
NOTES TO THE FINANCIAL STATEMENTS

NOTE 20: 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, 2006, was \$5.9 billion with interest rates varying from 1.6% 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 also 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 2045, the outstanding principal of such bonds and notes as of June 30, 2006, was \$1.7 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 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.

NOTES TO THE FINANCIAL STATEMENTS

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 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. On July 1, 2005, the Supreme Court reversed the Court of Appeals in part, concluding that a majority of the funds in dispute are civil penalties required to be paid into the Civil Penalty and Forfeiture Fund for the benefit of public schools. Based upon information supplied by the defendant state agencies, the amount owed could be as much as \$770 million. The case is now pending in Superior Court while the parties discuss a negotiated resolution.

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 and in September, 2006 allowed the State's motions as to several claims. The parties will continue to litigate the remaining claims.

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 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 appealed this ruling to the North Carolina Court of Appeals. The Court of Appeals issued a unanimous opinion affirming the superior court. Philip Morris has filed a notice of appeal and petition for discretionary review with the North Carolina Supreme Court.

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. The Court of Appeals remanded the case to the Superior Court of Wake County without opinion and without considering any remaining issues.

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 currently proceeding through class notification and toward trial. On September 6, 2006, the trial court issued an interlocutory order in response to cross-motions for summary judgment. The court's order found the diversion of funds to be in violation of the constitution, but did not direct any repayment of funds.

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 returned to the Highway Trust Fund. The suit further

NOTES TO THE FINANCIAL STATEMENTS

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. On September 20, 2005, the North Carolina Court of Appeals upheld the trial court's order. The plaintiff filed a petition for discretionary review with the North Carolina Supreme Court, and the Court agreed on March 2, 2006 to review a portion of the Court of Appeals' decision and oral argument is scheduled for October 16, 2006.

Diana Coley, et al. v. State of North Carolina, et al. — Refund of Income Tax. 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 appealed to the Court of Appeals. The Court of Appeals issued a 2-1 opinion sustaining the constitutionality of the tax. Plaintiffs appealed to the North Carolina Supreme Court. Arguments were heard in the Supreme Court in March 2006. The Supreme Court upheld the Court of Appeals decision on June 30, 2006. A petition for rehearing was denied on August 17, 2006.

DirecTV, Inc. and EchoStar Satellite Corporation v. State of North Carolina et al. — Refund of Sales Tax. Effective January 1, 2002, the legislature enacted a provision to impose the sales tax on satellite TV service providers. On September 30, 2003, DirecTV and Echostar filed a complaint in Wake County Superior court for a refund of state sales tax paid, which currently amounts to approximately \$70 million. Plaintiffs claim this tax, which was not imposed on cable television providers, is unconstitutional under the Commerce Clause because it discriminates against interstate commerce. It is the State's position that the sales tax does not violate the Commerce Clause. 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. In 2005, the trial court allowed summary judgment in the State's favor.

Plaintiffs appealed to the North Carolina Court of appeals. Oral arguments were heard on May 9, 2006. On August 1, 2006, the Court of Appeals unanimously affirmed the decision and upheld the constitutionality of the tax.

Lessie J. Dunn, et al. v. The State of North Carolina, et al. — Tax on Municipal Bonds. 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 and seeking class certification. An order certifying a class has been entered by the superior court. The State has appealed the scope of the class certification to the North Carolina Court of Appeals. On October 17, 2006, the Court of Appeals unanimously affirmed the order certifying the class.

Wal-Mart Stores East, Inc. v. Tolson and Sam's East, Inc. v. Tolson — Refund of Corporate Income Tax. On March 17, 2006, the Plaintiffs filed complaints seeking a refund of over \$33.5 million in corporate income taxes in Wake County Superior Court (06 CVS 3928 and 06 CVS 3929). Plaintiffs are challenging the Secretary's authority to require them to file a "combined return" on various statutory and constitutional grounds. Defendant has filed a motion to dismiss under Rule 12(b)(6) and Plaintiffs have filed a motion for summary judgment. On August 31, 2006, Defendant's Motion to Dismiss was heard before Judge Horton who has been assigned to hear the actions as exceptional cases.

State of North Carolina v. Philip Morris, Inc., et al., 98 CVS 14377 — Master Settlement Agreement ("MSA") Payments. On April 20, 2006, the State of North Carolina filed a Motion for Declaratory Order in the North Carolina Business Court against defendants Philip Morris, Inc., R.J. Reynolds Tobacco Company, and Lorillard Tobacco Company. The Motion is seeking a declaration that (1) in 2003, North Carolina continuously had a Qualifying Statute in full force and effect and "diligently enforced" its provisions throughout that year in accordance with the MSA; (2) North Carolina is not subject to a Non-Participating Manufacturers' Adjustment for 2003; and (3) defendants are obligated not to withhold or pay into a disputed payments account any payments due, or seek any offset of any payments made, on the basis that North Carolina is subject to a Non-Participating Manufacturers' Adjustment for 2003. If the State is unable to ultimately prevail in the diligent enforcement litigation, the State may be unable to recover a portion of this year's MSA payment.

Petroleum Traders Corporation (PTC) v. State. Petroleum Traders Corporation (PTC) brought a Declaratory Judgment

NOTES TO THE FINANCIAL STATEMENTS

action in Wake County Superior Court on July 19, 2006, seeking a declaration that the North Carolina e-procurement fee is a tax and is unconstitutional under provisions of the state and national constitutions. PTC claims to have paid over \$1 million itself in e-procurement fees. PTC also seeks to have the action proceed as a class action, allegedly involving potential refunds in excess of \$100 million. The State has moved to dismiss the complaint, and the motion is expected to be heard this year.

Other Litigation. The State is involved in numerous other claims and legal proceedings, many of which are normal for 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. During the fiscal year ending June 30, 2006, the U.S. Department of Health and Human Services (USDHHS) notified the state Department of Health and Human Services (DHHS) of a disallowance of \$95 million in federal funds under Title IV-E of the Social Security Act. This disallowance has been appealed by DHHS to the USDHHS Departmental Appeals Board.

Any disallowance as a result of questioned costs could become a liability of the State. As of June 30, 2006, the State is unable to estimate what liabilities may result from such audits except for the \$154 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).

D. Highway Construction

The State may be liable for approximately \$51.55 million to contractors for highway construction claims that the State has contested. The State may also be liable for an additional \$10.31 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 \$114.37 million.

E. USDA-Donated Commodities

The State has custodial responsibility for \$2.81 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, 2006, the State had commitments of \$1.43 billion for construction of highway facilities. Of this amount, \$776.74 million relates to the Highway Fund, and \$651.29 million relates to the Highway Trust Fund. The other commitments for construction and improvements of state government facilities totaled \$580.24 million (including \$442.92 million for the Department of Environment and Natural Resources and \$86.72 million for the Department of Correction).

At June 30, 2006, the University of North Carolina System (component unit) had outstanding construction commitments of \$506.96 million (including \$107.66 million for North Carolina State University, \$84.97 million for North Carolina Agricultural and Technical State University, \$56.82 million for East Carolina University, \$36.23 million for University of North Carolina - Wilmington, \$36.29 million for Appalachian State University and \$35.55 million for University of North Carolina - Charlotte).

At June 30, 2006, community colleges (component units) had outstanding construction commitments of \$153.49 million (including \$39.56 million for Wake Technical Community College, \$15.09 million for Blue Ridge Community College, \$14.75 million for Sandhills Community College, \$11.76 million for College of the Albemarle, \$9.04 million for Cape Fear Community College, and \$8.17 million for Central Piedmont Community College).

At June 30, 2006, The Golden LEAF, Inc. (component unit) had outstanding commitments of \$61.9 million.

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

NOTES TO THE FINANCIAL STATEMENTS

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. This accrual estimate is based on the projected payment schedule in the MSA adjusted for historical payment trends.

paid back. As of June 30, 2006, the Authority has received approximately \$20.1 million from the FAA.

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.

H. Other Contingencies

As of June 30, 2006, the North Carolina Global TransPark Authority (component unit) had a loan outstanding including accrued interest payable totaling \$30.47 million to the Escheat Fund (special revenue fund). The loan is due on October 1, 2007. 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
