by our redrafting of Titles I-VI and VIII-XI. These titles have been edited to remove any linkages to the civil liability provisions. The second part addresses the issues that are raised by our redrafting of Titles VII and XII, which involve choices about where to place various provisions related to civil liability and how to structure the consensual portions of the legislation.

Part I -- TITLES I-VI and VIII-XI

I. Significant Policy Choices

A. <u>Additional Advertising Restrictions</u>

Subtitle I.B of the McCain bill includes marketing restrictions that are to be placed in a protocol, as well as the direct imposition of labelling and advertising restrictions and point-of-sale restrictions.

<u>Options</u>

1. Replace this subtitle with language that gives the FDA full authority over advertising (unless that FDA authority title already accomplishes this goal) and that would make the existing FDA regulations on advertising legally operative, and then place the current FDA regulations, along with the additional advertising restrictions described in the June 20th Resolution, as independent terms in the protocol that is more fully set forth in Title XII.

2. Codify the FDA regulations in this subtitle while confirming FDA authority to establish additional regulations, and then place the current FDA regulations, along with

the additional advertising restrictions described in the June 20th Resolution, as independent terms in the protocol that is more fully set forth in Title XII.

3. Codify in this subtitle the FDA regulations and narrowly tailored extensions of them (along the lines that are set forth in the attached white paper) while confirming the FDA's authority to establish additional regulations, and then place the current FDA regulations, along with the additional advertising restrictions described in the June 20th Resolution, as independent terms in the protocol that is more fully set forth in Title XII.

B. Magnitude of Look-Back Surcharges

Larger look-back surcharges may be appropriate if the tobacco companies do not consent.

Options

✓ 1. Leave surcharges as they are.

2. Increase surcharges

C. Substantial Non-attainment of Required Youth Smoking Reductions

Section 203 of the McCain bill allows the Secretary to bring an action against a tobacco company to remove the company's liability protections if it misses its target reductions by 20 percentage points. This section no longer has meaning in Titles I-XI because there are no liability protections. It could be eliminated and placed in Title XII as a qualification for "participating manufacturer" status. Making this change may provide an opportunity to argue for a different version of this provision (i.e., one that provides less process for the companies to challenge the Secretary's determination).

Options

1. Eliminate entirely

✓ 2. Move to Title XII in substantially the same form

3. Move to Title XII and alter significantly

D. The Wyden Amendment

Section 224 (repeated in Section 801) establishes an "Accountability Panel" that, in some ways is duplicative of Section

203, and in other ways erodes the Secretary's power. It would also permit the Commissioner of the FDA to bring an action against a tobacco manufacturer if there is a "clear and present danger" that the manufacturer will miss its youth-smoking target. Some of this section, such as the provisions of requiring a Tobacco Company Plan and an annual report could be preserved in Title II. The remainder of the section, which deals with suspension and withdrawal of liability protections no longer belongs in Titles I-XI; it could be placed in Title XII (and changed).

Options

1. Eliminate entirely

2. Keep Plan and Report requirements and eliminate the rest

√ 3. Move to Title XII in substantially the same form

3. Move to Title XII and alter significantly

E. Bonding

Under Section 708 of the McCain bill, non-participating manufacturers must place 150% of the amount they would have paid had they been participating manufacturers in assessments into an escrow fund for payment of liability judgments; they are able to recover this money in 35 years. There is some value in having manufacturers who do not participate post a bond that could provide for recovery in the event that they go bankrupt. Such a bond would be an additional inducement to participation and a disincentive for new manufacturers.

At present, however, the required "bond" might seem punitive and undermine the voluntariness of the choice to participate because non-participating manufacturers also have to make payments into the same fund that participating manufacturers pay into, even though participating manufacturers receive liability protections and receive an offset on their annual assessments whenever they pay out judgments. As we explain in connection with Title XII, requiring non-participants to both place money in escrow to fund their own liability judgments and to pay in a fund that will be used to pay the liability judgments of non-participating manufacturers makes the offer of liability protection appear to be more like a threat: unless a manufacturer signs onto the protocol, they will effectively have to fund not only their own liabilities, but their competitors as well.

Options

1. Do nothing (no bond requirement)

√ 2. Make clear (probably in Title IV) that the bond requirement acts as a means of

insuring that non-participants can fund liability judgments and not as a penalty on non-participating manufacturers.

F. State and Federal Accounts

Title IV of the McCain bill establishes separate State and Federal Accounts (pp. 156, 167-68). These are not well-explained and are often described in reference to the Trust Agreement that the State AGs envisioned. Their purpose is to ensure that certain money goes directly to the states. As there would be no trust agreement in our version, we could delete these separate accounts and provide a mechanism that distinguishes between the money that goes to the states who elect to opt into the federal scheme and the money that goes solely to the federal government. We could also delete the separate accounts, but this would certainly be noticed by the state AGs.

Options

√ 1. Do nothing

2. Remove references to State and Federal Accounts

G. Distributing Money to the States

As drafted, the McCain bill refers to the Master Settlement Agreement as the mechanism for distributing money to the states. That Agreement in turn refers to the Irrevocable Trust Agreement, which apportions money to each state. Because those instruments are not contemplated in this model, a different mechanism needs to be used. One could use a chart similar to that contemplated by the Irrevocable Trust Agreement, specify a formula, leave it to the Secretary under some standard, provide some other mechanism.

Options

1. Include chart similar to that in the Trust Agreement

2. Specify a formula

3. Leave to the Secretary's discretion

4. Other

H. Document Provisions

As drafted, the McCain bill applies the document disclosure requirements to "participating manufacturers" only. This would have allowed very small manufacturers, including Indian tribes, to avoid the document disclosure requirements if they so desired. Removing the "participating" language would place this obligation on all manufacturers.

Options

1. Do nothing; leave requirement on all manufacturers

2. Exempt very small manufacturers

3. Move to Title XII; impose requirement only on participating manufacturers

I. Findings

Possible Additional Findings

It may be useful to add some additional findings, including those that focus on the health costs of smoking . These may provide additional support for the assessments -- they are to defray health costs, ensure a rise in the price of cigarettes, disgorge revenues from illegal sales (if this number is large enough, it has enormous value as a rhetorical point). Additional findings may include:

1. Health costs of smoking ($100 billion per year)

2. Revenues from sales to underage smokers (???)

3. The basis for the $10 billion up front payment

4. It is the intention of the bill to ensure that companies cannot escape their obligations through manipulation of the corporation form or shifting of assets

5. A more complete set of findings for the Title IX -- Document Disclosure

6. Findings to support the financial provisions of the LEAF Act

Placement of Existing Findings

There are a number of findings and purposes in Sections 2 and 3 of the McCain bill that make reference to civil suits and the resolution of those suits. These findings and purposes could be moved in Title XII if all of the civil liability provisions are placed there, or could be at the beginning of the bill and modified somewhat to reflect changes in the bill. In addition, parts of Section 4 (Scope and Effect) could also moved to Title XII. The relevant sections are: Findings 12, 13, and 14; Purposes 13, 16, and 17; and Scope and Effect subsections (2), (3), and (4).

II. Smaller Policy Calls

A. Apportionment of Payment Among Manufacturers

In general, the McCain bill apportions payments among

manufacturers according to market share, but appears (it's unclear) to allow the manufacturers to make separate arrangements among themselves. This language, which refers to the Protocol, has been removed (p. 159).

B. Pass-through of Payments to Price

The McCain bill requires manufacturers to use "best efforts" to pass the annual payments through to the price (p. 160). The bill provides for law suits to penalize the companies for a violation of this requirement, but only in reference to the identical provisions of the Master Settlement Agreement. This has been reformulated to allow for actions based on a violation of the statutory "best efforts" requirement.

The McCain bill makes penalties paid for violations of this "best efforts" requirement tax deductible; this does not appear, however, to have been intentional. This has been changed.

C. Document Disclosure to the Department of Justice and Inspection and Discovery Rights of States

Title IX of the McCain bill makes reference to documents submitted to the Department of Justices and State antitrust authorities and the "inspection and discovery rights" of the State AGs, pursuant to the protocol. This provision has been deleted, although some variation could be incorporated if desired.

D. Severability of Document Disclosure Requirements

There is a risk that some of the document disclosure requirements could be deemed a taking or a violation of due process. It may be useful to include some form of severability clause to ensure that, if a court holds that a manufacturer cannot be required to turn over certain documents, the rest of the Title survives. We have not done this yet.

E. Participating Language in the LEAF Act

The LEAF Act portion of the bill uses the term "participating tobacco producer." This does not appear to be related to "participating tobacco manufacturer" and has been left as is.

F. Antitrust Exemption

Under our model, the industry will be required to enter into a Protocol, but will not be required to enter into agreements with each other. Therefore, the antitrust exemption is unnecessary even in the "consent" portion of the bill. It has been removed.

III. Technical Changes/Issues

A. No Duplication of Recovery

Section 7 prohibits duplicate recovery and could be placed in Title XII if all of the civil liability provisions are placed there. It can be (and has been) left as is.

B. Penalty to Surcharge in Title II

The word "penalty" has been changed to "surcharge" throughout Title II.

C. Language Changes in Title IV

The word "Settlement" has been deleted from references to the National Tobacco Trust Fund. The phrase "participating tobacco product manufacturer" has been changed to "tobacco product manufacturer."

D. Elimination of References to MSA and Trust Agreement

Requirements that are linked to the Master Settlement Agreement have been changed to relate to the identical provisions of the Act. References to the Trust Agreement have been deleted, although it is possible that specific terms of the agreement may be appropriate for incorporation into the legislation.

E. Application to Indian Tribes

This Title was drafted as a stand-alone bill and has been edited to make it fit into this legislation. References to the June 20 settlement have been deleted.

Part 2 -- TITLES VII AND XII

There are a number of choices about how to structure Titles VII and XII. McCain's Title VII includes provisions that apply to tobacco claims all manufacturers and others that apply only to participating manufacturers. One general approach, the model that we have followed, involves separating these provisions to create a federal cause of action in Title VII, applicable to all tobacco claims, and to set forth civil liability protections for participating manufacturers in a newly created Title XII. It might be simpler, as a drafting matter, to present Title XII as a second subtitle of Title VII (definitions could be stated only once). However, for the sake of clarity, we continue to refer to the portion of the bill containing liability limitations as Title XII.

There are many difficult policy choices that need to be made with respect to this proposal. For the most part, however, they are no different from the choices that remain to be made under the McCain bill as currently structured.

I. Title VII (or Subtitle A of Title VII)

Title VII creates a federal cause of action for tobacco-related injury, patterned on the cause of action in the McCain bill. The cause of action adopts state rules of decision, but includes an important new substantive component -- rebuttable evidentiary presumptions that nicotine is addictive and that a number of diseases are caused by use of tobacco products.

One cautionary note is that the less substance the federal cause of action has, the more likely it is to be the subject to a successful federalism challenge. The federal cause of action proposed above may steer close to the edge.

II. Title XII (or Subtitle B of Title VII)

Title XII contains the qualifications for a participating tobacco product manufacturers and the benefits that such a manufacturer receives. As part of this, this Title establishes the Judgment Fund and payment provisions for participating manufacturers.

A. Qualifications of a Participating Manufacturer

The section defining the qualifications for a participating manufacturer may be among the most important provisions in the bill. The McCain bill provides for loss of a manufacturer's liability limitations in a number of places. These can be collected in one place and revised. A principal objective of this section will be to create significant disincentives for participating manufacturers to challenge the constitutionality of the Act. The following are proposed qualifications for participating manufacturers:

1. Execution of a Protocol with the Secretary of HHS containing:

    a. Restatements of sections of the Act that manufacturers must adhere to in order to qualify for liability protection; these would include, but not be limited to, the look-back assessments, marketing restrictions, assessment provisions, and document disclosure provisions

    b. Possible references to sections of the Act that must be in place generally; these could include marketing restrictions that are thought to be essential to any effective program to reduce youth smoking

    c. Additional marketing restrictions, such as a ban on outdoor advertising, a ban on internet advertising, etc.

    d. Agreement to contract with distributors and retailers to limit marketing and advertising

2. The manufacturer must not have missed any youth smoking reduction target by more than 20 percentage points

3. The manufacturer must not have been convicted of certain specified criminal acts

4. Other qualifications.

New entrants into the tobacco industry will have a specified time to become "participating" manufacturers.

B. <u>Benefits for Manufacturers</u>

Assuming a model similar to that in the McCain bill, the major benefits to be offered to the participating manufacturers are 1) a liability cap (set at $6.5 billion per year on an assumption that manufacturers accounting for that vast majority of tobacco products consumed in the United States would participate); 2) the chance to offset liability payments against the assessments required in Title IV of the bill; (3) preemption of tobacco claims against the participating manufacturer's suppliers, officers, and distributors; (4) preemption of addiction and dependence claims.

Under such a proposal, participating manufacturers would pay a pro rata share (based on each manufacturer's market share) of $6.5 billion into a fund; the manufacturer would then be able to offset (at 80 cents on the dollar) its liability judgments against its annual assessment. In a given year, the total amount of payments into the liability fund could be no more than $6.5

billion, but could be much less. If major manufacturers did not participate, money will not flow into the fund.

If the fund at any time reached $20 billion, monies could be rolled back into the treasury for public health purposes.

III. Policy/Drafting Choices

A. Attorneys Fees

Attorneys fees continue to be a significant issue. There is no straightforward way to make a non-participating manufacturer pay attorneys fees. Any attempt to do so would almost certainly give rise to significant due process claims. If, however, only participating manufacturers are required to pay attorneys fees, there is a significant disincentive for manufacturers to participate.

Options

1. Eliminate all references; allow clients' fee obligations to be determined under existing state-law principles

2. Require participating manufacturers to participate in an arbitration scheme, similar to that in McCain, at the election of attorney-claimants

C. Bond/Settlement Reserve for Non-participants

The McCain bill treatment of non-participating manufacturers is confusing. The bill simply did not contemplate that there would be non-participation by any significant part of the market. Our model assumes that many tobacco manufacturers, representing a large share of the market, could choose not to participate, and then seeks to encourage participation through the offer of benefits.

Any legislation will create two different revenue streams -- assessments to the fund for public health and other purposes and payments for liability judgments. With respect to the first revenue stream, all manufacturers are or should be equally responsible. With respect to the latter revenue stream, participating and non-participating manufacturers are in distinctly different positions and should not be equally responsible. How the bill deals with this difference will determine its effectiveness in encouraging participation and the level of risk that the bill be subject to a successful unconstitutional conditions challenge.

Options

1) Akin to the McCain bill, the legislation could offer participating manufacturers 1) liability protection and 2) the chance to offset liability payments against the annual assessments. This variation ensures that the tobacco industry pays out sums that we believe are

sufficient to raise the price $1.10 a pack. It errs on the side of greater price increases, however, because non-participating manufacturers will be subject to payments equivalent to the payments made by participants (which include the participants assessment payment and their liability payment) <u>and</u> to whatever liability payments they will have to make. This could cause an even greater increase in the price of cigarettes. While this provides a significant inducement to participation, it also makes non-participation more onerous and may increase the chance that the scheme will be struck down.

2) Rather than give participating manufacturers an offset, one could separate the two revenue streams. All manufacturers would be subject to one set of assessments, which would be lower than the assessments currently in Title IV of the McCain bill. Participating manufacturers would make a separate payment into a liability fund and their liability would be capped. This payment would be calibrated so that, if every manufacturer participated, the amount of money raised would be equivalent to the sum that needed to raise the price $1.10 a pack. Non-participants would be required to pay a bond into a settlement reserve fund that may be significantly higher than the payment made by participating manufacturers (150% or more -- it should be calculated to ensure that, if everyone did not participate, the price would rise $1.10 per pack). Non-participants' liability would be paid out of this reserve fund (until it was exhausted) and would not be capped, but the non-participants would recover funds after 35 years (with interest). This option appears more secure as a constitutional matter, but may not provide as significant incentives to participate.

E. <u>Protection for Distributors and Suppliers</u>

The McCain bill protects distributor and suppliers who deal with participating manufacturers. It appears that such distributors and suppliers cannot be sued for violations for tobacco-related injury; all such claims must be brought against the manufacturers. This gives manufacturers an incentive to participate, but it may also give distributors and retailers a pass if they advertise to young people or induce people to smoke based on false statements.

<u>Options</u>

1. Protect distributors and suppliers who deal with participating manufacturers

2. Do not protect distributors and suppliers who deal with participating manufacturers

F. Qualifications

There are many drafting issues with respect to the qualifications for a participating manufacturer. This is also intimately tied in to the severability issue discussed below. Possible requirements for participating manufacturers are listed above, but others are possible, including requiring participating manufacturers to pay attorneys fees pursuant to an arbitration process.

Execution of a protocol with the Secretary of HHS will be one of the qualifications. What will be in the protocol, however, and in how much detail the statute will recite language for the protocol remains to be decided. We are continuing to investigate the best approach.

The McCain bill includes a number of provisions throughout the bill that penalize participating manufacturers with the loss of their liability protection if certain events occur. The two principal provisions are 1) the Wyden Amendment, which allows withdrawal of liability protection if there is a "clear and present danger" of missing a youth smoking target and 2) the withdrawal of liability protection for a substantial non-attainment percentage, i.e., missing a youth-smoking target by 20 percentage points. Each of these provisions include intricate judicial review provisions. They could be incorporated into Title XII almost in their entirety or could be simplified. The options are discussed above with respect to Titles I-VI and VIII-XI.

G. The Spigot Problem

The "spigot" problem -- how to deal with a manufacturer that has liability protections, loses them, and then seeks to get them back -- was not resolved in the June 20 settlement, and has not been even mentioned in any of the bills. The simplest method for dealing with this is to make loss of liability protections irrevocable. This avoids the problem, but may be too blunt an approach. Other options, however, run the risk of creating confusing situations related to whether a particular suit or judgment is subject to the liability provisions and should be collected from the fund or is not subject to those provisions and should be collected from the manufacturer. Moreover, as we indicated in our earlier memorandum, it would be advisable to place jurisdiction over all constitutional challenges to the Act in a single forum, such as the district court for the District of Columbia and to provide for expedited review to the Supreme Court to alleviate the on/off concerns that could arise from conflicting judgments.

Options

1. Make loss of liability irrevocable

2. Allow re-qualification with or without specific rules for

dealing with claims pending when the limitations did not apply

3. Other?

H. Severability Issues

These were highlighted in our last memo and include at least four options.

Options

1. Deal vanishes if any provision is struck down or rendered inapplicable

2. Deal vanishes if specific, tagged provisions are struck down or rendered in applicable

3. Secretary of HHS has discretion to end the deal if a provision is struck down or rendered inapplicable

4. Standards specified for court to determine if deal can should be invalidated

I. Final Settlements in TX, FL, and MS

The settlements in the Texas, Florida, and Mississippi cases leave open the possibility of their settlement agreements being superseded by "substantially similar" legislation. It is unclear whether the McCain bill would qualify. Provision will need to be made to ensure that these states 1) have the option of opting in and 2) do not lose any vested rights.

J. Allocation Mechanisms

The McCain bill does not currently contain any mechanism for allocating the limited money to pay judgments among many claimants. The bill leaves it to the Secretary of the Treasury's discretion to establish regulations for paying claims and establishes a clear preference for first-come, first-serve. The legislation could contain an explicit allocation mechanisms, such as capping damages at a certain amount until all other claims are paid for a given year, or paying compensatory damages before punitives.

Options

1. Leave as is (By regulation with preference for first in time)

2. By regulation without a preference

3. Explicit allocation mechanism

K. Content of the Federal Cause of Action

L. Settlement of State Suits

Tob - xr - reorganization (title XII)

A MODEL FOR LEGISLATION THAT DOES NOT DEPEND ON INDUSTRY CONSENT

The McCain bill, which draws heavily on the bill proposed by the state Attorneys General, was drafted with the assumption that the tobacco companies would participate. Thus, although it has provisions for non-participating manufacturers and imposes most of its requirements on all manufacturers, the bill was not intended to operate in a world without the manufacturers' consent. Given the industry's current threat to walk away from the table, it becomes critical to draft a bill that not only achieves the President's five goals without the industry's consent, but also includes provisions which would permit the companies to return to the table.

Our vision is a single piece of legislation with two parts -- a tough comprehensive package that applies to all tobacco manufacturers and a separate "deal" that further advances the President's goals while giving the tobacco industry a significant inducement to participate. This approaches closer to the sort of bill that one would have drafted had there been no prospect of or interest in industry participation at the outset. The first part is a stand-alone piece of legislation. It could be enacted alone. The second part is in the nature of an inducement to the industry not to challenge the law because it offers the liability protection that the industry wants.

As the Administration has noted, the McCain bill is in need of substantial revision on both technical and policy grounds. In addition, as we have noted in our chart outlining concerns with the McCain bill, various provisions of the legislation raise significant constitutional concerns. These constitutional concerns may generally be satisfied through modest modifications, although in some instances -- such as the provisions that purport to restrict non-commercial speech -- we believe deletions are necessary. However, the reshaping the McCain bill into the two-part structure that we discuss here would not require enormous modifications. It would be necessary to remove the consent-based provisions throughout the bill and gather them (or some subset thereof) in a separate Title that embodies the "deal." The result, however, would be a simpler, clearer bill that deals more effectively with both scenarios -- consent and no consent.

There are a number of advantages to this model:

* It is less complicated and therefore easier to administer than the present bill, particularly in the face of industry opposition

* The bulk of restrictions do not rely on cumbersome consent mechanisms, such as consent decrees, settlement agreements and protocols

* There is no basis for an antitrust exemption in the stand-alone portion of the bill because there will be no "agreement" to effectuate (we continue to believe that there should be no antitrust exemption under any circumstances)

* The bill can easily be modified if it becomes clear the industry will never consent by removing the final title and will be more effective if some, but not all, manufacturers decide to participate

We have done a quick review of the McCain bill and identified the changes that would need to be made to modify it as described. Further study will be required to make sure all of the pieces fit together.

THE MODIFIED MCCAIN BILL

Part One: The Industry-Wide Package

* Increases the price of cigarettes by $1.10 per pack over 5 years

* Full FDA Authority
  McCain's version or an administration substitute

* Marketing Restrictions
  The FDA Regulations + narrowly tailored extensions (but not the additional restrictions barring all outdoor advertising, advertising on the Internet, and the use of human images and cartoons).

* Expansion of smoking cessation and prevention programs and the reduction of secondhand smoke

* Protection for tobacco farmers and their communities
  The LEAF bill or a substitute

* Significant look-back penalties
  McCain or an administration substitute

* Extensive labelling and constituent disclosure requirements

* Licensing and registration provisions
  McCain or an administration substitute

* Disclosure of all non-privileged documents

Part Two: The Deal

* The Additional marketing restrictions (such as the restrictions barring outdoor advertising, the use of human or animal images and cartoons, etc.)

* Compliance with all of the marketing restrictions contained in the industry-wide package, which would be set forth as independent terms of the protocol so that they would still apply to the participating manufacturers even if they were held invalid as to non-participants

* Civil liability provisions

* Some enforcement provisions that rely on withdrawal of liability protections for egregious conduct

* Attorneys fees provision (if necessary)

* The Look-back provisions in the industry-wide package, which

would be set forth as independent terms of the protocol so that they would still apply to the participating manufacturers even if they were held invalid as to non-participants

THE DEAL

I. Problems in the current McCain bill

The current McCain bill is confusing, in large part because it incorporates several different consent mechanisms. The bill contemplates the following:

1) a Protocol, apparently between tobacco companies and the federal government;
2) multiple consent decrees, probably between individual companies and individual states, though the bill also suggests that the consent decrees are between companies;
3) a Master Settlement Agreement;
4) a Trust Agreement of unclear scope.

The bill does not clearly connect these consent mechanisms to each other or to the liability provisions. Moreover, the bill intersperses these consent mechanisms throughout the bill, making severability difficult.

II. A Better Consent-based Bill

Some of the complexities of the McCain bill can be avoided if one assumes a bill with two fundamental parts -- a freestanding set of statutory provisions that contains most of the relevant provisions that can be imposed consistent with the constitution (a modified version of Titles I-XI of McCain) and an additional title (Title XII) that contains all of the provisions of "the deal." Tobacco companies that decide not to participate will simply continue to be subject to the provisions of Titles I-XI, as will the companies that do participate. By contrast, participating companies will receive the benefits of Title XII, even though they would remain subject to the restrictions set forth in Titles I-XI. The bill would be designed to ensure that Title XII was wholly severable from the remainder of the bill; if any aspect of Title XII were struck down, Titles I-XI would remain in force and would provide a coherent regulatory framework for the future (There remain, however, substantial questions as to whether the converse should be true and how severability should work as a general matter.).

The bill would not use the term "non-participating manufacturer." A non-participating manufacturer would simply comply with Title I-XI (one could create additional incentives, such as bonding requirements, but the greater such incentives are, the more likely Title XII will be struck down as an unconstitutional condition).

Title XII (the deal) would contain two principal sections: 1) how a tobacco manufacturer qualifies for the deal (e.g., by agreeing to advertising restrictions and look-back assessments) and

2) the liability limitations that a participating manufacturer would receive in exchange. In contrast to McCain, which places the qualifications throughout the bill in a series of enforcement provisions, the qualifications would be in a single place. We would propose that the qualifications should be the definition of "participating tobacco product manufacturer." As this bill would be designed, that term would have meaning only in Title XII.

As we have previously discussed, additional marketing restrictions would be most likely to survive constitutional challenge if the qualifications for being a "participating tobacco product manufacturer" were speech-neutral. If it is necessary to specify advertising restrictions, the preferred consent mechanism is a Protocol between the federal government and the tobacco industry. A Protocol signed by the Secretary of Health and Human Services ensures that the federal government can enforce all relevant provisions, avoids the initial judicial approval that would be required under a consent decree approach, and does not require the federal legislation to condition the receipt of any state funding on their willingness to enter into settlements that include constitutionally suspect advertising restrictions. For these reasons, the Protocol may be the best choice.

A bill that used a Protocol would not preclude the existence of state court consent decrees. Indeed, such a bill could require the state suits to be settled, but it would not require any particular terms in those settlement agreements (other than, perhaps, payment of attorneys fees, see below).

The qualifications for becoming a participating tobacco product manufacturer can be extensive. They should ensure that there will be minimal litigation over the marketing restrictions and other provisions in the law and that bad actors and those who do not meet their youth smoking reduction targets do not get the liability protections. Thus, we would propose that participating manufacturers must be subject to all of the marketing restrictions (the FDA restrictions plus narrowly tailored extensions plus additional, broader restrictions that would raise constitutional concerns if imposed directly).

III. Open Policy Issues

There remain a number of fundamental policy issues with respect to this proposal, including:

A. Impact of Invalidation of Part of the Deal on Liability Limits

There are a variety of difficult questions concerning the loss of liability protection by bad actors, implicating both legal and policy concerns. We have set forth some general options for provisions that would define the circumstances under which

participating tobacco manufactures would lose liability protection due to judicial invalidation of those restrictions and burdens.[1]

We note at the outset that severe practical concerns arise if the loss of liability protection is tied to the judicial invalidation of certain burdens and restrictions. We have previously referred to concerns similar to these as the "spigot" problem. One key problem is figuring out when a provision has been invalidated, given appeal rights and multiple federal jurisdictions where different rulings might be returned. To alleviate these concerns, we recommend that the legislation provide that all constitutional challenges to the act be brought in a single forum -- such as the United States District Court for the District of Columbia -- with direct review (on an expedited basis) as of right to the Supreme Court. This approach will minimize litigation delay and avoid the problems that would result from conflicting lower court decisions, as such conflicts would make it very difficult to determine whether the liability protections were in force at a given moment.

1. General Points -- A primary benefit of a liability protection bargain is that it would weaken the incentive for participating manufacturers to raise constitutional objections not only to the burdens and restrictions contained in that bargain but also to the similar burdens and restrictions that would be contained in the accompanying stand alone legislation. To the extent that the burdens and restrictions on tobacco manufacturers -- such as the conditional assessments imposed through the lookback provisions and the advertising restrictions currently found in the FDA regulation -- appeared both in the bill's mandatory, industry-wide provisions and in the bargain, participating manufacturers might have sufficient incentives not to challenge the direct imposition of the burdens or restrictions that they had accepted in exchange for liability protection. They would continue to be subject to the similar (and perhaps even more expansive) restrictions contained in the bargain even if a challenge to their direct imposition succeeded.

[1]We do not discuss how the bill should handle the general question of severability, i.e., which portions of the stand alone legislation should survive invalidation of other portions of that legislation. One option for addressing this problem would be to rely on conventional severability language. But conventional severability language is not well suited to defining when judicial invalidations should result in the loss of liability protection. This section address that problem.

There are two distinct sets of circumstances under which the judicial invalidation of various burdens and restrictions might cause participating manufacturers to lose liability protection.

(1) Courts could invalidate some of the burdens and restrictions that the stand-alone portion of the bill would impose directly on all tobacco manufacturers. These rulings would not necessarily affect the application of these burdens and restrictions to participating manufacturers if such burdens and restrictions were also set forth as independent terms of the bargain. However, there may be policy reasons for tying the continued availability of the bargain to the continued validity of the burdens and restrictions contained in the stand alone portion of the legislation. For instance, if courts struck down the direct imposition of important restrictions on youth advertising by non-participating manufacturers, the public health benefits that could be obtained from a bargain that required participating manufacturers to comply with similar, or even more expansive, restrictions might be too small to justify the liability protection.

(2) Courts could invalidate some or all of the burdens and restrictions that would be included as independent terms of the liability protection bargain itself. Manufacturers who elected to participate presumably would not bring a challenge to these burdens and restrictions, but other parties might. For instance, a non-participating manufacturer might object to the liability protection enjoyed by its competitors; or a distributor who wishes to advertise might challenge the legal incentive that prompted a participating supplier to insist that a distributor cease advertising its brands.

In sum, the bill's provisions respecting the loss of liability protection for participating manufacturers must account for two types of potential judicial rulings: (1) invalidation of key elements of the statutory regime affecting non-participating manufacturers in a manner that could undermine the basis for the bargain and (2) invalidation of important aspects of the government's bargain with participating manufacturers.

If drafters of the bill determined, as a policy matter, that the liability protection bargain will only benefit the public if all manufacturers, whether participating or not, remain subject to critical burdens and restrictions, then the protocol should be structured so that the liability protections are withdrawn upon a holding that either some or perhaps all of the

advertising restrictions that have been imposed directly are unconstitutional. There are, however, real costs to such an approach: It would permit a third party, by bringing a successful challenge to the direct imposition of advertising restrictions, to nullify the conditional portion of the legislation.

2. Options -- With these points in mind, we offer several options for providing for the termination of liability protection in response to holdings that certain of the advertising restrictions are unconstitutional.

Option 1: Specify in the statute which burdens and restrictions must remain in force (a) under the bargain, and/or (b) under the stand alone legislation in order for liability protections to remain in place.

Pros: Clearly sets forth the conditions for retaining liability protection.

Cons: Requires an extremely difficult present day judgment as to the future conditions under which the offer of liability protection should be withdrawn. Also, requires that the statute define what counts as "invalidation" of the specified burdens and restrictions -- e.g., Would a successful as applied challenge constitute "invalidation" of a particular provision?

Option 2: Provide for presumptive withdrawal of liability protection if specified burdens and restrictions are invalidated (a) as to the bargain, and/or (b) as to the stand alone legislation, with the proviso that the Secretary of HHS could prevent the withdrawal of liability protection based on a determination that the invalidation in question would not significantly interfere with the attainment of the Act's purposes, taking into account whether regulations could be promulgated in lieu of the invalidated restriction. The Secretary's determination shall not be subject to judicial review.

Pros: Provides flexibility to account for the varying significance of judicial holdings invalidating certain provisions

or portions thereof.

Cons: May place enormous political/appropriations pressure on the Secretary. HHS understandably has this concern. (Consideration could be given to substituting the President for the Secretary of HHS in order to minimize appropriations pressure.)

Option 3: Provide for presumptive withdrawal of liability protection if specified burdens and restrictions are invalidated (a) as to participating manufacturers, and/or (b) as to non-participating manufacturers, unless a court determined that the invalidation would not substantially interfere with the attainment of the Act's purposes.

Pros: Avoids present-day judgment as to the future conditions under which the offer of liability protections should be withdrawn and political pressures presented by Option 2.

Cons: Leaves the decision largely to the courts unless the standard is crafted in a manner that imposes real constraints. In addition, this approach could raise concerns about impermissible delegations of policy discretion to the courts. Again, this concern could perhaps be accommodated through crafting of a sufficiently specific standard.

B. Settling the State Suits

We have always been concerned about inequities in bargaining power permitting one side or another to hold up settlement of the state suits. If states have all of the incentives to settle (to get federal money), then tobacco manufacturers will find some way to get a good deal. If the reverse is true (because tobacco companies need the settlements to become participating manufacturers), the states may impose arduous conditions. These concerns may be alleviated by simply providing that states that agree not to pursue certain claims against tobacco companies may receive federal funds and that manufacturers must simply agree to the terms of the protocol in order to get liability protections, without regard to whether they have settled with the states. In other words, a tobacco company could be a signatory to the protocol and still be subject to suit by a state that was willing to forgo

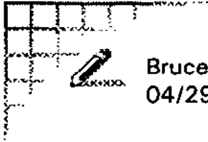
the federal money.

Attorneys Fees

Attorneys fees remain a thorny problem. We continue to question whether we need to do anything. Our analysis of the state contracts suggests that very few of the attorneys have any argument that they recover under their contracts in the event of federal legislation; they may have quantum meruit and other claims. It might be easier to leave well enough alone. Indeed, settlement of the state lawsuits, including attorneys fees, was the centerpiece of the June 20th settlement. It becomes difficult to see where the fees issue fits in when federal laws become central.

One option is to require payment of the attorneys fees and participation in an arbitration process as a separate condition of being a participating manufacturer. It would not be linked to the settlement of the law suits and thus would not allow the tobacco companies to hold up the states for lower attorneys fee payments.

Tob - ser - reorganization (Title XII)



Bruce N. Reed
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Defenses/legal rules

Record Type: Record

To: Elena Kagan/OPD/EOP, Cynthia A. Rice/OPD/EOP

cc:
Subject: justice draft

One more concern: I don't think DOJ should get into drafting the tort fund for these guys. That is a much more complex question than their draft suggests, and they should just flag it as an issue that needs to be resolved.

Also, why would attys fees go into Title XII? Wouldn't it be an issue with state suits as well?

Tob-scr - reorganization proposal (Title XII)

DOT mtg re McC bill 4/21

Stand-alone piece - 11 titles (as in McCain)
"The deal" - 12th title

(All apply to new entrants)

1. price - BL: tax? origination clause?
do they have standing to sue
2. FDA auth
3. Marketing restrictions: FDA plus
4. Second-hand smoke
5. LEAF
6. Lookback "surcharges"
7. Labelling
8. Licensing + reg provisions
9. Disclosure of docs.

McC has provisions on preemption that makes life easier for TIs 705(e)(5)

Could close out suits above (cond. state funding on dropping suit)

Part 2: Title 12 - The Deal

Model - how to become "participating manufacturer" -
They only qualify for burdens + benefits
1 qualif-protocol w/ fed govt -
repeats everything they would challenge - be inclusive
Liability protection - their inducement
Severability provisions - loss of liab. protections for challenging
If you sue + win, Title 12 drops out of bill.
How about if someone else sues + wins?
See analysis - has to decide whether deal is conditional on partic. provisions.

could combine these:
tag specific provisions?
have admin mech - should deal fall?
Standards for judicial decision on invalidation.

Additional marketing restrictions - e.g. outdoor advert.

What does this really require?

Provisions in T. 1 - protocol : remove this

put in const. marketing restrictions (narrowly tailored)

or have stat language

T. 7 - liability protections -

remove + insert as T. 12

or have some part in: e.g. presumptions } both go together

fed cl a

settle some suits? - preempt or are spending

Throughout - kickout provisions - don't get liability, if you...

[Wyden amend]

prompt payment e.g.

take them out - if you want to keep - put in as part of qualify to become partic. manu.

take out refs to agreements throughout - partic. in payment provisions.

design T. 12:

Pt 1: def of partic manu - load in all things you need from them (agree to comply, etc.)

Poss: include offset for judgments { in total payments

What happens in event of Chapter 11?