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**NOTES TO THE FINANCIAL STATEMENTS**


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**NOTE 19: COMMITMENTS AND CONTINGENCIES**


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**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, 2004, was \$4.8 billion with interest rates varying from 1.60 % 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, 2004, was \$1.5 billion with fixed interest rates varying from 2.4% to 7.1% and variable interest rates which can be reset weekly.

**B. Litigation**

***Hoke County et al. v. State of North Carolina and State Board of Education — Right to a Sound Basic Education (formerly Leandro).*** 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. On July 30, 2004, the North Carolina Supreme Court affirmed the majority of the trial court's orders, thereby directing the executive and legislative branches to take corrective action necessary to ensure that every child has the opportunity to obtain a sound, basic education. The Supreme Court did agree with the State that the trial court exceeded its authority in ordering pre-kindergarten programs for at-risk children. The State is now undertaking measures to respond to the trial court's directives. The magnitude of State resources which may be 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. Richard H. Moore, 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

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**NOTES TO THE FINANCIAL STATEMENTS**

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 retroactive to December 1995. This case was argued in the Court of Appeals in February, 2003. The North Carolina Court of Appeals rendered a decision in September 2003 substantially favorable to the State. Cross appeals have been filed with the North Carolina Supreme Court and oral arguments have been heard. The amount in controversy in this litigation is approximately \$84 million.

The North Carolina Attorney General's Office believes that sound legal arguments support the State's position on the outstanding claims.

**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 Special Master heard oral arguments on dispositive motions filed by both sides on September 3, 2004.

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

**Philip Morris USA Inc. v. Tolson -- Refund of Corporate Income Tax.** On June 13, 2000, Philip Morris filed a complaint in Wake County Superior Court for a refund of approximately \$30 million in corporate income taxes paid for 1989 through 1991. An order of the Augmented Tax Review Board in the 1970's allowed it to apportion its income under a modified formula, which included a more favorable property factor. When the law changed in 1989 to move to double weighting of the sales factor, Philip Morris incorporated this change into its formula. The Board's order did not permit

double weighting. Philip Morris argued that the principle of *in pari materia* required incorporation of the amendment, and that failure to allow double weighting violated the equal protection and separation of powers clauses. The Wake County Superior Court recently ruled that Philip Morris was required to use the formula approved by the Board without double weighting the sales factor unless the statutory formula (without the modified property factor) produced a more favorable result. Philip Morris is expected to appeal this ruling.

**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, and the North Carolina Court of Appeals affirmed this dismissal on December 3, 2002. The Supreme Court, on June 13, 2003, reversed the Court of Appeals on issues related to class standing and remanded with instructions to consider procedural issues raised but not addressed by the Court of Appeals.

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. A class comprised of all members of the Retirement System has been certified and the case is proceeding through class notification and toward trial.

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. Other counties, municipalities and some individuals have moved to be added as plaintiffs. 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. Summary judgment was granted in favor of the State on all issues and Plaintiffs have filed a notice of appeal.

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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**NOTES TO THE FINANCIAL STATEMENTS**

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. Summary Judgment was granted in favor of the State on all issues and Plaintiff has filed a notice of appeal. 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.

***Diana Coley, et al. v. State of North Carolina, et al.*** On April 25, 2003, Plaintiffs 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. On June 30, 2004, the trial court granted summary judgment in favor of the State on all issues. Plaintiffs are expected to appeal.

***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. In 2002, in order to raise additional capital, MMICNC demanded that all policy holders, including ECUBSOM, purchase guaranteed capital shares under threat of termination or nonrenewal of policies. In the face of MMICNC's demand, ECUBSOM decided to purchase insurance for almost all 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 professional from MMICNC triggered an obligation to pay a termination fee to MMICNC of approximately \$26.7 million. ECUBSOM believes that MMICNC is not entitled to any further payments. The North Carolina Attorney General's office believes that no fee may be owed because of MMICNC's termination of the contract; however, in the event that a fee is owed, the North Carolina Attorney General's Office believes that it would be substantially less than \$26.7 million. The suit is pending in Superior Court and related administrative proceedings before the Department of Insurance are ongoing. In August 2004, the trial court entered an order referring the case to arbitration. The parties are also engaged in settlement discussions.

***DirecTV, Inc. and EchoStar Satellite Corporation v. State of North Carolina et al. -- Refund of Sales Tax.*** On September 30, 2003, DirecTV and Echostar filed a complaint in Wake County Superior Court for a \$32 million refund of state sales tax paid. The legislature recently enacted a provision to impose the sales tax on satellite TV service providers. Plaintiffs claim this tax, which is not imposed on cable television providers, is unconstitutional in that it violates the commerce clause (because it is discriminatory and not fairly related to benefits provided by the state), the equal protection clause and North Carolina's uniformity of taxation constitutional requirement. It is the State's position that although cable providers are not subject to this tax, they are subject to city and county franchise taxes. The tax on satellite companies was enacted to equalize the tax burden on these various forms of entertainment. The case has been designated as exceptional under Rule 2.1 of the North Carolina Rules of Civil Procedure and the parties are currently conducting discovery.

***Lessie J. Dunn, et al. v. The State of North Carolina, et al.*** On February 9, 2004, Plaintiffs, on behalf of a class of all others similarly situated, filed suit in Forsyth County Superior Court alleging that the State's imposition and collection of State income tax on interest received by certain taxpayers on municipal bonds issued by non-North Carolina state and local governments constitutes a violation of the Commerce Clause of the United States Constitution. A similar case recently filed in Ohio was ultimately unsuccessful. The North Carolina Attorney General's Office has filed an answer in the case and discovery is in progress. The Attorney General's Office believes there are sound defenses in this case.

**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, 2004, the State is unable to estimate what liabilities may result from such audits except for the \$7.5 million settlement balance with the U.S. Department of Justice and the U.S. Department of Health and Human Services which is included in the long-term liabilities footnote (Note 7).

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**NOTES TO THE FINANCIAL STATEMENTS****D. Highway Construction**

The State may be liable for approximately \$81.11 million to contractors for highway construction claims that the State has contested. The State may also be liable for an additional \$8.92 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 \$71.35 million.

**E. USDA-Donated Commodities**

The State has custodial responsibility for \$3.46 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, 2004, the State had commitments of \$1.91 billion for construction of highway facilities. Of this amount, \$1.3 billion relates to the Highway Fund, and \$610 million relates to the Highway Trust Fund. The other commitments for construction and improvements of State government facilities totaled \$522.9 million (including \$358.6 million for the Department of Environment and Natural Resources, \$137.5 million for the Department of Correction, and \$14.9 million for the Wildlife Resources Commission).

At June 30, 2004, the University of North Carolina System (component unit) had outstanding construction commitments of \$574.3 million (including \$124.6 million for North Carolina State University, \$67.3 million for University of North Carolina – Chapel Hill, \$66.5 million for Appalachian State University, \$43.9 million for University of North Carolina – Charlotte, and \$41.9 million for UNC Hospitals).

At June 30, 2004, community colleges (component units) had outstanding construction commitments of \$159.1 million (including \$22.9 million for Central Piedmont Community College, \$15.2 million for Guilford Technical Community College, \$12.7 million for Fayetteville Technical Community College and \$12.5 million for Cape Fear Community College).

At June 30, 2004, The Golden LEAF, Inc. (component unit) had outstanding commitments of \$60.2 million.

During the fiscal year, the State entered into a ground lease with the N.C. Aquarium Society in order for the society to renovate and expand the Aquarium at Pine Knoll Shores. The Society entered into a lease back of the renovated facilities to the State starting on July 1, 2006 and ending on July 1, 2025. The lease payments are projected to total \$26.745 million over the 20-year period or about \$1.337 million annually. The State will manage and maintain this property after the completion of the construction.

**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 received initial payments that were distinct from annual payments. The initial payments were 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 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. At year-end, the State recognizes a receivable and revenue for the tobacco settlement based on the underlying domestic shipment of cigarettes (see Note 20). This accrual estimate is based on the projected payment schedule in the MSA adjusted for historical payment trends.

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.

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**NOTES TO THE FINANCIAL STATEMENTS****H. Other Contingencies**

As of June 30, 2004, the North Carolina Global TransPark Authority (component unit) had a loan outstanding including accrued interest payable totaling \$30 million to the Escheat Fund (special revenue fund). The loan is due on July 1, 2005. The current amount of operating cash held by the Authority is not sufficient to pay the balance due to the Escheat Fund and as such, substantial doubt about the Authority's ability to continue as a going concern exists. In addition, if the Authority declares bankruptcy all funding received to date from the Federal Aviation Administration (FAA) is required to be paid back. As of June 30, 2004, the Authority has received approximately \$21.6 million from the FAA.