No. 03-13-00753-CV

In the Court of Appeals for the Third Judicial District Austin, Texas

---

SUSAN COMBS, IN HER OFFICIAL CAPACITY AS TEXAS COMPTROLLER, AND GREG ABBOTT, IN HIS OFFICIAL CAPACITY AS TEXAS ATTORNEY GENERAL
Appellants,

v.

TEXAS SMALL TOBACCO COALITION AND GLOBAL TOBACCO, INC.,
Appellees.

On Appeal from the
98th District Court, Travis County

BRIEF OF APPELLANTS

GREG ABBOTT
Attorney General of Texas

DANIEL T. HODGE
First Assistant Attorney General

JONATHAN F. MITCHELL
Solicitor General

ARTHUR C. D'ANDREA
Assistant Solicitor General
State Bar No. 24050471

ERIKA KANE
Assistant Attorney General

OFFICE OF THE ATTORNEY GENERAL
P.O. Box 12548 (MC 059)
Austin, Texas 78711-2548
[Tel.] (512) 936-2868
[Fax] (512) 474-2697
arthur.dandrea@texasattorneygeneral.gov

COUNSEL FOR APPELLANTS

ORAL ARGUMENT REQUESTED

IDENTITY OF PARTIES AND COUNSEL

The following is a complete list of all parties and the names and addresses of all counsel of record.

***Appellant*:**
Susan Combs, in her official capacity
Greg Abbott, in his official capacity

***Counsel for Appellant*:**

Appellate Counsel
Arthur C. D'Andrea
Assistant Solicitor General
State Bar No. 24050471
P.O. Box 12548 (MC 059)
Austin, Texas 78711-2548
[Tel.] (512) 936-2868
[Fax] (512) 474-2697

Trial Court Counsel
Erika Kane
Assistant Attorney General
State Bar No. 24032093
P.O. Box 12548 (MC 029)
Austin, Texas 78711-2548
[Tel.] (512) 463-2120
[Fax] (512) 457-4452

***Appellees*:**
Small Tobacco Coalition
Global Tobacco

***Counsel for Appellee*:**
Craig T. Enoch
Melissa A. Lorber
Amy Leila Saberian
Shelby O'Brien
ENOCH KEVER PLLC.
600 Congress Avenue, Suite 2800
Austin, Texas 78701

TABLE OF CONTENTS

Identity of Parties and Counsel ii

Index of Authorities v

Statement of the Case xi

Issues Presented xii

Statement of Facts 3

I. Major Tobacco Manufacturers Settle Lawsuits With The States . . . 3

a. Texas Settlements 3

b. Master Settlement Agreement 4

II. Small Tobacco Fills the Void 5

III. The Texas Legislature Responds 7

Procedural History 9

Summary of the Argument 10

Argument 12

I. Plaintiffs Failed To Overcome Defendants' Immunity Because They Failed To Plead Valid Constitutional Claims 12

A. Plaintiffs Failed To Plead A Valid Claim That HB 3536 Violates The Equal And Uniform Clause of the Texas Constitution 12

B. Plaintiffs Failed To Plead Valid Claims That HB 3536 Violates The United States Constitution's Guaranties of Equal Protection and Due Process 18

II. The Small Tobacco Coalition Lacks Standing To Maintain A Taxpayer Suit Under Chapter `112 Of The Tax Code, Which Is The Exclusive Means For Challenging The Legislature's Imposition of A Tax or Fee 19

Prayer 21

Certificate of Service 23

Certificate of Compliance 23

Appendix

INDEX OF AUTHORITIES

Cases

Council of Independent. Tobacco Mfrs v. Minn.,
713 N.W.2d 300 (Minn. 2006) 16

Dancetown U.S.A., Inc. v. State,
439 S.W.2d 333 (Tex. 1969) 12

Enron Corp. v. Spring Indep. School Dist.,
922 S.W.2d 931 (Tex. 1996) 18

Grand River Enter. Six Nations, Ltd. v. Pryor,
481 F.3d 60 (2d Cir. 2007) 4

Grand River Enter. Six Nations, Ltd. v. Beebe,
574 F.3d 929 (8th Cir. 2009) 16

Grand River Enter. Six Nations, Ltd. v. Prior,
425 F.3d 158 (2d Cir. 2005) 16

Grayson v. Calvert,
357 S.W.2d 160 (Tex. Civ. App.—Austin 1962, writ ref'd n.r.e.) 12

In re Allcat Claims Servs., L.P.,
356 S.W.3d 455 (Tex. 2011) 19

In re Nestle USA, Inc.,
359 S.W.3d 207 (Tex. 2012) 21

In re Nestle USA, Inc.,
387 S.W.3d 610 (Tex. 2012) 13, 18

International Shoe Co. v. Washington,
326 U.S. 310 (1945) 19

KT&G Corp. v. Attorney General of Oklahoma,
535 F.3d 1114 (10th Cir. 2008) 16

Quill Corp. v. N.D.,
504 U.S. 298 (1992) 18

R Communications, Inc. v. Sharp,
875 S.W.2d 314 (Tex. 1994) 20, 21

Richmont Aviation, Inc. v. Combs,
2013 Tex. App. LEXIS 11663
(Tex. App. Austin Sept. 12, 2013, pet. filed) 20, 21

Rylander v. Bandag Licensing Corp.,
18 S.W.3d 296 (Tex.App.-Austin 2000, pet. denied) 20

S&M Brands, Inc. v. Summers,
393 F. Supp.2d 604 (M.D. Tenn. 2005) 16

Star Scientific, Inc. v. Beales,
278 F.3d 339 (4th Cir. 2002) 16

Texas v. Stephens,
103 S.W. 481 (Tex. 1907) 10, 12, 13

Vinson v. Burgess,
773 S.W.2d 263 (Tex. 1989) 13

Xcaliber Int'l Ltd. v. Attorney General of La.,
612 F.3d 368 (5th Cir. 2010) 16

Statutes, Rules, and Constitutional Provisions

ALA. CODE 1975 § 6-12-1 15

ALASKA STAT. §§ 45.53.010-.100 15

ARIZ. REV. STAT. ANN. § 44-7101 15

ARK. STAT. ANN. §§ 26-57-260-261 15

CAL. HEALTH & SAFETY CODE §§ 104555-104557 15

COLO. REV. STAT. §§ 39-28-201-203 15

CONN. GEN. STAT. ANN. §§ 4-28h-j 15

1999 D.C. STAT. § 6-201.1 15

1999 D.C. STAT. § 6-920.1 15

DEL. CODE ANN. tit. 29, §§ 6080-6082 15

GA. CODE ANN. §§ 10-13-1-3 15

HAWAII REV. STAT. §§ 675-1-3 15

IDAHO CODE §§ 39-7801-7803 15

ILL. ANN. STAT. ch. 30 §§ 168/5-168/13 15

IND. CODE §§ 24-3-3-1 - 24-3-3-13 15

IOWA CODE ANN. §§ 453C.1-C2 15

KAN. STAT. ANN. §§ 50.6a01-6a03 15

KY. REV. STAT. ANN. §§ 31.600-602 15

LA. REV. STAT. ANN. §§ 13:5061-13:5063 15

MASS. GEN. L. ch. 94E, §§ 1-2 15

Chapter 169, Laws of MD 15

ME. REV. STAT. ANN. tit. 22 §§ 1580-G-1 15

MICH. COMP. LAWS ANN. §§ 445.2051-.2052 15

MINN. STAT. § 297F.24 15

MISS. CODE ANN. § 27.70.1 *et seq.* 15

MO. ANN. STAT. §§ 196.1000-1003 15

MONT. CODE ANN. §§ 16-11-401-403 15

N.C. GEN. STAT. §§ 66-290-291, 105-113.4C 15

N.D. CENT. CODE §§ 51-25-01-02 15

NEB. REV. STAT. §§ 69-2701-2703 15

NEV. REV. STAT. ANN. §§ 370A.020-150 15

N.H. REV. STAT. ANN. §§ 78:33, 541-C:1-C:3 15

N.J. STAT. ANN. §§ 52:4D-1-3 15

N.M. STAT. ANN. §§ 6-4-12-13 15

N.Y. PUB. HEALTH LAWS §§ 1399-nn-pp 15

OHIO REV. CODE ANN. §§ 1346.01-.02 15

OKLA. STAT. ANN. tit. 37, §§ 600.21-.23 15

OR. REV. STAT. §§ 293.530-.535 15

PA. STAT. ANN. §§ 5672-5674 15

R.I. GEN. LAWS §§ 23.71.1.3 15

S.C. CODE ANN. §§ 11-47-10-30 15

S.D. CODIFIED LAWS §§ 10-50B-1-8 15

TENN. CODE ANN. §§ 47-31-102-103 15

TEX. HEALTH & SAFETY CODE § 161.601 8

TEX. HEALTH & SAFETY CODE § 161.601(4) 7

TEX. HEALTH & SAFETY CODE § 161.604(a) 7

TEX. HEALTH & SAFETY CODE § 161.604(c) 7

TEX. TAX CODE § 112.001 19

TEX. TAX CODE § 112.003 19

TEX. TAX CODE § 112.003(8) 19

TEX. TAX CODE § 112.101(a)(2) 19

TEX. TAX CODE § 112.102 19

TEX. TAX CODE § 112.108 19

TEX. TAX CODE § 151.314 17

TEX. TAX CODE § 161.601 2

UTAH CODE ANN. §§ 59-22-201-203 15

VA. CODE §§ 3.1.336.1-.2 15-16

VT. STAT. ANN. tit. 33, §§ 1912-1914 15

W. VA. CODE §§ 16-9B-1-3 15

WASH. REV. CODE ANN. §§ 70.157.005-.020 16

Other Authorities

Andrew Blair-Stanek,
Tax in the Cathedral: Property Rules, Liability Rules, and Tax,
99 VA. L. REV. 1169 (2013) 16

Senate Comm. On Finance, Bill Analysis,
H.B. 3536, 83d Leg. R.S. (2013) 9

STATEMENT OF THE CASE

Nature of the Case:	This appeal from a final judgment arises from the trial court's denial of the State defendants' plea to the jurisdiction, which was based on sovereign immunity, and the trial court's grant of the plaintiffs' motion for summary judgment.
Trial Court:	98th District Court, Travis County, The Honorable Stephen Yelenosky
Trial Court Disposition:	The trial court denied the plea and granted the plaintiffs motion for summary judgment. CR.1357-58 (Tab A).[1]
Parties in the Trial Court and Court of Appeals:	Appellants: Susan Combs, Comptroller of Public Accounts of the State of Texas, in her official capacity Greg Abbott, Attorney General of Texas, in his official capacity Appellees: Texas Small Tobacco Coalition; Global Tobacco, Inc.

1. Citations to the single-volume record will appear as "CR.__", with the number indicating the page number.

ISSUES PRESENTED

The Texas Tax Code distinguishes between cigarette manufacturers who have already agreed to pay the State roughly $0.64 per pack to offset the health-care costs that they impose on taxpayers, and those cigarette manufacturers who pay nothing.

(1) Does this tax classification violate the Equal and Uniform Clause of the Texas Constitution?

(2) Does this tax classification violate the United States Constitution's guarantees of equal protection or due process?

(3) Does the Small Tobacco Coalition have standing to challenge the tax under Chapter 112 of the Tax Code, which is the exclusive means of challenging the imposition of taxes or fees?

No.03-13-00753-CV

In the Court of Appeals for the Third Judicial District Austin, Texas

---

SUSAN COMBS, IN HER OFFICIAL CAPACITY AS TEXAS COMPTROLLER, AND GREG ABBOTT, IN HIS OFFICIAL CAPACITY AS TEXAS ATTORNEY GENERAL
Appellants,

v.

TEXAS SMALL TOBACCO COALITION AND GLOBAL TOBACCO, INC.,
Appellees.

On Appeal from the
98th District Court, Travis County

BRIEF OF APPELLANTS

TO THE HONORABLE THIRD COURT OF APPEALS:

There are two different kinds of cigarettes behind the counter at Texas convenience stores. Cigarettes sold by Big Tobacco cost at least $0.64 more per pack. This money flows into the State's coffers, under a settlement agreement reached years ago, to offset the health care costs that cigarettes impose on state taxpayers. If any of these settling manufacturers leave the cigarette business, they will no longer owe the state these annual payments. Until then, Big Tobacco must pay these fees to the State in perpetuity, based on their annual sales.

The other kind cigarette behind the counter is noticeably cheaper. These cigarettes are manufactured by companies that never settled with the state, and therefore do not pay the state for the negative externalities they generate. Many of these companies were founded after the state settled with the major tobacco companies. Indeed, their business models exploit the market opportunities created by the settlement agreement: Their cigarettes are cheaper, because they are not forced to internalize health care costs; their cigarettes come in flavors like grape, vanilla, and wild cherry, because they are not bound by the settlement agreement's prohibitions on marketing to children; and their cigarettes come in inexpensive "two packs," (which are widely criticized as youth "sampler packs") a marketing tactic not available to settling manufacturers who promised the States not to sell cigarettes in packs less than twenty.

In 2013, the Texas Legislature voted to tax the non-settling manufacturers at $0.55 per pack, in order to "recover health care costs to the state imposed by non-settling manufacturers" and to "prevent non-settling manufacturers from undermining this state's policy of reducing underage smoking by offering cigarettes and cigarette tobacco products at prices that are substantially below the prices of cigarettes and cigarette tobacco products of other manufacturers." TEX. TAX CODE § 161.601.

The Small Tobacco Coalition is a litigation entity that includes of a handful of small tobacco manufacturers, most of which were founded a few years after the major

tobacco companies settled with the states. Their lawsuit's principle allegation is that the tobacco tax discriminates between settling and non-settling manufacturers, in violation of the Equal and Uniform Clause of the Texas Constitution. But the tobacco tax reasonably distinguishes between settling and non-settling manufactures. The settling manufacturers sell cigarettes priced to internalize the health care costs they impose on state taxpayers. The non-settling manufacturers, by contrast, sell cigarette that are not priced to account for the costs they impose.

STATEMENT OF FACTS

I. MAJOR TOBACCO MANUFACTURERS SETTLE LAWSUITS WITH THE STATES

a. Texas Settlements

In 1996, the State of Texas filed a federal lawsuit against five major tobacco companies, seeking to recover billions of tax dollars it had spent to treat tobacco-related illnesses suffered by Texas citizens. *See Texas v. American Tobacco Co.*, No. 5:96-cv-91 (E.D. Tex.). The parties ultimately settled the suit, and the settling tobacco companies agreed to pay annual payments to the State based on their sales in the State, plus an extra $2.3 billion to Texas counties and hospital districts. *See* CR 1043, 1049-56.

These annual payments are subject to adjustment formulas related to tobacco sales, inflation, and industry profitability. *Id.* The payment amounts rise and fall in proportion to domestic consumption of cigarettes each year as compared to the level

of consumption in 1997. *Id*. at 1055. The purpose of these annual payments, which continue to this day, is to force major tobacco companies to internalize the health-care costs generated by their products. For fiscal years 2011 and 2012, annual payments to Texas have totaled approximately $483 million and $476 million, respectively. CR 1111.

In addition to these payments, the settlement agreement requires the settling manufacturers to discourage children from using their products. They agreed to stop advertising on highway billboards, particularly near schools and playgrounds. CR 1051. They also agreed not to oppose initiatives by the State to strengthen penalties for sales of tobacco products to minors. CR 1052. And they agreed to support programs aimed at reducing youth smoking. CR 1053. Such initiatives have contributed to a significant reduction in smoking rates among middle school and high school students. *See, e.g.*, CR. 136 (reporting that middle school smoking rates in Harris County fell from 24.5% to 16.6% from 1998 to 2003).

b. Master Settlement Agreement

Forty-six States, not including Texas, entered into a Master Settlement Agreement (MSA) with major tobacco companies in 1998. *See, e.g.*, *Grand River Enter. Six Nations, Ltd. v. Pryor*, 481 F.3d 60, 63 (2d Cir. 2007) (noting that the settling manufacturers agreed "to internalize the health care costs created by their products"). Subsequently, other cigarette manufacturers signed on to this agreement

and are known as Subsequent Participating Manufacturers (SPMs). The MSA requires tobacco companies to pay billions of dollars to the States, in perpetuity, to internalize the negative externalities created by their products. CR 219-20 (establishing base payments between $8 to $9 billion per year). These base payments are subject to downward adjustment to account for a loss in market share suffered by the settling manufacturers to the non-settling manufacturers. CR 217-46. In addition to these payments, the MSA restricts participating tobacco manufacturers' ability to market their products to children, prohibits manufacturers to sell their cigarettes in packs of less than twenty, and imposes other restrictions on how the products are sold and marketed. CR 181-199.

II. SMALL TOBACCO FILLS THE VOID

By forcing major tobacco companies to raise prices and stop marketing to children, the settlement agreements created opportunities in the market that small tobacco rushed to fill. Sandia Tobacco Company, for example, is a prominent member of the Small Tobacco Coalition. Sandia was founded in 2002, a few years after the major tobacco companies settled with the States. Because it did not participate in the settlement agreement, Sandia's cigarettes are not required to internalize their health-care costs. This means that Sandia is free to sell its cigarettes at prices that are substantially below the settling manufacturers' brands—and substantially below an efficient market price. *See* CR. 311-12. Sandia's low-priced cigarettes, and others

like them, impose negative externalities on state taxpayers, in the form of uncompensated health-care costs. And these low prices provide easy access for underage smokers. *Id.* As a non-settling manufacturer, Sandia also is free to sell flavored cigarettes that appeal to children, which explains why Sandia's tobacco products come in flavors such as grape, vanilla, and cherry.

Another prominent member of the Small Tobacco Coalition is Tantus Tobacco, LLP. *See id.* (reporting that Tantus contributed over 20% of Small Tobacco's lobbying dollars this session). Tantus Tobacco, which was founded a few years after the settlement agreements, enjoys the same pricing advantages as Sandia. And like Sandia, Tantus's cigarettes seem more at home in a candy store than a smoke shop, and include flavors like wild cherry, vanilla, peach, strawberry, and grape. Tantus sells these flavored cigarettes in regular packs of twenty and also in $0.99 "two packs," presumably to accommodate the resource constraints of its youngest customers. Such marketing tactics were explicitly banned by the MSA, to which Tantus is not a party. *See, e.g.*, CR 191 ("No Participating Manufacturer may . . . sell or distribute . . . any pack or other container of Cigarettes containing fewer than 20 Cigarettes.").

A final example from the Small Tobacco Coalition is National Tobacco Company, or NTC, a leading purveyor of flavored tobacco products. National Tobacco owns the Zig Zag brand, which comes in flavors (and "two packs") including

cherry, grape, melon, strawberry, mango, apple, and peach. Can you imagine any self-respecting adult smoking a grape-flavored cigarette?

III. THE TEXAS LEGISLATURE RESPONDS

During the 2013 session, the Texas Legislature passed HB 3536, which imposed a fee on cigarettes manufactured by companies that do not pay funds to Texas as part of the Texas tobacco settlement. HB 3536 amends the Texas Health and Safety Code to add Chapter 161 and impose a fee of $ 0.0275 per cigarette, or on each 0.09 ounces of cigarette-tobacco product, produced by manufacturers that never settled with Texas or with the 46 state signatories to the MSA. TEX. HEALTH & SAFETY CODE § 161.604(a).

HB 3536 also imposes a much smaller fee on cigarettes manufactured by companies that never settled with Texas but that did sign the MSA. The fee imposed on these entities (which HB 3536 calls "Subsequently Participating Manufacturers" or "SPMs") is $ 0.0075 per cigarette, or on each 0.09 ounces of cigarette-tobacco product. TEX. HEALTH & SAFETY CODE § 161.604(c). The fee is lower because SPMs already make full payments under the MSA to reflect their Texas sales, so the health care cost are internalized. TEX. HEALTH & SAFETY CODE § 161.601(4). This lower fee is only temporary. *Id.* It will expire once the MSA credits these Texas payments. *Id.*

In the statutory text itself, the Legislature explained the purpose of these fees: (1) to force non-settling tobacco companies to internalize the health-care costs associated with their products, like settling tobacco companies have done for years and (2) to fight the non-settling companies' marketing efforts toward minors:

> The purpose of this subchapter is to:
>
> (1) recover health care costs to the state imposed by non-settling manufacturers;
>
> (2) prevent non-settling manufacturers from undermining this state's policy of reducing underage smoking by offering cigarettes and cigarette tobacco products at prices that are substantially below the prices of cigarettes and cigarette tobacco products of other manufacturers;
>
> (3) protect the tobacco settlement agreement and funding, which has been reduced because of the growth of sales of non-settling manufacturer cigarettes and cigarette tobacco products, for programs that are funded wholly or partly by payments to this state under the tobacco settlement agreement and recoup for this state settlement payment revenue lost because of sales of non-settling manufacturer cigarettes and cigarette tobacco products;
>
> (4) ensure evenhanded treatment of manufacturers and further protect the tobacco settlement agreement and funding by imposing a partial payment obligation on non-settling manufacturers that already make payments on Texas sales under the master settlement agreement until a credit amendment to that agreement that will provide those manufacturers with a credit for payments to Texas is effective; and
>
> (5) provide funding for any purpose the legislature determines.

TEX. HEALTH & SAFETY CODE § 161.601.

These purposes reflect the legislative finding that the sale and use of tobacco products in Texas imposes significant costs on state taxpayers, both through increased healthcare costs and by undermining programs designed to prevent children from consuming addictive drugs. *See, e.g.*, CR 1278-83 (Senate Comm. On Finance, Bill Analysis, H.B. 3536, 83d Leg. R.S. (2013)). The legislature found that settling manufacturers have paid, and will continue to pay, significant annual sums in order to compensate taxpayers for these social costs. HB 3536 ensures that non-settling manufacturers bear their share of the burden for the social costs imposes by their own sales.

PROCEDURAL HISTORY

The Texas Small Tobacco Coalition is a litigation entity whose members include manufacturers, distributors, and retailers who are subject to the fee imposed by HB 3536. CR 947-72. Global is a non-settling manufacturer whose products are also subject to the fee. The Small Tobacco Coalition and Global sued Susan Combs and Greg Abbott, in their official capacities, alleging that: (1) the fee imposed by HB 3536 is a tax that violates the Texas Constitution's Equal and Uniform Clause; (2) the fee violates the Equal Protection Clause of the United States Constitution because the fee treats non-settling differently than those who previously settled with the State or who participate in the MSA; (3) the fee violates the Due Process Clause of the United States Constitution because "the tax on NSMs bears no relation to the protection,

opportunities and benefits afforded NSMs by the state." *Id.* Plaintiffs sought to enjoin the state defendants from collecting these taxes, plus attorneys' fees. *Id*. Plaintiffs asserted these claims under Chapter 112 of the Texas Tax Code and Chapters 37 and 65 of the Texas Civil Practice and Remedies Code. *Id.*

The trial court denied the State's plea to the jurisdiction and granted plaintiffs' motion for summary judgment, entering a final injunction against the collection of the tobacco tax. CR 1367-68.

SUMMARY OF THE ARGUMENT

Plaintiffs failed to overcome defendants' immunity because they failed to plead valid constitutional claims. The tobacco tax does not violate the Equal and Uniform Clause of the Texas Constitution because the Legislature's decision to distinguish between non-settling manufacturers and settling manufacturers is reasonable. The Equal and Uniform Clause gives the legislature wide latitude to place products or companies in different sales tax categories. *Texas v. Stephens*, 103 S.W. 481, 485 (Tex. 1907).

The statute's primary purpose is to force all cigarettes sold in Texas to internalize their externalities, so it makes sense to distinguish between products that are efficiently priced (accurately reflecting the health care costs that they impose on taxpayers) and products that are inefficiently priced (imposing uncompensated health care costs on the public). In accounting for the State's smoking-related health-care

costs, it is reasonable for the Legislature to distinguish between companies that pay their fair share and those that free ride at taxpayers' expense.

The statute's other purpose is to raise revenue, so it makes sense to distinguish between manufacturers that already contribute revenue to the State's coffers and those who do not. The settling manufacturers contribute about $0.64 to the State treasury for each pack sold. CR. 1304. HB 3536 imposes a fee of about $0.55 per pack on non-settling manufactures. *Id.* In raising money from an industry, it is reasonable for the Legislature to distinguish between companies that already have been forced to pay, and those who do not pay their share.

Every State and territory in the United States except Florida (a total of 54 jurisdictions) has enacted a statute distinguishing between non-settling and settling manufacturers. Each of these jurisdictions has singled out non-settling manufacturers, forcing them to internalize health care costs by paying extra for each cigarette sold, either through fees or payment into escrow account. Small tobacco has challenged these statutes relentlessly, but it has failed to win a single victory. If this Court rules for the plaintiffs, it must not only hold that the Texas Legislature acted arbitrarily and unreasonably, it must also declare unreasonable the judgment of fifty four other legislatures, and it must also reject the reasoning of every court of appeals in the nation to consider the question.

ARGUMENT

I. PLAINTIFFS FAILED TO OVERCOME DEFENDANTS' IMMUNITY BECAUSE THEY FAILED TO PLEAD VALID CONSTITUTIONAL CLAIMS.

A. Plaintiffs Failed To Plead A Valid Claim That HB 3536 Violates The Equal And Uniform Clause of the Texas Constitution.

The tobacco fee does not violate the Equal and Uniform Clause of the Texas Constitution because the Legislature's decision to classify non-settling manufacturers differently from settling manufacturers is based on a reasonable distinction. A reviewing court must uphold such sales-tax classifications where the tax operates equally within a *reasonable* tax classification. *Grayson v. Calvert*, 357 S.W.2d 160, 162 (Tex. Civ. App.—Austin 1962, writ ref'd n.r.e.). The parties agree on this standard, *see* CR. 985 (Plaintiffs' Amended Motion For Summary Judgment), and disagree only on it application.

The Equal and Uniform Clause gives the legislature wide latitude to place products or companies in different sales tax categories. "Considerations upon which [tax] classifications shall be based are primarily within the discretion of the Legislature." *Texas v. Stephens*, 103 S.W. 481, 485 (Tex. 1907); *see also Dancetown U.S.A., Inc. v. State*, 439 S.W.2d 333, 336 (Tex. 1969) (""[T]he power of the Legislature to classify for purposes of taxation is quite broad."). Applying this standard, courts of appeals almost always reject challenges to tax classifications, holding that "courts . . . can only interfere when it is made clearly to appear that an

attempted classification has no reasonable basis in the nature of the business classified, and that the law operates unequally upon subjects between which there is no real difference to justify the separate treatment of them undertaken by the Legislature." *Stephens*, 103 S.W. at 485.

Not only will plaintiffs find this legal standard difficult to overcome, they also face an "especially strong" presumption of constitutional validity with regard to "statutes relating to taxation." *Vinson v. Burgess*, 773 S.W.2d 263, 266 (Tex. 1989); *id.* ("It must be shown that [the legislation] *clearly* appears to violate some provision of the constitution.") (emphasis added). Indeed, the Legislature's power to create classifications for sales-tax purposes is robust. *See In re Nestle USA, Inc*. (Nestle II), 387 S.W.3d 610, 620 (Tex. 2012) ("The Legislature's authority to make classifications in levying occupation, use, and sales taxes unquestionably is broader than its authority to do so with respect to ad valorem taxes.").

The Legislature's distinction between settling and non-settling tobacco companies is reasonable because there is "a real difference to justify the separate treatment." *Stephens*, 103 S.W. at 485. First, because the statute's primary purpose is to force all cigarettes sold in Texas to internalize their externalities, it makes sense to distinguish between products that are efficiently priced (accurately reflecting the health care costs that they impose on taxpayers) and products that are inefficiently priced (imposing uncompensated health care costs on the public). The tax imposed

by HB 3536 is called a "Pigovian tax," which are commonly imposed on products or activities like gasoline, tobacco, and pollution. *See, e.g.*, Andrew Blair-Stanek, *Tax in the Cathedral: Property Rules, Liability Rules, and Tax*, 99 VA. L. REV. 1169, 1192 (2013) ("Pigovian taxes aim to correct market failures such as negative externalities by taxing them."). In accounting for the State's smoking-related health-care costs, it is reasonable for the Legislature to distinguish between companies that pay their fair share and those that free ride at taxpayers' expense.

Second, because the statute's other purpose is to raise revenue, it makes sense to distinguish between manufacturers that already contribute revenue to the State's coffers and those who do not. The settling manufacturers contribute about $0.64 to the State treasury for each pack sold. CR. 1304. HB 3536 imposes a fee of about $0.55 per pack on non-settling manufactures. *Id.* In raising money from an industry, it is reasonable for the Legislature to distinguish between companies that already have been forced to pay, and those who do not pay their share.

The Texas Legislature is not the first to draw a distinction between settling and non-setting tobacco manufacturers. Indeed, every State and territory in the United States except Florida (a total of 54 jurisdictions) has enacted a statute distinguishing between non-settling and settling manufacturers. Each of these jurisdictions has singled out non-settling manufacturers, forcing them to internalize health care costs by paying extra for each cigarette sold, either through fees or payment into escrow

account. *See* ALA. CODE 1975 § 6-12-1; ALASKA STAT. §§ 45.53.010-.100; ARIZ. REV. STAT. ANN. § 44-7101; ARK. STAT. ANN. §§ 26-57-260-261; CAL. HEALTH & SAFETY CODE §§ 104555-104557; COLO. REV. STAT. §§ 39-28-201-203; CONN. GEN. STAT. ANN. §§ 4-28h-j; DEL. CODE ANN. tit. 29, §§ 6080-6082; 1999 D.C. STAT. § 6-201.1; 1999 D.C. STAT. § 6-920.1; GA. CODE ANN. §§ 10-13-1-3; HAWAII REV. STAT. §§ 675-1-3; IDAHO CODE §§ 39-7801-7803; ILL. ANN. STAT. ch. 30 §§ 168/5-168/13; IND. CODE §§ 24-3-3-1 - 24-3-3-13; IOWA CODE ANN. §§ 453C.1-C2; KAN. STAT. ANN. §§ 50.6a01-6a03; KY. REV. STAT. ANN. §§ 31.600-602; LA. REV. STAT. ANN. §§ 13:5061-13:5063; ME. REV. STAT. ANN. tit. 22 §§ 1580-G-1; Chapter 169, Laws of MD; MASS. GEN. L. ch. 94E, §§ 1-2; MICH. COMP. LAWS ANN. §§ 445.2051-.2052; MO. ANN. STAT. §§ 196.1000-1003; MINN. STAT. § 297F.24; MISS. CODE ANN. § 27.70.1 *et seq*.; MONT. CODE ANN. §§ 16-11-401-403; NEB. REV. STAT. §§ 69-2701-2703; NEV. REV. STAT. ANN. §§ 370A.020-150; N.H. REV. STAT. ANN. §§ 78:33, 541-C:1-C:3; N.J. STAT. ANN. §§ 52:4D-1-3; N.M. STAT. ANN. §§ 6-4-12-13; N.Y. PUB. HEALTH LAWS §§ 1399-nn-pp; N.C. GEN. STAT. §§ 66-290-291, 105-113.4C; N.D. CENT. CODE §§ 51-25-01-02; OHIO REV. CODE ANN. §§ 1346.01-.02; OKLA. STAT. ANN. tit. 37, §§ 600.21-.23; OR. REV. STAT. §§ 293.530-.535; PA. STAT. ANN. §§ 5672-5674; R.I. GEN. LAWS §§ 23.71.1.3; S.C. CODE ANN. §§ 11-47-10-30; S.D. CODIFIED LAWS §§ 10-50B-1-8; TENN. CODE ANN. §§ 47-31-102-103; UTAH CODE ANN. §§ 59-22-201-203; VT. STAT. ANN. tit. 33, §§ 1912-1914; VA. CODE

§§ 3.1.336.1-.2; WASH. REV. CODE ANN. §§ 70.157.005-.020; W. VA. CODE §§ 16-9B-1-3.

Small tobacco has challenged these statutes relentlessly, but it has failed to win a single victory. If this Court rules for the plaintiffs, it must not only hold that the Texas Legislature acted arbitrarily and unreasonably, it must also declare unreasonable the judgment of fifty four other legislatures, and it must also reject the reasoning of every court of appeals in the nation to consider the question. *See Council of Independent. Tobacco Mfrs v. Minn.*, 713 N.W.2d 300, 308-13 (Minn. 2006) (Minnesota's fee on non-settling manufacturers draws "relevant and logical" distinctions that serve "many legitimate purposes," including "internalizing" health care costs.); *see also Grand River Enter. Six Nations, Ltd. v. Prior*, 425 F.3d 158, 175 (2d Cir. 2005); *Star Scientific, Inc. v. Beales*, 278 F.3d 339, 351 (4th Cir. 2002); *Xcaliber Int'l Ltd. v. Attorney General of La.*, 612 F.3d 368, 381 (5th Cir. 2010); *Grand River Enterprises Six Nations, Ltd. v. Beebe*, 574 F.3d 929, 944 (8th Cir. 2009); *KT&G Corp. v. Attorney General of Oklahoma*, 535 F.3d 1114, 1139 (10th Cir. 2008); *S&M Brands, Inc. v. Summers*, 393 F. Supp.2d 604, 637 (M.D. Tenn. 2005).

In the trial court, plaintiffs offered two arguments in response: (1) the fees "arbitrarily segregate identical tobacco products," unreasonably asking small tobacco to pay for big tobacco's past misconduct, *see* CR 985- 90; and (2) the only legitimate

purpose of a sales tax is raising revenue, so the Legislature's imposition of a Pigovian tax is unreasonable. CR. 1320-21. Plaintiffs are twice incorrect.

First, the Legislature is not asking small tobacco to pay for anyone's past misconduct. Both the settlement agreement's payments and HB 3536's fees are calculated to offset the State's future health care costs. To be sure, the State's settlement with big tobacco included damages for past misconduct plus injunctive relief aimed at prior bad acts. But big tobacco's schedule of annual payments is not tied to prior bad acts: They are tied to big tobacco's future sales, and calculated to offset the State's ongoing health care costs. Indeed, if any of the big tobacco companies gets out of the cigarette business, they will no longer owe any payments to the State.

Second, there is nothing inherently unreasonable about a Pigovian tax. CR. 1320-21. Plaintiffs are surely correct to argue that an important purpose of sales taxes (and often the primary purpose) is rasing revenue. But it cannot be denied that sales taxes are also designed to create disincentives. The Tax Code draws countless distinctions that have nothing to do with revenue. For instance, candy and soft drinks are taxed, unless sold by a church or school. TEX. TAX CODE § 151.314. Popcorn and pretzels are not taxed, unless they come in a single serving "snack sized" bag. *Id.* Any attempt to isolate a primary purpose of these distinctions would be unworkable.

In all events, if plaintiffs are correct that a Pigovian tax is not a tax at all, but is instead an exercise of the police power, then this becomes an easy case. For unlike the taxing power, the State's police power is not subject to the requirements of the Equal and Uniform Clause.

B. Plaintiffs Failed To Plead Valid Claims That HB 3536 Violates The United States Constitution's Guaranties of Equal Protection and Due Process.

1. The tobacco fee does not violate the Equal Protection Clause. The requirements of the Equal Protection Clause are essentially the same as those of the Equal and Uniform Clause, *see Enron Corp. v. Spring Indep. School Dist.*, 922 S.W.2d 931, 936-37 (Tex. 1996), so for the reasons discussed above, the plaintiffs' equal protection challenge to the tobacco fee must fail. *See Nestle II*, 387 S.W.3d at 624 ("A failure of [a] challenge based on the Equal and Uniform Clause forecloses [an] Equal Protection challenge").

2. The tobacco fee does not violate the Due Process Clause. Due process has nothing to say about in-state sales tax. Due process is implicated only when a State attempts to tax a transaction that occurs out-of-state, or property that exists out-of-state. When a State does such things, it must prove "some definite link, some minimum connection, between the state and the person, property, or transaction it seeks to tax." *Quill Corp. v. N.D.*, 504 U.S. 298, 312 (1992) (North Dakota could tax

an out-of-state mail-order company's sales in the State, even though the company had no physical presence in North Dakota). This requirement is something like the "minimum contacts" test for personal jurisdiction, which is also rooted in the Due Process Clause. *International Shoe Co. v. Washington*, 326 U.S. 310 (1945). Because Texas is taxing only products sold in Texas, there is, without question, a "definite link" and "some minimum connection" between the cigarette sales and the State.

II. THE SMALL TOBACCO COALITION LACKS STANDING TO MAINTAIN A TAXPAYER SUIT UNDER CHAPTER `112 OF THE TAX CODE, WHICH IS THE EXCLUSIVE MEANS FOR CHALLENGING THE LEGISLATURE'S IMPOSITION OF A TAX OR FEE.

The Tax Code provides an exclusive mechanism for challenging the imposition of a tax or fee. TEX. TAX CODE § 112.108; *see In re Allcat Claims Servs., L.P.*, 356 S.W.3d 455, 479 (Tex. 2011). And under the Tax Code, only the taxpayer itself has standing to sue; lawsuits by associations of taxpayers, such as the Small Tobacco Coalition, are forbidden. TEX. TAX CODE §§ 112.101(a)(2), 112.001, 112.003(8). The Tax Code insists that the taxpaying entity itself submit to the jurisdiction of the court, so that, among other things, the court may fulfill the Tax Code's monitoring requirements. *See, e.g.*, TEX. TAX CODE §§ 112.102, 112.003 (requiring applicants for injunctive relief to continue to keep records and file reports while any injunction is in effect, to ensure the taxpayer maintains solvency).

In *Bandag*, and more recently in *Richmont Aviation*, this Court held that the Tax Code's prepayment provision amounts to an unreasonable restraint on a party's right of access to the courts. *Rylander v. Bandag Licensing Corp*., 18 S.W.3d 296 (Tex.App.-Austin 2000, pet. denied) (holding that the prepayment requirement, even with an exception for indigence, "constitutes an unreasonable financial barrier to access to the courts"); *Richmont Aviation, Inc. v. Combs*, 2013 Tex. App. LEXIS 11663 at n.3 (Tex. App. Austin Sept. 12, 2013, pet. filed) (citing *R Communications, Inc. v. Sharp*, 875 S.W.2d 314 (Tex. 1994)).

But the Small Tobacco plaintiffs have already prepaid their taxes. The only question presented in this case is whether the ban on associational standing also amounts to an unreasonable restraint on a party's access to the courts. This Court has never held as much, and we do not understand why requiring the taxpayer *itself* to submit to the state courts' jurisdiction is asking too much.

In any event, we ask the Court to reconsider its holdings in *Bandag* and *Richmont Aviation* in order to preserve the argument for further appellate review. In particular, the Court should take notice of the Supreme Court's explicit pronouncement that the Open Courts violation identified in *R Communications* has been cured:

> In *R Communications, Inc. v. Sharp*, 875 S.W.2d 314 (Tex. 1994), we held that the Open Courts provision of the Texas Constitution did not allow the Legislature to condition all declaratory relief on prepayment of taxes. Section 112.108 has since been amended to preclude an Open Courts violation.

In re Nestle USA, Inc. (Nestle I), 359 S.W.3d 207, 211 n.38 (Tex. 2012); *cf. Richmont Aviation*, 2013 WL 5272834, at *5 n.3 ("[N]or did the [Nestle I] court expressly state that the amendment cured the constitutional infirmity.").

PRAYER

The Court should reverse the judgment of the trial court and render judgment dismissing plaintiffs' claims for lack of subject-matter jurisdiction.

Respectfully submitted.

GREG ABBOTT
Attorney General of Texas

DANIEL T. HODGE
First Assistant Attorney General

JONATHAN F. MITCHELL
Solicitor General

/s/ Arthur C. D'Andrea
ARTHUR C. D'ANDREA
Assistant Solicitor General
State Bar No. 24050471

ERIKA KANE
Assistant Attorney General

OFFICE OF THE ATTORNEY GENERAL
P.O. Box 12548 (MC 059)
Austin, Texas 78711-2548
[Tel.] (512) 936-2868
[Fax] (512) 474-2697
arthur.dandrea@texasattorneygeneral.gov

COUNSEL FOR APPELLANT

CERTIFICATE OF SERVICE

I certify that on February 18, 2014, a copy of this brief was sent to counsel below for Appellees via File&ServeXpress:

Craig T. Enoch
Melissa A. Lorber
Amy Leila Saberian
Shelby O'Brien
ENOCH KEVER PLLC.
600 Congress Avenue, Suite 2800
Austin, Texas 78701

COUNSEL FOR APPELLEES

/s/ Arthur C. D'Andrea
ARTHUR C. D'ANDREA
Assistant Solicitor General

CERTIFICATE OF COMPLIANCE

In compliance with Texas Rule of Appellate Procedure 9.4(i)(2), this brief contains 4,619 words, excluding the portions of the brief exempted by Rule 9.4(i)(1).

/s/ Arthur C. D'Andrea
ARTHUR C. D'ANDREA

Appendix

CAUSE NO. D-1-GN-13-002414

TEXAS SMALL TOBACCO COALITION and GLOBAL TOBACCO, INC.	§	IN THE DISTRICT COURT OF
Plaintiffs,	§	
v.	§	TRAVIS COUNTY, TEXAS
SUSAN COMBS, COMPTROLLER OF PUBLIC ACCOUNTS OF THE STATE OF TEXAS, and GREG ABBOTT, ATTORNEY GENERAL OF TEXAS,	§	
Defendants.	§	98th JUDICIAL DISTRICT

ORDER ON PLAINTIFFS' AMENDED MOTION FOR SUMMARY JUDGMENT, DEFENDANTS' AMENDED PLEA TO THE JURISDICTION, AND DEFENDANTS' CROSS-MOTION FOR SUMMARY JUDGMENT

On October 30, 2013, the Court heard Plaintiffs' Amended Motion for Summary Judgment, Defendants' Plea to the Jurisdiction, and Defendants' Motion for Summary Judgment, and the related responses and replies.

Having reviewed the pleadings and case law and heard the arguments of counsel, this Court GRANTS the Plaintiffs' Amended Motion for Summary Judgment, DENIES the Defendants' Amended Plea to the Jurisdiction, and DENIES the Defendants' Cross-Motion for Summary Judgment.

Accordingly, Plaintiffs' Amended Motion for Summary Judgment is GRANTED in its entirety, Defendants' Amended Plea to the Jurisdiction is DENIED in its entirety, and Defendants' Cross-Motion for Summary Judgment is DENIED in its entirety.

Further, the Court declares that House Bill 3536, in its entirety, is unconstitutional. Defendants are permanently enjoined from assessing, collecting, and enforcing the tax prescribed in House Bill 3536, enacted by the 83rd Texas Legislature and made effective on September 1, 2013. This injunction is granted because House Bill 3536 is unconstitutional and Defendants will continue to implement it unless enjoined. This Order is a final and appealable judgment because it fully and finally resolves all claims made by all parties.

It is so ORDERED.

Signed on the 15 day of November, 2013.

The Honorable Stephen Yelenosky, Judge Presiding

AGREED AS TO FORM:

/s/ Craig T. Enoch
Craig T. Enoch
Attorney for Plaintiff

/s/ Erika Kane
Erika Kane
Attorney for Defendants