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**NOTES TO THE FINANCIAL STATEMENTS**

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**NOTE 21: 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 2045, the outstanding principal of such bonds and notes as of June 30, 2014, was \$7.1 billion with interest rates varying from 0.2% to 7%.

The North Carolina Capital Facilities Finance Agency (Agency) is authorized by the State to issue tax-exempt bonds and notes to finance industrial and manufacturing facilities, pollution control facilities for industrial (in connection with manufacturing) or pollution control facilities and to finance facilities and structures at private nonprofit colleges and universities, and institutions providing kindergarten, elementary and secondary education, and various other nonprofit entities. The Agency's authority to issue bonds and notes also includes financing private sector capital improvements for activities that constitute a public purpose. The bonds issued by the Agency 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 outstanding principal of such bonds and notes as of June 30, 2014, was \$3.1 billion carrying both fixed interest rates and variable interest rates which can be reset periodically.

**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.

On June 15, 2011, the General Assembly enacted legislation which placed certain restrictions on the North Carolina Pre-Kindergarten Program (N.C. Pre-K) which had been established by the General Assembly in 2001. Following a hearing requested by the plaintiffs, the trial court entered an order prohibiting the enforcement of legislation having the effect of restricting participation in the N.C. Pre-K program. On appeal, the North Carolina Court of Appeals affirmed the trial court's order prohibiting the State from denying any eligible "at risk" children admission to the N.C. Pre-K program. The State has appealed this decision and the North Carolina Supreme Court, in

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November 2013, held that amendments to the 2011 legislation had rendered the appeal moot. The case will now be remanded to Superior Court.

**Lake v. North Carolina State Health Plan — Retiree Health Insurance.** The main issue is whether the State wrongfully charged a monthly premium to retired state employees for the state's 80/20 coinsurance health plan. The general theme of the complaint is that the State established vesting requirements under which if the employee fulfilled the requirements the State contracted with each employee to provide 80/20 insurance coverage at no monthly cost to the retiree for the duration of each retiree's retirement. Similarly, the plaintiffs allege that the State terminated an optional 90/10 health plan to which they had vested rights. Plaintiffs claim (1) breach of contract; (2) unconstitutional impairment of contract; (3) unconstitutional denial of equal protection; and (4) unconstitutional denial of due process. The plaintiffs also allege a variety of equitable claims (e.g., specific performance, common fund) that piggy-back on the legal claims.

The State has filed and briefed its motion to dismiss based on Rules of Civil Procedure 12(b) (1), (2) and (6). After a hearing, the trial court denied the motion to dismiss. The State has appealed to the North Carolina Court of Appeals.

**Pashby v. Wos – Personal Care Services Program.** This case is a class action lawsuit in Federal District Court involving challenges to the Personal Care Services Program (PCS) in North Carolina. The Plaintiffs have alleged violations of the ADA, Rehabilitation Act, due process, and the Medicaid Act based on a change in the eligibility criteria for a Medicaid beneficiary to receive personal care services. The Plaintiffs alleged that the eligibility criteria for PCS differed between Medicaid beneficiaries receiving PCS in their home as opposed to in an Adult Care Home and which would then force Medicaid beneficiaries into Adult Care Homes in order to receive PCS. The District Court certified the class and entered a Preliminary Injunction in December 2011 which was appealed to the Fourth Circuit Court of Appeals. The 4th Circuit entered a stay of the District Court Preliminary Injunction but in April 2013 issued an opinion upholding the Preliminary Injunction and remanded the matter. Upon remand, defendants filed a motion to dismiss which was denied and the plaintiffs filed a motion to amend their complaint and amend the class definition to expand the class to Medicaid beneficiaries affected by a subsequent change in PCS policy effective January 1, 2013. The District Court allowed both of plaintiffs' motions and defendants are in the process of answering the amended complaint. At this stage of the litigation, the likelihood of any potential liability cannot be determined as "probable" or "remote". Likewise, any potential liability to the State cannot be reasonably estimated.

**State Employees Association of North Carolina (SEANC) 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, reserving the question of repayment for consideration, if necessary after appeal of the constitutional issues. On August 5, 2008, the Court of Appeals affirmed the Superior Court order. Both sides gave notice of appeal and filed petitions for discretionary review with the North Carolina Supreme Court. On June 17, 2009, the Supreme Court dismissed the appeals and denied the petitions for discretionary review.

The case now returns to the Superior Court for consideration of damages. Because the General Assembly has repaid the principal amount withheld from the Retirement System, consideration will focus on lost interest and earnings, if any. A new judge will need to be appointed to hear the case, as the judge previously assigned to the case is now employed by the North Carolina Department of Transportation.

**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

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ultimately prevail in the diligent enforcement litigation, the State may be unable to recover a portion of this year's MSA payment. On December 4, 2006, Judge Tennille allowed the defendant's motion to compel arbitration of these issues. The Court of Appeals upheld the Order and on March 19, 2009, the State's Petition to the North Carolina Supreme Court was denied. The State participated in a national arbitration process with the tobacco companies and all other MSA states, but has entered into a settlement agreement which, unless overturned, provides a lump sum to the State in 2013 balanced by an almost equal aggregate in corresponding reductions in the next five annual payments.

During fiscal year 2013, the lump sum of \$119.54 million was released under the Tobacco Master Settlement Agreement for the benefit of the State of North Carolina, above the State's regular annual MSA payment. Of that amount, \$94.9 million was received by the State. The remaining \$24.64 million was received by the nonprofit corporation Golden LEAF, Inc. but on March 26, 2014 was transferred to the State.

Under the settlement, over years 2013-2017, approximately \$98.1 million will be credited back to the Participating Manufacturers against their annual MSA payments to the State. During the 2013 fiscal year approximately \$49.05 million was credited to the Participating Manufacturers, by the application of a credit against that year's April annual MSA payment owed to the State. The remaining \$49.05 million will be applied in equal amounts of approximately \$12.5 million as credits to the 2014-2017 MSA payments owed the State. Also for 2014 and 2015, there will be a "transition year" credit of \$4.5 million applied for sales years 2013 and 2014.

**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. Any disallowance as a result of questioned costs could become a liability of the State. As of June 30, 2014, the State is unable to estimate what liabilities may result from such audits.

### **D. Highway Construction**

The State has placed on deposit in court \$159.84 million for a potential liability to property owners for contested rights-of-way acquisition costs in condemnation proceedings. The State may also be liable for an additional \$49.8 million in these proceedings. Also, the State is contingently liable for outstanding contractors' claims in the amount of \$54.52 million. These costs have not been included in project-to-date costs.

### **E. Construction and Other Commitments**

At June 30, 2014, the State had commitments of \$3.594 billion for construction of highway infrastructure. Of this amount, \$3.05 billion relates to the Highway Fund, \$8 million relates to the NC Turnpike Authority, and \$536 million relates to the Highway Trust Fund. The other commitments for construction and improvements of state government facilities totaled \$514.85 million (including \$406.72 million for the Department of Environment and Natural Resources and \$74.33 million for the Division of Mental Health within the Department of Health and Human Services).

At June 30, 2014, the University of North Carolina System (component unit) had outstanding construction commitments of \$551.97 million (including \$112.27 million for UNC Healthcare System, \$96.37 million for University of North Carolina at Charlotte, \$85.02 million for University of North Carolina at Chapel Hill, \$84.57 million for University of North Carolina at Greensboro, \$55.8 million for East Carolina University, and \$34.58 million for North Carolina State University).

At June 30, 2014, community colleges (component units) had outstanding construction commitments of \$199.83 million (including \$57.7 million for Cape Fear Community College, \$57.03 million for Wake Technical Community College, \$24.88 million for Central Piedmont Community College, and \$18.7 million for Pitt Community College).

The State Treasurer has entered into contracts with external fund managers of the Real Estate Investment, Alternative Investment, Inflation Protection Investment, and Credit Investment portfolios, where the State Treasurer agrees to commit capital to these investments. The portfolios are part of the State Treasurer's Investment Pool as described in section A of Note 3. As of June 30, 2014, the State Treasurer has \$2.36 billion in unfunded commitments in the Real Estate Investment portfolio which includes 33.72 million euro

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and 176.52 million pounds sterling converted to U.S. dollar equivalent. In the Alternative Investment portfolio, the State Treasurer has unfunded commitments of \$2.37 billion which include 167 million euro and 55.73 million pounds sterling converted to the U.S. dollar equivalent. At June 30, 2014, there were also unfunded commitments in the Inflation Protection Investment and Credit Investment portfolios in the amount of \$2.15 billion and \$579.17 million, respectively. In addition, the Escheat Investment Account had unfunded commitments of \$5.7 million at June 30, 2014. These consist of commitments under the private equity investment partnerships described in Section A of Note 3.

The UNC Investment Fund, LLC (UNC Investment Fund) at the University of North Carolina at Chapel Hill has entered into agreements with limited partnerships to invest capital. These agreements represent the funding of capital over a designated period of time and are subject to adjustments. As of June 30, 2014, the UNC Investment Fund had approximately \$705.91 million unfunded committed capital.

**F. Tobacco Settlement**

In 1998, North Carolina, along with 45 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 \$4.74 billion from the inception of the agreement through the year 2025. Since the inception, the State has received approximately \$2.57 billion in MSA payments. 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 in the government wide statements 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.

**G. Other Contingencies**

The Civil Rights Division of the U.S. Department of Justice investigated the state's mental health system and found the State to be in violation of Title II of the Americans with Disabilities Act of 1990 (ADA), 42 U.S.C. Sec 12131, and the following, as interpreted by the U.S. Supreme Court in *Olmstead v. L.C.*, 527 U.S. 581 (1999), and Section 504 of the Rehabilitation Act of 1973 (Rehab Act), 29 U.S.C. Sec 794(a). On August 23, 2012, the Civil Rights Division and the State entered into an agreement that addresses the corrective measures that will ensure that the State will willingly meet the requirements of the ADA, Section 504 of the Rehab Act, and the *Olmstead* decision. Through the agreement, it is intended that the goals of community integration and self-determination will be achieved. The State is responsible for determining and identifying the amount of appropriation funding that is needed to fulfill this agreement which will be phased in over the next eight years. In House Bill 950 [Session Law 2012-142 Section 10.23A.(e)], \$10.3 million was appropriated as recurring funds to support the Department of Health and Human Services in the implementation of its plan for transitioning individuals with severe mental illness to community living arrangements, including establishing a rental assistance program. In Senate Bill 402 [Session Law 2013-360], additional money was appropriated in the expansion budget for \$3.83 million for 2013-14 and \$9.39 million for 2014-15. Both parties of the agreement have selected a reviewer to monitor the State's implementation of this agreement. The reviewer will have full authority to independently assess, review, and report annually on the State's implementation of and compliance with the provisions of this agreement. The potential liability to the State cannot be reasonably estimated. If the State fails to comply with this agreement, the United States can seek an appropriate judicial remedy. To date, the State has demonstrated good faith effort in the early stage of the settlement agreement by providing sufficient funding essential to the initial development of the services.