

VECTOR GROUP LTD  
Form 10-Q  
July 31, 2012

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

For The Quarterly Period Ended June 30, 2012

VECTOR GROUP LTD.  
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation incorporation or organization)	1-5759  Commission File Number	65-0949535  (I.R.S. Employer Identification No.)
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100 S.E. Second Street  
Miami, Florida 33131  
305/579-8000  
(Address, including zip code and telephone number, including area code,  
of the principal executive offices)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.  Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).  Yes  No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer       Accelerated filer       Non-accelerated filer       Smaller reporting company

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(Do not check if a smaller  
reporting company)

Indicate by check mark whether the Registrant is a shell company as defined in Rule 12b-2 of the Exchange Act. o  
Yes x No

At July 31, 2012, Vector Group Ltd. had 81,400,512 shares of common stock outstanding.

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VECTOR GROUP LTD.

FORM 10-Q

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VECTOR GROUP LTD. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED BALANCE SHEETS

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

	June 30, 2012	December 31, 2011
<b>ASSETS:</b>		
Current assets:		
Cash and cash equivalents	\$208,748	\$240,923
Investment securities available for sale	68,141	76,486
Accounts receivable - trade	10,825	24,869
Inventories	105,988	109,228
Deferred income taxes	41,604	42,951
Income tax receivable, net	6,418	9,553
Restricted assets	1,475	1,474
Other current assets	5,079	4,257
Total current assets	448,278	509,741
Property, plant and equipment, net	58,277	56,556
Investment in Escena, net	13,206	13,280
Long-term investments accounted for at cost	16,367	5,675
Long-term investments accounted for under the equity method	5,552	16,499
Investments in non-consolidated real estate businesses	130,803	124,469
Restricted assets	9,678	9,626
Deferred income taxes	43,015	31,017
Intangible asset	107,511	107,511
Prepaid pension costs	10,796	10,047
Other assets	42,255	43,347
Total assets	\$885,738	\$927,768
<b>LIABILITIES AND STOCKHOLDERS' DEFICIENCY:</b>		
Current liabilities:		
Current portion of notes payable and long-term debt	\$24,246	\$50,844
Current portion of fair value of derivatives embedded within convertible debt	—	84,485
Current payments due under the Master Settlement Agreement	70,304	51,174
Current portion of employee benefits	2,721	2,690
Accounts payable	4,231	9,532
Accrued promotional expenses	15,733	17,056
Income taxes payable, net	6,817	6,597
Accrued excise and payroll taxes payable, net	12,611	17,992
Litigation accruals	1,404	1,551
Deferred income taxes	28,665	35,885
Accrued interest	20,888	20,888
Other current liabilities	12,478	16,504
Total current liabilities	200,098	315,198
Notes payable, long-term debt and other obligations, less current portion	516,058	493,356
Fair value of derivatives embedded within convertible debt	120,410	49,015
Non-current employee benefits	45,137	45,982
Deferred income taxes	68,684	60,642
Payments due under the Master Settlement Agreement	51,415	49,338
Litigation accruals	1,761	1,600
Other liabilities	1,712	1,667

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Total liabilities	1,005,275	1,016,798
Commitments and contingencies		
Stockholders' deficiency:		
Preferred stock, par value \$1.00 per share, 10,000,000 shares authorized	—	—
Common stock, par value \$0.10 per share, 150,000,000 shares authorized, 84,981,333 and 83,022,812 shares issued and 81,400,512 and 79,441,991 shares outstanding	8,141	7,944
Additional paid-in capital	—	—
Accumulated deficit	(104,043	) (80,440 )
Accumulated other comprehensive loss	(10,778	) (3,677 )
Less: 3,580,821 shares of common stock in treasury, at cost	(12,857	) (12,857 )
Total stockholders' deficiency	(119,537	) (89,030 )
Total liabilities and stockholders' deficiency	\$885,738	\$927,768

The accompanying notes are an integral part of the condensed consolidated financial statements.

VECTOR GROUP LTD. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

	Three Months Ended		Six Months Ended	
	June 30,	2011	June 30,	2011
	2012		2012	
Revenues*	\$276,594	\$291,180	\$534,200	\$551,558
Expenses:				
Cost of goods sold*	211,752	231,073	411,933	436,250
Operating, selling, administrative and general expenses	23,914	22,140	47,893	45,865
Operating income	40,928	37,967	74,374	69,443
Other income (expenses):				
Interest expense	(26,509)	(25,082)	(52,761)	(50,010)
Change in fair value of derivatives embedded within convertible debt	(6,003)	9,437	(27,060)	8,862
Acceleration of interest expense related to debt conversion	(7,888)	(1,217)	(7,888)	(1,217)
Equity income from non-consolidated real estate businesses	5,232	6,197	8,095	11,101
Equity (loss) income on long-term investments	(1,215)	(154)	(1,329)	609
Gain on sale of investment securities available for sale	—	1,506	—	14,541
Gain on liquidation of long-term investments	—	19,475	—	23,611
Gain on sales of townhomes	—	577	—	3,712
Other, net	583	140	515	216
Income (loss) before provision for income taxes	5,128	48,846	(6,054)	80,868
Income tax expense (benefit)	1,233	18,545	(2,259)	31,194
Net income (loss)	\$3,895	\$30,301	\$(3,795)	\$49,674
Per basic common share:				
Net income (loss) applicable to common shares	\$0.05	\$0.38	\$(0.05)	\$0.62
Per diluted common share:				
Net income (loss) applicable to common shares	\$0.05	\$0.34	\$(0.05)	\$0.61
Cash distributions and dividends declared per share	\$0.40	\$0.38	\$0.80	\$0.76

\* Revenues and Cost of goods sold include excise taxes of \$130,967, \$142,934, \$252,892 and \$270,568, respectively.

The accompanying notes are an integral part of the condensed consolidated financial statements.

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VECTOR GROUP LTD. AND SUBSIDIARIES  
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
 (Dollars in Thousands, Except Per Share Amounts)  
 Unaudited

	Three Months Ended June 30, 2012		Six Months Ended June 30, 2012	
	2011	2011	2011	2011
Net income (loss)	\$3,895	\$30,301	\$(3,795)	\$49,674
Net unrealized gains on investment securities available for sale:				
Change in net unrealized gains	(3,025)	(950)	(14,269)	3,420
Net unrealized (gains) reclassified into net income	—	(1,506)	—	(14,541)
Net unrealized gains on investment securities available for sale	(3,025)	(2,456)	(14,269)	(11,121)
Net unrealized (losses) gains on long-term investments accounted for under the equity method	(2,505)	(1,885)	542	(1,453)
Net change in forward contracts	17	15	32	31
Net change in pension-related amounts	871	679	1,741	1,360
Other comprehensive loss	(4,642)	(3,647)	(11,954)	(11,183)
Income tax effect on change in net unrealized gains on investment securities	1,228	380	5,793	(1,368)
Income tax effect on net unrealized gains reclassified into net income on investment securities	—	602	—	5,816
Income tax effect on change in unrealized long-term investments	1,017	756	(220)	583
Income tax effect on forward contracts	(7)	(6)	(13)	(14)
Income tax effect on pension-related amounts	(354)	(272)	(707)	(544)
Income tax benefit on other comprehensive loss	1,884	1,460	4,853	4,473
Other comprehensive loss, net of tax	(2,758)	(2,187)	(7,101)	(6,710)
Comprehensive income (loss)	\$1,137	\$28,114	\$(10,896)	\$42,964

The accompanying notes are an integral part of the condensed consolidated financial statements.



VECTOR GROUP LTD. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' DEFICIENCY  
(Dollars in Thousands, Except Per Share Amounts)  
Unaudited

	Common Stock		Additional Paid-In	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total
	Shares	Amount	Capital	Deficit	(Loss) Income	Stock	Total
Balance, December 31, 2011	79,441,991	\$7,944	\$ —	\$ (80,440 )	\$ (3,677 )	\$(12,857)	\$(89,030 )
Net loss	—	—	—	(3,795 )	—	—	(3,795 )
Pension-related minimum liability adjustments, net of income taxes	—	—	—	—	1,034	—	1,034
Forward contract adjustments, net of income taxes	—	—	—	—	19	—	19
Unrealized gain on long-term investment securities, accounted for under the equity method, net of income taxes	—	—	—	—	322	—	322
Change in net unrealized gain on investment securities, net of income taxes	—	—	—	—	(8,476 )	—	(8,476 )
Unrealized loss on investment securities, net of income taxes	—	—	—	—	—	—	(8,476 )
Total other comprehensive loss	—	—	—	—	—	—	(7,101 )
Total comprehensive loss	—	—	—	—	—	—	(10,896 )
Distributions and dividends on common stock	—	—	(45,909)	(19,808 )	—	—	(65,717 )
Note conversion, net of income taxes	1,955,425	196	44,243	—	—	—	44,439
Exercise of employee stock options	3,096	1	44	—	—	—	45
Tax benefit of employee stock options exercised	—	—	4	—	—	—	4
Amortization of deferred compensation	—	—	1,618	—	—	—	1,618
Balance, as of June 30, 2012	81,400,512	\$8,141	\$ —	\$ (104,043 )	\$ (10,778 )	\$(12,857)	\$(119,537)

The accompanying notes are an integral part of the condensed consolidated financial statements.

VECTOR GROUP LTD. AND SUBSIDIARIES  
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
 (Dollars in Thousands, Except Per Share Amounts)  
 Unaudited

	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011	
Net cash provided by operating activities	\$57,829	\$36,587	
Cash flows from investing activities:			
Sale of investment securities	—	19,703	
Purchase of investment securities	(1,148)	(1,788)	)
Proceeds from sale or liquidation of long-term investments	72	62,219	
Purchase of long-term investments	(5,000)	(10,000)	)
Investments in non-consolidated real estate businesses	(9,667)	(6,712)	)
Distributions from non-consolidated real estate businesses	6,221	2,425	
Proceeds from sale of townhomes, net	—	19,629	
Increase in cash surrender value of life insurance policies	(620)	(677)	)
(Increase) decrease in restricted assets	(53)	1,775	)
Issuance of notes receivable	(234)	(161)	)
Proceeds from sale of fixed assets	404	9	
Capital expenditures	(7,394)	(4,872)	)
Net cash (used in) provided by investing activities	(17,419)	81,550	)
Cash flows from financing activities:			
Proceeds from debt issuance	14,018	77	
Deferred financing costs	(315)	—	)
Repayments of debt	(13,493)	(2,281)	)
Borrowings under revolver	525,350	486,298	
Repayments on revolver	(532,082)	(521,995)	)
Dividends and distributions on common stock	(66,112)	(61,846)	)
Proceeds from exercise of employee stock options	45	966	
Tax benefit of employee stock options exercised	4	808	
Net cash used in financing activities	(72,585)	(97,973)	)
Net (decrease) increase in cash and cash equivalents	(32,175)	20,164	)
Cash and cash equivalents, beginning of period	240,923	299,825	
Cash and cash equivalents, end of period	\$208,748	\$319,989	

The accompanying notes are an integral part of the condensed consolidated financial statements.

VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### (a) Basis of Presentation:

The condensed consolidated financial statements of Vector Group Ltd. (the “Company” or “Vector”) include the accounts of VGR Holding LLC (“VGR Holding”), Liggett Group LLC (“Liggett”), Vector Tobacco Inc. (“Vector Tobacco”), Liggett Vector Brands LLC (“Liggett Vector Brands”), New Valley LLC (“New Valley”) and other less significant subsidiaries. All significant intercompany balances and transactions have been eliminated.

Liggett and Vector Tobacco are engaged in the manufacture and sale of cigarettes in the United States. New Valley is engaged in the real estate business and is seeking to acquire additional operating companies and real estate properties.

The interim condensed consolidated financial statements of the Company are unaudited and, in the opinion of management, reflect all adjustments necessary (which are normal and recurring) to state fairly the Company's consolidated financial position, results of operations, comprehensive income and cash flows. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011 filed with the Securities and Exchange Commission. The consolidated results of operations for interim periods should not be regarded as necessarily indicative of the results that may be expected for the entire year.

Certain reclassifications have been made to the 2011 financial information to conform to the 2012 presentation.

### (b) Distributions and Dividends on Common Stock:

The Company records distributions on its common stock as dividends in its condensed consolidated statement of stockholders' equity to the extent of retained earnings and accumulated paid-in capital. Any amounts exceeding retained earnings are recorded as a reduction to additional paid-in capital. Any amounts then exceeding accumulated paid-in capital are recorded as an increase to accumulated deficit.

### (c) Earnings Per Share (“EPS”):

Information concerning the Company's common stock has been adjusted to give retroactive effect to the 5% stock dividend paid to Company stockholders on September 29, 2011. All per share amounts have been updated to reflect the retrospective effect of the stock dividends.

Net income for purposes of determining basic EPS was as follows:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2012	2011	2012	2011
Net income (loss)	\$3,895	\$30,301	\$(3,795)	) \$49,674
Income (expense) attributable to participating securities	(79)	) (639)	) —	(1,033)
Net income (loss) available to common stockholders	\$3,816	\$29,662	\$(3,795)	) \$48,641



## VECTOR GROUP LTD.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

Net income (loss) for purposes of determining diluted EPS was as follows:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2012	2011	2012	2011
Net income (loss)	\$3,895	\$30,301	\$(3,795)	\$49,674
Income attributable to 3.875% Variable Interest Senior Convertible Debentures	—	(95)	) —	—
Expense attributable to 6.75% Variable Interest Senior Convertible Note	—	—	—	1,856
Income (expense) attributable to participating securities	(79)	) (637)	) —	(1,072)
Net income (loss) available to common stockholders	\$3,816	\$29,569	\$(3,795)	\$50,458

Basic and diluted EPS were calculated using the following shares:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2012	2011	2012	2011
Weighted-average shares for basic EPS	79,376,192	78,394,709	79,218,365	78,305,932
Plus incremental shares related to stock options and non-vested restricted stock	193,446	659,393	—	470,702
Plus incremental shares related to convertible debt	—	6,728,285	—	3,848,489
Weighted-average shares for fully diluted EPS	79,569,638	85,782,387	79,218,365	82,625,123

The following stock options, non-vested restricted stock and shares issuable upon the conversion of convertible debt were outstanding during the three and six months ended June 30, 2012 and 2011 but were not included in the computation of diluted EPS because the effect was anti-dilutive.

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2012	2011	2012	2011
Number of stock options	N/A	157,278	2,190,133	163,772
Weighted-average exercise price	N/A	\$23.69	\$13.74	\$23.42
Weighted-average shares of non-vested restricted stock	3,334	N/A	365,321	N/A
Weighted-average expense per share	17.98	N/A	11.40	N/A
Weighted-average number of shares issuable upon conversion of debt	17,004,017	11,144,039	17,159,342	14,087,525
Weighted-average conversion price	\$14.79	\$14.13	\$14.80	\$15.43

(d) Fair Value of Derivatives Embedded within Convertible Debt:

The Company has estimated the fair market value of the embedded derivatives based principally on the results of a valuation model. The estimated fair value of the derivatives embedded within the convertible debt is based

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## VECTOR GROUP LTD.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

principally on the present value of future dividend payments expected to be received by the convertible debt holders over the term of the debt. The discount rate applied to the future cash flows is estimated based on a spread in the yield of the Company's debt when compared to risk-free securities with the same duration; thus, a readily determinable fair market value of the embedded derivatives is not available. The valuation model assumes future dividend payments by the Company and utilizes interest rates and credit spreads for secured to unsecured debt, unsecured to subordinated debt and subordinated debt to preferred stock to determine the fair value of the derivatives embedded within the convertible debt. The valuation also considers other items, including current and future dividends and the volatility of the Company's stock price. The range of estimated fair market values of the Company's embedded derivatives was between \$117,824 and \$123,106. The Company recorded the fair market value of its embedded derivatives at the midpoint of the inputs at \$120,410 as of June 30, 2012. At December 31, 2011, the range of estimated fair market values of the Company's embedded derivatives was between \$130,917 and \$136,182. The Company recorded the fair market value of its embedded derivatives at the midpoint of the inputs at \$133,500 as of December 31, 2011. The estimated fair market value of the Company's embedded derivatives could change significantly based on future market conditions. (See Note 4.)

## (e) New Accounting Pronouncements:

In May 2011, the FASB issued amendments to disclosure requirements for common fair value measurement. These amendments, effective for the interim and annual periods beginning on or after December 15, 2011 (early adoption is prohibited), result in a common definition of fair value and common requirements for measurement of and disclosure requirements between U.S. GAAP and IFRS. Consequently, the amendments change some fair value measurement principles and disclosure requirements. This accounting guidance only impacted presentation and disclosures and did not have a material impact on the Company's condensed consolidated financial position, results of operations or cash flows.

In June 2011, the FASB issued authoritative guidance that will be included in ASC Topic 220, "Comprehensive Income". This guidance eliminates the option to report other comprehensive income and its components in the statement of changes in equity. Companies can elect to present items of net income and other comprehensive income in one continuous statement or in two separate, but consecutive, statements. In December 2011, this guidance was subsequently amended, which deferred the requirement for companies to present reclassification adjustments for each component of accumulated other comprehensive income in both other comprehensive income and net income on the face of the financial statements. The Company elected to early adopt the guidance and added the Statement of Comprehensive Income to the Company's consolidated financial statements as of and for the period ended December 31, 2011.

## 2. INVENTORIES

Inventories consist of:

	June 30, 2012	December 31, 2011
Leaf tobacco	\$68,631	\$65,411
Other raw materials	3,745	3,831

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Work-in-process	528	688	
Finished goods	59,292	64,594	
Inventories at current cost	132,196	134,524	
LIFO adjustments	(26,208	) (25,296	)
	\$ 105,988	\$ 109,228	

The Company has a leaf inventory management program whereby, among other things, it is committed to purchase certain quantities of leaf tobacco. The purchase commitments are for quantities not in excess of

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VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

anticipated requirements and are at prices, including carrying costs, established at the commitment date. At June 30, 2012, Liggett had leaf tobacco purchase commitments of approximately \$15,368.

All of the Company's inventories at June 30, 2012 and December 31, 2011 have been reported under the LIFO method.

### 3. LONG-TERM INVESTMENTS

Long-term investments accounted for at cost:

	June 30, 2012		December 31, 2011	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Investment partnerships	\$15,540	\$15,837	\$4,776	\$6,199
Real estate partnership	827	1,365	899	1,293
Investments accounted for at cost	\$16,367	\$17,202	\$5,675	\$7,492

The Company received a distribution of \$207 for the three and six months ended June 30, 2012, respectively, from a real estate partnership. The Company recognized a gain of \$135 for the three and six months ended June 30, 2012. The company received distributions of \$53,333 and \$62,219 for the three and six months ended June 30, 2011, respectively, primarily from the liquidation of two long-term investments. The Company received an additional distribution of \$2,775 in July 2011. The Company recognized a gain of \$19,475 and \$23,611 for the three and six months ended June 30, 2011, respectively.

Long-term investment partnerships accounted for under the equity method:

	June 30, 2012	December 31, 2011
Investment partnerships	\$5,552	\$16,499

In January 2012, the Company invested \$5,000 in an investment partnership with an underlying investment in a hedge fund. In April 2011, the Company invested \$10,000 in an investment partnership with an underlying investment in a hedge fund. The Company accounted for these investments and an investment in another limited partnership under the equity method. During the second quarter the Company's ownership percentages fell below the percentage required for equity method accounting for the two investment partnerships and are now accounted for under the cost method.

The Company had an equity loss of \$1,215 and \$1,329 for the three and six months ended June 30, 2012, respectively, related to the limited partnerships accounted for under the equity method. The Company recorded an equity loss of \$154 and equity income of \$609 related to the limited partnership for the three and six months ended June 30, 2011, respectively.

The carrying value of the investments was approximately \$5,552 as of June 30, 2012 which approximated the investments' fair value. The carrying value of the investments was \$16,499 as of December 31, 2011 which approximated the investments' fair value.

VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## 4. NOTES PAYABLE, LONG-TERM DEBT AND OTHER OBLIGATIONS

Notes payable, long-term debt and other obligations consist of:

	June 30, 2012	December 31, 2011
Vector:		
11% Senior Secured Notes due 2015, net of unamortized discount of \$505 and \$591	\$414,495	\$414,409
6.75% Variable Interest Senior Convertible Note due 2014, net of unamortized discount of \$33,533 and \$35,704*	16,467	14,296
6.75% Variable Interest Senior Convertible Exchange Notes 2014, net of unamortized discount of \$51,752 and \$57,036*	55,778	50,494
3.875% Variable Interest Senior Convertible Debentures due 2026, net of unamortized discount of \$56,725 and \$82,948*	10,903	16,052
Liggett:		
Revolving credit facility	14,740	21,472
Term loan under credit facility	4,327	5,689
Equipment loans	23,179	21,255
Other	415	533
Total notes payable, long-term debt and other obligations	540,304	544,200
Less:		
Current maturities	(24,246	) (50,844
Amount due after one year	\$516,058	\$493,356

\* The fair value of the derivatives embedded within the 6.75% Variable Interest Convertible Note (\$14,741 at June 30, 2012 and \$16,929 at December 31, 2011, respectively), the 6.75% Variable Interest Senior Convertible Exchange Notes (\$27,938 at June 30, 2012 and \$32,086 at December 31, 2011, respectively), and the 3.875% Variable Interest Senior Convertible Debentures (\$77,731 at June 30, 2012 and \$84,485 at December 31, 2011, respectively) is separately classified as a derivative liability in the condensed consolidated balance sheets.

## Credit Facility - Liggett:

In February 2012, Liggett and Wells Fargo Bank, National Association ("Wells Fargo") renewed the \$50,000 credit facility through February 2015. The Credit Facility is collateralized by all inventories and receivables of Liggett and a mortgage on its manufacturing facility. The Credit Facility expires on March 8, 2015, subject to automatic renewal for additional one-year periods unless a notice of termination is given by Liggett at least 30 days prior to such date or the anniversary of such date.

Prime rate loans under the Credit Facility bear interest at a rate equal to the prime rate of Wells Fargo and Eurodollar rate loans bear interest at a rate equal to 2.0% more than Wells Fargo's adjusted Eurodollar rate. The Credit Facility contains covenants that provide that Liggett's earnings before interest, taxes, depreciation and amortization, as defined under the Credit Facility, on a trailing twelve month basis, shall not be less than \$100,000 if Liggett's Excess Availability, as defined under the Credit Facility, is less than \$20,000. The covenants also require that annual Capital

Expenditures, as defined under the Credit Facility (before a maximum carryover amount of \$2,500), shall not exceed \$15,000 during any fiscal year.

Term Loan under Credit Facility

On February 21, 2012, Wells Fargo, as successor-in-interest to Wachovia Bank, National Association, amended and restated the existing \$5,600 term loan (the "Term Loan") made to 100 Maple LLC ("Maple"), a subsidiary of Liggett, within the commitment under the Credit Facility. In connection with the amendment and restatement the maturity date of the Term Loan was extended to March 1, 2015 and the outstanding principal amount was paid

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down to \$4,425. The Term Loan bears an interest rate equal to 1.75% more than Wells Fargo's adjusted Eurodollar rate. Monthly payments of \$25 are due under the Term Loan from March 1, 2012 to February 1, 2015 (\$885 in total) with the balance of \$3,540 due at maturity on March 1, 2015.

The Term Loan is collateralized by the existing collateral securing the Credit Facility, including, without limitation, certain real property owned by Maple. The Term Loan did not increase the \$50,000 borrowing amount of the Credit Facility, but did increase the outstanding amounts under the Credit Facility by the amount of the term loan and proportionately reduces the maximum borrowing availability under the Credit Facility.

As of June 30, 2012, a total of \$19,067 was outstanding under the revolving and term loan portions of the credit facility. Availability as determined under the facility was approximately \$30,933 based on eligible collateral at June 30, 2012.

11% Senior Secured Notes due 2015 - Vector:

The Company has outstanding \$415,000 principal amount of its 11% Senior Secured Notes due 2015 (the "Senior Secured Notes"). The Senior Secured Notes were sold in August 2007 (\$165,000), September 2009 (\$85,000), April 2010 (\$75,000) and December 2010 (\$90,000) in private offerings to qualified institutional investors in accordance with Rule 144A of the Securities Act of 1933.

In May 2011, the Company completed an exchange offer to exchange the Senior Secured Notes issued in December 2010 for an equal amount of newly issued 11% Senior Secured Notes due 2015. The new Secured Notes have substantially the same terms as the original notes, except that the new Secured Notes have been registered under the Securities Act.

3.875% Variable Interest Senior Convertible Debentures due 2026 - Vector:

The Company was required to mandatorily redeem 10% of the total aggregate principal amount outstanding, or \$11,000, of the Company's 3.875% Variable Interest Senior Convertible Debentures due 2026 (the "Debentures") on June 15, 2011. Other than the holders of \$7 principal amount of the Debentures, who had 10% of their aggregate principal amount of Debentures mandatorily redeemed, each holder of the notes chose to convert its pro-rata portion of the \$11,000 of principal into the Company's common stock. The Company recorded accelerated interest expense related to the converted debt of \$1,217 for the three and six months ended June 30, 2011, on the conversion of the \$11,000 of notes into 685,005 shares of common stock. The debt conversion resulted in a non-cash financing transaction of \$10,993.

In February 2012, a holder of the Debentures converted \$2 principal amount of the Debentures into 125 shares of common stock. The holders of the \$98,998 principal amount of the Debentures had the option to put all of the remaining senior convertible notes on June 15, 2012. None of the Debentures were surrendered for repurchase by the Company. The holders of the Debentures next have the option to put all or part of the remaining Debentures on June 15, 2016. Accordingly, the Company reclassified the Debentures and related fair value of derivatives embedded within convertible debt from current liabilities to long-term liabilities as of June 30, 2012.

In June 2012, the holders of \$31,370 principal amount of the Debentures converted \$31,370 of principal into 1,955,300 shares of the Company's common stock. The Company recorded accelerated interest expense related to the converted debt of \$7,888 for the three and six months ended June 30, 2012, respectively, on the conversion of the \$31,372 of Debentures into 1,955,425 shares of common stock. The debt conversion resulted in a non-cash financing transaction of \$31,372.

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## Non-cash Interest Expense - Vector:

Components of non-cash interest expense are as follows:

	Three Months Ended		Six Months Ended	
	June 30, 2012	2011	June 30, 2012	2011
Amortization of debt discount	\$4,004	\$2,560	\$7,441	\$4,842
Amortization of deferred finance costs	751	1,464	1,461	2,881
Accelerated interest expense on 3.875%				
Variable Interest Senior Convertible Debentures converted	7,888	1,217	7,888	1,217
	\$12,643	\$5,241	\$16,790	\$8,940

## Fair Value of Notes Payable and Long-term Debt:

	June 30, 2012		December 31, 2011	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Notes payable and long-term debt	\$540,304	\$732,013	\$544,200	\$801,353

Notes payable and long-term debt are carried on the condensed balance sheet at amortized cost. The fair value determination disclosed above would be classified as Level 2 under the fair value hierarchy disclosed in Note 8 if such liabilities were recorded on the condensed balance sheet at fair value. The estimated fair value of the Company's notes payable and long-term debt has been determined by the Company using available market information and appropriate valuation methodologies including the evaluation of the Company's credit risk as described in Note 1. However, considerable judgment is required to develop the estimates of fair value and, accordingly, the estimate presented herein are not necessarily indicative of the amount that could be realized in a current market exchange.

## 5. CONTINGENCIES

## Tobacco-Related Litigation:

## Overview

Since 1954, Liggett and other United States cigarette manufacturers have been named as defendants in numerous direct, third-party and purported class actions predicated on the theory that cigarette manufacturers should be liable for damages alleged to have been caused by cigarette smoking or by exposure to secondary smoke from cigarettes. New cases continue to be commenced against Liggett and other cigarette manufacturers. The cases have generally fallen into the following categories: (i) smoking and health cases alleging personal injury brought on behalf of individual plaintiffs ("Individual Actions"); (ii) lawsuits by individuals requesting the benefit of the Engle ruling ("Engle progeny

cases"); (iii) smoking and health cases primarily alleging personal injury or seeking court-supervised programs for ongoing medical monitoring, as well as cases alleging the use of the terms "lights" and/or "ultra lights" constitutes a deceptive and unfair trade practice, common law fraud or violation of federal law, purporting to be brought on behalf of a class of individual plaintiffs ("Class Actions"); and (iv) health care cost recovery actions brought by various foreign and domestic governmental plaintiffs and non-governmental plaintiffs seeking reimbursement for health care expenditures allegedly caused by cigarette smoking and/or disgorgement of profits ("Health Care Cost Recovery Actions"). As new cases are commenced,



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the costs associated with defending these cases and the risks relating to the inherent unpredictability of litigation continue to increase. The future financial impact of the risks and expenses of litigation are not quantifiable at this time. For the six months ended June 30, 2012 and 2011, Liggett incurred legal expenses and other litigation costs totaling approximately \$4,030 and \$3,718, respectively.

Litigation is subject to uncertainty and it is possible that there could be adverse developments in pending or future cases. Management reviews on a quarterly basis with counsel all pending litigation and evaluates whether an estimate can be made of the possible loss or range of loss that could result from an unfavorable outcome. An unfavorable outcome or settlement of pending tobacco-related or other litigation could encourage the commencement of additional litigation. Damages awarded in some tobacco-related litigation can be significant.

**Bonds.** Although Liggett has been able to obtain required bonds or relief from bonding requirements in order to prevent plaintiffs from seeking to collect judgments while adverse verdicts are on appeal, there remains a risk that such relief may not be obtainable in all cases. This risk has been reduced given that a majority of states now limit the dollar amount of bonds or require no bond at all. To obtain stays on judgments pending current appeals, Liggett has secured approximately \$5,212 in bonds as of June 30, 2012.

In June 2009, Florida amended its existing bond cap statute by adding a \$200,000 bond cap that applies to all Engle progeny cases (defined below) in the aggregate and establishes individual bond caps for individual Engle progeny cases in amounts that vary depending on the number of judgments in effect at a given time. Plaintiffs, in several cases, have challenged the constitutionality of the bond cap statute, but to date, the courts that have addressed the issue have upheld the constitutionality of the statute. The plaintiffs have appealed some of these rulings and the Florida Supreme Court has granted review of the Hall decision denying plaintiff's challenge to the bond cap statute. No federal court has yet addressed the issue. Although the Company cannot predict the outcome of such challenges, it is possible that the Company's consolidated financial position, results of operations, and cash flows could be materially affected by an unfavorable outcome of such challenges.

**Accounting Policy.** The Company and its subsidiaries record provisions in their consolidated financial statements for pending litigation when they determine that an unfavorable outcome is probable and the amount of loss can be reasonably estimated. At the present time, while it is reasonably possible that an unfavorable outcome in a case may occur, except as disclosed in this Note 5: (i) management has concluded that it is not probable that a loss has been incurred in any of the pending tobacco-related cases; or (ii) management is unable to estimate the possible loss or range of loss that could result from an unfavorable outcome of any of the pending tobacco-related cases and, therefore, management has not provided any amounts in the consolidated financial statements for unfavorable outcomes, if any. Legal defense costs are expensed as incurred.

**Cautionary Statement About Engle Progeny Cases.** Judgments have been entered against Liggett and other industry defendants in Engle progeny cases. Several of the judgments have been affirmed on appeal. To date, the United States Supreme Court has declined to review these cases. At June 30, 2012, Liggett and the Company are currently defendants in 3,007 state court and 2,642 federal court Engle progeny cases. As of June 30, 2012, 12 Engle progeny cases involving Liggett have resulted in verdicts, exclusive of the Lukacs case, discussed below. Seven verdicts were returned in favor of the plaintiffs and five were returned in favor of Liggett. Other cases have either been voluntarily dismissed by plaintiffs, dismissed by the court on summary judgment or a mistrial was declared. Excluding the Lukacs case, the verdicts against Liggett have ranged from \$1 to \$3,008. In two of these cases, punitive damages were also awarded for \$1,000 and \$7,600. Since Engle progeny trials started in February 2009, 66 cases have been tried to a verdict. Based on the current rate of trials per year, it would require decades to resolve the remaining Engle progeny cases. Except as discussed in this Note 5 with respect to the seven cases where an adverse verdict was entered against Liggett, management is unable to estimate the possible loss or range of loss from the remaining Engle progeny cases

as there are currently multiple defendants in each case and discovery has not occurred or is limited. As a result, the Company lacks information about whether plaintiffs are in fact Engle class members (non-class members' claims are generally time-barred), the relevant smoking history, the nature of the alleged injury and the availability of various defenses, among other things. Further, plaintiffs typically do not specify their demand for damages. The Company believes that the process under which Engle progeny cases are tried is unconstitutional and continues to pursue its appellate rights.

Although Liggett has generally been successful in managing litigation, litigation is subject to uncertainty and

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significant challenges remain, particularly with respect to the Engle progeny cases. There can be no assurances that Liggett's past litigation experience will be representative of future results. Judgments have been entered against Liggett in the past, in non-Engle Individual Actions and Engle progeny cases, and several of those judgments were affirmed on appeal. Litigation is subject to many uncertainties. It is possible that the consolidated financial position, results of operations and cash flows of the Company could be materially adversely affected by an unfavorable outcome or settlement of certain pending smoking-related litigation. Liggett believes, and has been so advised by counsel, that it has valid defenses to the litigation pending against it, as well as valid bases for appeal of adverse verdicts. All such cases are, and will continue to be, vigorously defended. Liggett may, however, enter into settlement discussions in particular cases if it believes it is in its best interest to do so. In connection with the Engle progeny cases, Liggett has been receptive to opportunities to settle these cases, individually or on some aggregated basis, on terms it believes are economically favorable to Liggett and will continue to explore such opportunities. As of June 30, 2012, Liggett (and in certain cases the Company), has settled 82 Engle progeny cases for approximately \$1,002, in the aggregate. If Liggett were able to resolve the Engle progeny cases on an aggregated basis, Liggett believes the range of loss could be between \$69,000 and \$85,000, but there can be no assurances that the Engle progeny cases can be resolved on an aggregated basis, nor can there be any assurances that Liggett's settlement experience to date will be representative of future results or intentions.

## Non-Engle Individual Actions

As of June 30, 2012, there were 65 Individual Actions pending against Liggett and, in certain cases, the Company, where one or more individual plaintiffs allege injury resulting from cigarette smoking, addiction to cigarette smoking or exposure to secondary smoke and seek compensatory and, in some cases, punitive damages. These cases do not include Engle progeny cases or the approximately 100 individual cases pending in West Virginia state court as part of a consolidated action. The following table lists the number of Individual Actions, by state, that are pending against Liggett or the Company as of June 30, 2012:

State	Number of Cases
Florida	47
New York	8
Louisiana	3
Maryland	3
West Virginia	2
Missouri	1
Ohio	1

The plaintiffs' allegations of liability in cases in which individuals seek recovery for injuries allegedly caused by cigarette smoking are based on various theories of recovery, including negligence, gross negligence, breach of special duty, strict liability, fraud, concealment, misrepresentation, design defect, failure to warn, breach of express and implied warranties, conspiracy, aiding and abetting, concert of action, unjust enrichment, common law public nuisance, property damage, invasion of privacy, mental anguish, emotional distress, disability, shock, indemnity and violations of deceptive trade practice laws, the federal Racketeer Influenced and Corrupt Organizations Act ("RICO"), state RICO statutes and antitrust statutes. In many of these cases, in addition to compensatory damages, plaintiffs also seek other forms of relief including treble/multiple damages, medical monitoring, disgorgement of profits and punitive damages. Although alleged damages often are not determinable from a complaint, and the law governing the pleading and calculation of damages varies from state to state and jurisdiction to jurisdiction, compensatory and punitive

damages have been specifically pleaded in a number of cases, sometimes in amounts ranging into the hundreds of millions and even billions of dollars.

Defenses raised in Individual Actions include lack of proximate cause, assumption of the risk, comparative fault and/or contributory negligence, lack of design defect, statute of limitations, equitable defenses such as “unclean hands” and lack of benefit, failure to state a claim and federal preemption.

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Engle Case. In May 1994, Engle was filed against Liggett and others in Miami-Dade County, Florida. The class consisted of all Florida residents who, by November 21, 1996, “have suffered, presently suffer or have died from diseases and medical conditions caused by their addiction to cigarette smoking.” In July 1999, after the conclusion of Phase I of the trial, the jury returned a verdict against Liggett and other cigarette manufacturers on certain issues determined by the trial court to be “common” to the causes of action of the plaintiff class. The jury made several findings adverse to the defendants including that defendants' conduct “rose to a level that would permit a potential award or entitlement to punitive damages.” Phase II of the trial was a causation and damages trial for three of the class plaintiffs and a punitive damages trial on a class-wide basis before the same jury that returned the verdict in Phase I. In April 2000, the jury awarded compensatory damages of \$12,704 to the three class plaintiffs, to be reduced in proportion to the respective plaintiff's fault. In July 2000, the jury awarded approximately \$145,000,000 in punitive damages, including \$790,000 against Liggett.

In May 2003, Florida's Third District Court of Appeal reversed the trial court and remanded the case with instructions to decertify the class. The judgment in favor of one of the three class plaintiffs, in the amount of \$5,831, was overturned as time barred and the court found that Liggett was not liable to the other two class plaintiffs.

In July 2006, the Florida Supreme Court affirmed the decision vacating the punitive damages award and held that the class should be decertified prospectively, but determined that the following Phase I findings are entitled to res judicata effect in Engle progeny cases: (i) that smoking causes lung cancer, among other diseases; (ii) that nicotine in cigarettes is addictive; (iii) that defendants placed cigarettes on the market that were defective and unreasonably dangerous; (iv) that defendants concealed material information knowing that the information was false or misleading or failed to disclose a material fact concerning the health effects or addictive nature of smoking; (v) that defendants agreed to conceal or omit information regarding the health effects of cigarettes or their addictive nature with the intention that smokers would rely on the information to their detriment; (vi) that defendants sold or supplied cigarettes that were defective; and (vii) that defendants were negligent. The Florida Supreme Court decision also allowed former class members to proceed to trial on individual liability issues (using the above findings) and compensatory and punitive damage issues, provided they filed their individual lawsuits by January 2008. In December 2006, the Florida Supreme Court added the finding that defendants sold or supplied cigarettes that, at the time of sale or supply, did not conform to the representations made by defendants. In October 2007, the United States Supreme Court denied defendants' petition for writ of certiorari.

Engle Progeny Cases. Pursuant to the Florida Supreme Court's July 2006 ruling in Engle, which decertified the class on a prospective basis, and affirmed the appellate court's reversal of the punitive damages award, former class members had until January 2008 in which to file individual lawsuits. As of June 30, 2012, Liggett and the Company are named defendants in 5,649 Engle progeny cases in both federal (2,642 cases) and state (3,007 cases) courts in Florida. Other cigarette manufacturers are also named as defendants in these cases, although as a case proceeds, one or more defendants may ultimately be dismissed from an action. These cases include approximately 6,912 plaintiffs. The number of state court Engle progeny cases may increase as multi-plaintiff cases continue to be severed into individual cases. The total number of plaintiffs may also increase as a result of attempts by existing plaintiffs to add additional parties. Although the Company was not named as a defendant in the Engle case, it has been named as a defendant in most of the Engle progeny cases where Liggett is named as a defendant.

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As of June 30, 2012 the following Engle progeny cases have resulted in judgments against Liggett:

Date	Case Name	County	Net Compensatory Damages	Punitive Damages	Status
June 2002	Lukacs v. R.J. Reynolds	Miami-Dade	\$12,418	None	Affirmed on appeal by the Third District Court of Appeal. Judgment has been satisfied and the case is concluded.
August 2009	Campbell v. R.J. Reynolds	Escambia	\$156	None	Affirmed on appeal by the First District Court of Appeal. Defendants filed a motion with the District Court of Appeal for certification to the Florida Supreme Court, which was denied on May 13, 2011. Defendants sought review by the US Supreme Court, which was denied in March 2012. In April 2012, the judgment was satisfied and, except for an issue regarding calculation of interest, the case is concluded.
March 2010	Douglas v. R.J. Reynolds	Hillsborough	\$1,350	None	Affirmed on appeal by the Second District Court of Appeal. The court certified the question of the constitutionality of the Engle findings as a question of great public importance. The Florida Supreme Court agreed to review the case. Oral argument is scheduled for September 6, 2012.
April 2010	Clay v. R.J. Reynolds	Escambia	\$349	\$1,000	Affirmed on appeal by the First District Court of Appeal on January 25, 2012. Defendants motion for rehearing was denied. Defendants filed a motion to recall the mandate.
April 2010	Putney v. R.J. Reynolds	Broward	\$3,008	None	On appeal to the Fourth District Court of Appeal.
April 2011	Tullo v. R.J. Reynolds	Palm Beach	\$225	None	On appeal to the Fourth District Court of Appeal.
January 2012	Ward v. R.J. Reynolds	Escambia	\$1	None	Joint and several judgment entered for \$487 against Liggett

					and RJR. On appeal to the First District Court of Appeal.
May 2012	Calloway v. R.J. Reynolds	Broward	\$1,947	\$7,600	Post trial motions are pending.

The Company's potential range of loss in the Douglas, Clay, Putney, Tullo, Ward and Calloway cases is between \$0 and \$15,967 in the aggregate, plus accrued interest and legal fees. In determining the range of loss, the Company considers potential settlements as well as future appellate relief. Except as disclosed elsewhere in this note, the Company is unable to determine a range of loss related to the remaining Engle progeny cases. No amounts have been expensed or accrued in the accompanying consolidated financial statements for these cases. The Company previously accrued \$156, plus related legal fees and interest, for the Campbell case. In April 2012, Liggett satisfied the Campbell judgment after the United States Supreme Court denied review. For further information on the Engle case and on Engle progeny cases, see "Class Actions — Engle Case," below.

Lukacs Case. In June 2002, the jury in a Florida state court action entitled Lukacs v. R.J. Reynolds Tobacco Co., awarded \$37,500 in compensatory damages, jointly and severally, in a case involving Liggett and two other cigarette manufacturers, which amount was subsequently reduced by the court. The jury found Liggett 50% responsible for the damages incurred by the plaintiff. The Lukacs case was the first case to be tried as an individual Engle progeny case, but was tried almost five years prior to the Florida Supreme Court's final decision in Engle. In November 2008, the court entered final judgment in the amount of \$24,835, plus interest from June 2002. In March 2010, the Third District Court of Appeal affirmed the decision, per curiam. Liggett satisfied its share of the judgment, including attorneys' fees and accrued interest, for \$14,361.

Federal Engle Progeny Cases. Three federal judges (in the Merlob, B. Brown and Burr cases) ruled that the findings in Phase I of the Engle proceedings could not be used to satisfy elements of plaintiffs' claims, and

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two of those rulings (B. Brown and Burr) were certified by the trial court for interlocutory review. The certification was granted by the United States Court of Appeals for the Eleventh Circuit and the appeals were consolidated (in February 2009, the appeal in Burr was dismissed for lack of prosecution). In July 2010, the Eleventh Circuit ruled that plaintiffs do not have an unlimited right to use the findings from the original Engle trial to meet their burden of establishing the elements of their claims at trial. Rather, plaintiffs may only use the findings to establish specific facts that they demonstrate with a reasonable degree of certainty were actually decided by the original Engle jury. The Eleventh Circuit remanded the case to the district court to determine what specific factual findings the Engle jury actually made. All federal cases were stayed pending review by the Eleventh Circuit. In December 2010, stays were lifted in 12 cases selected by plaintiffs, two of which were subsequently re-stayed. Liggett is no longer a defendant in any of the 12 cases. In August 2011, the court ordered the activation of an additional 22 cases, one of which was subsequently deactivated and one of which was voluntarily dismissed. Liggett is a defendant in 12 of the remaining 20 cases.

**Appeals of Engle Progeny Verdicts.** In December 2010, in the Martin case, a state court case against R.J. Reynolds, the First District Court of Appeal issued the first ruling by a Florida intermediate appellate court to address the B. Brown decision discussed above. The panel held that the trial court correctly construed the Florida Supreme Court's 2006 decision in Engle in instructing the jury on the preclusive effect of the Phase I Engle proceedings, expressly disagreeing with certain aspects of the B. Brown decision. In July 2011, the Florida Supreme Court declined to review the First District Court of Appeal's decision. In March 2012, the United States Supreme Court declined to review the Martin case, along with the Campbell case and two other Engle progeny cases. This decision could lead to other adverse rulings by state appellate courts.

In the Waggoner case, the United States District Court for the Middle District of Florida directed the parties to brief the applicability of the Engle findings to all Middle District cases. Liggett and the Company are not defendants in Waggoner, but nonetheless, were directed to submit motions on the issues. In December 2011, the district court ruled that it was bound by Martin and Jimmie Lee Brown (discussed below) and that the application of the Phase I findings did not deprive defendants of any constitutional due process rights. The court ruled, however, that plaintiffs must establish legal causation to establish liability. With respect to punitive damages, the district court held that the plaintiffs could rely on the findings in support of their punitive damages claims but that, in addition, plaintiffs must demonstrate specific conduct by specific defendants, independent of the Engle findings, that satisfies the standards for awards of punitive damages. The Waggoner ruling will apply to all of the cases pending in the Middle District of Florida. The defendants are seeking review of the due process ruling by the United States Court of Appeals for the Eleventh Circuit. The Waggoner court declined to reach certain issues raised by Liggett and the Company and directed that their motion be re-filed in a case in which they are named as defendants. As a result, Liggett filed a motion in the Young-McCray case raising issues specific to Liggett. The court denied the motion and adopted the Waggoner ruling as to Liggett.

In Jimmie Lee Brown, a state court case against R.J. Reynolds, the trial court tried the case in two phases. In the first phase, the jury determined that the smoker was addicted to cigarettes that contained nicotine and that his addiction was a legal cause of his death, thereby establishing he was an Engle class member. In the second phase, the jury determined whether the plaintiff established legal cause and damages with regard to each of the underlying claims.

The jury found in favor of plaintiff in both phases. In September 2011, the Fourth District Court of Appeal affirmed the judgment entered in plaintiff's favor and approved the trial court's procedure of bifurcating the trial. The Fourth District Court of Appeal agreed with Martin that individual post-Engle plaintiffs need not prove conduct elements as part of their burden of proof, but disagreed with Martin to the extent that the First District Court of Appeal only required a finding that the smoker was a class member to establish legal causation as to addiction and the underlying claims. The Fourth District Court of Appeal held that in addition to establishing class membership, Engle progeny



plaintiffs must also establish legal causation and damages as to each claim asserted. In so finding, the Fourth District Court of Appeal's decision in Jimmie Lee Brown is in conflict with Martin. In dicta, the Fourth District Court of Appeal further voiced concern that the preclusive effect of the Engle findings violates the tobacco company defendants' due process rights and, in the special concurring opinion, the court emphasized that until the Florida Supreme Court gives trial courts guidance as to what it intended by its Engle decision, trial courts will continue to play "a form of legal poker." In September 2011, R.J. Reynolds filed a motion asking the Fourth District Court of Appeal to certify the case to the Florida Supreme Court for review. The motion was denied in October 2011.

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In the Rey case, a state court Engle progeny case, the trial court entered final summary judgment on all claims in favor of the Company, Liggett and Lorillard (the "Moving Defendants") based on what has been referred to in the Engle progeny litigation as the "Liggett Rule." The Liggett Rule stands for the proposition that a manufacturer cannot have liability to a smoker under any asserted claim if the smoker did not use a product manufactured by that particular defendant. The Liggett Rule is based on the entry of final judgment in favor of Liggett/Brooke Group in Engle on all of the claims asserted against them by class representatives Mary Farnan and Angie Della Vecchia, even though the Florida Supreme Court upheld, as res judicata, the generic finding that Liggett/Brooke Group engaged in a conspiracy to commit fraud by concealment. In September 2011, the Third District Court of Appeal affirmed in part and reversed in part holding that the Moving Defendants were entitled to summary judgment on all claims asserted against them other than the claim for civil conspiracy. The Moving Defendants' motions for rehearing were denied with regard to the Liggett Rule issues. Moving Defendants are seeking further review by the Florida Supreme Court. In March 2012, the Fifth District Court of Appeal, in other progeny cases, followed the Third District Court of Appeal and reversed summary judgment on the conspiracy claims.

On March 30, 2012, in Douglas, the Second District Court of Appeal issued a decision affirming the judgment of the trial court in favor of the plaintiff and upholding the use of the Engle jury findings but certified to the Florida Supreme Court the question of whether granting res judicata effect to the Engle jury findings violates defendants' federal due process rights. On April 2, 2012, the defendants in Douglas filed a Notice to Invoke Discretionary Jurisdiction of the Florida Supreme Court, which was accepted. Oral argument is scheduled for September 6, 2012.

Liggett Only Cases. There are currently eight cases pending where Liggett is the only remaining tobacco company defendant. Cases where Liggett is the only defendant could increase substantially as a result of the Engle progeny cases.

In February 2009, in Ferlanti v. Liggett Group, a Florida state court jury awarded compensatory damages to plaintiff and an \$816 judgment was entered by the court. That judgment was affirmed on appeal and was satisfied by Liggett. In September 2010, the court awarded plaintiff legal fees of \$996. Plaintiff appealed the amount of the attorneys' fee award. Liggett previously accrued \$2,000 for the Ferlanti case. In Welch v. R.J. Reynolds, Katz v. R.J. Reynolds, and Hinkle v. R.J. Reynolds, all Engle progeny cases, no trial dates have been set. There has been no recent activity in Hausrath v. Philip Morris, a case pending in New York state court, where two individuals are suing. The other three Individual Actions are pending in Florida and are inactive.

#### Class Actions

As of June 30, 2012, there were five actions pending for which either a class had been certified or plaintiffs were seeking class certification, where Liggett is a named defendant, including one alleged price fixing case. Other cigarette manufacturers are also named in these actions.

Plaintiffs' allegations of liability in class action cases are based on various theories of recovery, including negligence, gross negligence, strict liability, fraud, misrepresentation, design defect, failure to warn, nuisance, breach of express and implied warranties, breach of special duty, conspiracy, concert of action, violation of deceptive trade practice laws and consumer protection statutes and claims under the federal and state anti-racketeering statutes. Plaintiffs in the class actions seek various forms of relief, including compensatory and punitive damages, treble/multiple damages and other statutory damages and penalties, creation of medical monitoring and smoking cessation funds, disgorgement of profits, and injunctive and equitable relief.

Defenses raised in these cases include, among others, lack of proximate cause, individual issues predominate, assumption of the risk, comparative fault and/or contributory negligence, statute of limitations and federal preemption. In Smith v. Philip Morris, a Kansas state court case filed in February 2000, plaintiffs allege that cigarette manufacturers conspired to fix cigarette prices in violation of antitrust laws. Plaintiffs seek to recover an unspecified amount in actual and punitive damages. Class certification was granted in November 2001. On January 18, 2012 the

trial court heard oral argument on defendants' motions for summary judgment and on March 23, 2012, the court granted the motions and dismissed plaintiffs' claims with prejudice. On July 18,

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2012, plaintiffs noticed an appeal.

In November 1997, in *Young v. American Tobacco Co.*, a purported personal injury class action was commenced on behalf of plaintiff and all similarly situated residents in Louisiana who, though not themselves cigarette smokers, are alleged to have been exposed to secondhand smoke from cigarettes which were manufactured by the defendants, and who suffered injury as a result of that exposure. The plaintiffs seek to recover an unspecified amount of compensatory and punitive damages. In October 2004, the trial court stayed this case pending the outcome of an appeal in another matter, which has been concluded. There has been no further activity in *Young*.

In February 1998, in *Parsons v. AC & S Inc.*, a case pending in West Virginia, a class was commenced on behalf of all West Virginia residents who allegedly have personal injury claims arising from exposure to cigarette smoke and asbestos fibers. The complaint seeks to recover \$1,000 in compensatory and punitive damages individually and unspecified compensatory and punitive damages for the class. The case is stayed as a result of the December 2000 bankruptcy of three of the defendants.

In April 2001, in *Brown v. Philip Morris USA*, a California state court granted in part plaintiffs' motion for class certification and certified a class comprised of adult residents of California who smoked at least one of defendants' cigarettes "during the applicable time period" and who were exposed to defendants' marketing and advertising activities in California. In December 2010, defendants filed a motion for a determination that the class representatives set forth in plaintiffs' Tenth Amended Complaint lacked standing to pursue the claims. The motion was granted by the court. Plaintiffs moved to file an amended complaint adding new class representatives, which motion was granted by the court and in July 2011, plaintiffs filed their Eleventh Amended Complaint adding new putative class representatives.

On January 31, 2012, defendants filed motions to decertify the class and challenging standing, typicality and adequacy of the newly named class representatives. After oral argument on May 24, 2012, the court found that three of the four plaintiffs were not adequate class representatives to assert the claims at issue. The court further narrowed the class claims to those involving the marketing and sale of "lights" cigarettes in California during the class period. A hearing on summary judgment motions is scheduled for December 18, 2012, and trial is scheduled to begin April 19, 2013.

Although not technically a class action, in *In Re: Tobacco Litigation (Personal Injury Cases)*, a West Virginia state court consolidated approximately 750 individual smoker actions that were pending prior to 2001 for trial of certain common issues. In January 2002, the court severed Liggett from the trial of the consolidated action, which commenced in June 2010 and ended in a mistrial. The rescheduled trial commenced in October 2011 and it, too, ended in a mistrial. A new trial is scheduled for April 13, 2013. If the case were to proceed against Liggett, it is estimated that Liggett could be a defendant in approximately 100 of the individual cases.

Class action suits have been filed in a number of states against cigarette manufacturers, alleging, among other things, that use of the terms "lights" and "ultra lights" constitutes unfair and deceptive trade practices. In December 2008, the United States Supreme Court, in *Altria Group v. Good*, ruled that the Federal Cigarette Labeling and Advertising Act did not preempt the state law claims asserted by the plaintiffs and that they could proceed with their claims under the Maine Unfair Trade Practices Act. The *Good* decision has resulted in the filing of additional "lights" class action cases in other states against other cigarette manufacturers. Although Liggett was not a defendant in the *Good* case, and is not a defendant in any other "lights" class actions other than *Brown*, an adverse ruling or commencement of additional "lights" related class actions could have a material adverse effect on the Company.

In addition to the cases described above, numerous class actions remain certified against other cigarette manufacturers. Adverse decisions in these cases could have a material adverse affect on Liggett's sales volume, operating income and cash flows.

Health Care Cost Recovery Actions

As of June 30, 2012, there was one Health Care Cost Recovery Action pending against Liggett, Crow Creek Sioux Tribe v. American Tobacco Company, a South Dakota case filed in 1997, where the plaintiff seeks to recover damages based on various theories of recovery as a result of alleged sales of tobacco products to minors. This case is inactive. Other cigarette manufacturers are also named as defendants.

The claims asserted in health care cost recovery actions vary. Although, typically, no specific damage amounts

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are pled, it is possible that requested damages might be in the billions of dollars. In these cases, plaintiffs typically assert equitable claims that the tobacco industry was “unjustly enriched” by their payment of health care costs allegedly attributable to smoking and seek reimbursement of those costs. Relief sought by some, but not all, plaintiffs include punitive damages, multiple damages and other statutory damages and penalties, injunctions prohibiting alleged marketing and sales to minors, disclosure of research, disgorgement of profits, funding of anti-smoking programs, additional disclosure of nicotine yields, and payment of attorney and expert witness fees.

Other claims asserted include the equitable claim of indemnity, common law claims of negligence, strict liability, breach of express and implied warranty, breach of special duty, fraud, negligent misrepresentation, conspiracy, public nuisance, claims under state and federal statutes governing consumer fraud, antitrust, deceptive trade practices and false advertising, and claims under RICO.

Department of Justice Lawsuit. In September 1999, the United States government commenced litigation against Liggett and other cigarette manufacturers in the United States District Court for the District of Columbia. The action sought to recover an unspecified amount of health care costs paid and to be paid by the federal government for lung cancer, heart disease, emphysema and other smoking-related illnesses allegedly caused by the fraudulent and tortious conduct of defendants, to restrain defendants and co-conspirators from engaging in alleged fraud and other allegedly unlawful conduct in the future, and to compel defendants to disgorge the proceeds of their unlawful conduct. Claims were asserted under RICO.

In August 2006, the trial court entered a Final Judgment against each of the cigarette manufacturing defendants, except Liggett. In May 2009, the United States Court of Appeals for the District of Columbia affirmed most of the district court's decision. In February 2010, the government and all defendants, other than Liggett, filed petitions for writ of certiorari to the United States Supreme Court. In June 2010, the United States Supreme Court, without comment, denied review. As a result, the cigarette manufacturing defendants, other than Liggett, are now subject to the trial court's Final Judgment which ordered the following relief: (i) an injunction against “committing any act of racketeering” relating to the manufacturing, marketing, promotion, health consequences or sale of cigarettes in the United States; (ii) an injunction against participating directly or indirectly in the management or control of the Council for Tobacco Research, the Tobacco Institute, or the Center for Indoor Air Research, or any successor or affiliated entities of each; (iii) an injunction against “making, or causing to be made in any way, any material false, misleading, or deceptive statement or representation or engaging in any public relations or marketing endeavor that is disseminated to the United States' public and that misrepresents or suppresses information concerning cigarettes”; (iv) an injunction against conveying any express or implied health message through use of descriptors on cigarette packaging or in cigarette advertising or promotional material, including “lights,” “ultra lights,” and “low tar,” which the court found could cause consumers to believe one cigarette brand is less hazardous than another brand; (v) the issuance of “corrective statements” in various media regarding the adverse health effects of smoking, the addictiveness of smoking and nicotine, the lack of any significant health benefit from smoking “low tar” or “lights” cigarettes, defendants' manipulation of cigarette design to ensure optimum nicotine delivery and the adverse health effects of exposure to environmental tobacco smoke; (vi) the disclosure of defendants' public document websites and the production of all documents produced to the government or produced in any future court or administrative action concerning smoking and health; (vii) the disclosure of disaggregated marketing data to the government in the same form and on the same schedules as defendants now follow in disclosing such data to the Federal Trade Commission for a period of ten years; (viii) certain restrictions on the sale or transfer by defendants of any cigarette brands, brand names, formulas or cigarette business within the United States; and (ix) payment of the government's costs in bringing the action. Two issues remain pending before the district court: (i) the substance of the court-ordered corrective statements and (ii) the requirements related to point-of-sale signage. Other matters are currently on appeal.

It is unclear what impact, if any, the Final Judgment will have on the cigarette industry as a whole. To the extent that the Final Judgment leads to a decline in industry-wide shipments of cigarettes in the United States or otherwise results in restrictions that adversely affect the industry, Liggett's sales volume, operating income and cash flows could be materially adversely affected.

Upcoming Trials

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As of June 30, 2012, there were 31 Engle progeny cases scheduled for trial through June 30, 2013. In *Whitney v. R.J. Reynolds*, a non-Engle Individual Action pending in Florida, trial is scheduled for February 4, 2013. The Company and/or Liggett and other cigarette manufacturers are currently named as defendants in each of these cases, although as a case proceeds, one or more defendants may ultimately be dismissed from an action. In addition, in *Brown v. Philip Morris USA*, a purported class action, trial is scheduled for April 19, 2013. There are additional cases against other cigarette manufacturers that are also scheduled for trial through June 30, 2013. Trial dates are, however, subject to change.

#### MSA and Other State Settlement Agreements

In March 1996, March 1997 and March 1998, Liggett entered into settlements of smoking-related litigation with 45 states and territories. The settlements released Liggett from all smoking-related claims made by those states and territories, including claims for health care cost reimbursement and claims concerning sales of cigarettes to minors. In November 1998, Philip Morris, Brown & Williamson, R.J. Reynolds and Lorillard (the “Original Participating Manufacturers” or “OPMs”) and Liggett (together with any other tobacco product manufacturer that becomes a signatory, the “Subsequent Participating Manufacturers” or “SPMs”) (the OPMs and SPMs are hereinafter referred to jointly as the “Participating Manufacturers”) entered into the Master Settlement Agreement (the “MSA”) with 46 states, the District of Columbia, Puerto Rico, Guam, the United States Virgin Islands, American Samoa and the Northern Mariana Islands (collectively, the “Settling States”) to settle the asserted and unasserted health care cost recovery and certain other claims of the Settling States. The MSA received final judicial approval in each Settling State.

As a result of the MSA, the Settling States released Liggett from:

all claims of the Settling States and their respective political subdivisions and other recipients of state health care funds, relating to: (i) past conduct arising out of the use, sale, distribution, manufacture, development, advertising and marketing of tobacco products; (ii) the health effects of, the exposure to, or research, statements or warnings about, tobacco products; and

all monetary claims of the Settling States and their respective subdivisions and other recipients of state health care funds relating to future conduct arising out of the use of, or exposure to, tobacco products that have been manufactured in the ordinary course of business.

The MSA restricts tobacco product advertising and marketing within the Settling States and otherwise restricts the activities of Participating Manufacturers. Among other things, the MSA prohibits the targeting of youth in the advertising, promotion or marketing of tobacco products; bans the use of cartoon characters in all tobacco advertising and promotion; limits each Participating Manufacturer to one tobacco brand name sponsorship during any 12-month period; bans all outdoor advertising, with certain limited exceptions; prohibits payments for tobacco product placement in various media; bans gift offers based on the purchase of tobacco products without sufficient proof that the intended recipient is an adult; prohibits Participating Manufacturers from licensing third parties to advertise tobacco brand names in any manner prohibited under the MSA; and prohibits Participating Manufacturers from using as a tobacco product brand name any nationally recognized non-tobacco brand or trade name or the names of sports teams, entertainment groups or individual celebrities.

The MSA also requires Participating Manufacturers to affirm corporate principles to comply with the MSA and to reduce underage use of tobacco products and imposes restrictions on lobbying activities conducted on behalf of Participating Manufacturers. In addition, the MSA provides for the appointment of an independent auditor to calculate and determine the amounts of payments owed pursuant to the MSA.

Under the payment provisions of the MSA, the Participating Manufacturers are required to make annual payments of \$9,000,000 (subject to applicable adjustments, offsets and reductions). These annual payments are allocated based on unit volume of domestic cigarette shipments. The payment obligations under the MSA are the several, and not joint, obligation of each Participating Manufacturer and are not the responsibility of any parent or affiliate of a Participating



Manufacturer.

Liggett has no payment obligations under the MSA except to the extent its market share exceeds a market share exemption of approximately 1.65% of total cigarettes sold in the United States. Vector Tobacco has no

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payment obligations under the MSA except to the extent its market share exceeds a market share exemption of approximately 0.28% of total cigarettes sold in the United States. Liggett and Vector Tobacco's domestic shipments accounted for 3.8% of the total cigarettes sold in the United States in 2011. If Liggett's or Vector Tobacco's market share exceeds their respective market share exemption in a given year, then on April 15 of the following year, Liggett and/or Vector Tobacco, as the case may be, must pay on each excess unit an amount equal (on a per-unit basis) to that due from the OPMs for that year. On December 31, 2011, Liggett and Vector Tobacco paid \$101,500 of their estimated \$154,600 2011 MSA payment obligation determined by the independent auditor. On April 16, 2012, Liggett and Vector Tobacco paid an additional approximately \$50,100, of which \$18,000 was paid into a disputed payment account. Liggett disputed and withheld approximately \$3,000.

#### Certain MSA Disputes

**NPM Adjustment.** In March 2006, an economic consulting firm selected pursuant to the MSA determined that the MSA was a "significant factor contributing to" the loss of market share of Participating Manufacturers, to non-participating manufacturers, for 2003. This is known as the "NPM Adjustment." The economic consulting firm subsequently rendered the same decision with respect to 2004 and 2005. In March 2009, a different economic consulting firm made the same determination for 2006. As a result, the manufacturers are entitled to potential NPM Adjustments to each of their 2003 - 2006 MSA payments. The Participating Manufacturers are also entitled to potential NPM Adjustments to their 2007 - 2011 payments pursuant to agreements entered into between the OPMs and the Settling States under which the OPMs agreed to make certain payments for the benefit of the Settling States, in exchange for which the Settling States stipulated that the MSA was a "significant factor contributing to" the loss of market share of Participating Manufacturers for each of those years. A Settling State that has diligently enforced its qualifying escrow statute in the year in question may be able to avoid application of the NPM Adjustment to the payments made by the manufacturers for the benefit of that Settling State.

For 2003 – 2011, Liggett and Vector Tobacco, as applicable, disputed that they owed the Settling States the NPM Adjustments as calculated by the Independent Auditor. As permitted by the MSA, Liggett and Vector Tobacco withheld payment or paid into a disputed payment account the amounts associated with these NPM Adjustments. For 2003, Liggett and Vector Tobacco paid the NPM adjustment amount of \$9,345 to the Settling States although both companies continue to dispute this amount is owed. The total amount withheld (or paid into a disputed payment account) by Liggett and Vector Tobacco for 2004 – 2011 was \$61,960. At June 30, 2012, included in "Other assets" on the Company's consolidated balance sheet was a non-current receivable of \$6,542 relating to the \$9,345 payment. The following amounts have not been expensed by the Company as they relate to Liggett and Vector Tobacco's NPM Adjustment claims: \$6,542 for 2003, \$3,789 for 2004 and \$800 for 2005. Liggett and Vector Tobacco have expensed all disputed amounts related to the NPM Adjustment since 2005.

Since April 2006, notwithstanding provisions in the MSA requiring arbitration, litigation was filed in 49 Settling States involving the issue of whether the application of the NPM Adjustment for 2003 was to be determined through litigation or arbitration. These actions related to the potential NPM Adjustment for 2003, which the independent auditor under the MSA previously determined to be as much as \$1,200,000 for all Participating Manufacturers. All but one of the 48 courts that have decided the issue ruled that the 2003 NPM Adjustment dispute is arbitrable. One court, the Montana Supreme Court, ruled that Montana's claim of diligent enforcement must be litigated. The United States Supreme Court denied certiorari with respect to that opinion. In response to a proposal from the OPMs and many of the SPMs, 45 of the Settling States, representing approximately 90% of the allocable share of the Settling States, entered into an agreement providing for a nationwide arbitration of the dispute with respect to the NPM Adjustment for 2003. In June 2010, the three person arbitration panel was selected. Substantive hearings commenced in April 2012 and are ongoing. Because states representing more than 80% of the allocable share signed the agreement, signing states will receive a 20% reduction of any 2003 NPM adjustment awarded in the arbitration. There can be no

assurance that Liggett or Vector Tobacco will receive any adjustment as a result of these proceedings.  
Gross v. Net Calculations. In October 2004, the independent auditor notified Liggett and all other Participating Manufacturers that their payment obligations under the MSA, dating from the agreement's execution in late

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1998, had been recalculated using “net” unit amounts, rather than “gross” unit amounts (which had been used since 1999). Liggett objected to this retroactive change and disputed the change in methodology. Liggett contends that the retroactive change from “gross” to “net” unit amounts is impermissible for several reasons, including: use of “net” unit amounts is not required by the MSA (as reflected by, among other things, the use of “gross” unit amounts through 2005);

such a change is not authorized without the consent of affected parties to the MSA;

the MSA provides for four-year time limitation periods for revisiting calculations and determinations, which precludes recalculating Liggett’s 1997 Market Share (and thus, Liggett’s market share exemption); and

Liggett and others have relied upon the calculations based on “gross” unit amounts since 1998.

The change in the method of calculation could result in Liggett owing as much as \$36,000 of additional MSA payments for prior years, including interest, because the proposed change from “gross” to “net” units would serve to lower Liggett’s market share exemption under the MSA. In August 2011, Liggett received notice from several states seeking to initiate arbitration as to this matter. The parties entered into an agreement regarding procedures for the arbitration and selection of the arbitrators and a panel of three arbitrators was selected. Discovery has commenced. The Company estimates that Liggett’s future MSA payments would be at least approximately \$2,500 higher if the method of calculation is changed. No amounts have been expensed or accrued in the accompanying consolidated financial statements for any potential liability relating to the “gross” versus “net” dispute. There can be no assurance that Liggett will not be required to make additional payments, which could adversely affect the Company’s consolidated financial position, results of operations and cash flows.

**Litigation Challenging the MSA.** In *Grand River Enterprises Six Nations, Ltd. v. King*, litigation pending in federal court in New York, plaintiff sought to enjoin the statutes enacted by New York and other states in connection with the MSA on the grounds that the statutes violate the Commerce Clause of the United States Constitution and federal antitrust laws. In September 2005, the United States Court of Appeals for the Second Circuit held that if all of the allegations of the complaint were assumed to be true, plaintiff had stated a claim for relief and that the New York federal court had jurisdiction over the other state defendants. On remand, the trial court held that plaintiff is unlikely to succeed on the merits. After discovery in November 2009, the parties cross-moved for summary judgment. In March 2011, the United States District Court for the Southern District of New York granted defendants’ motion for summary judgment. Plaintiff appealed the decision. That appeal has been stayed, pending resolution of a motion to alter or amend judgment. At the end of 2011, Grand River dismissed the action and the appeal with prejudice as to certain state defendants.

In October 2008, Vibo Corporation, Inc., d/b/a General Tobacco (“Vibo”) commenced litigation in the United States District Court for the Western District of Kentucky against each of the Settling States and certain Participating Manufacturers, including Liggett and Vector Tobacco. Vibo sought damages from Participating Manufacturers under antitrust laws, and also brought a number of constitutional challenges to the MSA and its provisions. Vibo alleged, among other things, that the market share exemptions (i.e., grandfathered shares) provided to SPMs that joined the MSA by a certain date, including Liggett and Vector Tobacco, violate federal antitrust and constitutional law. In January 2009, the district court dismissed the complaint. In January 2010, the court entered final judgment in favor of the defendants. Vibo appealed to the United States Court of Appeals for the Sixth Circuit, and the case was argued on October 6, 2011. On February 22, 2012, the Sixth Circuit affirmed the District Court’s decision.

Litigation challenging the validity of the MSA, including claims that the MSA violates antitrust laws, has not been successful to date, although several cases are pending. Participating Manufacturers are not typically named as defendants in these cases.

**Other State Settlements.** The MSA replaced Liggett’s prior settlements with all states and territories except for Florida, Mississippi, Texas and Minnesota. Each of these four states, prior to the effective date of the MSA, negotiated and

executed settlement agreements with each of the other major tobacco companies, separate

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from those settlements reached previously with Liggett. Except as described below, Liggett's agreements with these states remain in full force and effect. These states' settlement agreements with Liggett contained most favored nation provisions which could reduce Liggett's payment obligations based on subsequent settlements or resolutions by those states with certain other tobacco companies. Beginning in 1999, Liggett determined that, based on each of these four states' settlements with United States Tobacco Company, Liggett's payment obligations to those states had been eliminated. With respect to all non-economic obligations under the previous settlements, Liggett believes it is entitled to the most favorable provisions as between the MSA and each state's respective settlement with the other major tobacco companies. Therefore, Liggett's non-economic obligations to all states and territories are now defined by the MSA.

In 2003, as a result of a dispute with Minnesota regarding its settlement agreement, Liggett agreed to pay \$100 a year, in any year cigarettes manufactured by Liggett are sold in that state. In 2003 and 2004, the Attorneys General for Florida, Mississippi and Texas advised Liggett that they believed that Liggett had failed to make certain required payments under the respective settlement agreements with these states. In December 2010, Liggett settled with Florida and agreed to pay \$1,200 and to make further annual payments of \$250 for a period of 21 years, starting in March 2011. The payments in years 12 – 21 will be subject to an inflation adjustment. These payments are in lieu of any other payments allegedly due to Florida under the original settlement agreement. The Company accrued approximately \$3,200 for this matter in 2010. In February 2012, Mississippi provided Liggett with a 60-day notice that the state intended to pursue its remedies if Liggett did not cure the alleged defaults. There can be no assurance that Liggett will be able to resolve the matters with Texas and Mississippi or that Liggett will not be required to make additional payments which could adversely affect the Company's consolidated financial position, results of operations and cash flows.

**Cautionary Statement.** Management is not able to predict the outcome of the litigation pending or threatened against Liggett or the Company. Litigation is subject to many uncertainties. For example, the jury in the Lukacs case, an Engle progeny case tried in 2002, awarded \$24,835 in compensatory damages and found Liggett 50% responsible for the damages. The judgment was affirmed on appeal and Liggett paid \$14,361 in June 2010. Through June 30, 2012, Liggett has been found liable in seven other Engle progeny cases. As discussed above, these cases have been, or currently are, on appeal, however, appellate efforts to date have not been successful. Liggett has also had judgments entered against it in other Individual Actions, which judgments were affirmed on appeal and, thereafter, satisfied by Liggett. It is possible that other cases could be decided unfavorably against Liggett and that Liggett will be unsuccessful on appeal. Liggett may attempt to settle particular cases if it believes it is in its best interest to do so. Management cannot predict the cash requirements related to any future defense costs, settlements or judgments, including cash required to bond any appeals, and there is a risk that those requirements will not be able to be met. An unfavorable outcome of a pending smoking-related case could encourage the commencement of additional litigation, or could lead to adverse decisions in the Engle progeny cases. Except as discussed in this Note 5, management is unable to estimate the loss or range of loss that could result from an unfavorable outcome of the cases pending against Liggett or the costs of defending such cases and as a result has not provided any amounts in its consolidated financial statements for unfavorable outcomes.

The tobacco industry is subject to a wide range of laws and regulations regarding the marketing, sale, taxation and use of tobacco products imposed by local, state and federal governments. There have been a number of restrictive regulatory actions, adverse legislative and political decisions and other unfavorable developments concerning cigarette smoking and the tobacco industry. These developments may negatively affect the perception of potential triers of fact with respect to the tobacco industry, possibly to the detriment of certain pending litigation, and may prompt the commencement of additional litigation or legislation.

It is possible that the Company's consolidated financial position, results of operations and cash flows could be materially adversely affected by an unfavorable outcome in any of the smoking-related litigation.

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The activity in the company's accruals for tobacco litigation for the six months ended June 30, 2012 were as follows:

	Current Liabilities			Non-Current Liabilities		
	Payments due under Master Settlement Agreement	Litigation Accruals	Total	Payments due under Master Settlement Agreement	Litigation Accruals	Total
Balance at January 1, 2012	\$51,174	\$1,551	\$52,725	\$49,338	\$1,600	\$50,938
Expenses	69,956	179	70,135	—	—	—
Change in MSA obligations capitalized as inventory	173	—	173	—	—	—
Payments	(50,094	) (574	) (50,668	) —	—	—
Reclassification to non-current liabilities	(905	) 224	(681	) 905	(224	) 681
Interest on withholding	—	24	24	1,172	385	1,557
Balance at June 30, 2012	\$70,304	\$1,404	\$71,708	\$51,415	\$1,761	\$53,176

The activity in the company's accruals for tobacco litigation for the six months ended June 30, 2011 were as follows:

	Current Liabilities			Non-Current Liabilities		
	Payments due under Master Settlement Agreement	Litigation Accruals	Total	Payments due under Master Settlement Agreement	Litigation Accruals	Total
Balance at January 1, 2011	\$43,888	\$4,183	\$48,071	\$30,205	\$—	\$30,205
Expenses	74,886	327	75,213	—	—	—
Change in MSA obligations capitalized as inventory	374	—	374	—	—	—
Payments	(26,758	) (1,561	) (28,319	) —	—	—
Reclassification to non-current liabilities	(17,667	) —	(17,667	) 17,667	—	17,667
Interest on withholding	—	70	70	—	—	—
Balance at June 30, 2011	\$74,723	\$3,019	\$77,742	\$47,872	\$—	\$47,872

## Other Matters:

Liggett's and Vector Tobacco's management are unaware of any material environmental conditions affecting their existing facilities. Liggett's and Vector Tobacco's management believe that current operations are conducted in material compliance with all environmental laws and regulations and other laws and regulations governing cigarette manufacturers. Compliance with federal, state and local provisions regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, has not had a material effect on the capital expenditures, results of operations or competitive position of Liggett or Vector Tobacco.

In February 2004, Liggett Vector Brands entered into a five year agreement with a subsidiary of the American Wholesale Marketers Association to support a program to permit certain tobacco distributors to secure, on





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reasonable terms, tax stamp bonds required by state and local governments for the distribution of cigarettes. This agreement has been extended through February 2016. Under the agreement, Liggett Vector Brands has agreed to pay a portion of losses incurred by the surety under the bond program, with a maximum loss exposure of \$500 for Liggett Vector Brands. To secure its potential obligations under the agreement, Liggett Vector Brands has delivered to the subsidiary of the association a \$100 letter of credit and agreed to fund up to an additional \$400. The Company believes the fair value of Liggett Vector Brands' obligation under the agreement was immaterial at June 30, 2012. There may be several other proceedings, lawsuits and claims pending against the Company and certain of its consolidated subsidiaries unrelated to tobacco or tobacco product liability. Management is of the opinion that the liabilities, if any, ultimately resulting from such other proceedings, lawsuits and claims should not materially affect the Company's financial position, results of operations or cash flows.

## 6. INCOME TAXES

The Company's provision for income taxes in interim periods is based on an estimated annual effective income tax rate derived, in part, from estimated annual pre-tax results from ordinary operations. The annual effective income tax rate is reviewed and, if necessary, adjusted on a quarterly basis.

The Company's income tax expense (benefit) consisted of the following:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2012	2011	2012	2011
Income (loss) before provision for income taxes	\$5,128	\$48,846	\$(6,054)	) \$80,868
Income tax expense (benefit) using estimated annual effective income tax rate	1,904	18,561	(2,247)	) 30,730
Out-of-period adjustment related to non-deductible expenses in 2011	—	—	757	—
Impact of discrete item, net	(769)	) 464	(769)	) 464
Changes in effective tax rates	98	(480)	) —	—
Income tax expense (benefit)	\$1,233	\$18,545	\$(2,259)	) \$31,194

The discrete item for the three and six months ended June 30, 2012 and 2011, respectively, is related to the conversion of the Company's 3.875% Senior Convertible Debentures due 2026. The out-of-period adjustment related to a non-accrual of a non-deductible expense related to a permanent difference for income taxes in the fourth quarter of 2011. The Company assessed the materiality of this error on all previously issued financial statements and concluded that the error was immaterial to all previously issued financial statements. The impact of correcting this error in the current year is not expected to be material to the Company's 2012 consolidated financial statements.

The Internal Revenue Service is auditing the Company's 2008 and 2009 tax years. The Company believes it has adequately reserved for any potential adjustments that may arise as a result of the audits.



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## 7. NEW VALLEY LLC

The components of “Investments in non-consolidated real estate businesses” were as follows:

	June 30, 2012	December 31, 2011
Douglas Elliman Realty LLC	\$57,453	\$53,970
New Valley Oaktree Chelsea Eleven LLC	—	6,320
Fifty Third-Five Building LLC	18,000	18,000
Sesto Holdings S.r.l.	5,037	5,037
1107 Broadway	5,489	5,489
Lofts 21 LLC	900	900
Hotel Taiwana	2,658	2,658
NV SOCAL LLC	24,624	25,095
HFZ East 68th Street	7,000	7,000
11 Beach Street Investor LLC	9,642	—
Investments in non-consolidated real estate businesses	\$ 130,803	\$ 124,469

Residential Brokerage Business. New Valley recorded income of \$4,929 and \$5,397 for the three months ended June 30, 2012 and 2011, respectively, and income of \$6,373 and \$8,801 for the six months ended June 30, 2012 and 2011, respectively, associated with Douglas Elliman Realty, LLC. New Valley received cash distributions from Douglas Elliman Realty, LLC of \$564 and \$2,725 for the three months ended June 30, 2012 and 2011, respectively and \$2,889 and \$3,800 for the six months ended June 30, 2012 and 2011, respectively. The summarized financial information of Douglas Elliman Realty, LLC is as follows:

	June 30, 2012	December 31, 2011
Cash	\$63,939	\$57,450
Other current assets	5,506	3,293
Property, plant and equipment, net	15,162	14,595
Trademarks	21,663	21,663
Goodwill	38,506	38,742
Other intangible assets, net	1,020	827
Other non-current assets	3,738	3,096
Notes payable - current	417	602
Other current liabilities	19,002	18,734
Notes payable - long term	530	1,104
Other long-term liabilities	9,683	9,490
Members' equity	119,902	109,736

## VECTOR GROUP LTD.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2012	2011	2012	2011
Revenues	\$97,955	\$96,353	\$169,130	\$174,397
Costs and expenses	88,568	85,613	157,794	157,114
Depreciation expense	831	878	1,646	1,814
Amortization expense	61	63	121	126
Other income	490	410	1,232	1,387
Interest expense, net	9	42	32	83
Income tax expense	269	305	323	504
Net income	\$8,707	\$9,862	\$10,446	\$16,143

New Valley Oaktree Chelsea Eleven, LLC. In April 2012, Chelsea closed on the two remaining residential units. As of June 30, 2012, all of the 54 residential units had been closed and the project has been completed.

The Company received net distributions of \$7,724 and \$220 from New Valley Oaktree Chelsea Eleven LLC for the three months ended June 30, 2012 and 2011, respectively. The Company received net distributions of \$8,439 and \$1,613 from New Valley Oaktree Chelsea Eleven LLC for the six months ended June 30, 2012 and 2011, respectively.

New Valley recorded equity income of \$451 and \$2,118 for the three and six months ended June 30, 2012, related to New Valley Chelsea. New Valley recorded \$500 and \$2,000 equity income for the three and six months ended June 30, 2011, related to New Valley Chelsea. The Company's maximum exposure to loss on its investment in New Valley Chelsea Eleven LLC is \$0 at June 30, 2012.

Fifty Third-Five Building LLC. In 2010, New Valley, through its NV 955 LLC subsidiary, contributed \$18,000 to a joint venture, Fifty Third-Five Building LLC ("JV"), of which it owns 50%. In 2010, the JV acquired a defaulted real estate loan, collateralized by real estate located in New York City for approximately \$35,500. The previous lender had commenced proceedings seeking to foreclose its mortgage. Upon acquisition of the loan, the JV succeeded to the rights of the previous lender in the litigation. In April 2011, the court granted the JV's motion for summary judgment, dismissing certain substantive defenses raised by the borrower and the other named parties. Thereafter, the borrower challenged the validity of the assignment from the previous lender to the JV. In February 2012, the court affirmed the validity of the assignment and its decision to grant summary judgment. Foreclosure proceedings are continuing.

The JV is a variable interest entity; however, New Valley is not the primary beneficiary. This investment is being accounted for under the equity method of accounting. The Company's maximum exposure to loss as a result of its investment in the JV is \$18,000 at June 30, 2012.

Sesto Holdings S.r.l. In October 2010, New Valley, through its NV Milan LLC subsidiary, acquired a 7.2% interest in Sesto Holdings S.r.l. for \$5,000. Sesto holds a 42% interest in an entity that has purchased a land plot of approximately 322 acres in Milan, Italy. Sesto intends to develop the land plot as a multi-parcel, multi-building mixed use urban regeneration project. Sesto is a variable interest entity; however, New Valley is not the primary beneficiary. New Valley accounts for Sesto under the equity method of accounting. The Company's maximum exposure to loss as a result of its investment in Sesto is \$5,037 at June 30, 2012.

Lofts 21 LLC. In February 2011, New Valley invested \$900 for an approximate 12% interest in Lofts 21 LLC. Lofts 21 LLC acquired an existing property in Manhattan, NY, which is scheduled to be developed into condominiums. New Valley accounts for Lofts 21 LLC under the equity method of accounting. Lofts 21 LLC is a variable interest entity; however, New Valley is not the primary beneficiary. The Company's maximum exposure to loss as a result of this investment is \$900 at June 30, 2012.

VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

1107 Broadway. During 2011, New Valley invested \$5,489 for an approximate indirect 5% interest in MS/WG 1107 Broadway Holdings LLC. In September 2011, MS/WG 1107 Broadway Holdings LLC acquired the 1107 Broadway property in Manhattan, NY. The joint venture plans to develop the property, which was formerly part of the International Toy Center, into luxury residential condominiums with ground floor retail space. New Valley accounts for MS/WG 1107 Broadway Holdings LLC under the equity method of accounting. MS/WG 1107 Broadway Holdings LLC is a variable interest entity; however, New Valley is not the primary beneficiary. The Company's maximum exposure on its investment in MS/WG 1107 Broadway Holdings LLC is \$5,489 at June 30, 2012.

Hotel Taiwana. In October 2011, New Valley invested \$2,658 for an approximate 17.39% interest in Hill Street Partners LLP ("Hill"). Hill purchased a 37% interest in Hill Street SEP ("Hotel Taiwana") which owns a hotel located in St. Barts, French West Indies. The hotel consists of 30 suites, 6 pools, a restaurant, lounge and gym. The purpose of the investment is to renovate and then sell the hotel in its entirety or as hotel-condos. The investment is a variable interest entity; however, New Valley is not the primary beneficiary. New Valley accounts for this investment under the equity method of accounting. The Company's maximum exposure to loss as a result of its investment in Hotel Taiwana is \$2,658 at June 30, 2012.

NV SOCAL LLC. On October 28, 2011, a newly-formed joint venture, between affiliates of New Valley and Winthrop Realty Trust, entered into an agreement with Wells Fargo Bank to acquire a \$117,900 C-Note (the "C-Note") for a purchase price of \$96,700. The C-Note is the most junior tranche of a \$796,000 first mortgage loan originated in July 2007 which is collateralized by a 31 property portfolio of office properties situated throughout southern California, consisting of approximately 4.5 million square feet. The C-Note bears interest at a rate per annum of LIBOR plus 310 basis points, requires payments of interest only prior to maturity and matures on August 9, 2012. On November 3, 2011, New Valley invested \$25,000 for an approximate 26% interest in the joint venture. In January 2012, the joint venture entered into a Master Repurchase and Securities contract with BSSF CABI LLC, an affiliate of Blackstone Real Estate Debt Strategies. This transaction secured \$40,000 through a non-recourse repurchase facility and all proceeds after expenses (approximately \$38,100) were distributed to Winthrop Realty Trust. This distribution increased the Company's ownership interest to approximately 42.19% interest in the joint venture.

The investment is a variable interest entity; however, New Valley is not the primary beneficiary. New Valley accounts for this investment under the equity method of accounting. New Valley recorded an equity loss of \$223 and \$471 for the three and six months ended June 30, 2012.

The Company's maximum exposure to loss as a result of its investment in NV SOCAL LLC is \$24,624 at June 30, 2012.

HFZ East 68th Street. In December 2011, New Valley invested \$7,000 for an approximate 18% interest in a condominium conversion project. The building is a 12-story, 105,000 square foot residential rental building located on 68th Street between Fifth Avenue and Madison Avenue in Manhattan, NY. The investment is a variable interest entity; however, New Valley is not the primary beneficiary. New Valley accounts for this investment under the equity method of accounting. The Company's maximum exposure to loss as a result of its investment in HFZ East 68th Street is \$7,000.

11 Beach Street Investor LLC. NV Beach LLC, a wholly-owned subsidiary of New Valley, invested \$9,642 in June 2012 with an additional \$1,321 investment to be made in the future for an approximate 49% interest in 11 Beach

Street Investor LLC (the "Beach JV"). Beach JV plans to renovate and convert an existing office building in Manhattan into a luxury residential condominium. Beach JV is a variable interest entity; however, New Valley LLC is not the primary beneficiary . New Valley LLC will account for its interest in Beach JV under the equity method of accounting. New Valley's maximum exposure on its investment in 11 Beach Street Investor LLC is \$9,642 at June 30, 2012.

St. Regis Hotel, Washington, D.C. The Company received \$75 and \$300 in distributions related to its former interest in the St. Regis Hotel for the six months ended June 30, 2012 and 2011, respectively. The Company recorded income of \$75 and \$300 for the three months ended June 30, 2012 and 2011, respectively, and \$75



## VECTOR GROUP LTD.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

and \$300 for the six months ended June 30, 2012 and 2011, respectively, related to its interest in the St. Regis Hotel. The Company does not anticipate receiving any additional payments related to the sale of the tax credits related to its former interest in St. Regis Hotel.

Consolidated real estate investments:

Aberdeen Townhomes LLC. In February 2011 and June 2011, Aberdeen sold its two remaining townhomes for \$11,635 and \$7,994, respectively, and recorded a gain on sale of townhomes of \$577 and \$3,712 for the three and six months ended June 30, 2011.

Investment in Escena. The components of the Company's investment in Escena are as follows:

	June 30, 2012	December 31, 2011
Land and land improvements	\$11,245	\$11,245
Building and building improvements	1,525	1,525
Other	1,294	1,208
	14,064	13,978
Less accumulated depreciation	(858)	(698)
	\$13,206	\$13,280

The Company recorded an operating loss of approximately \$123 and \$184 for the three months ended June 30, 2012 and 2011, respectively, from its investment in Escena. The Company recorded an operating income of \$487 and \$283 for the six months ended June 30, 2012 and 2011, respectively, from Escena.

## 8. INVESTMENTS AND FAIR VALUE MEASUREMENTS

The Company's recurring financial assets and liabilities subject to fair value measurements are as follows:

Description	Fair Value Measurements as of June 30, 2012			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Money market funds	\$147,866	\$147,866	\$—	\$—
Certificates of deposit	2,233	—	2,233	—
Bonds	5,212	5,212	—	—
Investment securities available for sale	68,141	66,738	1,403	—
Warrants (1)	1,108	—	—	1,108

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Total	\$224,560	\$219,816	\$3,636	\$1,108
Liabilities:				
Fair value of derivatives embedded within convertible debt	\$120,410	\$—	\$—	\$120,410

(1) Warrants include 1,000,000 of LTS Warrants received on November 4, 2011 which were carried at \$1,031 as of June 30, 2012 and are

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## VECTOR GROUP LTD.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

included in "Other assets". The company recognized a loss of \$854 for the six months ended June 30, 2012 related to the change in fair value.

## Fair Value Measurements as of December 31, 2011

Description	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets:</b>				
Money market funds	\$ 194,259	\$ 194,259	\$—	\$—
Certificates of deposit	2,206	—	2,206	—
Bonds	4,573	4,573	—	—
Investment securities available for sale	76,486	70,884	5,602	—
Warrants (1)	1,962	—	—	1,962
Total	\$ 279,486	\$ 269,716	\$ 7,808	\$ 1,962
<b>Liabilities:</b>				
Fair value of derivatives embedded within convertible debt	\$ 133,500	\$—	\$—	\$ 133,500

(1) Warrants include 1,000,000 of LTS Warrants received on November 4, 2011 which were carried at \$1,890 as of December 31, 2011 and are included in "Other assets".

The fair value of the Level 2 certificates of deposit are based on prices posted by the financial institutions. The fair value of investment securities available for sale included in Level 1 are based on quoted market prices from various stock exchanges. The Level 2 investment securities available for sale are based on quoted market prices of securities that are thinly traded.

The fair value of derivatives embedded within convertible debt was \$120,410 and \$132,622 as of June 30, 2012 and 2011, respectively. The fair value of derivatives embedded within convertible debt was derived using a valuation model and have been classified as Level 3. The valuation model assumes future dividend payments by the Company and utilizes interest rates and credit spreads for secured to unsecured debt and unsecured to subordinated debt to determine the fair value of the derivatives embedded within the convertible debt. The changes in fair value of derivatives embedded within convertible debt are presented on the Condensed Consolidated Statements of Operations.

The value of the embedded derivatives is contingent on changes in interest rates of debt instruments maturing over the duration of the convertible debt, our stock price as well as projections of future cash and stock dividends over the term of the debt. The interest rate component of the value of the embedded derivative is computed by comparing the yield on the Company's 11% Senior Secured Notes to the average difference in interest yields on unsecured, subordinated debt and comparable risk-free investments. Thus, the yields of the Company's 11% Senior Secured Notes, unsecured and subordinated debt and the comparable risk-free investments all affect the discount rate used to compute the value

of embedded derivatives.

The Company recognized charges of \$27,060 for the six months ended June 30, 2012 and income of \$8,862 for the six months ended June 30, 2011.

The fair value of the warrants was derived using the Black-Scholes model and has been classified as Level 3. The assumptions used under the Black-Scholes model in computing the fair value of the warrants are based on contractual term of the warrants, volatility of the underlying stock based on the historical quoted prices of the underlying stock, assumed future dividend payments and a risk-free rate of return.

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VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

The unobservable inputs related to the valuations of the Level 3 assets and liabilities are as follows at June 30, 2012:

Quantitative Information about Level 3 Fair Value Measurements					
	Fair Value at June 30, 2012	Valuation Technique	Unobservable Input	Range (Actual)	
Warrants	\$1,108	Option model	Stock price	\$1.54	
			Exercise price	\$1.68	
			Term (in years)	4.4	
			Volatility	95.19	%
			Dividend rate	—	
			Risk-free return	0.64	%
Fair value of derivatives embedded within convertible debt	120,410	Discounted cash flow	Assumed annual stock dividend	5	%
			Assumed annual cash dividend	\$1.60	
			Yield to worst call on the Company's Senior Secured Notes	5.23	%
			Average spread of unsecured debt	0.90	%
			Average spread of subordinated debt	1.27	%
			Discount rate	7.00% - 8.00% (7.50%)	

## VECTOR GROUP LTD.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

The unobservable inputs related to the valuations of the Level 3 assets and liabilities are as follows at December 31, 2011:

Quantitative Information about Level 3 Fair Value Measurements					
	Fair Value at December 31, 2011	Valuation Technique	Unobservable Input	Range (Actual)	
Warrants	\$1,962	Option model	Stock price	\$2.48	
			Exercise price	\$1.68	
			Term (in years)	4.9	
			Volatility	94.12	%
			Dividend rate	—	
			Risk-free return	0.83	%
Fair value of derivatives embedded within convertible debt	133,500	Discounted cash flow	Assumed annual stock dividend	5	%
			Assumed annual cash dividend	\$1.60	
			Yield to worst call on the Company's senior secured notes	9.33	%
			Average spread of unsecured debt	1.49	%
			Average spread of subordinated debt	1.89	%
			Discount rate	12% - 13% (12.5%)	

In addition to assets and liabilities that are recorded at fair value on a recurring basis, the Company is required to record assets and liabilities at fair value on a nonrecurring basis. Generally, assets and liabilities are recorded at fair value on a nonrecurring basis as a result of impairment charges. The Company had no nonrecurring nonfinancial assets subject to fair value measurements as of June 30, 2012 and 2011, respectively.

## 9. SEGMENT INFORMATION

The Company's significant business segments for the three and six months ended June 30, 2012 and 2011 were Tobacco and Real Estate. The Tobacco segment consists of the manufacture and sale of cigarettes. The Real Estate segment includes the Company's investment in Escena, Aberdeen and investments in non-consolidated real estate businesses. The accounting policies of the segments are the same as those described in the summary of significant accounting policies.



## VECTOR GROUP LTD.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

Financial information for the Company's operations before taxes for the three and six months ended June 30, 2012 and 2011 follows:

	Tobacco	Real Estate	Corporate and Other	Total
Three months ended June 30, 2012				
Revenues	\$276,594	\$—	\$—	\$276,594
Operating income (loss)	44,590	(249	) (3,413	) 40,928
Equity income from non-consolidated real estate businesses	—	5,232	—	5,232
Depreciation and amortization	2,383	88	68	2,539
Three months ended June 30, 2011				
Revenues	\$291,180	\$—	\$—	\$291,180
Operating income (loss)	42,214	(487	) (3,760	) 37,967
Equity income from non-consolidated real estate businesses	—	6,197	—	6,197
Depreciation and amortization	2,386	80	191	2,657
Six months ended June 30, 2012				
Revenues	\$534,200	\$—	\$—	\$534,200
Operating income (loss)	82,105	272	(8,003	) 74,374
Equity income from non-consolidated real estate businesses	—	8,095	—	8,095
Depreciation and amortization	4,878	173	259	5,310
Capital expenditures	6,334	99	961	7,394
Six months ended June 30, 2011				
Revenues	\$551,558	\$—	\$—	\$551,558
Operating income (loss)	78,639	(330	) (8,866	) 69,443
Equity income from non-consolidated real estate businesses	—	11,101	—	11,101
Depreciation and amortization	4,384	160	774	5,318
Capital expenditures	4,813	48	11	4,872

## 10. CONDENSED CONSOLIDATING FINANCIAL INFORMATION

The accompanying condensed consolidating financial information has been prepared and presented pursuant to Securities and Exchange Commission Regulation S-X, Rule 3-10, "Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered". Each of the subsidiary guarantors are 100% owned, directly or indirectly, by the Company. The guarantees are subject to certain automatic release provisions. Relief from the



financial statement requirements under Rule 3-10 is being provided because the Company's guarantee release provisions are considered customary pursuant to Section 2510.5 of the SEC Division of Corporation Finance Financial Reporting Manual. The Company's investments in its consolidated subsidiaries are presented under the equity method of accounting.

Certain revisions have been made to the Company's Condensed Consolidating Statement of Operations for the three and six months ended June 30, 2011 to conform to the 2012 presentation. For the three months ended June 30, 2011, the revisions increased parent "Income tax benefit (expense)" by \$1,077 and decreased parent "Equity income in consolidated subsidiaries" by \$1,077. The revisions increased subsidiary guarantors' "Income tax benefit (expense)" by \$1,077. For the six months ended June 30, 2011, the revisions increased parent

VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

“Income tax benefit (expense)” by \$2,576 and decreased parent "Equity income in consolidated subsidiaries" by \$2,576. The revisions increased subsidiary guarantors' "Income tax benefit (expense)" by \$2,576.

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## VECTOR GROUP LTD.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## CONDENSED CONSOLIDATING BALANCE SHEETS

	June 30, 2012				Consolidated Vector Group Ltd.
	Parent/ Issuer	Subsidiary Guarantors	Subsidiary Non- Guarantors	Consolidating Adjustments	
<b>ASSETS:</b>					
Current assets:					
Cash and cash equivalents	\$ 188,132	\$ 19,967	\$ 649	\$ —	\$ 208,748
Investment securities available for sale	37,245	30,896	—	—	68,141
Accounts receivable - trade	—	10,825	—	—	10,825
Intercompany receivables	565	—	—	(565 )	—
Inventories	—	105,988	—	—	105,988
Deferred income taxes	38,669	2,935	—	—	41,604
Income taxes receivable, net	31,430	13,470	—	(38,482 )	6,418
Restricted assets	—	1,475	—	—	1,475
Other current assets	806	4,134	139	—	5,079
Total current assets	296,847	189,690	788	(39,047 )	448,278
Property, plant and equipment, net	1,747	56,530	—	—	58,277
Investment in Escena, net	—	—	13,206	—	13,206
Long-term investments accounted for at cost	15,541	—	826	—	16,367
Long-term investments accounted for under the equity method	5,552	—	—	—	5,552
Investments in non- consolidated real estate businesses	—	—	130,803	—	130,803
Investments in consolidated subsidiaries	229,584	—	—	(229,584 )	—
Restricted assets	1,893	7,785	—	—	9,678
Deferred income taxes	30,852	6,454	5,709	—	43,015
Intangible asset	—	107,511	—	—	107,511
Prepaid pension costs	—	10,796	—	—	10,796
Other assets	26,394	15,861	—	—	42,255
Total assets	\$ 608,410	\$ 394,627	\$ 151,332	\$ (268,631 )	\$ 885,738
<b>LIABILITIES AND STOCKHOLDERS' DEFICIENCY:</b>					
Current liabilities:					
Current portion of notes payable and long-term debt	\$ —	\$ 24,095	\$ 151	\$ —	\$ 24,246
Current portion of employee benefits	—	2,721	—	—	2,721
Accounts payable	307	3,838	86	—	4,231
Intercompany payables	—	565	—	(565 )	—
Accrued promotional expenses	—	15,733	—	—	15,733
Income taxes payable, net	—	—	45,299	(38,482 )	6,817
Accrued excise and payroll taxes payable, net	—	12,611	—	—	12,611
	—	71,708	—	—	71,708

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Litigation accruals and current payments due under the Master Settlement Agreement					
Deferred income taxes	25,789	2,876	—	—	28,665
Accrued interest	20,888	—	—	—	20,888
Other current liabilities	4,849	6,977	652	—	12,478
Total current liabilities	51,833	141,124	46,188	(39,047 )	200,098
Notes payable, long-term debt and other obligations, less current portion	497,643	18,274	141	—	516,058
Fair value of derivatives embedded within convertible debt	120,410	—	—	—	120,410
Non-current employee benefits	23,657	21,480	—	—	45,137
Deferred income taxes	33,397	32,043	3,244	—	68,684
Other liabilities, primarily litigation accruals and payments due under the Master Settlement Agreement	1,007	53,176	705	—	54,888
Total liabilities	727,947	266,097	50,278	(39,047 )	1,005,275
Commitments and contingencies					
Stockholders' deficiency	(119,537 )	128,530	101,054	(229,584 )	(119,537 )
Total liabilities and stockholders' deficiency	\$608,410	\$394,627	\$151,332	\$(268,631 )	\$885,738

## VECTOR GROUP LTD.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## CONDENSED CONSOLIDATING BALANCE SHEETS

	December 31, 2011				
	Parent/ Issuer	Subsidiary Guarantors	Subsidiary Non- Guarantors	Consolidating Adjustments	Consolidated Vector Group Ltd.
<b>ASSETS:</b>					
Current assets:					
Cash and cash equivalents	\$238,262	\$2,488	\$173	\$—	\$ 240,923
Investment securities available for sale	50,401	26,085	—	—	76,486
Accounts receivable - trade	—	24,869	—	—	24,869
Intercompany receivables	64	—	—	(64	) —
Inventories	—	109,228	—	—	109,228
Deferred income taxes	39,883	3,068	—	—	42,951
Income taxes receivable, net	47,484	4,984	—	(42,915	) 9,553
Restricted assets	—	1,474	—	—	1,474
Other current assets	565	3,498	194	—	4,257
Total current assets	376,659	175,694	367	(42,979	) 509,741
Property, plant and equipment, net	1,345	55,211	—	—	56,556
Investment in Escena, net	—	—	13,280	—	13,280
Long-term investments accounted for at cost	4,777	—	898	—	5,675
Long-term investments accounted for under the equity method	16,499	—	—	—	16,499
Investments in non- consolidated real estate businesses	—	—	124,469	—	124,469
Investments in consolidated subsidiaries	211,219	—	—	(211,219	) —
Restricted assets	2,161	7,465	—	—	9,626
Deferred income taxes	18,564	6,412	6,041	—	31,017
Intangible asset	—	107,511	—	—	107,511
Prepaid pension costs	—	10,047	—	—	10,047
Other assets	28,108	15,239	—	—	43,347
Total assets	\$659,332	\$377,579	\$145,055	\$ (254,198	) \$ 927,768
<b>LIABILITIES AND STOCKHOLDERS' DEFICIENCY:</b>					
Current liabilities:					
Current portion of notes payable and long-term debt	\$ 16,052	\$34,651	\$141	\$—	\$ 50,844
Current portion of fair value of derivatives embedded within convertible debt	84,485	—	—	—	84,485
Current portion of employee benefits	—	2,690	—	—	2,690
Accounts payable	1,040	8,321	171	—	9,532
Intercompany payables	—	64	—	(64	) —
Accrued promotional expenses	—	17,056	—	—	17,056
Income taxes payable, net	6,597	—	42,915	(42,915	) 6,597
Accrued excise and payroll taxes payable, net	—	17,992	—	—	17,992

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Litigation accruals and current payments due under the Master Settlement Agreement	—	52,725	—	—	52,725
Deferred income taxes	32,558	3,327	—	—	35,885
Accrued interest	20,888	—	—	—	20,888
Other current liabilities	6,683	9,079	742	—	16,504
Total current liabilities	168,303	145,905	43,969	(42,979 )	315,198
Notes payable, long-term debt and other obligations, less current portion	479,199	13,941	216	—	493,356
Fair value of derivatives embedded within convertible debt	49,015	—	—	—	49,015
Non-current employee benefits	23,023	22,959	—	—	45,982
Deferred income taxes	27,970	30,135	2,537	—	60,642
Other liabilities, primarily litigation accruals and payments due under the Master Settlement Agreement	852	51,010	743	—	52,605
Total liabilities	748,362	263,950	47,465	(42,979 )	1,016,798
Commitments and contingencies					
Stockholders' deficiency	(89,030 )	113,629	97,590	(211,219 )	(89,030 )
Total liabilities and stockholders' deficiency	\$659,332	\$377,579	\$145,055	\$ (254,198 )	\$ 927,768

VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS

	Three Months Ended June 30, 2012				Consolidated Vector Group Ltd.
	Parent/ Issuer	Subsidiary Guarantors	Subsidiary Non- Guarantors	Consolidating Adjustments	
Revenues	\$—	\$276,594	\$—	\$—	\$276,594
Expenses:					
Cost of goods sold	—	211,752	—	—	211,752
Operating, selling, administrative and general expenses	5,223	18,419	272	—	23,914
Management fee expense	—	2,290	—	(2,290)	—
Operating (loss) income	(5,223)	44,133	(272)	2,290	40,928
Other income (expenses):					
Interest expense	(25,497)	(1,006)	(6)	—	(26,509)
Changes in fair value of derivatives embedded within convertible debt	(6,003)	—	—	—	(6,003)
Acceleration of interest expense related to debt conversion	(7,888)	—	—	—	(7,888)
Equity income from non-consolidated real estate businesses	—	—	5,232	—	5,232
Equity loss on long-term investments	(1,215)	—	—	—	(1,215)
Equity income in consolidated subsidiaries	28,924	—	—	(28,924)	—
Management fee income	2,290	—	—	(2,290)	—
Other, net	456	(8)	135	—	583
(Loss) income before provision for income taxes	(14,156)	43,119	5,089	(28,924)	5,128
Income tax benefit (expense)	18,051	(16,973)	(2,311)	—	(1,233)
Net income	3,895	26,146	2,778	(28,924)	3,895
Comprehensive income	\$1,137	\$26,585	\$2,778	\$(29,363)	\$1,137

VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS

	Three Months Ended June 30, 2011				Consolidated Vector Group Ltd.
	Parent/ Issuer	Subsidiary Guarantors	Subsidiary Non- Guarantors	Consolidating Adjustments	
Revenues	\$—	\$291,180	\$—	\$—	\$291,180
Expenses:					
Cost of goods sold	—	231,073	—	—	231,073
Operating, selling, administrative and general expenses	5,428	16,225	487	—	22,140
Management fee expense	—	2,209	—	(2,209)	—
Operating (loss) income	(5,428)	41,673	(487)	2,209	37,967
Other income (expenses):					
Interest expense	(24,764)	(310)	(8)	—	(25,082)
Change in fair value of derivatives embedded within convertible debt	9,437	—	—	—	9,437
Acceleration of interest expense related to debt conversion	(1,217)	—	—	—	(1,217)
Equity income from non-consolidated real estate businesses	—	—	6,197	—	6,197
Equity loss on long-term investments	(154)	—	—	—	(154)
Gain on investment securities available for sale	—	1,506	—	—	1,506
Gain on liquidation of long-term investments	19,475	—	—	—	19,475
Gain on sale of townhome	—	—	577	—	577
Equity income in consolidated subsidiaries	30,599	—	—	(30,599)	—
Management fee income	2,209	—	—	(2,209)	—
Other, net	128	12	—	—	140
Income before provision for income taxes	30,285	42,881	6,279	(30,599)	48,846
Income tax benefit (expense)	16	(16,051)	(2,510)	—	(18,545)
Net income	30,301	26,830	3,769	(30,599)	30,301
Comprehensive income	\$28,114	\$23,024	\$3,769	\$(26,793)	\$28,114



## VECTOR GROUP LTD.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS

Six Months Ended June 30, 2012

	Parent/ Issuer	Subsidiary Guarantors	Subsidiary Non- Guarantors	Consolidating Adjustments	Consolidated Vector Group Ltd.	
Revenues	\$—	\$534,200	\$—	\$—	\$534,200	
Expenses:						
Cost of goods sold	—	411,933	—	—	411,933	
Operating, selling, administrative and general expenses	11,484	36,623	(214	) —	47,893	
Management fee expense	—	4,581	—	(4,581	) —	
Operating (loss) income	(11,484	) 81,063	214	4,581	74,374	
Other income (expenses):						
Interest expense	(50,406	) (2,342	) (13	) —	(52,761	)
Change in fair value of derivatives embedded within convertible debt	(27,060	) —	—	—	(27,060	)
Acceleration of interest expense related to debt conversion	(7,888	) —	—	—	(7,888	)
Equity income from non-consolidated real estate businesses	—	—	8,095	—	8,095	
Equity loss on long-term investments	(1,329	) —	—	—	(1,329	)
Equity income in consolidated subsidiaries	53,542	—	—	(53,542	) —	
Management fee income	4,581	—	—	(4,581	) —	
Other, net	361	19	135	—	515	
(Loss) income before provision for income taxes	(39,683	) 78,740	8,431	(53,542	) (6,054	)
Income tax benefit (expense)	35,888	(30,206	) (3,423	) —	2,259	
Net (loss) income	(3,795	) 48,534	5,008	(53,542	) (3,795	)
Comprehensive (loss) income	\$(10,896	) \$48,349	\$5,008	\$(53,357	) \$(10,896	)

## VECTOR GROUP LTD.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS

	Six Months Ended June 30, 2011				Consolidated Vector Group Ltd.
	Parent/ Issuer	Subsidiary Guarantors	Subsidiary Non- Guarantors	Consolidating Adjustments	
Revenues	\$—	\$551,558	\$—	\$—	\$551,558
Expenses:					
Cost of goods sold	—	436,250	—	—	436,250
Operating, selling, administrative and general expenses	11,758	33,777	330	—	45,865
Litigation judgment expense	—	—	—	—	—
Management fee expense	—	4,417	—	(4,417)	—
Operating (loss) income	(11,758)	77,114	(330)	4,417	69,443
Other income (expenses):					
Interest expense	(49,250)	(743)	(17)	—	(50,010)
Change in fair value of derivatives embedded within convertible debt	8,862	—	—	—	8,862
Acceleration of interest expense related to debt conversion	(1,217)	—	—	—	(1,217)
Equity income from non-consolidated real estate businesses	—	—	11,101	—	11,101
Gain on investment securities available for sale	—	14,541	—	—	14,541
Gain on liquidation of long-term investments	23,611	—	—	—	23,611
Gain on sales of townhomes	—	—	3,712	—	3,712
Equity income on long-term investments	609	—	—	—	609
Equity income in consolidated subsidiaries	64,579	—	—	(64,579)	—
Management fee income	4,417	—	—	(4,417)	—
Other, net	194	22	—	—	216
Income before provision for income taxes	40,047	90,934	14,466	(64,579)	80,868
Income tax benefit (expense)	9,627	(35,036)	(5,785)	—	(31,194)
Net income	49,674	55,898	8,681	(64,579)	49,674
Comprehensive income	\$42,964	\$47,655	\$8,681	\$(56,336)	\$42,964

VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## CONDENSED CONSOLIDATING STATEMENTS OF CASH FLOWS

	Six Months Ended June 30, 2012				Consolidated Vector Group Ltd.
	Parent/ Issuer	Subsidiary Guarantors	Non- Guarantors	Consolidating Adjustments	
Net cash provided by (used in) operating activities	\$22,900	\$74,473	\$5,557	\$ (45,101 )	\$57,829
Cash flows from investing activities:					
Purchase of investment securities	—	(1,148 )	—	—	(1,148 )
Proceeds from sale or liquidation of long-term investments	—	—	72	—	72
Purchase of long-term investments	(5,000 )	—	—	—	(5,000 )
Investments in non-consolidated real estate businesses	—	—	(9,667 )	—	(9,667 )
Distributions from non-consolidated real estate businesses	—	—	6,221	—	6,221
Increase in cash surrender value of life insurance policies	(425 )	(195 )	—	—	(620 )
Decrease (increase) in non-current restricted assets	268	(321 )	—	—	(53 )
Issuance of notes receivable	(234 )	—	—	—	(234 )
Investments in subsidiaries	(1,008 )	—	—	1,008	—
Proceeds from sale of fixed assets	393	11	—	—	404
Capital expenditures	(961 )	(6,334 )	(99 )	—	(7,394 )
Net cash (used in) provided by investing activities	(6,967 )	(7,987 )	(3,473 )	1,008	(17,419 )
Cash flows from financing activities:					
Proceeds from debt issuance	—	14,018	—	—	14,018
Deferred financing costs	—	(315 )	—	—	(315 )
Repayments of debt	—	(13,428 )	(65 )	—	(13,493 )
Borrowings under revolver	—	525,350	—	—	525,350
Repayments on revolver	—	(532,082 )	—	—	(532,082 )
Capital contributions received	—	950	58	(1,008 )	—
Intercompany dividends paid	—	(43,500 )	(1,601 )	45,101	—
Dividends and distributions on common stock	(66,112 )	—	—	—	(66,112 )
Proceeds from exercise of Vector options	45	—	—	—	45
Tax benefit of options exercised	4	—	—	—	4
Net cash (used in) provided by financing activities	(66,063 )	(49,007 )	(1,608 )	44,093	(72,585 )
Net (decrease) increase in cash and cash equivalents	(50,130 )	17,479	476	—	(32,175 )
	238,262	2,488	173	—	240,923

Cash and cash equivalents, beginning of period

Cash and cash equivalents, end of period	\$188,132	\$19,967	\$649	\$—	\$208,748
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## VECTOR GROUP LTD.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## CONDENSED CONSOLIDATING STATEMENTS OF CASH FLOWS

	Six Months Ended June 30, 2011				Consolidated Vector Group Ltd.
	Parent/ Issuer	Subsidiary Guarantors	Non- Guarantors	Consolidating Adjustments	
Net cash provided by (used in) operating activities	\$28,423	\$76,133	\$3,472	\$ (71,441 )	\$36,587
Cash flows from investing activities:					
Sale of investment securities	—	19,703	—	—	19,703
Purchase of investment securities	—	(1,788 )	—	—	(1,788 )
Proceeds from sale of or liquidation of long-term investments	62,219	—	—	—	62,219
Purchase of long-term investments	(10,000 )	—	—	—	(10,000 )
Investments in non-consolidated real estate businesses	—	—	(6,712 )	—	(6,712 )
Distributions from non-consolidated real estate businesses	—	—	2,425	—	2,425
Increase in cash surrender value of life insurance policies	(315 )	(362 )	—	—	(677 )
Decrease in non-current restricted assets	781	994	—	—	1,775
Issuance of notes receivable	(161 )	—	—	—	(161 )
Proceeds from sale of townhomes	—	—	19,629	—	19,629
Proceeds from sale of fixed assets	—	—	9	—	9
Investments in subsidiaries	(2,628 )	—	—	2,628	—
Capital expenditures	(11 )	(4,813 )	(48 )	—	(4,872 )
Net cash provided by investing activities	49,885	13,734	15,303	2,628	81,550
Cash flows from financing activities:					
Proceeds from debt issuance	—	77	—	—	77
Repayments of debt	—	(2,221 )	(60 )	—	(2,281 )
Borrowings under revolver	—	486,298	—	—	486,298
Repayments on revolver	—	(521,995 )	—	—	(521,995 )
Capital contributions received	—	2,588	40	(2,628 )	—
Intercompany dividends paid	—	(53,303 )	(18,138 )	71,441	—
Dividends and distributions on common stock	(61,846 )	—	—	—	(61,846 )
Proceeds from exercise of Vector options and warrants.	966	—	—	—	966
Tax benefits from exercise of Vector options and warrants	808	—	—	—	808
Net cash (used in) provided by financing activities	(60,072 )	(88,556 )	(18,158 )	68,813	(97,973 )
Net increase in cash and cash equivalents	18,236	1,311	617	—	20,164
	283,409	16,214	202	—	299,825

Cash and cash equivalents, beginning of  
period

Cash and cash equivalents, end of period	\$301,645	\$17,525	\$819	\$—	\$319,989
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## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

(Dollars in Thousands, Except Per Share Amounts)

### Overview

We are a holding company and are engaged principally in:

the manufacture and sale of cigarettes in the United States through our Liggett Group LLC and Vector Tobacco Inc. subsidiaries, and

the real estate business through our New Valley LLC subsidiary, which is seeking to acquire additional operating companies and real estate properties. New Valley owns 50% of Douglas Elliman Realty, LLC, which operates the largest residential brokerage company in the New York metropolitan area.

All of our tobacco operation's unit sales volume in 2011 and for the first six months of 2012 was in the discount segment, which management believes has been the primary growth segment in the industry for more than a decade. The significant discounting of premium cigarettes in recent years has led to brands, such as EVE, that were traditionally considered premium brands to become more appropriately categorized as discount, following list price reductions.

Our tobacco subsidiaries' cigarettes are produced in approximately 118 combinations of length, style and packaging. Liggett's current brand portfolio includes:

**PYRAMID** - the industry's first deep discount product with a brand identity re-launched in the second quarter of 2009, and

**GRAND PRIX** - re-launched as a national brand in 2005,

**LIGGETT SELECT** - a leading brand in the deep discount category,

**EVE** - a leading brand of 120 millimeter cigarettes in the branded discount category, and

**USA** and various Partner Brands and private label brands.

In 1999, Liggett introduced LIGGETT SELECT, one of the leading brands in the deep discount category. LIGGETT SELECT's unit volume was 7.5% for the six months ended June 30, 2012 and 8.7% of Liggett's unit volume for the year ended December 31, 2011. In September 2005, Liggett repositioned GRAND PRIX to distributors and retailers nationwide. GRAND PRIX's unit volume was 10.6% of Liggett's unit volume for the six months ended June 30, 2012 and 12.7% for the year ended December 31, 2011. In April 2009, Liggett repositioned PYRAMID as a box-only brand with a new low price to specifically compete with brands which are priced at the lowest level of the deep discount segment. PYRAMID is now the largest seller in Liggett's family of brands with 61.6% of Liggett's unit volume for the six months ended June 30, 2012 and 56.4% for the year ended December 31, 2011.

Under the Master Settlement Agreement reached in November 1998 with 46 states and various territories, the three largest cigarette manufacturers must make settlement payments to the states and territories based on how many cigarettes they sell annually. Liggett, however, is not required to make any payments unless its market share exceeds

approximately 1.65% of the U.S. cigarette market. Additionally, Vector Tobacco has no payment obligation unless its market share exceeds approximately 0.28% of the U.S. market. Liggett's and Vector Tobacco's payments under the Master Settlement Agreement are based on each company's incremental market share above the minimum threshold applicable to such company. We believe that our tobacco subsidiaries have gained a sustainable cost advantage over their competitors as a result of the settlement.

The discount segment is a challenging marketplace, with consumers having less brand loyalty and placing greater emphasis on price. Liggett's competition is now divided into two segments. The first segment is made up of the three largest manufacturers of cigarettes in the United States, Philip Morris USA Inc., Reynolds American Inc., and Lorillard Tobacco Company. The three largest manufacturers, while primarily premium cigarette based companies, also produce and sell discount cigarettes. The second segment of competition is comprised of a group of smaller manufacturers



and importers, most of which sell deep discount cigarettes. Our largest competitor in this segment is Commonwealth Brands, Inc. (a wholly-owned subsidiary of Imperial Tobacco PLC).

#### Recent Developments

**Senior Secured Notes.** In December 2010, we sold an additional \$90,000 principal amount of our 11% Senior Secured Notes due 2015 (the "Senior Secured Notes") in private offerings to qualified institutional investors in accordance with Rule 144A of the Securities Act of 1933. In May 2011, we completed an exchange offer to exchange the Senior Secured Notes issued in December 2010 for an equal amount of newly issued 11% Senior Secured Notes due 2015. The new Secured Notes have substantially the same terms as the original notes, except that the new Secured Notes have been registered under the Securities Act.

**Variable Interest Senior Convertible Debentures due 2026.** We were required to mandatorily redeem 10% of the total aggregate principal amount outstanding, or \$11,000, of our 3.875% Variable Interest Senior Convertible Debentures due 2026 (the "Debentures") on June 15, 2011. Other than the holders of \$7 principal amount of the Debentures, who had 10% of their aggregate principal amount of Debentures mandatorily redeemed, each holder of the Debentures chose to convert its pro-rata portion of the \$11,000 of principal into our common stock. We recorded accelerated interest expense related to the converted debt of \$1,217 for the three and six months ended June 30, 2011, on the conversion of the \$11,000 of Debentures into 685,005 shares of common stock. The debt conversion resulted in a non-cash financing transaction of \$10,993.

In February 2012, a holder of our Debentures converted \$2 principal amount of the Debentures into 125 shares of common stock. The debt conversion resulted in a non-cash financing transaction of \$2. The holders of the remaining \$98,998 principal amount of the Debentures had the option to put all of the remaining Debentures on June 15, 2012. None of the debentures were surrendered for repurchase. The holders of the Debentures next have the option to put all or part of the remaining Debentures on June 15, 2016. Accordingly, we reclassified the Debentures and related fair value of derivatives embedded within convertible debt from current liabilities to long-term liabilities as of June 30, 2012.

In June 2012, the holders of \$31,370 principal amount of the Debentures converted the \$31,370 of principal amount into 1,955,300 shares of our common stock. We recorded accelerated interest expense related to the converted debt of \$7,888 for the six months ended June 30, 2012 on the conversion of the \$31,372 of Debentures into 1,955,425 shares of common stock.

**New Valley Oaktree Chelsea Eleven, LLC.** In April 2012, Chelsea closed on the two remaining residential units. As of June 30, 2011, all of the 54 residential units have been sold and the project has been completed. We received net distributions of \$8,439 and \$1,613 from New Valley Oaktree Chelsea Eleven LLC for the six months ended June 30, 2012 and 2011, respectively. New Valley recorded equity income of \$451 and \$2,118 for the three and six months ended June 30, 2012, related to New Valley Chelsea. New Valley had recorded equity income of \$500 and \$2,000 for the three and six months ended June 30, 2011, related to New Valley Chelsea.

**NV SOCAL LLC.** On October 28, 2011, a newly-formed joint venture, between affiliates of New Valley and Winthrop Realty Trust, entered into an agreement with Wells Fargo Bank to acquire a \$117,900 C-Note (the "C-Note") for a purchase price of \$96,700. The C-Note is the most junior tranche of a \$796,000 first mortgage loan originated in July 2007 which is collateralized by a 31 property portfolio of office properties situated throughout southern California, consisting of approximately 4.5 million square feet. The C-Note bears interest at a rate per annum of LIBOR plus 310 basis points, requires payments of interest only prior to maturity and matures on August 9, 2012. On November 3, 2011, New Valley invested \$25,000 for an approximate 26% interest in the joint venture. In January 2012, the joint venture entered into a Master Repurchase and Securities contract with BSSF CABI LLC, an affiliate of

Blackstone Real Estate Debt Strategies. This transaction secured \$40,000 through a non-recourse repurchase facility and all proceeds after expenses (approximately \$38,100) were distributed to Winthrop Realty Trust. This distribution increased our ownership interest to approximately 42.19% interest in the joint venture. New Valley recorded an equity loss of \$223 and \$471 for the three and six months ended June 30, 2012.

Fifty Third-Five Building LLC. In 2010, New Valley, through its NV 955 LLC subsidiary, contributed \$18,000 to a joint venture, Fifty Third-Five Building LLC ("JV"), of which it owns 50%. In 2010, the JV acquired a defaulted real estate loan, collateralized by real estate located in New York City for approximately \$35,500. The previous lender had commenced proceedings seeking to foreclose its mortgage. Upon acquisition of the loan, the JV succeeded to the rights of the previous lender in the litigation. In April 2011, the court granted the JV's motion for summary judgment,

dismissing certain substantive defenses raised by the borrower and the other named parties. Thereafter, the borrower challenged the validity of the assignment from the previous lender to the JV. In February 2012, the court affirmed the validity of the assignment and its decision to grant summary judgment. Foreclosure proceedings are continuing.

11 Beach Street. NV Beach LLC, a wholly-owned subsidiary of New Valley, invested \$9,642 in June 2012 with an additional \$1,321 investment to be made in the future for an approximate 49% interest in 11 Beach Street Investor LLC (the "Beach JV"). Beach JV plans to renovate and convert an existing office building in Manhattan into a luxury residential condominium. Beach JV is a variable interest entity; however, New Valley LLC is not the primary beneficiary. New Valley LLC will account for its interest in Beach JV under the equity method of accounting. New Valley's maximum exposure on its investment in 11 Beach Street Investor LLC is \$9,642 at June 30, 2012.

Long-term Investments. We received a distribution of \$207 from a real estate partnership for the three and six months ended June 30, 2012. Two of our long-term investment liquidated and we received distributions of \$62,219 for the six months ended June 30, 2011. We received an additional distribution of \$2,775 in July 2011. The Company recognized a gain of \$19,475 and \$23,611 for the three and six months ended June 30, 2011, respectively.

#### Recent Developments in Smoking-Related Litigation

The cigarette industry continues to be challenged on numerous fronts. New cases continue to be commenced against Liggett and other cigarette manufacturers. Liggett could be subjected to substantial liabilities and bonding requirements from litigation relating to cigarette products. Adverse litigation outcomes could have a negative impact on our ability to operate due to their impact on cash flows. We and our Liggett subsidiary, as well as the entire cigarette industry, continue to be challenged on numerous fronts, particularly with respect to the Engle progeny cases in Florida. New cases continue to be commenced against Liggett and other cigarette manufacturers. It is likely that similar legal actions, proceedings and claims will continue to be filed against Liggett. Punitive damages, often in amounts ranging into the billions of dollars, are specifically pled in certain cases, in addition to compensatory and other damages. It is possible that there could be adverse developments in pending cases including the certification of additional class actions. An unfavorable outcome or settlement of pending smoking-related litigation could encourage the commencement of additional litigation. In addition, an unfavorable outcome in any smoking-related litigation could have a material adverse effect on our consolidated financial position, results of operations and cash flows. Liggett could face difficulties in obtaining a bond to stay execution of a judgment pending appeal.

As of June 30, 2012, there were approximately 5,649 Engle progeny cases, 65 individual suits, five purported class actions and one healthcare cost recovery action pending in the United States in which Liggett or us, or both, were named as a defendant. As of June 30, 2012, 12 Engle progeny cases involving Liggett have resulted in verdicts, exclusive of the Lukacs case. Seven verdicts were returned in favor of the plaintiffs and five were returned in favor of Liggett. As of June 30, 2012, 31 alleged Engle progeny cases, where Liggett is currently named as a defendant, were scheduled for trial through June 30, 2013.

Liggett Only Cases. There are currently eight cases pending where Liggett is the only tobacco company defendant. Cases where Liggett is the only defendant could increase substantially as a result of the Engle progeny cases.

Engle Progeny Cases. In 2000, a jury in *Engle v. R.J. Reynolds Tobacco Co.* rendered a \$145,000,000 punitive damages verdict in favor of a "Florida Class" against certain cigarette manufacturers, including Liggett. Pursuant to the Florida Supreme Court's July 2006 ruling in *Engle*, which decertified the class on a prospective basis, and affirmed the appellate court's reversal of the punitive damages award, former class members had one year from January 11, 2007 in which to file individual lawsuits. In addition, some individuals who filed suit prior to January 11, 2007, and who claim they meet the conditions in *Engle*, are attempting to avail themselves of the *Engle* ruling. Lawsuits by individuals requesting the benefit of the *Engle* ruling, whether filed before or after the January 11, 2007 deadline, are referred to as the "Engle progeny cases." Liggett and us have been named in 5,649 Engle progeny cases in both federal (2,642 cases) and state (3,007 cases) courts in Florida. Other cigarette manufacturers have also been named as defendants in these cases, although as a case proceeds, one or more defendants may ultimately be dismissed from the action. These

cases include approximately 6,912 plaintiffs. The number of state court Engle progeny cases may increase as multi-plaintiff cases continue to be severed into individual cases. The total number of plaintiffs may also increase as a result of attempts by existing plaintiffs to add additional parties.

### Critical Accounting Policies

There are no material changes from the critical accounting policies set forth in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations," of our Annual Report on Form 10-K, for the year ended December 31, 2011. Please refer to that section and the information below for disclosures regarding the critical accounting policies related to our business.

### Results of Operations

The following discussion provides an assessment of our results of operations, capital resources and liquidity and should be read in conjunction with our condensed consolidated financial statements and related notes included elsewhere in this report. The condensed consolidated financial statements include the accounts of VGR Holding, Liggett, Vector Tobacco, Liggett Vector Brands, New Valley and other less significant subsidiaries.

For purposes of this discussion and other consolidated financial reporting, our significant business segments for the three and six months ended June 30, 2012 and 2011 were Tobacco and Real Estate. The Tobacco segment consists of the manufacture and sale of cigarettes and the research related to reduced risk products. The Real Estate segment includes our investments in consolidated and non-consolidated real estate businesses.

	Three Months Ended		Six Months Ended	
	June 30, 2012	June 30, 2011	June 30, 2012	June 30, 2011
Revenues:				
Tobacco	\$276,594	\$291,180	\$534,200	\$551,558
Operating income:				
Tobacco	\$44,590	\$42,214	\$82,105	\$78,639
Real Estate	(249 )	(487 )	272	(330 )
Corporate and other	(3,413 )	(3,760 )	(8,003 )	(8,866 )
Total operating income	\$40,928	\$37,967	\$74,374	\$69,443

### Three Months Ended June 30, 2012 Compared to Three Months ended June 30, 2011

Revenues. All of our revenues were from the Tobacco segment for the second quarter of 2012 and 2011. Liggett increased the list price of PYRAMID by \$1.30 per carton in January 2011, \$1.10 per carton in August 2011 and \$1.00 per carton in June 2012. Liggett increased the list price of LIGGETT SELECT, EVE, and GRAND PRIX by \$0.80 per carton on October 31, 2011 and \$1.00 per carton in June 2012. The list price of LIGGETT SELECT and EVE also increased by \$1.00 per carton in June 2011. The list price of GRAND PRIX also increased by \$1.10 per carton in June 2011.

All of our sales in 2012 and 2011 were in the discount category. For the three months ended June 30, 2012, revenues were \$276,594 compared to \$291,180 for the three months ended June 30, 2011. Revenues declined by 5.0% (\$14,586) primarily due to an unfavorable sales volume of \$28,535 (approximately 237.8 million units) offset by a favorable price variance of \$13,949 primarily related to increases in price of the PYRAMID.

Cost of Goods Sold. Our cost of goods sold declined from \$231,073 for the three months ended June 30, 2011 to \$211,752 for the three months ended June 30, 2012. The major components of our cost of goods sold are federal excise taxes, expenses under the MSA, FDA legislation and tobacco buyout, which are variable costs based on the number of units sold, and tobacco and other manufacturing costs, which are fixed and variable costs. Federal excise taxes declined from \$142,934 for the three months ended June 30, 2011 to \$130,967 for the three months ended June 30, 2012 as a result of decreased unit sales volume of 8.4%. Tobacco and other manufacturing costs were \$33,019 and \$34,975 for the three months ended June 30, 2012 and 2011, respectively. Expenses under the MSA were \$36,151 and \$41,242 for the three months ended June 30, 2012 and 2011, respectively.

**Tobacco Gross Profit.** Tobacco gross profit was \$64,842 for the three months ended June 30, 2012 compared to \$60,107 for the three months ended June 30, 2011. This represented an increase of \$4,735 (7.9%) from the 2011 period. This increase was due primarily to higher prices. As a percentage of revenues (excluding federal excise taxes), Tobacco gross profit increased to 44.5% in the 2012 period compared to gross profit of 40.5% in the 2011 period due to higher prices.

**Expenses.** Operating, selling, general and administrative expenses were \$23,914 for the three months ended June 30, 2012 compared to \$22,140 for the same period last year, an increase of \$1,774 (8.0%). Tobacco expenses were \$20,252 for the three months ended June 30, 2012 compared to \$17,893 for the same period in the prior year. This is an increase of \$2,359, which was primarily the result of higher expenses due to an increase in sales force headcount over the last twelve months, increases in legal expenses due to MSA arbitration and Engle progeny cases and an increase in point of sales materials. Tobacco product liability legal expenses and other litigation costs were \$2,069 and \$1,679 for the three months ended June 30, 2012 and 2011, respectively. Expenses at the corporate level decreased from \$3,760 to \$3,413 due to the timing of expenses.

**Operating income.** Operating income was \$40,928 for the three months ended June 30, 2012 compared to \$37,967 for the same period last year, an increase of \$2,961 (7.8%). Tobacco segment operating income increased from \$42,214 in 2011 to \$44,590 in 2012 primarily due to higher prices in 2012. The real estate segment operating loss was \$249 and \$487 for the three months ended June 30, 2012 and 2011, respectively, related primarily to Escena's operations.

**Other income (expenses).** Other expenses were \$35,800 for the three months ended June 30, 2012 compared to income of \$10,879 for the same period last year. For the three months ended June 30, 2012, other expenses primarily consisted of interest expense of \$26,509, accelerated interest expense related to the conversion of debt of \$7,888 losses of \$6,003 from changes in fair value of derivatives embedded within convertible debt and an equity loss on long-term investments of \$1,215. This was offset by equity income on non-consolidated real estate businesses of \$5,232 and interest and other income of \$583. For the three months ended June 30, 2011, other income primarily consisted of a realized gain on liquidation of long-term investment of \$19,475, a realized gain on investments held for sale of \$1,506, income of \$9,437 from changes in fair value of derivatives embedded within convertible debt, equity income on non-consolidated real estate businesses of \$6,197 and a realized gain on sale of a townhome of \$577. This income was offset by interest expense of \$25,082 and accelerated interest expense related to the conversion of debt of \$1,217.

The value of the embedded derivatives is contingent on changes in interest rates of debt instruments maturing over the duration of the convertible debt, our stock price as well as projections of future cash and stock dividends over the term of the debt. The interest rate component of the value of the embedded derivative is computed by comparing the yield on our 11% Senior Secured Notes to the average difference in interest yields on unsecured and subordinated debt. The interest rate component declined from 8.25% at March 31, 2012 to 7.50% at June 30, 2012. The decline was primarily due to the shortened duration of the 11% Senior Secured Notes at June 30, 2012 compared to March 31, 2012. These changes caused the yield (computed on a yield to worst call basis) to decline from approximately 5.6% to approximately 5.3%. Further, the spread between the yield on subordinated debt and comparable risk free investments declined from approximately 2.7% to approximately 2.2% for the three months ended June 30, 2012. These changes significantly reduced the discount rate of future cash flows used to compute the embedded derivative. Thus, improvements in debt markets caused us to recognize an expense of \$6,003 related to increases in the embedded derivative for the three months ended June 30, 2012. The gain of \$9,437 from the embedded derivatives in the three months ended June 30, 2011, was primarily the result of increasing spreads (from approximately 2.7% to approximately 3.0%) between corporate convertible debt and risk free investments offset by interest payments during the period.

Income before income taxes. Income before income taxes for the three months ended June 30, 2012 was \$5,128 compared to \$48,846 for the three months ended June 30, 2011.

Income tax provision. The income tax provision was \$1,233 and \$18,545 for the three months ended June 30, 2012 and 2011, respectively. Our provision for income taxes in interim periods is based on an estimated annual effective income tax rate derived, in part, from estimated annual income before provision for income taxes in accordance with guidance on accounting for income taxes on interim periods. For the three months ended June 30, 2012, our income tax expense was decreased by the impact of the acceleration of interest expense related to the conversion of debt, which decreased the income tax provision by approximately \$769.



Six Months Ended June 30, 2012 Compared to Six Months Ended June 30, 2011

Revenues. All of our revenues were from the Tobacco segment in the first six months of 2012 and 2011. Liggett increased the list price of PYRAMID by \$1.30 per carton in January 2011, \$1.10 per carton in August 2011 and \$1.00 per carton in June 2012. Liggett increased the list price of LIGGETT SELECT, EVE, and GRAND PRIX by \$0.80 per carton on October 31, 2011 and \$1.00 per carton in June 2012. The list price of LIGGETT SELECT and EVE also increased by \$1.00 per carton in June 2011. The list price of GRAND PRIX also increased by \$1.10 per carton in June 2011.

All of our sales were in the discount category in 2012 and 2011. For the six months ended June 30, 2012, revenues were \$534,200 compared to \$551,558 for the six months ended June 30, 2011. Revenues declined by 3.1% (\$17,358) due to an unfavorable sales volume of \$42,992 (approximately 350.8 million units) offset by a favorable price variance of \$25,634 primarily related to increases in the price of PYRAMID.

Cost of Goods Sold. Our cost of goods sold declined from \$436,250 for the six months ended June 30, 2011 to \$411,933 for the six months ended June 30, 2012. The major components of our cost of goods sold are federal excise taxes, expenses under the MSA, FDA legislation and tobacco buyout, which are variable costs based on the number of units sold, and tobacco and other manufacturing costs, which are fixed and variable costs. Federal excise taxes declined from \$270,568 for the six months ended June 30, 2011 to \$252,892 for the six months ended June 30, 2012 as a result of decreased unit sales volume of 6.5%. Tobacco and other manufacturing costs were \$64,154 and \$65,955 for the six months ended June 30, 2012 and 2011, respectively. Expenses under the MSA were \$69,819 and \$74,885 for the six months ended June 30, 2012 and 2011, respectively.

Tobacco gross profit. Tobacco gross profit was \$122,267 for the six months ended June 30, 2012 compared to \$115,308 for the six months ended June 30, 2011. The \$6,959 (6.0%) increase was due primarily to increases in the price of PYRAMID. As a percentage of revenues (excluding federal excise taxes), Tobacco gross profit increased to 43.5% in the 2012 period compared to gross profit of 41.0% in the 2011 period due to price increases.

Expenses. Operating, selling, general and administrative expenses were \$47,893 for the six months ended June 30, 2012 compared to \$45,865 for the same period last year, an increase of \$2,028 (4.4%). Tobacco expenses were \$40,162 for the six months ended June 30, 2012 compared to \$36,669 for the six months ended June 30, 2011. The increase of \$3,493 was primarily the result of higher sales force expenses due to an increase in sales force over the last twelve months, increases in legal expenses due to MSA arbitration and Engle progeny cases and an increase in point of sales materials. Tobacco product liability legal expenses and other litigation costs were \$4,030 and \$3,718 for the six months ended June 30, 2012 and 2011, respectively. Expenses at the corporate segment declined from \$8,866 to \$8,003 in 2012 due to the timing of expenses.

Operating income. Operating income was \$74,374 for the six months ended June 30, 2012 compared to \$69,443 for the same period last year, an increase of \$4,931 (7.1%). For the six months ended June 30, 2012, Tobacco segment operating income increased from \$78,639 in 2011 to \$82,105 in 2012 primarily due to increases in the price of PYRAMID in 2012. The real estate segment's operating income was \$272 for the six months ended June 30, 2012 compared to a loss of \$330 for the same period in 2011, primarily related to Escena's operations.

Other income (expenses). Other expenses were \$80,428 for the six months ended June 30, 2012 compared to other income of \$11,425 for the same period last year. For the six months ended June 30, 2012, other expenses primarily consisted of interest expense of \$52,761, a loss of \$27,060 from changes in fair value of derivatives embedded within convertible debt, accelerated interest expense related to the conversion of debt of \$7,888 and an equity loss on long-term investments of \$1,329. This was offset by equity income on non-consolidated real estate businesses of \$8,095 and interest and other income of \$515. For the six months ended June 30, 2011, other income

primarily consisted of a realized gain on liquidation of long-term investment of \$23,611, income of \$8,862 from changes in fair value of derivatives embedded within convertible debt, equity income on non-consolidated real estate businesses of \$11,101, a realized gain on investments held for sale of \$14,541 and a realized gain on sales of townhomes of \$3,712. This income was offset by interest expense of \$50,010 and accelerated interest expense related to the conversion of debt of \$1,217.

The value of the embedded derivatives is contingent on changes in interest rates of debt instruments maturing over the duration of the convertible debt, our stock price as well as projections of future cash and stock dividends over the term of the debt. The interest rate component of the value of the embedded derivative is computed by comparing the yield on our 11% Senior Secured Notes to the average difference in interest yields on unsecured and subordinated

debt. The interest rate component declined from 12.5% at December 31, 2011 to 7.50% at June 30, 2012. The decline was primarily due to the prices of our 11% Senior Secured Notes increasing and a shortened duration of the 11% Senior Secured Notes at June 30, 2012 compared to December 31, 2011. These changes caused the yield (computed on a yield to worst call basis) to decline from approximately 9.3% to approximately 5.3%. Further, the spread between the yield on subordinated debt and comparable risk free investments declined from approximately 3.4% to approximately 2.2% for the six months ended June 30, 2012. These changes significantly reduced the discount rate of future cash flows used to compute the embedded derivative. Thus, improvements in debt markets caused us to recognize a charge of \$27,060 related to increases in the embedded derivative for the six months ended June 30, 2012. The gain of \$8,862 from the embedded derivatives in the six months ended June 30, 2011, was primarily the result of increasing spreads (from approximately 3.3% to approximately 3.0%) between corporate convertible debt and risk free investments offset by interest payments during the period.

(Loss) income before income taxes. Loss before income taxes for the six months ended June 30, 2012 was \$6,054 compared to income before income taxes of \$80,868 for the six months ended June 30, 2011.

Income tax provision. The income tax benefit was \$2,259 for the six months ended June 30, 2012, compared to an expense of \$31,194 for the six months ended June 30, 2011. Our provision for income taxes in interim periods is based on an estimated annual effective income tax rate derived, in part, from estimated annual income before provision for income taxes in accordance with guidance on accounting for income taxes on interim periods. For the six months ended June 30, 2012, our income tax benefit was increased by the impact of the acceleration of interest expense related to the conversion of debt, which increased the income tax benefit by approximately \$769. For the six months ended June 30, 2012, our income tax benefit was reduced by an out-of-period adjustment of \$757. The out-of-period adjustment resulted from a non-accrual of a non-deductible expense related to permanent difference for income taxes in the fourth quarter of 2011. We assessed the materiality of this error on all previously issued financial statements and concluded that the error was immaterial to all previously issued financial statements. The impact of correcting this error in the current year is not expected to be material to our 2012 consolidated financial statements.

### Liquidity and Capital Resources

Net cash and cash equivalents decreased by \$32,175 for the six months ended June 30, 2012 compared to an increase of \$20,164 for the six months ended June 30, 2011.

Net cash provided from operations was \$57,829 and \$36,587 for the six months ended June 30, 2012 and 2011, respectively. The change related to increased operating income in the 2012 period, a reduction of accounts receivable in 2012 compared to an increase in 2011 and an increase in inventory in the 2011 period. In 2011, Liggett extended terms on PYRAMID sales by five days and this program has continued in 2012. The initiation of longer terms for PYRAMID increased trade accounts receivable by \$18,873 in the 2011 period. Trade accounts receivable declined by \$14,044 for the six months ended June 30, 2012 due to the timing of receipts in June 2012 compared to December 2011. The changes related to trade accounts receivable increased cash flow from operations by \$32,917 in the 2012 period as compared to the 2011 period. The amount was offset by a lower increases in accruals under the Master Settlement Agreement in 2012 compared to 2011 due to lower unit sales in 2012.

Cash used in investing activities was \$17,419 for the six months ended June 30, 2012 compared to cash provided by investing activities of \$81,550 for the six months ended June 30, 2011. In the first six months of 2012, cash used in investing activities was for purchase of real estate businesses of \$9,667, capital expenditures of \$7,394, purchase of long-term investments of \$5,000, the purchase of investment securities of \$1,148, an increase in cash surrender value of corporate-owned life insurance policies of \$620, the issuance of notes receivable of \$234, and a decrease in non-current restricted assets of \$53. This was offset by the proceeds from distributions from non-consolidated real

estate businesses of \$6,221, the proceeds from the sale of fixed assets of \$404, and proceeds from the sale or liquidation of long-term investments of \$72. In the first six months of 2011, cash provided by investing activities was from the proceeds from the sale or maturity of investment securities of \$19,703, proceeds from the sale or liquidation of long-term investments of \$62,219, distributions from non-consolidated real estate businesses of \$2,425, proceeds from the sales of townhomes of \$19,629 and the decrease in non-current restricted assets of \$1,775 offset by cash used for the purchase of investment securities of \$1,788, purchase of real estate businesses of \$6,712, purchase of long-term investments of \$10,000, capital expenditures of \$4,872, an increase in cash surrender value of corporate-owned life insurance policies of \$677 and the issuance of notes receivable of \$161.

Cash used in financing activities was \$72,585 and \$97,973 for the six months ended June 30, 2012 and 2011,

respectively. In the first six months of 2012, cash was used for distributions on common stock of \$66,112, net repayments of debt under the revolver of \$6,732, repayment of debt of \$13,493, deferred financing costs of \$315. This was offset by proceeds from debt issuance of \$14,018, proceeds from the exercise of Vector options of \$45, and tax benefit of options exercised of \$4. In the first six months of 2011, cash was primarily used for distributions on common stock of \$61,846, net repayments of debt under the revolver of \$35,697 and repayment of debt of \$2,281 offset by proceeds from debt issuance of \$77, proceeds from the exercise of Vector options of \$966, and tax benefit of options exercised of \$808.

**Liggett Credit Facility.** In February 2012, Liggett and Wells Fargo Bank, National Association ("Wells Fargo") renewed the \$50,000 credit facility (the "Credit Facility") through February 2015. The Credit Facility is collateralized by all inventories and receivables of Liggett and a mortgage on its manufacturing facility. The Credit Facility expires on March 8, 2015, subject to automatic renewal for additional one-year periods unless a notice of termination is given by Liggett at least 30 days prior to such date or the anniversary of such date.

Prime rate loans under the Credit Facility bear interest at a rate equal to the prime rate of Wells Fargo and Eurodollar rate loans bear interest at a rate equal to 2.0% more than Wells Fargo's adjusted Eurodollar rate. The Credit Facility contains covenants that provide that Liggett's earnings before interest, taxes, depreciation and amortization, as defined under the Credit Facility, on a trailing twelve month basis, shall not be less than \$100,000 if Liggett's Excess Availability, as defined under the Credit Facility, is less than \$20,000. The covenants also require that annual Capital Expenditures, as defined under the Credit Facility (before a maximum carryover amount of \$2,500), shall not exceed \$15,000 during any fiscal year. Liggett had future machinery and equipment purchase commitments of \$3,910 at June 30, 2012.

**Liggett Term Loan Under Credit Facility.** On February 21, 2012, Wells Fargo, as successor-in-interest to Wachovia Bank, National Association, amended and restated the existing \$5,600 term loan (the "Term Loan") made to 100 Maple LLC ("Maple"), a subsidiary of Liggett, within the commitment under the Credit Facility. In connection with the amendment and restatement the maturity date of the Term Loan was extended to March 1, 2015 and the outstanding principal amount was paid down to \$4,425. The Term Loan bears an interest rate equal to 1.75% more than Wells Fargo's adjusted Eurodollar rate. Monthly payments of \$25 are due under the Term Loan from March 1, 2012 to February 1, 2015 (\$885 in total) with the balance of \$3,540 due at maturity on March 1, 2015.

The Term Loan is collateralized by the existing collateral securing the Credit Facility, including, without limitation, certain real property owned by Maple. The Term Loan did not increase the \$50,000 borrowing amount of the Credit Facility, but did increase the outstanding amounts under the Credit Facility by the amount of the term loan and proportionately reduces the maximum borrowing availability under the Credit Facility.

As of June 30, 2012, \$19,067 was outstanding. Availability as determined under the Credit Facility was approximately \$30,933 based on eligible collateral at June 30, 2012. At June 30, 2012, management believed that Liggett was in compliance with all covenants under the credit facility; Liggett's EBITDA, as defined, were approximately \$152,979 for the twelve months ended June 30, 2012.

In June 2002, the jury in an individual case brought under the third phase of the Engle case awarded \$24,835 of compensatory damages against Liggett and two other defendants and found Liggett 50% responsible for the damages. The verdict was affirmed on appeal and Liggett paid \$14,361 in June 2010. To date, six other verdicts have been entered in Engle progeny cases against Liggett in the total amount of approximately \$6,100, three of which have been affirmed on appeal. It is possible that additional cases could be decided unfavorably. Liggett may enter into discussions in an attempt to settle particular cases if it believes it is appropriate to do so. An unfavorable outcome of a pending smoking and health case could encourage the commencement of additional similar litigation. In recent years, there have been a number of adverse regulatory, political and other developments concerning cigarette smoking and

the tobacco industry. These developments generally receive widespread media attention. Neither we nor Liggett are able to evaluate the effect of these developing matters on pending litigation or the possible commencement of additional litigation or regulation. See Note 5 to our condensed consolidated financial statements and “Legislation and Regulation” below for a description of litigation, legislation and regulation.

Management cannot predict the cash requirements related to any future settlements or judgments, including cash required to bond any appeals, and there is a risk that those requirements will not be able to be met. Except as disclosed in Note 5 to our Condensed Consolidated Financial Statements, management is unable to make a reasonable estimate of the amount or range of loss that could result from an unfavorable outcome of the cases pending against Liggett or the costs of defending such cases. It is possible that our consolidated financial position, results of operations or cash flows could be materially adversely affected by an unfavorable outcome in any such tobacco-related litigation.

Senior Secured Notes. We have a total of \$415,000 principal amount of the Senior Secured Notes outstanding. The Senior Secured Notes pay interest on a semi-annual basis at a rate of 11% per year and mature on August 15, 2015. Effective August 15, 2011, we may redeem some or all of the Senior Secured Notes at a make-whole redemption price. On or after August 15, 2011 we may redeem some or all of the Senior Secured Notes at a premium that will decrease over time, plus accrued and unpaid interest and liquidated damages, if any, to the redemption date. In the event of a change of control, as defined in the indenture governing the Senior Secured Notes, each holder of the Senior Secured Notes may require us to repurchase some or all of its Senior Secured Notes at a repurchase price equal to 101% of their aggregate principal amount plus accrued and unpaid interest and liquidated damages, if any to the date of purchase.

The Senior Secured Notes are guaranteed subject to certain customary automatic release provisions on a joint and several basis by all of our wholly-owned domestic subsidiaries that are engaged in the conduct of our cigarette businesses. In addition, some of the guarantees are collateralized by second priority or first priority security interests in certain collateral of some of the subsidiary guarantors pursuant to security and pledge agreements.

The indenture contains covenants that restrict the payment of dividends by us if our consolidated earnings before interest, taxes, depreciation and amortization, which is defined in the indenture as Consolidated EBITDA, for the most recently ended four full quarters is less than \$50,000. The indenture also restricts the incurrence of debt if our Leverage Ratio and our Secured Leverage Ratio, as defined in the indenture, exceed 3.0 and 1.5, respectively. Our Leverage Ratio is defined in the indenture as the ratio of our and our guaranteeing subsidiaries' total debt less the fair market value of our cash, investments in marketable securities and long-term investments to Consolidated EBITDA, as defined in the indenture. Our Secured Leverage Ratio is defined in the indenture in the same manner as the Leverage Ratio, except that secured indebtedness is substituted for indebtedness. The following table summarizes the requirements of these financial covenants and the results of the calculation, as defined by the indenture.

Covenant	Indenture Requirement	June 30, 2012	December 31, 2011
Consolidated EBITDA, as defined	\$50,000	\$196,077	\$226,554
Leverage ratio, as defined	<3.0 to 1	1.2 to 1	0.9 to 1
Secured leverage ratio, as defined	<1.5 to 1	0.8 to 1	0.5 to 1

We and our subsidiaries have significant indebtedness and debt service obligations. At June 30, 2012, we and our subsidiaries had total outstanding indebtedness with a total aggregate principal amount outstanding of approximately \$682,819.

The holders of the \$98,998 principal amount of our 3.875% Variable Interest Senior Convertible Debentures due 2026 had the option to put all of the remaining senior convertible debentures on June 15, 2012. None of the debentures were surrendered for repurchase. The holders of the Debentures next have the option to put all or part of the remaining Debentures on June 15, 2016.

In February 2012, a holder of our 3.875% Variable Interest Senior Convertible Debentures due 2026 converted \$2 principal amount of the Debentures into 125 shares of common stock. In June 2012, the holders of \$31,370 principal amount of the Debentures converted the \$31,370 of principal into 1,955,300 shares of the our common stock. We recorded accelerated interest expense related to the conversion of debt of \$7,888 for the six months ended June 30, 2012 on the conversion of the \$31,372 of Debentures into 1,955,425 shares of common stock.

Approximately \$157,530 of our 6.75% convertible debt matures in 2014 and \$415,000 of our 11% senior secured notes matures in 2015. In addition, subject to the terms of any future agreements, we and our subsidiaries will be able

to incur additional indebtedness in the future. There is a risk that we will not be able to generate sufficient funds to repay our debt. If we cannot service our fixed charges, it would have a material adverse effect on our business and results of operations.

We believe that our cigarette operations are positive cash flow generating units and will continue to be able to sustain their operations without any significant liquidity concerns.

In order to meet the above liquidity requirements as well as other anticipated liquidity needs in the normal course



of business, we had cash and cash equivalents of approximately \$208,700, investment securities available for sale of approximately \$68,100, long-term investments with an estimated value of approximately \$22,800 and availability under Liggett's credit facility of approximately \$30,900 at June 30, 2012. Management currently anticipates that these amounts, as well as expected cash flows from our operations, proceeds from public and/or private debt and equity financing, management fees and other payments from subsidiaries should be sufficient to meet our liquidity needs over the next 12 months. We may acquire or seek to acquire additional operating businesses through merger, purchase of assets, stock acquisition or other means, or to make other investments, which may limit our liquidity otherwise available.

On a quarterly basis, we evaluate our investments to determine whether an impairment has occurred. If so, we also make a determination if such impairment is considered temporary or other-than-temporary. We believe that the assessment of temporary or other-than-temporary impairment is facts and circumstances driven. However, among the matters that are considered in making such a determination are the period of time the investment has remained below its cost or carrying value, the likelihood of recovery given the reason for the decrease in market value and our original expected holding period of the investment.

### Market Risk

We are exposed to market risks principally from fluctuations in interest rates, foreign currency exchange rates and equity prices. We seek to minimize these risks through our regular operating and financing activities and our long-term investment strategy. Our market risk management procedures cover all market risk sensitive financial instruments.

As of June 30, 2012, approximately \$19,100 of our outstanding debt at face value had variable interest rates determined by various interest rate indices, which increases the risk of fluctuating interest rates. Our exposure to market risk includes interest rate fluctuations in connection with our variable rate borrowings, which could adversely affect our cash flows. As of June 30, 2012, we had no interest rate caps or swaps. Based on a hypothetical 100 basis point increase or decrease in interest rates (1%), our annual interest expense could increase or decrease by approximately \$191.

In addition, as of June 30, 2012, approximately \$83,100 (\$225,158 principal amount) of outstanding debt had a variable interest rate determined by the amount of the dividends on our common stock. The difference between the stated value of the debt and carrying value is due principally to certain embedded derivatives, which were separately valued and recorded upon issuance.

Changes to the estimated fair value of these embedded derivatives are reflected within our statements of operations as "Changes in fair value of derivatives embedded within convertible debt." The value of the embedded derivative is contingent on changes in interest rates of debt instruments maturing over the duration of the convertible debt as well as projections of future cash and stock dividends over the term of the debt and changes in the closing stock price at the end of each quarterly period. Based on a hypothetical 100 basis point increase or decrease in interest rates (1%), our annual "Changes in fair value of derivatives embedded within convertible debt" could increase or decrease by approximately \$5,085 with approximately \$184 resulting from the embedded derivative associated with our 6.75% Note due 2014, \$348 resulting from the embedded derivative associated with our 6.75% exchange notes due 2014, and the remaining \$4,553 resulting from the embedded derivative associated with our 3.875% variable interest senior convertible debentures due 2026. An increase in our quarterly dividend rate by \$0.10 per share would increase interest expense by approximately \$5,480 per year.

We have estimated the fair market value of the embedded derivatives based principally on the results of a valuation model. The estimated fair value of the derivatives embedded within the convertible debt is based principally

on the present value of future dividend payments expected to be received by the convertible debt holders over the term of the debt. The discount rate applied to the future cash flows is estimated based on a spread in yield of our debt when compared to risk-free securities with the same duration; thus, a readily determinable fair market value of the embedded derivatives is not available. The valuation model assumes our future dividend payments and utilizes interest rates and credit spreads for secured to unsecured debt, unsecured to subordinated debt and subordinated debt to preferred stock to determine the fair value of the derivatives embedded within the convertible debt. The valuation also considers items, including current and future dividends and the volatility of Vector's stock price. The range of estimated fair market values of our embedded derivatives was between \$123,106 and \$117,824. We recorded the fair market value of our embedded derivatives at the midpoint of the inputs at \$120,410 as of June 30, 2012. The estimated fair market value of our embedded derivatives could change significantly based on future market conditions.

We held investment securities available for sale totaling approximately \$68,100 at June 30, 2012, which includes 13,891,205 shares of Ladenburg Thalmann Financial Services Inc. carried at \$21,393.

We and New Valley also hold long-term investments in various investment partnerships. These investments are illiquid, and their ultimate realization is subject to the performance of the underlying entities.

#### New Accounting Pronouncements

Refer to Note 1, Summary of Significant Accounting Policies, to our financial statements for further information on New Accounting Pronouncements.

#### Legislation and Regulation

Reports with respect to the alleged harmful physical effects of cigarette smoking have been publicized for many years and, in the opinion of Liggett's management, have had and may continue to have an adverse effect on cigarette sales. Since 1964, the Surgeon General of the United States and the Secretary of Health and Human Services have released a number of reports which state that cigarette smoking is a causative factor with respect to a variety of health hazards, including cancer, heart disease and lung disease, and have recommended various government actions to reduce the incidence of smoking. In 1997, Liggett publicly acknowledged that, as the Surgeon General and respected medical researchers have found, smoking causes health problems, including lung cancer, heart and vascular disease, and emphysema.

On June 22, 2009, the President signed into law the "Family Smoking Prevention and Tobacco Control Act" (Public Law 111-31) (the "Tobacco Control Act"). The law grants the Food and Drug Administration ("FDA") broad authority over the manufacture, sale, marketing and packaging of tobacco products, although FDA is prohibited from issuing regulations banning all cigarettes or all smokeless tobacco products, or requiring the reduction of nicotine yields of a tobacco product to zero. Among other measures, the law (under various deadlines):

- increases the number of health warnings required on cigarette and smokeless tobacco products, increases the size of warnings on packaging and in advertising, requires FDA to develop graphic warnings for cigarette packages, and grants FDA authority to require new warnings;

- requires practically all tobacco product advertising to eliminate color and imagery and instead consist solely of black text on white background;

- imposes new restrictions on the sale and distribution of tobacco products, including significant new restrictions on tobacco product advertising and promotion, as well as the use of brand and trade names;

- bans the use of "light," "mild," "low" or similar descriptors on tobacco products;

- bans the use of "characterizing flavors" in cigarettes other than tobacco or menthol;

- gives FDA the authority to impose tobacco product standards that are appropriate for the protection of the public health (by, for example, requiring reduction or elimination of the use of particular constituents or components, requiring product testing, or addressing other aspects of tobacco product construction, constituents, properties or labeling);

- requires manufacturers to obtain FDA review and authorization for the marketing of certain new or modified tobacco products;

- requires pre-market approval by FDA for tobacco products represented (through labels, labeling, advertising, or other means) as presenting a lower risk of harm or tobacco-related disease;

- requires manufacturers to report ingredients and harmful constituents and requires FDA to disclose certain constituent information to the public;

- mandates that manufacturers test and report on ingredients and constituents identified by FDA as requiring such testing to protect the public health, and allows FDA to require the disclosure of testing results to the public;

requires manufacturers to submit to FDA certain information regarding the health, toxicological, behavioral or physiological effects of tobacco products;  
prohibits use of tobacco containing a pesticide chemical residue at a level greater than allowed under federal

law;

- requires FDA to establish “good manufacturing practices” to be followed at tobacco manufacturing facilities;
- requires tobacco product manufacturers (and certain other entities) to register with FDA;
- authorizes FDA to require the reduction of nicotine (although it may not require the reduction of nicotine yields of a tobacco product to zero) and the potential reduction or elimination of other constituents, including menthol;
- imposes (and allows FDA to impose) various recordkeeping and reporting requirements on tobacco product manufacturers; and
- grants FDA the regulatory authority to impose broad additional restrictions.

The law also required establishment, within FDA’s new Center for Tobacco Products, of a Tobacco Products Scientific Advisory Committee (“TPSAC”) to provide advice, information and recommendations with respect to the safety, dependence or health issues related to tobacco products, including:

- a recommendation on modified risk applications;
- a recommendation on the effects of tobacco product nicotine yield alteration and whether there is a threshold level below which nicotine yields do not produce dependence;
- a report on the public health impact of the use of menthol in cigarettes; and
- a report on the public health impact of dissolvable tobacco products.

TPSAC completed its review of the use of menthol in cigarettes and issued a report with recommendations to FDA in March 2011. The report states that “removal of menthol cigarettes from the marketplace would benefit public health in the United States,” but does not expressly recommend that FDA ban menthol cigarettes. FDA is considering the report and recommendations of TPSAC and will make a determination about what future regulatory action(s), if any, it believes are warranted. A decision by FDA to ban menthol in tobacco products could have a material adverse effect on us.

The law imposes user fees on certain tobacco product manufacturers in order to fund tobacco-related FDA activities. User fees will be allocated among tobacco product classes according to a formula set out in the legislation, and then among manufacturers and importers within each class based on market share. FDA user fees for Liggett and Vector Tobacco for 2011 were \$16,707 and we estimate that they will be significantly higher in the future.

The law also imposes significant new restrictions on the advertising and promotion of tobacco products. For example, as required under the law, FDA has finalized certain portions of regulations previously adopted by FDA in 1996 (which were struck down by the Supreme Court in 2000 as beyond FDA’s authority). Subject to limitations imposed by a federal injunction (discussed below), these regulations took effect on June 22, 2010. As written, these regulations significantly limit the ability of manufacturers, distributors and retailers to advertise and promote tobacco products, by, for example, restricting the use of color and graphics in advertising, limiting the use of outdoor advertising, restricting the sale and distribution of non-tobacco items and services, gifts, and sponsorship of events, and imposing restrictions on the use for cigarette or smokeless tobacco products of trade or brand names that are used for nontobacco products.

In August 2009, several cigarette manufacturers filed a federal lawsuit against FDA challenging the constitutionality of a number of the restrictions imposed by the Tobacco Control Act, including the ban on color and graphics in advertising, the color graphic and non-graphic warning label requirement, limits on the right to make truthful statements regarding modified risk tobacco products, restrictions on the placement of outdoor advertising, and a ban on the distribution of product samples. In January 2010, a federal judge in Kentucky ruled that the regulations’ ban on the use of color and graphics in certain tobacco product advertising was unconstitutional and prohibited FDA from enforcing that ban. The judge, however, let stand numerous other advertising and promotion restrictions. In March 2010, both parties appealed this decision. In May 2010, FDA issued a guidance document indicating that it intends to exercise its enforcement discretion and not commence enforcement actions based upon these provisions during the pendency of the litigation. In March 2012, a Federal appellate court reviewing the district court’s decision also let stand numerous advertising and promotion restrictions, but held that the ban on the use of color and graphics in advertising was unconstitutional. We cannot predict the future course or outcome of this lawsuit.

In April 2010, a number of cigarette manufacturers filed a federal lawsuit against FDA challenging the restrictions on trade or brand names based upon First Amendment and other grounds. In May 2010, FDA issued a guidance

document indicating that FDA was aware of concerns regarding the trade and brand name restrictions and is considering what changes, if any, would be appropriate to address those concerns. FDA also indicated that while the agency was considering those issues, it intended to exercise its enforcement discretion and not commence trade or brand name

enforcement actions for the duration of its consideration where: (1) The trade or brand name of the cigarettes or smokeless tobacco product was registered, or the product was marketed, in the United States on or before June 22, 2009; or (2) The first marketing or registration in the United States of the tobacco product occurs before the first marketing or registration in the United States of the non-tobacco product bearing the same name; provided, however, that the tobacco and non-tobacco product are not owned, manufactured, or distributed by the same, related, or affiliated entities (including as a licensee). The lawsuit was subsequently stayed, at the request of the parties, pending FDA's evaluation of these concerns. In November 2011, FDA issued a proposal to amend its trade name restrictions. The proposal remains under consideration by the FDA. We cannot predict the future course of this proposed amendment or its potential impact on the litigation.

On June 22, 2011, FDA issued a final rule that would modify the required warnings that appear on cigarette packages and in cigarette advertisements. The rule was to become effective on September 22, 2012, and would have required each cigarette package and advertisement to bear one of nine new textual warning statements accompanied by graphic images. The warnings would appear on at least the top 50% of the front and rear panels of cigarette packages and occupy at least 20% of cigarette advertisements. In August 2011, a number of cigarette manufacturers, including Liggett, filed a federal lawsuit against FDA challenging the constitutionality of these new graphic images on First Amendment and other grounds. The manufacturers sought a preliminary injunction staying implementation of the graphic images, and other related labeling requirements, pending the court's ruling on the merits of the challenge. In November 2011, a Federal judge in the District of Columbia granted the industry's motion for a preliminary injunction, enjoining implementation of the rules for graphic images on cigarette packaging and advertising until 15 months after the court issued a final ruling in the case. FDA appealed the ruling, and on February 29, 2012, the court granted the industry's motion for summary judgment permanently enjoining implementation of FDA's graphic warnings regulation on First Amendment grounds. Should FDA ultimately issue new graphic warnings that are deemed constitutionally valid, the decision provides that such warnings would go into effect 15 months after they are issued. FDA also appealed this ruling. Both FDA appeals were consolidated and the Federal appellate court heard oral argument in April 2012. We cannot predict the ultimate outcome of this litigation or whether or how the inclusion of the new warnings, if ultimately required by FDA in new rulemaking, will impact product sales or whether it will have a material adverse effect on us.

The Tobacco Control Act requires premarket review of "new tobacco products." A "new tobacco product" is one that was not commercially marketed in the U.S. before February 15, 2007 or that was modified after that date. In general, before a company may commercially market a "new tobacco product," it must either (a) submit an application and obtain an order from FDA permitting the product to be marketed; or (b) submit a report and receive an FDA order finding the product to be "substantially equivalent" to a "predicate" tobacco product that was commercially marketed in the U.S. prior to February 15, 2007. A "substantially equivalent" tobacco product is one that has the "same characteristics" as the predicate or one that has "different characteristics" but does not raise "different questions of public health." Manufacturers of products first introduced after February 15, 2007 and before March 22, 2011 who submitted a substantial equivalence report to FDA prior to March 23, 2011 may continue to market the tobacco product unless FDA issues an order that the product is not substantially equivalent. Failure to submit the report before March 23, 2011, or FDA's conclusion that such a "new tobacco product" is not substantially equivalent, will cause the product to be deemed misbranded and/or adulterated. After March 22, 2011, a "new tobacco product" may not be marketed without an FDA substantial equivalence determination. Prior to the deadline, Liggett and Vector Tobacco submitted substantial equivalence reports to FDA for numerous products. It is possible that FDA could determine some, or all, of these products are not "substantially equivalent" to a preexisting tobacco product. Such a determination could prevent us from marketing these products in the United States and could have a material adverse effect on us.

On July 5, 2011, FDA issued a final rule to establish the process and criteria for requesting an exemption from substantial equivalence requirements. We cannot predict how FDA will interpret and apply these requirements, or whether FDA will deem our products to be substantially equivalent to already marketed tobacco products. Separately, the law also requires FDA to issue future regulations regarding the promotion and marketing of tobacco products sold through non-face-to-face transactions. FDA has been acting to implement the law and will continue to

implement various provisions over time. Liggett and Vector Tobacco have been monitoring FDA tobacco initiatives and have made various regulatory submissions to FDA in order to comply with new requirements.

It is likely that the new tobacco law could result in a decrease in cigarette sales in the United States, including sales of Liggett's and Vector Tobacco's brands. Total compliance and related costs are not possible to predict and depend substantially on the future requirements imposed by FDA under the new tobacco law. Costs, however, could be substantial and could have a material adverse effect on the companies' financial condition, results of operations, and cash flows. In addition, FDA has a number of investigatory and enforcement tools available to it. We are aware,



for example, that FDA has already requested company-specific information from competitors. FDA has also initiated a program to award contracts to states to assist with compliance and enforcement activities. Failure to comply with the new tobacco law and with FDA regulatory requirements could result in significant financial penalties and could have a material adverse effect on the business, financial condition and results of operation of both Liggett and Vector Tobacco. At present, we are not able to predict whether the new tobacco law will impact Liggett and Vector Tobacco to a greater degree than other companies in the industry, thus affecting its competitive position.

Liggett and Vector Tobacco provide ingredient information annually, as required by law, to the states of Massachusetts, Texas and Minnesota. Several other states are considering ingredient disclosure legislation. In October 2004, the Fair and Equitable Tobacco Reform Act of 2004 ("FETRA") was signed into law. FETRA provides for the elimination of the federal tobacco quota and price support program through an industry funded buyout of tobacco growers and quota holders. Pursuant to the legislation, manufacturers of tobacco products have been assessed \$10,140,000 over a ten year period, commencing in 2005, to compensate tobacco growers and quota holders for the elimination of their quota rights. Cigarette manufacturers are currently responsible for approximately 92% of the assessment (subject to adjustment in the future), which is allocated based on relative unit volume of domestic cigarette shipments. Liggett's and Vector Tobacco's assessment was \$32,370 for 2011. The relative cost of the legislation to the three largest cigarette manufacturers will likely be less than the cost to smaller manufacturers, including Liggett and Vector Tobacco, because one effect of the legislation is that the three largest manufacturers are no longer obligated to make certain contractual payments, commonly known as Phase II payments, that they agreed in 1999 to make to tobacco-producing states. The ultimate impact of this legislation cannot be determined, but there is a risk that smaller manufacturers, such as Liggett and Vector Tobacco, will be disproportionately affected by the legislation, which could have a material adverse effect on us.

Cigarettes are subject to substantial and increasing federal, state and local excise taxes. On April 1, 2009, the federal cigarette excise tax increased from \$0.39 to \$1.01 per pack. State excise taxes vary considerably and, when combined with sales taxes, local taxes and the federal excise tax, may exceed \$4.00 per pack. Many states are considering, or have pending, legislation proposing further state excise tax increases. Management believes increases in excise and similar taxes have had, and will continue to have, an adverse effect on sales of cigarettes.

Over the last several years all 50 states and the District of Columbia have enacted virtually identical legislation requiring cigarettes to meet a laboratory test standard for reduced ignition propensity. Cigarettes that meet this standard are referred to as "fire standards compliant" or "FSC," and are sometimes commonly called "self-extinguishing." All of the cigarettes that Liggett and Vector Tobacco manufacture are fire standards compliant. Compliance with such legislation could be burdensome and costly and could harm the business of Liggett and Vector Tobacco, particularly if there were to be varying standards from state to state.

In November 2008, the Federal Trade Commission ("FTC") rescinded guidance it issued in 1966 that generally permitted statements concerning cigarette "tar" and nicotine yields if they were based on the Cambridge Filter Method, sometimes called FTC method. In its rescission notice, FTC also indicated that advertisers should no longer use terms suggesting FTC's endorsement or approval of any specific test method, including terms such as "per FTC Method" or other phrases that state or imply FTC endorsement or approval of the Cambridge Filter Method or other machine-based methods for measuring cigarette "tar" or nicotine yields. Also in its rescission notice, FTC indicated that cigarette descriptors such as "light" and "ultra light" have not been defined by FTC, nor has FTC provided any guidance or authorization for their use. FTC indicated that to the extent descriptors are used in a manner that convey an overall impression that is false, misleading, or unsubstantiated, such use could be actionable. FTC further indicated that companies must ensure that any continued use of descriptors does not convey an erroneous or unsubstantiated message that a particular cigarette presents a reduced risk of harm or is otherwise likely to mislead consumers. In response to FTC's action, we have removed all reference to "tar" and nicotine testing from our point-of-sale advertising. In addition, the new tobacco law imposes a ban - which took effect in June 2010 - on the use of "light", "mild", "low" or similar descriptors on tobacco product labels and in labeling or advertising. To the extent descriptors are no longer used to market or promote our cigarettes, this may have a material adverse effect on us.

A wide variety of federal, state and local laws limiting the advertising, sale and use of cigarettes have proliferated in recent years. For example, many local laws prohibit smoking in restaurants and other public places, and many

employers have initiated programs restricting or eliminating smoking in the workplace. There are various other legislative efforts pending at the federal, state or local level which seek to, among other things, eliminate smoking in public places, curtail affirmative defenses of tobacco companies in product liability litigation, and further restrict the sale, marketing and advertising of cigarettes and other tobacco products. This trend has had, and is likely to continue to have, an adverse effect on us. It is not possible to predict what, if any, additional legislation, regulation or other governmental action will be enacted or implemented, or to predict what the impact of the new FDA tobacco law will be on these pending legislative efforts.

In addition to the foregoing, there have been a number of other restrictive regulatory actions, adverse legislative and political decisions and other unfavorable developments concerning cigarette smoking and the tobacco industry. These developments may negatively affect the perception of potential triers of fact with respect to the tobacco industry, possibly to the detriment of certain pending litigation, and may prompt the commencement of additional similar litigation or legislation.

#### SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

In addition to historical information, this report contains “forward-looking statements” within the meaning of the federal securities law. Forward-looking statements include information relating to our intent, belief or current expectations, primarily with respect to, but not limited to:

- economic outlook,
- capital expenditures,
- cost reduction,
- new legislation,
- cash flows,
- operating performance,