STATE OF MINNESOTA

# Office of the Attorney General

tobacco MN. documents

TO: Officials Concerned about Federal Tobacco Policy

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SUBJECT: U.S. Supreme Court Ruling

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# Minnesota Office of the Attorney General
# Hubert H. Humphrey III

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SUBJECT: Supreme Court Ruling

Today, the United States Supreme Court stayed, for 24 hours, a ruling by the Minnesota Supreme Court that would release 39,000 of the most fiercely guarded tobacco industry internal documents. We know these documents contain the industry's darkest secrets. A lower court ruling reveals evidence that the industry covered up research on children as young as five years old.

This limited stay indicates that the Court is likely to act quickly - we hope to have an answer as to whether or not these documents will become public within the next two days. Should the Supreme Court rule in a manner similar to the Minnesota courts, these never before seen documents could come out as early as next week.

Attached, you will also find "The Truth About Tobacco Bankruptcy", a response to the tobacco industry's claims that they will go bankrupt without liability protections.

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# THE TRUTH ABOUT TOBACCO BANKRUPTCY

The tobacco industry and some of its supporters contend that Congress must limit the potential liability of the tobacco industry because, without such protection, a few large judgments will render the industry insolvent and force them to go bankrupt. The result, the argument goes, is that while a few plaintiffs may win, most injured smokers and their families will be left empty-handed or left standing in line with a long list of creditors. Meanwhile, as the present tobacco companies struggle to reorganize their debts in bankruptcy court, new entrants will come into the tobacco market, without the burden of liability exposure for past misconduct, and will sell cigarettes that are just as addictive and just as deadly as those currently on the market. Those who oppose liability protection, these advocates contend, are therefore really more interested in punishing the tobacco companies than they are in protecting the health of the public.

There are several flaws in this line of reasoning.

1. **The tobacco industry is far from insolvency and bankruptcy.**

The conglomerates that own the six major domestic tobacco companies have a net capitalized market value exceeding $150 billion and net operating profits exceeding $20 billion each year.[1] The profit margin on domestic tobacco sales is now at 29.9%, meaning that for every thousand dollars in sales, the companies make $299, among the highest profitability levels in any American industry. On top of that, given the oligopolistic structure of this industry, analysts have estimated that, if cigarette prices were pegged at their profit-maximizing potential, up to an additional $32 billion per year in revenue could be generated. Even before considering issues such as the potential value of the industry's insurance assets, then, it is clear that the tobacco industry is far from being judgment-proof. It will take a lot more than a few judgments to drive these companies into insolvency.

[1] The revenues and profits from the domestic tobacco subsidiaries standing alone are lower--$22 billion and $7.8 billion in 1997, but those figures are largely immaterial. Today, given the uncertain liability exposure of the tobacco industry, any attempt to "spin off" the tobacco subsidiaries, put the liability there, but keep most of the assets in other parts of these companies, would be challenged immediately, and probably successfully, as being a "fraudulent transfer" or "fraudulent conveyance" intended to defeat the claims of creditors. Ironically, any Congressional attempt to cap the industry's liability will likely remove that barrier, allow the "spin-offs" to occur, and, if those tobacco subsidiaries are left relatively undercapitalized, actually increase the likelihood that one or more of those companies would go bankrupt or become genuinely insolvent.

## 2. Bankruptcy does not mean "nobody gets any money."

The word "bankruptcy" carries with it connotations which do not reflect the reality of what happens when a company files a chapter 11 petition. When a company files for bankruptcy protection, the trustee or debtor-in-possession's responsibility under the Bankruptcy Code is to marshall all of the assets of the bankrupt entity (the "bankruptcy estate"), distribute all or part[2] of those assets to the creditors according to the priority scheme set forth in the statute, and then discharge the prepetition debts. One of the core concepts in the Code is the doctrine of "absolute priority," which means that the claims of creditors have priority over the interests of shareholders. Therefore, in a bankruptcy setting, it would be those who have enjoyed the profits from the tobacco industry who would be at great risk. The industry's creditors would, on the other hand, have the actual and potential assets of the companies available to satisfy their claims. It is possible, indeed likely, that some unsecured prepetition claimants would be left with less than 100 cents on the dollar, but it is not fair to say "nobody gets any money."

## 3. There are many reasons why the tobacco industry would not file for bankruptcy protection willingly.

Any decision to seek bankruptcy protection would not be taken lightly. When a company seeks reorganization of debts under chapter 11 of the Bankruptcy Code, effective control over the company's assets and future passes from the CEO, the board of directors, and the company's shareholders to the company's creditors. The creditors, who in this case would include victims seeking compensation, would, under the supervision of the bankruptcy judge, decide the terms on which any bankrupt tobacco entity would emerge from chapter 11 with a "fresh start." It seems unlikely that these industry officials would cede that control easily or willingly. Nor could they subject their shareholders to that kind of wipeout of share value, and the personal liability that could be triggered, without evaluating all their options.

The attractiveness of a bankruptcy filing is even lower in this circumstance, because the Bankruptcy Code may not even protect them from many of the most important cases currently pending. The Bankruptcy Code's "automatic stay" does not extend to actions brought by state and local governments under their "police power" to enforce regulations, 11 U.S.C. § 362(b)(4), and, as the U.S. Supreme Court again ruled just last week, the "bankruptcy discharge" of debt upon approval of a plan of reorganization does not extend to any liability arising from fraud. Cohen v. De La Cruz, No. 96-1923 (U.S. March 24, 1998). Therefore, even if one or more of these companies were operating under bankruptcy protection, the state and private cases for injunctive and equitable relief would likely continue (and with all the public health benefits that might accrue from that), the states and private litigants would also likely be able to litigate their claims for monetary damages in the regular court system, and the tobacco companies may well not be able to shed that liability in the bankruptcy court.

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[2] Often, creditors choose to leave some of the assets in place, to permit a reorganized company to emerge from bankruptcy with the ability to better serve the longer-range interests of the creditors.

4. **The prospects for new, liability-free, entrants to the tobacco market is very limited.**

First of all, it is not likely that all of the tobacco companies are going to file bankruptcy at the same time, face possible restrictions on their ability to incur further liability from keeping their product on the market, and therefore leave the field open to new entrants. A more scenario likely, is that a weaker company, in a tough competitive position and facing judgments it cannot pay, would file, and, for a time, might gain a competitive advantage by being able to operate with its creditors at bay. To maintain that competitive advantage, however, that bankrupt company will have to assure its creditors and the bankruptcy judge that it has made the changes in its behavior or in its products necessary to be "viable" (that is, with minimum future liability) as a reorganized company. Only then will it be able to emerge from chapter 11 with greatly reduced debt, and maintain or even enhance that competitive edge.

Second, even if all the tobacco companies did go into chapter 11, entering the tobacco industry in any kind of major way would hardly be an easy undertaking, given the capital investment required, brand loyalties, and the other barriers to entry. To attract leaders and investors to a new venture, selling a product that has generated so much liability--even though due primarily to past misconduct, that the established players are now in bankruptcy--would be no small trick. Moreover, by that point, it seems likely that the regulatory framework governing tobacco would have tightened considerably, and no new company would be able to market a tobacco product that is as dangerous as the products currently on the market.

5. **Even in the worst case, offering liability protection to these companies would be indefensible.**

The message Congress would be sending if it grants the tobacco industry liability protection to keep it out of bankruptcy would be this: If your conduct has been so egregious, and the damage you have caused is so massive, that you now face the prospect of bankruptcy because of liability to your victims, come to Congress. Congress will not only let you off the hook, but Congress will happily go into business with you--guaranteeing your future profitability in exchange for a piece of the action. That is precisely what the tobacco industry is proposing.

There is little question that previous mass tort bankruptcy situations have been messy (particularly asbestos), and the transaction costs, including attorney fees, have in some cases been unconscionably high. As the current "third wave" of tobacco litigation matures, and the industry's liability prospects become more predictable, it may make sense for Congress to explore alternatives to the bankruptcy courts to administer claims, e.g. smoker compensation proposals, if the industry is genuinely facing insolvency. On the other hand, to offer liability protection now, not for the purpose of developing a fairer compensation system, but rather as a "deal" in exchange for money, and the hope of softened opposition to regulatory initiatives, is very difficult to defend.

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