# No. 03-13-00753-CV



*In the Court of Appeals*
*Third District of Texas — Austin*

**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*

# APPELLEES' RESPONSE TO BRIEFS OF AMICI CURIAE

Craig T. Enoch
Melissa A. Lorber
Shelby O'Brien
ENOCH KEVER PLLC
600 Congress Avenue, Suite 2800
Austin, Texas 78701
(512) 615-1200 / (512) 615-1198 fax

***Attorneys for Appellees,***
***Texas Small Tobacco Coalition and Global Tobacco, Inc.***

## INTRODUCTION

The attorneys general of other states (the "Attorneys General") and a distributor of competing cigarette products, McLane Company, Inc. ("McLane"), have filed amicus briefs urging this Court to uphold the targeted tax against small, independent tobacco manufacturers. The amici largely repeat the State's arguments, and like the State they offer this Court distortions that have no basis in the actual law that forms the backdrop of this tax challenge. To avoid unnecessary duplication, the Texas Small Tobacco Coalition (the "Coalition") refers the Court to its response brief and responds only briefly to three of the amici's' arguments here.

First, synonymous with the State's arguments, the amici contend that the tax imposed by House Bill 3536 (the "Act") is like the escrow statutes enacted by other states. That is not true. The escrows are true escrows. Those statutes require the affected manufacturers to escrow a certain amount of funds on a periodic basis. The funds are not paid to the states' general funds. Instead, the funds are held as assets of the affected manufactures and accumulate interest for the benefit of the manufactures. And after 25 years, the escrows will be discontinued and the accounts released to the manufactures in the event no claims for wrongdoing by the companies have been made. The Texas Act imposes a tax, not an escrow.

Second, again synonymous with the State, the amici contend that the Court should uphold the Act under the equal protection "rational basis" test, asserting the test under the Texas Constitution's equal and uniform mandate merely mirrors that test. That likewise is not true: the Texas Supreme Court has expressly stated that the test under the Texas Constitution's equal and uniform mandate is an enhanced test, the effect of which is to prohibit tax statutes from taxing differently businesses whose natures, operations, and products are identical.

Finally, in the amici's one departure from the State's arguments, McLane claims that the tax imposed by the Act is in fact a regulatory fee that would not be subject to the equal and uniform constitutional requirement. Notably, this is an issue that has not been raised by the State in this litigation and it is therefore not before this Court. Regardless, this too is not true: the primary purpose of the Act is to raise revenue. By definition, then, this is not a fee. It is a tax and thus is subject to equal and uniform scrutiny.

## I.

### Statutes creating escrow accounts and the cases interpreting them are inapposite.

Parroting one of the State's primary arguments, the amici contend that the tax imposed by the Act is identical to escrow payments non-settling manufacturers are required to pay in other states. Not so. There are material differences between the escrow statutes and the Act:

- Escrow accounts terminate after 25 years. *See Grand River Enter. Six Nations v. Pryor*, 481 F.3d 60, 63 (2d Cir. 2007). The purpose of the escrow accounts is to create a pool of funds from which states can secure damage awards in the event of any successful cigarette-related claims. *See id.* And after 25 years, any funds remaining in the escrow accounts must be restored to the non-settling manufacturers. *See id.*

- Non-settling manufacturers earn interest on the funds they pay to the escrow fund. *See KT&G Corp. v. Attorney Gen. of Okla.*, 535 F.3d 1114, 1122 (10th Cir. 2008). And tobacco companies that put funds in escrow accounts hold those funds as assets.

- The escrow statutes do not impose a tax. The escrow statutes were evaluated under a "rational basis" test, not the stricter standard the Texas Supreme Court has required in evaluating tax statutes under the Texas Constitution's Equal and Uniform Clause. *In re Nestle USA, Inc.*, 387 S.W.3d 610, 624 (Tex. 2012).

- Any funds a non-settling manufacturer escrows in a given year must be released to the manufacturer if the amounts exceed what the manufacturer would have paid if it were a party to the Master Settlement Agreement. *KT&G Corp.*, 535 F.3d 1114 at 1122.

Conversely, under the Act, the Coalition's members will never be refunded the taxes paid to the State, even if they do not engage in wrongful acts that lead to a damages award. Nor will a member receive a refund if the taxes paid under the Act exceed what it would have paid in a given year were it a party to a settlement agreement. Instead, the Coalition's members will be required to pay in perpetuity a tax with no opportunity to earn the money back. Far from being determinative, the escrow cases provide no persuasive authority.

## II.

### The Texas Constitution's Equal and Uniform Clause requires an enhanced scrutiny test, not merely a rational basis test.

The amici ask this Court to apply the "rational basis" test used in evaluating a tax under the Equal Protection Clause to evaluate the tax under the Texas Constitution's Equal and Uniform Clause. And they urge the Court to hold that it is legitimate to tax the products of one group of cigarette manufacturers but not another, even though the nature and operations of, and the products manufactured by, these businesses are identical. But to hold as they ask would reject explicit Texas Supreme Court precedent. Under *In re Nestle USA, Inc.*, it is not enough that a classification has a rational basis. Instead, it is impermissible to differently tax businesses whose natures, operations, and products are identical. *Id.* at 622, 624; *see also, e.g.*, *Hurt v. Cooper*, 110 S.W.2d 896, 901 (Tex. 1937).

Here, there is no distinction between those manufacturers that entered into private agreements with the State and those that did not: their products and operations and the nature of their businesses are identical. The ***only*** distinction is that some manufacturers were sued for wrongdoing and entered into settlements with the State—while other manufacturers were not sued and did not enter into settlement agreements. In order to hold the Act constitutional, this Court would need to conclude that it is permissible to differently tax businesses whose products, operations, and natures are identical merely because one had a private settlement

agreement with the State and the other did not. Though the Coalition recognizes the deference courts afford the legislature when enacting a tax statute, this cannot mean—as the State and amici seem to believe—that "anything goes" under the Equal and Uniform Clause. To hold that a tax can properly be used to "level the playing field" in favor of a group of manufacturers that entered private settlement agreements to resolve tort claims against them (by unequally taxing only their competitors who were not sued for any wrongdoing) would rob the Equal and Uniform Clause of any meaning.

McLane cites three cases it claims support its contention that a private settlement agreement is a legitimate classification under the constitutional equal and uniform mandate. But not only did none of the cases involve a classification based on a private settlement agreement, the classifications used demonstrate obvious differences in the products, operations, and natures of the businesses:

- In *Central Power and Light Co. v. Sharp*, this Court determined that a tax on regulated public utilities but not on unregulated utilities was constitutional under the Equal and Uniform Clause. 919 S.W.2d 495, 488-89 (Tex. App.—Austin 1996, writ denied).

- In *American Home Assurance v. Texas Department of Insurance*, this Court determined that a tax imposed on insurers offering policies to the most high-risk employers but not insurers that did not did not violate the Equal and Uniform Clause. 907 S.W.2d 90, 95-98 (Tex. App.—Austin 1995, no writ).

- In *Calvert v. Canteen Co.*, the Texas Supreme Court determined that a sales tax that was calculated as a percentage of the price of products sold, though resulting in a different amount of tax because of the

different prices charged for different products, did not violate the Equal and Uniform Clause. 371 S.W.2d 556, 556-59 (Tex. 1963).

In each of these cases, there were clear distinctions between the nature and operations of the businesses or the products sold. But there is no distinction here. The only distinction here is that settling manufacturers entered into private settlement agreements to resolve tort claims against them. This is not a permissible classification under the Equal and Uniform Clause.

## III.

### The Minnesota Supreme Court case reviewing a cigarette tax under the rational basis test is likewise not binding or persuasive authority for this Court's review of whether the Act complies with the Texas Constitution's equal and uniform mandate.

Both amici rely heavily on the Minnesota Supreme Court's *Council of Independent Tobacco Manufacturers of America v. Minnesota* case. There, the Minnesota Supreme Court upheld a tax similar to that imposed by the Act that was challenged on equal protection grounds. 713 N.W.2d 300, 311 (Minn. 2006). But not only did the Minnesota court not apply the enhanced test required under the Texas Constitution's Equal and Uniform Clause, the court's analysis under the "rational basis" test is unpersuasive:

- The Minnesota court reviewed the tax under the Equal Protection Clause's rational basis test. *Id.* at 308. But Texas' Equal and Uniform Clause disallows tax statutes from disparately taxing companies whose products, operations, and natures are identical. Indeed, in *Nestle*, the Texas Supreme Court listed those states with provisions analogous to the Equal and Uniform Clause—and Minnesota was not among them. 387 S.W.3d at 621.

- The Minnesota court's reasoning is facile. For instance, it concluded the tax on the settling manufacturers' competitors was akin to a tax imposed on out-of-state beer distributors, while excluding in-state distributors, or like a tax imposed on environmentally contaminated property, but not uncontaminated property. *Council of Indep. Tobacco Mfrs.*, 713 N.W.2d at 309-10. The distinctions drawn in those examples are too obvious to miss and provide no basis to justify a tax imposed solely on non-settling manufacturers.

- The Minnesota court's opinion demonstrates that the court did not fully appreciate the terms of the settlement agreements. It wrote that the non-settling manufacturers' products were cheaper than the settling manufacturers and that coercing them to raise prices helped support the continuing viability of the settlement agreements. *Id.* at 312. But under the settlement agreements, the settling manufactuers' payments are capped at a maximum amount. Thus, absent competitive pressure, the settling manufacturers are free to increase market share with no resulting additional revenue to the state. And simultaneously, as the non-settling manufacturers' market shares decrease, the state recovers less tax revenue.

- In any event, in the instant case, there is no evidence that settling manufacturers' products cost more than those manufactured by non-settling manufacturers.[1] And regardless, protecting the market share of a group of manufacturers by taxing its competitors is exactly the sort of tax that Texas' Equal and Uniform Clause was designed to prevent.

- The Minnesota court's public policy analysis is unpersuasive. The court failed to recognize that the actual impact of the tax was to change the competitive environment to the settling manufacturers' benefit, nullifying the penalties the state had sought against them. And regardless of whether a tax serves the public interest, in Texas, a tax still may not differently tax identical businesses.

[1] The only evidence is a stipulation between the State and the Coalition that a few settling manufacturers' products cost more on a given day than a few non-settling manufacturers' products. Clerk's Record 1329.

Like the escrow cases, the Minnesota case is not instructive. And more to the point, even under the rational basis test, the Minnesota case was simply wrong.

## IV.

**The issue of whether the tax imposed by the Act is actually a fee was never raised by the State and is not before this Court. But regardless, the tax is not a fee under Texas law.**

The Court can dismiss McLane's invitation to decide this appeal on grounds that the tax is in fact a fee. The State did not argue that the tax is a fee at the trial court or in this Court. An argument not raised by the parties to the litigation is not one properly considered by the Court. *See* TEX. R. APP. P. 38.1, 33.1; *WorldPeace v. Comm'n for Lawyer Discipline*, 183 S.W.3d 451, 460 (Tex. App.—Houston [14th Dist.] 2005, pet. denied); *Med. Specialist Group, P.A. v. Radiology Assocs., L.L.P.*, 171 S.W.3d 727, 732 (Tex. App.—Corpus Christi 2005, pet. denied).

In any event, Texas law confirms that the tax imposed by the Act is just that—a tax. The Texas Supreme Court has repeatedly declared that whether an assessment is a tax or a "fee" depends on the nature of the assessment, not on what the Legislature calls the assessment.

In *Conlen Grain & Mercantile, Inc. v. Texas Grain Sorghum Producers Board*, the Court announced the principles that govern the ability of the State to impose fees without implicating the Texas Constitution's mandate governing taxes. *See* 519 S.W.2d 620, 622-23 (Tex. 1975). Holding that an assessment against only certain product growers to raise revenues for state programs "calculated to increase

the production and use of particular agricultural commodities" was a tax, and therefore subject to the equal and uniform constitutional mandate, the Court stated:

> These programs doubtless promote the economic welfare of many who are engaged in producing the commodities, but ***the assessment paid by any particular person is not necessarily related to the benefits that will be received by that person*** through the Board's expenditure of the money he paid. The levy is not a special assessment.

Thus, it was a tax, and because it was not equal and uniform, it was prohibited. *Id*. (emphasis added).

Further, in *Lowenberg, v. City of Dallas*, the Court explained how to determine whether an assessment is a tax or a fee when the statute has multiple purposes. 261 S.W.3d 54, 57-58 (Tex. 2008). The Court wrote:

> It is sometimes difficult to determine whether a given statute should be classed as a regulatory measure or as a tax measure. The principle of distinction generally recognized is that when, from a consideration of the statute as a whole, ***the primary purpose of the fees provided therein is the raising of revenue***, ***then such fees are in fact*** occupation ***taxes***, and this regardless of the name by which they are designated. On the other hand, if its primary purpose appears to be that of regulation, then the fees levied are license fees and not taxes.

*Id*. (emphasis added).

Here, there is no relationship between the tax targeted against the Coalition members and any benefits conferred uniquely on those manufacturers, but not on their untaxed Big Tobacco competitors. The primary purpose of the Act is raising

revenue. The "fee" imposed by the Act is a tax and can only stand if it complies with the constitutional equal and uniform mandate.

## PRAYER

For these reasons, Appellees Texas Small Tobacco Coalition and Global Tobacco, Inc. respectfully pray that this Court affirm the trial court's judgment.

Respectfully submitted,

By: /s/ *Craig T. Enoch*

Craig T. Enoch
Texas Bar No. 00000026
cenoch@enochkever.com
Melissa A. Lorber
Texas Bar No. 24032969
mlorber@enochkever.com
Shelby O'Brien
Texas Bar No. 24037203
sobrien@enochkever.com

**ENOCH KEVER PLLC**
600 Congress Avenue, Suite 2800
Austin, Texas 78701
(512) 615-1200 / (512) 615-1198 fax

**ATTORNEYS FOR APPELLEES,
TEXAS SMALL TOBACCO COALITION
and GLOBAL TOBACCO, INC.**

## CERTIFICATE OF COMPLIANCE

Appellees certify that this Appellees' Response to Briefs of Amici Curiae (when excluding the caption, signature, certificate of compliance, and certificate of service) contains 2,445 words.

*/s/ Craig T. Enoch*
Craig T. Enoch

## CERTIFICATE OF SERVICE

The undersigned certifies that this Appellees' Response to Briefs of Amici Curiae has been served on the following counsel of record via electronic filing on May 23, 2014:

ERIKA M. KANE
ARTHUR C. D'ANDREA
Office of the Attorney General
P.O. Box 12548, Capitol Station
Austin, Texas 78711-2548
(512) 320-0067 Fax
erika.kane@texasattorneygeneral.gov
arthur.dandrea@texasattorneygeneral.gov

*/s/ Craig T. Enoch*
Craig T. Enoch