
NOTES TO THE FINANCIAL STATEMENTS

NOTE 19: COMMITMENTS AND CONTINGENCIES

A. No Commitment Debt

The State, by action of the General Assembly, created the North Carolina Medical Care Commission which is authorized to issue tax-exempt bonds and notes to finance construction and equipment projects for nonprofit and public hospitals, nursing homes, continuing care facilities for the elderly and related facilities. The bonds are not an indebtedness of the State and, accordingly, are not reflected in the accompanying financial statements. Each issue is payable solely from the revenues of the facility financed by that issue and any other credit support provided. Therefore, each issue is separately secured and is separate and independent from all other issues as to source of payment and security. The indebtedness of each entity is serviced and administered by a trustee independent of the State. Maturing serially to calendar year 2041, the outstanding principal of such bonds and notes as of June 30, 2003, was \$4.7 billion with interest rates varying from 2.00 % to 7.57 %.

The North Carolina Capital Facilities Finance Agency is authorized by the State to issue tax-exempt bonds and notes to finance industrial and manufacturing facilities, pollution control facilities for industry (in connection with manufacturing) where there is a favorable impact on employment or pollution control commensurate with the size and cost of the facilities and to finance facilities and structures at private nonprofit colleges and universities, and institutions providing kindergarten, elementary and secondary education. Its authority to issue bonds and notes includes financing private sector capital improvements for activities that constitute a public purpose. The bonds are not an indebtedness of the State and, accordingly, are not reflected in the accompanying financial statements. Each issue is payable solely from the revenues of the facility financed by that issue and any other credit support provided. Therefore, each issue is separately secured and is separate and independent from all other issues as to source of payment and security. The indebtedness of each issue is serviced and administered by a trustee independent of the State. Maturing serially to calendar year 2042, the outstanding principal of such bonds and notes as of June 30, 2003, was \$1.3 billion with fixed interest rates varying from 2.4% to 7.4% and variable interest rates which can be reset weekly.

B. Litigation

Leandro et al v. State of North Carolina and State Board of Education — Right to a Sound Basic Education. In 1994, students and boards of education in five counties in the State filed suit in Superior Court requesting a declaration that the public education system of North Carolina, including its system of funding, violates the State constitution by failing to provide adequate or substantially equal educational opportunities, by denying due process of law, and by violating various statutes relating to public education. Five other school boards and students therein intervened, alleging claims for relief on the

basis of the high proportion of at-risk and high-cost students in their counties' systems.

The suit is similar to a number of suits in other states, some of which resulted in holdings that the respective systems of public education funding were unconstitutional under the applicable state law. The State filed a motion to dismiss, which was denied. On appeal the North Carolina Supreme Court upheld the present funding system against the claim that it unlawfully discriminated against low wealth counties but remanded the case for trial on the claim for relief based on the Court's conclusion that the constitution guarantees every child the opportunity to obtain a sound basic education. Trial on the claim of one plaintiff-county was held in the fall of 1999. On October 26, 2000 the trial court, in Section Two of a projected three-part ruling, concluded that at-risk children in North Carolina are constitutionally entitled to such pre-kindergarten educational programs as may be necessary to prepare them for higher levels of education and the "sound basic education" mandated by the Supreme Court. On March 26, 2001, the Court issued Section Three of the three-part ruling, in which the judge ordered all parties to investigate certain school systems to determine why they are succeeding without additional funding. The State filed a Notice of Appeal to the Court of Appeals, which resulted in the Court's decision to re-open the trial and call additional witnesses. That proceeding took place in the fall of 2001. On April 4, 2002 the Court entered Section Four of the ruling, ordering the State to take such actions as may be necessary to remedy the constitutional deficiency for those children who are not being provided with access to a sound basic education and to report to the Court at 90-day intervals remedial actions being implemented. Although a Notice of Appeal has again been filed, the State did not seek a stay of the order and has undertaken preliminary measures to respond to the Court's directive. The Supreme Court has accepted the case and oral argument was heard on September 10, 2003. The magnitude of State resources which may ultimately be required cannot be determined at this time, however, the total cost could exceed \$100 million.

N.C. School Boards Association, et. al. v. Harlan E. Boyles, State Treasurer, et. al. — Use of Administration Payments. On December 14, 1998, plaintiffs, including county school boards of Wake, Durham, Johnston, Buncombe, Edgecombe and Lenoir Counties, filed suit in Superior Court requesting a declaration that certain payments to State administrative agencies must be distributed to the public schools on the theory that such amounts are civil penalties which under the North Carolina Constitution must be paid to the schools.

On December 14, 2001, the Superior Court of Wake County granted summary judgment in favor of the plaintiffs on all issues, concluding that the funds in dispute are civil fines or penalties required by Article IX, Section 7 of the Constitution to be remitted to the public schools in the county where the violation occurred. The court further determined a three-year statute of limitations to be applicable, making the order

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retroactive to December 1995. This case was argued in the Court of Appeals in February, 2003.

The last year for which information was available to them, plaintiffs allege liability of approximately \$84 million. Until this matter is resolved, any refunds and interest will continue to accrue. The North Carolina Attorney General's Office believes that sound legal arguments support the State's position on the outstanding claims.

Faulkenbury v. Teachers' and State Employees' Retirement System, Peele v. Teachers' and State Employees' Retirement System, and Woodard v. Local Governmental Employees' Retirement System — Disability Retirement Benefits. The plaintiffs are disability retirees who brought class actions in State court challenging changes in the formula for payment of disability retirement benefits and claiming impairment of contract rights, breach of fiduciary duty, violation of other federal constitutional rights, and violation of state constitutional and statutory rights. The Superior Court ruled in favor of the plaintiffs. The Order was affirmed by the North Carolina Supreme Court in 1997. The case went back to the Superior Court for calculations of benefits and payment of retroactive benefits, along with determination of various remedial issues. As a result of the remedial proceedings, there have been two appeals to the appellate courts concerning calculation of the retroactive benefits. The plaintiffs previously submitted documentation to the court asserting that the cost in damages and higher prospective benefit payments to the plaintiffs and class members would amount to \$407 million. Calculations and payments so far indicate that retroactive benefits will be significantly less than estimated, depending in part on the pending appeal. Payments have been made by the State in excess of \$97.3 million. A liability of \$8 million for the retroactive benefits has been booked in the Teachers' and State Employees' Retirement System.

Southeast Compact Commission — Disposal of Low-level Radioactive Waste. North Carolina and seven other southeastern states created the Southeast Interstate Low-level Radioactive Waste Management Compact to plan and develop a site for the disposal of low-level radioactive waste generated in the member states. North Carolina was assigned responsibility for development of the first disposal site, with costs to be distributed equitably among the Compact members. In 1997 the Compact Commission discontinued funding of the development of the North Carolina site, alleging that the State was not actively pursuing the permitting and development of the proposed site. North Carolina withdrew from the Compact in 1999. The Compact subsequently asked the United States Supreme Court to accept its Complaint against North Carolina demanding the repayment, with interest, of \$80 million of Compact payments expended on the permitting of the site, plus \$10 million of future lost income, interest and attorney fees. The Supreme Court denied this motion in August 2001. On August 5, 2002 the Compact, with the addition of four member states as plaintiffs, filed a new motion requesting the United States Supreme Court to accept the claim under its original jurisdiction. On June 16, 2003, the Court accepted jurisdiction of the case and the State filed an answer and motion to dismiss

on August 21, 2003. On November 17, 2003, the motion to dismiss was denied, and the U.S. Supreme Court appointed a special master with authority to determine when additional pleadings will be filed in the case.

The North Carolina Attorney General's office believes that sound legal arguments support the State's position on this matter.

State Employees Association of North Carolina v. State; Stone v. State — Diversion of Employer's Retirement System Contribution. On May 22, 2001, SEANC filed an action in Wake County Superior Court demanding repayment of approximately \$129 million in employer retirement contributions to the Retirement Systems. The Governor withheld, and subsequently used, the withheld funds under his constitutional authority to balance the state budget. The trial court dismissed the action on May 23, 2001, finding that the plaintiffs lacked standing and plaintiffs appealed to the Court of Appeals. The Court of Appeals affirmed this dismissal on December 3, 2002. The Supreme Court, on June 13, 2003, reversed the Court of Appeals on the standing issue and remanded the case to the Court of Appeals with instructions to reconsider procedural issues which were raised, but not addressed, in the court's prior opinion.

In June, 2002, the *Stone* case was filed in Wake County Superior Court on behalf of individual state employees and retirees seeking repayment of the withheld employer contribution and a prohibition against future diversions. The State has filed a Motion to Dismiss.

The North Carolina Attorney General's Office believes that sound legal arguments support the state's defense of these cases.

Cabarrus County v. Tolson — Diversion of Local Government Tax Reimbursements and Shared Revenue. On September 17, 2002, six counties and three municipalities filed suit against the Secretary of Revenue in Wake County Superior Court, demanding that the State release payments of local tax reimbursements and shared revenues in excess of \$200 million and a prohibition against future diversions. The Governor, in the exercise of his constitutional responsibility to balance the state budget, withheld approximately \$211 million in tax revenues designated by statute for payment to local governments. The State has filed a Motion to Dismiss.

The North Carolina Attorney General's Office believes that sound legal arguments support the defense of this action.

Goldston v. State of North Carolina — Highway Trust Fund Transfers. On November 14, 2002, a lawsuit was filed in Wake County Superior Court demanding that \$80 million transferred by the Governor from the Highway Trust Fund to the General Fund for purposes of balancing the State budget be

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returned to the Highway Trust Fund. The suit further alleges that actions of the General Assembly regarding the transfer of funds from the Highway Trust Fund to the General Fund constitute a borrowing by the State of Highway Trust Fund cash surplus and are unlawful and unconstitutional. The lawsuit requests a declaration that taxes collected for purposes of Highway Trust Fund expenditures cannot be used for other purposes. The North Carolina Attorney General's Office believes that sound legal arguments support the defense of this action and has filed a Motion to Dismiss. Plaintiff's motion for a preliminary injunction was denied on February 5, 2003.

Edward N. Rodman, et al. v. State of North Carolina, et al. On April 25, 2003, Edward N. Rodman and four other citizens filed suit in the Superior Court of Wake County against the State of North Carolina and the Secretary of Revenue challenging the constitutionality of retroactively applying the 2001 increase in the highest rate of North Carolina's state income tax to the entire 2001 tax year. Plaintiffs seek refunds, for themselves and a proposed class of similarly situated taxpayers, of all taxes paid for the year 2001 in excess of the prior 7.75% maximum rate, on the theory that a retroactive midyear tax increase violates the state and federal constitutions. Plaintiffs claim the total amount of taxes involved exceeds \$76 million, plus interest. The North Carolina Attorney General's office has filed a Motion to Dismiss and believes sound legal arguments support dismissal of the case.

Medical Mutual Insurance Corporation of North Carolina v. The Board of Governors of the University of North Carolina and its Constituent Institution, East Carolina University, the East Carolina School of Medicine, et al. On March 18, 2003, Medical Mutual Insurance Corporation of North Carolina (MMICNC) filed this action in Wake County Superior Court against the Board of Governors of the University of North Carolina (UNC), East Carolina University Brody School of Medicine (ECUBSOM), and various doctors who are or might be defendants in actions or claims made covered by medical malpractice insurance policies ECUBSOM purchased for their benefit from MMICNC. MMICNC claims additional insurance premiums for medical malpractice policies provided for healthcare professionals employed at the East Carolina University Brody School of Medicine. In 1990, MMICNC and ECUBSOM entered into a five year Purchase Agreement under which MMICNC agreed to provide and ECUBSOM agreed to purchase annual medical malpractice insurance policies for ECUBSOM's healthcare professionals. The premiums for those insurance policies were set under a Retrospective Rating Plan under which the parties agreed ECUBSOM would pay half of the "maximum premium" for schools of medicine approved by the Department of Insurance, subject to adjustment based on a complex formula which included a large deductible and ECUBSOM's loss experience. The Purchase Agreement was twice renewed for five additional year in 1994 and 1999. Under the original agreement and the amendments, ECUBSOM purchased insurance from MMICNC for approximately thirteen years. In 2002, in order to raise additional capital, MMICNC demanded that all policy holders purchase guaranteed capital shares under threat of termination or nonrenewal of policies. While ECUBSOM had some shares in MMICNC from an

earlier capital call, it did not believe that it could expend State funds to purchase the additional capital shares which were valued at approximately \$400,000. In the face of MMICNC's demand, ECUBSOM decided to purchase insurance for all but a handful of its healthcare professionals from another insurance company. In this lawsuit, MMICNC claims that ECUBSOM's decision not to purchase insurance for all its healthcare professionals from MMICNC constitutes an election to terminate the insurance Purchase Agreement and invoke a commutation clause included in the Retrospective Rating Plan. According to MMICNC, as a result of ECUBSOM's decision to elect to terminate and commute its obligations under the Retrospective Rating Plan it now must pay MMICNC a sum equal to the highest one month maximum premium MMICNC could ever have charged ECUBSOM during the past thirteen years times the number of months the Retrospective Rating Plan was in existence. According to MMICNC, that sum equals \$26.7 million. ECUBSOM believes that MMICNC is not entitled to any further payments from ECUBSOM. MMICNC has made an arbitration demand in addition to filing suit, which ECUBSOM has resisted. Settlement discussions are in progress.

State v. Waterfall Investment Group, LLC. On October 24, 2000 the State filed an eminent domain proceeding against the defendants and deposited \$12 million as its estimation of the value of the 2,223 acres, taken by the State. It is anticipated that defendant will attempt to present evidence of valuation in amounts as much as \$34 million. Trial is set for August 2003.

Other Litigation. The State is involved in numerous other claims and legal proceedings, many of which normally recur in governmental operations. A review of the status of outstanding lawsuits involving the State by the North Carolina Attorney General did not disclose other proceedings that are expected to have a material adverse effect on the financial position of the State.

C. Federal Grants

The State receives significant financial assistance from the Federal Government in the form of grants and entitlements, which are generally conditioned upon compliance with terms and conditions of the grant agreements and applicable federal regulations, including the expenditure of the resources for eligible purposes. Under the terms of the grants, periodic audits are required and certain costs may be questioned as not being appropriate expenditures. Any disallowance as a result of questioned costs could become a liability of the State. As of June 30, 2003, the State is unable to estimate what liabilities may result from such audits except for the settlement with the U.S. Department of Justice and the U.S. Department of Health and Human Services which is explained in the subsequent event footnote (Note 22).

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The State may be liable for approximately \$82.29 million to contractors for highway construction claims that the State has contested. The State may also be liable for an additional \$9.05 million in contested rights-of-way acquisition costs to property owners in condemnation proceedings. These costs have not been included in project-to-date costs. Also, the State is contingently liable for outstanding contractors' claims in the amount of \$41.93 million.

E. USDA-Donated Commodities

The State has custodial responsibility for \$2.87 million of U.S. Department of Agriculture donated food commodities for which the State is liable in the event of loss.

F. Construction and Other Commitments

At June 30, 2003, the State had commitments of \$1.6 billion for construction of highway facilities. Of this amount, \$1.2 billion relates to the Highway Fund, and \$434.8 million relates to the Highway Trust Fund. The other commitments for construction and improvements of State government facilities totaled \$362.6 million (including \$337.5 million for the Department of Environment and Natural Resources, \$4.6 million for the Department of Correction, and \$3.4 million for the Department of Health and Human Services).

At June 30, 2003, the University of North Carolina System (component unit) had outstanding construction commitments of \$529.4 million (including \$110.3 million for North Carolina State University, \$80.7 million for University of North Carolina - Charlotte, \$55.7 million for Appalachian State University, \$48.8 million for University of North Carolina - Chapel Hill and \$29.8 million for UNC Hospitals).

At June 30, 2003, community colleges (component units) had outstanding construction commitments of \$130.8 million (including \$17.9 million for Central Piedmont Community College, \$14.2 million for Sandhills Community College, \$10.5 million for Wake Technical Community College and \$9.1 million for Guilford Technical Community College).

G. Tobacco Settlement

In 1998, North Carolina, along with forty-five other states, signed the Master Settlement Agreement (MSA) with the nation's largest tobacco companies to settle existing and potential claims of the states for damages arising from the use of the companies' tobacco products. Under the MSA, the tobacco companies are required to adhere to a variety of marketing, advertising, lobbying, and youth access restrictions, support smoking cessation and prevention programs, and

provide payments to the states in perpetuity. The amount that North Carolina will actually receive from this settlement remains uncertain, but projections are that the state will receive approximately \$4.6 billion through the year 2025. In the early years of MSA, participating States receive initial payments that are distinct from annual payments. The initial payments are made for five years: 1998 and 2000 through 2003. The annual payments began in 2000 and will continue indefinitely. However, these payments are subject to a number of adjustments including an inflation adjustment and a volume adjustment. Some these adjustments (e.g., inflation) should result in an increase in the payments while others (e.g., domestic cigarette sales volume) may decrease the payments. Also, future payments may be impacted by continuing and potential litigation against the tobacco industry and changes in the financial condition of the tobacco companies. Because the present value of the future settlement payments is not measurable, the State has not recorded a receivable for the future payments at June 30.

In 1999, the State approved legislation to implement the terms of the MSA in North Carolina. The State created a nonprofit corporation, the Golden LEAF, Inc., to distribute 50 percent of the settlement funds received by the State of North Carolina. The legislation directed that these funds be used for the purposes of providing economic impact assistance to economically affected or tobacco-dependent regions of North Carolina. However, the Foundation's share of the payments may be diverted by the North Carolina General Assembly prior to the funds being received by the North Carolina State Specific Account. The Golden LEAF, Inc. is reported as a discretely presented component unit.

In 2000, the State enacted legislation that established the Health and Wellness Trust Fund and the Tobacco Trust Fund and created commissions charged with managing these funds. Each fund will receive 25 percent of the tobacco settlement payments. The purpose of the Health and Wellness Trust Fund is to finance programs and initiatives to improve the health and wellness of the people of North Carolina. An eighteen-member Health and Wellness Trust Fund Commission will administer the Fund. The primary purpose of the Tobacco Trust Fund is to compensate the tobacco-related segment of North Carolina's economy for the economic hardship it is expected to experience as a result of the MSA. An eighteen-member Tobacco Trust Fund Commission will administer the Fund. The Health and Wellness Trust Fund and Tobacco Trust Fund are reported as special revenue funds.
