



STATE OF KANSAS
OFFICE OF THE ATTORNEY GENERAL

DEREK SCHMIDT
ATTORNEY GENERAL

MEMORIAL HALL
120 SW 10TH AVE., 2ND FLOOR
TOPEKA, KS 66612-1597
(785) 296-2215 • FAX (785) 296-6296
WWW.AG.KS.GOV

Testimony in Opposition to House Bill 2430
Presented to the House Committee on Appropriations
By Attorney General Derek Schmidt

Mr. Chairman, members of the committee:

Thank you for this opportunity to testify in opposition to House Bill 2430, a bill that proposes to sell to investors a portion of the annual payment Kansas receives under the 1998 Tobacco Master Settlement Agreement (MSA), a process commonly known as “securitization.”

In my view, this is poor public policy for two general reasons.

First, it’s a bad financial trade. Kansas to date has received more than \$1 billion in payments from the tobacco companies since the MSA was signed in 1998. If, in the early years of the MSA, Kansas had “securitized” its MSA payments, then today the cumulative amount received by the State would be considerably less because a significant portion of that \$1 billion would have been diverted to investors instead of to state coffers.

That is why, as a state senator and member of the Judiciary Committee when securitization previously was proposed in the early 2000’s, I opposed it. So did a majority of my colleagues. In hindsight, we clearly made the right choice. And the case for securitization is even weaker today than it was then because we now know the MSA will not bankrupt the tobacco companies. Thus, with no significant risk that bankruptcy will interrupt future MSA payments, there is little to be gained from “securing” future payments by trading them for a discounted lump sum today.

Second, and more important from my vantage point as attorney general, this bill *weakens* our ability to protect the future MSA payments to the State and may imperil the stability of that revenue stream that has put more than \$1 billion in the State treasury since 1998. Under the MSA, Kansas has significant and ongoing obligations that must continually be met. This process is known as “diligent enforcement” – Kansas must “diligently enforce” its “qualifying statute” in order to remain in compliance with the MSA and continue to receive payments.

Our office has three employees dedicated exclusively to diligent enforcement and MSA compliance. Other employees in state government, such as employees at the Department of Revenue, also carry a significant workload to maintain MSA compliance. This significant

amount of ongoing work is worth the price in order to ensure that Kansas continues to receive its tens of millions in MSA payments each year.

The tobacco companies regularly accuse states, including Kansas, of failing to meet our “diligent enforcement” obligations. In general, the companies’ demand is that because (in their view) the states did not live up to their MSA obligations, the companies want their money back.

This is no abstract problem. When I assumed office in 2011, the tobacco companies had accused Kansas and other states of failure to diligently enforce our MSA obligations. The state was embroiled in arbitration, and the companies were demanding repayment of what could have been a decade worth of payments. To put this in perspective, when I assumed office, the tobacco arbitration was the State’s second largest contingent liability from pending litigation behind only school finance. In the worst case scenario, Kansas could have been required to repay to the tobacco companies in the range of three-quarters of a *billion* dollars.

Through extensive (and expensive) arbitration and negotiation, we managed to resolve 12 years of disputed payments and extinguish that enormous contingent liability through a term sheet agreement reached in December 2012. To this day, the final details of that 2012 settlement remain under negotiation and the final agreement has not yet been signed – even though its terms are in effect.

House Bill 2430 would weaken our ability to protect future tobacco payments from similar challenges – challenges that already are looming – in several ways:

- By giving bondholders a legal interest in a portion of our MSA payment, this legislation virtually guarantees that in future challenges to Kansas’ “diligent enforcement” our state will face not only counsel for the tobacco companies but also counsel for the bondholders. And worse, under the specific terms of House Bill 2430 (Section 1(f)(6)), if we lose, Kansas could be required to pay the bondholders’ litigation costs and expenses.
- The bill would prohibit the State from amending the MSA in any manner that would materially impair the rights of the financing corporation or the holders of such bonds or obligations to receive tobacco asset payments necessary to make payment on such bonds or obligations. As noted above, Kansas (and other settling states) continue to negotiate with the tobacco companies over specific provisions of the 2012 settlement that resolved the last round of “diligent enforcement” arbitration. Obviously, these multi-party negotiations are difficult, as evidenced by the fact we are now in our fifth year of negotiating details even after the agreement in principle was reached and entered into force. House Bill 2430 will make this process even more difficult by adding bondholders (and perhaps the financing corporation) to the list of parties to the negotiation.
- Starting with the April 2018 MSA annual payment, the state will no longer be receiving tobacco payments calculated under Section IX(c)(2) of the MSA. I have warned the Legislature for years that the end of this funding stream will represent a sizable – and permanent – reduction in the state’s annual payments. It must be recognized by the

legislature that the \$19 million authorized by this bill represents almost forty percent of the state's anticipated annual payment. Because the diversion of this \$19 million to new bond-payment obligations would begin roughly concurrently with the long-expected reduction from the end of Section IX(c)(2) payments, the drop in annual funds available to the Legislature for all other purposes will be substantially more than otherwise predicted. In other words, the reduction in available tobacco funds in each year's appropriations process will suddenly drop by the *sum* of both reductions – and that cumulative drop will be permanent, at least for the (presumably rather lengthy) term of any bonds issued.

Mr. Chairman, I have other detailed but important concerns about the particulars of this legislation. But I will not provide that laundry list here. The bottom line is this: Enactment of this legislation will bring to Kansas less money, not more, from the tobacco settlement payments and beyond that will make substantially less money available to the Legislature each year during the annual appropriations process. At the same time, securitization will increase the burden and cost of maintaining compliance with the MSA. That, in turn, will increase the risk that Kansas falls out of compliance, thus putting future MSA payments at risk.

Of course, the policy decision whether to proceed down this perilous road is up to you as the state's appropriators. If, despite the high cost, the Legislature wishes to pledge up to \$19 million per year in future funds available to the State to pay newly issued bonds in order to generate "quick cash," then I respectfully suggest there is no particular reason the \$19 million must come from the State's annual tobacco payment. Surely there are other sources of revenue the Legislature could pledge as security for a loan – sources that would not present serious complications, such as those described above, that risk killing the proverbial goose that lays this golden egg.

I respectfully recommend you reject this legislation. Thank you for your consideration.

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