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**IN THE 2003 NPM ADJUSTMENT PROCEEDINGS**

**BEFORE AN ARBITRATION PANEL**

**PURSUANT TO SECTION XI(c) OF THE MASTER SETTLEMENT**  
**AGREEMENT**

**EXPERT REPORT OF SCOTT HEMPLING**

**FOR THE STATE OF MARYLAND**

August 13, 2012

CONFIDENTIAL

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## Summary of Conclusions

### I. Effective regulation conditions market access on compliance with market rules.

Effective regulation aligns private behavior with the public interest. Where the public interest requires even-handed competition, this alignment requires us to condition market access on compliance with market rules. This connection between market access and compliance is illustrated by varied regulatory regimes, including cigarette excise tax, personal taxation, lawyer licensing, sale of wholesale electricity, and competitive retail sale of electricity. Each example demonstrates not only the benefits of regulating at the market's threshold, but also the inevitability of gaps and noncompliance in any regulatory scheme. While there is no perfect regulatory regime, the more that market access depends on compliance, the less likely the noncompliance.

### II. The Model Statute was a model of ineffective regulation.

- A. The Model Statute<sup>1</sup> failed the test of effective regulation because it allowed market access to the noncompliant. It neither (a) ensured prospective compliance by market entrants; nor (b) prohibited access by the already noncompliant. The Model Statute allowed entry by NPMs regardless of any intention to comply or not comply. They then could stay in the market up to 27.5 months, plus the time necessary to secure a court judgment.
- B. Because the Model Statute accommodated noncompliance, the existence of noncompliance – both its existence and its rate – cannot provide reliable evidence of how well Maryland enforced the Model Statute, during 2003 or for 2002 or earlier year sales.

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<sup>1</sup> In this report, I use the term “Model Statute” to refer to Md. Code Ann. Bus Reg. § 16-401 *et seq.*, which with two exceptions is the same as the MSA “Model Statute” found at MSA Exhibit T. In 2004, the Model Statute was amended to address the “allocable share release” loophole. In 2006, the State made a slight modification to the Model Statute’s “units sold” definition to cover tax-collected but unstamped containers of “roll-your-own” tobacco. I understand that the PMs agreed in MSA Amendment 21 that Maryland’s 2004 amendment would not change its statute’s status as the MSA “Model Statute,” and that they similarly agreed to Maryland’s 2006 modification to the “units sold” definition.

**III. Maryland's Complementary Legislation corrected most of the Model Statute's flaws.**

- A. The best way Maryland could counteract the Model Statute's ineffectiveness was to close its gaps with new legislative authority, and then to move quickly to use that new authority. Consequently, in 2003 Maryland enacted "Complementary Legislation," Md. Code Ann. Bus. Reg. § 16-501 *et seq.*,<sup>2</sup> to close the gaps in the Model Statute. The Complementary Legislation was effective on June 1, 2003. Its key feature – publication of the Maryland Tobacco Directory – was required by September 15, 2003 (and was implemented by the Attorney General by that date).
- B. The contrast between the two statutes is stark:
1. Whereas the Model Statute allowed market entry regardless of noncompliance, the Complementary Legislation conditioned market entry on compliance.
  2. Whereas the Model Statute allowed distributors to tax-stamp noncompliant cigarettes, the Complementary Legislation forbade distributors from tax-stamping noncompliant cigarettes.
  3. Whereas enforcement of the Model Statute depended on voluntary acts by manufacturers with little regulatory nexus to Maryland, the Complementary Legislation built on the existing regulation of the distributors' tax-stamping obligation.
  4. Whereas under the Model Statute NPMs could be denied market access only after they had made sales (for as long as 27.5 months or more), under the Complementary Legislation NPMs evading escrow could be denied entry before they made sales.
  5. Whereas under the Model Statute NPMs could be denied market entry only after two knowing violations and a court injunction, under the Complementary Legislation the State could revoke market access administratively and immediately.

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<sup>2</sup> All references to section numbers (§) herein are to the specified provisions of the Business Regulations article of the Maryland Annotated Code.

- C. By conditioning market entry on compliance, the Complementary Legislation enabled Maryland to enforce more effectively the Model Statute's primary obligation: for NPMs to deposit money into escrow for their sales in the State.<sup>3</sup>

**IV. Maryland's compliance information and the PMs' writings support the conclusion that the Model Statute undermined enforcement while the Complementary Legislation aided enforcement.**

- A. Maryland's NPM compliance information demonstrates that the Complementary Legislation caused a permanent, structural change in regulation, a change that stopped most noncompliance in 2003, nearly immediately. That change in compliance confirms my conclusions described above.
- B. The same information also shows that the 2003 drop in NPM noncompliance was no one-time anomaly. The drop was permanent: Noncompliance post-2003 in Maryland is minimal, demonstrating that (a) successfully enforcing the NPM escrow obligation required tools missing from the Model Statute, and (b) Maryland's enactment and implementation of Complementary Legislation were the most effective ways to secure NPM escrow deposits for 2003 and later year sales.
- C. The writings of the Participating Manufacturers (PMs), contemporaneously created (*i.e.*, around 2003), are empirical evidence consistent with my analysis, that the Model Statute provided insufficient and ineffective tools for ensuring prospective NPM compliance and addressing past NPM non-compliance. These writings – from entities in head-to-head competition with NPMs whose noncompliance provided what the PMs perceived to be an unfair cost advantage – also are consistent with my conclusion that the most effective action Maryland could take in 2003 to address NPM noncompliance was to enact and implement legislation to close the Model Statute's gaps.

**V. Given the Model Statute's ineffective design, noncompliance cannot logically equate to ineffective enforcement.**

- A. The PMs have sought to prove nondiligence by showing noncompliance. This approach has two errors. First, it ignores a central fact: As long as some NPMs were motivated to avoid their escrow obligation, noncompliance was an inevitable result of the Model Statute's failure to condition entry on compliance.

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<sup>3</sup> References to "sales" of NPM cigarettes means sales of NPM cigarettes subject to the Model Statute, *i.e.*, cigarettes that qualify as "units sold" under § 16-402(k).

- B. Second, in documenting noncompliance, the PMs use only total figures, without any consideration of the market players and their motivations. ***These total figures obscure the critical distinction between short-termers and long-termers.*** Short-termers seek to exploit regulatory gaps for a temporary profit. Long-termers seek to establish a longer presence in the market for long-term profit. In Maryland, it was the short-termers who were noncompliant, who exploited the Model Statute's gaps. The long-termers were compliant. Short-termers – those who move in and out of markets to avoid detection, pursuit and lawsuit – were not susceptible to effective enforcement under the Model Statute. When the Model Statute was replaced by the Complementary Legislation, the short-termers ceased to exist in Maryland.
- C. The PMs also assert that Maryland was non-diligent because it failed to pursue enough lawsuits. Lawsuits were indeed the Model Statute's primary form of enforcement. But lawsuits were inherently ineffective because the noncompliant were short-termers. Short-termers are, by definition, entities that moved beyond the reach of lawsuits – entities that made quick profits and then re-shuffled corporate form or dissolved. In the context of NPM noncompliance, lawsuits are not an effective form of regulation.
- D. A failed regulatory statute does not prevent noncompliance. It allows noncompliance, then relies on the uncertainties of detection, pursuit and lawsuit to stop and penalize the noncompliant. It necessarily follows that the noncompliance in Maryland for 2002 sales or 2003 sales prior to publication of the Tobacco Directory is not a logical or valid measure of the quality of Maryland's enforcement work.

## **Professional Background**

I am an advisor to government agencies, domestically and internationally, on the regulation of public utilities. In addition to my advisory work, I provide expert testimony before Congress, State legislatures and State regulatory commissions; teach seminars to law students and practitioners; and publish frequently in industry journals such as *The Electricity Journal*.

From 1990 to 2006, I had a national law practice, advising public and private sector clients – particularly State regulatory commissions – on utility regulation, with an emphasis on electricity issues. I have represented clients in many cases under the Federal Power Act of 1935 and the Public Utility Holding Company Act of 1935, before federal agencies and the United States Courts of Appeals.

From October 2006 through August 2011, I was Executive Director of the National Regulatory Research Institute (NRRI). Founded by the National Association of Regulatory



Utility Commissioners, NRRI's mission is to provide the research that empowers utility regulators to make decisions of the highest possible quality. At NRRI, I oversaw publication of 80 research papers on regulatory substance and process. I also published my own research papers, and advised contract clients (including State commissions, regional transmission organizations, private industry, and international institutions).

In September 2011, I returned to private practice. Since then, I have provided expert testimony in State utility proceedings, published research papers (most recently, a series on orders of the Federal Energy Regulatory Commission promoting multi-utility, multi-jurisdictional planning), and advised clients. Currently, I am assisting Mexico's Comisión Reguladora de Energía in its efforts to create measures of effective regulation. In a separate engagement, I am working with the electricity regulators in Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and Panama on ways to modify each nation's regulatory practices to integrate electric power planning across Central America, an effort funded by the U.S. State Department.

Under contract to the American Bar Association, I am writing a treatise on public utility law, to be published in 2013. I write monthly essays on effective regulation which circulate internationally. NRRI has published the first 32 in a book entitled *Preside or Lead? The Attributes and Actions of Effective Regulators* (2010).

I am an Adjunct Professor at Georgetown University Law Center in Washington, D.C., where I teach a practicum seminar entitled "Monopolies and the Nation's Infrastructure: The Regulation of Public Utility Performance." Since beginning a series of intensive seminars in 1997, I have taught thousands of decisionmakers and practitioners on the principles of effective regulation and substantive utility law, with an emphasis on electricity. In addition to hundreds of appearances in the United States, I have addressed students and professional regulators in Canada, Germany, India, Italy, Jamaica, Mexico, and Nigeria.

I earned a B.A. *cum laude* from Yale University, majoring in (1) Economics and Political Science and (2) Music, where I received a Continental Grain fellowship and a Patterson research grant. I received a J.D. *magna cum laude* from Georgetown University Law Center, along with an *American Jurisprudence* award for Constitutional Law.

My resume is attached to this report as Attachment 1. More detail is at [www.scotthemplinglaw.com](http://www.scotthemplinglaw.com).

## **Purpose and Preparation**

I was retained to evaluate (a) Md. Code Ann. Bus. Reg. § 16-401 *et seq.*, which is Maryland's Qualifying Statute and the same as the Model Statute found at Exhibit T of the MSA; and (b) Md. Code Ann. Bus. Reg. § 16-501 *et seq.*, which is commonly referred to as the

Complementary Legislation. My evaluation seeks to determine the effectiveness of these statutes in achieving the purpose of the Model Statute: to have NPMs deposit escrow on their sales. Accordingly, my review focused on and my analysis relies on the statutory language in those statutes.

I was also asked to evaluate whether Maryland's NPM compliance record is consistent with my analysis of the statutes, and whether the PMs' contemporaneously created documents that discuss or evaluate the Model Statute and Complementary Legislation are consistent with my own assessment of those statutes. For these purposes, I reviewed summaries provided by counsel that cover NPM sales and escrow deposits for sales in Maryland from 1999-2009 to assess whether the summarized information is consistent with my analysis of the flaws in the Model Statute and the ameliorative effects of Complementary Legislation. These summaries are attached as Exhibits A-I to this report. I also reviewed PM documents that were created contemporaneously (during or around 2003) that evaluate or discuss the MSA Exhibit T Model Statute and Model Complementary Legislation to determine whether they are consistent with my analysis.

As part of my analysis, I have reviewed Maryland laws in addition to the Model Statute and Complementary Legislation to determine the extent to which they may affect the State's authority to further the purpose of having NPMs deposit escrow for their sales in Maryland. I also have reviewed certain pleadings filed by the parties, including Maryland's Statement of Claim, the Joint Statement of Claim filed by a number of States, the PMs' Amended Statement of Claim, and the PMs' Statement of Contest with Respect to Maryland.

I have not been asked to evaluate, and have not evaluated, the actions that Maryland took to enforce the Model Statute or the Complementary Legislation. My report instead addresses the enforcement tools available under, and the effectiveness of, the provisions of the Model Statute and the Complementary Legislation.

## **Analysis and Conclusions**

### **I. Effective Regulation Aligns the Private Interest with the Public Interest, by Conditioning Market Access on Compliance.**

Effective regulation aligns private behavior with the public interest. Where the public policy goal is even-handed competition, alignment requires a specific technique: conditioning market access on compliance with market rules. Conditioning market access on compliance takes two forms: regulation of access to the market, and regulation of behavior once an entity has entered the market.

The first type is regulation of access to the market. It positions the regulator at the market's threshold. Each prospective entrant must identify itself, and provide information necessary for the regulator to assess its fitness to sell and its willingness to comply with market

rules. Some regulatory regimes require periodic re-approvals. Acting as gatekeeper, regulators can establish qualifications and standards for market entry, and condition continued access on lawful behavior. The result is a market structure that is even-handed, where sellers compete on the merits without unfair advantages.

The second type of regulation aims not at prospective market entrants but at existing market participants. It identifies participants who violate market rules, then penalizes them by imposing fines and/or revoking their market access.

Examples in different contexts illustrate these two forms of regulating market access. Each of these examples demonstrates the benefits of regulating at the market's threshold, as well as the inevitability of gaps and noncompliance in any regulatory scheme. These examples illustrate that while there is no perfect regulatory regime, the more that market access depends on compliance, the less likely the noncompliance.

1. *Cigarette excise tax:* Market entry regulation consists of requiring licensed wholesalers to pay the tax before selling any cigarettes. Only by paying the tax can the licensee acquire stamps for his packs, and only stamped packs can be sold. Ongoing regulation includes (a) field audits and recordkeeping requirements to ensure that all packs sold to retailers have tax stamps, (b) penalties – both fines and license revocation – for wholesalers who sell packs without stamps, and (c) seizure of non-stamped packs as contraband. Noncompliance can and does occur, in the form of black market transactions, but it is reduced because legitimate market entry depends on paying the tax first.
2. *Personal taxation:* With payroll withholding, the employee-taxpayer never has the option of non-payment, for that portion of his tax that is predicted by his pay and number of dependents. A worker's access to the above-board labor market is conditioned on his compliance with the tax laws. The remainder of compliance, *e.g.*, taking the proper deductions, not receiving pay "off the books," is enforced through government detection, pursuit and lawsuit. Noncompliance happens, even with vigorous efforts by tax authorities, because no administrative means exists to police the decisions of millions of individuals.
3. *Lawyer licensing:* No one can legally practice law without getting a license. A regulator – the Bar – screens all entrants for competence and honesty. Continuing regulation exists in the form of Bar proceedings for violations of ethics rules or unauthorized practice. Success of that ongoing regulation depends on detection. Again, noncompliance can occur, even with vigorous enforcement by the Bar, because of the large number of possible violators.
4. *Sale of wholesale electric energy:* In what the industry calls "organized wholesale markets," owners of electric generating units bid 24 hours in advance to sell power

on any hourly basis the next day. A central computer, administered by a “regional transmission organization” (RTO), ranks the bidders by price, then selects bidders in the order of their prices, from low to high, until the quantity selected equals the quantity demanded. At the appointed hour, only RTO-selected bidders are permitted to sell. Anyone who injects electricity without permission is automatically detected by the RTO. A generation owner cannot be a bidder unless it is on the list of authorized sellers. The generation owner receives that authorization only by passing separate advance screens administered by the RTO and by the Federal Energy Regulatory Commission. Once the generation owner receives the authorization to enter the market generally, its actual, daily entry into the organized wholesale power market, and its ongoing compliance, are subject to oversight by the RTO. The RTO, in turn, is an entity whose existence, procedures and contractual relationships are subject to advance approval by the Federal Energy Regulatory Commission.

5. *Competitive retail sales of electricity:* A new retail marketer must have a license to sell electricity. Physically, a retail marketer’s electricity cannot reach the marketer’s customer except by using the physical distribution system of the local distribution utility. The local distribution utility has a State-granted, State-regulated monopoly over the physical distribution system, and is subject to the State’s jurisdiction and regulation. There is no way for the retail seller to reach the retail consumer, except by transacting with the local distribution utility. The local distribution utility will not accept power supply from anyone other than a licensed retail seller. Physical access to the market therefore is conditioned on compliance. Note that this relatively new regulatory regime is knitted directly into the pre-existing regulatory regime, which consists of State regulation of monopolies.

Each of these regulatory scenarios has the two forms of gatekeeping: (a) regulation that restricts market entry to those entities that adequately identify themselves and meet requirements designed to ensure future compliance; and (b) regulation that conditions continued market access on continued compliance.

Further, each of these contexts starts with an effective regulatory statute. An effective regulatory statute establishes a mandatory relationship between the regulator and the regulated, with effective regulatory jurisdiction over relevant actors. Entities whose behavior affects the public are subject to the regulator’s jurisdiction, and must satisfy the regulator before receiving permission to do business in the State (*e.g.*, through licensing, certification, or tax payment). Other necessary components of an effective regulatory statute include:

1. description of the behavior to prohibit and the behavior to encourage,
2. grant of authority to the regulator to –

- (a) fill in details unaddressed by the statute,
- (b) gather and demand accurate information to verify compliance, and
- (c) use enforcement tools that create a high probability of swift detection, applied non-discriminatorily and at a sufficiently high level to induce the rational actor to obey (specifically, disgorgement of all financial benefits flowing from the violation *plus* a penalty).

Absent these regulatory features, entities with short-term interests will exploit the regulatory gaps. Exploitation can be legal, such as taking advantage of loopholes until the regulator or legislature learns of the behavior and fills the holes. And exploitation can be illegal, such as when a bootlegger illegally copies and sells compact discs; or, after a hurricane, when a contractor takes a homeowner's money but fails to perform the work. A frequent feature of unlawful exploiters is a short-term presence selling a particular product or in a specific geographic market.

## **II. The Model Statute Was a Model of Ineffective Regulatory Design: Instead of Conditioning Market Access on Compliance, It Depended on Lawsuits to Catch the Noncompliant.**

### **A. The Model Statute failed to condition market access on compliance.**

The Model Statute failed the basic test of an effective regulatory statute, because it did not condition (a) market entry on evidence of past compliance or (b) continued market access on continued compliance.

#### **1. The Model Statute failed to condition *entry to the market* on compliance with market rules.**

The Model Statute allowed every NPM to enter the market untouched by any regulation, until "April 15 of the year following" the year of sale. § 16-403(a)(2). On that April 15 (as many as 15.5 months after market entry), an NPM had one primary obligation (to place in an escrow fund a designated amount for each "unit sold" in the State during the preceding year); and two secondary obligations (to establish a "qualified escrow fund" to receive the deposit, and to certify that it had complied with the escrow requirement). § 16-403(a)(2), (c)(1).

That was it. Until April 15 of the year following sales, the NPM had no obligation to disclose its identity to Maryland, to obtain Maryland's permission to enter Maryland's market or even to notify Maryland it had in fact entered the market. Maryland thus had no power to restrict or condition access to its markets. With no regulatory criteria conditioning market entry, anyone could enter – including NPMs (or their corporate replacements) that had flouted the statute

previously or that regulators suspected would do so. The regulators' sole lawful action under the Model Statute was to notify and remind NPMs (if regulators knew the NPMs existed and could find them) of their future April 15 obligation.

One could ask: What about pre-existing Maryland law, *i.e.*, statutes other than the Model Statute? The answer is unambiguous: In 2003, prior to the Complementary Legislation, there was no authority, outside of the Model Statute, in the Attorney General, the Comptroller, the courts, or any government body, to restrict market entry by an NPM, even one that had failed to make a required escrow deposit.

The timing of the escrow obligation, due as long as 15.5 months after the NPMs' first sale in the State, allowed entities to enter Maryland's cigarette market temporarily, for the purpose of making quick profits, before moving to other geographic markets or other business opportunities.

**2. The Model Statute fails to condition *continued market access* on compliance with market rules.**

Because the Model Statute allowed unrestricted market entry, regulation and enforcement (beyond publicizing future obligations) could not begin until noncompliance occurred. Yet once noncompliance occurred, the statute's enforcement tool – filing lawsuits – was unlikely to succeed because it failed the central test of regulation: It did not align the noncomplying NPM's self-interest with the statutory purpose of ensuring escrow deposits on sales. The Model Statute provided inadequate tools for correcting past noncompliance and for ensuring future compliance. An NPM that had ignored the law for one sales year (by failing to pay escrow the following April 15) could continue selling for another year, then fail to pay on the next April 15. The Model Statute allowed NPMs to remain in the market without complying.

**a. The Model Statute permits NPMs with past noncompliance to continue to sell and generate more noncompliance.**

The Model Statute gives Maryland only one enforcement tool: suing an NPM for failing to make the escrow deposit on April 15 following the year of sale:

“The Attorney General may bring a civil action on behalf of the State against any tobacco product manufacturer that fails to place into escrow the funds required under this section.”

§ 16-403(c)(2). If the lawsuit is successful, the Model Statute provides authority for the court to require the NPM to make the required escrow deposit:

“Any tobacco product manufacturer that fails in any year to place into escrow the funds required under this section shall be required

within 15 days to place such funds into escrow as will bring the manufacturer into compliance with this section.”

§ 16-403(c)(3)(i). Under certain conditions, a court may enjoin the NPM from selling cigarettes in the State for two years:

“In the case of a second knowing violation of subsection (a)(2) or (b) of this section, the tobacco product manufacturer shall be prohibited from selling cigarettes to consumers within the State, whether directly or through a distributor, retailer, or similar intermediary or intermediaries, for a period not to exceed 2 years.”

§ 16-403(c)(5). The injunction applies only to knowing “violations.” A “violation” is defined as “[e]ach failure to make the annual deposit.” § 16-403(c)(6).

The PMs assert that Maryland’s lawsuit efforts were insufficient.<sup>4</sup> This argument ignores a real world factor: The statutory provisions on lawsuits were not reliable enforcement options, because they failed to align the NPM’s interest with the statutory goals of fair competition and compliance:

1. The noncompliant NPM can sell, without paying the escrow, until the State wins its lawsuit and executes successfully on the paper judgment.
2. No injunction is possible unless the manufacturer fails to make the required deposit for two different sales years.
3. The injunction applies to enjoin sales only by the manufacturer. The State has no recourse to the distributor who purchased from some entity in the chain of commerce.
4. The injunction lasts for two years from the date of issuance, after which point the NPM can re-enter the market.

Accordingly, an NPM already noncompliant in Maryland for sales during one year could continue selling cigarettes in Maryland for at least another year, fail to pay the annual escrow a second time, and only then face a limited, two-year injunction (if the State could prove that its violations were “knowing” violations), which injunction would not take effect until the passage of all the time necessary for the State to find, sue, and serve the defendant, and win the lawsuit that includes an injunction. Further, nothing in Maryland law prevented the principals in the

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<sup>4</sup> See Participating Manufacturers’ Statement of Contest With Respect to the State of Maryland, filed November 3, 2011, at 3-4 (Lexis # 40718808) (hereinafter “PMs’ Statement of Contest”).

noncompliant company to form a new company that would not be subject to the injunction. These principals, already knowing the market and having formed commercial relationships with suppliers and customers, could continue their strategy of noncompliance through a new company, even as their prior company remained enjoined from selling.

In short, the Model Statute permitted NPMs with noncompliant sales to continue selling cigarettes for up to 27.5 months, plus the time to go to court and obtain an injunction. Even then, the injunction applied only to the manufacturer, not to wholesalers or retailers selling its cigarettes. This lag time for enforcement through injunction, built into the Model Statute, provided openings for NPMs seeking to exploit the market for short-term profit, by increasing the amount of time the short-term entities could remain in the market while avoiding compliance.

**b. The Model Statute contains ineffective enforcement tools for addressing NPMs with past non-compliant sales.**

Having allowed market access with no assurance of compliance, the Model Statute used a wait-for-noncompliance approach. Its tool – the filing of a lawsuit – still failed to align NPM self-interest with compliance.

**(1) Detection was necessary – but difficult – because the Model Statute allowed unrestricted entry of non-jurisdictional actors.**

The Model Statute creates two classes of cigarette manufacturers (defined as “tobacco product manufacturers” in § 16-402(j)): MSA “Participating Manufacturers” and *any other* manufacturer “that sells cigarettes to consumers within the State, whether directly or through a distributor, retailer, or similar intermediary or intermediaries.” § 16-403(a). This second, catch-all category – the NPMs – must “place into a qualified escrow fund by April 15 of the year following the year in question” funds for each “unit sold.” § 16-403(a)(2).

While the universe of *PMs* under the Model Statute is a defined set of manufacturers, the universe of *NPMs* is unlimited. The Model Statute allows anyone, from anywhere, to sell cigarettes into Maryland, without first notifying the State or first obtaining the State’s approval.

Faced with an unknown number of unknown NPMs (which had no advance obligation to identify themselves or obtain approval to sell), the State’s first step, once it learned of noncompliance the year after sale, was to detect the non-complier. Detection is not straightforward, because a manufacturer needs no presence in the State to make money from sales in the State. Nor need a manufacturer reveal its presence under the Model Statute, for up to 15.5 months after its first sale. The State had to identify entities it did not know existed, and, once identified, find out where they were.



Exacerbating the detection problem is the Model Statute's failure to use the pre-existing regulatory system for cigarette sales. The Model Statute imposes escrow responsibility on the manufacturer, while the pre-existing regulation – for excise taxes – focused on licensed distributors. It is the distributors, not the manufacturers, who have to obtain a license, purchase tax stamps from the State, and comply with extensive statutes and regulations. Instead of building on this pre-existing regulatory regime over the licensed distributors (through whom all cigarette sales in Maryland must pass), the Model Statute starts from scratch. Contrast the typical State licensing scheme for retail electricity sellers, which builds on the pre-existing foundation of State regulation of distribution utilities, discussed in Part I above.

The Model Statute suffered yet another defect. Because it failed to connect to the existing, in-State distribution network, and because it allowed manufacturers to enter the market with no advance regulatory intervention, a manufacturer's owners and employees could develop business relationships that survived corporate re-shuffling. Those seeking to profit through noncompliance could use shell companies, arranging their corporate structure and transactional relations to make detection difficult. The reliable way to prevent this practice is to enact legislation that (a) conditions market access on actors identifying themselves; (b) denies access to the unqualified, including previous violators; and (c) requires submission to the regulator's jurisdiction.

**(2) Pursuit was difficult because the Model Statute did not provide Maryland regulators jurisdiction over all relevant actors.**

The Model Statute failed a key test of effective regulation: It required no jurisdictional connection between the NPM and the State. Because the NPMs could come from any location, inside or outside Maryland, without registering to do business in the State, they could legally avoid any jurisdictional nexus with the State. Exacerbating the jurisdictional avoidance was a commercial fact: NPMs could sell their cigarettes through several intermediaries before the product arrived at Maryland stores.

This jurisdictional gap, between cigarette manufacture and in-State sale, meant that even if the State could identify the NPM, it might be unable to influence its behavior. The more attenuated the jurisdictional tie, the less ability to influence. The largest problem would be with foreign NPMs. If a foreign NPM sold its cigarettes to an importer, which in turn sold the product to distributors (which may then have sold to other distributors) before the cigarettes entered Maryland, Maryland regulators had no ready way to exercise effective regulatory jurisdiction over the foreign NPM. The Model Statute created this jurisdictional gap by allowing foreign NPMs into Maryland markets without restriction. This jurisdictional gap again facilitated the opportunities for short-term entities looking to turn a quick profit without regulatory consequence.

**(3) Even if regulators could overcome the hurdles of detection and jurisdiction, the Model Statute opened additional paths to noncompliance.**

Regulation-avoiders can use incorporation laws to move owners, employees, assets and business relationships among a shifting series of corporate entities. Maryland corporate law allows owners to create new companies, to acquire pre-existing ones, and/or to transfer assets, contracts, employees and business relationships among unaffiliated or affiliated companies. The Model Statute in no way diminished these opportunities. Thus, noncompliant could dissolve and re-create. These are the tools and the techniques of the non-compliant.

Effective regulatory statutes use entry restrictions to prevent such avoidance. The regulator-as-gatekeeper allows entry only to the compliant, denying entry to new entities created by the noncompliant. The Model Statute failed this test. It accommodated avoidance through corporate structure, because it granted no gatekeeping role to the regulators. A noncompliant entity, once detected and pursued through litigation, could dissolve and recreate, then continue to sell for up to another 27.5 months. The same persons, possibly using the same assets and employees, could continue their noncompliant ways.

**3. Conclusion: Given the Model Statute's defects, NPM noncompliance cannot indicate ineffective enforcement, especially with the futility of lawsuits.**

In the battle over regulatory effectiveness, the Model Statute gave the manufacturer the upper hand. The Model Statute combined three weaknesses: (a) it made the manufacturer the sole entity whose actions determined compliance with the escrow requirement; (b) it depended for detection on manufacturer self-identification (where that self-identification was not necessary for initial market access); and (c) it allowed manufacturers market access for up to 15.5-27.5 months without obligation, penalty or injunction. These weaknesses produced a regulatory scheme that could not succeed. It could not succeed because the NPM's interests were not aligned with the statutory goal of escrow deposit. With this defective design, the key to successful regulation, market access conditioned on compliance, was missing.

***But what about lawsuits?*** The PMs have framed this case as about the success or failure of efforts to enforce a statute incapable of successful enforcement. The Model Statute's primary method for enforcing the escrow obligation was to file a lawsuit, after entry occurred. In the context of NPM noncompliance, lawsuits are not an effective form of regulation.

The Model Statute's gaps were systemic. Even assuming Maryland could successfully detect, pursue, and sue an evading NPM, it faced another problem: While detection, pursuit and lawsuit were continuing for one or more noncompliant NPMs, any number of additional NPMs could be making sales in the State, only to evade the escrow obligation on April 15 of the following year. In other words, at best lawsuits could address a symptom, but not the root cause,

of NPM noncompliance. Lawsuits – even if they produced enforceable judgments – could only bail water; they could not plug the leak. As John Long, Vice President & General Counsel of Liggett Vector Brands LLC, explained in an e-mail to another Liggett employee, under the Model Statute [REDACTED]

[REDACTED]”<sup>5</sup>  
The universe of NPMs – the source of the leaks – was not limited. New entities could always enter the market to exploit the regulatory gap and make a temporary profit, because the Model Statute provided those opportunities, and because the Model Statute failed to condition market access on escrow compliance.

The Model Statute’s failure to align NPM self-interest (especially NPMs or intermediaries with a short-term business strategy) with compliance means that noncompliance was possible despite even the most aggressive enforcement. Even if Maryland’s regulators suspected an NPM might be, or intended to be, noncompliant (because, for example, the NPM had past noncompliance), their means to address continued sales by that NPM were limited: they needed to wait for two knowing violations of the annual escrow payment obligation, then they needed to obtain a judicial injunction, then they needed to face the possibility that the owners of the enjoined entity would create a new corporate entity to continue the noncompliance.

These failures of the Model Statute mean that data on NPM noncompliance cannot be logically connected to the effectiveness of Maryland regulation. Neither the Model Statute nor any other provision of Maryland law authorized any government entity to block market entry by a noncompliant NPM for failure to make its required escrow deposit.

Because of the systemic problems with the operation of the Model Statute, the best step Maryland could take to promote NPM compliance, both in the near term and long term, was to enact legislation to close the gaps in the Model Statute, and then implement that legislation. The new legislation, to allow for effective enforcement, would need to align the NPM’s self-interest with the statutory purpose, by conditioning market entry with compliance.

**B. Maryland’s NPM compliance record under the Model Statute is consistent with the Model Statute’s deficiencies.**

The summaries of NPM sales compliance information, attached as Exhibits A-H, show that when Maryland had only the Model Statute to enforce the escrow obligation, it experienced relatively low levels of compliance. The summaries are consistent with my analysis of the Model Statute’s ineffectiveness. *See* Part IV below.

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<sup>5</sup> E-mail from John Long, Vice President & General Counsel of Liggett Vector Brands LLC, to Tim Jackson, a Liggett employee, dated October 14, 2004, NPM2003-LIGGETT-014813-R. Copies of all of the PM documents cited in this report are attached hereto as Attachment 2.

**C. The evidence that long-term sellers complied, while short-term sellers did not, confirms that the Model Statute would produce noncompliance regardless of enforcement efforts.**

The PMs have sought to prove nondiligence by showing noncompliance.<sup>6</sup> In showing noncompliance, they use only total figures.<sup>7</sup> *These total figures mask the critical distinction between short-termers, who seek to exploit regulatory gaps for a temporary profit, and long-termers, who seek to establish a longer presence in the market.* It was the short-termers who exploited the Model Statute's gaps. Short-termers – those who move in and out of markets to avoid detection, pursuit and lawsuit – are not susceptible to effective enforcement. They are like the non-lawyers who practice unauthorized law, like the workers who get paid “off-the-books,” like the tax-cheaters who take excess deductions. They exist because of statutory and jurisdictional gaps that allow them to exist; and because outside of a police state, no regulatory regime can track every action of every citizen. Given those gaps, they will exist regardless of enforcement efforts – until a statute closes the gaps. Here, the Model Statute had gaps that allowed the short-term exploiters to exist. When Complementary Legislation took hold, the short-termers ceased to exist.

This distinction, with the compliant being those intending presence for the long-term, and the noncompliant being those seeking to exploit the statute's gaps in the short-term, is borne out by all the evidence. In Maryland, the initially compliant stayed in the market; the initially noncompliant actually left the market.

**1. The compliant stayed in the market for the long-term, rather than exploit the statute's gaps in the short-term.**

According to distributor reports of 2002 sales, there were 13 NPMs for which more than \$1,000 in escrow was due April 15, 2003.<sup>8</sup> Of these 13, five deposited their full escrow obligation

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<sup>6</sup> See PMs' Statement of Contest, at 1-2.

<sup>7</sup> *Id.* at 1 (referring to a collection rate of approximately 50% for 2002 sales).

<sup>8</sup> Six NPMs (three compliant and three noncompliant) has sales in 2002 resulting in escrow obligations of less than \$1,000 due April 15, 2003. Because their sales were insubstantial, they failed to evidence any intent to enter Maryland for the short- or long-term. I therefore disregard them in this analysis.

(for 2002 sales) and 8 did not (for 2002 sales).<sup>9</sup> See Exhibit E. All five compliant NPMs remained in Maryland's market for the long-term:

- Three NPMs (Carolina Tobacco, KT&G Corp., and S&M Brands) were still on the Maryland Tobacco Directory in 2009 (Exhibit I), and were compliant for all sales through 2009 (Exhibit E);
- One NPM (Protobacco/Sun Tobacco) was compliant for its sales as an NPM during 2003 (Exhibit E) and became a Participating Manufacturer in 2004 (thereby indicating an intent to remain in the market);
- One NPM (Star Scientific) certified for several years (2003-2006) then stopped selling, and was compliant for its sales in all of those years (Exhibit E).

## **2. The noncompliant did not stay in the market long-term.**

The eight NPMs that were noncompliant for 2002 sales largely disappeared from the Maryland cigarette market after September 15, 2003, when the Tobacco Directory went into effect. Specifically:

The three NPMs that had the most noncompliant sales in 2002 were GTC Industries, CigTec Tobacco, and Sekap. See Exhibit E. Those companies made all their 2003 sales during the first three quarters of 2003. All three companies then disappeared from the Maryland cigarette market, with no sales at all during the fourth quarter of 2003 (see Exhibit A-03) – by which time Maryland had published the Tobacco Directory pursuant to the Complementary Legislation – or at any time thereafter. See Exhibit A1-04 through Exhibit A1-09.

As for the remaining five noncompliant NPMs for 2002 sales, two of the five had no sales at all after 2003. The remaining three had insubstantial sales after 2003 resulting in *de minimus* escrow obligations (*i.e.*, less than \$1,000); two them had their last sales in 2004, and the other had its last sales in 2005. See Exhibit E; Exhibit A1-03 through Exhibit A1-09.

**To summarize:** NPMs seeking a long-term presence in the market deposited their escrow obligation while NPMs satisfied with a short-term presence did not. Short-termers existed because the Model Statute permitted evasion by those whose intentions were to make a quick profit regardless of statutory obligations. The Model Statute's operation left it to each NPM to decide whether to obey the Model Statute or disregard it, and no level of enforcement effort by

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<sup>9</sup> Two of the NPMs considered "compliant" for 2002 sales, KT&G Corp. and S&M Brands, Inc., made supplemental escrow deposits for 2002 sales after 2003 to make up for escrow deficiencies. Even though these deposits were made after the statutory deadline, they brought the NPMs into full compliance and demonstrate the companies' long-term commitment to compliance.

Maryland officials could determine the compliance of NPMs seeking to exploit the Model Statute’s gaps.

**D. The PMs’ contemporaneous analyses of the Model Statute’s effectiveness corroborate that the Model Statute was ineffective.**

Part II.A of my Report analyzed the Model Statute from the perspective of regulatory effectiveness, and found it defective. Parts II.B and C described the evidence of compliance – especially the distinction between short-term and long-term players; this evidence supports my regulatory analysis of ineffectiveness. I turn now to additional empirical support for my conclusion of statutory ineffectiveness: the concerned commentary by those whose competitive status was adversely affected by the Model Statute’s flaws; specifically, the Participating Manufacturers. The PMs were in head-to-head competition with NPMs whose noncompliance with the Model Statute reduced their market costs, distorting competition to the PMs’ detriment.

Documents prepared by the PMs, during or around 2003, contain contemporaneous assessments or descriptions of the Model Statute. Some assess the impact of NPMs on the cigarette market; others assess the need for additional legislation to supplement the Model Statute; and others are documents submitted to legislative bodies or other parties. These documents are consistent with –

1. my analysis that the Model Statute was ineffective in promoting compliance with the requirement that NPMs deposit escrow for sales in Maryland;
2. my conclusion that the fact of NPM noncompliance has no logical connection with how well Maryland enforced the NPM escrow obligation; and
3. my conclusion that given the regulatory gaps in the Model Statute – gaps described by me and these documents – the most effective action Maryland could take to support the purpose of the Model Statute, *i.e.*, to induce NPMs to make timely escrow deposits for sales in Maryland, was to enact and then implement legislation designed to close the regulatory gaps.

Excerpts from some of these documents follow:

*Liggett:*

\_\_\_\_\_  
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\_\_\_\_\_  
\_\_\_\_\_

E-mail from John Long, Vice President & General Counsel of Liggett Vector Brands LLC, to Tim Jackson, a Liggett employee, dated October 14, 2004, NPM2003-LIGGETT-014813-R.

*PMs' letter to lawyers for the Settling States:*

[REDACTED]

Letter from certain Subsequent Participating Manufacturers to Mark E. Greenwold of the Tobacco Project of the National Association of Attorneys General, dated November 18, 2003, at 3, NPM2003-KMM-001230 to NPM2003-KMM-001233.

*Philip Morris:*

[REDACTED]

[REDACTED]

Email from Mark Berlind, Philip Morris in-house counsel, to Janice McDaniel, a Philip Morris employee, dated January 18, 2003, Philip Morris Bates Nos. 5042726869 to 5042726870.

*R.J. Reynolds Tobacco Co.:*

[REDACTED]

Document entitled "State Government Relations (Description of Certain Key Issues)," attached to an e-mail dated May 13, 2003, RJR Bates Nos. 55853 7942 to 55853 7945, at 55853 7943.

[REDACTED]

[REDACTED]

Document entitled “NPM Escrow Compliance,” attached to an e-mail dated February 15, 2002, RJR Bates Nos. 55853 1063 (emphasis in original).

\* \* \*

The PMs argue that “Maryland failed to collect escrow on a large percentage of NPM sales.”<sup>10</sup> But their subject-predicate phrasing obscures the relevant question. About the predicate, “failed,” there is no disagreement. An NPM’s deposit of less than its obligation is a failure, of something. But of what?

By making the subject of the sentence “Maryland,” the PMs literally beg the question, *i.e.*, they assume the answer in the question to be answered. The question for the Panel is whether the “failure” was attributable to (1) ineffective State efforts, or (2) an ineffective Model Statute. The PMs’ diction erases that question, in favor of a different question: “*Maryland* failed – Does its failure equal nondiligence?” By assuming the answer (Maryland failed) in their question, the PMs lead the Panel away from the relevant question: *What* caused the failure?

The failure of some NPMs to deposit escrow was a failure of the regulatory system. That regulatory system has two components: the Model Statute, plus Maryland’s efforts to enforce it. The question for the Panel is: Was the failure caused by the insufficiency of Maryland’s efforts, or was it caused by the failures of the statute? My analysis has explained that NPM noncompliance was an inevitable result of the deficiencies of the Model Statute so long as there were willing non-compliers.

### **III. In 2003, Maryland Ameliorated the Key Problems with the Model Statute by Enacting and Implementing Complementary Legislation That Conditioned Market Access on Full Compliance.**

In 2003, Maryland enacted Complementary Legislation to “prevent violations and aid the enforcement of the Escrow Act.” § 16-502(b). Enacting and implementing the Complementary Legislation was the most effective action Maryland could take in 2003 to promote NPM compliance with the escrow obligation. Only through structural reform, authorized by new legislation, would effective enforcement be possible.

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<sup>10</sup> PMs’ Statement of Contest, at 1-2.



**A. The Complementary Legislation fixed many of the gaps in the Model Statute.**

Maryland's Complementary Legislation addressed the Model Statute's gaps in the seven ways discussed next.

- 1. The Complementary Legislation aligned NPM self-interest with the Model Statute's purpose: requiring escrow deposits for all lawful NPM sales in the State.**
  - a. Upon implementation of the Complementary Legislation, NPMs or NPM brands with any history of noncompliance were immediately prohibited from the Maryland market.**

Under the Complementary Legislation, the Attorney General established a statewide Tobacco Directory of approved cigarette manufacturers and brands. The Complementary Legislation then prohibits anyone from “sell[ing], offer[ing] or possess[ing] for sale in this State, or import[ing] for personal consumption in this State, cigarettes of a tobacco product manufacturer or brand family not included in the directory.” § 16-504(c)(2). Previous noncompliance, left unresolved, keeps a brand and manufacturer off the list. *In other words, the Complementary Legislation authorized the Attorney General to block, immediately, market access for the previously noncompliant.* Contrast the Model Statute, which allowed NPMs with past noncompliance to continue selling in the State, absent a court injunction following a second knowing violation. By denying directory listing, the new legislation enabled regulators to block NPMs with past noncompliance from making any future sales. Regulators could erect this barrier administratively, without the need for a lawsuit and without having to wait for, and then prove, knowing violations of two annual escrow deposit obligations – see § 16-504(b)(3) (authorizing the Attorney General to update the directory “as necessary in order to correct mistakes and to add or remove a tobacco product manufacturer or brand family to keep the directory in conformity with requirements of [the Complementary Legislation]”).

Unlike the Model Statute, the Complementary Legislation builds its manufacturer enforcement house on the existing foundation of distributor regulation. The system in place prior to the Model Statute required that all cigarettes sales in Maryland pass through licensed distributors, who must affix pre-paid tax stamps to all packs. The Complementary Legislation prohibits distributors from “affix[ing] a stamp to a package or other container of cigarettes of a tobacco product manufacturer or brand family not included in the directory.” § 16-504(c)(1).

These features were sufficient to make illegal, immediately upon publication of the Tobacco Directory, any further sale, by anyone, of an NPM's cigarettes or an NPM's brands having any history of noncompliance, at least until that noncompliance was cured.

**b. Even NPMs with no history of noncompliance must demonstrate their qualifications before entering the market.**

The Complementary Legislation authorized the State to block entry not only of NPMs and brands with a history of noncompliance, but also of NPMs that failed to meet qualifications and fulfill certification requirements designed to ensure future compliance. § 16-503. Whereas the Model Statute allowed market entry for an unlimited universe of NPMs, the Complementary Legislation shrunk that universe to qualifying NPMs.

The technique for limiting market access to qualifying NPMs is a requirement that all cigarette manufacturers file an annual certification with the Maryland Attorney General, certifying that they are either PMs, or NPMs in “full compliance” with the Escrow Act. § 16-503. The certification process is mandatory for market entry: “The Attorney General may not include or retain in the directory the name or brand families of any nonparticipating manufacturer that fails to provide the required certification . . .” § 16-504(b)(1).

To establish its qualifications, an NPM must certify that –

- i. it has identified all brand families, including past sales in Maryland of those brand families, and identified any other manufacturers of those brand families, § 16-503(c)(2);
- ii. it “is registered to do business in the State or has appointed a resident agent for service of process,” § 16-503(d)(1)(i);
- iii. it has “established and continues to maintain a qualified escrow fund,” and has “executed a qualified escrow agreement” that “has been reviewed and approved by the Attorney General,” § 16-503(d)(1)(ii);
- iv. it “is in full compliance with the Escrow Act,” § 16-503(d)(1)(iii);
- v. it accepts financial responsibility for escrow deposits for all sales of the brand families sought for certification, § 16-503(e)(1)(ii); and
- vi. it satisfies any additional informational requirements “necessary to enable the Attorney General to determine whether a tobacco product manufacturer is in compliance with [the Complementary Legislation].” § 16-506(d).

NPMs also must provide the State with detailed information about the “financial institution in which the nonparticipating manufacturer has established a qualified escrow fund.” § 16-503(d)(2).

Although the Complementary Legislation, compared to the Model Statute, more closely aligns NPM self-interest with compliance and provides Maryland important new enforcement tools, it is imperfect. The Complementary Legislation allows an NPM with no known past noncompliance to obtain listing on the Tobacco Directory, sell in the State, and then fail to comply when the escrow deposit comes due, particularly if it has no intention to make future sales. The Complementary Legislation thus fails to preclude short-term players from exploiting the primary problem built into the Model Statute – delay of the escrow deposit obligation until after the NPM had sold the cigarettes in the State. The way to align an NPM’s self-interest with compliance more effectively would have been to change the Model Statute to require the NPMs to deposit escrow in advance of their sales, much like the cigarette excise tax is paid prior to sale. Nevertheless, the Complementary Legislation’s gatekeeping provisions – the Tobacco Directory and the advance certification process – give Maryland a critical means of promoting NPM compliance, a means not present in the Model Statute. While noncompliance can still occur, it no longer can occur indefinitely. Under the Model Statute, the State, on learning of noncompliance, had to serve, sue and collect judgment (all actions with unclear likelihoods); under the Complementary Legislation, the State needed only to remove the noncompliant from the Directory, and could do so immediately.

**2. The Complementary Legislation draws strength from its explicit connection to the existing cigarette regulatory regime over licensed distributors.**

The Model Statute never mentions cigarette distributors. The Complementary Legislation, in contrast, includes multiple provisions that task Maryland-licensed distributors with responsibilities that induce NPMs to comply with the Model Statute. Most importantly, § 16-504(c)(1) prohibits licensed distributors from applying tax stamps to cigarette packs of manufacturers or brands not included on the Tobacco Directory of approved manufacturers and brands. This prohibition serves the critical function of tying Model Statute enforcement to the existing regulatory regime of licensed distributor enforcement. Other provisions in the Complementary Legislation also build on, and make use of, the regulatory regime governing licensed cigarette distributors. *See* § 16-504(b)(4)(requiring licensed wholesalers to maintain an electronic mail address with the Attorney General “for the purpose of receiving . . . notifications” – including notifications about NPMs included and excluded from the Directory); § 16-506(a)(1) (stating that “[n]ot later than 21 days after the end of each calendar quarter, and more frequently if so directed by the Comptroller, each licensed wholesaler shall submit information in the form and manner the Comptroller requires to facilitate compliance with [the Complementary Legislation],” including information on cigarette sales by NPM brand family and roll-your-own tobacco); § 16-506(a)(2) (requiring licensed wholesalers to maintain documents pertaining to NPM sales); § 16-507 (establishing an array of penalties available against licensed wholesalers, including license revocation, civil fines, seizure of cigarettes, injunctions, and criminal penalties for not complying with obligations under the Complementary Legislation).

**3. The Complementary Legislation created a jurisdictional nexus between NPMs and regulators.**

Section 16-505(a)(1) eliminates the jurisdictional nexus gap in the Model Statute by requiring any nonresident or foreign NPM to “appoint and continually engage without interruption” an agent for service of process, “as a *condition precedent* to having its brand families included or retained in the directory . . .” (emphasis added). Accordingly, in the event that an NPM failed to deposit its required escrow obligation the year following its sales, the Attorney General could effect service of a complaint against the company on the company’s resident agent in Maryland rather than having to effect service on the company in another State or a foreign country.

**4. The Complementary Legislation provided regulators means to prevent NPMs from using corporate structure, asset transfers, dissolution and reincorporation to avoid compliance.**

By addressing only “NPMs,” the Model Statute enabled their escape from their escrow obligations through corporate dissolution and incorporation. The Complementary Legislation blocks these moves, in two ways. First, the new certification and qualification process allows the State to screen out companies formed through such maneuvers. *See, e.g.*, § 16-503(e)(2) (providing “the State’s right to maintain that a brand family constitutes cigarettes of a different tobacco product manufacturer . . . for purposes of the Escrow Act”). Second, the new legislation addressed not just the NPMs (whose identities could change), but their “brand families.” *See* §16-501(b) (defining “brand family”) and § 16-504(b)(2) (denying Tobacco Directory status for any brand families for which there was past noncompliance, regardless of manufacturer). No longer can an entity shift brand families among corporate entities to evade the escrow obligation. *See, e.g.*, § 16-503(c)(1) (requiring NPMs to certify a “complete list” of their brand families); § 16-503(c)(2)(iv) (requiring identification of all other manufacturers of brand families with sales in the preceding or current calendar year); § 16-504(b)(2)(i) (prohibiting listing on the Tobacco Directory of any brand family if the Attorney General concludes the brand has been noncompliant in the past); § 16-504(c)(1)-(2) (prohibiting the stamping, selling and possession of cigarette brand families not listed on the Tobacco Directory).

**5. The Complementary Legislation provided the Attorney General and Comptroller authority to monitor compliance.**

By requiring the tobacco product manufacturer to “maintain all invoices and documentation of sales and any other information relied upon for its certification for a period of 5 years, unless otherwise required by law to maintain them for a greater period of time,” § 16-503(e)(3), the statute gives regulators continuous authority to require the information they needed to monitor compliance. This authority was missing from the Model Statute.

**6. The Complementary Legislation gave the Attorney General and Comptroller broad enforcement tools that work swiftly.**

No longer must the regulators climb the steep, slow mountain of writing a complaint, going to court, serving process, getting a judgment, executing on the judgment, tracking down distant violators and waiting months for an injunction. Under § 16-504(b)(2), the Maryland Attorney General can act unilaterally and quickly to remove a manufacturer or brand that is noncompliant, and, under § 16-507, the Comptroller may suspend or revoke the license of a wholesaler that sells product not listed on the Tobacco Directory, impose civil penalties, and seize as contraband any unlisted product. The Attorney General or the Comptroller can take all those actions without delay, and without judicial intervention. In addition, the Attorney General can seek, without delay, injunctions under § 16-507(c) against wholesalers for actual or threatened violations of the Complementary Legislation, and criminal sanctions against any “person who sells, distributes, acquires, holds, owns, possesses, transports, imports, or causes to be imported, cigarettes that the person knows or should know are intended for distribution or sale in the State in violation of” the Tobacco Directory provisions. § 16-507(d).

**7. The Complementary Legislation broadened regulatory authority to address actions not anticipated by the statute.**

Evasion can take forms that statutory drafters fail to anticipate. The Complementary Legislation therefore authorized the Attorney General and the Comptroller to “adopt regulations necessary to effectuate the purposes of this subtitle,” § 16-508(b), and to require from wholesalers and manufacturers “any additional information, including samples of the packaging or labeling of each brand family, as is necessary to enable the Attorney General to determine whether a tobacco product manufacturer is in compliance with this subtitle.” § 16-506(d).

**8. Conclusion**

In contrast to the Model Statute, the Complementary Legislation aligned the private interest, of both the NPMs and the distributors, with the public interest of ensuring escrow deposits. It does so by conditioning NPM market access on both NPM and distributor compliance. It replaces enforcement uncertainty with certainty. The certification process and directory listing placed regulators at the market’s gateway. No longer could there be unrestrained market entry by the noncompliant and the intending-not-to-comply. By eliminating the potential problems of distance and remoteness, of non-nexus and corporate shuffling, it reduces the need for detection, pursuit and lawsuit. Regulators can act unilaterally and quickly, rather than file lawsuits against entities over whom they may have no ready jurisdiction.

By building on the existing excise tax regulation, the Complementary Legislation brings distributors into the enforcement team. The focus of regulatory attention is not the unknown distant manufacturers, but the known, licensed wholesalers – entities who want a long-term presence in the State and who must purchase tax stamps from the State to sell cigarettes in the

State. If they sell unlisted product they can lose their license, pay fines, and face criminal charges. There is, in short, a tight correspondence between market access (for both NPMs and distributors) and compliance.

**B. The PMs' contemporaneous documents confirm the importance of the Complementary Legislation for effective enforcement.**

In Part II.D. I presented empirical evidence, contemporaneous comments by PM competitors of noncompliant NPMs, that was consistent with my analysis of the Model Statute's flaws. As indicated above, the PMs assessed the Model Statute before, during and after 2003. They concluded that it was an ineffective statute, and that new legislation was necessary to plug the Model Statute's regulatory gaps. There is similar evidence on the issue of the Complementary Legislation's ameliorative effects. The PMs' writings on this subject are consistent with my conclusion that in 2003 Maryland pursued the most effective action for promoting compliance, by enacting Complementary Legislation and implementing its key feature, the Tobacco Directory.

John Long, Vice President & General Counsel for the PM Liggett Vector Brands LLC,

[REDACTED]

[REDACTED] explained that:

[REDACTED]

E-mail from John Long, Vice President & General Counsel of Liggett Vector Brands LLC, to Tim Jackson, a Liggett employee, dated October 14, 2004, NPM2003-LIGGETT-014813-R.

[REDACTED]

[REDACTED]

Letter from John R. Long to Donald D. Stanley, Jr., Assistant Attorney General for the State of Iowa, dated October 19, 2001, NPM2003-LIGGETT-001340.

[REDACTED]

[REDACTED]

Document entitled “State Government Relations (Description of Certain Key Issues),” attached to an e-mail dated May 13, 2003, RJR Bates Nos. 55853 7942 to 55853 7945, at 55853 7944.

[REDACTED]

[REDACTED]

Document entitled “Why Should I Support the Model Statute Compliance Act?”, attached to an e-mail dated February 15, 2002, RJR Bates Nos. 55853 1064 to 55853 1065, at 55853 1065 (emphasis in original).

**IV. Maryland’s NPM Compliance Record Evidences Both the Model Statute’s Deficiencies and Maryland’s 2003 Efforts to Correct Them.**

I have reviewed the summaries of NPM sales and escrow deposits provided to me by counsel and assume their accuracy.

The data from 2000-2009, and specifically from 2002-2003, are consistent with my conclusions regarding the ineffectiveness of the Model Statute and the effectiveness of the Complementary Legislation. While the 2002-2003 data shows the enforcement difference clearly, the 2004-2009 data demonstrates that the 2003 noncompliance drop was not a statistical oddity: That year’s sharp change in results has been sustained at least through 2009 (the last year included in the summaries). Consider first the 2002-2003 data from Exhibit H in Table 1:

Table 1: Quarterly NPM Compliance 2002-2003 (1000s of packs)								
	2002				2003			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Total NPM	1,328	2,282	1,595	1,413	1,656	1,427	1,254	<b>762</b>
Compliant NPM	793	1,069	756	508	687	693	692	<b>746</b>
Noncompliant NPM	534	1,213	839	906	969	734	563	<b>16</b>
Total PM & NPM	72,756	89,928	53,031	64,319	63,871	82,306	53,286	<b>69,151</b>
Noncompliant NPM / Total (PM & NPM)	0.73%	1.35%	1.58%	1.41%	1.52%	0.89%	1.06%	<b>0.02%</b>

The sharp decline in the number of noncompliant sticks in fourth quarter 2003 coincides with the implementation of the Complementary Legislation. That decline shows the change – occurring over one calendar quarter – from an ineffective regulatory statute to an effective regulatory statute.

Table 1 shows that the number of noncompliant NPM cigarettes dropped in 4<sup>th</sup> quarter 2003 to 16,000 packs from 563,000 packs in the 3<sup>rd</sup> quarter. That drop is probative of a meaningful change in the regulatory regime.

Notice that the ratio in the last row of Table 1 (and Table 2 below) is the ratio of noncompliant NPM sticks sold to total sticks sold. The ratio shows a drop in the noncompliance rate from over one percent in the third quarter 2003 to *two-hundredths* of one percent in the fourth quarter 2003. I use this particular ratio because it accurately describes how the enactment and implementation of Complementary Legislation in 2003 succeeded in eliminating the problem (with *de minimus* exceptions) of NPM noncompliance. Here’s why: Enforcement can have two possible effects: It can (1) convert noncompliant NPMs into compliant NPMs, and (2) push out of the market NPMs who are either noncompliant or are considering noncompliance. Assuming constant demand for cigarettes, the sales in category 2 (the noncompliant or possibly noncompliant) will be replaced by sales that are legal (sales by compliant NPMs or by PMs). The ratio thus captures the precise goal of the Model Statute: to reduce the market presence of noncompliant NPM sticks.

Table 2, based on data provided in Exhibit G, shows the drop was not a statistical oddity; it was permanent through 2009, the last date for which data is provided:



<b>Table 2: Annual NPM Compliance 2000-2009 (1000s of packs)</b>										
	2000	2001	2002	2003	<b>2004</b>	2005	2006	2007	2008	2009
Total NPM	1,232	4,252	6,617	5,099	<b>1,655</b>	1,362	931	823	416	320
Compliant NPM	830	3,207	3,125	2,818	<b>1,461</b>	1,073	910	823	416	320
Noncompliant NPM	402	1,045	3,493	2,281	<b>194</b>	289	22	0	0	0
Total PM & NPM	304,538	298,740	280,034	268,614	<b>265,413</b>	271,085	276,697	275,526	197,686	196,694
Noncompliant NPM / Total (PM & NPM)	0.13%	0.35%	1.25%	0.85%	<b>0.07%</b>	0.11%	0.01%	0.00%	0.00%	0.00%

Tables 1 and 2 show that when Complementary Legislation eliminated the Model Statute's defects, noncompliance dropped permanently, to *de minimus* levels. The first period of *de minimus* noncompliance was the first reporting period after Maryland published the Tobacco Directory pursuant to the statutory deadline of September 15, 2003, and the drop – to levels approaching or at zero – has been sustained through 2009.

These facts are consistent with my conclusion that the Model Statute failed as a regulatory statute. A failed regulatory statute cannot prevent noncompliance. It allows noncompliance, then relies on the uncertainties of detection, pursuit and lawsuit to stop and penalize the noncompliant. It necessarily follows that the noncompliance in Maryland for 2002 sales or 2003 sales prior to publication of the Tobacco Directory is not a logical or valid measure of the quality of Maryland's enforcement work.

These facts also are consistent with my conclusion that the best way to counteract the Model Statute's ineffectiveness was to enact legislation giving the State authority to close the Model Statute's gaps, then to move quickly to use the new authority. My review of Maryland's Complementary Legislation and the NPM sales and escrow deposit summaries confirms that during 2003 Maryland identified and implemented the most effective means of promoting NPM compliance with the Model Statute's escrow obligation; it enacted and then implemented legislation that permanently effected compliance, by providing Maryland regulators the tools to condition market access on compliance and subjecting the NPMs that are allowed to enter the market to Maryland's jurisdiction.




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Scott Hempling