

VECTOR GROUP LTD  
Form 10-Q  
October 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 September 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.)
------------------------------------------------------------------------------------------------	--------------------------------------	--------------------------------------------------------

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. x Yes o 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). x Yes o 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.

x Large accelerated filer    o Accelerated filer    o Non-accelerated filer    o 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 October 31, 2012, Vector Group Ltd. had 87,003,808 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

	September 30, 2012	December 31, 2011
<b>ASSETS:</b>		
Current assets:		
Cash and cash equivalents	\$217,256	\$240,923
Investment securities available for sale	65,193	76,486
Accounts receivable - trade, net	11,567	24,869
Inventories	106,439	109,228
Deferred income taxes	39,880	42,951
Income tax receivable, net	823	9,553
Restricted assets	1,476	1,474
Other current assets	4,549	4,257
Total current assets	447,183	509,741
Property, plant and equipment, net	56,909	56,556
Investment in Escena, net	13,174	13,280
Long-term investments accounted for at cost	16,368	5,675
Long-term investments accounted for under the equity method	6,152	16,499
Investments in non-consolidated real estate businesses	123,877	124,469
Restricted assets	10,777	9,626
Deferred income taxes	50,647	31,017
Intangible asset	107,511	107,511
Prepaid pension costs	11,171	10,047
Other assets	41,872	43,347
Total assets	\$885,641	\$927,768
<b>LIABILITIES AND STOCKHOLDERS' DEFICIENCY:</b>		
Current liabilities:		
Current portion of notes payable and long-term debt	\$ 15,628	\$50,844
Current portion of fair value of derivatives embedded within convertible debt	—	84,485
Current payments due under the Master Settlement Agreement	104,207	51,174
Current portion of employee benefits	1,000	2,690
Accounts payable	5,388	9,532
Accrued promotional expenses	16,999	17,056
Income taxes payable, net	6,730	6,597
Accrued excise and payroll taxes payable, net	235	17,992
Litigation accruals	1,336	1,551
Deferred income taxes	29,256	35,885
Accrued interest	9,332	20,888
Other current liabilities	14,085	16,504
Total current liabilities	204,196	315,198
Notes payable, long-term debt and other obligations, less current portion	515,015	493,356
Fair value of derivatives embedded within convertible debt	87,466	49,015
Non-current employee benefits	45,097	45,982
Deferred income taxes	81,187	60,642
Payments due under the Master Settlement Agreement	52,022	49,338
Litigation accruals	1,809	1,600
Other liabilities	1,797	1,667

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Total liabilities	988,589	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, 90,763,670 and 83,022,812 shares issued and 87,003,808 and 79,441,991 shares outstanding	8,701	7,944
Additional paid-in capital	—	—
Accumulated deficit	(88,373	) (80,440 )
Accumulated other comprehensive loss	(10,419	) (3,677 )
Less: 3,759,862 shares of common stock in treasury, at cost	(12,857	) (12,857 )
Total stockholders' deficiency	(102,948	) (89,030 )
Total liabilities and stockholders' deficiency	\$ 885,641	\$ 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 September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Revenues*	\$272,783	\$288,995	\$806,983	\$840,553
Expenses:				
Cost of goods sold*	203,749	227,863	615,682	664,113
Operating, selling, administrative and general expenses	25,841	23,277	73,734	69,142
Operating income	43,193	37,855	117,567	107,298
Other income (expenses):				
Interest expense	(25,906 )	(25,421 )	(78,667 )	(75,431 )
Change in fair value of derivatives embedded within convertible debt	6,040	4,386	(21,020 )	13,248
Acceleration of interest expense related to debt conversion	(7,072 )	—	(14,960 )	(1,217 )
Equity income from non-consolidated real estate businesses	12,874	6,496	20,969	17,597
Equity income (loss) on long-term investments	124	(1,699 )	(1,205 )	(1,090 )
Gain on sale of investment securities available for sale	1,640	6,017	1,640	20,558
Gain on liquidation of long-term investments	—	2,221	—	25,832
Gain on sales of townhomes	—	10	—	3,722
Other, net	341	135	856	351
Income before provision for income taxes	31,234	30,000	25,180	110,868
Income tax expense	13,302	12,451	11,043	43,645
Net income	\$17,932	\$17,549	\$14,137	\$67,223
Per basic common share:				
Net income applicable to common shares	\$0.21	\$0.21	\$0.17	\$0.80
Per diluted common share:				
Net income applicable to common shares	\$0.21	\$0.20	\$0.16	\$0.78
Cash distributions and dividends declared per share	\$0.38	\$0.36	\$1.14	\$1.09

\* Revenues and Cost of goods sold include excise taxes of \$126,389, \$141,473, \$379,281 and \$412,041, 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 September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net income	\$17,932	\$17,549	\$14,137	\$67,223
Net unrealized gains (losses) on investment securities available for sale:				
Change in net unrealized gains (losses)	883	1,933	(13,386)	5,353
Net unrealized gains reclassified into net income	(1,640)	(6,017)	(1,640)	(20,558)
Net unrealized losses on investment securities available for sale	(757)	(4,084)	(15,026)	(15,205)
Net unrealized gains (losses) on long-term investments accounted for under the equity method	476	(1,549)	1,018	(3,002)
Net change in forward contracts	15	18	47	49
Net change in pension-related amounts	870	680	2,611	2,040
Other comprehensive income (loss)	604	(4,935)	(11,350)	(16,118)
Income tax effect on:				
Change in net unrealized gains (losses) on investment securities	(358)	(1,025)	5,435	(2,393)
Net unrealized gains reclassified into net income on investment securities	665	2,531	665	8,347
Change in unrealized long-term investments	(193)	629	(413)	1,212
Net unrealized gains reclassified into net income on long-term investments	—	—	—	—
Forward contracts	(6)	(5)	(19)	(19)
Pension-related amounts	(353)	(105)	(1,060)	(649)
Income tax (provision) benefit on other comprehensive income (loss)	(245)	2,025	4,608	6,498
Other comprehensive income (loss), net of tax	359	(2,910)	(6,742)	(9,620)
Comprehensive income	\$18,291	\$14,639	\$7,395	\$57,603

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 income	—	—	—	14,137	—	—	14,137
Pension-related minimum liability adjustments, net of income taxes	—	—	—	—	1,551	—	1,551
Forward contract adjustments, net of income taxes	—	—	—	—	28	—	28
Unrealized gain on long-term investment securities, accounted for under the equity method, net of income taxes	—	—	—	—	605	—	605
Change in net unrealized loss on investment securities, net of income taxes	—	—	—	—	(7,951 )	—	(7,951 )
Net unrealized gains reclassified into net income, net of income taxes	—	—	—	—	(975 )	—	(975 )
Unrealized loss on investment securities, net of income taxes	—	—	—	—	—	—	(8,926 )
Total other comprehensive loss	—	—	—	—	—	—	(6,742 )
Total comprehensive income	—	—	—	—	—	—	7,395
Distributions and dividends on common stock	—	—	(77,891)	(21,656 )	—	—	(99,547 )
Effect of stock dividend	4,142,378	414	—	(414 )	—	—	—
Note conversion, net of income taxes	3,476,654	348	76,540	—	—	—	76,888
Exercise of employee stock options	15,314	2	138	—	—	—	140
Surrender of shares in connection with employee stock option exercise and restricted stock vesting	(72,529 )	(7 )	(1,269)	—	—	—	(1,276 )
Tax benefit of employee stock options exercised	—	—	48	—	—	—	48
Amortization of deferred compensation	—	—	2,434	—	—	—	2,434
Balance, as of September 30, 2012	87,003,808	\$ 8,701	\$ —	\$ (88,373 )	\$ (10,419 )	\$(12,857)	\$(102,948 )

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 CASH FLOWS  
(Dollars in Thousands, Except Per Share Amounts)  
Unaudited

	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011	
Net cash provided by operating activities	\$97,245	\$64,015	
Cash flows from investing activities:			
Sale of investment securities	3,831	28,102	
Purchase of investment securities	(1,148)	(2,847)	)
Proceeds from sale or liquidation of long-term investments	72	66,190	
Purchase of long-term investments	(5,000)	(10,000)	)
Investments in non-consolidated real estate businesses	(22,467)	(7,201)	)
Distributions from non-consolidated real estate businesses	31,221	6,752	
Proceeds from sale of townhomes, net	—	19,629	
Increase in cash surrender value of life insurance policies	(831)	(717)	)
(Increase) decrease in restricted assets	(1,126)	738	
Issuance of notes receivable	(355)	(216)	)
Proceeds from sale of fixed assets	418	156	
Capital expenditures	(8,268)	(8,469)	)
Net cash (used in) provided by investing activities	(3,653)	92,117	
Cash flows from financing activities:			
Proceeds from debt issuance	14,018	2,823	
Deferred financing costs	(315)	—	
Repayments of debt	(15,440)	(3,522)	)
Borrowings under revolver	794,249	769,247	
Repayments on revolver	(809,567)	(804,957)	)
Dividends and distributions on common stock	(100,392)	(92,987)	)
Proceeds from exercise of employee stock options	140	1,029	
Tax benefit of employee stock options exercised	48	821	
Net cash used in financing activities	(117,259)	(127,546)	)
Net (decrease) increase in cash and cash equivalents	(23,667)	28,586	
Cash and cash equivalents, beginning of period	240,923	299,825	
Cash and cash equivalents, end of period	\$217,256	\$328,411	

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 28, 2012 and September 29, 2011. The dividends were recorded at par value of \$414 and \$378 since the Company did not have retained earnings at September 30, 2012 and 2011, respectively. All per share amounts and references to 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 September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net income	\$17,932	\$17,549	\$14,137	\$67,223

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Income attributable to participating securities	(350	)	(359	)	(284	)	(1,390	)
Net income available to common stockholders	\$17,582		\$17,190		\$13,853		\$65,833	

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## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net income	\$17,932	\$17,549	\$14,137	\$67,223
Expense attributable to 3.875% Variable Interest Senior Convertible Debentures	—	680	—	4,608
Expense attributable to 6.75% Variable Interest Senior Convertible Note	—	—	—	2,994
Income attributable to participating securities	(350 )	(373 )	(284 )	(1,548 )
Net income available to common stockholders	\$17,582	\$17,856	\$13,853	\$73,277

Basic and diluted EPS were calculated using the following shares:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Weighted-average shares for basic EPS	85,299,645	82,965,473	83,891,231	82,472,035
Plus incremental shares related to stock options and non-vested restricted stock	165,723	640,507	191,974	527,305
Plus incremental shares related to convertible debt	—	6,479,204	—	10,952,616
Weighted-average shares for fully diluted EPS	85,465,368	90,085,184	84,083,205	93,951,956

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Number of stock options	N/A	11,088	N/A	11,088
Weighted-average exercise price	N/A	\$22.70	N/A	\$22.70
Weighted-average shares of non-vested restricted stock	3,500	N/A	3,500	N/A
Weighted-average expense per share	17.12	N/A	17.12	N/A
Weighted-average number of shares issuable upon conversion of debt	15,929,565	11,701,241	17,316,315	7,660,326
Weighted-average conversion price	\$13.95	\$13.47	\$14.05	\$14.04

VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## (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 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 \$85,887 and \$89,106. The Company recorded the fair market value of its embedded derivatives at the midpoint of the inputs at \$87,466 as of September 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 July 2012, the FASB issued amendments to the indefinite-lived intangible asset impairment guidance which provides an option for companies to use a qualitative approach to test indefinite-lived intangible assets for impairment if certain conditions are met. The amendments are effective for annual and interim indefinite-lived intangible asset impairment tests performed for fiscal years beginning after September 15, 2012 (early adoption is permitted). The implementation of the amended accounting guidance is not expected to have a material impact on the Company's consolidated financial position or results of operations.

## 2. INVENTORIES

Inventories consist of:

September 30, 2012	December 31, 2011
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Leaf tobacco	\$66,920	\$65,411
Other raw materials	3,877	3,831
Work-in-process	727	688
Finished goods	61,139	64,594
Inventories at current cost	132,663	134,524
LIFO adjustments	(26,224	) (25,296
	\$106,439	\$109,228

## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

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 anticipated requirements and are at prices, including carrying costs, established at the commitment date. At September 30, 2012, Liggett had tobacco purchase commitments of approximately \$7,169.

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

## 3. LONG-TERM INVESTMENTS

Long-term investments accounted for at cost:

	September 30, 2012		December 31, 2011	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Investment partnerships	\$ 15,541	\$ 16,317	\$ 4,776	\$ 6,199
Real estate partnership	827	1,388	899	1,293
Investments accounted for at cost	\$ 16,368	\$ 17,705	\$ 5,675	\$ 7,492

The Company received a distribution of \$207 in June 2012 from a real estate partnership. The Company recognized a gain of \$135 in June 2012 related to the distribution. The Company received distributions of \$3,971 and \$66,190 for the three and nine months ended September 30, 2011, respectively, primarily from the liquidation of two long-term investments. The Company recognized a gain of \$2,221 and \$25,832 for the three and nine months ended September 30, 2011, respectively.

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

	September 30, 2012	December 31, 2011
Investment partnerships	\$6,152	\$ 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 2012 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 recorded equity income of \$124 for the three months ended September 30, 2012 and an equity loss of \$1,205 for the nine months ended September 30, 2012, related to the limited partnerships accounted for under the equity method. The Company recorded an equity loss of \$1,699 and \$1,090 for the for the three and nine months ended September 30, 2011, respectively, related to the limited partnership.

The carrying value of the investments was approximately \$6,152 as of September 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:

	September 30, 2012	December 31, 2011
Vector:		
11% Senior Secured Notes due 2015, net of unamortized discount of \$458 and \$591	\$414,542	\$414,409
6.75% Variable Interest Senior Convertible Note due 2014, net of unamortized discount of \$32,092 and \$35,704*	17,908	14,296
6.75% Variable Interest Senior Convertible Exchange Notes due 2014, net of unamortized discount of \$48,571 and \$57,036*	58,959	50,494
3.875% Variable Interest Senior Convertible Debentures due 2026, net of unamortized discount of \$36,184 and \$82,948*	7,038	16,052
Liggett:		
Revolving credit facility	6,153	21,472
Term loan under credit facility	4,253	5,689
Equipment loans	21,448	21,255
Other	342	533
Total notes payable, long-term debt and other obligations	530,643	544,200
Less:		
Current maturities	(15,628	) (50,844
Amount due after one year	\$515,015	\$493,356

\* The fair value of the derivatives embedded within the 6.75% Variable Interest Senior Convertible Note (\$13,951 at September 30, 2012 and \$16,929 at December 31, 2011, respectively), the 6.75% Variable Interest Senior Convertible Exchange Notes (\$26,446 at September 30, 2012 and \$32,086 at December 31, 2011, respectively), and the 3.875% Variable Interest Senior Convertible Debentures (\$47,069 at September 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 (the "Credit Facility"). 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; provided that Liggett may terminate the Credit Facility prior to March 8, 2015 at any time by giving at least 30 days prior written notice to Wells Fargo, and Wells Fargo may, at Wells Fargo's option, terminate the Credit Facility at any time upon the occurrence and during the continuance of an Event of Default.

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

In February 2012, Wells Fargo 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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

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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 September 30, 2012, a total of \$10,406 was outstanding under the revolving and term loan portions of the credit facility. Availability as determined under the facility was approximately \$39,594 based on eligible collateral at September 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.

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 non-cash accelerated interest expense related to the converted debt of \$1,217 for the nine months ended September 30, 2011, on the conversion of the \$11,000 of notes into 719,256 shares of common stock. The debt conversion resulted in a reclass from debt to equity in the amount of \$10,993.

Holders of the Debentures converted \$2 principal amount of the Debentures into 131 shares of the Company's common stock in February 2012, \$31,370 principal amount into 2,053,065 shares of common stock in June 2012, and \$24,406 principal amount into 1,597,290 shares of common stock in September 2012. The Company recorded non-cash accelerated interest expense related to the converted debt of \$7,072 and \$14,960 for the three and nine months ended September 30, 2012. The debt conversion resulted in a reclassification from debt to equity in the amount of \$55,778. As of September 30, 2012, the principal amount of the Debentures outstanding was \$43,222.

The holders 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 to the Company 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.

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

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## Non-cash Interest Expense - Vector:

Components of non-cash interest expense are as follows:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Amortization of debt discount	\$4,779	\$2,709	\$12,220	\$7,551
Amortization of deferred finance costs	606	1,123	2,067	4,004
Accelerated interest expense on 3.875% Variable Interest Senior Convertible Debentures converted	7,072	—	14,960	1,217
	\$12,457	\$3,832	\$29,247	\$12,772

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

	September 30, 2012		December 31, 2011	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Notes payable and long-term debt	\$530,643	\$693,452	\$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.



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## 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, 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 nine months ended September 30, 2012 and 2011, Liggett incurred legal expenses and other litigation costs totaling approximately \$6,006 and \$5,216, 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 \$6,306 in bonds as of September 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, after granting review of the Hall decision denying plaintiff's challenge to the bond cap statute, subsequently dismissed the matter prior to the scheduled argument as moot. 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.

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**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 September 30, 2012, Liggett and the Company are currently defendants in 3,063 state court and 2,016 federal court Engle progeny cases. As of September 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 compensatory 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 February 2009, when Engle progeny trials commenced, 71 cases have been tried to a verdict. Based on the current rate of trials per year, it would require decades to resolve the remaining 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 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 September 30, 2012, Liggett (and in certain cases the Company), has settled 91 Engle progeny cases for approximately \$1,017, 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.

## VECTOR GROUP LTD.

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

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## Non-Engle Individual Actions

As of September 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 September 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.

## Engle Progeny Cases

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.

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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.

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 September 30, 2012, Liggett and the Company are named defendants in 5,079 Engle progeny cases in both federal (2,016 cases) and state (3,063 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 6,594 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 September 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 appeal 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 occurred on 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, which was also denied. Defendants are seeking review by the US Supreme Court.
April 2010	Putney v. R.J. Reynolds	Broward	\$3,008	None	On appeal to the Fourth District Court of Appeal. Oral argument occurred on September 27, 2012.

April 2011	Tullo v. R.J. Reynolds	Palm Beach	\$225	None	A decision is pending. On appeal to the Fourth District Court of Appeal.
January 2012	Ward v. R.J. Reynolds	Escambia	\$1	None	A joint and several judgment was entered for \$487 against Liggett and RJR. On appeal to the First District Court of Appeal. Post trial motions were denied. A joint and several judgment was entered for \$16,100 against all defendants. On appeal to the Fourth District Court of Appeal.
May 2012	Calloway v. R.J. Reynolds	Broward	\$1,947	\$7,600	

The Company's potential range of loss in the Douglas, Clay, Putney, Tullo, Ward and Calloway cases is between \$0 and \$15,480 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 5, 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. However, as cases proceed through the appellate process, the Company will consider accruals on a case-by-case basis if an unfavorable outcome becomes probable and the amount can be reasonably estimated.

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.



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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 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. The stays were subsequently lifted in 34 cases. At present, Liggett is a defendant in 7 of the 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 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 defendants were entitled to summary judgment on all claims asserted against them other than the claim for civil conspiracy. Defendants' motions for rehearing were denied with regard to the Liggett Rule issues. Defendants sought further review by the Florida Supreme Court and on August 20, 2012, the petition for review was denied. 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. Defendants have sought review by the Florida Supreme Court of these decisions.

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 occurred on September 6, 2012. A decision is pending. Liggett Only Cases. There are currently eight cases pending where Liggett is the only remaining tobacco company defendant. These cases consist of Individual Actions and Engle progeny cases. 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 September 30, 2012, there were four 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.



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(Dollars in Thousands, Except Per Share Amounts)

Unaudited

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, 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. On September 24, 2012, plaintiffs filed a motion to dismiss the case with prejudice against Liggett and certain of the other defendants. The dismissal was approved by the court on September 27, 2012 and this matter is concluded.

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 15, 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 currently a defendant in any other "lights" class actions, 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 September 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. The case is inactive. Other cigarette manufacturers are also named as defendants.



VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

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

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.

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VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

#### Upcoming Trials

As of September 30, 2012, there were 30 Engle progeny cases scheduled for trial through September 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. There are additional cases against other cigarette manufacturers that are also scheduled for trial through September 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.

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VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

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 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 September 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 June 2012, Montana and the Participating Manufacturers reached an agreement that the Participating Manufacturers will not contest Montana's diligent enforcement for 2003.



## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

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. 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. In June 2010, the three person arbitration panel was selected. In November 2011, the Participating Manufacturers advised the arbitration panel that they were not contesting diligent enforcement of 16 Settling States and territories. Substantive hearings commenced in April 2012 and are ongoing. To date, evidentiary hearings have been held for 12 of the remaining 35 Settling States and territories. 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 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 \$37,500 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.** 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 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.



VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

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Unaudited

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. Liggett responded to Mississippi's letter but has heard nothing further on the matter. 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 September 30, 2012, Liggett has been found liable in seven other Engle progeny cases. In one of these cases, although plaintiff had minimal history of smoking Liggett products, Liggett was found liable for \$1,947 in compensatory damages and \$7,600 in punitive damages. As discussed above, these cases have been, or currently are, on appeal, however, appellate efforts to date have generally not been successful. Liggett has also had judgments entered against it in other Individual Actions, which judgments were affirmed on appeal. 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.





## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

The activity in the company's accruals for tobacco litigation for the nine months ended September 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	103,682	214	103,896	—	—	—
Change in MSA obligations capitalized as inventory	350	—	350	—	—	—
Payments	(50,094 )	(684 )	(50,778 )	—	—	—
Reclassification to non-current liabilities	(905 )	224 )	(681 )	905	(224 )	681
Interest on withholding	—	31	31	1,779	433	2,212
Balance at September 30, 2012	\$104,207	\$1,336	\$105,543	\$52,022	\$1,809	\$53,831

The activity in the company's accruals for tobacco litigation for the nine months ended September 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	114,783	444	115,227	—	—	—
Change in MSA obligations capitalized as inventory	479	—	479	—	—	—
Payments	(26,758 )	(1,754 )	(28,512 )	—	—	—
Reclassification to non-current liabilities	(17,667 )	—	(17,667 )	17,667	—	17,667
Interest on withholding	—	70	70	885	—	885
Balance at September 30, 2011	\$114,725	\$2,943	\$117,668	\$48,757	\$—	\$48,757



VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## 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 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 September 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 consisted of the following:

	Three Months Ended		Nine Months Ended		
	September 30,		September 30,		
	2012	2011	2012	2011	
Income before provision for income taxes	\$31,234	\$30,000	\$25,180	\$110,868	
Income tax expense using estimated annual effective income tax rate	12,024	11,920	9,694	44,051	
Out-of-period adjustment related to non-deductible expenses in 2011	—	—	757	—	
Impact of discrete item, net	(148	) —	(808	) 464	
Changes in effective tax rates	1,426	1,401	1,400	—	
Reduction of valuation allowance	—	(870	) —	(870	)
Income tax expense	\$13,302	\$12,451	\$11,043	\$43,645	

The discrete item for the nine months ended September 30, 2012 and the three and nine months ended September 30, 2011, 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.

## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

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.

## 7. NEW VALLEY LLC

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

	September 30, 2012	December 31, 2011
Douglas Elliman Realty LLC	\$62,351	\$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	—	25,095
HFZ East 68th Street	7,000	7,000
11 Beach Street Investor LLC	9,642	—
NV Maryland LLC	5,000	—
NV 701 Seventh Avenue LLC	7,800	—
Investments in non-consolidated real estate businesses	\$123,877	\$124,469

Residential Brokerage Business. New Valley recorded income of \$5,223 and \$5,496 for the three months ended September 30, 2012 and 2011, respectively, and income of \$11,596 and \$14,297 for the nine months ended September 30, 2012 and 2011, respectively, associated with Douglas Elliman Realty, LLC. New Valley received cash distributions from Douglas Elliman Realty, LLC of \$325 and \$2,216 for the three months ended September 30, 2012 and 2011, respectively and \$3,214 and \$6,016 for the nine months ended September 30, 2012 and 2011, respectively. The summarized financial information of Douglas Elliman Realty, LLC is as follows:

	September 30, 2012	December 31, 2011
Cash	\$73,969	\$57,450
Other current assets	4,739	3,293
Property, plant and equipment, net	15,614	14,595
Trademarks	21,663	21,663
Goodwill	38,517	38,742
Other intangible assets, net	959	827
Other non-current assets	3,601	3,096
Notes payable - current	417	602
Other current liabilities	19,304	18,734
Notes payable - long term	462	1,104
Other long-term liabilities	9,680	9,490

Members' equity	129,199	109,736
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## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Revenues	\$103,146	\$96,989	\$272,276	\$271,386
Costs and expenses	93,111	86,027	250,905	243,141
Depreciation expense	822	820	2,468	2,634
Amortization expense	60	64	181	190
Other income	449	517	1,681	1,904
Interest expense, net	17	16	49	99
Income tax expense	288	317	611	821
Net income	\$9,297	\$10,262	\$19,743	\$26,405

New Valley Oaktree Chelsea Eleven, LLC. In April 2012, Chelsea closed on the two remaining residential units. All of the 54 residential units have been sold and the project has been completed.

The Company received net distributions of \$0 and \$4,327 from New Valley Oaktree Chelsea Eleven LLC for the three months ended September 30, 2012 and 2011, respectively. The Company received net distributions of \$8,439 and \$5,940 from New Valley Oaktree Chelsea Eleven LLC for the nine months ended September 30, 2012 and 2011, respectively.

New Valley recorded equity income of \$0 and \$2,118 for the three and nine months ended September 30, 2012, related to New Valley Chelsea. New Valley recorded equity income of \$1,000 and \$3,000 for the three and nine months ended September 30, 2011, related to New Valley Chelsea. The Company has no exposure to loss on its investment in New Valley Chelsea Eleven LLC at September 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 September 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 September 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 September 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 September 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 September 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. 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 accounted for this investment under the equity method of accounting.

The summarized income statement information of the joint venture is as follows:

	Three Months Ended September 30, 2012	Nine Months Ended September 30, 2012
Interest and dividend income	\$23,143	\$25,122
Costs and expenses	78	422
Interest expense, net	5,065	7,794
Income tax expense	—	6
Net income	\$18,000	\$16,900

On September 28, 2012, all outstanding principal and interest was repaid and the note was retired. New Valley received a liquidating distribution of \$32,275 from the joint venture on September 28, 2012. New Valley recorded equity income of \$7,651 and \$7,180 for the three and nine months ended September 30, 2012.

The Company's has no exposure to loss as a result of its investment in NV SOCAL LLC at September 30, 2012.

HFZ East 68th Street. In December 2011, New Valley invested \$7,000 for an approximate 18% interest in a

VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

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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 at September 30, 2012.

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 to loss on its investment in 11 Beach Street Investor LLC is \$9,642 at September 30, 2012.

NV Maryland LLC. In July 2012, New Valley invested \$5,000 for an approximate 33% interest in a joint venture that owns a 25% interest in a portfolio of approximately 5,500 apartment units primarily located in Baltimore County, Maryland. The investment is a variable interest entity; however, New Valley is not the primary beneficiary. New Valley will account for this investment under the equity method of accounting. The Company's maximum exposure to loss as a result of its investment in NV Maryland is \$5,000 at September 30, 2012.

NV 701 Seventh Avenue LLC. In August and September 2012, New Valley invested a total of \$7,800 for an approximate 15% interest in a joint venture that acquired property located at 701 Seventh Avenue in Times Square in Manhattan. The joint venture plans to redevelop the property for retail space and signage, as well as a site for a potential hotel. The investment closed in October 2012 and New Valley invested an additional \$1,420 at closing. New Valley may have additional future capital contributions of approximately \$14,000. The property, located on the northeast corner of Seventh Avenue and 47th Street, totals approximately 120,000 gross square feet and is a rectangular corner parcel currently occupied by two buildings. 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. As of September 30, 2012, the Company's maximum exposure to loss as a result of its investment in NV 701 Seventh Avenue was \$7,800.

St. Regis Hotel, Washington, D.C. The Company received a distribution of \$75 in June 2012 and a distribution of \$300 in June 2011 related to its former interest in the St. Regis Hotel. The Company recorded income of \$75 and \$300 for the nine months ended September 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 \$10 and \$3,722 for the three and nine months ended September 30, 2011.



## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

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

	September 30, 2012	December 31, 2011
Land and land improvements	\$11,272	\$11,245
Building and building improvements	1,525	1,525
Other	1,325	1,208
	14,122	13,978
Less accumulated depreciation	(948)	(698)
	\$13,174	\$13,280

The Company recorded an operating loss of approximately \$762 and \$544 for the three months ended September 30, 2012 and 2011, respectively, from its investment in Escena. The Company recorded an operating loss of \$275 and \$261 for the nine months ended September 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 September 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	\$126,465	\$126,465	\$—	\$—
Certificates of deposit	2,237	—	2,237	—
Bonds	6,306	6,306	—	—
Investment securities available for sale	65,193	63,790	1,403	—
Warrants (1)	894	—	—	894
Total	\$201,095	\$196,561	\$3,640	\$894
Liabilities:				
Fair value of derivatives embedded within convertible debt	\$87,466	\$—	\$—	\$87,466

Warrants include 1,000,000 of LTS Warrants received on November 4, 2011 which were carried at \$826 as of (1) September 30, 2012 and are included in "Other assets". The Company recognized a loss of \$1,064 for the nine months ended September 30, 2012 related to the change in fair value of the Warrants.



## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## 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
<b>Total</b>	<b>\$279,486</b>	<b>\$269,716</b>	<b>\$7,808</b>	<b>\$1,962</b>
<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 \$87,466 and \$128,236 as of September 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 \$21,020 for the nine months ended September 30, 2012 and income of \$13,248 for the nine months ended September 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.



## 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 September 30, 2012:

Quantitative Information about Level 3 Fair Value Measurements					
	Fair Value at September 30, 2012	Valuation Technique	Unobservable Input	Range (Actual)	
Warrants	\$894	Option model	Stock price	\$1.32	
			Exercise price	\$1.68	
			Term (in years)	4.1	
			Volatility	95.05	%
			Dividend rate	—	
			Risk-free return	47.40	%
Fair value of derivatives embedded within convertible debt	87,466	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	5.58	%
			Average spread of unsecured debt	1.50	%
			Average spread of subordinated debt	1.52	%
			Discount rate	8.00% - 9.00% (8.50%)	

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 September 30, 2012 and 2011, respectively.

## 9. SEGMENT INFORMATION

The Company's significant business segments for the three and nine months ended September 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 nine months ended September 30, 2012 and 2011 follows:

	Tobacco	Real Estate	Corporate and Other	Total
Three months ended September 30, 2012				
Revenues	\$272,783	\$—	\$—	\$272,783
Operating income (loss)	48,139	(1,054	) (3,892	) 43,193
Equity income from non-consolidated real estate businesses	—	12,874	—	12,874
Depreciation and amortization	2,425	119	94	2,638
Three months ended September 30, 2011				
Revenues	\$288,995	\$—	\$—	\$288,995
Operating income (loss)	42,888	(947	) (4,086	) 37,855
Equity income from non-consolidated real estate businesses	—	6,496	—	6,496
Depreciation and amortization	2,337	82	194	2,613
Nine months ended September 30, 2012				
Revenues	\$806,983	\$—	\$—	\$806,983
Operating income (loss)	130,244	(782	) (11,895	) 117,567
Equity income from non-consolidated real estate businesses	—	20,969	—	20,969
Depreciation and amortization	7,303	292	353	7,948
Capital expenditures	7,151	156	961	8,268
Nine months ended September 30, 2011				
Revenues	\$840,553	\$—	\$—	\$840,553
Operating income (loss)	121,527	(1,277	) (12,952	) 107,298
Equity income from non-consolidated real estate businesses	—	17,597	—	17,597
Depreciation and amortization	6,721	242	968	7,931
Capital expenditures	8,129	139	201	8,469

VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

#### 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, and all guarantees are joint and several and 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.

## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## CONDENSED CONSOLIDATING BALANCE SHEETS

	September 30, 2012				Consolidated Vector Group Ltd.
	Parent/ Issuer	Subsidiary Guarantors	Non- Guarantors	Consolidating Adjustments	
<b>ASSETS:</b>					
Current assets:					
Cash and cash equivalents	\$ 199,299	\$ 17,674	\$ 283	\$ —	\$ 217,256
Investment securities available for sale	34,760	30,433	—	—	65,193
Accounts receivable - trade, net	—	11,538	29	—	11,567
Intercompany receivables	136	—	—	(136 )	—
Inventories	—	106,439	—	—	106,439
Deferred income taxes	37,035	2,845	—	—	39,880
Income taxes receivable, net	44,358	—	—	(43,535 )	823
Restricted assets	—	1,476	—	—	1,476
Other current assets	780	3,612	157	—	4,549
Total current assets	316,368	174,017	469	(43,671 )	447,183
Property, plant and equipment, net	1,640	55,037	232	—	56,909
Investment in Escena, net	—	—	13,174	—	13,174
Long-term investments accounted for at cost	15,541	—	827	—	16,368
Long-term investments accounted for under the equity method	6,152	—	—	—	6,152
Investments in non- consolidated real estate businesses	—	—	123,877	—	123,877
Investments in consolidated subsidiaries	185,907	—	—	(185,907 )	—
Restricted assets	1,895	8,855	27	—	10,777
Deferred income taxes	39,876	5,460	5,311	—	50,647
Intangible asset	—	107,511	—	—	107,511
Prepaid pension costs	—	11,171	—	—	11,171
Other assets	25,763	15,892	217	—	41,872
Total assets	\$ 593,142	\$ 377,943	\$ 144,134	\$ (229,578 )	\$ 885,641
<b>LIABILITIES AND STOCKHOLDERS' DEFICIENCY:</b>					
Current liabilities:					
Current portion of notes payable and long-term debt	\$ —	\$ 15,472	\$ 156	\$ —	\$ 15,628
Current portion of employee benefits	—	1,000	—	—	1,000
Accounts payable	303	4,843	242	—	5,388
Intercompany payables	—	136	—	(136 )	—
Accrued promotional expenses	—	16,999	—	—	16,999
Income taxes payable, net	—	994	49,271	(43,535 )	6,730
Accrued excise and payroll taxes payable, net	—	235	—	—	235
	—	105,543	—	—	105,543

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Litigation accruals and current payments due under the Master Settlement Agreement					
Deferred income taxes	25,332	3,924	—	—	29,256
Accrued interest	9,332	—	—	—	9,332
Other current liabilities	5,441	7,818	826	—	14,085
Total current liabilities	40,408	156,964	50,495	(43,671 )	204,196
Notes payable, long-term debt and other obligations, less current portion	498,447	16,466	102	—	515,015
Fair value of derivatives embedded within convertible debt	87,466	—	—	—	87,466
Non-current employee benefits	23,974	21,123	—	—	45,097
Deferred income taxes	44,714	32,789	3,684	—	81,187
Other liabilities, primarily litigation accruals and payments due under the Master Settlement Agreement	1,081	53,832	715	—	55,628
Total liabilities	696,090	281,174	54,996	(43,671 )	988,589
Commitments and contingencies					
Stockholders' deficiency	(102,948 )	96,769	89,138	(185,907 )	(102,948 )
Total liabilities and stockholders' deficiency	\$593,142	\$377,943	\$144,134	\$(229,578 )	\$885,641

## 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, net	—	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 September 30, 2012				Consolidated Vector Group Ltd.
	Parent/ Issuer	Subsidiary Guarantors	Subsidiary Non- Guarantors	Consolidating Adjustments	
Revenues	\$—	\$272,783	\$—	\$—	\$272,783
Expenses:					
Cost of goods sold	—	203,749	—	—	203,749
Operating, selling, administrative and general expenses	5,585	19,238	1,018	—	25,841
Management fee expense	—	2,291	—	(2,291)	—
Operating (loss) income	(5,585)	47,505	(1,018)	2,291	43,193
Other income (expenses):					
Interest expense	(24,903)	(998)	(5)	—	(25,906)
Changes in fair value of derivatives embedded within convertible debt	6,040	—	—	—	6,040
Acceleration of interest expense related to debt conversion	(7,072)	—	—	—	(7,072)
Equity income from non-consolidated real estate businesses	—	—	12,874	—	12,874
Equity income on long-term investments	124	—	—	—	124
Gain on investment securities available for sale	—	1,640	—	—	1,640
Equity income in consolidated subsidiaries	36,173	—	—	(36,173)	—
Management fee income	2,291	—	—	(2,291)	—
Other, net	340	—	1	—	341
Income before provision for income taxes	7,408	48,147	11,852	(36,173)	31,234
Income tax benefit (expense)	10,524	(19,014)	(4,812)	—	(13,302)
Net income	17,932	29,133	7,040	(36,173)	17,932
Comprehensive income	\$18,291	\$36,330	\$7,040	\$(43,370)	\$18,291

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 September 30, 2011				
	Parent/ Issuer	Subsidiary Guarantors	Subsidiary Non- Guarantors	Consolidating Adjustments	Consolidated Vector Group Ltd.
Revenues	\$—	\$288,995	\$—	\$—	\$288,995
Expenses:					
Cost of goods sold	—	227,863	—	—	227,863
Operating, selling, administrative and general expenses	5,693	16,637	947	—	23,277
Management fee expense	—	2,209	—	(2,209)	—
Operating (loss) income	(5,693)	42,286	(947)	2,209	37,855
Other income (expenses):					
Interest expense	(24,265)	(1,148)	(8)	—	(25,421)
Change in fair value of derivatives embedded within convertible debt	4,386	—	—	—	4,386
Equity income from non-consolidated real estate businesses	—	—	6,496	—	6,496
Equity loss on long-term investments	(1,699)	—	—	—	(1,699)
Gain on investment securities available for sale	—	6,017	—	—	6,017
Gain on liquidation of long-term investments	2,221	—	—	—	2,221
Gain on sale of townhome	—	—	10	—	10
Equity income in consolidated subsidiaries	30,119	—	—	(30,119)	—
Management fee income	2,209	—	—	(2,209)	—
Other, net	121	14	—	—	135
Income before provision for income taxes	7,399	47,169	5,551	(30,119)	30,000
Income tax benefit (expense)	10,150	(19,894)	(2,707)	—	(12,451)
Net income	17,549	27,275	2,844	(30,119)	17,549
Comprehensive income	\$14,639	\$32,675	\$2,844	\$(35,519)	\$14,639

VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS

	Nine Months Ended September 30, 2012				
	Parent/ Issuer	Subsidiary Guarantors	Subsidiary Non- Guarantors	Consolidating Adjustments	Consolidated Vector Group Ltd.
Revenues	\$—	\$806,983	\$—	\$—	\$806,983
Expenses:					
Cost of goods sold	—	615,682	—	—	615,682
Operating, selling, administrative and general expenses	17,069	55,861	804	—	73,734
Management fee expense	—	6,872	—	(6,872)	—
Operating (loss) income	(17,069)	) 128,568	(804)	) 6,872	117,567
Other income (expenses):					
Interest expense	(75,309)	) (3,340)	) (18)	) —	(78,667)
Change in fair value of derivatives embedded within convertible debt	(21,020)	) —	—	—	(21,020)
Acceleration of interest expense related to debt conversion	(14,960)	) —	—	—	(14,960)
Equity income from non-consolidated real estate businesses	—	—	20,969	—	20,969
Equity loss on long-term investments	(1,205)	) —	—	—	(1,205)
Gain on investment securities available for sale	—	1,640	—	—	1,640
Equity income in consolidated subsidiaries	89,715	—	—	(89,715)	—
Management fee income	6,872	—	—	(6,872)	—
Other, net	701	19	136	—	856
(Loss) income before provision for income taxes	(32,275)	) 126,887	20,283	(89,715)	) 25,180
Income tax benefit (expense)	46,412	(49,220)	) (8,235)	) —	(11,043)
Net income	14,137	77,667	12,048	(89,715)	) 14,137
Comprehensive income	\$7,395	\$84,679	\$12,048	\$(96,727)	) \$7,395

VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS

	Nine Months Ended September 30, 2011				Consolidated Vector Group Ltd.
	Parent/ Issuer	Subsidiary Guarantors	Subsidiary Non- Guarantors	Consolidating Adjustments	
Revenues	\$—	\$840,553	\$—	\$—	\$840,553
Expenses:					
Cost of goods sold	—	664,113	—	—	664,113
Operating, selling, administrative and general expenses	17,451	50,414	1,277	—	69,142
Litigation judgment expense	—	—	—	—	—
Management fee expense	—	6,626	—	(6,626)	—
Operating (loss) income	(17,451)	) 119,400	(1,277)	) 6,626	107,298
Other income (expenses):					
Interest expense	(73,515)	) (1,891)	) (25)	) —	(75,431)
Change in fair value of derivatives embedded within convertible debt	13,248	—	—	—	13,248
Acceleration of interest expense related to debt conversion	(1,217)	) —	—	—	(1,217)
Equity income from non-consolidated real estate businesses	—	—	17,597	—	17,597
Gain on investment securities available for sale	—	20,558	—	—	20,558
Gain on liquidation of long-term investments	25,832	—	—	—	25,832
Gain on sales of townhomes	—	—	3,722	—	3,722
Equity loss on long-term investments	(1,090)	) —	—	—	(1,090)
Equity income in consolidated subsidiaries	97,274	—	—	(97,274)	—
Management fee income	6,626	—	—	(6,626)	—
Other, net	315	36	—	—	351
Income before provision for income taxes	50,022	138,103	20,017	(97,274)	) 110,868
Income tax benefit (expense)	17,201	(52,354)	) (8,492)	) —	(43,645)
Net income	67,223	85,749	11,525	(97,274)	) 67,223
Comprehensive income	\$57,603	\$82,906	\$11,525	\$(94,431)	) \$57,603

## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## CONDENSED CONSOLIDATING STATEMENTS OF CASH FLOWS

	Nine Months Ended September 30, 2012				Consolidated Vector Group Ltd.
	Parent/ Issuer	Subsidiary Guarantors	Non- Guarantors	Subsidiary Consolidating Adjustments	
Net cash provided by (used in) operating activities	\$ 81,661	\$ 145,446	\$ 11,423	\$ (141,285 )	\$ 97,245
Cash flows from investing activities:					
Sale of investment securities	—	3,831	—	—	3,831
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	—	—	(22,467 )	—	(22,467 )
Distributions from non-consolidated real estate businesses	—	—	31,221	—	31,221
Increase in cash surrender value of life insurance policies	(425 )	(406 )	—	—	(831 )
Decrease (increase) in non-current restricted assets	266	(1,392 )	—	—	(1,126 )
Issuance of notes receivable	(355 )	—	—	—	(355 )
Investments in subsidiaries	(14,351 )	—	—	14,351	—
Proceeds from sale of fixed assets	406	12	—	—	418
Capital expenditures	(961 )	(7,151 )	(156 )	—	(8,268 )
Net cash (used in) provided by investing activities	(20,420 )	(6,254 )	8,670	14,351	(3,653 )
Cash flows from financing activities:					
Proceeds from debt issuance	—	14,018	—	—	14,018
Deferred financing costs	—	(315 )	—	—	(315 )
Repayments of debt	—	(15,341 )	(99 )	—	(15,440 )
Borrowings under revolver	—	794,249	—	—	794,249
Repayments on revolver	—	(809,567 )	—	—	(809,567 )
Capital contributions received	—	1,450	12,901	(14,351 )	—
Intercompany dividends paid	—	(108,500 )	(32,785 )	141,285	—
Dividends and distributions on common stock	(100,392 )	—	—	—	(100,392 )
Proceeds from exercise of Vector options	140	—	—	—	140
Tax benefit of options exercised	48	—	—	—	48
Net cash (used in) provided by financing activities	(100,204 )	(124,006 )	(19,983 )	126,934	(117,259 )
Net (decrease) increase in cash and cash equivalents	(38,963 )	15,186	110	—	(23,667 )

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Cash and cash equivalents, beginning of period	238,262	2,488	173	—	240,923
Cash and cash equivalents, end of period	\$199,299	\$17,674	\$283	\$—	\$217,256

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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

	Nine Months Ended September 30, 2011				Consolidated Vector Group Ltd.
	Parent/ Issuer	Subsidiary Guarantors	Non- Guarantors	Consolidating Adjustments	
Net cash provided by (used in) operating activities	\$63,422	\$124,989	\$5,108	\$ (129,504 )	\$64,015
Cash flows from investing activities:					
Sale of investment securities	—	28,102	—	—	28,102
Purchase of investment securities	—	(2,847 )	—	—	(2,847 )
Proceeds from sale of or liquidation of long-term investments	66,190	—	—	—	66,190
Purchase of long-term investments	(10,000 )	—	—	—	(10,000 )
Investments in non-consolidated real estate businesses	—	—	(7,201 )	—	(7,201 )
Distributions from non-consolidated real estate businesses	—	—	6,752	—	6,752
Increase in cash surrender value of life insurance policies	(315 )	(402 )	—	—	(717 )
Decrease in non-current restricted assets	514	224	—	—	738
Issuance of notes receivable	(216 )	—	—	—	(216 )
Proceeds from sale of townhomes	—	—	19,629	—	19,629
Proceeds from sale of fixed assets	—	147	9	—	156
Investments in subsidiaries	(3,463 )	—	—	3,463	—
Capital expenditures	(201 )	(8,129 )	(139 )	—	(8,469 )
Net cash provided by investing activities	52,509	17,095	19,050	3,463	92,117
Cash flows from financing activities:					
Proceeds from debt issuance	—	2,823	—	—	2,823
Repayments of debt	—	(3,431 )	(91 )	—	(3,522 )
Borrowings under revolver	—	769,247	—	—	769,247
Repayments on revolver	—	(804,957 )	—	—	(804,957 )
Capital contributions received	—	3,220	243	(3,463 )	—
Intercompany dividends paid	—	(105,550 )	(23,954 )	129,504	—
Dividends and distributions on common stock	(92,987 )	—	—	—	(92,987 )
Proceeds from exercise of Vector options and warrants.	1,029	—	—	—	1,029
Tax benefits from exercise of Vector options and warrants	821	—	—	—	821
Net cash (used in) provided by financing activities	(91,137 )	(138,648 )	(23,802 )	126,041	(127,546 )
Net increase in cash and cash equivalents	24,794	3,436	356	—	28,586
	283,409	16,214	202	—	299,825



Cash and cash equivalents, beginning of period

Cash and cash equivalents, end of period	\$308,203	\$19,650	\$558	\$—	\$328,411
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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 nine 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 117 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 7.3% for the nine months ended September 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 10.1% of Liggett's unit volume for the nine months ended September 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 62.3% of Liggett's unit volume for the nine months ended September 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

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 non-cash accelerated interest expense related to the converted debt of \$1,217 for the nine months ended September 30, 2011, on the conversion of the \$11,000 of Debentures into 719,256 shares of common stock. The debt conversion resulted in a reclassification from debt to equity in the amount of \$10,993.

Holders of our Debentures converted \$2 principal amount of the Debentures into 131 shares of our common stock in February 2012, \$31,370 principal amount into 2,053,065 shares of our common stock in June 2012, and \$24,406 principal amount into 1,597,290 shares of our common stock in September 2012. We recorded non-cash accelerated interest expense related to the converted debt of \$7,072 and \$14,960 for the three and nine months ended September 30, 2012. The debt conversion resulted in a reclassification from debt to equity in the amount of \$55,778. As of September 30, 2012, the principal amount of the Debentures outstanding was \$43,222.

The holders of our Debentures 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 to us on June 15, 2016.

New Valley Oaktree Chelsea Eleven, LLC. In April 2012, Chelsea closed on the two remaining residential units. All of the 54 residential units have been sold and the project has been completed. We received net distributions of \$8,439 and \$5,940 from New Valley Oaktree Chelsea Eleven LLC for the nine months ended September 30, 2012 and 2011, respectively. New Valley recorded equity income of \$0 and \$2,118 for the three and nine months ended September 30, 2012, related to New Valley Chelsea. New Valley recorded equity income of \$1,000 and \$3,000 for the three and nine months ended September 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. 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.

On September 28, 2012, all outstanding principal and interest was repaid and the note was retired. New Valley received a liquidating distribution of \$32,275 from the joint venture on September 28, 2012. New Valley recorded an equity income of \$7,651 and \$7,180 for the three and nine months ended September 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 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 to loss on its investment in 11 Beach Street Investor LLC is \$9,642 at September 30, 2012.

NV Maryland. In July 2012, New Valley invested \$5,000 for an approximate 33% interest in a joint venture that owns a 25% interest in a portfolio of approximately 5,500 apartment units primarily located in Baltimore County, Maryland. The investment is a variable interest entity; however, New Valley is not the primary beneficiary. New Valley will account for this investment under the equity method of accounting. New Valley's maximum exposure to loss as a result of its investment in NV Maryland is \$5,000 at September 30, 2012.

NV 701 Seventh Avenue. In August and September 2012, New Valley invested a total of \$7,800 for an approximate 15% interest in a joint venture that acquired property located at 701 Seventh Avenue in Times Square in Manhattan. The joint venture plans to redevelop the property for retail space and signage, as well as a site for a potential hotel. The investment closed in October 2012 and New Valley invested an additional \$1,420 at closing. New Valley may have additional future capital contributions of approximately \$14,000. The property, located on the northeast corner of Seventh Avenue and 47th Street, totals approximately 120,000 gross square feet and is a rectangular corner parcel currently occupied by two buildings. 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. As of September 30, 2012, the Company's maximum exposure to loss as a result of its investment in NV 701 Seventh Avenue was \$7,800.

Long-term Investments. We received a distribution of \$207 in June 2012 from a real estate partnership. We recognized a gain of \$135 in June 2012 related to the distribution. Two of our long-term investments liquidated and we received distributions of \$66,190 for the nine months ended September 30, 2011. We recognized a gain of \$2,221 and \$25,832 for the three and nine months ended September 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 September 30, 2012, there were approximately 5,079 Engle progeny cases, 65 individual suits, four 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 September 30, 2012, 12 Engle progeny cases involving Liggett 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 September 30, 2012, 30 Engle progeny cases, where Liggett is currently named as a defendant, were scheduled for trial through September 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 5,079 Engle progeny cases in both federal (2,016 cases) and state (3,063 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 6,594 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 nine months ended September 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 September 30		Nine Months Ended September 30	
	2012	2011	2012	2011
Revenues:				
Tobacco	\$272,783	\$288,995	\$806,983	\$840,553
Operating income:				
Tobacco	\$48,139	\$42,888	\$130,244	\$121,527
Real Estate	(1,054 )	(947 )	(782 )	(1,277 )
Corporate and other	(3,892 )	(4,086 )	(11,895 )	(12,952 )
Total operating income	\$43,193	\$37,855	\$117,567	\$107,298

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

Revenues. All of our revenues were from the Tobacco segment for the third 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 September 30, 2012, revenues were \$272,783 compared to \$288,995 for the three months ended September 30, 2011. Revenues declined

by 5.6% (\$16,212) primarily due to an unfavorable sales volume of \$31,884 (approximately 299.6 million units) offset by a favorable price variance of \$15,672 primarily related to increases in price of the PYRAMID.

**Cost of Goods Sold.** Our cost of goods sold declined from \$227,863 for the three months ended September 30, 2011 to \$203,749 for the three months ended September 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 \$141,473 for the three months ended September 30, 2011 to \$126,389 for the three months ended September 30, 2012 as a result of decreased unit sales volume of 10.7%. Tobacco and other manufacturing costs were \$32,108 and \$34,641 for the three months ended September 30, 2012 and 2011, respectively. Expenses under the MSA were \$33,727 and \$39,897 for the three months ended September 30, 2012 and 2011, respectively.

**Tobacco Gross Profit.** Tobacco gross profit was \$69,035 for the three months ended September 30, 2012 compared to \$61,132 for the three months ended September 30, 2011. This represented an increase of \$7,903 (12.9%) 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 47.2% in the 2012 period compared to gross profit of 41.4% in the 2011 period due to higher prices.

**Expenses.** Operating, selling, general and administrative expenses were \$25,841 for the three months ended September 30, 2012 compared to \$23,277 for the same period last year, an increase of \$2,564 (11.0%). Tobacco expenses were \$20,895 for the three months ended September 30, 2012 compared to \$18,244 for the same period in the prior year. This is an increase of \$2,651, 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 \$1,976 and \$1,498 for the three months ended September 30, 2012 and 2011, respectively. Expenses at the corporate level decreased from \$4,086 to \$3,892 due to the timing of expenses.

**Operating income.** Operating income was \$43,193 for the three months ended September 30, 2012 compared to \$37,855 for the same period last year, an increase of \$5,338 (14.1%). Tobacco segment operating income increased from \$42,888 in 2011 to \$48,139 in 2012 primarily due to higher prices in 2012. The real estate segment operating loss was \$1,054 and \$947 for the three months ended September 30, 2012 and 2011, respectively, related primarily to Escena's operations.

**Other income (expenses).** Other expenses were \$11,959 for the three months ended September 30, 2012 compared to expenses of \$7,855 for the same period last year. For the three months ended September 30, 2012, other expenses primarily consisted of interest expense of \$25,906 and accelerated interest expense related to the conversion of debt of \$7,072. This was offset by equity income on non-consolidated real estate businesses of \$12,874, income of \$6,040 from changes in fair value of derivatives embedded within convertible debt, gain on sale of investment securities available for sale of \$1,640, equity income on long-term investments of \$124 and interest and other income of \$341. For the three months ended September 30, 2011, other expenses primarily consisted of interest expense of \$25,421 and an equity loss on long-term investments of \$1,699, offset by a realized gain on liquidation of long-term investment of \$2,221, a realized gain on investments available for sale of \$6,017, income of \$4,386 from changes in fair value of derivatives embedded within convertible debt, equity income on nonconsolidated real estate businesses of \$6,496 and interest and other income of \$135.

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 increased from 7.50% at June 30, 2012 to 8.50% at September 30, 2012. The increase was primarily due to increasing spreads between corporate convertible debt and risk free investments. The yield (computed on a yield to worst call basis) increased from approximately 5.3% to approximately 5.7%. Further, the spread between the yield on subordinated debt and comparable risk free investments increased from approximately 2.2% to approximately 3.0% for the three months ended September 30, 2012. These changes significantly increased the discount rate of future cash flows used to compute the embedded derivative. Thus, these increases in interest rate spreads in debt markets as well as interest payments during the quarter caused us to recognize a gain of \$6,040 related to decreases in the embedded derivative for the three months ended September 30, 2012. The gain of \$4,386 from the embedded derivatives in the three months ended September 30, 2011, was primarily the result of increasing

spreads (from approximately 3.0% to approximately 3.3%) 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 September 30, 2012 was \$31,234 compared to \$30,000 for the three months ended September 30, 2011.

Income tax provision. The income tax provision was \$13,302 and \$12,451 for the three months ended September 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 September 30, 2012, our income tax provision 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 \$148. We recorded a benefit of approximately \$870 for the reduction of a previously established valuation allowance of a deferred tax asset for the three months ended September 30, 2011. The net deferred tax asset has been recognized for state tax net operating losses at Vector Tobacco Inc. after evaluating the impact of the negative and positive evidence that such asset would be realized.

#### Nine Months Ended September 30, 2012 Compared to Nine Months Ended September 30, 2011

Revenues. All of our revenues were from the Tobacco segment in the first nine 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 nine months ended September 30, 2012, revenues were \$806,983 compared to \$840,553 for the nine months ended September 30, 2011. Revenues declined by 4.0% (\$33,570) due to an unfavorable sales volume of \$74,721 (approximately 650.4 million units) offset by a favorable price variance of \$41,151 primarily related to increases in the price of PYRAMID.

Cost of Goods Sold. Our cost of goods sold declined from \$664,113 for the nine months ended September 30, 2011 to \$615,682 for the nine months ended September 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 \$412,041 for the nine months ended September 30, 2011 to \$379,281 for the nine months ended September 30, 2012 as a result of decreased unit sales volume of 7.9%. Tobacco and other manufacturing costs were \$96,262 and \$100,596 for the nine months ended September 30, 2012 and 2011, respectively. Expenses under the MSA were \$103,546 and \$114,782 for the nine months ended September 30, 2012 and 2011, respectively.

Tobacco gross profit. Tobacco gross profit was \$191,302 for the nine months ended September 30, 2012 compared to \$176,440 for the nine months ended September 30, 2011. The \$14,862 (8.4%) 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 44.7% in the 2012 period compared to gross profit of 41.2% in the 2011 period due to price increases.

Expenses. Operating, selling, general and administrative expenses were \$73,734 for the nine months ended September 30, 2012 compared to \$69,142 for the same period last year, an increase of \$4,592 (6.6%). Tobacco expenses were \$61,057 for the nine months ended September 30, 2012 compared to \$54,913 for the nine months ended September 30, 2011. The increase of \$6,144 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 \$6,006 and \$5,216 for the nine months ended September 30, 2012 and 2011, respectively. Expenses at the corporate segment declined from \$12,952 to \$11,895 in 2012 due to lower professional fees.

Operating income. Operating income was \$117,567 for the nine months ended September 30, 2012 compared to \$107,298 for the same period last year, an increase of \$10,269 (9.6%). For the nine months ended September 30, 2012, Tobacco segment operating income increased from \$121,527 in 2011 to \$130,244 in 2012 primarily due to increases in the price of PYRAMID in 2012. The real estate segment's operating loss was \$782 and \$1,277 for the nine months ended September 30, 2012 and 2011, respectively, primarily related to Escena's operations.

Other income (expenses). Other expenses were \$92,387 for the nine months ended September 30, 2012 compared to other income of \$3,570 for the same period last year. For the nine months ended September 30, 2012, other expenses primarily consisted of interest expense of \$78,667, a loss of \$21,020 from changes in fair value of derivatives embedded within convertible debt, accelerated interest expense related to the conversion of debt of \$14,960 and an equity loss on long-term investments of \$1,205. This was offset by equity income on non-consolidated real estate businesses of \$20,969, gain on sale of investment securities available for sale of \$1,640, and interest and other income of \$856. For the nine months ended September 30, 2011, other income primarily consisted of a realized gain on liquidation of long-term investment of \$25,832, income of \$13,248 from changes in fair value of derivatives embedded within convertible debt, equity income on non-consolidated real estate businesses of \$17,597, a realized gain on investments available for sale of \$20,558, a realized gain on sales of townhomes of \$3,722, and interest and other income of \$351. This income was offset by interest expense of \$75,431, an equity loss on long-term investments of \$1,090, 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 8.50% at September 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 September 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 5.7%. Further, the spread between the yield on subordinated debt and comparable risk free investments declined from approximately 3.4% to approximately 3.0% for the nine months ended September 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 \$21,020 related to increases in the embedded derivative for the nine months ended September 30, 2012. The gain of \$13,248 from the embedded derivatives in the nine months ended September 30, 2011, was primarily the result of increasing spreads between corporate senior secured debt and risk free investments offset by interest payments during the period.

Income before income taxes. Income before income taxes for the nine months ended September 30, 2012 was \$25,180 compared to \$110,868 for the nine months ended September 30, 2011.

Income tax provision. The income tax provision was \$11,043 for the nine months ended September 30, 2012, compared to \$43,645 for the nine months ended September 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 nine months ended September 30, 2012, our income tax provision 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 \$808. For the nine months ended September 30, 2012, our income tax provision was increased 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. We recorded a benefit of approximately \$870 for the reduction of a previously established valuation allowance of a deferred tax asset for the nine months ended September 30, 2011. The net deferred tax asset has been recognized for state tax net operating losses at Vector Tobacco Inc. after evaluating the impact of the negative and positive evidence that such asset would be realized.

#### Liquidity and Capital Resources

Net cash and cash equivalents decreased by \$23,667 for the nine months ended September 30, 2012 compared to an increase of \$28,586 for the nine months ended September 30, 2011.

Net cash provided from operations was \$97,245 and \$64,015 for the nine months ended September 30, 2012 and 2011, respectively. The change primarily 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 \$15,666 in the 2011 period. Trade accounts receivable declined by \$13,331 for the nine months ended September 30, 2012 due to the timing of receipts in September 2012 compared to December 2011. The changes related to trade accounts receivable increased cash flow from operations by \$28,997 in the 2012 period as compared to the 2011 period. The amount was offset by a higher payments under the Master Settlement Agreement in 2012 compared to 2011 as well as lower accruals under the Master Settlement Agreement due to lower unit sales in 2012.

Cash used in investing activities was \$3,653 for the nine months ended September 30, 2012 compared to cash provided by investing activities of \$92,117 for the nine months ended September 30, 2011. In the first nine months of 2012, cash used in investing activities was for purchase of real estate businesses of \$22,467, capital expenditures of \$8,268, 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 \$831, the issuance of notes receivable of \$355, and a increase in non-current restricted assets of \$1,126. This was offset by the proceeds from distributions from non-consolidated real estate businesses of \$31,221, the sale of investment securities of \$3,831, the proceeds from the sale of fixed assets of \$418, and proceeds from the sale or liquidation of long-term investments of \$72. In the first nine months of 2011, cash provided by investing activities was from the proceeds from the sale or maturity of investment securities of \$28,102, proceeds from the sale or liquidation of long-term investments of \$66,190, distributions from nonconsolidated real estate businesses of \$6,752, proceeds from the sales of townhomes of \$19,629, decrease in noncurrent restricted assets of \$738, and the proceeds from the sale of fixed assets of \$156. This was offset by cash used for the purchase of investment securities of \$2,847, purchase of real estate businesses of \$7,201, purchase of long-term investments of \$10,000, capital expenditures of \$8,469, an increase in cash surrender value of corporate owned life insurance policies of \$717, and the issuance of notes receivable of \$216.

Cash used in financing activities was \$117,259 and \$127,546 for the nine months ended September 30, 2012 and 2011, respectively. In the first nine months of 2012, cash was used for distributions on common stock of \$100,392, net repayments of debt under the revolver of \$15,318, repayment of debt of \$15,440 , and deferred financing costs of \$315. This was offset by proceeds from debt issuance of \$14,018, proceeds from the exercise of Vector options of \$140, and tax benefit of options exercised of \$48. In the first nine months of 2011, cash was used for distributions on common stock of \$92,987, net repayments of debt under the revolver of \$35,710 and repayment of debt of \$3,522 offset by proceeds from debt issuance of \$2,823, proceeds from the exercise of Vector options of \$1,029, and tax benefit of options exercised of \$821.

Liggett Credit Facility. In February 2012, Liggett and Wells Fargo Bank, National Association ("Wells Fargo") renewed the \$50,000 credit facility (the "Credit Facility"). 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 provided that Liggett may terminate the Credit Facility prior to March 8, 2015 at any time by giving at least 30 days prior written notice to Wells Fargo, and Wells Fargo may, at Well Fargo's option, terminate the Credit Facility at any time upon the occurrence and during the continuance of an Event of Default.

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 \$3,300 at September 30, 2012.

Liggett Term Loan Under Credit Facility. On February 21, 2012, Wells Fargo 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 September 30, 2012, \$10,406 was outstanding. Availability as determined under the Credit Facility was approximately \$39,594 based on eligible collateral at September 30, 2012. At September 30, 2012, management believed that Liggett was in compliance with all covenants under the credit facility; Liggett's EBITDA, as defined, were approximately \$159,290 for the twelve months ended September 30, 2012.

The verdict was affirmed on appeal and Liggett paid \$14,361 in June 2010. To date, seven other verdicts, exclusive of Lukacs, have been entered in Engle progeny cases against Liggett in the total amount of approximately \$15,600, 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	September 30, 2012	December 31, 2011
Consolidated EBITDA, as defined	\$50,000	\$222,973	\$226,554
Leverage ratio, as defined	<3.0 to 1	1.0 to 1	0.9 to 1
Secured leverage ratio, as defined	<1.5 to 1	0.6 to 1	0.5 to 1

We and our subsidiaries have significant indebtedness and debt service obligations. At September 30, 2012, we and our subsidiaries had total outstanding indebtedness with a total aggregate principal amount outstanding of approximately \$647,949.

Holders of our Debentures converted \$2 principal amount of the Debentures into 131 shares of our common stock in February 2012, \$31,370 principal amount into 2,053,065 shares of our common stock in June 2012, and \$24,406 principal amount into 1,597,290 shares of our common stock in September 2012. We recorded non-cash accelerated interest expense related to the converted debt of \$7,072 and \$14,960 for the three and nine months ended September 30, 2012. The debt conversion resulted in a reclassification from debt to equity in the amount of \$55,778. As of September 30, 2012, the principal amount of the Debentures outstanding was \$43,222.

The holders 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.

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 \$217,300, investment securities available for sale of approximately \$65,200, long-term investments with an estimated value of approximately \$23,900 and availability under Liggett's credit facility of approximately \$39,600 at September 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 September 30, 2012, approximately \$10,400 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 September 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 \$104.

In addition, as of September 30, 2012, approximately \$83,900 (\$200,752 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 \$3,106 with approximately \$156 resulting from the embedded derivative associated with our 6.75% Note due 2014, \$296 resulting from the embedded derivative associated with our 6.75% exchange notes due 2014, and the remaining \$2,654 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 \$5,720 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 \$89,106 and \$85,887. We recorded the fair market value of our embedded derivatives at the midpoint of the inputs at \$87,466 as of September 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 \$65,193 at September 30, 2012, which includes 13,891,205 shares of Ladenburg Thalmann Financial Services Inc. carried at \$18,336.

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 D.C. Circuit Court of Appeals heard oral argument in April 2012. On August 24, 2012, the appellate court affirmed the district court and vacated the graphic warning requirements. FDA filed a petition asking that the case be reheard en banc. 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,
- legislation and regulations,
- cash flows,
- operating performance,
- litigation,
- impairment charges and cost saving associated with restructurings of our tobacco operations, and
- related industry developments (including trends affecting our business, financial condition and results of operations).

We identify forward-looking statements in this report by using words or phrases such as “anticipate”, “believe”, “estimate”, “expect”, “intend”, “may be”, “objective”, “plan”, “seek”, “predict”, “project” and “will be” and similar words or phrases or their negatives.

The forward-looking information involves important risks and uncertainties that could cause our actual results, performance or achievements to differ materially from our anticipated results, performance or achievements expressed or implied by the forward-looking statements. Factors that could cause actual results to differ materially from those suggested by the forward-looking statements include, without limitation, the following:

- general economic and market conditions and any changes therein, due to acts of war and terrorism or otherwise,
- governmental regulations and policies,
- effects of industry competition,
- impact of business combinations, including acquisitions and divestitures, both internally for us and externally in the tobacco industry,
- impact of legislation on our competitors’ payment obligations, results of operations and product costs, i.e. the impact of federal legislation eliminating the federal tobacco quota system and providing for regulation of tobacco products by the FDA,
- impact of substantial increases in federal, state and local excise taxes,
- uncertainty related to product liability litigation including the Engle progeny cases pending in Florida; and,
- potential additional payment obligations for us under the MSA and other settlement agreements with the states.

Further information on the risks and uncertainties to our business include the risk factors discussed above in "Management's Discussion and Analysis of Financial Condition and Results of Operations" and under Item 1A, "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2011 filed with the Securities and Exchange Commission.

Although we believe the expectations reflected in these forward-looking statements are based on reasonable assumptions, there is a risk that these expectations will not be attained and that any deviations will be material. The forward-looking statements speak only as of the date they are made.

## ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The information under the caption “Management's Discussion and Analysis of Financial Condition and Results of Operations - Market Risk” is incorporated herein by reference.

#### ITEM 4. CONTROLS AND PROCEDURES

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we have evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report, and, based on their evaluation, our principal executive officer and principal financial officer have concluded that these controls and procedures are effective.

There were no changes in our internal control over financial reporting during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

#### PART II

#### OTHER INFORMATION

##### Item 1. Legal Proceedings

Reference is made to Note 5, incorporated herein by reference, to our condensed consolidated financial statements included elsewhere in this report which contains a general description of certain legal proceedings to which our company, or its subsidiaries are a party and certain related matters. Reference is also made to Exhibit 99.1 for additional information regarding the pending smoking-related legal proceedings to which Liggett or us is a party. A copy of Exhibit 99.1 will be furnished without charge upon written request to us at our principal executive offices, 100 S.E. Second St., 32<sup>nd</sup> Floor, Miami, Florida 33131, Attn. Investor Relations.

##### Item 1A. Risk Factors

Except as set forth below, there are no material changes from the risk factors set forth in Item 1A, "Risk Factors," of our Annual Report on 10-K, as amended, for the year ended December 31, 2011.

We have significant liquidity commitments

We have certain liquidity commitments that could require the use of our existing cash resources. As of September 30, 2012, our corporate expenditures (exclusive of Liggett, Vector Tobacco and New Valley) and other potential liquidity requirements over the next 12 months included the following:

- cash interest expense of approximately \$76.3 million,
- dividends on our outstanding common shares (currently at an annual rate of approximately \$142.0 million, and
- other corporate expenses and taxes.

In order to meet the above liquidity requirements as well as other liquidity needs in the normal course of business, we will be required to use cash flows from operations and existing cash and cash equivalents. Should these resources be insufficient to meet the upcoming liquidity needs, we may also be required to liquidate investment securities available for sale and other long-term investments, or, if available, draw on Liggett's credit facility. While there are actions we can take to reduce our liquidity needs, there can be no assurance that such measures can be achieved.

We and our subsidiaries have a substantial amount of indebtedness.

We and our subsidiaries have significant indebtedness and debt service obligations. At September 30, 2012, we and our subsidiaries had total outstanding indebtedness (including the embedded derivative liabilities related to our convertible notes) of \$647.9 million. Approximately \$157.5 million of our 6.75% convertible notes mature in 2014

and \$415 million of our 11% senior secured notes mature 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.



## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

No securities of ours which were not registered under the Securities Act of 1933 have been issued or sold by us during the three months ended September 30, 2012 except for approximately 4,142,378 shares of our common stock issued as a stock dividend on September 28, 2012.

## Issuer Purchases of Equity Securities

Our purchases of our common stock during the three months ended September 30, 2012 were as follows:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
July 1 to July 31, 2012	—	—	—	—
August 1 to August 31, 2012	—	—	—	—
September 1 to September 30, 2012	72,529	(1) 17.59	(1) —	—
Total	72,529	\$17.59	—	—

Delivery of shares to us in payment of tax withholding in connection with an employee's vesting in restricted stock.

(1) The shares were immediately canceled. The number of shares and average price paid per share have not been adjusted for the impact of our 5% stock dividend, payable on September 28, 2012.

Item 6. Exhibits

- 10.1 Office Lease, dated as of September 10, 2012, between Vector Group Ltd. and Frost Real Estate Holdings, LLC. (incorporated by reference to Exhibit 10.1 in Vector's Form 8-K dated September 10, 2012).
- 12.1 Computation of Ratio of Earnings to Fixed Charges for each of the five years within the period ended December 31, 2011 and for each of the nine months within the periods ended September 30, 2012 and 2011.
- 31.1 Certification of Chief Executive Officer, Pursuant to Exchange Act Rule 13a-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer, Pursuant to Exchange Act Rule 13a-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer, Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Chief Financial Officer, Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 99.1 Material Legal Proceedings
- 101.INS XBRL Instance Document
- 101.SCH XBRL Taxonomy Extension Schema
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase
- 101.DEF XBRL Taxonomy Extension Definition Linkbase
- 101.LAB XBRL Taxonomy Extension Label Linkbase
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase

SIGNATURE

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned thereunto duly authorized.

VECTOR GROUP LTD.  
(Registrant)

By: /s/ J. Bryant Kirkland III  
J. Bryant Kirkland III  
Vice President, Treasurer and  
Chief Financial Officer

Date: October 31, 2012