Outstanding Investor Digest

PERSPECTIVES AND ACTIVITIES OF THE NATION'S MOST SUCCESSFUL MONEY MANAGERS.

Investors featured in this Edition:

Other Investors in this Edition:

Companies & Investments in this Edition:

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WEITZ FUNDS' WALLY WEITZ
"THIS ONE'S NOT GOING TO BE A 10 TO 20-YEAR HOLD, BUT A FAIRLY COMFORTABLE 20-30% TRADE...."

With founder Wally Weitz as their portfolio manager, Weitz Partners Value Fund and its predecessor have earned a compound annual return from inception on 6/1/83 through 6/30/03 of 15.5% after all fees and expenses versus 12.2% for the S&P 500. Recently joining Weitz at his annual meeting to help celebrate his 20th anniversary was a contributor to those returns — Warren Buffett, chairman of long-time holding, Berkshire Hathaway.

(continued on page 2)

CLIPPER FUND'S
JAMES GIPSON & MICHAEL SANDLER
"SOME COMPANIES ARE LIKELY TO BE CONTROVERSIAL. BUT IT'S THE CONTROVERSY THAT MAKES THEM CHEAP."

Jim Gipson's letters to shareholders of Clipper Fund are consistently some of the most thoughtful and well written that we come across. And his fund's returns have been no less exceptional. According to *Morningstar*, which gives the Clipper its highest rating, its returns place it in the top 1% of funds in its category for 3 years, 5 years and 10 years — with the fund having outperformed the S&P 500 in those periods by 21.7%, 11.5% and 5.3% per *year*, respectively.

(continued on page 3)

SEMPER VIC PARTNERS' TOM RUSSO
"A GREAT INVESTMENT IDEA AND A GREAT STORY ABOUT HOW POLITICS DRIVES JUSTICE...."

Under the direction of Gardner Russo & Gardner's Tom Russo, Semper Vic Partners has earned a compound annual return net of all fees and expenses for the 19 years ended 12/31/02 of 17.7% versus 12.2% for the S&P 500. It's had only two down years — with the worst year down only 2.1%. And in the the three-year period ending 12/31/02 — a period in which the S&P was down 9.3% per year — clients were actually *up* over 4.6% per year after fees and expenses.

(continued on page 10)

OAKMARK FUNDS' BILL NYGREN
"CONSISTENT GROWTH HAS SURPRISINGLY HIGH VALUE IN AN ENVIRONMENT WITH LOW INTEREST RATES."

Portfolio Managers Bill Nygren and Henry Berghoef continue to run circles around the indices and other funds with their standout, Oakmark Select Fund. For example, since its inception on 11/1/96 through June 30th of this year, the fund's earned a compound annual return of 22.1% — vs. 6.5%, 12.1% and 7.7%, respectively, for the S&P 500, S&P Mid Cap 400 and Lipper Mid Cap Value Index.

And by the way, their 5-year and 3-year figures are

(continued on page 57)

WEITZ FUNDS'
WALLY WEITZ
(cont'd from page 1)

On his latest conference call which was held on August 6th, Weitz talked about why he had recently been buying former Buffett favorite, Freddie Mac. We were interested in knowing his investment rationale and thought that you might be, too. Here's what he had to say:

Freddie & Fannie are very large, *very* profitable businesses.

Shareholder: I'd like to know why you feel so strongly about Freddie Mac. The news is still bleak. And I know that typically is a good time to be looking at a situation. But this one just seems like it really smells bad.

Wally Weitz: OK. Well, we had sort of a minor version of fallout with Fannie Mae a few quarters ago when their one-month duration gap — or whatever their term for that is — got out of line and scared people. And we bought a fair amount of Fannie at that point.

It *is* a complicated story. However, Freddie Mac and Fannie Mae control something like 40% of the mortgages in America. They have a connection with the government — they're government-sponsored enterprises [GSEs].

There's confusion about whether the government really would support their balance sheet in a pinch. But they really are very large, very important, *very* profitable businesses. Some would even say that they have unfair advantages because of their cost of capital and so on.

Their 14-15% historical growth is a thing of the past....

Weitz: There are long-term issues that worry us — which is why we didn't own *either* of 'em until nine months or a year ago. And those issues include the potential that their funding costs might go up if the government clarifies the fact that they are not government supported, and political risk — that Congress will make some other kinds of changes. Also, because of the sheer *size* of the companies — they're so big — there's no way they'll be able to maintain the 14-15% per year kind of growth that they have historically. So there are plenty of *long*-term issues.

And truth be known, I really don't look at Freddie, probably, as a long-term hold — which to me means something we're likely to own for 10-20 years. I think of it more as a *trade* — which to us means a year or two.

What they did was *very* different than what WorldCom did.

Weitz: The immediate news and problem at Freddie was that like many, many American corporations, they learned that Wall Street was very interested in earnings predictability and that a smooth pattern of growth would get rewarded much more highly than a lumpy pattern that had the same average rate of return. And so they were certainly not unique in being interested in smoothing out their earnings. And they have a *very* complicated balance sheet.

They changed auditors — because Arthur Andersen was their auditor. And their new auditor, PriceWaterhouse,

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came in and said that ... Freddie Mac had postponed recognizing profits improperly. In effect, their idea was: "We have all the earnings we need in this period, so let's characterize it differently on our balance sheet so we can pull it out of the sock, so to speak, in later periods and keep our streak going."

Well, that's definitely illegal and immoral, it's an integrity issue and it's not good. We don't like it. I'm not making light of it at *all*. But I think it is very different to have taken between $1.5 and $4 billion of *real* earnings and postponed their recognition — that's *very* different — from just making up earnings like WorldCom did.

It looks to us like a fairly comfortable 20-30% trade.

Weitz: So the chairman and the CFO were forced out. Greg Parseghian was made CEO. And I talked to several people... The morning this news broke, *all* of us got together and said, "What do we need to know to get comfort to see if we can buy this stock?" I talked to some people in the mortgage industry. Others of us talked to different analysts. We talked to other people in the business. And we had to act on imperfect information that's *still* not perfect.

PORTFOLIO REPORTS estimates the following were Weitz Partners Value Fund's largest equity purchases during the 3 months ended 6/30/03:

1. FEDERAL HOME LOAN MTGE
2. SAFEWAY INC
3. BERKSHIRE HATHAWAY CL A
4. PAPA JOHN'S INTL INC
5. MAIL-WELL INC
6. PARK PLACE ENTERTAINMENT
7. VORNADO REALTY TRUST
8. INSIGHT COMMUNICATIONS
9. SIX FLAGS INC

But the judgement was the business was still real, the earnings were still real and when they restate the pattern of earnings, there would still be a funding advantage, a portfolio that was match-funded that would generate income, and that the business would continue. And the judgement was that investors would get enough comfort that Freddie's stock would go back to selling at, say, 12 times earnings — and that that would give us a price in the $60s. Therefore, if we could buy it in the high $40s or the low $50s, Freddie Mac might be a fairly comfortable 20-30% trade.

And more recently, we've bought Fannie Mae again, too.

Weitz: Since Freddie Mac and Fannie Mae do very much the same business — there's a sort of a duopoly — some thought that Fannie would be the way to play that, because their stock went down too and they didn't have the integrity question. But we went ahead and bought Freddie because it had gone down more — and we figured that the *macro* questions were the same for both anyway.

Now, recently, as interest rates have ticked back up and *all* financials have been weak and Fannie's come down, we've actually bought Fannie Mae, too.

But it was a judgement that the underlying assets and business value were intact and undervalued, and that the risk/reward was good. But that remains to be seen — because the stock's still down around $50. So anyway, that's the story.

—OID

CLIPPER FUND'S JAMES GIPSON & MICHAEL SANDLER (cont'd from page 1)

The excerpts which follow were selected from the prepared remarks and answers to shareholder questions by Clipper Fund founder Jim Gipson and long-time fellow portfolio manager Michael Sandler at their annual meeting which was held on March 27th in Beverly Hills. Given their outstanding track record and the quality of their letters, we should have had high expectations going in. However, I think that it's fair to say that our expecations were greatly exceeded.

We hope that you find their comments as valuable as we do.

IF WE DON'T HAVE A FEW CONTROVERSIAL STOCKS, THEN WE'RE PROBABLY NOT DOING OUR JOB.

In recent years, most important has been what we *avoided*.

James Gipson: ...Three years ago ... the stock market had gone to valuation levels never seen before in American history by virtually all measures of valuation: by P/E ratio, by dividend yield, by ratio of stock market capitalization to gross domestic product, etc. The relevant requirement for success at that point did not require much in the way of brain power. It simply meant staying out of the way of elements of the market that were *very* generously priced — particularly dot.com and tech companies — as we did....

As you may have noticed, in 2000-2001, our portfolios were up in the face of a declining market. That reflected the fact that we were able to find some cheap stocks. However, the most important value we added was not what we *bought*, but what we *avoided*. And in the case of the dot.com stocks, many of them — actually, *most* of them that had no sales and profits — have run out of cash and have simply gone away....

It's controversy that creates cheapness for the portfolio.

Gipson: ...If we don't have a *few* controversial stocks, we're not doing our job right. We do have some stocks that are downright boring: Fannie Mae and Freddie Mac being two of the most boring stocks you'll ever find. They are two fine businesses selling at under 10 times earnings. So they are cheap. And we're happy to have them.

However, we also recognize that some companies are likely to be controversial. But it's that controversy that creates cheapness for the portfolio....

As controversy recedes, Tyco's business quality will surface.

Gipson: Probably our *most* controversial stock [has been] Tyco. We bought Tyco just before the last year's Clipper annual meeting— [and it's] had more than its share of controversy. I think we are nearing the end of that. There was a small number of people at the company — Mark Swartz and Dennis Kozlowski — who were flat out stealing from it on present facts. Those people are long gone. I've met with both Ed Breen, the new CEO, and David FitzPatrick, the new CFO — ... and I think they are good people for a difficult job....

And as the controversy recedes — by the way, the stock price is well up from its bottom — what people are likely to focus on is the fact that it has a number of good, understandable businesses. They're up there in the ceiling — the little sprinkler heads that are made by Tyco, for example. Their American District Telegraph [ADT] unit — the security service — serves my home.... And as investors focus on them, I think that particularly from this point forward, we have a very good chance of making some good money in Tyco.

With the benefit of hindsight, however, we bought Tyco too soon. There was controversy and cheapness in the stock, but it became cheaper after we bought it....

[Editor's note: How quickly things change, as Gipson pointed out in his June 30, 2003 letter to shareholders:

"Last quarter we observed that our stocks fell into two categories — abhorred and ignored. Those two categories remain the same, but their contents have changed.

"Tyco was (note the past tense) the most controversial stock of last year ... and Freddie Mac was (note the past tense again) our most ignored stock. Year after year Freddie performed its normal functions of guaranteeing mortgages, holding mortgages in its portfolio, and generating impressive profits. The company's excellent performance during the last three years was a notable contrast to the disappointing profits turned in by many companies.

"Freddie's normally very low profile ended abruptly last month. It now appears that Freddie Mac made some errors in accounting (both unintentional and otherwise) that resulted in the company understating its actual profitability. Management is currently re-calculating Freddie's earnings for the past three years and expects past earnings and current book value for the company to be revised upwards. Based on present facts there appears to be no decrease in the long-term value of the company, but one conclusion is certain — Freddie is no longer ignored."]

TENET APPEARS TO BE A *VERY* CHEAP STOCK — AND EL PASO SHOULD WORK OUT VERY WELL, TOO.

We think we bought Tenet just right....

Gipson: But to apply hindsight to another controversial holding, Tenet, with the benefit of hindsight we apparently bought that just right. Michael [Sandler] and I and some others met [in November] when Tenet's stock was down to $27. And they were having an analyst announcement later that afternoon. Investors were nervous. We addressed the question as to whether we should buy it — and concluded it was only a *little* cheap, not cheap enough with a margin of safety that would make us want to step up. So we passed on it thinking that it'd probably be at $35 six months down the road.

Well, the announcement they made wasn't what investors wanted. It opened at *$15* the next day. And we *did* buy it then....

Tenet appears to be a *very* cheap stock.

Gipson: The principal problem had been a very large amount of what are called "outlier payments" to Medicare. On present facts, this doesn't look as though they've done anything illegal. They haven't been charged with anything

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CLIPPER FUND'S
JAMES GIPSON & MICHAEL SANDLER
(cont'd from preceding page)

illegal. They just had a number of people who were gaming the Medicare system.

The people at Tenet have significantly reduced their outlier charges to Medicare — probably more than they really *have* to. But even on somewhat reduced profits as a consequence, it appears to be a *very* cheap stock....

Hospital utilization is going up. Hospital rooms are *not*.

Gipson: The balance of power is slowly shifting back to hospitals. Starting in 1986 when the DRG [Diagnostic Related Group] system came in with Medicare, hospital utilization started going down — a trend which continued for over a decade. And that trend was exacerbated because of the better technology of outpatient operations.

But because the population is growing larger and growing older and growing more in *need* of medical care, hospital utilization is going up. Hospital rooms are *not*. And the slow balance of power is going to [shift — which is going to] benefit Tenet over the long term.

There are some other controversies in the stock. There was an excessive number of operations at one of their 113 hospitals which still has some troubling aspects to us.... But this is another example of a controversial company that we think is *very* cheap at current prices.

[Editor's note: Pacific Financial Research filed a 13G on 6/25/03 showing Gipson had ramped up their 6.3% position in Tenet as of 3/31/03 to 10.3% of the company.]

It looks like El Paso is going to work out for us as well.

Gipson: A third one is El Paso. We bought this *way* down from its high, but a bit too soon on present facts. But the controversy looks likely to resolve itself in our favor.

The bulk of the value consists of pipelines. They're the largest pipeline company in the country. That's a good, cash-generating business. The other major component of the value consists of gas wells. And as you may have noted, gas and oil prices have gone through the roof. This is a bonanza for El Paso. It is a short-term *qualified* bonanza because they have made forward contracts to sell nearly 40% of their production. And as a consequence, they have to post cash collateral for the future performance of those contracts. Fortunately, those contracts generally are of short duration — more than half of them roll off in the next 12 months. So that cash comes back to them.

However, in the meantime, El Paso *did* have a liquidity problem. I use the past tense because although it is still not entirely gone, it is *mostly* gone. They have recently completed negotiations with bankers who are, in the words of their lead director when I talked to him Monday, "delighted". I have a certain difficulty visualizing what a delighted banker looks like — [laughs] because I've never met one. But on the present facts, it looks as though El Paso is going to work out for us as well.

But in all cases, we bought with a margin of safety in case we were wrong — which occasionally we will be.... I think that we have a very cheap portfolio though — and we are very happy to have it.

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WE OWN A GOOD PORTFOLIO OF CHEAP STOCKS. OUR NEXT CHALLENGE? TO HAVE ENOUGH PATIENCE.

Since last summer, we've been finding more things to buy.

Gipson: Just to mention one last bit of perspective: Starting about six months before Alan Greenspan made his "Irrational Exuberance" speech in the Fall of '96, we found more stocks to sell than to buy. And you've noted that the cash position in Clipper Fund has stayed at right around one third for *years* up until the summer of last year. Starting in the summer of last year, we began to find more individually cheap stocks that were worth committing some capital to. And that's why your cash position is now down from roughly one third to slightly under 10%.

It is the stock-by-stock issue, not the overall macro market valuation, that really determines the shaping of your portfolio....

Thanks for standing by us when we looked like dinosaurs.

Gipson: Since I've seen a number of your faces here in past years, I'd like to thank those of you who were here three years ago for your patience at that time. It was just three years ago that the stock market hit its peak. And we looked like intellectually deficient dinosaurs because we just didn't get it — why you should pay 1,000 times earnings for Yahoo. And that's not an exaggeration. It *was* selling at 1,000 time earnings. I know it was because I was personally *short* the stock — unfortunately.

But that was a period where there was a good deal of lunacy in pricing assets. And we tried to remain rational, disciplined people in the face of that. We'll see elements of lunacy in the future — I don't know when. But right now, as I said, I think we have a good portfolio of cheap stocks....

BALANCE SHEET RISK IS COMPANY SPECIFIC. FOR EXAMPLE, TAKE TENET, TYCO AND EL PASO....

At Tenet, there's *no* balance sheet risk.

Shareholder: It seems like one of the reasons ... that companies are trading cheaply is because they do have balance sheet issues — in particular, Tyco and El Paso....

Are there certain ratios — like debt-to-cap or coverage ratios — that you look for? How do you analyze the balance sheet side of companies?

Gipson: This has to be very company specific. I'll use the three companies I mentioned earlier. In the case of Tenet, there's a lot of controversy. But there's *no* balance sheet risk. They have a very conservative capital structure.

Actually, when I was up there recently to have lunch with their CEO, they'd just taken the little short-term debt they had and extended it out for 10 years. In the language of basic finance, they'd essentially matched their long-term assets with their long-term liabilities. And therefore, there's no balance sheet risk there.

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CLIPPER FUND'S
JAMES GIPSON & MICHAEL SANDLER
(cont'd from preceding page)

Tyco dealt with its balance sheet risk by selling CIT.

Gipson: With regard to Tyco, we recognized that there *was* some balance sheet risk. But you can't use a general formula to apply to all companies. It has to be company specific. We did recognize that Tyco had a liquidity issue, but we also recognized that they had the means necessary to deal with it. They sold CIT Financial, for example, which went a *long* way toward eliminating any balance sheet risk there.

It's behind Tyco. And you're *very* well paid for it at El Paso.

Gipson: With regard to El Paso, it's been interesting to watch that company which was having moderate balance sheet problems that became larger as their problems advanced. They lost their receivable financing facility, for example. As I mentioned earlier, the good news of high gas prices is mixed news for them because of the collateral they had to post. Now, that collateral comes back to them in time — and in not very *much* time.

But again, what we do is analyze each company's specific situation to see if the balance sheet situation is bad enough to sink it. In the case of Tyco and El Paso, as you rightly pointed out, that was a controversy at the time. But no one's talking about Tyco's balance sheet problems now. They've pretty well put those behind them.

And I think with the recent events at El Paso — the settlement with the state of California and ... their settlement with their bankers (again, I'm still having trouble visualizing what they just described as their "delighted" bankers) — I think that this is risk that you're being *very* well paid to take.

Liabilities are only *half* of the equation....

Gipson: But that's not typical of the companies in our portfolio. The vast majority have no balance sheet problems. And as I mentioned earlier, for some companies, I would have a distinct balance sheet problem if you consider the more extended liability of pension and healthcare claims.

Actually, Tyco's fairly typical in that its pension plan is underfunded, as is Pfizer's, but only to a very small degree relative to the total market value of the company.

Michael Sandler: A lot of the process internally is driven off a discounted cash flow and sort of a net cash flow process. As Jim mentioned, it's looking at *off*-balance-sheet items as well as balance-sheet items and seeing how much cash they're generating at the end of the day to pay their liabilities. That's the exercise we go through as a key thread among all the companies we look at.

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PHILIP MORRIS IS REMARKABLY CHEAP.
SOCIETY KNOWS SMOKERS ACCEPTED THE RISK.

It's one of the most undervalued companies out there.

Shareholder: Why are we invested in Philip Morris?

Gipson: Michael, since I've been doing all the talking so far and that's one of your favorite ones, I'll let you address that controversial one.

Sandler: Philip Morris *is* controversial. There's no doubt that cigarettes are not healthy things to smoke. But the way we look at Philip Morris is that it produces a legal product sold in the United States. And the company really is trying to work within the guidelines. In fact, the company right now wants to get FDA regulation — because they want to get this whole past behind them.

PORTFOLIO REPORTS estimates the following were Clipper Fund's largest equity purchases during the 3 months ended 6/30/03:

1. HCA INC
2. TENET HEALTHCARE CORP
3. FEDERAL NATL MTG ASSOC
4. ALTRIA GROUP INC
5. FEDERAL HOME LOAN MTGE
6. EL PASO CORP
7. AMERICAN EXPRESS CO
8. KROGER CO
9. UST INC
10. PFIZER INC
11. SAFEWAY INC

The fact of the matter is that it's a legal product. About 20% of the population *still* smokes. It's not going to disappear. It's probably one of the most undervalued companies out there. And we're value managers. We focus on making impartial, rational decisions rather than decisions about societal issues. And this is a decision where we feel comfortable holding the company.

Most of society realizes that smokers have taken the risk.

Sandler: But there's a lot of litigation surrounding the company. Until this very recent Miles lawsuit, Philip Morris had won eight lawsuits in a row — because *most* of society realizes, we think, that smokers have taken the risk themselves. There is an addictive element to it. However, it's been known for so long that smoking is dangerous.

So again, we are *not* pro-smoking. None of us smoke. We wouldn't advise anyone to *start* smoking. But it is a company that's available at a very significant discount to what we think the business is worth.

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CLIPPER FUND'S JAMES GIPSON & MICHAEL SANDLER (cont'd from preceding page)

It's remarkably cheap. I'll leave the judgements to others.

Shareholder: I'd be much more comfortable if you would not own it.... I think it's immoral.

Gipson: As Michael said, it's a decision *I* haven't made. But I'm not going to impose my own decisions on other people, as well. From a quantitative standpoint, it's remarkably cheap with a yield of over 7% and a P/E ratio half that of the stock market. And as a portion of a portfolio, I think that you're being very well paid to take the risk.

That said, I can understand the view on your side. I'm not a smoker myself. However, I'm not going to impose my judgements on others — so long as it's a legal activity.

JUSTICE LAWSUIT WILL PROBABLY BE DISMISSED. WHAT'S MORE, WE THINK THE ANALYSTS *KNOW* IT.

We think the Justice Dep't lawsuit is likely to be dismissed.

Shareholder: There's a Justice Department suit for something like $300 billion. Would you address it? And second, analysts like Martin Feldman, [Merrill Lynch's Senior Tobacco and Beverage Analyst], seem somewhat cautious on Altria.... How do you take the analysts' input — or *do* you take analysts' input?

Sandler: Both are very fair questions. Let's start with the Justice Department lawsuit first. There's some posturing going on. Ashcroft has talked about moving away from that litigation. Most of the claims that the Justice Department made have been thrown out. They've just never come up and stated a specific number. And we were surprised by the fact that the Justice Department even *mentioned* the number now. That was a little bit of a surprise to us. But it doesn't make their claim — the one that remains of their three original claims — any stronger.

We still think that that one's likely to be dismissed because the federal government's *known* about the ill effects of tobacco as long as the tobacco companies have.

And it's *already* a government business....

Sandler: And the federal government collects so much money *from* the tobacco companies. The federal and state governments together collect over $40 billion a year from tobacco. By comparison, the tobacco companies make about $4 billion a year after tax in the current depressed environment. So that business is essentially *already* being run for the federal government and the states. And I think they're being a little disingenuous with that. But we'll see how it plays out.

We think that the tobacco companies have some pretty good defenses. I could talk on that forever, too.

Analysts have an enormous disadvantage — namely clients.

Sandler: However, the other issue with the analysts — and we could expand it more broadly... There are some very smart analysts on Wall Street, but we don't take their decisions as the driving force of our process. In fact, we generally look for analysts who are *concerned* about a company we're interested in. Most of the value that we get from Wall Street is using analysts as devil's advocates to sort of curb our enthusiasm, if you will....

The problem with most analysts is that they have a very *short*-term investment horizon — perhaps not personally. However, there's a lot of pressure from the average institutional investor in Wall Street. What picks do you have to make me money in the next three months or the next six months? Therefore, the horizon that most analysts have goes out three to six months.

However, if you were to sit down with Martin and say to him, "Where do you think Philip Morris will be five years from now?", he'll say that it's very cheap. Basically, he's got this concern just because it's sort of a gamesmanship — where they try to look out just a few months from now and see if the stock is going to pop. So you'll see analysts chop and change their recommendations all the time — more on a trading basis than a long-term investment basis. And we've always taken that with a grain of salt.

Recent "revelations" weren't revelations to *us*.

Sandler: The "revelations" that have come out recently are not new. We weren't surprised with some of these so-called "revelations" [regarding the Spitzer investigations about bogus brokerage recommendations] that various authorities in New York have been jumping up and down and yelling about. It's ... *caveat emptor* — buyer beware.

WE THINK THE MILES CASE IS SOMEWHAT SPURIOUS, BUT WE'RE BEING PAID VERY WELL FOR THE RISK.

The most prolific class action district in the country....

Shareholder: How about the Lights cigarettes [case]?

Sandler: Oh, the Miles case.... I don't *like* this litigation thing. I think it's annoying for all parties. But the Miles lawsuit was in East St. Louis — which is the most prolific class action district in the country. I understand that the plaintiffs' attorney who brought the suit was the largest campaign [fundraiser] for the judge [in] the case.

And I guess you could say the judge was reasonable in that he only announced 17% of the total damages as plaintiffs' attorneys fees — which is $1.7 *billion*.

Apparently, Lights cigarettes require red flashing lights....

Sandler: But the point is that the grounds on which this lawsuit was brought was not the same as other tobacco litigation. There was no... If there was fraud, it wasn't based on making smokers sick. That was *irrelevant* to this case. It was basically that people smoked Lights because they thought they were less dangerous.

But the labeling that Philip Morris has always had on cigarette packs is the same for Lights cigarettes as it is for regular cigarettes. However, that was basically the whole thrust of the lawsuit. It was really just to recoup the profits Philip Morris has made on selling Lights to Illinois residents — not whether smoking's good for you or bad for you or anything along those lines.

So based on the facts as we understand them, we think it seems somewhat spurious. We think it'll get overturned. But it is an issue that we're closely monitoring right now — especially with Philip Morris being forced to post a very large bond for it.

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CLIPPER FUND'S
JAMES GIPSON & MICHAEL SANDLER
(cont'd from preceding page)

We're not expecting an end to litigation. But that's OK....

Gipson: Just one last very quick observation... For the tobacco industry, as for some others, litigation is a fact of life. The question is, are you being very well paid to take that risk? In the case of Philip Morris, I think we are....

MILITARY SPENDING IS STILL *VERY* LOW. BUT WE'LL LEAVE PREDICTIONS TO OTHERS.

We spend a remarkably small part of our GDP on military.

Shareholder: If I rewind 30 years to the beginning of the 1970s, we had the guns and butter philosophy of the administration going into Vietnam.... Recognizing that interest rates are probably the most difficult thing to forecast, if I look at the demand for funds in the economy — in terms of our domestic economy, our military endeavors in Iraq, rebuilding Iraq and Afghanistan — and try to integrate that together, what kind of conclusions can you draw from that about the outlook for interest rates and the investment environment in general?

Gipson: ...First, the cost of rebuilding Afghanistan gets lost in the noise level. And whatever costs we're engaging in Iraq are likely to be a one-time spike — and then some continuing element after that.

To put it in perspective, total defense spending — which admittedly has gone up quite a bit — is still only 4% of gross domestic product. Under Kennedy, it was 8-9%. And of course under Johnson, it went right back up there to nearly *10%* as well during the prosecution of the Vietnam war. So it's important to keep all this in a reasonable quantitative perspective.

In terms of the last 50 years, we are spending — even at *current* levels — a remarkably small percentage of our gross domestic product on military-type items. Is it something that the nation can afford? Yes.

But we don't even *try* to predict that kind of stuff.

Gipson: ...Is it possible to take a guess that government spending would go up for some period of time — and can you translate that into a forecast for either long or short-term interest rates?

I think the numbers are small enough in relation to the economy that you can't do that. And even if the numbers were larger, it is exceptionally difficult in the conceptual flow of funds analysis that you're talking about to say that there is going to be a demand for funds here and a supply there and then try to put the two of them together. There's a *whole* lot of work and intellectual effort that goes into that — and, we think, very little in the way of accurate predictions come out of it.

As I've said, I certainly don't think I'm particularly good at predictions — at least as far as the future goes.

IT'S ALL ABOUT THE GAP BETWEEN VALUE AND PRICE — AND WHEN THAT GAP GOES AWAY, SO DO WE.

As value investors, we're really looking at two numbers....

Shareholder: I understand your buy philosophy. Could you tell us about your *sell* philosophy?

Gipson: That's a very good question because I think most investment managers are better buyers than sellers. Our sell philosophy is really the reverse of the buy. So I'll start with that — and it can help to address the sell side. As value investors, we're really looking at two numbers:

First, there is the valuation for a given company. This is where we try to determine a reasonable valuation for the company — that if you were a long-term partner in it (forget the stock market) is it a business you understand? Is it a reasonably good business? And is it cheap in relation to what a rational private buyer would pay to be a long-term partner in the business? That's what we're trying to determine when we come up with the value.

The second number is the market price. Well, we get that figure off the quote machine just like everyone else. And if the company is selling at a discount of 30% or more to our estimate of intrinsic value, then it becomes a candidate for purchase. That discount is there in case we're wrong — which occasionally we are. It's also there because the basic faith of the value investor is that at some point, the stock will rise from where it is to its intrinsic value. And at that point, we'll sell it....

It's all about the gap between value and price.

Gipson: Now the second aspect to this is that we continue to update the value over time. Facts do change.... So that at the time we buy, we have a value, we have a share price in the market — and we're looking to have a wide gap between them in our favor. We sell when those two numbers close.

But there are two ways they can close. One is ... where the price rises to the value. The less frequent and more painful case is where the value declines over time.

But that's the basic answer to your question. It is that focus on those two elements — price and value. When there's a wide gap between them, we'll buy. And when that gap goes away, then we'll sell.

A good test for a value investor....

Shareholder: Is there a set percentage at which point you decide to sell or buy more?

Gipson: Yeah. It's the ratio of price to value. When the price is low and the value is high, then we'll buy more. In the case of Tyco, which I mentioned earlier, we [started buying it] — and then when it dropped sharply, we bought more because we thought the value had not changed nearly as much as the share price.

That's actually a good test for a value investor: If you liked the price at X — if you think a stock is cheap here — and it drops, do you buy more? Normally we do, as long as there hasn't been a change in value. On the other hand, if the share price gets up to our estimate of intrinsic value — if the price-to-value ratio gets up to 1 — then we'll sell it.

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CLIPPER FUND'S
JAMES GIPSON & MICHAEL SANDLER
(cont'd from preceding page)

THERE'S NO SUBSTITUTE FOR PATIENCE.
THAT'S JUST THE WAY IT WORKS....

It's *easy* to be patient during a *bull* market....

Shareholder: One factor that I'm maybe *overly* sensitive to — and it isn't just targets — is the time value of money and how long it takes you to reach that target while you might be doing better in something else....

Gipson: Possibly the *alternative* is what you want to consider, too, because there is a patience aspect of buying something cheaply, and then how long you have to wait — how long you have to be patient. It's very simple during a bull market to say "I'm a patient long-term investor" when you're being rewarded on a short-term basis — daily, weekly, monthly or what have you. So generally, investors' time frames are very, very long during a bull market. At least that's what they *think*.

It's when you're *not* being rewarded on a daily, weekly or monthly basis that time frames begin to shorten dramatically. That's just the way it is. I can't help you with any of that. That's the way the investment world works — much the way the sunrise works. It's always been that way....

Of course, it helps if the underlying value is rising....

Sandler: We try to buy companies that compound shareholder value over time — companies that are worth more a year from now than they are today. And that helps establish our margin of safety. Even if the share price moves nowhere, if the value rises, then we're very comfortable holding the company.

Eating well is nice. But it's important to sleep well, too.

Sandler: However, I think the most important thing is that the capital you allocate to the stock market — whether it's with Clipper or anyone else — *must* be long-term capital. It's got to be capital that you don't need to live on today. And that's so important in a bear market (and this bear market has probably been one of the uglier bear markets that we've ever seen) to have that long-term perspective.

But if you do feel very uncomfortable having capital committed to equities, you shouldn't keep it committed to equities — because you just won't sleep well at night.

For example, we're very happy to own Freddie and Fannie.

Gipson: Let me give you a concrete example of what I think you're concerned about: Fannie Mae or Freddie Mac. These are two holdings we've had for some time. They've gone *nowhere* in the stock market in the last three years. Actually, going nowhere has been a positive [he chuckles] in many ways.

But if you were a partner in the business, you would look at it very differently. You would be happier that they continue to add mortgages and profits. Their profits are sizably greater now than they were three years ago. And so if you view yourself as a partner in their business, then you're very happy with them.

Now just when the stock goes up, I don't know. They're both selling for about 9 times this year's earnings, which we think is remarkably low for companies which are that profitable. However, for the last three or four years, the operations and profitability of the companies have done very well — and they've become cheaper and cheaper because the share prices have not.

Will they go up at some point? Well, I think they will. But I have *no* capacity to predict when that day is going to come — nor does anyone else.

BIGGEST RISK W/FANNIE & FREDDIE? CREDIT QUALITY.
THAT'S WHY WE HAVE A CANARY IN THE COAL MINE.

We look at GSEs' credit quality closely. And so far, so good.

Shareholder: What do you see as ... the biggest risk to Freddie and Fannie?

Gipson: ...If there's any problem that they have with regard to Fannie and Freddie, it would be (as it is for any leveraged financial institution) credit quality. There, we've spent a good deal of time focusing on trying to make sure we *understand* it well. The credit quality to date has been absolutely superb. So we have no current concerns.

Last summer, I went by Fannie and spent some time with some of their credit people. And their top person in credit quality was in our office about three months ago.

Even better, we have a great early warning indicator....

Gipson: However, actually, my *best* yardstick is what I term my "canary in the coal mine". If they have a higher loan-to-value ratio, they use private mortgage insurance. And for some time now, I've known the president of a mortgage guarantee company — one of the companies that Fannie and Freddie use for their riskier loans. So if Fannie and Freddie ever have credit quality problems, this fellow is going to see it — long before anyone else does.

I talk to him every two or three months. And actually, for the last year, the response has been the same: He has been expecting an increase in loan losses that he has not seen. He is embarrassed at the level of profits that his *own* company is making. And again, this fellow would have to be in deep trouble before there were any effect on Fannie and Freddie....

And we see no significant credit risks at Fannie.

Gipson: For example, six months ago, Fannie was in the news because their duration gap widened. But this is well within the range of how Fannie normally manages their business — and really not a long-term source of concern. If there is one primary risk that you would worry about as a shareholder, it would be asset quality. And in terms of current operations, in terms of their approach and in terms of my canary in the coal mine, there is no reason to think there is any significant risk to investors there.

Fannie/Freddie are *resistant* to rate rises, not invulnerable.

Shareholder: Would higher interest rates impact them ... to a large degree?

Gipson: Let me give you a two-part response: If interest rates go up, because Fannie and Freddie are very well matched on their book of business, it would not have

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CLIPPER FUND'S
JAMES GIPSON & MICHAEL SANDLER
(cont'd from preceding page)

any short or medium-term impact on their earnings. In the longer term, if mortgage rates were to go from the current 5.7% on a 30-year conventional mortgage to 9% — particularly in the context of a recessionary economy — that would have a negative impact on home values....

But if a rise in interest rates — and this is *long* rates we're talking about, not short rates; short rates *can* be very volatile — if long rates were to go up a lot very quickly, that could be a problem for them. I think that's a very low-risk event, but it's not a zero probability. That's why we have an equity risk premium when we value the stock....

OUR SECRET SAUCE? NOT AVOIDING CRITICISM AND DOWNRIGHT MULE-LIKE STUBBORNNESS.

For us, valuation is basically about future cash flows.

Shareholder: How do you define intrinsic value when you look at companies you're considering buying?

Gipson: [T]here is no single formula that defines value for all companies. The price to book ratio is often very useful for financial companies, but it has no bearing at all for a television broadcaster or an apartment building — unless you're dealing with the tax consequences.

So a lot of what we do is put together a lot of special purpose valuation models to come up with intrinsic value. And we define intrinsic value as the price that a rational private buyer would pay for an asset if he's going to keep it for a 10-year period.

Sandler: The thrust of a lot of our valuation — again, adjusted for the industry specifics — is today's value of the future cash flows the company's going to generate. And you just want to buy that lump of cash flows you'll be receiving at a big discount to what you calculate them to be worth.

So our estimate of intrinsic value is often driven through a discounted cash flow valuation — which is company-specific. It's not just a simple little multiple of something or other.

New low list is a good idea source. And experience helps....

Shareholder: Can you go into a little bit about how you guys find your ideas? Are you guys doing screens on valuation issues? Are you doing a top-down industry-type process, more bottom up or what?

Gipson: I suppose the right answer is "all of the above". You asked if we're doing screens. The computer's very useful in that. Just looking at the new low list is sometimes a source of new ideas.

Also, one advantage of having been in the business for some time is that you get to know a lot of businesses and a lot of companies so that at the time controversy *does* arise, you have a reasonable basis of knowledge from which to start your analysis — so you're not starting from [scratch].

We look for controversy, but try to recognize our ignorance.

Gipson: In the case of some companies, if there is bad news on the front page of the newspaper as opposed to the back page of the business section, that by itself may attract us to it. One bullet we *missed*, by the way — and this goes back to how we operate — is back when Enron was getting a lot of negative publicity, its stock had dropped to $35. So we started to analyze it, realizing that it had been an investor favorite. That was about a year-and-a-half ago. So this is not really ancient history. But the conclusion we came to — and this goes to the previous balance sheet issue — is not that it was overvalued at $35, but that we couldn't understand it at *any* price....

So that was an example of something where the controversy was in the news. You didn't have to be terribly bright to see the idea. However, you did have to be intellectually honest to realize you couldn't understand it....

What's helped us succeed? Not succumbing to criticism.

Shareholder: ...Even among disciplined value investors, your track record's outstanding. Can you elaborate on your secret sauce as you guys see it?

Gipson: Well, if there really is a secret sauce, I'm still looking for the recipe.

Shareholder: Don't be too bashful.

Gipson: Well, this is a business where if you don't have a certain amount of modesty, then reality will force it on you. [Ed. note: Amen.] However, I think, particularly in the last three or four years, one aspect has really been the willingness to withstand criticism. A sizable chunk of people conduct their lives to avoid and prevent criticism. And the simplest thing would have been for us to have bought a pile of dot.com stocks....

Speaking of criticism, I'll use Michael as an example. In December of '99, just as the market was hitting its peak, he went to a party and a young woman asked him how we were doing that year. And he said we were flat. She said, "You're pathetic." [Sandler cracks up]. During that period, we had a good many shareholders and clients leaving us because we were intellectually deficient dinosaurs.

Sometimes brains matter. But recently, it's been patience.

Gipson: However, because of patience, conviction or mule-like stubbornness — however you want to put it — we continued doing what we considered the rational thing. There are times that brain power really *is* a major requirement for success in this business. But particularly in the last three or four years, it has not been brain power — because the right thing to do was *obvious*. But what mattered most was whether you had the patience, conviction and mule-like stubbornness to do it. So if there has been a secret sauce, that would have been it....

Sandler: And it's also focusing on your best ideas, too. It's pretty simple....

—OID

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SEMPER VIC PARTNERS' TOM RUSSO
(cont'd from page 1)

As long-time subscribers know, prior to forming Semper Vic Partners, Russo worked with and learned from the folks at Ruane, Cunniff & Co. — through whom he met his long-time partner, Gene Gardner. Incidentally, we understand that Gardner, who trained with Bill Ruane at Kidder, Peabody in the early '60s, has earned returns which are very similar to the spectacular returns earned by Sequoia Fund over the past 30+ years.

With a law degree and MBA from Stanford, his membership in the California Bar Association and the Board of Visitors of Stanford Law School and his training at Ruane, Cunniff, Russo brings a unique perspective to bear on a small number of industries which have historically generated substantial free cash flow — including food, beverage and tobacco.

Russo's been featured in *OID* pounding the table on Altria Group (then Philip Morris) at a couple of particularly opportune times in the past. In our October 1993 edition, for example, when we reported that it had been his largest purchase year-to-date, he discussed the idea at length. And from that point in time, we guestimate that an investment in Philip Morris held until today with dividends reinvested would have generated a compound annual return of about 17% versus about 9.9% for the S&P 500.

Then, in our December 10, 1999 edition, we featured Russo extolling its investment virtues and lamenting runaway litigation in his latest letter (dated October 1999). And we guestimate that an investment in Philip Morris from that point in time with dividends reinvested would have resulted in a compound return of about 22% per year — during a time when the Dow, the S&P 500 and the Nasdaq didn't even manage to break even. In fact, we understand that from January 1, 2000 to date, Altria's actually been the best performing Dow component.

Therefore, with Russo once again pounding the table and Altria Group in the news, we thought it might be a good time to revisit both. Little did we know what we had in store for us. Presented in four installments — basically as events unfolded — the conversations from which the following comments were excerpted began in late April and continued right up until late in the evening of the day that we actually headed to press. We hope that you find them as valuable as we do.

INSTALLMENT #1: POST-STATE FARM, PRE-REVERSAL OF ENGLE — LATE APRIL

OID: I gather from your latest letter that you believe the legal firestorm at the Philip Morris USA unit of Altria Group [MO-NYSE] is...

Tom Russo: Transitory and overblown. I say that because the catalyst for the recent spate of rating downgrades was a case in Illinois that is on all grounds likely to be reversed on appeal. And the way they found themselves in the position they did is one of the great stories about how politics drives justice in the U.S. today. It's a *great* story.

On the other hand, I should confess that I suspect my risk assessment is being blinded a bit by principle — because I can't help but think, "Gosh, that's just not how we're supposed to conduct our affairs as a nation."

OID: I couldn't agree more.

Russo: It's a very interesting time — because for the first time ever, there's simultaneously credit rating dismay and investor fear over acceleration of U.S. litigation risk...

OID: Not to mention Marlboro Friday revisited...

Russo: That's right. Making matters even worse, Philip Morris USA, Altria's domestic tobacco segment, will show sharp declines this year and possibly even into the start of next year. Deep discount competitors can conduct their business against PM USA's full price products without the burden of the same advertising restrictions and taxes. And others operate through distribution channels that are largely outside the law — internet channels, counterfeit channels, grey market channels, etc.

OID: All, one might argue, made much more serious than ever before as a result of the $5 billion or so per year payment due from Philip Morris USA as per the Master Settlement Agreement with the states.

Russo: Right again. So I think you have an unusual amount of concern over a disruption in the U.S. market. Basically, the market is extrapolating the last six months — which is a sharp downward trajectory — out forever, whereas I expect it to reverse and return to normal. And part of the reason why I expect it to return to normal is that there are a tremendous number of parties with a vested interest in Philip Morris USA being successful at stabilizing the market.

But meanwhile, we're in a very interesting moment in time when the market is setting Altria's stock price based on those fears.

OID: Understandably. Wasn't Philip Morris USA actually threatening to declare bankruptcy if their $12 billion bond in the Illinois case wasn't reduced?

Russo: They were.

OID: And aren't they also appealing an award of $140 billion — that's "billion" with a "b" — in the Engle case in Florida?

Russo: That's right.

OID: At the same time that they're being sued for a sum in the hundreds of billions of dollars by the Justice Department under RICO?

Russo: Yep.

OID: And aren't they also facing the possibility of the very harsh legal climate in the U.S. being replicated elsewhere as a result of the FCTC — the so-called Framework Convention on Tobacco Control?

Russo: Theoretically, yes.

OID: And you really think that this one's a long?

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SEMPER VIC PARTNERS'
TOM RUSSO
(cont'd from preceding page)

Russo: I do. I believe that right will ultimately prevail in the appellate process. So the investment rating agencies, who turned into weakened fawn and fled, will eventually have to come back and rethink their rating downgrades — because Altria Group has debt service coverage, I believe, of at least 8 times and cash flows from other operations that are ample to service all corporate liability.

That's *excluding* domestic tobacco — whose cash flows I'm convinced are going to remain abundant. So I believe that Altria's a great story and a great investment idea.

MILES CASE GETS HIGH MARKS FOR CREATIVITY, BUT IT COULD HARDLY BE MORE "LIGHT" ON MERIT.

OID: So many risks, so few pages. Where to start...

Russo: Well, I think the #1 issue clouding the scene today is probably the Illinois case — which you usually see referred to as the Miles case, although sometimes it's called the Price case or the "Lights" case.

OID: That sounds like as good a place to start as any. I gather from your letter that you think the case against Philip Morris USA is, in effect, groundless?

Russo: I do. The arguments are novel — because the plaintiffs are not claiming harm. They even suggest that the consumer who allegedly has been defrauded over the years, once aware of the fact that he or she has been defrauded, has no obligation to express in any fashion a different set of behaviors. In other words, those consumers aren't saying, "Holy smokes! I never thought they might be *dangerous*! Therefore, I certainly deserve to be made whole. And oh, by the way, I'd never do that again — because I'd *never* have consumed the product had they not defrauded me."

Many of those consumers who are presumably deserving of a $7 billion rebate for products they purchased as a consequence of that fraud are still smoking Marlboro Lights.

OID: That's amazing.

Russo: It really is. Also, every package that ever went out said, in effect, "By the way, according to the Surgeon General, these products are likely to kill you." None of this activity occurred except at times when the FDA warning label was fully smacked on the product.

OID: And hasn't the U.S. Supreme Court repeatedly ruled in the cigarette companies' favor in that matter?

Russo: What the United States Supreme Court said, as interpreted by Judge Byron in the Illinois Case... Well,

(continued in next column)

according to Philip Morris USA, it actually wasn't *interpreted* by Judge Byron. It was the plaintiffs' brief that the judge filed into his opinion — typos and all — to give you a sense of justice in Judge Byron's court.

OID: And wasn't the plaintiffs' attorney actually the head of the election campaign for Judge Byron?

Russo: That's my understanding.

OID: That seems only fair.

Russo: Oh sure. But that's payback. I'm not sure that it's justice. However, it's corrupt. There's just no two ways around it. For the first words out of the judge's mouth to be, "Here's the verdict — $10.1 billion. And $1.7 billion goes to the attorney."... That was unseemly. And, in any case, there's a clear conflict.

OID: Say what you will about Judge Byron, you certainly can't accuse him of ingratitude. And I'll bet he does a bang-up job of fund-raising, too.

Russo: Yeah. So Judge Byron makes a distinction. He says that the U.S. Supreme Court indeed spoke about the companies' ability to defend against "failure to warn" claims. In other words, companies met their duty to warn consumers about the health risks associated with smoking by including the warning on their label mandated by Congress. So companies are likely to prevail against *those* claims. So don't bother going down that road — because it's preempted by the warning labels.

But that's an argument the judge in Illinois distinguished by saying, "Hold on. These aren't 'failure to warn' claims. These are consumer fraud claims. And the descriptors gratuitously placed on the packs which said, 'Lights' and 'Low tar and nicotine' are consumer fraud — and the company knew it. And the class as a matter of judicial record *all* believed that 'Light' meant 'healthy'."

Therefore, the judge took it as a matter of record — because it wasn't determined by a jury to be reasonable — for people to believe that "Light" meant "healthy". The judge presumably just relied on an expert witness, Cialdini — who wrote the book Influence — who attested to the judge's satisfaction that anybody who read the word "Light" would have relied upon it to mean "healthy".

OID: Incredible.

Russo: And it doesn't stop there. There are a couple of other wrinkles. The company in its defense on the merits of a consumer fraud case has said, "You have to show efforts on our part to affirmatively defraud the consumer. We never went out and said *anything* about Light being healthy. The only people who were in the marketplace during that time saying that lower tar and nicotine meant healthier was the government."

[Editor's note: We understand Philip Morris protested against the procedures the federal government mandated to be used to test for levels of tar and nicotine at the time.]

Russo: In fact, a body of the international health community in Europe even recently released a pronunciation that said, "If you have to smoke, smoke low tar and nicotine cigarettes because they're less harmful."

That was just pronounced in Europe — as it was in the past in the U.S. The cigarette companies said, "Low tar and nicotine" because, by federally-mandated testing standards,

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SEMPER VIC PARTNERS'
TOM RUSSO
(cont'd from preceding page)

those products were, in fact, lower in tar and nicotine.

OID: But because they called them "Lights"...

Russo: Exactly. "Lights" were also less full flavored — and they were in a lighter colored pack — yellow, not red. And the company points out that they didn't take affirmative steps as a company — such as claiming the products were less hazardous — to defraud the consumer.

However, according to Cialdini, because the company called them "Lights", every single consumer, with *certainty*, was deceived. So the judge said, "That sounds good to me. I like your experts better than the company's experts. Therefore, I assume that Cialdini is right."

OID: Wow.

Russo: And mind you, the court reached that verdict not before a jury — not after a review of the facts by a body of the public who's charged normally with the duty of assessing whether or not it's reasonable to rely on such statements. Rather, the court simply relied on the testimony of the plaintiffs' experts.

OID: So you think Philip Morris USA's case is solid.

Russo: I think it's *very* solid — because they didn't deliver a message beyond saying "Light" and "Low in tar". The government was actually in the market with suggestions that lower tar and nicotine was preferable. That's why filtered cigarettes were considered an improvement to non-filtered cigarettes. So they believe that they'll win on their conduct.

OID: Plus, if using the word "Light" in the name exposes PM USA to liability, can you imagine the exposure of every company that's used the words "diet" or "low fat" or "light" in the name of its products? It fails the reasonableness test — and it fails it quite badly.

Russo: It really does.

AND PM USA SHOULD WIN BASED ON PREEMPTION — GIVEN THE FEDERALLY MANDATED WARNING LABEL.

OID: And very few food and beverage products have a warning label.

Russo: Absolutely. Again, that's the other reason why the company believes they'll prevail. They believe they'll win based on "preemption" — the Supreme Court's statement that the warning label is sufficient — notwithstanding the distinction that the judge makes between consumer fraud versus "failure to warn".

[Editor's note: Here's some of what Philip Morris USA's VP and Associate General Counsel William Ohlemeyer had to say on the subject in an April 14th conference call:

"...It is impossible to reconcile the decision in the case and the claim in the case with the Federal Cigarette Labeling and Advertising Act and the Supreme Court's decision interpreting the effect of that act on state law judges and state law juries. In this claim, the class says two things: First, 'We were misled or unaware of the health risks of smoking Marlboro Lights' or, second, 'We didn't know that if we smoked Marlboro Lights, we might get more or less tar and nicotine than the FTC test method says the cigarette will deliver when it's tested in that fashion.'

"But the U.S. Supreme Court has made it very clear that Congress has decided that it and only it should write the language of health warnings on cigarette packages. Congress had to make a balance between uniformity and consistency and informing people of the risks of smoking. And Congress has decided that after 1969, you should put a health warning on cigarettes that says, 'Smoking causes cancer.'

"They've decided that that warning is adequate as a matter of law to fully inform people of the risks of smoking. And the Supreme Court has said on three occasions — including as recently as last summer — that no state court judge and no state court jury can substitute their judgement for that of Congress on the issue, and that you cannot hold the company liable for failing to provide an additional, or a more clearly stated, warning on a cigarette package.

"And every package of Marlboro Lights ever sold had a health warning on it that said, 'Cigarette smoking can cause cancer.' It was the same warning on Marlboro Full Flavor, Marlboro Medium, Marlboro Ultra Light and any other brand of cigarettes. So what this case really is, and what this judgement really is, is a determination that Philip Morris USA should have said *more* than that. But these cigarettes were never sold before 1971. So they've always been subject to this preemptive effect of the Labeling Act.

"Therefore, I think it's a pretty simple, but compelling example of what we will ask the appellate court to do and how strongly we feel about our position — because there are state and federal courts all over the country that have very clearly accepted, acknowledged and observed that rule. And this judge *didn't*."]

OID: You say that that's what the company thinks. What do you think?

Russo: I *agree* — because at the end of the day, it stretches belief to say to someone that a cigarette pack that had a warning that says, "Smoking causes lung cancer, heart disease, emphysema and may complicate pregnancy" wasn't already *telling* the consumer that the product was harmful.

Again, what's the element of fraud if the warning label indicates that the product will kill you?

OID: That they didn't warn smokers that cigarettes would stain their teeth and give them bad breath?

Russo: That's about it. And if on appeal, they can establish that they had entered into no affirmative conduct in pursuit of the fraud independent of labeling a product...

OID: And/or that punitive damages were barred by the Master Settlement Agreement with the states...

Russo: Oh, yes. Even though that issue hasn't really been contested in the courts yet, I believe the MSA *will* be deemed by the courts to eliminate the punitive side.

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SEMPER VIC PARTNERS'
TOM RUSSO
(cont'd from preceding page)

BASED ON ILLINOIS SUPREME COURT PRECEDENT, CLASS ACTION STATUS ISN'T LIKELY TO BE UPHELD.

Russo: Also, there's no evidence *anyone* specifically *relied* on the name.

OID: Which also gets us to the issue of certification of the lawsuit as a class action.

Russo: That's right. And the company believes that the Illinois Supreme Court, in an opinion called Oliveira, has already determined that class action is inappropriate for a case like this.

[Editor's note: Here's some of what Ohlemeyer had to say regarding the unsuitability of the Price/Miles case for class action treatment from that same conference call:

"For all of the reasons state and federal courts have refused to certify cigarette and fraud cases against tobacco companies as class actions ... a compelling argument can be made that this case shouldn't have been certified as a class action.... The recent Illinois Supreme Court decision in the Oliveira Case is a very clear *example* of why we think this case should not have been certified as a class action — because essentially what it allowed the plaintiffs to do was to *assume* that everybody who purchased these cigarettes was somehow misled or defrauded. And that is not what the law requires you to prove in order to establish a claim under this statute.

"So we think the issue of proximate cause and reliance is one the Illinois Supreme Court's dealt with very recently and very clearly. And we think that when you apply that reasoning to this case, the judge allowed this case to proceed as a class action and created a situation in which it would be *impossible* to prove — in fact, it was *not* proven — the thing the law requires the plaintiffs' lawyers to prove in order to prove fraud in a case like this."]

OID: And I gather you agree.

Russo: That makes sense to me. It sounds like it's a relevant precedent. But ironically, Judge Byron cites Oliveira as the reason why the class *should* be certified.

OID: Fascinating.

Russo: But I believe that's just a tactic you engage in if you know something is harmful to your case: You bring it into your own brief rather than ignore it — because you want to somehow say, "We understand that Oliveira stands for our principle when Philip Morris USA says it stands for just the opposite." So I don't have an answer to that.

Based on the force of Philip Morris USA's argument, probably even in consumer fraud, I suspect it does require that the plaintiffs show that the consumer specifically relied on material misrepresentations that were affirmatively made by the companies. Such specific proof of individual reliance violates class actions' requirement that common issues predominate over individual issues.

However, that's a very hard case for the plaintiffs to argue, I think, because of the absence of affirmative steps — other than the descriptors on the box.

OID: I'll take that to mean that you agree with Philip Morris USA's position.

Russo: I do. Basically, what the company has said is that class action is reserved for those events where an act takes place on people without contribution on their part. So the facts of each and every case of harm are the same. If a bridge collapses and there are 7,500 people underneath it, they may have all been hit the same way. If there isn't any argument about whether or not they were all crushed under the weight of the fallen bridge, you can consolidate because it's more judicially expedient and it doesn't deprive the defendants of their right in court.

On the other hand, due process requires that in order to satisfy a cause of action that depends upon reasonable reliance, the accused has a right to defend the reasonableness of the reliance.

And it's very hard for me to imagine that requirement being satisfied by having Cialdini say that in his opinion, it's *certain* that everybody who read it understood it to mean "healthy" — and since it *wasn't* healthy, it's a fraud.

OID: Yeah. Frankly, I think it borders on the absurd.

Russo: That's how *I* react.

[Editor's note: Here's how Philip Morris USA's Ohlemeyer described it in his April 14th conference call:

"The law doesn't allow you to aggregate claims unless the issues that give rise to liability are common and predominate in the group of people bringing the lawsuit.... To the contrary, in *these* cases, especially cases involving fraud and personal injury, it's impossible to treat groups of people identically — because the issues that give rise to liability are not the question of whether smoking causes cancer or even the question of whether a cigarette company lied or told the truth. The question that gives rise to liability *has* to involve an analysis of what the individual smoker knew about the risks of smoking, what brand of cigarettes [each smoked,] what advertisements each saw, what his or her health history and employment history looked like, etc.

"So courts have concluded that you can't fairly try tobacco cases as class action lawsuits because if you do, you prevent the defendant from defending himself — because the issues that give rise to liability have to be examined on an individual-by-individual basis...."]

Russo: Plus, there's an interesting wrinkle in terms of PM USA's obligation under the Consumer Fraud Act — because you could say that the consumer is entitled to the amount of money they put up over those years. But even assuming that they lost on every count in Illinois, only about 20% of the price that was paid by consumers went to the companies. When a customer paid for their cigarettes over the years, they were paying state and federal excise taxes and state sales taxes. So the state is obligated to make Philip Morris whole. Also, the retailers got a spread, as did the wholesalers. So all those players would be deemed to be involved with the fraud, too — and therefore be asked to participate in the payment.

So Philip Morris might be liable for the payment. But they in turn have a cause of action that they should be able to enforce against others who received their share of those revenues. And their net revenues were not *remotely*

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SEMPER VIC PARTNERS'
TOM RUSSO
(cont'd from preceding page)

$7 billion. While that may have been what the consumer paid, it's not what Philip Morris got. So Philip Morris USA would be entitled to significant reimbursement from the other participants.

OID: And so Philip Morris USA might only be liable for something like 20% of that $7 billion...

Russo: At *worst*. But again, I think the entire *case* is without legal basis — and very clearly so.

OID: Well, so much for what you say is the #1 fear.

[Editor's note: See page 50 for an update on this case as we were going to press.]

ENGLE IS JUST *SO* REVERSIBLE — AND FOR A *VARIETY* OF REASONS.

OID: One risk down, how many to go?

Russo: I've lost count. But the record across the country at the federal circuit and district court level is to deny class action certification in tobacco-related cases. Tobacco cases that allege harm have almost *always* been denied certification — even within New York State. All over the country that's happened — with *very* few exceptions.

However, one of those exceptions, notably, is Engle. And there, every Wednesday, we await a decision from the appellate court in Florida to make sense of that case — where the class has already been awarded $140 *billion* of punitive damages even though compensatory damages haven't been determined yet.

And unfortunately for people who'd have liked to have been *supported* on appeal, as they awaited that ruling, the U.S. Supreme Court came out with a very forceful decision [State Farm v. Campbell] that established the requirement that punitives can't exist independent of compensatory damages and that punitives have to bear some relationship to actual harm.

Well, what could be *more* violative of State Farm than Engle — where, once again, the punitive damages were awarded in *advance*. How could they be in a reasonable relationship to compensatory damages where compensatory damages don't even *exist*?

OID: Sounds like a no-brainer, all right.

Russo: But the judge didn't let that stop him from creating punitive damages of $140 billion. So it's completely backwards and upside down.

OID: So you don't believe that Engle is likely to withstand judicial scrutiny on appeal either?

Russo: I don't see how it can. It's just *so* reversible — and for a *variety* of reasons.

OID: And you've given us a couple of those reasons. Might you give us a couple more?

Russo: I'll give you three. First, as the company says, class actions work really well when there's been a single event — like an airplane crash or a Bopal-style disaster — that affected a certain body of people in a similar fashion. However, once you move away from there into something like smoking where most smokers in the class probably started smoking in a different jurisdiction, you wind up with choice of law issues. Different smokers relied upon representations differently. They assumed different risks. They smoked differently. And they have different ailments. So class actions don't work.

You can't consolidate a class when at the core of every claim is individual harm. And that's what was done in that case. Each person has specific health conditions. Each has different awareness of the risks. That's at the heart of assumption of the risk and duty to warn fulfillment. And that's how defendants are entitled to defend themselves — to contend that plaintiffs were not only warned, but that they assumed the risk.

And defendants are entitled to contend that they may not have even been *harmed* by the defendants — that there may have been other extenuating factors. They're entitled to raise those points in their defense. And to prevent a defendant from doing so, no matter how much it may have been vilified, clearly violates due process.

OID: That seems pretty obvious on its face.

Russo: I think so. I think it's clear that the plaintiffs in Engle should not constitute a class. Certainly, it would be a form of convenience, but not a class.

OID: And our legal system doesn't allow convenience at the expense of due process.

Russo: Exactly.

ENGLE IS *VERY* UNLIKELY TO WITHSTAND APPEAL — AT LEAST ONCE IT LEAVES THE FLORIDA COURTS.

Russo: Furthermore, the judge who heard Engle was a Florida smoker. So he was a *member* of the class.

OID: That sounds like a definite no-no.

Russo: You bet. So there's conflict at the heart of the judge's decision not to recuse himself.

And third, an extraordinary amount of racial baiting was allowed by the bench. So there are procedural points on review.

However, as you may know, the Florida court system is not very satisfying...

OID: As demonstrated in Gore v. Bush.

Russo: Of course. There could be no better instance than to watch the Florida Supreme Court work its way through the Presidential election.

OID: Yeah. It was obvious that even the chief justice of the Florida Supreme Court was embarrassed by that remarkable display of torturing the law.

Russo: It was *very*, *very* disheartening.

OID: Almost as disheartening as watching every member of the United States Supreme Court vote along the lines of the party that appointed 'em to the Court

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SEMPER VIC PARTNERS'
TOM RUSSO
(cont'd from preceding page)

— except for Stealth Justice Souter.

Russo: But they ultimately did the right thing. The Constitution compelled the U.S. Supreme Court to act even though it appeared to some that they were intruding on the core sovereignty of the states. Florida didn't establish and abide by election rules.

The states are permitted very significant discretion on how they conduct their elections. However, one caveat is that they have to announce rules of the election in advance that are clear and *adhere* to them. And they *violated* that.

OID: Picky, picky, picky.

Russo: It's really as simple as that. All the garbage about state jurisdiction and all of that falls away when you just cut to the chase — which is that there were deadlines that were exceeded badly and changing standards of what constituted a vote throughout. End of discussion.

OID: I couldn't agree more.

Russo: And to think that Florida Supreme Court is the court that could wind up hearing this case on appeal... However, again, the U.S. Supreme Court in State Farm v. Campbell has ruled in a way that compromises the very core of Engle. Understand, though, that in this action, the attorney carved out a $500 million escrow account which he'll basically profit from even if it's lost on appeal. That was what they agreed to in Engle.

OID: What a great racket.

Russo: That's what the judge and attorney, I'm sure, were angling for in Illinois, too — because by slapping that enormous bond requirement on PM USA and awarding a $1.7 billion "fair take" to the plaintiffs' attorney, they set up the arguments in advance over settlement. Then, when the judge wouldn't bend on the bond, you can imagine what the discussions were: "Well, how much do we have to put in escrow that the attorney can get in order to get the attorney's approval to reduce or waive the bond?" And you know that number was *large* — because it was measured against the $1.7 billion that the plaintiffs' attorney was said to be entitled to.

OID: And they say extortion is illegal. Amazing.

Russo: Exactly. Legal extortion is *exactly* what it is. And it *is* amazing.

COURT PROCEEDINGS WERE FULL OF RACE BAITING.
THIS GUY WROTE THE BOOK ON IT — LITERALLY.

OID: Speaking of amazing, I'm amazed at the depth of knowledge required to try to intelligently assess this idea. Just the legal stuff alone...

Russo: I hear you. But those are the rejoinders to the casual observer who says, "But because of Illinois, Light cigarette suits are going to go all around the world." You can say, "Well, that doesn't make any sense." However, you've got to know the reasons *why* it doesn't.

OID: Absolutely. But do you think we could get continuing education credits towards a law degree?

Russo: You *deserve* it.

OID: Although, based on what I've read in some of those briefs... I suspect that I already know more about the law, frankly, than the judge in Engle. It reads like a cheap shakedown.

Russo: Oh, it's *unbelievable*. If you really want to have a good laugh (or maybe a good cry) read a transcript of the court proceedings. It's just full of racial baiting. The jury was largely non-white. So the plaintiffs' attorney said (and I'm paraphrasing), "Dare to set new law." This was a case about smoking. And it should have been about the application of conduct within the *existing* law. But he said, "*Forget* about existing law. If people concerned themselves with existing law, then Rosa Parks would still be at the back of the bus. *She* dared to be great. You as a jury should dare to punish — dare to be great."

OID: Unbelievable.

Russo: And that was duly noted by Philip Morris USA and objected to as racial baiting. But the judge didn't do anything about it. And I'm not exaggerating when I say that the entire record of that case is *full* of things like that.

[Editor's note: Russo isn't just whistling Dixie. Here are some quotes from the plaintiffs' attorney at that trial which we excerpted from court materials:

- "Let's tell the truth about the law, before we all get teary-eyed about the law. Historically, the law's been used as an instrument of oppression and exploitation."
- "[The defendants say:] 'It's a legal product. It's a legal product.' [Well,] legal don't make it right. Legal don't make it right."
- "...Look back in history. The whole civil rights movement of the '60s was fighting against unjust laws."
- "In this building, in this building, a temple to the law, they were — there were drinking fountains which said 'Whites Only'. I tell my kid about that. He said: 'How did you put up with this, Daddy?' "
- "[L]egal is a very relative term" and "[T]he only moral, ethical, religious decent judgement to make [is that defendants] should have [gotten] out of the business, and they should be punished for not doing so."

And lest you imagine such comments may have been inadvertent, according to PM USA's attorneys: "Indeed, plaintiffs' counsel explicitly admitted that such appeals have an incurable effect, in his book *Murder of Mercy*.... Rosenblatt admitted that the script he laid out in his book, which he followed almost verbatim here, is specifically designed to achieve jury nullification and is incurably prejudicial even in the face of curative instructions: 'Days or weeks later, when the jurors are deliberating their verdict, how can they be expected to forget those statements that they allegedly didn't hear?' No court can 'unring a bell'."]

OID: Not to mention the poor excuse for a trial that seemingly bore little or no resemblance to Florida law or even the road map the judge apparently established at the beginning of the trial. I can't imagine the Supreme Court letting that one stand.

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SEMPER VIC PARTNERS'
TOM RUSSO
(cont'd from preceding page)

Russo: Neither can I. It was quite offensive.

AND JUSTICE DEPARTMENT LAWSUIT'S BEEN CRIPPLED. JUDGE WILL LIKELY THROW WHAT'S LEFT OF IT OUT.

OID: What about the Justice Department lawsuit?

Russo: That one's pretty straightforward. There were three causes of action — two of which were substantive. And both of those were thrown out by the judge.

The third cause of action was a RICO action.

OID: Hasn't that law traditionally been used against organized crime?

Russo: Yeah — it's a conspiracy theory law. It was used against Michael Milken. It's used against any entity that the government feels that they need extra leverage against in their core case in order to bring it to court.

But in this case, both aspects of the court case have been thrown out by the judge. So you have a RICO action standing independent of any cause of action. And that's so peculiar that the industry believes it can't stand — because the only thing that's left is the RICO action that, in point of fact, is intended to enable a more forceful pursuit of the actual causes of action. But both causes have already been thrown out of court.

OID: And do you agree that it can't stand?

Russo: I do. The remedy of a RICO action is that you're forced to return ill-gotten gains that arose from a fraud — gains which society fears will be used to commit fraud in the *future*. That's the term. RICO is extraordinarily powerful. It denies the defendant all *sorts* of civil liberties. And the reason why you're allowed to impose such a powerful weapon against a defendant in a case is just what I described — to extract ill-gotten gains that resulted from fraud that would surely be applied to committing fraud in the future.

In this case, they still have to somehow have a proceeding that proves that fraud in fact took place. And absent that, which isn't part of the hearing, there's no way that they can establish a RICO damage.

OID: Gotcha.

Russo: Therefore, the company believes, and I agree, that ultimately the Justice case is likely to go away, that the judge is likely to throw it out, because RICO won't reward them without proof of the existence of an initial fraud or the threat of an ongoing fraud — especially the *ongoing* fraud. And how anyone would ever prove that after all of these settlements is totally beyond me.

OID: I understand that the judge in that case is skeptical about it having sufficient basis, too.

Russo: That's my understanding as well.

OID: And some speculate that she could throw it out prior to it coming to trial in September 2004.

Russo: That's what *I* think is most likely, too. The DOJ case has been so carved out that the company is going to appeal for summary judgement in that case in September. And we should learn this year whether they receive favorable review by the judge in that case. But again, at worst, they're left with a RICO claim that really can't exist independent of the core causes of action — both of which have already been dropped.

ASBESTOS-RELATED LAWSUITS AGAINST TOBACCO? SO FAR, THEY'VE PREVAILED NOWHERE AT *ALL*.

OID: What about asbestos-related litigation? One of our most savvy contributors has suggested to us that he believes that litigation alone is very likely to bankrupt the cigarette companies.

Russo: Well, so far, those suits haven't prevailed *anywhere*.

OID: Why do you think that is?

Russo: I don't really know. I would guess that it's a problem of establishing proximate causation.

OID: So plaintiffs, whether individuals or companies which have paid out damages to individuals, would have to establish that the harm resulted from smoking and that the harmed individual was not warned, etc.

Russo: That's right. And again, that's been a successful defense to date. That's also been a defense that's worked because the asbestos bar has heretofore had enough fat targets to go after purely on a straight up asbestos claim. So as they go after increasingly remote participants in asbestos, they will likely come back more forcefully against tobacco later on. But it hasn't happened to date.

OID: To what degree is that a risk in your view?

Russo: Because they've failed to date on issues of proximate causation, I've felt that it's a lesser risk. So frankly, I haven't been concerned about it.

Incidentally, asbestos causes a disease that lends itself to class because everyone has the same reaction. And it's far more recoverable. There've been thousands of people who have been able to recover on asbestos-related claims — because it has very direct, knowable outcomes.

By contrast, we know from experience that the odds of the person who sues for smoking-related harm succeeding are *low*. Only a dozen-or-so cases have prevailed at trial...

OID: Out of...

Russo: Out of *thousands* of attempts — with the usual result being that they're thrown out of court on a summary judgement basis. What the court generally says is, "You were warned. You assumed the risk. Go away." That's the standard response.

To the extent it's been anything beyond that, it's been, "You were warned. You assumed the risk. And by the way, it's not clear that was the only cause of your ailment. Go away."

So I don't think simply by lumping it in with something that's known to be far more toxic anyhow increases the odds of success against tobacco companies. But that's a fair

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SEMPER VIC PARTNERS'
TOM RUSSO
(cont'd from preceding page)

question. I'm going to dust off that conjugative risk, think about it further and maybe talk to the company just to make sure that I'm up to date there. However, that's my feeling.

LEGAL OUTLOOK ISN'T DETERIORATING. INDEED, IT MAY EVEN BE *IMPROVING*.

Russo: So I think that there'll always be fears about the next Miles/Price case. But in actuality, the threat from private litigation's been constrained because of State Farm. And the industry's recent record of cases won is quite good. Hundreds of cases have been thrown out. And they've won eight out of the last nine that went to a verdict. So already, their experience has been increasingly favorable.

OID: And I gather the company's record on appeal has, if anything, been even better.

Russo: Up until recently, Philip Morris has had relatively little experience in the appeals courts — because it's been so rare for them to *lose*.

[Editor's note: We believe it was Merrill Lynch senior tobacco and beverage analyst Martin Feldman who recently observed that only one case against cigarette companies awarding monetary damages to the plaintiff(s) had ever survived through the full trial and appellate process.]

Russo: And then, on top of that, when you layer the diminished prospects for outsized punitives, you start to slow down that litigation calendar even *more*.

OID: Very interesting. And yet it could scarcely be more of a contrary opinion.

Russo: That's exactly right. And class actions? Well, that's one of the biggest fears right now. But the record is that something like 38 attempts to certify class action lawsuits in tobacco have been defeated — 38 different attempts — at the state and federal level in locales that include New York, Florida, West Virginia and Illinois.

OID: How many have been successfully certified?

Russo: Florida, Illinois, West Virginia and maybe Louisiana have been venues where plaintiffs have gotten cases certified as class actions. However, they've failed to get class action certification in eight of 11 "Lights" cases. And the only "Lights" case to receive certification where Philip Morris doesn't have the right of interlocutory appeal was Price/Miles in Illinois. In two other states — Florida and Massachusetts — the certifications for "Lights" suits are being appealed.

And in the class action world, new novel claims and old harmful health claims have generally been dismissed — at least they've been dismissed 35 times so far. So the fact that there's a fear of class actions proliferating based on "Lights" would clearly go against the record.

[Editor's note: Philip Morris USA's Bill Ohlemeyer said the same thing regarding the Price case on an April 14th conference call:

"[S]ome people suggest that this claim or this situation is the beginning of some new frontier in litigation. And I would tell you that this was a considered judgement on the part of the plaintiffs' lawyers to bring this case in the one place in the country where they thought they had the best chance of getting a class certified, avoiding an appellate court and getting a judge-tried case in which a judge would *agree* with 'em. I think it would be very difficult to reproduce all of that somewhere else and then find a judge who would ignore the law....

"We actually had a summary judgement decision last year from a trial court judge in California in which he basically said in dismissing a class action brought under the State Business Practices Act that there's nothing at *all* misleading about selling Light cigarettes so long as you put a federal health warning on 'em. (That's the Daniels case that was dismissed on summary judgement.)

"As they used to say in law school, anybody can sue. The real issue is whether they have a cause of action or whether it's one that will survive scrutiny on the law and the facts. I think you will see *fewer* of these kinds of cases, not more, get as far as this one did."]

WILL AMERICAN-STYLE TORT LAW SPREAD OVERSEAS? FRANKLY, I CAN'T IMAGINE *HAVING* A WORLD LIKE THAT.

OID: What about the FCTC — the Framework Convention on Tobacco Control? Couldn't that treaty turn the legal environment in international markets into an environment just as harsh as that in the U.S., if not worse?

Russo: I don't think so. For example, if one of the issues is the extension globally of American-style tort law, that just can't happen.

OID: Why do you say that?

Russo: Because it would violate local sovereignty and local judicial systems. And the nations that would have to be most opposed on that issue because it would contradict their legal system would be France and England. I say that because the French don't *have* a system of tort law. They have a code-based system. So they *can't* sign on.

And England doesn't have a system of contingency fee rewards either. That's not part of their culture. They have a culture of loser pays in litigation because they don't want to tie up scarce and important state resources of justice. So if you lose the case that you bring, you pay for court costs and your opponent's costs.

And so if the FCTC supposedly allows someone to sue on a contingency basis and not to pay if they lose, well, that just violates the English system.

OID: And yet I read recently about the only thing preventing international acceptance of the latest draft of the FCTC is President Bush.

Russo: That's just propaganda from an anti-smoking group. Take my word for it — there's no *way* that America is standing alone against the FCTC. I can't imagine it — because on its face, it's so violative and invasive of sovereignty of important legal ground. It just wouldn't make any sense. Now if you're talking about Albania or

(continued on next page)

SEMPER VIC PARTNERS'
TOM RUSSO
(cont'd from preceding page)

some place like that, then for political reasons, yeah — maybe they would sign on. But they're not giving up anything. They don't already possess a developed, embedded legal system of standing.

OID: Couldn't plaintiffs' attorneys just shop for those random venues — the equivalent of litigation mills run amok in the U.S. like Madison County, Illinois — and make off with similar mega-billion dollar verdicts?

Russo: Theoretically, yes. But there's no history of anything like that happening. And I just think that's a very remote possibility.

Also, even if such an award *were* to occur, any resulting award would probably be relatively small. And in any case, it's hard for me to imagine such a liability not being contained within the borders of that country.

OID: I understand that one of the draft proposals — if not the final one — included the phrase "to put an end to tobacco use in any form".

Russo: That's OK. They could do that. And they *may* do it. That's always an option. But even in that case, there's at *least* $15 per share worth of value in Kraft Foods net of Altria's debt — arguably $20 or more — and another $3 or thereabouts per share of non-tobacco related assets. So even *that* wouldn't be a total disaster.

On the other hand, if that means we're in a world where there's the ability to sue in every nation under increasingly uncertain standards for outcomes like those so far in Southern California or Madison County, Illinois, then there's not $15-20 left in the company, it's *zero* — because that would mean that there would be nations around the world with loose standards suing for legal acts, for the sale of a legal product sold legally.

And frankly, I can't imagine *having* a world like that. My view just doesn't encompass that possibility.

OID: You give the world more credit than that?

Russo: It's partly that. Plus I have a belief in the proper roles of different branches of government to hear these issues out and come up with what each country wishes to do with its own health and social policies.

The business climate will probably worsen over time. However, the business — well regulated, well controlled and well supervised — will still be a reasonable business.

OID: I've also read that certain provisions of the FCTC would be clearly unconstitutional. I guess that's another way of saying the same thing.

Russo: Exactly. So the ability of plaintiffs' attorneys to pursue contingency fee-based, class action lawsuits in other countries is a stretch — at least in my opinion — because those countries have proud legal traditions that don't allow contingency fees or class actions.

So those are the major legal issues. And whatever the rating agencies may say, I think the record backs up the company when they say the legal outlook isn't deteriorating — that, indeed, it may be *improving*.

[Editor's note: That said, Russo's not kidding when he says that we've talked about "the *major* legal issues" — because it looks to us like there are at least half a dozen or so *other* categories of lawsuits facing the company, although the ones Russo addresses do appear to be far and away the ones most observers are most concerned about.]

I'VE SEEN THIS KIND OF MARKET INSTABILITY BEFORE — AND ORDER ALWAYS WINDS UP BEING RESTORED.

Russo: And after legal fears, the #2 issue has been dismay associated with RJR's recent announcement that their business had seen its profits drop from $270 million, I think, to $70 million — some enormous collapse. Essentially, the market's extrapolating RJR's disappointing first quarter results to a permanent destruction of a once profitable market because of the industry's inability to bring back pricing discipline.

OID: And you don't think that's appropriate.

Russo: I actually read those numbers as evidence of Philip Morris' program having its intended effect — which is to take back the business they were losing because they weren't fully engaging in response to competitive activity. To me, it's evidence that they've taken that lesson to heart and are doing something about it.

So I think RJR's problems, which the equity market took poorly, are relatively company specific. In fact, they're in large measure *caused* by Philip Morris. The decline in Philip Morris USA's earnings, given their position in the premium market, is primarily a reflection of their aggressive efforts to restore discipline in the marketplace — of the investments that they're making against the discounters. In my view, it's a difficult time because of important steps they're taking to restore order in a market that became dislodged as a result of sharp, dramatic changes in price that have onetime impacts.

Whatever channels the discounters are using today, it's an unsustainable chapter in the industry's history that simply won't last.

OID: You say that with such conviction.

Russo: That's because it's the same thing that's happened around the world over time. About 12 years ago, we talked about Rothman's of Canada.

[Editor's note: See our July 1, 1991 edition.]

Russo: It was a market that was very much like the U.S. market today where the prices had gone up a lot and the bottom was falling out of the demand because people had restrictions against workplace smoking — basically all of the things that we're going through. And Rothman's was able to conduct its business well throughout that period of diminished opportunities. It's just that they had to discipline and adjust the market.

OID: Given that you're holding Canada out as an indication of what's likely to happen here in the U.S., could you give us some idea of what's happened to excise taxes, cigarette prices and consumption in Canada since you told us about it in 1991?

Russo: They stabilized at the end of the day. They

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SEMPER VIC PARTNERS'
TOM RUSSO
(cont'd from preceding page)

continued to bounce around from province to province. The provinces took taxes to such a high level that they just had enormous smuggling and cross border conduct. But at the end of the day, I think they had to pull back from some of the provincially imposed taxes that led to this outcome. So the rate of increase has slowed down.

OID: But they're still increasing...

Russo: Yes. But not nearly at the same kind of rate.

OID: How much does it look like it impacted the incidence of smoking?

Russo: I'd estimate that unit sales of cigarettes in Canada 10 years later are probably down a little over 40% — or slightly over 5% per year.

[Editor's note: Based on the recent testimony of a panelist before a House subcommittee, the decline in cigarette smoking in Canada accelerated the last two years — to something closer to 10% per year.]

OID: In the context of what kind of price increases?

Russo: I don't have a good answer. I'd guess that the retail prices have gone up something like three-fold.

OID: Very interesting. But what about pricing to the manufacturers — and their profitability — during that same period?

Russo: I can't quote you precise figures. But I recall that during this entire period of time, Rothman's was able to sustain its profitability.

[Editor's note: Ditto for the largest player in Canada during that time — which we understand was Imasco.]

OID: Since you mention Canada as an indicator of what might happen here, how expensive are cigarettes today in Canada?

Russo: Right now, I would guess that a pack of cigarettes in Canada might be around C$7.00 — which would be something around US$4.75. By comparison, before Philip Morris' latest round of promotions, cigarettes in the U.S. were selling for about $4.15.

So we've seen that kind of disruption before. And that combination of competitive steps, branding, governmental intervention and taxation on the entire spectrum of products always ends up with order being restored.

So I think the Canadian experience is a good analogy. In fact, I've also seen Philip Morris do the same thing in Germany, France, England and elsewhere. And I expect to witness that same kind of pattern here in the U.S. market.

OID: So that you basically just count on Philip Morris to do intelligent things on pricing.

Russo: You bet.

COMPANIES AREN'T ALONE IN WANTING STABILITY. GOVERNMENT AND HEALTH AUTHORITIES DO, TOO.

Russo: Just as an anecdote, in terms of *why* the U.S. market will improve, there are a *tremendous* number of parties interested in that outcome — including health bodies who want more expensive, not cheaper, cigarettes, and state and federal taxing agencies who want to make sure the low end doesn't enjoy tax-free products via smuggling or inter-jurisdictional transactions. The health community is interested in seeing higher prices — because people smoke less when they pay more. So having cigarettes available at $2.20 instead of $3.50 or $4.15 is disruptive to their interests. Therefore, those players will do what they can to help increase the incidence of taxes on the low end.

OID: That makes sense.

Russo: Also, as the migration takes place from premium cigarettes to the low end, up to $1.70 per pack of taxes *disappears* — 60+ cents of Master Settlement Agreement [MSA] payments, 70¢ or so of excise taxes to the states, and 39¢ of excise taxes to the federal government.

OID: Why do the taxes disappear?

Russo: Well, at the *very* lowest end, they're *completely* ex-tax because they're smuggled and illegal.

OID: That would certainly explain it.

Russo: So it may look like a good deal to the smoker at $2.20. If they're not paying $1.70 of taxes, of course, it's going to be compelling for someone to deliver it for $2.20 to the consumer.

OID: However, I gather that you think the government might frown on that practice.

Russo: Given that the government's total take through all layers is about $45 billion per year, I'd say so.

OID: Any rough guesstimate of the industry's profits?

Russo: I would guess $5 billion max this year — for operating income. That's $3 billion± for Philip Morris USA, probably $900 million for The Carolina Group and then another $1.1 billion scattered among the other players.

OID: So the government has become what amounts to the senior financial partner. And it ain't even close.

Russo: That's right. So there's enormous interest on the part of governments to make sure that this business doesn't dissolve as a result of low-end competitive activity — because their revenues are at risk at a time when budgets are extremely tight. And I think that shows the commitment on the part of a number of third parties to this cause of restoring U.S. market stability.

OID: Absolutely. And the most important thing there, I gather, is reestablishing a reasonable price differential between the premium brands and the discounters and deep discounters.

Russo: Closing the gap. Yeah. And the way the industry does that is by forcing players on the low end to pay their applicable excise taxes as well as their obligations due under the Master Settlement Agreement via litigation, by going after retailers who are trafficking in counterfeit and grey-market goods and by asking the government to shut down their internet sites.

And the industry also closes the gap via promotions on the high end. For example, I understand PM USA is

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SEMPER VIC PARTNERS'
TOM RUSSO
(cont'd from preceding page)

going to spend $5 billion this year on price givebacks just to promote Philip Morris products.

OID: Sounds like quite some promotion.

Russo: Yeah. That promotion will take the price down 75¢ per pack from around $4.15 to about $3.40. And again, the low end's at $2.20 or thereabouts. Today, it's basically a three-tier market — the high end at $3.40, the mid-tier segment at $3.25 and finally the low end at something like $2.20.

So the price difference barely exceeds 50% — which is the threshold that the industry believes induces switching from brands that the consumer would otherwise rather have to brands that they will accept because of the price differential.

OID: You say that's what the industry thinks...

Russo: And I agree. I think that today's retail price spread after promotions should be low enough to slow down the share growth in the low end and even to enable the premium segment to *reclaim* share.

DON'T EXTRAPOLATE RJR'S DIFFICULTIES TOO FAR. THEY'RE MORE REFLECTIVE OF PM USA'S *SUCCESS*.

Russo: In my opinion, those observers who worry about the collapse of the domestic business based on RJR's recent results fail to recognize its special situation. RJR is *far* more exposed to the low end. They're 60% exposed to the middle and low end. By comparison, PM USA has 85% exposure to the *high* end. That's why RJR felt the impact of the discounters so much more forcefully than PM USA did.

So RJR just doesn't have the resources that it takes to compete. For example, they aren't able to promote as broadly as Philip Morris. In many markets — in fact, in fully 15% of the U.S. — they're not promoting products at *all* today. Therefore, in those places, Marlboro goes up against what effectively is RJR's full-priced Camel.

RJR *does* compete more often on the *low* end. But that's where they're losing out to the deep discounters.

OID: When you say Philip Morris USA is promoting, and that RJR is not, in 15% of the U.S., you mean...

Russo: Philip Morris USA is promoting "Off Invoice" throughout the country. So consumers of Philip Morris products are seeing 75¢ off the regular price per pack. RJR can't *afford* to do that. So there are broad sections of the market where they're not discounting. As a result, you see Philip Morris' Marlboro up against RJR's Camel — only with Marlboro at a meaningful discount. I have to believe that that's triggering switching. And that may be at least in part what's behind RJR's recent difficult results.

OID: Makes sense.

Russo: It does — especially when you consider that RJR claims that the market's dropped 8% year over year, whereas both BAT and Philip Morris USA see the market dropping at much slower rates. So to my way of thinking, it's more RJR-specific trouble — which the market is interpreting as being symptomatic of the overall market. But it doesn't seem to apply to BAT, Philip Morris or Lorillard nearly to the same degree.

OID: Very interesting. But why doesn't Philip Morris participate more aggressively in the low end, too?

Russo: Well, they do have Basic in the low end. So they have an offering there. And they are *beginning* to participate in the middle and lower tiers in foreign markets where they've been heavily skewed to the premium end. But that's because it represents incremental volume there.

However, in the U.S., thus far, they've tried to avoid creating products in the low end that would give credibility to that segment and cannibalize their existing sales. Their goal has been to bring the pricing into line sufficiently to *reduce* the low end rather than give legitimacy to it.

OID: And does that strategy make sense to you?

Russo: It does — because I think the low end isn't yet properly bearing its fair share of taxes. So PM USA's efforts are better spent trying to sustain its brands in this period of time and focus on averting brand erosion by supporting the promotion of its core brands — and then lobbying like hell to police the low end so that its costs go way up and those products can't come to market at those prices.

They're basically sustaining the consumer's loyalty to the high end through the promotional process while they work like mad to discipline and eliminate the low end by taking their profits away.

[Editor's note: Subsequently, a story on *Reuters* suggested that Philip Morris USA was strongly considering introducing a brand to compete with offerings from the deep-discount manufacturers. Prudential Securities' tobacco industry analyst Rob Campagnino said that he believes the brand "would be priced at a discount to Basic," Philip Morris USA's main generic cigarette.]

Russo: And a third way Philip Morris USA could stabilize the market would be to engage the FDA in efforts to regulate the industry — because the smaller players couldn't meet the burdens of regulation. For example, they could mandate an audit trail for legally sold products that are FDA inspired and implemented, but which are unable to be complied with by very small manufacturers.

OID: That certainly sounds like it could work.

Russo: I think so. Philip Morris USA's brands are

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SEMPER VIC PARTNERS'
TOM RUSSO
(cont'd from preceding page)

powerful enough that so long as they're able to offer their more coveted brands at a price that isn't *too* much higher than the competitive low-end brands, the consumer should prefer their brands and migrate back. So I'm convinced that Philip Morris USA will succeed in their efforts to restore competitive balance...

OID: And stop their loss of share to the discounters and even begin to increase share.

Russo: Exactly. I'm not saying it's going to be easy — or even that it's going to happen immediately. But you're already *beginning* to see it happen. After all, even though we're still in the period of the most aggressive discounting, PM USA's share of the premium segment has already bounced back from 46% to 47% and then to 48%. And the rate of growth of the low end has already slowed way down. So it's already started to have some effect.

OID: Do you have any sense of what the pricing trend is likely to be going forward — and how close to their former levels prices are likely to wind up once they finally do stabilize?

Russo: I can't tell you that prices will stabilize at 2002 levels — because I don't know that. Basically, I just think they're going to have to titrate their price increases back into the market very slowly — as they see their various efforts sticking. But I think it's very likely that they manage to return the U.S. market to a state of normalcy over, say, the next 18 months. Meanwhile, the stock market seems to believe it's going to take forever — because it seems to be assuming that Philip Morris USA is worthless or that it even has a *negative* value.

SUFFERING FROM ITS CURRENT TOBACCO TAINT, ALTRIA'S WORTH NO MORE THAN $57-58 PER SHARE.

OID: Might we trouble you to break out those values as you see them?

Russo: Well, as I said earlier, Philip Morris USA will probably only earn about $3± billion this year — because they're promoting so heavily. But to give you some idea of its normalized earning power, during the four prior years, that division earned $4 billion, $5 billion, $5.3 billion, and $5.3 billion. And I think its normalized earnings are closer to the historical average of the past four years than to what they're going to earn this year.

OID: I think you've made a pretty good case there.

Russo: That said, it will likely wind up never being as profitable a market as it once was.

OID: You think that's a probability.

Russo: Oh yeah — because the state and federal government and all of the other entities have taken an awful lot of the profit out of the business by virtue of the taxes and the fees that have been applied. Consumer pricing's gone up sharply because of higher state and federal excise taxes.

Also, I don't think their problems will ever go away. It's just that the company will manage those problems. They'll face competition in one form or another from legal or extra-legal channels going forward in a way that will be hard to police. So they'll just have to be more disciplined in their pricing going forward.

OID: But you say that you think Philip Morris USA's normalized earning power is closer to what it earned during each of the past four years than what it's likely to earn this year.

Russo: I think that it will migrate up to that level — yes. But I don't think that it's going to happen right away. I think they can see growth in profitability again — in part just because they achieve more volume at that higher price thanks to eliminating counterfeit brands and the share that's been lost to the lower end.

So if we use $5 billion of operating income, that would equate to about $1.60 of net income per share — assuming an effective tax rate of 35% and 2 billion shares outstanding.

[Editor's note: *Value Line* shows Altria paying an effective tax rate of 40%, not 35%, beginning this year and continuing thereafter. However, we heard the CFO tell analysts that he would use a 35.2% rate. And when Russo checked with the company, they told him the same thing.]

Russo: And based on the P/E multiples accorded RJR and Carolina Group prior to the recent market disarray — and afterwards, actually — of about 10 times earnings, I think it'd be fair to assign Philip Morris USA a multiple of at *least* that given its dominant market position. Therefore, a P/E of 10 on those normalized earnings would imply a value for Philip Morris USA of at least $16 per Altria share.

OID: And Philip Morris International?

Russo: They should have operating income in 2003 of about $6.25 billion — which implies about $2.00 of earnings per share for Philip Morris International.

And I think it would deserve a P/E of at least 12 — which is where I think British American Tobacco trades. BAT is also an international tobacco company, but it's far less exposed to premium global brands than Philip Morris. Many of BAT's brands are second-tier brands in the less-than-premium sector. What Philip Morris International has that BAT doesn't is a controlling stake around the world largely in the premium sector.

[Editor's note: And that's reflected in their margins, their returns on capital and equity and their historical growth in earnings, cash flow and dividends per share. According to *Value Line*, Altria Group's return on capital is well over 20% — versus 10% for BAT. And over the past 10 years, Altria Group's earnings and cash flow per share have increased between 9-1/2% and 10% per year, while BAT's have essentially gone nowhere. (To be fair, BAT has paid out more of its earnings to shareholders as dividends — up around 80% versus something like 55% for Altria.)]

OID: PMI's domination of the premium sector as laid out by Altria's Chairman and CEO, Louis Camilleri, at their annual meeting was pretty amazing.

Russo: It *was* amazing.

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SEMPER VIC PARTNERS'
TOM RUSSO
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OID: I believe Camilleri said the Philip Morris brand has a 51% share of the international premium segment — and that it's as large as the next six or seven brands combined.

Russo: And that it doesn't stop there. He said that even if you exclude Marlboro and their #2 brand, L&M, PMI's next four brands have total sales that are equivalent to the sales of all of BAT's global brands *combined*.

OID: Talk about domination...

Russo: And as was pointed out by the new head of Philip Morris International, André Calantzopoulos, what they dominate is the high end of global developing markets — which is the preeminent spot in that business. I think the underlying growth rate of the operating income in that business is up in the high single digits.

OID: After that kind of buildup, I hope you don't expect to get away with a piddling 12 P/E...

Russo: I'd be willing to give it a P/E of 13.

OID: Why do I still think that you're lowballing us?

Russo: I think it *is* low. But I think it's reasonable — because it is, after all, global *tobacco*. It's not chocolate, it's not bottled water — it's tobacco. And globally, there are zealots and thoughtful individuals who think the business needs to be regulated, constrained and limited. So it's likely to face a headwind for as far as the eye can see.

OID: Hey, it's your idea. But if you truly think that BAT is worth 12 times earnings, it's hard for me to understand why you think Philip Morris International would only be worth 13 times earnings given the huge difference in market presence between the two.

Russo: That is a very conservative number.

OID: Like I said.

Russo: Anyway, that would imply a value of at least $26 per share for Altria's international tobacco segment.

OID: What about Altria's stake in Kraft Foods?

Russo: Altria owns 83.9% of Kraft Foods — which has about 1.732 billion shares outstanding. And at its current price of $31 per share, that stake would be worth about $45 billion. So deducting Altria's total net debt of $20 billion and dividing by its 2 billion shares outstanding implies a value at its current market price of about $12.50 worth of Kraft Foods per share of Altria.

And then Altria owns a 36% stake in SAB/Miller — the second largest brewer in the world. And I believe that stake is worth something around $3 billion.

OID: Or roughly $1.50 per Altria share.

Russo: Correct. And then, Altria's finance division, Philip Morris Capital Corporation, owns some very valuable assets. And the value there is hard to know exactly because some of those assets — like airplane leases to major carriers — have diminished in value and are subject to some contingent liabilities. However, for the three or four years prior to 2002, that division had earned something in the neighborhood of $260 million per year. So let's just say that it's worth about $3 billion, too — which I think, if anything, is conservative.

OID: So there's another $1.50 per Altria share.

Russo: That's right. Therefore, on a per share basis, we have about $26 for Philip Morris International, $16 for Philip Morris USA, $12.50 for Kraft and $1.50 each for Philip Morris Capital and SAB/Miller. What would that imply for Altria Group's total value — something like $57.50 per share?

OID: Yep. And as you say, that's on a tainted basis — with tobacco-related fears at or near all-time highs and you lowballing us like crazy.

Russo: I think that's right.

IF LEGAL CLOUDS RECEDE AND MARKET STABILIZES, ALTRIA WOULD BE WORTH MORE LIKE $65-70.

Russo: And if Altria were to get to that price tomorrow, it would still only be trading at a P/E multiple of 12-1/2 or less with a dividend yield of nearly 4-1/2% — versus an S&P that probably has a P/E of about 20 and a dividend yield of perhaps 2%.

Furthermore, the value of Altria's components are each supported by relatively modest multiples based on the comparables — Altadis, Gallaher, Imperial, BAT, etc. All of those trade for something between 11 and 14 times net.

OID: Like I said. And you use the same multiple for Philip Morris USA as RJR — even though RJR looks downright fragile by comparison.

Russo: It *is*. RJR has nowhere *near* the wherewithal that Philip Morris has to compete in this market. They're basically trying to support all their core brands in free-fall — aside from Camel — with a core business that's clearly far more exposed to the lowest end of the market. And they just can't afford to underwrite their defense.

To give you some idea, this year, RJR expects to have operating earnings of $500 million. As I said, PM USA should have operating income of $3 *billion*. And again, promotional spending for Philip Morris this year is expected to be $5 billion — which is probably not all that far from RJR's total *revenues*.

OID: Yep. Value Line shows RJR's revenues as being something around $6.7 billion.

It sounds like your conscience is bothering you — which, of course, it should. You know you'd feel better if you were to go ahead and confess what you think Philip Morris USA and Altria are really worth.

Russo: Again, I think the fear of existing lawsuits is overblown. And I think the fear of the liability from a breakout of Illinois-like lawsuits is unwarranted.

OID: Don't try to change the subject. The issue was a fair P/E multiple for Philip Morris USA...

Russo: Absent today's troubles, I think it would *easily* be worth at least *11* times earnings.

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SEMPER VIC PARTNERS'
TOM RUSSO
(cont'd from preceding page)

OID: So using your P/E of "at least 11" for PM USA would add another $1.60 or thereabouts per share of implied value to Altria.

Russo: You're relentless.

OID: I'm just getting started. If the other companies you mentioned are trading at 11-14 times earnings, given your earlier comments about their dominance, shouldn't Philip Morris International by comparison deserve a multiple of at least 14-15 times earnings?

Russo: I can't argue with you...

OID: It wouldn't help if you did. We get to edit last.

Russo: Frankly, it's hard for me to imagine how a business as dominant as PMI, with its returns on capital, growth prospects, etc., should command a P/E multiple of less than 14 or 15. And if so, that would imply a value of $28-30.

OID: Which would add another $2 to $4 per share.

Russo: That's right.

OID: And I suspect that part of your rationale for buying Altria Group — whether it's needed or not — is your belief that Kraft is worth substantially more than its current stock price.

Russo: I think it *is* undervalued because, obviously, 14 times earnings — dividing Kraft's current price of $31 by the $2.25 that I expect it to earn — for what is clearly the preeminent U.S. food company is low. Just thumb through *Value Line*. I think that General Mills is probably trading up around 19 times earnings and that Kellogg is up around 18 times earnings. And I think that those two would probably be pretty good benchmarks.

OID: Yeah. Looking out a few years, Value Line seems to expect a normalized P/E of 21 for Kraft.

Russo: That wouldn't surprise me in the least. On the other hand, I'm happy to accept the market's verdict — because, after all, Kraft does suffer from a tobacco taint.

OID: Whether it deserves it or not.

Russo: Yeah. Even though Philip Morris USA has typically been the defendant in these legal cases, Kraft is burdened by the concern that if PM USA suffers a colossal verdict against it, Kraft's assets would be attached through piercing of the corporate veil. Of course, that would require a plaintiff to somehow go from PM USA up to the parent — which is already a leap — and then dip into Kraft, which is a separate company, for their damages.

But once it's separated from Philip Morris USA and Altria, Kraft becomes a much stronger credit. And that credit strength is important in the marketplace — both because of the lower borrowing costs and the accessibility to capital if they decide they need it in order to do deals in the face of a consolidating industry.

OID: And talking about the smoke clearing, if Kraft were to ever get to the kind of multiple that Kellogg and General Mills have today — which, incidentally, it did have before the recent credit downgrade — that would add another $5-7 per share to Altria's value.

Russo: That sounds about right.

[Editor's note: We don't think this would shock Russo given that Gardner, Russo and Gardner has been a buyer of Kraft shares in each of the past five quarters — and that it appears to have been one of his 10 largest purchases in the first quarter of 2003.

On the other hand, there are two major negatives associated with Kraft Foods (besides the possibility of a litigant against Philip Morris USA one day managing to pierce the corporate veil). First, as *Value Line* points out, Kraft has little or no representation in the rapidly growing healthy foods segment. Second, in the U.S., which accounts for the lion's share of its sales, we understand that store brands only account for something like half of the market share that they do elsewhere and that the gap is closing fast.]

OID: Which would imply a total blue sky value for Altria of more like $65-70 per share?

Russo: In the context of an environment where the perceived legal risks have substantially receded and normality's returned to the domestic marketplace? Sure.

OID: With all of the foregoing in mind (along with the fact that this is investment publishing), we note that the P/E multiple for Philip Morris from 1991 to 1993, according to Value Line, averaged somewhere between 13.5 and 14.8.

Russo: I think that's a perfectly *reasonable* multiple for Altria.

OID: Is there a reason why you elected to wait so long into the feature to start imbibing?

Russo: Because I had no *reason* to drink until now. But that's a *perfectly* reasonable multiple.

OID: And it just happens to correspond almost exactly to the $65-70 valuation we came up with earlier.

Russo: That *is* interesting.

OID: And yet one big difference that probably bears mentioning is that the proportion of Altria's earnings in that 1991-93 period...

Russo: ...from domestic tobacco was much higher.

OID: Exactly. So, presumably, the quality of earnings is much higher today than it was back then.

Russo: Yeah. I think that's right.

WHY WAS I WILLING TO PAY $51 LAST YEAR? WELL, A COUPLE OF THINGS HAVE CHANGED.

OID: Along those lines, weren't you buying shares with the stock trading in the $50s early last year?

Russo: Yep. I've probably paid $51 for some shares. And I don't think they were *expensive* at that price.

OID: How do you figure?

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SEMPER VIC PARTNERS'
TOM RUSSO
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Russo: At $51, it had a P/E below 11-1/2 and a dividend yield in excess of 4-1/2%. That's not expensive. But at that point, they weren't facing a $12 billion bonding requirement and a $10 billion verdict on a trumped up class action lawsuit based on descriptors.

OID: Although I guess you did have Engle going on.

Russo: For all of the reasons that we talked about and more, Engle didn't mean that much to me. I couldn't imagine it withstanding U.S. Supreme Court appeal.

So why was I willing to pay $51 early last year? First, I felt all along that Engle would eventually go away. Second, I felt that the individual lawsuits would be reduced on appeal — that you couldn't have such extraordinary punitives. And now the State Farm case — decided April 2003 — has firmed that up. But that was my belief all along — because of two other U.S. Supreme Court rulings — BMW and Exxon Valdez. They both spoke the same language. They both stood for the principle of limiting punitive damages, although it wasn't until State Farm that it was so forcefully expressed. But they both spoke to that same outcome. And I had new clients come in at that time. So I bought it for them.

[Editor's note: Among other *OID* contributors buying Philip Morris at that time were Jim Gipson and Michael Sandler (for Clipper Fund) and Chris Davis and Ken Feinberg (for Davis Advisors).]

OID: I'm not trying to put you on the spot or anything because as Jackie Mason says, that's not in my nature.

Russo: I appreciate it.

OID: But for God's sake, what were you thinking?!

Russo: That's a fair question. Bear in mind that a couple of things have changed since that time: One of those things is that Philip Morris USA's profitability is down $1 billion below what I would have expected it to be.

OID: For now.

Russo: That's right. But that resulted in earnings falling about 31¢ per share.

BUT MY VALUATION IS ALSO CONSERVATIVE —
A STATIC ANALYSIS USING CONSERVATIVE P/E'S.

Russo: Also, the numbers we've been talking about for Altria's valuation on all measures are very *conservative*.

OID: Thanks for that confession. The offense rests.

Russo: The multiples we used relate to uncertainty that exists in an apparently worsened legal environment. Plus, they're based on a somewhat static analysis. So they're clearly conservative multiples, in my view. However, if there isn't a confiscation of cash flows from a business that's going to generate $5 of free cash per share — of which $3 billion is going to be used to buy back stock at, say, $50 per share...

OID: Now you're talking.

Russo: So operating income will grow next year. And free cash flow will grow next year. And once the cloud from Price/Miles clears, they'll probably allocate 40% or so of their free cash flow to share repurchases. So if you play that out for five years, absent any draconian loss of value because of disastrous litigation outcomes, we're going to see a much higher intrinsic value per share.

OID: With the litigation environment hopefully providing the stimulus to keep the price low enough for the buybacks to provide some serious benefit.

Russo: Exactly. Unfortunately, right now, they can't buy back stock until the legal uncertainty is cleared up. But you're right. Further legal uncertainty may actually enable them to increase their per share value more rapidly than they could otherwise.

For example, if Altria's stock continues to trade at this kind of discount and they have the ability to buy back the $3-4 billion worth of stock that they'd planned on buying and have bought back each year recently, they'd buy back something like 5% of their shares outstanding each year. Despite paying out over 50% of their earnings each year as dividends, they've been plowing about 40% of their profits back into share repurchases. That's very powerful.

OID: I'm certainly impressed. In fact, if I were them, I think I'd be giving some serious thought to selling off some things and using the proceeds to buy back stock.

Russo: And that's exactly what they did with Miller. They applied the $2 billion of cash that they received in the Miller transaction with South African Breweries to increase their buyback in 2002. Here's what they've spent on buybacks during the last three years: $3.6 billion in 2000, $3.96 billion in 2001 and $6.22 billion in 2002.

OID: Wow.

[Editor's note: Lest anyone wonder whether the pause in share buybacks signals a change in corporate strategy, here's some of what Altria Group Senior VP and CFO Dinyar Devitre had to say on the topic on Altria Group's First Quarter conference call on April 16th:

"[W]e've suspended share repurchases until we have access to the commercial paper and capital markets. But other than that, I think we feel pretty confident about the strategies we've followed to date. And we will continue to follow them in the future. Obviously, there'll be a bit of a lag before we can get back into the capital markets. However, overall, I'd say that our long-term strategies are very much in place."

And in reply to a question about when he expects the rating agencies to raise their ratings and thus allow them to restart their share repurchases, he said:

"You'd have to ask the rating agencies that question. I think we are worthy of going back to our original ratings right now. I think our businesses are sound. We have solid cash flows. But you'll have to ask the rating agencies. And please *do* ask them."]

Russo: So if you then project the numbers forward and assume operating income grows only modestly in total, you have a business that will probably earn something like double today's profits per share in six years' time based on

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SEMPER VIC PARTNERS'
TOM RUSSO
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the likely pace of share buybacks. Again, that's one of the key ingredients to this investment — that without harming its operating vitality, because the business doesn't consume capital, free cash redeployed to buying back stock at these low prices has enormous benefit to the remaining intrinsic value per share and, also, to the reported profits.

OID: The benefits of a huge, albeit reduced, ROE.

Russo: Yeah. Therefore, even if the P/E multiple remains constant...

Ironically, both before Marlboro Friday and also even as recently as when I paid $50 per share, that's the math that kept me interested even though the share price was higher — because from that point, you can still reasonably expect a satisfactory return.

OID: Absolutely. Perhaps even from nosebleed levels like $51...

Russo: I still believe it was reasonably priced at $51.

OID: Don't hand me that "reasonably priced" crap. Obviously, you thought that it was cheap at $51 or you wouldn't have bought it.

Russo: It's true. And I actually think that from $50, we could *still* see our way clear to double-digit returns.

OID: And even from $51?

Russo: Even from $51.

[Editor's note: Legal issues aside, we believe that Russo is right. Granted, Russo and *Value Line* differ a tad in their outlook for Altria's future dividend growth. Russo says he expects Altria's dividends to grow 10-11% per year, whereas *Value Line* seems to be expecting them to grow more like 2-1/2% per year.

However, if Russo is right (and Altria Group's 9-1/2% per year compound growth in earnings and cash flow over the past 10 years, and 16%+ per year growth over the past 35 years, don't exactly make his forecast look wild-eyed), the buyer of Altria would earn a compound annual return equivalent to its dividend yield at purchase plus 10-11% even if the stock's P/E never rises from today's level!]

FDA REGULATION MAY BE GOOD FOR SMOKERS, GOOD FOR SOCIETY AND GOOD FOR PHILIP MORRIS.

OID: At their annual meeting, Camilleri talked about their reduced-exposure cigarette. Any thoughts there?

Russo: They have a couple of existing products in the reduced-exposure category that have been pretty clumsy.

OID: When you say they're clumsy, you remind me of the old RJR reduced-exposure cigarette that was lampooned in Barbarians at the Gate.

Russo: Oh, yes — the one that tasted like crap and smelled the same. That was very funny. Believe it or not, I've got a friend who I think still smokes those things. He's loyal to his brand.

OID: RJR still produces 'em!?

Russo: I think so.

OID: How's your friend's breath?

Russo: No comment... That's one of the things that Philip Morris is trying to get the FDA on board for — so they can make health claims with FDA approval. There's a whole body of thinking — whether it's regarding beverages or cigarettes or snuff — that it's terrific to encourage abstinence, but it's important to face up to the reality that most people are going to fall short of that goal. So if smokers are not likely to quit, at least they'll smoke something less harmful. That's a big issue right now.

OID: Why can't I imagine members of popular culture lampooning people for telling kids to "Just say no" to smoking, much less advocating the distribution of reduced-exposure cigarettes at schools — even for kids who already smoke?

Russo: In contrast to teenage sex and condoms — you bet. But reduced-exposure cigarettes are a big issue right now. And the company is actually lobbying for it. That's one of many reasons why they would like to enlist FDA regulation.

OID: I find that notion fascinating. You don't think that FDA regulation would wind up hurting 'em?

Russo: Well, others in the business do. However, as I mentioned, Philip Morris thinks it will help them police the low end because many of the other products served there probably won't comply. And their ability to support new initiatives will help in delivering reduced-exposure products — which the low end can't supply. The low end is basically going to supply old-fashioned products at a cheap price.

OID: And when it comes to the R&D required to develop and deliver reduced-exposure products...

Russo: They can't do it. And they won't be able to source it for quite a long time. So Philip Morris thinks that they'll be able to gain an advantage *that* way.

OID: Which, if true, could be a win/win/win situation — higher share for Philip Morris, better collection and enforcement of excise taxes and MSA payments, and reduced harmful exposure to smokers, not to mention a lower incidence of smoking thanks to higher prices.

Russo: Exactly.

AND SPEAKING OF HEALTH, EVERYTHING'S RELATIVE. CONSIDER WHAT MOST PEOPLE SMOKE TODAY....

OID: Speaking of reduced-exposure offerings, I can't recall if it was you or John Constable who told us that American-style cigarettes, while harmful, are much less harmful than the cigarettes smoked by most people around the world. Is that true?

Russo: It is. And it all has to do with this notion of the level of tar and nicotine — and the filter. As I mentioned, the international health community recently stated that if people are going to continue to smoke, they should smoke

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SEMPER VIC PARTNERS'
TOM RUSSO
(cont'd from preceding page)

cigarettes that are measured to be low in tar and nicotine.

OID: And that's not the perspective of Philip Morris or the tobacco industry...

Russo: No. That's the health care agencies in Europe. They're actually confronting and, in some ways, supporting a reduced-risk product — recognizing that not everybody who smokes will quit and, therefore, encouraging them to migrate towards products that are likely to be less harmful. So if you smoke Gauloises or something that is quite strong and made with dark tobacco with no filter, according to those health authorities, it would be advisable health-wise for you to migrate to a filtered American-blend cigarette that's lower in tar and nicotine. And they're promoting that.

OID: Are the cigarettes most people smoke in huge markets like China and India filtered or unfiltered? Where would you put them on the health spectrum relative to Philip Morris' offerings?

Russo: In India, by and large, they smoke something different. They smoke something called a bidi — which is not something you would recognize as a cigarette at all. It's got seasonings and flavors. It doesn't look like what you would probably think of as a cigarette. And I believe that those are unfiltered.

OID: And in China?

Russo: In China, all of the aspects relating to cigarettes have been far less developed. So for example, they use wood pulp for the paper wrapper with no filter. So there's no ventilation whatsoever.

American tobacco companies largely use flax pulp — which is much, much thinner and much more porous, thereby allowing much more air to come in. So it's more filtered — and delivers lower amounts of tar and nicotine.

OID: What does more air have to do with anything?

Russo: Well, it's just lighter. It's the cigarette paper, the tipping paper, the plug wrap, all of those sophisticated non-wood-pulp-type constituents that create the outcome of lower tar and nicotine because in the filter, for example, there are perforations that, as you draw, bring in air at the same time you bring in smoke. And that substitution of air for smoke is a primary reason why a cigarette ends up delivering less tar and nicotine.

So in China, first of all, very few people smoke cigarettes with filters. Second, the paper's not ventilated. Just imagine a cylinder of regular wood pulp paper with tobacco in it — you're just steering all of the smoke right down that cylinder.

OID: So if these health organizations are correct, Philip Morris is doing people an enormous favor by getting them to trade up to their premium brands.

Russo: Certainly Philip Morris' cigarettes measure less in tar and nicotine. But again, there are debates about whether or not the availability of a product that is less harmful based on the tests actually encourages more people to remain smokers or start smoking.

OID: Although there, by charging more and driving others to do the same, they're aiding the public policy goal of reducing the total <u>incidence</u> of smoking.

Russo: Absolutely.

BANKRUPTCY SCENARIO IS VERY UNLIKELY.
BUT EVEN THAT WOULD NOT BE A DISASTER.

OID: Let me give you a hypothetical... Let's say that Judge Kessler does throw out the Justice lawsuit and that both Engle and Price are reversed on appeal.

Russo: That's not very hard for me to imagine — since it's exactly what I think is most likely to happen.

OID: But even assuming all of those positive outcomes for Philip Morris USA, if I'm hearing you correctly, smart, well-heeled plaintiffs' attorneys who've contributed generously to campaigns of well-selected judges can still extort the company for half a billion dollars or more at a pop.

Russo: I think that's right. But that's still OK. It's the situation where they have to post a $12 billion bond before they can appeal that's the killer. And that's a unique set of circumstances.

OID: Why are multiple half billion dollar payoffs OK?

Russo: Because they don't *happen*. The industry has well expressed through their stands on the Price lawsuit that they're not in the business of setting aside leavebacks.

OID: But didn't they basically express it by threatening to declare bankruptcy?

Russo: That's right.

OID: So doesn't it just take one stupid or venal judge in the right locale to push them over the precipice?

Russo: Sure. But again, I think that's very unlikely. And even if that *were* to occur, I think they'd *still* be fine — because what would bankruptcy mean?

OID: That they'd gone into investment publishing?

Russo: It would mean they have a court-appointed overseer watching how they conduct their affairs. And they may not be able to upstream any money to the parent. But the parent could still service its obligations based on their dividends from <u>Kraft</u>, their cash flow from PMI, etc.

OID: And their ownership wouldn't be wiped out?

Russo: I don't think so. Chapter 11 is just a holiday from immediate creditors in order to enable a company to go through a period of time and organize its liabilities without the threat of seizure from one creditor to the detriment of the entirety — including other creditors. And if the liability is the posting of a bond in a case like this, at the end of the day, the worst case scenario in the short run would be that <u>Altria</u> would have to place PM USA to the court through an administrator in bankruptcy for a court-appointed trustee to run for the benefit of all claimants, but not necessarily force it into actions that will ruin its business.

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SEMPER VIC PARTNERS'
TOM RUSSO
(cont'd from preceding page)

OID: That certainly sounds reassuring.

Russo: That's what bankruptcy's about. So if I were to posit what would happen there, it would simply be that others would supervise all aspects of the business so that no monies could be distributed away from PM USA.

OID: So the holiday would last long enough that...

Russo: They could pursue their appeal.

OID: And as long as they ultimately won the appeal, the rogue judge would have failed.

Russo: That's how I suspect it would work out. And while they were in bankruptcy, they'd just escrow funds and build cash much the same way the $1.3 billion verdict against UST was prefunded in an escrow account in the Conwood case.

OID: Would a court-appointed trustee be in a position to manage their other litigation?

Russo: I don't know the answer.

OID: If so, couldn't they also settle the other cases on terms that would not leave the current shareholders with anything when all is said and done?

Russo: Sure. They could give it all away.

OID: So maybe it is something to worry about.

Russo: It *may* be.

[Editor's note: As Russo suggests, a court-appointed trustee running the company would be the *worst* case scenario. A much more likely scenario, we understand, would be for its current management to continue running the company as a debtor in possession.]

Russo: But I'd fall back on the observation the company made about the class actions. Somebody asked, "Won't these 'Light' cases come out all over the country?" And for reasons we talked about in terms of the classes not being certifiable, among others, the company basically said: "These plaintiffs' attorneys are the smartest business people in the world. They chose Madison County for a reason. It was the best spot — the sweet spot. They chose it because it was where the fix was deepest and the terms were the most generous and most advantageous to them.

OID: But when you start to say that about Illinois and Florida and Oregon — you know, it becomes a case of $7 billion here, $140 billion there, before you know it, you're talking about real money. And we haven't even talked about Texas and Mississippi...

Russo: It's true. But they didn't *file* in Texas and Mississippi. And some of those other states have already ruled against class actions. It was a confluence of factors that made Madison County *the* spot.

OID: For that one.

Russo: That's right. But other venues should be less threatening by virtue of code, bonding caps, etc. However, that's a fair question.

CALIFORNIA JURIES ARE VERY HOSTILE TO TOBACCO, BUT STATE FARM AND STATE STATUTE MAY HELP.

OID: Any other major negatives we haven't covered?

Russo: One other case that might be threatening that I think may go against the industry is in California.

OID: Why is that case so threatening?

Russo: Because the juries have rage. And the judges there have been able to instruct in a fashion that allows for the venting of that rage. The Los Angeles court has had a couple of ridiculously high verdicts. I suspect that the population there is probably more hostile to the industry than it is anywhere else.

I think that's evidenced by one court in Los Angeles where a verdict that involved fairly modest *actual* damages received a $28 billion *punitive* damage award.

OID: Wow!

Russo: And it was a fairly standard case — you know, a person smoked, they got sick, they sued and they won a jury verdict for damages. But then it got grossed up to $28 billion. It was later reduced on appeal to something like $25 *million*. And it will likely be reduced on appeal again if State Farm controls. But that's the legal environment the company is facing in California.

OID: Do you think that might be part of the reason why California has the most attorneys in the nation while New Jersey has the most toxic waste dumps?

Russo: You mean because you get what you reward?

OID: Actually, I thought it was because New Jersey got first choice.

Russo: Sadly, California is usually a bellwether. The rest of the country usually follows its lead.

OID: Now there's a cheery thought.

Russo: But the State Farm case put some dimension to what courts are allowed to do. And I think that's important. Given the U.S. Supreme Court's decision, the likelihood that we get another verdict where there's, say, $1 million of actual damages and $28 billion of punitives is certainly less likely. California was also the first state where there was a fairly *sizeable* verdict against the tobacco industry (the trial was in San Francisco, I think). As I recall, it was something like a $50-80 million verdict.

The other interesting thing about the legal system in California is that there was a moratorium on private plaintiff lawsuits that commenced in 1988 and was in place until the beginning of 1998. During that entire period, the state had a statute in place that prevented lawsuits against smoker-related illnesses. You weren't allowed to sue for the knowing harm that comes from smoking.

OID: Fascinating.

Russo: But then, in 1998, the legislature had to repeal that statute to allow the state attorney general to participate in the Master Settlement Agreement.

OID: Incredible.

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SEMPER VIC PARTNERS'
TOM RUSSO
(cont'd from preceding page)

Russo: So subsequent to 1998, you were once again *able* to sue. But the question that hasn't been determined is if you win post-1998, whether or not you're allowed to keep the damages that would have been incurred in whole or in part during that excluded period — 1988 to 1998 — when there was no ability to sue. If not, that would presumably gut most of the actual damages because people who can sue today either had to smoke before 1988 or after 1998. And there's just not enough time to develop the kind of harm that would lead to nearly as large a reward as that which would exist if that period when the statute did not allow lawsuits was exempted.

OID: What a fascinating wrinkle. Any opinion on how that issue is likely to ultimately play out?

Russo: We'll know the answer based on how some of the suits that are underway now ultimately play out. However, I believe the industry has a defense that is likely to protect them from damages incurred during the period of statutory protection. I believe California appellate courts have said as much.

OID: Wow.

Russo: Yeah.

[Editor's note: Indeed, it appears that it was the California Supreme Court that said as much. In a press release dated March 20th, 2003, Philip Morris USA alludes to the California Supreme Court's decisions on Naegele and Myers in which it "held that a 1998 statute repealing an earlier state law was not intended to create liability for conduct that occurred during the ten-year period [— which began on January 1, 1988 and ended on December 31, 1997 —] that the statute was on the books."]

Russo: And that's important — because for all of those people who are coming to court today and saying that they've been smoking since 1964, there's obviously a broad section of that time during which damages that would otherwise apply won't. So actual damages for which tobacco companies could be liable will be lower than they would be otherwise.

THE MSA HAS YIELDED A BITTER DIVIDEND — IN REGULATION, TAXATION AND LITIGATION.

OID: When the tobacco companies look back at having signed onto the Master Settlement Agreement [MSA], do you think they're pleased that they did?

Russo: I wouldn't think so — because it didn't get them the relief from litigation that I suspect they would have envisioned.

OID: Yeah. Far from providing any relief, didn't it give mustard and credibility to subsequent lawsuits — not to mention hope to plaintiffs and their attorneys?

Russo: It *did*. It created the sense of "you've done something *wrong*" rather than "we've already accepted our medicine and made peace with the nation". It's been used by the plaintiffs' attorneys as an expression of culpability.

OID: And evidence that the companies can be rolled — a cautionary tale for other industries...

Russo: It's true. I think the MSA's had a lot to do with the lawsuits that have followed. However, of course, it wasn't just the MSA. It was also footage from U.S. Representative Waxman's panel where one tobacco executive after another refused to acknowledge that cigarettes were addictive. So there were really a series of things that combined to undermine the industry at that moment in time.

But one of the things that the MSA did was reward the attorneys. So those attorneys became self funding. And you've seen 'em come back again and again and again — because they now have resources to apply to the task.

OID: Sure. If I pulled a lever and was rewarded with umpteen billion dollars, I might think about pulling that lever <u>again</u>. Even if I saw someone <u>else</u> do it... And that's not even including other indirect effects like apparently getting access to goodies via lawsuits in California with the change in legislation that was implemented in order to facilitate the MSA payment.

Russo: That's true. And that was part of the package. The other thing that's interesting is that you can say that it opened up the public's mind to the belief that this industry is an admitted wrongdoer.

OID: Exactly.

Russo: And you may say, "Therefore, what?" Well, therefore, these verdicts started to come in pro-plaintiff. On the other hand, at the end of the day, we're likely to see most of those verdicts reversed on appeal and never paid. If so, then the vilification in the context of litigation will ultimately have proven not to have any lasting impact.

However, boy, did it have a lasting impact in terms of *regulation*. For example, people can no longer smoke in New York City bars. People can't smoke while traveling on public transportation. And excise taxes are going up at a startling rate — in part due to the public policy arena having changed in spirit as a result of the MSA and all of the seeming admission of guilt that it suggested.

So it's possible that the harvest ultimately won't actually be litigation — because I think most of these cases are going to be reversed on appeal. However, the harvest in the arena of regulation and taxation has been bitter.

OID: Aside from leading the industry to turn over a new leaf and making it hard for them to be found guilty of any ongoing wrongdoing, I can't find any significant positives in the agreement. And they could have done those things without signing on to the MSA. Are there <u>any</u> positives that you can point to?

Russo: Besides possibly barring punitives, not really.

OID: And it sounds like you don't think those are likely to amount to a hill of beans anyway — certainly not a $10 billion a year hill of beans.

Russo: That's right. It yielded a bitter dividend. There's no question about it.

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SEMPER VIC PARTNERS'
TOM RUSSO
(cont'd from preceding page)

ANTI-SMOKING ADS? TRY INDUSTRY VILIFICATION ADS — ESPECIALLY IN AND AROUND TRIAL VENUES.

OID: Even watching that MSA from afar left me shaking my head — wondering what I was missing.

Russo: Well, just what you feared is what happened.

OID: Also, based on what I've read of the MSA so far, it seems like they got outmaneuvered completely. Frankly, to me, that agreement reads more like a surrender document than a negotiated settlement.

Russo: I didn't realize that the MSA agreement had been made public. But what were you thinking of?

OID: Several things, actually. For example, it looks like they've drastically restricted their own ability to communicate with the public while they fund what are being called "anti-smoking messages"...

Russo: That's right.

OID: However, the vast majority of those messages — at least of the ones I've seen — don't appear to be "anti-smoking" as much as "anti-tobacco company". They appear to be designed to vilify the companies and make them more vulnerable to future lawsuits rather than reduce the incidence of smoking.

Russo: It's fascinating that you say that — because the message, just as you suggest, appears to be intended to have exactly that effect. In fact, one of the observations of the industry has been that those ads run fiercely — in frequency and placement — in and around venues where there are trials going on.

OID: Fascinating, but not surprising.

Russo: So if there's a trial going on in California, the ads increase in their venom as well as their frequency. And they're speaking to the jury in some way.

OID: In some way?! Try totally.

Russo: Yep. And RJR has sued the states for misleading advertising. It's in the court right now.

OID: And obviously, that's no small matter given that reprehensibility excludes them from protection that they would otherwise be granted under the law — not to mention its implications for their likelihood of winning or losing their lawsuits in the first place.

Russo: There's no question about it.

OID: And it seems like the industry got outmaneuvered in several other ways. For example, everybody talks about it being a 25-year agreement. My reading says the payments are in perpetuity.

Russo: That's news to me.

OID: And there's an inflation adjustment — which is the greater of inflation or 3% in each and every year.

Russo: Fascinating. I didn't realize that.

OID: So they're way above the stated payment already. And a prolonged deflationary — or very low inflation — environment could make the effective burden of their payment far greater than it would be otherwise.

Russo: Absolutely.

OID: Just let me know if I've managed to talk you out of this idea — so we can both cut our losses...

Russo: [He laughs.]

OID: Everything seems totally one-sided.

Russo: Unbelievable. I hadn't read that agreement — because I didn't know that it was available. But now that you've let me know that it is, I'm definitely going to read it.

[Editor's note: He asked for the web address — which is the following:

http://naag.org/upload/1032468605_cigmsa.pdf

from the National Association of Attorneys General website.]

Russo: I'm so impressed by the power of the internet to enable you to get the primary documents in your grasp so quickly. It's really incredible. Great sleuthing.

OID: And just imagine if I weren't technologically illiterate. But I hope you'll feel free to say that again — and this time with more emphasis.

Russo: I mean it. Great sleuthing!

OID: Thanks. So anyway, I think that agreement is probably the biggest negative that we've come across. Unfortunately, it seems like it may be a pretty big one — since it sounds like the war will ultimately be won or lost based on whether or not the plaintiffs' bar is able to sufficiently vilify the industry.

Russo: Again, I can't disagree.

IN HINDSIGHT, THE MSA LOOKS LIKE A TRAP — IN A CASE THE INDUSTRY WOULD HAVE *WON*.

OID: Which really begs the question of why they ever agreed to sign on to that agreement in the first place.

Russo: One of the reasons why they wound up in that spot is that they had negotiated a federal resolution through the summer with President Clinton with many of the same terms that would have stood in lieu of it. And at the last minute — not surprising to anyone who watched President Clinton maneuver, but surprising to the industry — he backed away.

Apparently he backed away despite the fact that the tobacco companies were told by President Clinton directly that the President had the votes and that he guaranteed that it would happen....

OID: Don't wait for me to comment. I'm biting my lip.

Russo: That makes two of us. However, the federal resolution would have included a comprehensive national settlement eliminating the ability for private litigants to sue and prohibiting class actions. And the companies were prepared to go to the table with that.

So once they conceded that they could reach a settlement like that with one party, it was just a series of steps to get them... And the steps were that every state

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SEMPER VIC PARTNERS'
TOM RUSSO
(cont'd from preceding page)

attorney general sued collectively. They brought them before a soft judge under the attorney general of former Vice President Hubert Humphrey's son in Minnesota. And they just found themselves in an unbelievably hostile forum.

OID: But if it was that hostile, why didn't they just back out at that point? Were they afraid that President Clinton would deliver — shall we say — political payback?

Russo: Well, it's possible. However, besides that, they were also before the Minnesota judicial system. So they *couldn't* back out. It was going to go to verdict — and one they feared would be against the industry. There was a court proceeding underway where the attorneys general were collectively suing them for reimbursement of their health care costs — not for the physical, bodily harm, because as we know, the defense of the warning labels was adequate and the defense of the assumption of the risk was adequate. So plaintiffs clearly still couldn't get at the physical harm. But the States had a claim, which was an insurance-like claim, seeking reimbursement for the costs that *they* had endured. That was the argument.

OID: But wouldn't they have the same defenses against those claims as those we talked about against asbestos companies — not to mention the fact that even if they were liable for those health care costs, offsetting them would be counter claims for reimbursement against the state and others?

Weren't the tobacco companies in good shape legally just based on governmental entities having to prove damages on an individual-by-individual basis — to name just one defense among many?

Russo: In theory, yes.

OID: And according to the law, right?

Russo: Yep. And that *was* their defense — that you can't sue in the aggregate. That was *exactly* their defense. There is no such thing as aggregate liability in something like this. Each medical record must be examined. It must be established that there were no other contributing factors.

OID: And wouldn't the plaintiffs have had to establish that the harmed individuals — and probably the individual states — weren't aware of the risks?

Russo: That's right. And each step of the case has the possibility of defense built into it.

OID: Again, what in the world were they thinking?

Russo: It was a bit like the conditions that existed around the Price/Miles case — because once they were able to get all of the states before one judge in Minnesota, which was a fairly liberal venue and before a group of liberal jurors, the possibility of a record-setting verdict that would cover past health care claims for all states was just too overwhelming a burden for them to risk. Should the jury have reached a verdict in favor of the attorney generals, it would have been so high — if it had rewarded them for all of the smoking-related illnesses that had taken place — that even though the probability of such a victory was low, the expected outcome was too high for the industry to accept.

OID: Had you been their legal counsel, would you have recommended that they sign on?

Russo: I don't think so. Then again, it's sort of like trying to think through moves made by generals when they're confronted with seemingly overwhelming odds and they put the troops on one side of the field as opposed to another thinking they're gaining some kind of advantage. In this case, it looks like it turned out to be a *trap*. However, it's still hard to say.

[Editor's note: We agree. One very knowledgeable shareholder says the agreement was not a mistake at all — because it turned adversaries into allies. And he points out that those adversaries turned allies lobbied aggressively on the company's behalf with decisive effect in the aftermath of the Engle and Price verdicts to reduce the bond which the company was required to post to manageable levels — and that it was only their intervention that staved off the necessity of the company declaring bankruptcy.

From that perspective, the payments the industry agreed to make amounted to insurance premiums — or protection payments, if you prefer — that reduced the risk of future disastrous outcomes.]

OID: Was that essentially former Philip Morris Chairman Geoffrey Bible making the final decision?

Russo: Yeah. The buck stopped with him. And not all of the industry was like-minded. That's for sure. The industry was split. And the tragedy from the industry's perspective is that afterwards, the exit polls for the jury suggested that the industry probably would have *won*. But the company just feared the possibility that they'd lose — and since the size of the potential claim was just so large...

So I think it was just that they were facing the possibility of a consortium of claims for health care costs that could have aggregated to such a large amount. And they just didn't know how to process the consequences of a verdict like that.

BUT DON'T EXPECT ALTRIA TO BE ROLLED AGAIN — ESPECIALLY ON A CASE AS SILLY AS PRICE/MILES.

OID: Have they said they wish they hadn't done it?

Russo: I think it's pretty well sensed. And I think that the company's conduct in Price/Miles suggests that they probably would have behaved differently with the benefit of hindsight in both the MSA case and, possibly, even with Engle.

OID: Meaning they probably wouldn't have allowed themselves to be extorted into paying $500 million to the plaintiffs' attorney in Engle.

Russo: That's right. That money was left as a deposit for the benefit of the class. But my understanding is that most of it was headed directly into Rosenblatt's pocket.

OID: What a gig!

Whose idea exactly was it to stop the payoffs and toughen up?

Russo: I believe that it was their new chairman —

(continued on next page)

SEMPER VIC PARTNERS'
TOM RUSSO
(cont'd from preceding page)

Louis Camilleri. But I think they had no choice.

OID: Because the extortion payments were just getting out of hand?

Russo: Yeah. And the other nice thing about it is that the Price/Miles "Lights" case was just so *silly*. That's when they first really stiffened up. In part, I think it was because they were finally hit with such a soft pitch — in terms of the claim and the merits of the claim.

OID: You're not suggesting that Engle is exactly a legal hardball, are you?

Russo: Well, in Engle, you did have allegations of physical harm. And you had plaintiffs going before juries and the appearance of the sympathetic plaintiff. However, in Price/Miles, there was no sympathetic plaintiff — because the petitioners there even continued to smoke. It's just such a "light" case.

OID: Very punny. And so they just decided it was time to stop letting themselves be rolled.

Russo: Well, the truth of the matter is that they did have a bonding cap statute in Florida. But rather than subject the company to... Well, I guess it was a cave in *some* sense. There was bonding cap legislation passed in Florida. But the plaintiff was going to sue on the grounds of constitutionality. And to excuse them from that suit, they accepted money in escrow. But they did have a bonding cap placed there. So...

I think they stiffened on Price/Miles both because the stakes were so high and, again, because the merits of the plaintiffs' case was so low.

THE WILLIAMS CASE IS *VERY* IMPORTANT —
IT WILL DETERMINE IF STATE FARM APPLIES.

OID: It sounds like you generally agree with the company on the legal issues facing them today.

Russo: I do.

OID: Is there any area where you disagree?

Russo: [After a long pause] The risk that exists — and that will continue to exist — is that this is now a marginalized and demonized industry.

OID: I don't think that's really so much a risk today — post-MSA — as it is a fact.

Russo: It's true. And conduct is less of a defense when character is really constantly on trial. And that's really what these trials are all about: "We don't *like* you. So we want to somehow reward others at your expense."

That's what the Williams case is about. In that case, the plaintiff was awarded around $800,000 of compensatory damages and $80 million of punitives. And after being reduced by the trial judge, the original award was reinstated by an appeals court in Oregon and the Oregon Supreme Court.

So Philip Morris USA has appealed that case to the United States Supreme Court. And the court has the opportunity to say, "Remand this case to a lower court in light of our recent ruling in State Farm — because the punitives bear an impermissible relationship to damages." On the other hand, if the Supreme Court declines to hear the case or affirms the award, they're in effect saying, "Nah. That's not so crazy. The conduct is sufficiently reprehensible and the industry is so crummy that we're not going to get involved." That would be a much less encouraging sign.

OID: I would think so.

Russo: So I think that one is *very* important because it would mean that the limit on punitive damages laid out in State Farm doesn't really apply — at least it doesn't in *tobacco* cases.

OID: Or any industry once it's been sufficiently vilified.

Russo: Exactly.

OID: Any prediction there?

Russo: I don't know. It's already unique. It's already odd for that kind of award to survive three layers of state court appeal. With the extraordinary exception of something so obviously political as the Florida State Supreme Court, most states *aren't* influencable all the way to the state supreme court. As you go up the appellate chain, each level is supposed to become more thoughtful.

OID: Not more creative.

Russo: Exactly. So Williams might be viewed as that broad exception that even State Farm allowed — which is that the award should bear some relation to actual damages *unless* the conduct is sufficiently reprehensible. And in this case, what are you going to say: "The conduct of a company that sold cigarettes to a person who died from smoking cigarettes is reprehensible."?

OID: I asked first.

Russo: I can't envision it. That's a legislative decision. If it's truly that reprehensible, then I'd argue companies ought not to be allowed to sell the product in the first place — because to sell a legal product in a legal fashion to a legal adult consumer who could have quit at any time, as millions have, substantially stretches the concept of reprehensibility in a judicial exception frame of reference.

So again, I don't personally feel that a smoker case alleging that someone has been harmed by cigarettes — which are *known* to be harmful — rises to reprehensibility.

OID: And if it does, then so could selling fast food, soft drinks, doughnuts, beer, pastries — almost any product for that matter — based on the contention that it made people obese or gave them heart disease, cancer or anything else.

Russo: You've got it.

[Editor's note: We understand that there's actually a greater reduction in average life expectancy associated with obesity than there is with smoking.]

OID: One could even argue that it may have more negative implications for companies in all sorts of other areas than it does for tobacco companies — because Williams continued to smoke three packs a

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SEMPER VIC PARTNERS'
TOM RUSSO
(cont'd from preceding page)

day after knowing that the product was harmful.

Russo: I believe this case relies on something called The Frank Statement where he relied on the fact that the tobacco companies would tell him — personally — if they ever learned smoking was definitely dangerous.

OID: That sounds right. Can you imagine the liability that would open up from people saying that they started eating three times a day at McDonald's, or any other fast food establishment, as a child — or started overeating three loaves of bread, three boxes of candy, three two-liter bottles of Coke or otherwise overdid it with just about any product for that matter — and couldn't quit?!

Russo: Exactly.

OID: And I doubt that many of those other products carried a Congressionally-mandated warning label.

Russo: You bet. And that line of reasoning is what keeps me at this table, as an investor in Altria, longer than I might otherwise stay — because of my belief, just as you articulated, that there *is* so much at stake in finally getting these cases right. Otherwise, nobody in commerce will be able to shield themselves from, in essence, unlimited liability no matter how careful and thoughtful they might try to be.

OID: Because there'd be no personal accountability.

Russo: That's right. If Williams, Price, etc. stand, the amount of opportunity to sue on this exact same principle becomes overbearing.

OID: I think "overbearing" is a major understatement. It would be almost unlimited, actually.

Russo: Absolutely. And that's why I think that ultimately what should happen *will* happen. One long-term view may be that we'll outlaw cigarettes. And that's OK. That can happen. If so, tobacco companies would just wind down their businesses.

But what *can't* happen is society allowing the business to continue to exist legally *and* have the right for smokers to simply say, "I was a victim. I couldn't quit. So pay me millions of dollars."

OID: At least you can't have that outcome without having consumers of many other products — and their attorneys — say and do that.

Russo: You've got it.

[Editor's note: As Tibor Machan observes in a working paper entitled "Morality and Smoking":

"...If potential consumers are victims of manipulation, were not arguably the executives brainwashed into peddling their tobacco wares? So they had no control about becoming tobacco and other product peddlers, so they cannot be blamed either. And their teachers, too, went to various universities and learned how to teach their own students effectively, so they would do well at their professions. And so on and so forth — everyone is a victim of someone else's influence, ad infinitum. Which is to say, in the end none of us is responsible for anything..."]

TODAY, EVERYONE SEEMS FOCUSED ON MILES.
BUT THERE'S FAR MORE GOOD NEWS THAN BAD.

OID: If you're right about all of these issues, I gather that you think these cases could wind up drying up and blowing away.

Russo: They *should* dry up. And that's actually what I *expect*. I think that State Farm is terribly important at this moment. It's big. And certain other things are coming along that are important.

However, what I think the market is focused more on is this anomaly in Illinois. And I think that the other important developments aren't being fully appreciated for what they represent. Even something as simple as the fact that eight out of the last nine individual lawsuits have been won by the industry is being ignored.

OID: Yeah. Most coverage of tobacco litigation reminds me of coverage of Operation Iraqi Freedom by the Los Angeles Times, The New York Times, ABC and the BBC. If you'd relied on them for your coverage, you'd think Saddam had us surrounded. And I gather that there's still something of a disconnect...

Russo: Exactly. Most of the press coverage of tobacco litigation definitely leaves much to be desired. And when it comes to the private litigant suits, the market may fear them... However, the market's concern about the possibility of Altria losing a whole series of individual cases — even though it's something the rating agencies have cited in their downgrades — simply doesn't withstand scrutiny given what's happened in private court cases during the past year-and-a-half.

I believe that all of those lawsuits are likely to proceed to a favorable resolution.

OID: So that Altria could wind up being perceived as a less risky investment than it has been for years.

Russo: Absolutely. And I say that in large part because of State Farm. However, there's also developing sentiment towards reining in abusive tort judicial activities — for example, by limiting the ability of plaintiffs to shop for the most single-plaintiff-friendly venue and then settle all claims nationwide in that locale.

Also, Congress is working to try to ensure that many of those cases are first heard in federal court. And that's also terribly important — because the federal rules of procedure are much more forceful than the state rules.

OID: Having read PM USA's brief appealing Engle, I have no doubt that's true — and terribly important.

Russo: And I think that what happens is that as those lawsuits move toward a favorable outcome on appeal, Altria will have an increased ability to distribute out to its owners pieces of its business that are currently under a litigation cloud. And I think their distribution will reduce the risks faced by Philip Morris International and Kraft as a result of any legal tide overwhelming Philip Morris USA in the future.

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SEMPER VIC PARTNERS'
TOM RUSSO
(cont'd from preceding page)

IF TOBACCO INDUSTRY ISN'T PROTECTED TODAY,
IT'S A RISKY WORLD FOR *ALL* OF US TOMORROW.

OID: Even if you're right on all counts, can't Altria be gutted the next time that the political winds happen to be blowing the wrong way?

Russo: That's another issue. When we have a different executive branch and a different Supreme Court with an agenda against the industry, you're right. But hopefully, by then, Kraft will be *completely* separate — and Philip Morris International may even be separate by then, too. So we'll be *less* at risk — at least that's my hope.

But as your line of questioning suggests, at the end of the day, there are political players who see a particular personal/political gain from pushing outcomes that may even violate due process against this industry.

OID: So you're acknowledging that as a significant and unavoidable risk.

Russo: That's a risk. Frankly, I think of it more as a *timing* risk since I hope the company succeeds in moving its assets further away from risk in advance of a more hostile executive and legislative federal government profile.

And you also have to recognize that the moment the government can act this way against *one* business, it can act that same way against another. And in defense of all businesses, there's a requirement that restraint is applied — even when the industry in question is one that is a pariah. That's it. That's the only rebuttal I can offer.

In other words, they should not be protected because of any merit held by the tobacco industry; rather they should be protected because if they aren't, others will fall prey, too — with the only restraint being that they have to first be demonized. And then it's open season.

And that will happen with other industries if it's allowed to happen with this one.

OID: Very eloquently stated. To borrow a phrase from our founding fathers, we'll either hang together or we'll hang separately.

Russo: You bet. So that's my guiding thought there. One of the reasons why judicial restraint ultimately must be brought to bear at some point is exactly because otherwise, liability *will* expand so quickly. I can write the plaintiffs' briefs that would be filed against any number of industries. You just substitute "cholesterol" for "cancer". And then you say, "They willingly sold the product — indeed they *marketed* it — knowing that it would both become habit forming and that it was unhealthy."

OID: That does sound familiar. But don't forget to throw in the fact that it was marketed to children.

Russo: Exactly. "They intentionally hooked kids." I'm telling you — it's the same brief. And whether you're talking about fast food, breakfast cereal, soft drinks — you name it — they'll say, "And here we have a statistically heavier population as a result."

OID: And an epidemic of heart disease and diabetes.

Russo: Exactly. "Therefore, pay." It's ever so simple — and ever so *dangerous*.

OID: And at that point, it's not just health care and cigarette prices that go through the roof — because society starts to pay what amounts to a huge tax on more and more products.

Russo: When the product is available at all, exactly — because just as some jurisdictions can't find doctors who are willing or able to subject themselves to the legal risks associated with practicing medicine in those areas, other products and services will suffer the same fate.

OID: Amen. Well, thanks again for the education — even if I don't know exactly how we're going to manage to share it with our subscribers.

Russo: Good luck. I know that I've given you a terrible conundrum — because I think if you treat it at the *higher* level, at least how *I* think through it, I think the plot sort of sets itself up. On the other hand, each of these deeper analytical discussions about the components are useful and important, but the forest is *very*, very thick. And you can get lost in the forest and get quite distracted.

OID: You've definitely got my head swimming.

Russo: Also, once you're lost in the forest, then you can start to fear all of the night sounds — because you just don't know exactly what it is that you're looking at. And the *biggest* night sounds have to do with things like "Because the industry is hated, they'll be treated extraordinarily badly by courts".

OID: You're reading my mind.

Russo: Well, that's a risky world for *all* of us. And one reason why I feel that we won't get there is precisely *because* the consequences of having that outcome would be so severe and unimaginable for *all* businesses — and for our entire society.

INSTALLMENT #2: LEGAL UPDATE
POST-COMPANY BRIEFING — EARLY MAY

ASBESTOS/TOBACCO SYNERGY CASES?
THEY'VE GONE NOWHERE. AND HERE'S WHY....

Russo told us that he wasn't sure about the answers to several of our questions and that he wanted to confirm his answers with someone at Philip Morris USA. The excerpts which follow were taken from our conversation with Russo shortly after he did exactly that:

Russo: As promised, I sort of crossed my t's and dotted my i's on the whole liability/litigation front with the company. And their belief — and I share it — is that the forward-looking litigation calendar has less uncertainty today than it's had for three or four years.

So it's ironic that the credit rating agencies who interpret the risks have chosen this point in time to take the most dramatic stand — the most negative posture —

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SEMPER VIC PARTNERS'
TOM RUSSO
(cont'd from preceding page)

that they've ever taken with respect to the industry.

OID: Public relations, anti-tobacco advertising and sloppy or agenda-driven journalism trumping reality.

Russo: Yeah. It's just a remarkable disconnect between what they're seeing and what the company and I are seeing.

OID: So you wouldn't change or take back any of your earlier comments about the legal landscape, etc.

Russo: No. But let me tell you what we talked about on a point-by-point basis. One of the things you asked me is why I said asbestos litigation isn't likely to spring up and bite them. Well, there are several technical issues: One is that the plaintiffs prefer to sue asbestos independent of tobacco because they know that asbestos settles, whereas tobacco doesn't. Therefore, plaintiffs prefer *not* to join.

OID: What about when asbestos companies sue the tobacco companies for their part in...

Russo: ...for their contributory part to harm? I think the difference in part is *choice*. Philip Morris USA's defense has been that when a plaintiff's been exposed to asbestos *and* smoked cigarettes, at least as it relates to their harm from cigarettes, the plaintiff had choice, whereas the other contributory factor was something over which the plaintiff had *no* choice.

OID: I imagine it also goes to the due process issue about tobacco plaintiffs having to prove causation rather than statistical incidence.

Russo: That remains, too — especially with tobacco — because each case expresses itself differently.

OID: So in order for asbestos companies, having paid out billions of dollars to claimants, to successfully sue tobacco companies, they still have to prove causation on a case-by-case basis — and prove that each person was not forewarned about the hazards of smoking.

Russo: Exactly. And the company tells me that the health warning on a pack still bans suits against harm — that there's no exception to the amended 1984 Warning Act which says that the warning labels were sufficient by virtue of governmental decree — and that plaintiffs who smoke assume the risks.

Unlike asbestos litigation, where plaintiffs can basically claim occupational hazard, the built-in defense against tobacco litigation is "choice" — which is a function of an informed and warned consumer's choosing. And then the health warning is deemed complete and adequate.

OID: So you see no way for an asbestos lawsuit to somehow circumnavigate that requirement.

Russo: I don't. By the way, those cases are what are called asbestos/tobacco "synergy cases" because there's a synergistic, collective effect. But those cases have never gone anywhere — for the reasons that we've just discussed.

THE MOTIVE FOR FCTC MAY BE DESPERATION.
IN ANY CASE, THE TREATY MAY NOT BE ALL BAD.

Russo: The *other* thing that I found interesting was their answer to the question you asked me about the exporting of tobacco-style plaintiffs' causes.

OID: The whole FCTC treaty thing.

Russo: That's right. One of their observations was that ironically, efforts to export U.S.-style tort laws abroad are an expression of how scant the opportunities are in the U.S. at this juncture. They suggest that that's why the plaintiffs' bar is grasping for *this* new straw.

OID: You don't just chalk it up to the plaintiffs' bar wanting to achieve international diversification, too?

Russo: Could be. But they say the plaintiffs' record overseas has been so bad in terms of litigation outcomes... There are double-digit experiences where Philip Morris International has already won dismissal of cases at the trial court and the appellate court level in Spain, Germany, France, Argentina, Brazil and Japan — where *all* cases have been dismissed.

OID: Pre-FCTC anyway.

Russo: That's right. The historical results of these cases abroad have been almost universally bad for plaintiffs. For example, there was a class dismissed recently in Israel and Australia. So the company believes that what you're seeing is an effort on the part of those behind this treaty to create the ability in these foreign jurisdictions to seek remedies through lawsuits rather than regulation — although, of course, there are elements of both.

But one of their points was that it's a far cry from attacking Philip Morris USA through a county court in Illinois and implementing American-style lawsuits in countries with no legal precedents for such actions.

OID: True. But then again, there was no precedent for the Master Settlement Agreement either.

Russo: They also claim that much of the treaty would facilitate a level playing field by providing for terms that Philip Morris International and the other global companies have already *agreed* to. So the restrictions that are part of the proposed WHO treaty — the operating restrictions — are things to which Philip Morris has already largely agreed.

OID: In other words, it's not that <u>much</u> of a negative — and it might even be a positive in some respects.

Russo: That's right. Where they've resisted is the issue of litigation and the efforts of some to extend American-style legal remedies to non-American consumers.

OID: God bless Philip Morris.

Russo: Amen. They also point out that there have been numerous attempts to find remedies in U.S. courts — both in the Federal Court of Appeals and the Florida State Court, for example — for people from various non-U.S. jurisdictions. And all have been kicked out of court.

[Editor's note: And again, it appears to us, at least, that some of the elements of the FCTC will almost certainly be ruled unconstitutional — both in the U.S. and abroad.]

Russo: And your concern about the extension of

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SEMPER VIC PARTNERS'
TOM RUSSO
(cont'd from preceding page)

American tort laws through the WHO treaty was averted.

OID: It wasn't in the final draft.

Russo: That's right.

OID: That's all well and good. But if advertising, sponsorships and the distribution of free samples are prohibited by the FCTC, wouldn't that in effect lock in existing market share leaders and reduce or eliminate growth opportunities for Philip Morris International in places like India and China?

Russo: You'd *think* so. But I don't think it would. Philip Morris has had an *extraordinary* degree of success in their foreign markets historically. For example, in Japan, they've managed to go from virtually a zero share to about 26% over the past 17 years.

OID: Although I suspect they did it during a time when advertising, sponsorships, etc. weren't banned.

Russo: That's right. But interestingly, when their market share went from zero to north of 50% in Italy, it did so during a time when advertising was banned in Italy.

OID: Wow.

Russo: Their initial share was definitely negligible. However, they worked with the Italian monopoly to gain extra distribution at that time. And their product was a lighter, American-style blend which the Italian consumer preferred both taste-wise and for health reasons — in part because if its less tar and nicotine. So there was an American-blend migration. It fit the consumers' desire to have those attributes.

In addition, the trademark was appealing. There's just a desire almost everywhere for Western trademarks — as well as movement away from traditional products to American-blend products.

OID: So besides the appeal of their products and their trademarks, there could be a public health initiative by governments in many emerging markets countries to have American products?

Russo: Not only *could* there be, but there *has* been across all markets a move towards what's called LTN — lower tar and nicotine cigarettes.

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OID: And I gather that U.S. cigarette manufacturers have an advantage there...

Russo: Absolutely — because that's part of the ventilated American-blend cigarettes.

OID: Does BAT sell that kind of thing?

Russo: Their heritage is Virginia blend — which traditionally has higher levels of tar and nicotine.

ONE OUTCOME OF EXCESS (EVENTUALLY)
IS EQUAL AND OPPOSITE REFORM.

OID: What about the issue of the rogue judge putting the company into bankruptcy and then signing on to unfavorable legal settlements?

Russo: Well, it's very interesting how they describe what's happened. They start with the observation that the forward-looking calendar looks more benign than it has for a long time. And they point to the notion of excess and reaction. In Engle, there was a $71 billion verdict before the trial even commenced in Florida — with the possibility of that verdict triggering a bonding request that would bankrupt the company.

Well, it's primarily *because* Engle was *so* outrageous that 17 states now have bonding caps — all instituted since Engle. The bonding cap trend began after Engle. And the company believes that it'll soon go to *25* states — and that once it goes to 25, that it will quickly go to all 50. And that's an outcome of excess — an example of excess followed by reaction.

OID: Very interesting.

Russo: And the outcome of excessive *punitive* awards has finally led to the State Farm decision. So again, excess led to reaction.

OID: Makes sense.

Russo: And the Miles decision, with its excessive application, has produced the legislative solution that permits interlocutory appeal of class certification. And that's now true even in Illinois. Had it been available, Miles/Price would never have been certified.

OID: Thus reducing extortion opportunity.

Russo: That's right. Absolutely.

OID: So strike another blow against excess.

Russo: Exactly. And the game theory on the part of plaintiffs' counsel has been that if you can certify a class before a fairly lax judge, you're 95% of the way home. And therefore, one of the industry's initiatives to try to restore a sensible playing field will be to somehow address the concept of elected judges who often preside in state courts by arranging for federal jurisdiction over class actions — which is one of the proposals for tort reform.

OID: I believe something along those lines may have come out of a Senate subcommittee recently...

Russo: I don't know exactly where it stands. But it's currently being discussed. The goal is to provide defendants in class actions with the right to have their cases heard in

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SEMPER VIC PARTNERS'
TOM RUSSO
(cont'd from preceding page)

federal court rather than state courts — because federal court judges are appointed for life, not elected.

OID: Wow — the right of a defendant to appear in a court where the plaintiffs' counsel isn't also the judge's largest campaign contributor. How novel.

Russo: Those are *your* words.

OID: Are they accurate?

Russo: Well, in so many cases, they've proven to be. So if that reform is achieved, defendants would get professional, life-tenured, *appointed* judges.

The other way to address the irregularities is to try to lend some kind of backing to those elections so that those judges aren't unopposed. But that's a harder process.

OID: Yeah. Especially if a judge is willing to sell opinions to the highest bidder. I don't see how you can ever get around that problem with elected judges.

Russo: Yeah. It's definitely an unholy bond. But those are three dimensions for you where recent excesses are in the process of being curbed.

AND WILLIAMS WILL PROBABLY BE OVERTURNED.
BUT EITHER WAY, THE LANDSCAPE HAS CHANGED.

Russo: And we talked about the Williams case. That's the one that went from $800,000 in actual damages to $80 million in punitive damages and the judge in the court of original jurisdiction said it was excessive and reduced it, but the Oregon appellate court reinstated it.

Oregon's Supreme Court obviously hadn't read BMW — because the U.S. Supreme Court was already talking about the need for a rational relationship between compensatory and punitive damages in that decision. And therefore, I have to believe that the appeals court reinstated an award that the U.S. Supreme Court itself would have probably deemed excessive from the start — because going from $800,000 in compensatory damages to $80 million in punitive damages is *quite* a stretch.

OID: Even if it looks like a model of jurisprudence next to Engle and Price/Miles.

Russo: Everything's relative. So anyway, as I said, Williams may or may not be heard by the Supreme Court. The court may *not* grant certiorari [agree to hear it] — although the company believes they surely will because they've already agreed to hear similar cases three times.

And the company believes that we'll know one way or the other whether the Supreme Court will agree to hear the case by sometime in July or August. And if they do agree to hear it, then they'd probably hear it sometime late this year.

However, they acknowledge that it's possible that they'll be *denied* certification — in which case the market will probably react quite harshly believing it to be a signal that somehow tobacco is *outside* of State Farm.

OID: Yeah. You know, I think I might be inclined to draw that same inference myself.

Russo: But I think future cases will still be reined in greatly based on State Farm no matter *what* happens to Williams. It still wouldn't suggest to me that judges are going to have the same unfettered discretion to incite high punitives from juries that they had before.

OID: Isn't that different than what you told us before when you said that Williams was very important and that it would send a signal about whether or not the principles of State Farm applied to tobacco cases?

Russo: It *is* different. And let me try to explain why. Our society and our system of justice tend to view harm involving personal injury as being more reprehensible than harm of an economic nature. So the outrage accompanying that reprehensibility tends to lead to higher punitives — because society wants to doubly punish that behavior and thereby send a message to other possible wrongdoers not to engage in that kind of behavior.

Well, when I first spoke with you about Williams, it wasn't clear whether the principles of the State Farm ruling would apply to cases involving personal injury as well as economic harm — in part because State Farm didn't really fit neatly into either category. However, since we spoke, several cases involving personal injury have been heard by the Supreme Court and remanded back to a lower court with instructions to make their punitives consistent with State Farm.

OID: One of those being Ford.

Russo: That's right — the first and most prominent of those cases.

[Editor's note: Ford involved a $290 million award to plaintiffs from Ford which the Supreme Court deemed excessive, set aside and returned to the California state court for further review with significant force on May 19th — despite both an appeals court in California and the California Supreme Court deeming Ford's conduct to be "grossly reprehensible".]

Russo: Therefore, if the U.S. Supreme Court refuses to hear Williams — which nearly all industry observers believe is highly unlikely in light of it having accepted and ruled on those other cases — what will it mean? Well, if the Supreme Court denies cert, they won't give a reason. So there'll be confusion.

But I think the confusion would be an overreaction — because that would *not* mean judges would then be free to instruct a jury: "If you think this conduct was particularly reprehensible, dare to be great. Send a message across the land. They're a wealthy company. They've been doing this time and again in other states. They've hurt other plaintiffs in this state who are not in this courtroom today. So dare to be great. Send a strong message."

That's pretty much the cocktail that judges have used to inspire huge verdicts.

OID: The specialty of the house in recent years in California.

Russo: That's right. However, those three statements run afoul of State Farm. The judges would be asking you to look at the defendants' wealth — which isn't allowed. They'd be asking you to look at conduct outside the state — which is also not allowed. And they'd be asking you to

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SEMPER VIC PARTNERS'
TOM RUSSO
(cont'd from preceding page)

look at conduct within the state which doesn't involve this specific plaintiff — which is also not allowed. So the elements of that cocktail that were used to rile up juries to grant those huge verdicts, I believe, would be grounds for an appeal based on the specific language of State Farm. And mind you, they'd be grounds for an appeal even if the conduct *were* reprehensible.

So even if Williams is not overturned, I believe that State Farm will still control future tobacco cases.

INSTALLMENT #3: ENGLE REVERSED — MAY 21ST APPEALS COURT RULING AND ITS IMPLICATIONS

ENGLE REVERSED, REMANDED AND DECERTIFIED — I CAN'T SEE THE CASE BEING REINSTATED.

Russo: Did you hear? The operative words were "reversed, remanded and class decertified". That was the operative language in Engle. It's really quite remarkable. You have a great journalistic nose.

OID: Is that a nice way of saying we're a day late and a dollar short?

Russo: Not at all. I think Altria Group is *still* cheap. In fact, I've added to our position since the decision.

OID: So despite the higher price, you've bought more?

Russo: You bet. And if new money were to come in today, I'd take a full position in Altria Group with its price between $43 and $44. As you've reminded me, I've paid more than $50 per share.

OID: Changing the subject as quickly as possible, you told us that you never took Engle seriously — and made no bones about it being so legally flawed.

Russo: That's right. It's ironic, actually. This same district court is known for being very liberal. But at an early stage in the case, even *they* said that you can't certify this case — that it's uncertifiable. However, then the plaintiffs' attorney was able to get it recertified by appealing to the court above.

OID: Did you think it was as incredibly well written as I did?

Russo: I was very impressed.

OID: Frankly, I thought it presented a far more compelling argument than the defendants' reply brief — which wasn't exactly poorly written.

Russo: Agreed. I thought the defendants' reply brief was *already* quite good.

OID: But it seems like the Third District Court of Appeals opinion had even more citations...

Russo: It did. And that's because the appeals court is charged with the burden of balance analysis, whereas the plaintiff is charged with the burden of advocacy.

OID: Which makes it all the more amazing that it was so forceful.

Russo: It's true. Plus, it was very well considered. For example, it introduced choice of law issues that I'd never seen addressed before that were really interesting. That discussion was just incontrovertible. It pointed out aspects of the case that damned it on its own devices. One plaintiff was controlled by state law that denies punitives. And another was controlled by state law that would require a higher standard of proof than that which Florida requires. So both of those demonstrate how inappropriate the forum of class action is for this type of case.

OID: As you and Ohlemeyer have said repeatedly.

Russo: Also intriguing was their conclusion that the class action is an inappropriate forum because it can *under*serve the interests of the downtrodden by relying on class representatives who may not adequately represent the class.

OID: By undercompensating them.

Russo: Yeah! That was really *quite* intriguing — because, in effect, it says that the class action mechanism is not only unfair to the defendant, but also to the plaintiff.

OID: Absolutely. And yet it's totally obvious once you stop and think about it.

Russo: It is. Also, one of the fundamental virtues of a class action is that it allows plaintiffs, for whom the probability of succeeding at trial on an individual basis is too low, to mass together against a defendant. So one of the arguments the plaintiffs' attorney in Engle used to inflame the jury to award greater punitives actually showed that the class was unnecessary because he pointed out that a single plaintiff in California had won an $80 million punitive damage award against the industry.

So the three plaintiffs named in Engle had every reason to suspect that they, too, could have been similarly treated in a court if they could make a compelling enough case. That very express act by the attorney, which was intended to inflame the jury, showed that a remedy *was* ample, abundant and available through individual action.

OID: And it seems that the three-judge panel agreed with you and Ohlemeyer that awarding punitive damages disproportionately to compensatory damages — much less in their absence — violates State Farm.

Russo: Exactly. They called it putting the proverbial cart before the horse — which is exactly what it is.

OID: And it appears they also agreed with you and Ohlemeyer about plaintiffs' counsel misconduct — and even about punitives being barred by the settlement agreements with the states, among other things.

Russo: Yeah. The Third District Appeals Court panel basically told the plaintiffs' attorney in no uncertain terms: "Get out of town" on all dimensions.

OID: That said, given its historical uh... tendencies, wouldn't it be less than shocking if the Florida Supreme Court were to ultimately reinstate Engle —

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SEMPER VIC PARTNERS'
TOM RUSSO
(cont'd from preceding page)

merits aside?

Russo: It would shock *me*. Honestly, I don't think they have the *ability* to reinstate it given that Third District Court of Appeals opinion.

OID: Really!?

Russo: I don't think so. I think the 3rd DCA opinion just lays bare a record of attorney and judicial misconduct that's too severe. The description of the failings of class along with failings of character of the attorney who represented the class — as well as the failings of procedure — in this case are so clearly laid out...

Then, when you couple those descriptions with the fact that 37 other venues and all of the federal courts that have reviewed the class action certification issue have said the same thing, the execution in this case in fact provides its own evidence as to the very inappropriateness of its use in this case. And it does so in such an elegant fashion that it's very hard for me to imagine *any* appellate court — including the infamous Florida Supreme Court — not being constrained from reinstating the case.

It's one thing during the process of the trial to say, "Let's just ignore what happened since we've come this far." And it's another thing altogether to have an appellate court say, "What the heck. Since this was an unusual trial, even though the appellate court decided the class didn't survive and the misconduct was severe, let's just ignore it."

OID: That is hard to imagine, isn't it?

Russo: You bet. And that's basically what they're going to be asked to do. The plaintiffs' attorney is basically going to be saying, "Everything they described in the original appellate decision is true. But it's such an unusual case. So let's just ignore it."

Having read the Third District Court opinion, it's almost *impossible* for me to imagine. I don't believe that they can do it.

JUSTICE DEPARTMENT *NEVER* HAD LEGAL STANDING. AND RICO REQUIRES *ONGOING* FRAUD. I DON'T SEE IT.

OID: And I presume the fact that Judge Kessler decided not to throw out the Justice lawsuit on summary judgement doesn't concern you.

Russo: Not in the least. Again, in my opinion, there's *no* chance based on the facts presented that the Justice Department can prevail on trial. The courts want to be very guarded in depriving plaintiffs — especially the Department of Justice — of their chance to be heard.

[Editor's note: Lest you worry Russo is wrong and Judge Kessler's decision not to throw the case out bodes ill for the defendants, consider the standard she describes as ruling at this stage of the proceeding — the so-called "summary judgement standard": Judge Kessler says, "The evidence of the non-movant [the plaintiff] is to be believed and all justifiable inferences are to be drawn in his favor."

So in deciding whether to grant the defendants' motion for summary dismissal, the judge in effect assumed that every allegation by the plaintiff was correct. In effect, the courts are *supposed* to be very reluctant to grant summary judgement.]

Russo: Mind you, Philip Morris has received summary judgement in far and away the majority of cases that they've ever been confronted with in the individual plaintiff arena. That's been the *typical* outcome. Time and again they've received summary judgement in their favor despite the fact that the standard has been, "Assume the facts were as the plaintiff suggests — i.e., I smoked, the product harmed me and I'm now passing away."

Despite assuming every fact in favor of the plaintiffs and against Philip Morris, the court has ruled in their favor again and again — despite the fact that such a ruling is a very draconian outcome.

OID: All the more impressive.

Russo: You bet. And let me give you just one more wrinkle on the Justice Department suit. The original suit wasn't pursued because it lacked standing. It has to do with the federal government's legal standing to be reimbursed for health-related expenditures. Its legal standing is different than the states' legal standing. So the states ultimately had leverage over the industry.

OID: Very interesting.

Russo: They were in some sense permitted to level a claim as they were in some manner reclaiming their own spending. And the states had standing even though the patients were the ones spending the money because of the intricacies of how states reimburse their citizens and their relationship with the patients — which was different legally than the relationship the federal government has.

It's a very complex analysis...

OID: Uncle. Just give us the bottom line.

Russo: The conclusion the Justice Department reached in their original analysis was that the federal government did not have standing to sue. And that was the reason why, despite the enormous pressure applied by the Clinton administration during the mid-1990s to sue, the administration's own Justice Department came back time and again and said, "We can't sue — because we don't have legal standing."

Well, I think their original interpretation was correct — that they never had the standing to sue to begin with. So given that they never had standing in the first place, they continue to lack standing today. And therefore, that's yet *another* reason why I'm not that concerned about the Justice Department lawsuit.

OID: So Judge Kessler's ruling not to dismiss the Justice Department lawsuit is a nonevent to you.

Russo: Absolutely. And as I told you before, to prove a RICO action requires a fraud in the past as well as ongoing fraud. And with the first two legs of the case having been dismissed, I don't see how it can be sustained.

OID: Especially the ongoing part — post-MSA.

Russo: Exactly.

OID: So you still think it'll be thrown out eventually?

Russo: Definitely.

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SEMPER VIC PARTNERS'
TOM RUSSO
(cont'd from preceding page)

[Editor's note: For more on the injustice of the Justice Department lawsuit, we refer you to an article by William Anderson and Candice Jackson entitled "Justice, Tobacco, and Retroactive Law" which you'll find at:

http://www.mises.org/fullarticle.asp?control=1192

from the Ludwig von Mises Institute website.]

ARKANSAS CASE IS LIKELY TO BE OVERTURNED. BUT THAT ONE'S REALLY NO BIG DEAL IF IT ISN'T.

OID: On the other hand, didn't the industry just lose a case in Arkansas?

Russo: That's right. Brown & Williamson just lost a case at the trial court level in Arkansas. But that was a defective product case rather than a negligence case. And in that case, the plaintiffs were awarded $4 million of actual damages and $11 million of punitive damages — which would appear to be in line with State Farm...

OID: Because the ratio of punitive damages to compensatory damages is only 2.75 to 1.

Russo: That's right. So it's within the guidelines of State Farm — as long as you believe that plaintiff could have suffered $4 million in actual damages. I don't know how that plaintiff substantiates that level of damages — because $4 million represents the largest harm recovery that I've ever heard of in the context of personal injury lawsuits against the tobacco industry.

Even in Williams, it was $300,000 grossed up to $800,000. So $4 million is a big number.

OID: So maybe the plaintiff was an entertainer — or some kind of pro athlete.

Russo: That's right. It has to be something like that. They'd have to be some kind of an economic stud.

OID: What do you see as the ultimate outcome of the Arkansas case?

Russo: The Arkansas case relies on the principle of cigarettes being a "defective product". And at one level, that's an easier action to prove — because society wants to discourage defective products from being in the market. But on balance, I actually think that's a weaker case than negligence or some kind of fraud because it doesn't seem to me that cigarettes *are* defective. They do exactly what they *say* they're doing as reasonably interpreted by most people — which is to deliver nicotine, tar, smoke, etc.

OID: And presumably, they also do what they say they're going to do on the warning label...

Russo: Yeah. So I can't see how that verdict can withstand an appeal based on the body of information that doesn't award based on it being a defective product. There's just too much law out there that says you can't win on the defective product argument.

OID: Yeah. It seems like you would be more likely to prevail if you smoked three packs a day for 40 years and <u>didn't</u> get one of the diseases listed on the package. You could argue that you budgeted for a shorter life expectancy and outlived your savings.

Russo: That's right. You get into the whole thing about whether it's reasonable for the person to have ignored the warning label and thereby pass the burden of assuming the risk. And I think the answer is probably no — that it's not reasonable for a jury to allow that verdict to withstand an affirmative defense of assumption of the risk.

In fact, the supreme court of neighboring state Mississippi recently decided that no product liability/personal injury claims would be allowed at *all* against the tobacco industry — because potential plaintiffs had knowledge that the product was harmful. And therefore, don't even *try* to sue for recovery for damages that arise from knowingly using a harmful product. By ruling that nobody in Mississippi could sue the tobacco companies for damages resulting from smoking, they were expressing the standards of the community — which is basically to say, "Wait a second. It's *silly* to say you didn't expect anything to happen to you when you chose to smoke cigarettes — whether you started 57 years ago or 27 years ago, whenever — and chose to *keep* smoking for all those years. The world is just too aware of the risks."

OID: And the argument that people can't quit would seem to be laid to rest by the fact that something like half of the people who ever have smoked <u>don't</u> smoke.

Russo: *More* than half. I understand that there are actually far more smokers who have quit than there are active smokers. In fact, I'm one of them.

OID: You, too!?

Russo: So is it reasonable to allow a jury to say that the plaintiff can survive an assumption of the risk affirmative defense? Can their claims overcome the defendants' affirmative defense that the plaintiff knowingly assumed the risks of the very harms for which they now seek recovery? That's something that I think the appellate court will look at. And I don't think it *can* be considered reasonable. So I suspect that it *won't* survive on appeal.

Also, a $4 million award for compensatory damages in a market where the standard award seems to top out at about $1 million seems like a big number. And I think the Supreme Court agrees. Remember in our last conversation, I told you the Supreme Court had remanded several personal injury cases back to the lower courts because they violated the guidelines that they laid out in State Farm.

OID: I do.

Russo: Well, the company says that the Supreme Court has now remanded *five* cases back — including one that had a 1-to-1 ratio of punitives because they considered the $4 million awarded in actual damages to be sufficient.

OID: Wow.

Russo: That said, the Arkansas case is hard to predict since the compensatory damages are so high. But on its face, based on the ratio, it would meet the State Farm guidelines — because 2.75 to 1 isn't crazy.

Again, I don't understand how they got such a divergent outcome. But it's the kind of action that most

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SEMPER VIC PARTNERS'
TOM RUSSO
(cont'd from preceding page)

states are moving against — which is personal injury — because of the unreasonableness of saying that you weren't assuming the risk of smoking. So that one's not very troublesome to the industry — at least it's not in *my* view.

PRICE/MILES WILL VERY LIKELY BE DECERTIFIED.
BUT ONE WAY OR ANOTHER, IT GETS THROWN OUT.

Russo: And I understand that an appellate court in Massachusetts decertified another class action against Philip Morris...

OID: Yeah — a "Lights" case.

Russo: That's right — Aspinall. So the data points continue to line up. And I believe that's typical of how the investment process in tobacco will continue. You have the resolution of a lawsuit with extrapolatable impact — which is a class action alleging misrepresentations based on the labeling of "Lights". Well, that class was just decertified.

And part of the downgrade of Altria's debt by the rating agencies after Price/Miles said specifically, in effect: "We worry about the fact that other states will follow suit — copycat lawsuits, if you will."

And there are two states with pending litigation. But now one of those two has just been addressed favorably for the industry.

OID: One copycat down, one to go.

Russo: So now the only "Lights" class action case left certified outside of Illinois is a case in Florida. And there, it's probably a pretty strong position based on the reversal of Engle to say, "Class actions in our case don't really work because of choice of law and all of the other reasons that they so clearly laid out in Engle." So if they can prevail on appeal in Massachusetts, I think it's likely that they can get to the same outcome in the "Lights" case in Florida.

OID: I think you present a very compelling case. However, if some combination of the developments we discussed wind up making lawsuits uneconomic, would that reopen the issue of class certification as a remedy to those who might not otherwise be able to access the legal system against cigarette companies?

Russo: I don't think so. I just can't imagine a scenario where tobacco cases ever meet the qualifications for class action certification — at least where it would withstand appellate review.

The other thing that was really terrific about the Engle selection of plaintiffs was that some of them had statute of limitation issues that came up differently than others because they had expressed awareness of the risks at different times. And that's what starts to toll the statute of limitations in Florida.

And they'd all moved to Florida — which was the reason why the choice of law becomes important. And some of them had different types of injuries. Therefore, they had different types of financial recoveries. And those complexities associated with just three members of a supposed class of 700,000 shows just how different the outcomes are from one person to another — which, again, very clearly demonstrates why a class action is such an inappropriate forum for tobacco cases.

OID: You make it sound so definitive.

Russo: Actually, the only place where I can see even the *tiniest* ray of hope for the plaintiffs' attorney on appeal, and it's a slim one, is by filing suit under statutory fraud statutes — because that's the one place where they might be able to avoid the burden of proof on the issue of individual reliance. They could say, "We can assume for the moment that everyone in the class relied upon the fraud since the legal claim is in the nature of a statutory claim, not a common law claim."

If it were determined to be a statutory fraud case, then they wouldn't have to show individual reliance that was reasonable. They could assume reliance across the whole class. That's one reason why the 3rd DCA opinion read so interesting to me — because they were willing to at least address that nuance in the footnote.

[Editor's note: Russo referred us to a section of the 3rd DCA opinion reversing Engle which mentions Davis v. Powertel. From that section: "Damage claims pursuant to Florida Deceptive and Unfair Trade Practices Act are different from common law fraud claims because plaintiff need not demonstrate individual reliance, unrelevant representation or omission. Therefore, such claims may be asserted on behalf of a class."]

OID: How did they ultimately resolve that issue?

Russo: I think the 3rd DCA just dropped back on it being a common law fraud case — thus requiring individual causation and reliance to be established.

However, the Illinois appellate courts could allow Price/Miles to go forward under that exception. Mind you, I don't see that happening — because choice of law issues remain incontrovertible. And since there is relief available in single plaintiff cases, that outcome is still very hard for me to imagine.

So it just seems like it would still fall down based on *other* aspects of certification. However, that is the one basis on which I could imagine the case avoiding decertification.

But even that argument doesn't finally win — because then you wind up with the whole failure to establish a case that shows the companies actually did something in support of defrauding consumers other than naming the product "Lights" — given that the cigarette companies made no health claims (they didn't say that it was healthier or take any affirmative steps whatsoever) in that regard.

OID: So Price/Miles and the other "Lights" cases are ultimately kaput, too.

Russo: That's sure the way it looks to me. It either gets thrown out as a class — or it gets thrown out because there's no evidentiary basis on which to condemn a defendant for statements that weren't made.

OID: Not to mention possible attorney misconduct.

Russo: That's right.

OID: In which case the issue becomes how many extortion attempts are made against the company

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SEMPER VIC PARTNERS'
TOM RUSSO
(cont'd from preceding page)

before the issue is finally resolved in its favor — and how successful those extortion attempts are.

Russo: That's right. But that then gets down to bonding requirements. And as I said, 10 more states have legislation in process right now for bonding limits.

ALSO, LEGAL PRECEDENT IN ILLINOIS (OLIVEIRA) SAYS EVEN STATUTORY FRAUD REQUIRES CAUSATION.

Russo: Also, we talked about whether or not consumer fraud cases require individual reliance in statutory fraud cases. Well, it turns out that in Oliveira, the Illinois Supreme Court disregarded the discussion as to whether reliance needed to be proven or not. They didn't even get to the issue of reliance. Instead, they went to the issue of causation. And the failure to allege acts that *caused* harm meant that the claim wasn't duly filed. So it was dismissed for failure to state a claim.

So in Oliveira, the court never even needed to rule on whether or not there was detrimental individual reliance — because they found that there was no causation. The defendant wasn't properly alleged to have taken steps that would have caused proven harm.

OID: So?

Russo: In Miles/Price, there's no proven harm — because that's an individualistic test. Did the consumer get what he bargained for? Did he get a lighter cigarette? Well, that depends. How did he smoke it? What did he want? What was the harm? Who made what specific promises? Those are individual issues. So the actual question about whether there was harm that was caused in the first place is individual, not class oriented. And so it would be dismissed based on that...

OID: Based on the Illinois Supreme Court's prior ruling in Oliveira.

Russo: Exactly. And then the question of did the defendant cause that harm is all about the actions that the defendant took. And those are individual issues, as well. So based on precedent within Illinois, even statutory fraud requires a showing of causation — which requires action. And in Oliveira, the plaintiffs didn't claim or show that the defendant caused anything.

OID: So, presumably, one should expect the same outcome in Price/Miles.

Russo: That's right. I think what it boils down to is that even under a statutory fraud claim, the state of Illinois requires the plaintiffs to prove causation — that the defendant actually did something to cause harm. And that requires individual testing — because, for example, in the case of the "Lights" lawsuits, the plaintiffs have to prove that the harm was that the consumer didn't get what they bargained for.

So it's hard to see how the case can be handled on a class-wide basis. It requires individual proof that the individual was misled — that there was a fraud relating to what the benefit of the bargain was that resulted from the defendants' conduct rather than just the name — and that the consumer didn't get the benefit of what they thought they were buying when they entered into the deal. That's the harm in a fraud case.

And they also don't go anywhere as individual suits either because the damages sought are only the recovery of money that each individual spent.

OID: So the likely payoff's not large enough.

Russo: That's right.

MSA MAY PROTECT SIGNERS FROM PUNITIVES. THEN AGAIN, IT MAY NOT. ONLY TIME WILL TELL.

Russo: And the Third District also clearly stated that, in their opinion, punitives relating to personal harm and injury cases are not available in Florida because they were subsumed by the agreement between the state of Florida and the industry.

OID: I don't know what the exact language is in the Florida agreement [FSA]. But in the Master Settlement Agreement, there's language prohibiting the agreement being "offered or received in evidence in other [legal] actions". And the language is very similar in the FSA.

Russo: The company says it varies by jurisdiction. Some allow it in as evidence of changed conduct, whereas some don't. The Third District actually said that barring it deprived the jury of information it should have been instructed to consider in its assessment of punitives. And they point out that one of the purposes of punitives is to induce a change of conduct by punishing past conduct. So the fact that their past conduct had already been punished — and the fact that there's been a change in conduct — should have been considered in determining whether or not punitive damages should have been assessed and, if so, how much they should be.

OID: To what degree do you think that's likely to become a settled standard?

Russo: Well, we'll find out in California this month. There's a case going before the court in California. And the issues that have been subsequently raised that have not yet had a chance to be part of a court record are going to be introduced. For example, they'll probably introduce the argument about the prohibition of punitive damages by the MSA. But they may not be able to get that admitted because state courts are loathe to allow anyone — even state attorneys general — to broker away perceived rights. So we'll just have to wait and see.

However, they're *certainly* going to introduce restraints against harm to other plaintiffs. For instance, in the case that resulted in an initial $28 billion verdict against Philip Morris USA, when the jury was assessing punitives, the judge allowed the jury to also consider the harm to 28,000 other people who the plaintiffs allege died from smoking-related causes whose cases weren't being heard in California and to apply punitives on their behalf. Well, State Farm says you can't *do* that. So if the judge permits that kind of language to influence the jury's

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SEMPER VIC PARTNERS'
TOM RUSSO
(cont'd from preceding page)

determination of punitives, then the verdict should be clearly reversible on appeal.

Conduct out of state can't be introduced. And it's been introduced in California cases up to now.

OID: Again, you have the Third District's perspective — which is consistent with the part of the FSA and the MSA that bars punitives for the same conduct.

Russo: That's right.

OID: But then you have the clause which prohibits the introduction of the FSA and the MSA in other actions.

Russo: Correct.

OID: How do you reconcile those two seemingly contradictory sections of the same agreement?

Russo: I don't know how to square those two...

OID: So that there may be a bar on punitives for the same conduct for the states that signed the MSA — and then again, there may not be.

Russo: That's absolutely right. I don't think that's been offered up in law yet.

OID: Do you have any thoughts about how that apparent conflict is likely to play out?

Russo: I don't know. We'll find out. But after all, this is new territory. And you don't have enough pages...

OID: Or enough stamina — you've convinced us there.

Russo: However, in Florida at least, until and unless it's overturned by an appellate court, the operative ruling from this particular district court of appeals is that as a matter of law, punitives are unavailable — in *all* cases.

[Editor's note: At least punitives are unavailable for actions involving the same behavior covered by the FSA.]

Russo: Frankly, it doesn't matter to me that much — because I think class actions are going to be less and less of a problem because of their failure to get certified in the first place and the very high likelihood that they get decertified on appeal in those few cases where they do get certified. And as for individual plaintiffs' suits, I think State Farm has so limited the application of punitives that they won't have nearly the same consequence.

And the defendant's wealth can't be introduced.

OID: Those definitely sound like pretty dramatic changes to the legal landscape.

Russo: Yeah. And as I mentioned, any question about whether State Farm applies to personal injury appears to have been clearly answered by five remands of personal injury cases since the original decision. So it's a meaningfully changed environment.

Again, in one of the personal injury cases that was remanded, the punitives were only 1 to 1. And yet the Supreme Court remanded it back to the lower court for reconciliation anyway. According to the company, that was because the actual damages were so large relative to the harm that punitives on top of the actuals were excessive despite the fact that they were only 1 to 1. So I think the question of whether the MSA disallows punitives would be very important if you still feared the advent of large class actions. But I guess I'm less worried about those now — all things considered.

OID: Less worried? It sounds like you're not worried.

Russo: I think that's a fair statement.

STATES WILL MAKE NON-SIGNERS OF THE MSA PAY — AND LEGAL ATTEMPTS TO AVOID PAYING WON'T WORK.

OID: On the topic of the MSA, I read recently that Minnesota was trying to implement a tax on the companies that had not yet signed onto the MSA.

Russo: Yeah.

OID: And I understand that some of those non-signers are contesting that tax in court.

Russo: That's right. At some point, the non-signers are going to argue that the Master Settlement Agreement was improper — and they'll try to dislodge it. But I think that's a nonstarter. It won't go anywhere.

OID: You say that with such confidence.

Russo: I *am* confident on that point.

OID: Why wouldn't the non-signers be able to say, "Look, you basically got these guys to pay based on what amounts to past bad behavior. We're clean. We didn't sign onto that suit. Why should we be punished for somebody else's transgressions?"

Russo: The defense that states have when they impose taxes that might restrain commerce among the states is that they can do it because there's a valid state interest relating to the health and safety of its citizens.

OID: Certainly the states have the right to do it. But do they have the right to do it on what appears to be a discriminatory basis?

Russo: They do. This is the one field, almost, that would define that exemption. It would seem to me to be very supportable.

OID: And perhaps the worst case scenario might be that the states have to structure the excise tax in such a fashion that MSA signers get a favorable credit against an excise tax that everyone has to pay?

Russo: That's possible. I just don't think it's going to be a legitimately defendable claim by the non-signers because of the nexus with safety and health.

By the way, under the terms of the MSA and the separate state agreements, even now, those non-signers are supposed to make payments once they achieve a certain market share. But many still aren't paying. So the mere enforcement by the states of those companies' obligations under the industry's agreements with the states will immediately reduce the competitive advantage that those companies enjoy today.

OID: And you expect that.

Russo: I expect it — and very soon. Again, the states

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SEMPER VIC PARTNERS'
TOM RUSSO
(cont'd from preceding page)

have an *enormous* financial incentive to see that everyone makes good on their obligations under the agreement.

For example, North Carolina just proposed increasing their state excise tax by 20¢ — from 5¢ to 25¢ — per pack for the MSA signators. However, non-signators will be required to pay a 50¢ excise tax. Again, that's in *addition* to the burden of payments they're forced to bear as non-signators to the MSA once they hit certain volumes.

OID: Excellent answer.

Russo: Needless to say, I was impressed that excise taxes are being used as part of the enforcement process by the states to encourage holdouts to sign on to the MSA.

[Editor's note: Even *more* impressive to us is the fact that fairly far reaching federal legislation's been introduced in the House and the Senate for the same purpose.]

Russo: Also, the company suggests that the states are enforcing the payment of those obligations already and that the U.S. market has already begun to stabilize — along with the discounters' and deep discounters' share.

COUNTERFEITS ARE MUCH BETTER THAN EVER.
BUT ONE WAY OR ANOTHER, THEY'LL BE SQUELCHED.

Russo: That said, as we discussed, the difference between where Philip Morris USA might come in this year and what their average operating income has been the past three or four years is about $2 billion. And a portion of that is gone because of the higher state and federal tax.

But a portion of that $2 billion is gone because of competition from counterfeit products. For instance, the company suggests that as much as 2 full points of Marlboro's reported share may be counterfeit product. Obviously, that's a huge number.

OID: "Huge" is the word. And I read somewhere that they're a pretty good knock-off.

Russo: Oh, yeah. The counterfeits are *much* better than they used to be. The company says the packaging is absolutely identical. You can't even tell it's fake with the naked eye. The tobacco and filters and paper are getting *awfully* close.

OID: Are most of those from China?

Russo: In some cases. In others, they believe they're from subsidiaries of other major European producers.

OID: Wow. How can that be?

Russo: You have a small Eastern European company with some excess capacity. So they may just knock off some of the Western products and then transship them through illegal channels to the U.S.

OID: Has Philip Morris ever encountered that quality of counterfeiting before?

Russo: No.

OID: Is that something that <u>can</u> be squelched?

Russo: Oh, sure. Absolutely. It *is* being squelched. There again, they've gotten the aid of the states.

OID: Their senior financial partners.

Russo: Yep. The states not only came to their defense on the amicus brief for Price/Miles, but they've also come to their defense on counterfeiting. The states are aggressively cracking down on counterfeiters and smugglers and the retailers through whom those products go to market. And that includes internet retailers as well as players in traditional channels.

OID: As you predicted.

Russo: And you asked about Chinese counterfeiting. Of course, that's an enormous problem not only with cigarettes, but with a wide range of products — even up to and including cars. However, what happened in China is most interesting. Right now, China is engaged in a massive crackdown on counterfeits. And that's because Chinese counterfeiters who were doing a big business counterfeiting Western trademarks started to counterfeit Chinese brands.

OID: What nerve!

Russo: And the Chinese government got wind of that. So they're cracking down on *all* counterfeiters.

OID: Color me skeptical. But in any case, I imagine that's in the unknowable risk category.

Russo: It is. But it's not one that I worry about — because Philip Morris has always been able to deal with it in the past. And I'm confident that they'll continue to be able to deal with it just fine going forward.

THINGS ARE LOOKING GOOD INTERNATIONALLY —
AND THINGS ARE EVEN BETTER THAN THEY APPEAR.

Russo: And Philip Morris International has made several announcements recently that I think are important. Despite everything we talked about that's been going on in PM USA's tobacco business, Philip Morris International's made continued investments abroad. They bought the Greek tobacco company — Papastratos. Also, they've agreed to put $250 million in a plant in the Philippines. And finally, they've agreed to put another $200 million into their plant in St. Petersburg.

OID: And those developments are important because...

Russo: I just think it's important to appreciate that for Philip Morris, life goes on — and that they continue to pursue commercial opportunities in a very vigorous way.

OID: You sound like you view that as a positive.

Russo: Oh, yeah. Definitely. They're out of capacity in St. Petersburg, so that's a terrific development. And in Greece, the company that they're buying operated in the Greek market with local brands. It has 17% of the market. But it also represented Marlboro. So Philip Morris wanted to secure its route to market. And then, in the Philippines, it's a new plant to increase production in order to meet growing demand. So all of those developments represent

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SEMPER VIC PARTNERS'
TOM RUSSO
(cont'd from preceding page)

investments towards securing their future.

OID: That all makes sense. But if there weren't a strategic justification for the Greek acquisition, I'd be concerned that they're missing the boat by not just allocating that capital to share buybacks.

Russo: Yeah. Although, of course, for the time being, Altria Group is out of the market for share buybacks while they wait for their credit rating to be restored in the wake of the Madison County case — which is on appeal. And that's too bad. But life could be worse.

OID: Yeah. They could be in publishing.

Russo: They'll be able to pay down a lot of debt.

OID: Like I said...

Russo: So they're making those investments. Again, Philip Morris International is a gem of a business. It's growing sharply. But one of the appearances that comes from that growth is that they have lower margins — because the highest growth is coming in markets with less well off consumers. So in those markets, they sell more mid-to-low-priced cigarettes — whose margins are lower.

Therefore, as they continue to grow internationally, there's the appearance of deteriorating operating margins. But what's really happening is that they're just garnering incremental profit by beginning to take some share in the mid and lower-priced categories that they don't presently participate in. And what's important to note is that they're not cannibalizing themselves in those markets.

OID: It's all incremental.

Russo: Exactly. Also, Philip Morris International is getting even more foreign currency benefits than they've let onto historically. Most of those currency-related profits have been reinvested back into the marketplace in the form of new launches, new products and promotional pricing.

So they'll report lower increases in profitability than they could report. For example, over the last 10 years, in aggregate, they've given back something like $2 billion of currency-related profits. And this year, they should earn unusually large currency-related gains in profits.

OID: I don't know about the last 10 years. But based on our back-of-the-envelope analysis, it looked like Philip Morris International could wind up with nearly an extra billion dollars of incremental pre-tax profits from currency gains in 2004 alone.

Russo: Yeah. That's probably a bit high, but not by too much. And you won't see a large portion of it. However, it's a big number. And the company thinks that when that incremental profitability does finally begin to express itself, it's going to be a *very* big number.

THEY DESERVE THEIR CREDIT RATING BACK TODAY.
BUT SOON THE RATING AGENCIES WON'T MATTER.

OID: Given all of those positives, how long do you think it's likely to take them to get the credit rating on their commercial paper restored so that they can restart their share repurchases?

Russo: They sound like they think of it as something that's not likely to happen in the next 12 months — even though the reality of the environment in which the credit rating agencies reviewed seems in hindsight to have been far better than what the agencies thought they were dealing with. The downgrade seems a bit reactionary.

That said, despite all the positive legal developments, the rating agencies seem worried about what they call the "deteriorating legal environment". And so when will they restore their credit rating? Your guess is as good as mine.

OID: But do I gather that you agree with Altria CFO Dinyar Devitre that they deserve an upgrade today?

Russo: Oh, sure. Absolutely. For crying out loud, last year, they probably covered their interest 10 times, even without including the operating income from PM USA.

OID: Wow.

Russo: It's a big number. Nevertheless, I get the impression that the company is thinking of the process of restoring their credit rating as one that might take two years.

On the other hand, their credit rating is going to be less and less relevant for a couple of reasons: First, they've gone to banks and drawn down credit lines which have covenants against share buybacks.

But they'll use cash flow to pay off those drawdowns. And they'll soon be able to retap the *long*-term market — because even though Moody's, Fitch and S&P say that their credit's impaired, the long-term capital markets are pricing their bonds up. So they're priced off of a much higher rating. And therefore, the company can tap the long-term credit market.

OID: So the credit markets are starting to ignore the rating agencies.

Russo: That's right — at the margin.

OID: So when does that suggest that the company is likely to restart its share repurchases?

Russo: I think they're unlikely to be able to repurchase shares until after the uncertainty associated with Price/Miles lifts. And that's unfortunate because given the depressed stock price, buybacks would have such a leveraging impact to remaining value per share.

However, since they've stopped granting options as part of their compensation package, their perceived need to buy back shares in order to offset the dilution associated with the conversion of those options goes down.

OID: They've stopped using options in compensation!

Russo: That's right. They're going to use cash and restricted stock. And Kraft has announced that they're doing something very similar.

OID: I'm impressed. But what was their rationale?

Russo: They just wanted to achieve transparency. Transparency is going to be required of them anyhow. They'll have to price options. And since accountants continue to claim that options are impossible to price, they figured they might as well switch to some other currency.

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