TEXAS COURT OF APPEALS, THIRD DISTRICT, AT AUSTIN

ON REMAND

NO. 03-13-00753-CV

Glenn Hegar, in his official capacity as Texas Comptroller, and Ken Paxton, in his official capacity as Texas Attorney General, Appellants

v.

Texas Small Tobacco Coalition and Global Tobacco, Inc., Appellees

FROM THE DISTRICT COURT OF TRAVIS COUNTY, 98TH JUDICIAL DISTRICT NO. D-1-GN-13-002414, HONORABLE STEPHEN YELENOSKY, JUDGE PRESIDING

M E M O R A N D U M O P I N I O N

Following remand from the Texas Supreme Court, we consider the remaining constitutional challenges to a tax statute made by appellees Texas Small Tobacco Coalition and Global Tobacco, Inc. ("Small Tobacco"). We reverse the trial court's order and render judgment granting summary judgment in favor of appellants Glenn Hegar, in his official capacity as Texas Comptroller, and Ken Paxton, in his official capacity as Texas Attorney General ("the State").[1]

[1] When this appeal was filed, Susan Combs was the Comptroller and Greg Abbott was the Attorney General. We have substituted the current officials pursuant to rule 7.2 of the rules of appellate procedure. *See* Tex. R. App. P. 7.2(a) (when public officer is party in official capacity and officeholder changes, successor is automatically substituted as party).

In the 1990s, the largest tobacco companies in the United States were sued by the states for wrongs such as fraud, racketeering, conspiracy, deceptive advertising, and antitrust violations.[2] In March 1997, one of the defendant manufacturers, Liggett Group, Inc., settled with Texas and a number of other states ("the Liggett Settlement"), agreeing to cooperate with the states in their suits against the remaining defendant manufacturers, Philip Morris Inc., R.J. Reynolds Tobacco Co., Brown & Williamson Tobacco Corp., and Lorillard Tobacco Co. ("Big Tobacco"). Liggett agreed to provide relevant documents and information, including documents protected by attorney-client privilege and work-product protections, related to the health effects of tobacco use. Liggett also agreed to pay a $25 million initial payment and then to pay 25% of its pretax income each year, subject to adjustments related to market share.

Once Liggett agreed to cooperate and to turn over industry documents, Big Tobacco settled the lawsuits pending against them. Forty-six states entered into a "Master Settlement Agreement" under which Big Tobacco agreed to make ongoing annual payments to the states and to comply with restrictions on marketing and sponsorship activity and other requirements largely related to advertising and not to object to or lobby against legislation intending to reduce tobacco use by minors. Texas did not enter into the Master Settlement Agreement, instead entering into its own settlement under which Big Tobacco agreed to pay $725 million and to "make annual payments in perpetuity," which vary with the manufacturer's market share and sales ("the Texas Settlement").

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[2] More details about the underlying facts and procedural history can be found in our original opinion, *Combs v. Texas Small Tobacco Coalition*, 440 S.W.3d 304 (Tex. App.—Austin 2014), in which we held that the tax in question violated Texas's Equal and Uniform Clause, and the supreme court's opinion reversing our decision, *Hegar v. Texas Small Tobacco Coalition*, 496 S.W.3d 778 (Tex. 2016).

In exchange for their settlements, Liggett and Big Tobacco were released from the states' claims to recover for public health expenses caused by the use of tobacco products.

Some manufacturers other than Big Tobacco were also allowed to join the Master Settlement Agreement; those manufacturers are referred to as "subsequent participating manufacturers" ("SPMs"). *See* Tex. Health & Safety Code § 161.602(14), (15). SPMs agreed to the Master Settlement Agreement's advertising, lobbying, and activity restrictions and also agreed to make annual payments in exchange for a release of claims against them (those payments are not made to Texas). Global Tobacco, Inc. and Texas Small Tobacco Coalition's members are non-settling manufacturers, as none of those companies are parties to any of the settlement agreements.

In 2013, the legislature enacted chapter 161, subchapter V, of the health and safety code, which taxes tobacco products manufactured by non-settling manufacturers. *See id.* §§ 161.601, .602(9), .603; *see generally id.* §§ 161.601-.614 (Subchapter V, "Fee on Cigarettes and Cigarette Tobacco Products Manufactured by Certain Companies"). Subchapter V also taxes products made by SPMs, but at a much lower rate than the products made by non-settling manufacturers. *See id.* §§ 161.602(11), (14), (15), .604(c).

Small Tobacco sued, alleging that the tax imposed on its tobacco products under subchapter V was unconstitutional under Texas's Equal and Uniform Clause, *see* Tex. Const. art. VIII, §§ 1, 2, the federal Equal Protection Clause, *see* U.S. Const. amend. XIV, § 1, and the federal Due Process Clause, *see id.* amend. XIV, § 1. The State filed a plea to the jurisdiction, and Small Tobacco and the State filed competing motions for summary judgment. The trial court signed an order denying the State's plea to the jurisdiction and motion for summary judgment and granting

Small Tobacco's motion for summary judgment, finding that subchapter V was unconstitutional. The State appealed, and we affirmed, determining that the tax violated Texas's Equal and Uniform Clause. *Combs v. Texas Small Tobacco Coal.*, 440 S.W.3d 304, 313 (Tex. App.—Austin 2014), *rev'd*, *Hegar v. Texas Small Tobacco Coal.*, 496 S.W.3d 778 (Tex. 2016).

The State appealed to the Texas Supreme Court, which held that we had incorrectly focused on the identical nature of the products produced by settling and non-settling manufacturers rather than "the nature of the taxpayer[s]" affected by the tax. 496 S.W.3d at 786. The court determined that the classifications imposed by subchapter V, distinguishing between non-settling manufacturers and settling manufacturers, were rational and reasonably related to the tax and did not violate the Equal and Uniform Clause. *Id.* at 787. The court held that subchapter V was justified by "sufficient differences in business operations" between Small Tobacco and settling manufacturers, which make payments under the settlement agreements and operate under broader marketing and lobbying restrictions than are imposed on non-settling manufacturers under current legislation, and by the "legitimate purposes for the tax" articulated by the legislature—to recover healthcare costs related to the use of the non-settling manufacturers' products and to prevent non-settling manufacturers from undermining Texas's attempts to reduce underage smoking. *Id.* at 787-88. The supreme court reversed this Court's decision and remanded for consideration of Small Tobacco's remaining challenges under the federal Equal Protection and Due Process clauses. *Id.* at 793. In light of the supreme court's decision in *Hegar*, we reverse the trial court's order granting summary judgment for Small Tobacco and render judgment granting the State's motion for summary judgment.

Federal Equal Protection

On remand, Small Tobacco asserts that subchapter V is unconstitutional under the federal Equal Protection Clause because (1) the tax is unequal as between Small Tobacco and SPMs, none of which make settlement payments to Texas; (2) the settling manufacturers benefitted from "sweeping releases" from past and future tort liability, while Small Tobacco is taxed without receiving any such benefit; and (3) the tax does not distinguish between the different formulae used in the Texas and Liggett settlement agreements, resulting in all of the manufacturers who entered into those settlements receiving the same tax exemptions despite making different payments to Texas.[3] Small Tobacco contends that "[e]ach of these three arbitrary distinctions renders irrational the classifications between settling manufacturers, subsequent participating manufacturers, and Small Tobacco" and that subchapter V thus violates the federal Equal Protection Clause.

The federal Equal Protection Clause provides that the State may not "deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws." U.S. Const. amend. XIV, § 1. However, the federal Equal Protection Clause "'simply keeps governmental decisionmakers from treating differently persons who are in all relevant respects alike,'" while Texas's Equal and Uniform clause "is more strict." *In re Nestle, Inc.*, 387 S.W.3d 610, 624 (Tex. 2012) (quoting *Nordlinger v. Hahn*, 505 U.S. 1, 10 (1992)). Because the Texas Supreme Court has held that subchapter V does not violate the more

[3] In its pleadings before the trial court and its initial pleadings in this Court, Small Tobacco spent little time on its federal claims and did not discuss differences between the Liggett and Texas settlements or focus on similarities between Small Tobacco and SPMs.

stringent requirements of Texas's Equal and Uniform Clause, we need not address the federal equal-protection issue. *See id*.

Further, Small Tobacco urges that in only "clarif[ying] the test under the Texas Equal and Uniform Clause," the supreme court "chose not [to] consider" Small Tobacco's three arguments related to federal equal protection but rather remanded them for our consideration. However, as the State notes, our opinion and the supreme court's review was limited to Texas's Equal and Uniform Clause, the parties did not ask the supreme court to reach the federal issues, and the supreme court did not "choose" not to consider the federal arguments.

In its briefing before the supreme court, Small Tobacco argued that subchapter V violated the Equal and Uniform Clause because the tax assessed against Small Tobacco was "not equal to the dramatically-reduced tax on subsequent participating manufacturers or the settlement payments made by Big Tobacco" and because it assessed different taxes on identical tobacco products—those manufactured by Big Tobacco, which are not taxed; those manufactured by SPMs, which are taxed fifteen cents a pack; and those manufactured by non-settling manufacturers, which are taxed fifty-five cents a pack. *See* Respondents' Brief on the Merits, *Hegar*, 496 S.W.3d 778 (No. 14-0747), 2015 WL 4733159, at *18, 25, 53-54. Small Tobacco also noted that SPMs had settled under the Master Settlement Agreement, not the Texas Settlement, do not make payments to Texas, and yet receive a tax break as a "result of monies paid to other states, not to Texas," and that Small Tobacco did not receive the same benefits, including a release from claims, as settling manufacturers. *See id.* at *14. On rehearing in the supreme court, which denied the motion without further opinion or explanation, Small Tobacco emphasized its argument that there is no rational

basis for taxing Small Tobacco differently from SPMs when the SPMs do not make payments to compensate Texas for tobacco-related healthcare costs. *See* Respondents' Motion for Rehearing, at 2-4, *Hegar*, 496 S.W.3d 778 (No. 14-747), available at http://www.search.txcourts.gov/SearchMedia.aspx?MediaVersionID=f44f93fb-c503-4458-9f4a-4f8d70d83c96&coa=cossup&DT=REHEARING&MediaID=5c6f4bce-a3f5-45fd-b9c5-701d009c205b.

Small Tobacco contends on remand that subchapter V violates the Equal Protection Clause because (1) the SPMs do not pay funds to Texas under any settlements and thus are similarly situated as Small Tobacco, and (2) there is therefore no rational basis for taxing SPMs differently than Small Tobacco. These are in essence the same arguments raised in the supreme court in the context of its arguments related to the Equal and Uniform Clause. We agree with the State that these arguments were considered and rejected by the Texas Supreme Court in its analysis of the more stringent Texas clause. We are bound by the supreme court's decision and therefore overrule Small Tobacco's arguments that there is no rational basis to tax Small Tobacco differently than SPMs. *See International Fid. Ins. Co. v. State*, No. 14-98-00324-CR, 2000 WL 729384, *1 (Tex. App.—Houston [14th Dist.] June 8, 2000, pet. ref'd) (not designated for publication) (law-of-the-case doctrine provides that questions of law determined in prior appeal "will generally govern a case throughout all of its subsequent stages"; issue "must be the same question of law as was previously determined, and the matter must have actually been resolved," but "doctrine applies to implicit holdings, *i.e.*, conclusions that are logically necessary implications of positions articulated by the court, as well as explicit ones"); *see also Texas Health & Human Servs. Comm'n v. El Paso Cty. Hosp. Dist.*, 351 S.W.3d 460, 484 (Tex. App.—Austin 2011), *aff'd*, 400 S.W.3d 72 (Tex. 2013) ("lower courts are bound to give effect to the judgment that the supreme court has rendered").

Small Tobacco next asserts that there is no rational basis for providing settling manufacturers with the benefits of a release of liability and protected market share while denying those benefits to Small Tobacco and yet imposing an unequal tax. This, too, was raised before the supreme court and found to be without merit. In the context of the Equal and Uniform Clause, the supreme court discussed the fact that settling manufacturers agreed to significant restrictions on marketing and lobbying efforts, some of which "would implicate serious First Amendment concerns" if not agreed to, and agreed to make substantial payments to Texas. *Hegar*, 496 S.W.3d at 787. The court concluded that "[t]hose distinctions establish sufficient differences in business operations to justify the non-settling-manufacturer and settling-manufacturer tax classifications." *Id.* Because the tax classification is sufficiently rational and reasonably related to its purposes to survive a challenge under the Equal and Uniform Clause, *see id.* at 787-89, it passes muster under the less-strict Equal Protection Clause, *see In re Nestle*, 387 S.W.3d at 624.

Finally, Small Tobacco asserts that subchapter V violates the Equal Protection Clause because it does not take into account the differences in the formulae used in the Texas Settlement and the Liggett Settlement.[4] Because the settlements use different methods to calculate the settling manufacturers' annual payments, Liggett pays different amounts under its settlement than does Big Tobacco under the Texas Settlement (or SPMs under the Master Settlement Agreement) yet has the same release of claims and tax exemption. Small Tobacco argues that there is no rational basis for

[4] Under the Texas Settlement, Big Tobacco agreed to an initial $725 million payment and annual payments proportional to market share. Liggett agreed to a $25 million initial payment and annual payments of 25% of its pretax income, subject to market-share adjustments, but the parties note that at the time of the settlement, Liggett was having serious financial struggles, and it was expected that the Liggett Settlement would yield little in the way of revenue.

assuming that the tax assessed against Small Tobacco is roughly equivalent to what Liggett pays under its settlement. However, the Liggett Settlement specifically noted that Liggett was "providing historic and valuable cooperation and other considerations." After Liggett entered into its settlement, the other manufacturers quickly decided to settle their suit as well, resulting in the Master Settlement Agreement and the Texas Settlement, approximately $500 million in annual payments to Texas, and significant restrictions on marketing and lobbying by the settling manufacturers. *See Hegar*, 496 S.W.3d at 781-82.

In considering Small Tobacco's claim under the Equal Protection Clause, we ask whether subchapter V "treat[s] differently persons who are in all relevant respects alike." *See Nordlinger*, 505 U.S. at 10; *In re Nestle*, 387 S.W.3d at 624. The legislature could rationally have believed that Liggett's entering into its settlement and cooperating with nationwide anti-tobacco lawsuits conferred sufficient benefits on Texas to merit treatment the same as Big Tobacco and different from SPMs or non-settling manufacturers. *See Hegar*, 496 S.W.3d at 781; *see also Fitzgerald v. Racing Ass'n of Cent. Iowa*, 539 U.S. 103, 108-09 (2003) (legislation granting racetracks authority to operate slot machines while also imposing rising tax on slot-machine revenue could rationally be understood to advance racetracks' economic interests, or "[a]t least a rational legislator might so believe"). We overrule Small Tobacco's claim that subchapter V violates the Equal Protection Clause.

Due Process

Small Tobacco's arguments related to due process[5] are that the tax "bears no relation to the protection, opportunities, and benefits afforded those businesses by the State" and is "simply an effort to improperly extract" from Small Tobacco "the same financial benefits" that Big Tobacco provided under the settlement agreements without providing the benefits granted to the settling manufacturers. Further, Small Tobacco notes, the settlement agreements were the result of lawsuits accusing Big Tobacco of serious wrongdoing, while Small Tobacco and its members have "never been accused of any wrongdoing," have never been sued, and have not had the chance to defend themselves in court. Thus, Small Tobacco urges, the tax imposes financial penalties without the required due process of law.

"[A] challenged statute is entitled to a 'strong presumption' of constitutional validity" that is "particularly robust" when applied to a taxation statute. *Hegar*, 496 S.W.3d at 787 (quoting *In re Nestle*, 387 S.W.3d at 623; *Vinson v. Burgess*, 773 S.W.2d 263, 266 (Tex. 1989)).

> The Due Process Clause places two restrictions on a State's power to tax income generated by the activities of an interstate business. First, no tax may be imposed, unless there is some minimal connection between those activities and the taxing State. . . . Second, the income attributed to the State for tax purposes must be rationally related to "values connected with the taxing State."

[5] For the first time on appeal, Small Tobacco claims that the tax also violates Texas's Due Course of Law Clause. *See* Tex. Const. art. I, § 19. A party may not raise a constitutional challenge to a statute for the first time on appeal. *See Loftin v. Lee*, 341 S.W.3d 352, 356 n.11 (Tex. 2011). Further, the Due Course of Law Clause is construed "in the same way as its federal counterpart." *Texas Workers' Comp. Comm'n v. Patient Advocates of Tex.*, 136 S.W.3d 643, 658 (Tex. 2004).

Moorman Mfg. Co. v. Bair, 437 U.S. 267, 272-73 (1978) (quoting *Norfolk & W. Ry. Co. v. Missouri State Tax Comm'n*, 390 U.S. 317, 325 (1968)).[6] We ask whether Texas's taxing power "'bears fiscal relation to protection, opportunities and benefits given by the state'—that is, 'whether the state has given anything for which it can ask return.'" *MeadWestvaco Corp. ex rel. Mead Corp. v. Illinois Dep't of Revenue*, 553 U.S. 16, 24 (2008) (quoting *ASARCO Inc. v. Idaho Tax Comm'n*, 458 U.S. 307, 315 (1982)). When considering a tax levied against in-state activities, such as in this case, the Due Process Clause is applicable only when the tax is "so arbitrary as to compel the conclusion that it does not involve an exertion of the taxing power, but constitutes, in substance and effect, the direct exertion of a different and forbidden power, as, for example, the confiscation of property." *A. Magnano Co. v. Hamilton*, 292 U.S. 40, 44 (1934). In other words:

> Collateral purposes or motives of a Legislature in levying a tax of a kind within the reach of its lawful power are matters beyond the scope of judicial inquiry. Nor may a tax within the lawful power of a state be judicially stricken down under the due process clause simply because its enforcement may or will result in restricting or even destroying particular occupations or businesses, unless, indeed, as already indicated, its necessary interpretation and effect be such as plainly to demonstrate that the form of taxation was adopted as a mere disguise, under which there was exercised, in reality, another and different power denied by the Federal Constitution to the state.

Id. at 44-45 (citations omitted).

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[6] *See also Quill Corp. v. North Dak. ex rel. Heitkamp*, 504 U.S. 298, 306, 308 (1992) (Delaware mail-order company challenged statute imposing tax when it sold and delivered goods to North Dakota residents; Supreme Court held that company had purposefully directed activities at North Dakota residents and that tax was related to benefits company received from access to state); *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344-45 (1954) (invalidating statute that required Delaware corporation to collect taxes on goods sold in Delaware to Maryland residents).

Regardless of whether a non-settling manufacturer is a Texas company, it is only required to pay the tax on products it sells in Texas, thus satisfying any minimal-connection requirement. The supreme court held that the legislature "articulated legitimate purposes for the tax," including recovery of future healthcare costs related to Texas residents' use of Small Tobacco's products and reducing underage smoking, and that those goals are reasonably related to the tax. *Hegar*, 496 S.W.3d at 788-89. Small Tobacco has not shown that the tax is fiscally unrelated to the benefit of being allowed to sell tobacco products in Texas, *see MeadWestvaco Corp.*, 553 U.S. at 24, nor has it demonstrated that the tax "was adopted as a mere disguise, under which there was exercised, in reality, another and different power denied by the Federal Constitution to the state," *see A. Magnano*, 292 U.S. at 44-45; *see also Hegar*, 496 S.W.3d at 788-89 (legislature articulated legitimate purposes for tax; tax classifications are reasonably related to goals of recovering healthcare costs and reducing underage smoking). We overrule Small Tobacco's due-process claims.

Conclusion

Having held that subchapter V does not violate the Due Process Clause or the Equal Protection Clause, we reverse the trial court's order and render judgment granting the State's motion for summary judgment and dismissing Small Tobacco's claims that subchapter V is unconstitutional.

David Puryear, Justice

Before Justices Puryear, Goodwin, and Field

Reversed and Rendered on Remand

Filed: March 24, 2017