

VECTOR GROUP LTD  
Form 10-Q  
November 03, 2011

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, 2011

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

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

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

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

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

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

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(Do not check if a smaller  
reporting company)

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

At November 3, 2011, Vector Group Ltd. had 79,442,674 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, 2011	December 31, 2010
<b>ASSETS:</b>		
Current assets:		
Cash and cash equivalents	\$328,411	\$299,825
Investment securities available for sale	58,935	78,754
Accounts receivable - trade	17,516	1,849
Inventories	110,539	107,079
Deferred income taxes	38,249	31,786
Restricted assets	1,477	2,661
Other current assets	4,272	4,809
Total current assets	559,399	526,763
Property, plant and equipment, net	55,898	55,412
Investment in Escena, net	13,243	13,354
Long-term investments accounted for at cost	5,675	46,033
Long-term investments accounted for under the equity method	16,863	10,954
Investments in non-consolidated real estate businesses	92,146	80,416
Investments in townhomes	—	16,275
Restricted assets	8,789	8,694
Deferred income taxes	28,013	37,828
Intangible asset	107,511	107,511
Prepaid pension costs	15,098	13,935
Other assets	28,317	32,420
Total assets	\$930,952	\$949,595
<b>LIABILITIES AND STOCKHOLDERS' DEFICIENCY:</b>		
Current liabilities:		
Current portion of notes payable and long-term debt	\$26,864	\$51,345
Current portion of fair value of derivatives embedded within convertible debt	77,176	480
Current portion of employee benefits	1,014	1,014
Accounts payable	5,572	9,027
Accrued promotional expenses	16,158	14,327
Income taxes payable, net	6,105	11,617
Accrued excise and payroll taxes payable, net	3,584	18,523
Settlement accruals	117,668	48,071
Deferred income taxes	29,565	36,963
Accrued interest	9,346	20,824
Other current liabilities	13,764	14,681
Total current liabilities	306,816	226,872
Notes payable, long-term debt and other obligations, less current portion	490,729	506,052
Fair value of derivatives embedded within convertible debt	51,060	141,012
Non-current employee benefits	39,665	38,742
Deferred income taxes	58,878	51,815
Other liabilities	50,474	31,336
Total liabilities	997,622	995,829
Commitments and contingencies		
Stockholders' deficiency:		

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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, 83,023,495 and 78,349,590 shares issued and 79,442,674 and 74,939,284 shares outstanding	7,944	7,494
Additional paid-in capital	—	—
Accumulated deficit	(56,593	) (45,327 )
Accumulated other comprehensive (loss) income	(5,164	) 4,456 )
Less: 3,580,821 and 3,410,306 shares of common stock in treasury, at cost	(12,857	) (12,857 )
Total stockholders' deficiency	(66,670	) (46,234 )
Total liabilities and stockholders' deficiency	\$930,952	\$949,595

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,	
	2011	2010	2011	2010
Revenues*	\$288,995	\$295,124	\$840,553	\$785,671
Expenses:				
Cost of goods sold*	227,863	239,160	664,113	620,065
Operating, selling, administrative and general expenses	23,277	26,088	69,142	69,274
Litigation judgment expense	—	—	—	14,361
Operating income	37,855	29,876	107,298	81,971
Other income (expenses):				
Interest expense	(25,421 )	(21,511 )	(75,431 )	(61,086 )
Change in fair value of derivatives embedded within convertible debt	4,386	1,660	13,248	12,735
Loss on extinguishment of debt	—	—	(1,217 )	—
Equity income from non-consolidated real estate businesses	6,496	7,060	17,597	18,838
Equity (loss) income on long-term investments	(1,699 )	(436 )	(1,090 )	2,334
Gain on sale of investment securities available for sale	6,017	708	20,558	11,819
Gain on liquidation of long-term investments	2,221	—	25,832	—
Gain on sales of townhomes	10	—	3,722	—
Other, net	135	179	351	387
Income before provision for income taxes	30,000	17,536	110,868	66,998
Income tax expense	12,451	6,629	43,645	24,930
Net income	\$17,549	\$10,907	\$67,223	\$42,068
Per basic common share:				
Net income applicable to common shares	\$0.22	\$0.14	\$0.84	\$0.53
Per diluted common share:				
Net income applicable to common shares	\$0.21	\$0.14	\$0.82	\$0.52
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 \$141,473, \$150,413, \$412,041 and \$396,823, 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 STOCKHOLDERS' DEFICIENCY  
(Dollars in Thousands, Except Share Amounts)  
Unaudited

	Common Stock		Additional Paid-In		Accumulated	Treasury	
	Shares	Amount	Capital	Deficit	Other Comprehensive (Loss) Income	Stock	Total
Balance, December 31, 2010	74,939,284	\$7,494	\$ —	\$ (45,327 )	\$ 4,456	\$(12,857)	\$(46,234 )
Net income	—	—	—	67,223	—	—	67,223
Pension-related minimum liability adjustments, net of income taxes	—	—	—	—	1,391	—	1,391
Forward contract adjustments, net of income taxes	—	—	—	—	30	—	30
Unrealized gain on long-term investment securities, accounted for under the equity method, net of income taxes	—	—	—	—	(1,790 )	—	(1,790 )
Change in net unrealized gain on investment securities, net of income taxes	—	—	—	—	2,960	—	2,960
Net unrealized gains reclassified into net income, net of income taxes	—	—	—	—	(12,211 )	—	(12,211 )
Unrealized gain on investment securities, net of income taxes	—	—	—	—	—	—	(9,251 )
Total other comprehensive income	—	—	—	—	—	—	(9,620 )
Total comprehensive income	—	—	—	—	—	—	57,603
Distributions and dividends on common stock	—	—	(14,409)	(78,111 )	—	—	(92,520 )
Effect of stock dividend	3,782,308	378	—	(378 )	—	—	—
Note conversion	652,386	65	12,150	—	—	—	12,215
Exercise of employee stock options, net of 300,799 shares to pay exercise price	181,125	18	1,011	—	—	—	1,029
Surrender of shares in connection with employee stock option exercise and restricted stock vesting	(112,429 )	(11 )	(1,950)	—	—	—	(1,961 )
Tax benefit of employee stock options exercised	—	—	821	—	—	—	821
Amortization of deferred compensation	—	—	2,377	—	—	—	2,377
Balance, as of September 30, 2011	79,442,674	\$7,944	\$ —	\$ (56,593 )	\$ (5,164 )	\$(12,857)	\$(66,670 )



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

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

	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010	
Net cash provided by operating activities	\$64,015	\$ 101,063	
Cash flows from investing activities:			
Sale of investment securities	28,102	16,140	
Purchase of investment securities	(2,847	) (9,394	)
Proceeds from sale or liquidation of long-term investments	66,190	1,106	
Purchase of long-term investments	(10,000	) (5,062	)
Investments in non-consolidated real estate businesses	(7,201	) (4,033	)
Purchase of Aberdeen mortgages	—	(13,462	)
Distributions from non-consolidated real estate businesses	6,752	3,539	
Proceeds from sale of townhomes, net	19,629	—	
Increase in cash surrender value of life insurance policies	(717	) (918	)
Decrease in restricted assets	738	384	
Issuance of notes receivable	(216	) (720	)
Cash acquired in Aberdeen consolidation	—	473	
Proceeds from sale of fixed assets	156	187	
Capital expenditures	(8,469	) (15,730	)
Net cash provided by (used in) investing activities	92,117	(27,490	)
Cash flows from financing activities:			
Proceeds from debt issuance	2,823	89,373	
Deferred financing costs	—	(2,582	)
Repayments of debt	(3,522	) (7,175	)
Borrowings under revolver	769,247	732,708	
Repayments on revolver	(804,957	) (750,091	)
Dividends and distributions on common stock	(92,987	) (87,797	)
Proceeds from exercise of employee stock options	1,029	980	
Tax benefit of employee stock options exercised	821	121	
Net cash used in financing activities	(127,546	) (24,463	)
Net increase in cash and cash equivalents	28,586	49,110	
Cash and cash equivalents, beginning of period	299,825	209,454	
Cash and cash equivalents, end of period	\$328,411	\$258,564	

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 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, 2010 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 2010 financial information to conform to the 2011 presentation.

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

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

### (c) Earnings Per Share (“EPS”):

Information concerning the Company's common stock has been adjusted to give retroactive effect to the 5% stock dividend paid to Company stockholders on September 29, 2011 and 2010. The dividends were recorded at par value of \$378 and \$357 since the Company did not have retained earnings at September 30, 2011 and 2010, respectively. All per share amounts have been updated to reflect the retrospective effect of the stock dividends.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Net income	\$17,549	\$10,907	\$67,223	\$42,068
Income attributable to participating securities	(359	) (228	) (1,390	) (897

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Net income available to common stockholders	\$17,190	\$10,679	\$65,833	\$41,171
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Net income for purposes of determining diluted EPS was as follows:

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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,	
	2011	2010	2011	2010
Net income	\$17,549	\$10,907	\$67,223	\$42,068
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	2,009
Expense attributable to 6.75% Variable Interest Senior Convertible Exchange Notes	—	—	—	3,770
Income attributable to participating securities	(373 )	(228 )	(1,548 )	(1,020 )
Net income available to common stockholders	\$17,856	\$10,679	\$73,277	\$46,827

Basic and diluted EPS were calculated using the following shares:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2011	2010	2011	2010
Weighted-average shares for basic EPS	79,014,736	78,068,346	78,544,795	78,016,140
Plus incremental shares related to stock options and non-vested restricted stock	610,007	487,136	502,195	298,497
Plus incremental shares related to convertible debt	6,170,670	—	10,431,063	11,144,039
Weighted-average shares for fully diluted EPS	85,795,413	78,555,482	89,478,053	89,458,676

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, 2011 and 2010 but were not included in the computation of diluted EPS.

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2011	2010	2011	2010
Number of stock options	10,560	273,335	10,560	671,900
Weighted-average exercise price	\$23.83	\$20.03	\$23.83	\$16.19
Weighted-average shares of non-vested restricted stock	N/A	N/A	N/A	22,413
Weighted-average expense per share	N/A	N/A	N/A	\$15.26
Weighted-average number of shares issuable upon conversion of debt	11,144,039	18,000,339	7,295,549	6,856,301
Weighted-average conversion price	\$14.14	\$14.87	\$14.74	\$16.05

## (d) Comprehensive Income:

Other comprehensive income is a component of stockholders' equity and includes such items as the unrealized gains and losses on investment securities available for sale, forward foreign contracts and minimum pension liability adjustments. The Company's comprehensive income was \$14,639 and \$57,603 for the three and nine months ended

September 30, 2011, respectively. The Company's comprehensive income was \$10,885 and \$52,348 for the three and nine months ended September 30, 2010, respectively.

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VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

(e) 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 \$125,889 and \$130,670. The Company recorded the fair market value of its embedded derivatives at the midpoint of the inputs at \$128,236 as of September 30, 2011. At December 31, 2010, the range of estimated fair market values of the Company's embedded derivatives was between \$138,701 and \$144,391. The Company recorded the fair market value of its embedded derivatives at the midpoint of the inputs at \$141,492 as of December 31, 2010. The estimated fair market value of the Company's embedded derivatives could change significantly based on future market conditions. (See Note 4.)

(f) New Accounting Pronouncements:

In January 2010, the FASB issued authoritative guidance intended to improve disclosure about fair value measurements. The guidance requires entities to disclose significant transfers in and out of fair value hierarchy levels and the reasons for the transfers and to present information about purchases, sales, issuances, and settlements separately in the reconciliation of fair value measurements using significant unobservable inputs (Level 3). Additionally, the guidance clarifies that a reporting entity should provide fair value measurements for each class of assets and liabilities and disclose the inputs and valuation techniques used for fair value measurements using significant other observable inputs (Level 2) and significant unobservable inputs (Level 3). This guidance is effective for interim and annual periods beginning after December 15, 2009 except for the disclosure about purchases, sales, issuances and settlements in the Level 3 reconciliation, which will be effective for interim and annual periods beginning after December 15, 2010. As this guidance provides only disclosure requirements, the adoption of this guidance did not impact the Company's condensed consolidated financial statements.

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 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. The implementation of this amended accounting guidance is not expected to have a material impact on the Company's consolidated financial position and results of operations.

In April 2011, the FASB issued authoritative guidance to clarify when a restructuring constitutes a troubled debt restructuring. In evaluating whether a restructuring constitutes a troubled debt restructuring, a creditor must separately conclude that two conditions exist: (1) the restructuring constitutes a concession and (2) the debtor is experiencing financial difficulties. The guidance became effective for interim and annual reporting periods beginning after June 15,

2011 and will be applied retrospectively to the beginning of the annual period of adoption. The adoption of this guidance did not impact the Company's condensed consolidated financial statements.

In June 2011, the FASB issued authoritative guidance that will be included in ASC Topic 220, "Comprehensive Income". This guidance eliminates the option to report other comprehensive income and its components in the statement of changes in equity. Companies can elect to present items of net income and other comprehensive income in one continuous statement or in two separate, but consecutive, statements. The Company is currently evaluating which method it will utilize to present items of net income and other comprehensive income. This



VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

presentation guidance is effective for the Company on January 1, 2012.

In September 2011, the FASB issued Accounting Standards Update (“ASU”) 2011-08, “Intangibles — Goodwill and Other” (“ASU No. 2011-08”). ASU No. 2011-08 amends current guidance to allow an entity to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test. Under this amendment an entity would not be required to calculate the fair value of a reporting unit unless the entity determines, based on a qualitative assessment, that it is more likely than not that its fair value is less than its carrying amount. ASU No. 2011-08 applies to all companies that have goodwill reported in their financial statements. The provisions of ASU No. 2011-08 are effective for reporting periods beginning after December 15, 2011. The implementation of this amended accounting guidance is not expected to have a material impact on the Company’s consolidated financial position and results of operations.

## 2. INVENTORIES

Inventories consist of:

	September 30, 2011	December 31, 2010
Leaf tobacco	\$63,833	\$54,479
Other raw materials	4,116	4,073
Work-in-process	211	2,067
Finished goods	67,569	67,773
Inventories at current cost	135,729	128,392
LIFO adjustments	(25,190	) (21,313
	\$110,539	\$107,079

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, 2011, Liggett had leaf tobacco purchase commitments of approximately \$24,640.

All of the Company’s inventories at September 30, 2011 and December 31, 2010 have been reported under the LIFO method.

## 3. LONG-TERM INVESTMENTS

Long-term investments accounted for at cost:

	September 30, 2011		December 31, 2010	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Investment partnerships	\$4,776	\$7,589	\$45,134	\$70,966

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Real estate partnership	899	1,275	899	1,136
Investments accounted for at cost	\$5,675	\$8,864	\$46,033	\$72,102

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:

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## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

In April 2011, the Company invested \$10,000 in an investment partnership with an underlying investment in a hedge fund. The Company accounts for this investment and an investment in another limited partnership under the equity method.

The Company had an equity loss of \$1,699 and \$436 related to the limited partnerships accounted for under the equity method for the three months ended September 30, 2011 and 2010, respectively. The Company recorded an equity loss of \$1,090 and equity income of \$2,334 related to the limited partnership for the nine months ended September 30, 2011 and 2010, respectively.

The carrying value of the investments was approximately \$16,863 as of September 30, 2011 which approximated the investments' fair value. The carrying value of the investment was \$10,954 as of December 31, 2010 which approximated the investment's fair value.

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

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

	September 30, 2011	December 31, 2010
Vector:		
11% Senior Secured Notes due 2015, net of unamortized discount of \$630 and \$730	\$414,370	\$414,270
6.75% Variable Interest Senior Convertible Note due 2014, net of unamortized discount of \$36,542 and \$38,353*	13,458	11,647
6.75% Variable Interest Senior Convertible Exchange Notes 2014, net of unamortized discount of \$59,282 and \$64,713*	48,248	42,817
3.875% Variable Interest Senior Convertible Debentures due 2026, net of unamortized discount of \$82,849 and \$83,060*	16,151	26,940
Liggett:		
Revolving credit facility	—	35,710
Term loan under credit facility	5,822	6,222
Equipment loans	18,939	19,030
Other	605	761
Total notes payable, long-term debt and other obligations	517,593	557,397
Less:		
Current maturities	(26,864	) (51,345
Amount due after one year	\$490,729	\$506,052

\* The fair value of the derivatives embedded within the 6.75% Variable Interest Convertible Note (\$17,636 at September 30, 2011 and \$20,219 at December 31, 2010, respectively), the 6.75% Variable Interest Senior Convertible Exchange Notes (\$33,424 at September 30, 2011 and \$38,324 at December 31, 2010, respectively), and the 3.875% Variable Interest Senior Convertible Debentures (\$77,176 at September 30, 2011 and \$82,949 at December 31, 2010, respectively) is separately classified as a derivative liability in the condensed consolidated balance sheets.

Revolving Credit Facility - Liggett:

Liggett has a \$50,000 credit facility with Wachovia Bank, N.A. (“Wachovia”), none of which was outstanding at September 30, 2011. Availability as determined under the facility was approximately \$36,000 based on eligible collateral at September 30, 2011.

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

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## VECTOR GROUP LTD.

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

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Secured Notes”). The Senior Secured Notes were sold in August 2007 (\$165,000), September 2009 (\$85,000), April 2010 (\$75,000) and December 2010 (\$90,000) in private offerings to qualified institutional investors in accordance with Rule 144A of the Securities Act of 1933.

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

## 3.875% Variable Interest Senior Convertible Notes 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 on June 15, 2011. Other than the holders of \$7 principal amount of the Notes, who had 10% of their aggregate principal amount of Notes 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 a loss of \$0 and \$1,217 for the three and nine months ended September 30, 2011, on the conversion of the \$11,000 of notes into 685,005 shares of common stock. The debt conversion resulted in a non-cash financing transaction of \$10,993. The holders have the option to put all of the remaining senior convertible notes on June 15, 2012. Accordingly, the Company reclassified the remaining Notes and related fair value of derivatives embedded within convertible debt to current liabilities.

## Non-cash Interest Expense - Vector:

Components of non-cash interest expense are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Amortization of debt discount	\$2,709	\$2,033	\$7,551	\$5,481
Amortization of deferred finance costs	1,123	1,276	4,004	3,418
Loss on 3.875% Variable Interest Senior Convertible Debentures mandatorily redeemed	—	—	1,217	—
	\$3,832	\$3,309	\$12,772	\$8,899

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

	September 30, 2011		December 31, 2010	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Notes payable and long-term debt	\$517,593	\$754,185	\$557,397	\$827,247

## 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.

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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) 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 (iii) 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, 2011 and 2010, Liggett incurred legal expenses and other litigation costs totaling approximately \$5,216 and \$22,418 (which included \$14,361 for the Lukacs case, discussed below), respectively.

Litigation is subject to uncertainty and it is possible that there could be adverse developments in pending or future cases. An unfavorable outcome or settlement of pending tobacco-related litigation could encourage the commencement of additional litigation. Damages claimed in some tobacco-related litigation are or can be significant.

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. Liggett has secured approximately \$4,308 in bonds as of September 30, 2011.

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. The legislation applies to judgments entered after the effective date of the legislation. Plaintiffs 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. Although the Company cannot predict the outcome of such challenges, it is possible that the Company's financial position, results of operations, or cash flows could be materially affected by an unfavorable outcome of such challenges.

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.

Although the Company and Liggett have generally been successful in managing litigation, litigation is subject to uncertainty and significant challenges remain, particularly with respect to the Engle progeny cases. Adverse verdicts have been rendered against Liggett in the past, in individual cases and Engle progeny cases, and several of these verdicts have been affirmed on appeal. It is possible that the consolidated results of operations, cash flows or financial

position of the Company could be materially adversely affected by an unfavorable outcome or settlement of certain pending 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. However, Liggett may enter into settlement discussions in particular cases if it believes it is in its best interest to do so.

#### Individual Actions

As of September 30, 2011, there were 33 individual cases pending against Liggett and/or the Company, where one or more individual plaintiffs allege injury resulting from cigarette smoking, addiction to cigarette smoking



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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 cases, by state, that are pending against Liggett or its affiliates as of September 30, 2011 (excluding Engle progeny cases in Florida and the consolidated cases in West Virginia):

State	Number of Cases
Florida	16
New York	9
Louisiana	3
Missouri	2
West Virginia	2
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 cases 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.

Liggett Only Cases. There are currently seven 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.

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 March 2011. 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* and *Katz v. R.J. Reynolds*, both 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, in which Liggett is the only tobacco company defendant, are dormant.

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." As of September 30, 2011, Liggett and the Company are defendants in 5,771 *Engle* progeny cases in both federal (2,755 cases) and state (3,016 cases) courts in Florida. Other cigarette manufacturers are also named as defendants in these

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cases, although as a case proceeds, one or more defendants may ultimately be dismissed from the action. These cases include approximately 8,000 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.

As of September 30, 2011, 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. Judgment has been paid and the case is concluded. See “Lukacs Case” description below.
August 2009	Campbell v. R.J. Reynolds	Escambia	\$156	None	Affirmed on appeal. Defendants filed a Motion with DCA for certification to FL Sup. Ct., which was denied by the court on May 13, 2011. Defendants sought review by the FL Sup. Ct., which was denied.
March 2010	Douglas v. R.J. Reynolds	Hillsborough	\$1,350	None	On appeal. Argument on the merits of the appeal was heard on October 4, 2011.
April 2010	Clay v. R.J. Reynolds	Escambia	\$349	\$1,000	On appeal.
April 2010	Putney v. R.J. Reynolds	Broward	\$3,008	None	On appeal.
April 2011	Tullo v. R.J. Reynolds	Palm Beach	\$225	None	On appeal.

Through September 30, 2011, there were 35 plaintiffs' verdicts in Engle progeny cases, including the six against Liggett referenced above, and 16 defense verdicts, excluding several cases which were either dismissed by the court on summary judgment or where a mistrial was declared. For further information on the Engle case and on Engle progeny cases, see “Class Actions -- Engle Case,” below.

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

## Class Actions

As of September 30, 2011, there were six 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.

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

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several findings adverse to the defendants including that defendants' conduct “rose to a level that would permit a potential award or entitlement to punitive damages.” Phase II of the trial was a causation and damages trial for three of the class plaintiffs and a punitive damages trial on a class-wide basis before the same jury that returned the verdict in Phase I. In April 2000, the jury awarded compensatory damages of \$12,704 to the three class plaintiffs, to be reduced in proportion to the respective plaintiff's fault. In July 2000, the jury awarded approximately \$145,000,000 in punitive damages, including \$790,000 against Liggett.

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

In July 2006, the Florida Supreme Court affirmed the decision vacating the punitive damages award and held that the class should be decertified prospectively, but determined that the following Phase I findings are entitled to res judicata effect in Engle progeny cases: (i) that smoking causes lung cancer, among other diseases; (ii) that nicotine in cigarettes is addictive; (iii) that defendants placed cigarettes on the market that were defective and unreasonably dangerous; (iv) that defendants concealed material information knowing that the information was false or misleading or failed to disclose a material fact concerning the health effects or addictive nature of smoking; (v) that defendants agreed to conceal or omit information regarding the health effects of cigarettes or their addictive nature with the intention that smokers would rely on the information to their detriment; (vi) that defendants sold or supplied cigarettes that were defective; and (vii) that defendants were negligent. The Florida Supreme Court decision also allowed former class members to proceed to trial on individual liability issues (using the above findings) and compensatory and punitive damage issues, provided they filed their individual lawsuits by January 2008. In December 2006, the Florida Supreme Court added the finding that defendants sold or supplied cigarettes that, at the time of sale or supply, did not conform to the representations made by defendants. In October 2007, the United States Supreme Court denied defendants' petition for writ of certiorari. As a result of the Engle decision, approximately 8,000 plaintiffs have claims pending against the Company and Liggett and other cigarette manufacturers.

Three federal district courts (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. In December 2010, stays were lifted in 12 cases selected by plaintiffs, two of which were subsequently re-stayed. Liggett is a defendant in two of the ten cases. In August 2011, the court ordered the activation of an additional 22 cases. Liggett is a defendant in 14 of the 22 cases.

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. This matter may be subject to review by the United States Supreme Court. This decision could lead to other adverse rulings by state appellate courts.

In *Jimmie Lee Brown*, another 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

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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, which was denied in October 2011.

In the Rey case, another state court Engle progeny case pending against all Engle defendants and the Company, the trial court entered final summary judgment on all claims in favor of the moving defendants, the Company, Liggett and Lorillard (the "Moving Defendants") based on what has been referred to in the progeny litigation as the "Liggett Rule." The Liggett Rule stands for the proposition that a manufacturer cannot have liability to a smoker under any asserted claim if the smoker did not use a product manufactured by that particular defendant. The Liggett Rule is based on the entry of final judgment in favor of Liggett/Brooke Group in Engle on all of the claims asserted against them by class representatives Mary Farnan and Angie Della Vecchia, even though the Florida Supreme Court upheld as res judicata the generic finding that Liggett/Brooke Group engaged in a conspiracy to commit fraud by concealment. In September 2011, the Third District Court of Appeal affirmed in part and reversed in part holding that the Moving Defendants were entitled to summary judgment on all claims asserted against them other than the claim for civil conspiracy. The Moving Defendants have filed motions for rehearing. This issue is also pending and fully briefed before the Fifth District Court of Appeal in other progeny cases in which summary judgment was granted in favor of non-use defendants.

Other Class Actions. 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. Discovery is ongoing. In November 2010, defendants filed a motion for summary judgment. In addition to joining that summary judgment motion, Liggett filed its own summary judgment motion in June 2011. Briefing is complete.

Class action suits have been filed in a number of states against cigarette manufacturers, alleging, among other things, that use of the terms "light" and "ultra light" 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 case was returned to the federal court in Maine and consolidated with other federal cases. In June 2011, plaintiffs voluntarily dismissed the case without prejudice after the district court denied plaintiffs' motion for class certification. The Good decision has resulted in the filing of additional "lights" class action cases in other states against other cigarette manufacturers. Although Liggett was not a defendant in the Good case, and is not a defendant in most of the 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 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 is now concluded.

In February 1998, in *Parsons v. AC & S Inc.*, a case pending in West Virginia, the personal injury 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 unspecified damages. The case has been stayed as a result of the December 2000 bankruptcy of three of the defendants.

In June 1998, in *Cleary v. Philip Morris*, a putative class action was brought in Illinois state court on behalf of persons who were allegedly injured by: (i) defendants' purported conspiracy to conceal material facts regarding the addictive nature of nicotine; (ii) defendants' alleged acts of targeting their advertising and marketing to minors; and (iii) defendants' claimed breach of the public's right to defendants' compliance with laws prohibiting the



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distribution of cigarettes to minors. Plaintiffs sought disgorgement of all profits unjustly received through defendants' sale of cigarettes to plaintiffs and the class. In March 2009, plaintiffs filed a third amended complaint adding, among other things, allegations regarding defendants' sale of "lights" cigarettes. The case was then removed to federal court on the basis of this new claim. In November 2009, plaintiffs filed a revised motion for class certification as to the three proposed classes, which motion was denied by the court. In February 2010, the court granted summary judgment in favor of defendants as to all claims, other than a "lights" claim involving another cigarette manufacturer. The court granted leave to the plaintiffs to reinstate the motion as to the addiction claims. Plaintiffs filed a Fourth Amended Complaint in an attempt to resurrect their addiction claims. In June 2010, the court granted defendants' motion to dismiss the Fourth Amended Complaint and in July 2010, the court denied plaintiffs' motion for reconsideration. In August 2011, the United States Court of Appeals for the Seventh Circuit affirmed the district court's decision. In September 2011, plaintiffs petitioned for rehearing en banc.

In April 2001, in *Brown v. Philip Morris USA*, a California state court granted in part plaintiffs' motion for class certification and certified a class comprised of adult residents of California who smoked at least one of defendants' cigarettes "during the applicable time period" and who were exposed to defendants' marketing and advertising activities in California. In March 2005, the court granted defendants' motion to decertify the class based on a recent change in California law. In June 2009, the California Supreme Court reversed and remanded the case to the trial court for further proceedings regarding whether the class representatives have, or can, demonstrate standing. In August 2009, the California Supreme Court denied defendants' rehearing petition and issued its mandate. In September 2009, plaintiffs sought reconsideration of the court's September 2004 order finding that plaintiffs' allegations regarding "lights" cigarettes are preempted by federal law, in light of the United States Supreme Court decision in *Good*. In March 2010, the trial court granted reconsideration of its September 2004 order granting partial summary judgment to defendants with respect to plaintiffs' "lights" claims on the basis of judicial decisions issued since its order was issued, including *Good*, thereby reinstating plaintiffs' "lights" claims. Since the trial court's prior ruling decertifying the class was reversed on appeal by the California Supreme Court, the parties and the court are treating all claims currently being asserted by the plaintiffs as certified, subject, however, to defendants' challenge to the class representatives standing to assert their claims. In December 2010, defendants filed a motion for a determination that the class representatives set forth in plaintiffs' tenth amended complaint lacked standing to pursue the claims. The motion was granted by the court. Plaintiffs moved to file an amended complaint adding new class representatives, which motion was granted by the court and in July 2011, plaintiffs filed their eleventh amended complaint adding new putative class representatives. Defendants will file their response on or before November 10, 2011. Oral argument is scheduled for January 24, 2012 to consider the defendants' challenge to the new class representatives. A trial date has been scheduled for September 14, 2012.

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 on October 17, 2011. If the case were to proceed against Liggett, it is estimated that Liggett could be a defendant in approximately 100 of the individual cases.

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, 2011, there was one Health Care Cost Recovery Action pending against Liggett, but this case is inactive. Other cigarette manufacturers are also named as defendants. The claims asserted in health care cost recovery actions vary. Although, typically, no specific damage amounts 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.

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

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

In August 2006, the trial court entered a Final Judgment against each of the cigarette manufacturing defendants, except Liggett. In May 2009, the United States Court of Appeals for the District of Columbia affirmed most of the district court's decision. In February 2010, the government and all defendants, other than Liggett, filed petitions for writ of certiorari to the United States Supreme Court. In June 2010, the United States Supreme Court, without comment, denied review. As a result, the cigarette manufacturing defendants, other than Liggett, are now subject to the trial court's Final Judgment which ordered the following relief: (i) an injunction against “committing any act of racketeering” relating to the manufacturing, marketing, promotion, health consequences or sale of cigarettes in the United States; (ii) an injunction against participating directly or indirectly in the management or control of the Council for Tobacco Research, the Tobacco Institute, or the Center for Indoor Air Research, or any successor or affiliated entities of each (iii) an injunction against “making, or causing to be made in any way, any material false, misleading, or deceptive statement or representation or engaging in any public relations or marketing endeavor that is disseminated to the United States public and that misrepresents or suppresses information concerning cigarettes”; (iv) an injunction against conveying any express or implied health message through use of descriptors on cigarette packaging or in cigarette advertising or promotional material, including “lights,” “ultra lights,” and “low tar,” which the court found could cause consumers to believe one cigarette brand is less hazardous than another brand; (v) the issuance of “corrective statements” in various media regarding the adverse health effects of smoking, the addictiveness of smoking and nicotine, the lack of any significant health benefit from smoking “low tar” or “light” 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.

In June 2005, the Jerusalem District Court in Israel added Liggett as a defendant in an action commenced in 1998 by the largest private insurer in that country, General Health Services, against the major United States cigarette

manufacturers. The plaintiff seeks to recover the past and future value of the total expenditures for health care services provided to residents of Israel resulting from tobacco related diseases, court ordered interest for past expenditures from the date of filing the statement of claim, increased and/or punitive and/or exemplary damages and costs. The court ruled that, although Liggett had not sold product in Israel since at least 1978, it might still have liability for cigarettes sold prior to that time. In July 2011, the Israeli Supreme Court rejected the plaintiff's claims. Although the plaintiff requested a rehearing with an extended panel of justices, Liggett was dismissed from the action.

In *Crow Creek Sioux Tribe v. American Tobacco Company*, a South Dakota case filed in 1997, the plaintiff seeks to recover damages based on various theories of recovery as a result of alleged sales of tobacco products to minors. There has been no activity in this case.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

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#### Upcoming Trials

As of September 30, 2011, there were 49 Engle progeny cases scheduled for trial through September 30, 2012. 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 the action. No other cases are currently scheduled for trial. Trial dates are subject to change.

#### MSA and Other State Settlement Agreements

In March 1996, March 1997 and March 1998, Liggett entered into settlements of smoking-related litigation with 45 states and territories. The settlements released Liggett from all smoking-related claims made by those states and territories, including claims for health care cost reimbursement and claims concerning sales of cigarettes to minors.

In November 1998, Philip Morris, Brown & Williamson, R.J. Reynolds and Lorillard (the “Original Participating Manufacturers” or “OPMs”) and Liggett (together with any other tobacco product manufacturer that becomes a signatory, the “Subsequent Participating Manufacturers” or “SPMs”) (the OPMs and SPMs are hereinafter referred to jointly as the “Participating Manufacturers”) entered into the Master Settlement Agreement (the “MSA”) with 46 states, the District of Columbia, Puerto Rico, Guam, the United States Virgin Islands, American Samoa and the Northern Mariana Islands (collectively, the “Settling States”) to settle the asserted and unasserted health care cost recovery and certain other claims of the Settling States. The MSA received final judicial approval in each Settling State.

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

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

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

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

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

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

Liggett has no payment obligations under the MSA except to the extent its market share exceeds a market share

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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. According to data from Management Science Associates, Inc., Liggett and Vector Tobacco's domestic shipments accounted for approximately 3.5%, of the total cigarettes sold in the United States in 2010. 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, 2010, Liggett and Vector Tobacco paid \$96,500 of the approximately \$144,200 of 2010 MSA payment obligations determined by the independent auditor. On April 15, 2011, Liggett and Vector Tobacco paid an additional approximately \$26,700. Liggett and Vector Tobacco disputed the balance of approximately \$21,000.

#### 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 their 2003, 2004, 2005 and 2006 MSA payments. The Participating Manufacturers are also entitled to potential NPM Adjustments to their 2007, 2008 and 2009 payments pursuant to an agreement entered into in June 2009 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 in 2007, 2008 and 2009. 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 - 2010, 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 associated with these NPM Adjustment amounts. For 2003, Liggett and Vector Tobacco paid the NPM adjustment amount of \$9,345 to the Settling States although both companies continue to dispute that this amount is owed. The total amount withheld (or paid into a disputed payment account) by Liggett and Vector Tobacco for 2004 - 2010 was \$46,938. At September 30, 2011, included in “Other assets” on the Company's condensed consolidated balance sheet was a noncurrent 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 over the issue of whether the application of the NPM Adjustment for 2003 is to be determined through litigation or arbitration. These actions relate 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 have ruled that the 2003 NPM Adjustment dispute is arbitrable. All 47 of those decisions are final. One court, the Montana Supreme Court, ruled that Montana's claim of diligent enforcement must be litigated. The United States Supreme Court denied certiorari with respect to that opinion. In response to a proposal

from the OPMs and many of the SPMs, 45 of the Settling States, representing approximately 90% of the allocable share of the Settling States, entered into an agreement providing for a nationwide arbitration of the dispute with respect to the NPM Adjustment for 2003. In June 2010, the three person arbitration panel was selected and procedural hearings, discovery and briefing on legal issues of general application commenced. Discovery should conclude by the end of 2011, and substantive hearings are currently scheduled to commence in the second quarter of 2012. Because states representing more than 80% of the allocable share signed the agreement, signing states will receive a 20% reduction of any potential 2003 NPM adjustment. There can be no assurance that Liggett or Vector Tobacco will receive any adjustment as a result of these proceedings.

Gross v. Net Calculations. In October 2004, the independent auditor notified Liggett and all other Participating Manufacturers that their payment obligations under the MSA, dating from the agreement's execution in late



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1998, had been recalculated using “net” unit amounts, rather than “gross” unit amounts (which had been used since 1999).

Liggett objected to this retroactive change and disputed the change in methodology. Liggett contends that the retroactive change from “gross” to “net” unit amounts is impermissible for several reasons, including:

- use of “net” unit amounts is not required by the MSA (as reflected by, among other things, the use of “gross” unit amounts through 2005);

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

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

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

The change in the method of calculation could result in Liggett owing, at a minimum, approximately \$10,500, plus interest, of additional MSA payments for prior years, because the proposed change from “gross” to “net” units would serve to lower Liggett's market share exemption under the MSA. The Company estimates that Liggett's future MSA payments would be at least approximately \$2,300 higher if the method of calculation is changed. No amounts have been expensed or accrued in the accompanying condensed 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 payments could adversely affect the Company's consolidated financial position, results of operations or cash flows. In August 2011, Liggett received notice from several states seeking to initiate arbitration as to this matter. The parties are currently engaged in discussions regarding procedures for the arbitration and in selection of the arbitrators.

**Litigation Challenging the MSA.** In *Grand River Enterprises Six Nations, Ltd. v. King*, litigation pending in federal court in New York, plaintiffs sought to enjoin the statutes enacted by New York and other states in connection with the MSA on the grounds that the statutes violate the Commerce Clause of the United States Constitution and federal antitrust laws. In September 2005, the United States Court of Appeals for the Second Circuit held that if all of the allegations of the complaint were assumed to be true, plaintiffs had stated a claim for relief and that the New York federal court had jurisdiction over the other defendant states. On remand, the trial court held that plaintiffs are unlikely to succeed on the merits. After discovery, in November 2009, the parties cross-moved for summary judgment. In March 2011, the United States District Court for the Southern District of New York granted defendants' motion for summary judgment. Plaintiff appealed the decision.

Litigation challenging the validity of the MSA, including claims that the MSA violates antitrust laws, has not been successful to date.

In October 2008, Vibo Corporation, Inc., d/b/a General Tobacco (“Vibo”) commenced litigation in the United States District Court for the Western District of Kentucky against each of the Settling States and certain Participating Manufacturers, including Liggett and Vector Tobacco. Vibo sought damages from Participating Manufacturers under antitrust laws. Vibo alleged, among other things, that the market share exemptions (i.e., grandfathered shares) provided to certain SPMs under the MSA, including Liggett and Vector Tobacco, violate federal antitrust and constitutional law. In January 2009, the district court dismissed the complaint. In January 2010, the court entered final

judgment in favor of the defendants. Vibo appealed to the United States Court of Appeals for the Sixth Circuit, and the case was argued on October 6, 2011. A decision is pending.

Other State Settlements. The MSA replaces 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

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settlements, Liggett believes it is entitled to the most favorable provisions as between the MSA and each state's respective settlement with the other major tobacco companies. Therefore, Liggett's non-economic obligations to all states and territories are now defined by the MSA.

In 2003, as a result of a dispute with Minnesota regarding the settlement agreement described above, 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. 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 or cash flows.

Cautionary Statement. Management is not able to predict the outcome of the litigation pending or threatened against Liggett. 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 plus interest against Liggett and two other defendants and found Liggett 50% responsible for the damages. The verdict was affirmed on appeal and Liggett paid \$14,361 in June 2010. Through September 30, 2011, Liggett has been found liable in five other Engle progeny cases. These cases are currently on appeal. As a result of the Engle decision, 5,771 lawsuits are pending against the Company and Liggett. Other cigarette manufacturers are also currently named as defendants in these cases. Liggett has also had verdicts entered against it in other individual cases, which verdicts were affirmed on appeal and, thereafter, satisfied by Liggett. It is possible that other cases could be decided unfavorably against Liggett and that Liggett will be unsuccessful on appeal. Liggett may attempt to settle particular cases if it believes it is in its best interest to do so.

Management cannot predict the cash requirements related to any future defense costs, settlements or judgments, including cash required to bond any appeals, and there is a risk that those requirements will not be able to be met. An unfavorable outcome of a pending smoking and health case could encourage the commencement of additional similar litigation, or could lead to multiple adverse decisions in the Engle progeny cases. Management is unable to make a reasonable estimate with respect to 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 and as a result has not provided any amounts in its condensed consolidated financial statements for unfavorable outcomes. The complaints filed in these cases rarely detail alleged damages. Typically, the claims set forth in an individual's complaint against the tobacco industry seek money damages in an amount to be determined by a jury, plus punitive damages, costs and legal fees.

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 or cash flows could be materially adversely affected by an unfavorable outcome in any of the smoking-related litigation.

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 and another cigarette manufacturer entered into a five year agreement

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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 2014. Under the agreement, Liggett Vector Brands has agreed to pay a portion of losses, if any, 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. Liggett Vector Brands has incurred no losses to date under this agreement, and the Company believes the fair value of Liggett Vector Brands' obligation under the agreement was immaterial at September 30, 2011.

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 September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Income before provision for income taxes	\$30,000	\$17,536	\$110,868	\$66,998
Income tax expense using estimated annual effective income tax rate	11,920	6,973	44,051	26,623
Impact of discrete item, net	—	—	464	—
Changes in effective tax rates	1,401	691	—	—
Reduction of valuation allowance	(870	) —	(870	) (500
Reversal of unrecognized tax benefits	—	(1,035	) —	(1,193
Income tax expense	\$12,451	\$6,629	\$43,645	\$24,930

The discrete item for the nine months ended September 30, 2011 related to the Company's nondeductible loss on extinguishment of debt. The Company recorded a benefit of \$870 and \$870 for the three and nine months ended September 30, 2011. The Company recorded a benefit of \$0 and \$500 for the three and nine months ended September 30, 2010 resulting from the reduction of a previously established valuation allowance of a deferred tax asset. The valuation allowance was reduced for the recognition of 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.

## 7. NEW VALLEY LLC

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

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

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	September 30, 2011	December 31, 2010
Douglas Elliman Realty LLC	\$54,702	\$46,421
New Valley Oaktree Chelsea Eleven LLC	8,018	10,958
Fifty Third-Five Building LLC	18,000	18,000
Sesto Holdings S.r.l.	5,037	5,037
1107 Broadway	5,489	—
Lofts 21 LLC	900	—
Investments in non-consolidated real estate businesses	\$92,146	\$80,416

Residential Brokerage Business. New Valley recorded income of \$5,496 and \$6,300 for the three months ended September 30, 2011 and 2010, respectively, and income of \$14,297 and \$18,078 for the nine months ended September 30, 2011 and 2010, respectively, associated with Douglas Elliman Realty, LLC. New Valley received cash distributions from Douglas Elliman Realty, LLC of \$2,216 and \$3,199 for the three months ended September 30, 2011 and 2010, respectively and \$6,016 and \$8,384 for the nine months ended September 30, 2011 and 2010, respectively. The summarized financial information of Douglas Elliman Realty, LLC is as follows:

	September 30, 2011	December 31, 2010
Cash	\$61,361	\$45,032
Other current assets	5,007	5,989
Property, plant and equipment, net	14,612	15,556
Trademarks	21,663	21,663
Goodwill	38,481	38,424
Other intangible assets, net	1,144	1,337
Other non-current assets	3,099	3,416
Notes payable - current	592	1,067
Other current liabilities	19,996	21,765
Notes payable - long term	733	1,129
Other long-term liabilities	10,265	10,500
Members' equity	113,781	96,956

	Three Months Ended		Nine Months Ended	
	September 30, 2011	2010	September 30, 2011	2010
Revenues	\$96,989	\$92,150	\$271,386	\$267,329
Costs and expenses	86,027	79,472	243,141	230,300
Depreciation expense	820	918	2,634	2,683
Amortization expense	64	87	190	252
Other income	517	794	1,904	1,632
Interest expense, net	16	55	99	500
Income tax expense	317	376	821	1,082
Net income	\$10,262	\$12,036	\$26,405	\$34,144

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.

New Valley Oaktree Chelsea Eleven, LLC. Chelsea sold two and twelve units during the three and nine months ended September 30, 2011. As of September 30, 2011, Chelsea had completed the sales of 51 of the 54 residential units.

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As of September 30, 2011, Chelsea Eleven LLC had approximately \$22,121 of total assets and \$1,524 of total liabilities, excluding amounts owed to New Valley Oaktree Chelsea Eleven LLC.

The Company received net distributions of \$4,327 and \$1,422 from New Valley Oaktree Chelsea Eleven LLC for the three months ended September 30, 2011 and 2010, respectively. The Company received net distributions of \$5,940 and \$498 from New Valley Oaktree Chelsea Eleven LLC for the nine months ended September 30, 2011 and 2010, respectively. 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. New Valley recorded no equity income for the three and nine months ended September 30, 2010, related to New Valley Chelsea. The Company's maximum exposure to loss on our investment in New Valley Chelsea Eleven LLC is \$8,018 at September 30, 2011.

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. On April 27, 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. A decision by the court is pending.

Lofts 21 LLC. In February 2011, New Valley LLC 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 LLC will account for Lofts 21 LLC under the equity method of accounting. Lofts 21 LLC is a variable interest entity; however, New Valley LLC is not the primary beneficiary. New Valley LLC's maximum exposure to loss as a result of this investment is \$900.

1107 Broadway. In 2011, New Valley LLC 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's maximum exposure on its investment in MS/WG 1107 Broadway Holdings LLC is \$5,489 at September 30, 2011. New Valley LLC will account 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 LLC is not the primary beneficiary.

St. Regis Hotel, Washington, D.C. In June 2011, the Company received \$300 in distributions related to its former interest in the St. Regis Hotel. The Company recorded income of \$300 for the nine months ended September 30, 2011, 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.

NV SOCAL LLC. On October 28, 2011, a newly-formed joint venture, between affiliates of New Valley LLC and Winthrop Realty Trust, entered into an agreement with Wells Fargo Bank to acquire a \$117,900 C-Note (the “C-Note”) for a purchase price of \$96,700. The C-Note is the most junior tranche of a \$796,000 first mortgage loan originated in July 2007 which is collateralized by a 31 property portfolio of office properties situated throughout southern

California, consisting of approximately 4.5 million square feet. The C-Note bears interest at a rate per annum of LIBOR plus 310 basis points, requires payments of interest only prior to maturity and matures on August 9, 2012. The transaction is scheduled to close on or before November 4, 2011. New Valley will initially invest \$25,000 million and will own a 26% interest in the joint venture.

Investment in Escena:

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

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	September 30, 2011	December 31, 2010
Land and land improvements	\$11,112	\$11,112
Building and building improvements	1,526	1,471
Other	1,220	1,144
	13,858	13,727
Less accumulated depreciation	(615	) (373
	\$13,243	\$13,354

The Company recorded an operating loss of approximately \$544 and \$682 for the three months ended September 30, 2011 and 2010, respectively, from its investment in Escena. The Company recorded an operating loss of \$261 and \$564 for the nine months ended September 30, 2011 and 2010, 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:

## Fair Value Measurements as of September 30, 2011

Description	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	\$271,110	\$271,110	\$—	\$—
Certificates of deposit	2,235	—	2,235	—
Bonds	4,573	4,573	—	—
Investment securities available for sale	58,935	56,421	2,514	—
Total	\$336,853	\$332,104	\$4,749	\$—
Liabilities:				
Fair value of derivatives embedded within convertible debt	\$128,236	\$—	\$—	\$128,236

## Fair Value Measurements as of December 31, 2010

Description	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	\$267,333	\$267,333	\$—	\$—

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Certificates of deposit	2,773	—	2,773	—
Bonds	5,300	5,300	—	—
Investment securities available for sale	78,754	74,640	4,114	—
Total	354,160	347,273	6,887	—
<b>Liabilities:</b>				
Fair value of derivatives embedded within convertible debt	\$ 141,492	\$—	\$—	\$ 141,492

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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 were not registered and do not have direct market quotes.

The fair value of derivatives embedded within convertible debt were 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, unsecured to subordinated debt and subordinated debt to preferred stock 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 fair value of derivatives embedded within convertible debt was \$128,236 and \$140,280 as of September 30, 2011 and 2010, respectively. The income of \$13,248 and \$12,735 from the embedded derivatives in the nine months ended September 30, 2011 and 2010, respectively, were primarily the result of declining spreads between corporate convertible debt and risk free investments offset by interest payments during the period.

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, 2011 and 2010, respectively.

## 9. SEGMENT INFORMATION

The Company's significant business segments for the three and nine months ended September 30, 2011 and 2010 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 the Company's investments in consolidated and non-consolidated real estate businesses. The accounting policies of the segments are the same as those described in the summary of significant accounting policies.

Financial information for the Company's operations before taxes for the three and nine months ended September 30, 2011 and 2010 follows:

## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

	Tobacco	Real Estate	Corporate and Other	Total
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
Three months ended September 30, 2010				
Revenues	\$295,124	\$—	\$—	\$295,124
Operating income (loss)	35,531	<sup>(1)</sup> (682	) (4,973	) 29,876
Equity income from non-consolidated real estate businesses	—	7,060	—	7,060
Depreciation and amortization	2,062	76	578	2,716
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
Nine months ended September 30, 2010				
Revenues	\$785,671	\$—	\$—	\$785,671
Operating income (loss)	96,490	<sup>(2)</sup> (564	) (13,955	) 81,971
Equity income from non-consolidated real estate businesses	—	18,838	—	18,838
Depreciation and amortization	6,254	220	1,737	8,211
Capital expenditures	15,319	384	27	15,730

(1) Operating income includes a non-recurring settlement charge of \$3,000.

(2) Operating income includes litigation judgment expense of \$14,361 and a non-recurring settlement charge of \$3,000.

## 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 full and unconditional and joint and several. The Company's investments in its consolidated subsidiaries are presented under the equity method of accounting.

Certain revisions have been made to the Company's condensed consolidating balance sheet as of December 31, 2010 to conform to the 2011 presentation. The revisions decreased parent "Investment in consolidated subsidiaries" by \$78,875, "Investment securities available for sale" by \$29,753, "Other current assets" by \$923, the current liability, "Deferred income taxes," by \$6,305, and the liability "Deferred income taxes" by \$103,246. The revisions increased subsidiary guarantors' "Investment securities available for sale" by \$29,753, "Other current assets" by \$923 and the current liability, "Deferred Income taxes," by \$6,305. The revisions decrease subsidiary guarantors' asset "Deferred income taxes" by \$103,246 and "Stockholders' equity (deficiency)" by \$78,875. The consolidating adjustments for the asset "Deferred income taxes" of \$103,246 and the liability "Deferred income taxes" of \$103,246 have been eliminated.

Certain revisions have been made to the Company's condensed consolidating statement of cash flows for the

VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

nine months ended September 30, 2010 to conform to the 2011 presentation. The revisions increased parent "Purchase of investment securities" by \$1,980 and decreased parent "Investment in subsidiaries" by \$1,983 and "Cash and cash equivalents, end of period" by \$3. The revisions increased subsidiary guarantors' "Capital contributions received" by \$1,983 and "Cash and cash equivalents, end of period" by \$3 and decreased subsidiary guarantors' "Purchase of investment securities" by \$1,980.

The Company's consolidated financial information for the three and nine months ended September 30, 2010 and as of December 31, 2010 has not changed. The Company does not believe these revisions are material to the consolidating financial information as of December 31, 2010 or any prior periods' consolidating financial statements.



## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## CONDENSED CONSOLIDATING BALANCE SHEETS

	September 30, 2011				Consolidated Vector Group Ltd.
	Parent/ Issuer	Subsidiary Guarantors	Non- Guarantors	Consolidating Adjustments	
<b>ASSETS:</b>					
Current assets:					
Cash and cash equivalents	\$ 308,203	\$ 19,650	\$ 558	\$ —	\$ 328,411
Investment securities available for sale	33,651	25,284	—	—	58,935
Accounts receivable - trade	—	17,512	4	—	17,516
Intercompany receivables	73	—	—	(73 )	—
Inventories	—	110,538	1	—	110,539
Deferred income taxes	35,143	3,106	—	—	38,249
Income taxes receivable	46,134	—	—	(46,134 )	—
Restricted assets	—	1,477	—	—	1,477
Other current assets	1,047	3,129	96	—	4,272
Total current assets	424,251	180,696	659	(46,207 )	559,399
Property, plant and equipment, net	724	55,174	—	—	55,898
Investment in Escena, net	—	—	13,243	—	13,243
Long-term investments accounted for at cost	4,777	—	898	—	5,675
Long-term investments accounted for under the equity method	16,863	—	—	—	16,863
Investments in non- consolidated real estate businesses	—	—	92,146	—	92,146
Investments in consolidated subsidiaries	170,211	—	—	(170,211 )	—
Restricted assets	2,159	6,630	—	—	8,789
Deferred income taxes	12,752	6,772	8,489	—	28,013
Intangible asset	—	107,511	—	—	107,511
Prepaid pension costs	—	15,098	—	—	15,098
Other assets	13,128	15,189	—	—	28,317
Total assets	\$ 644,865	\$ 387,070	\$ 115,435	\$ (216,418 )	\$ 930,952
<b>LIABILITIES AND STOCKHOLDERS' DEFICIENCY:</b>					
Current liabilities:					
Current portion of notes payable and long-term debt	\$ 16,151	\$ 10,577	\$ 136	\$ —	\$ 26,864
Current portion of fair value of derivatives embedded within convertible debt	77,176	—	—	—	77,176
Current portion of employee benefits	—	1,014	—	—	1,014
Accounts payable	511	4,725	336	—	5,572
Intercompany payables	—	73	—	(73 )	—
Accrued promotional expenses	—	16,158	—	—	16,158
Income taxes payable, net	—	6,707	45,532	(46,134 )	6,105
Accrued excise and payroll taxes payable, net	—	3,584	—	—	3,584

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Settlement accruals	—	117,668	—	—	117,668
Deferred income taxes	25,166	4,399	—	—	29,565
Accrued interest	9,346	—	—	—	9,346
Other current liabilities	5,492	7,624	648	—	13,764
Total current liabilities	133,842	172,529	46,652	(46,207 )	306,816
Notes payable, long-term debt and other obligations, less current portion	476,076	14,400	253	—	490,729
Fair value of derivatives embedded within convertible debt	51,060	—	—	—	51,060
Non-current employee benefits	22,147	17,518	—	—	39,665
Deferred income taxes	27,597	29,251	2,030	—	58,878
Other liabilities	813	48,875	786	—	50,474
Total liabilities	711,535	282,573	49,721	(46,207 )	997,622
Commitments and contingencies					
Stockholders' deficiency	(66,670 )	104,497	65,714	(170,211 )	(66,670 )
Total liabilities and stockholders' deficiency	\$644,865	\$387,070	\$115,435	\$(216,418 )	\$930,952

## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## CONDENSED CONSOLIDATING BALANCE SHEETS

	December 31, 2010				
	Parent/ Issuer	Subsidiary Guarantors	Subsidiary Non- Guarantors	Consolidating Adjustments	Consolidated Vector Group Ltd.
<b>ASSETS:</b>					
Current assets:					
Cash and cash equivalents	\$283,409	\$16,214	\$202	\$—	\$ 299,825
Investment securities available for sale	49,001	29,753	—	—	78,754
Accounts receivable - trade	—	1,846	3	—	1,849
Intercompany receivables	62	—	—	(62	) —
Inventories	—	107,079	—	—	107,079
Deferred income taxes	27,470	4,316	—	—	31,786
Income taxes receivable	51,260	—	—	(51,260	) —
Restricted assets	—	2,310	351	—	2,661
Other current assets	406	4,258	145	—	4,809
Total current assets	411,608	165,776	701	(51,322	) 526,763
Property, plant and equipment, net	609	54,803	—	—	55,412
Investment in Escena, net	—	—	13,354	—	13,354
Long-term investments accounted for at cost	45,134	—	899	—	46,033
Long-term investments accounted for under the equity method	10,954	—	—	—	10,954
Investments in non- consolidated real estate businesses	—	—	80,416	—	80,416
Investment in townhomes	—	—	16,275	—	16,275
Investments in consolidated subsidiaries	180,719	—	—	(180,719	) —
Restricted assets	2,673	6,021	—	—	8,694
Deferred income taxes	22,742	3,075	12,011	—	37,828
Intangible asset	—	107,511	—	—	107,511
Prepaid pension costs	—	13,935	—	—	13,935
Other assets	17,710	14,710	—	—	32,420
Total assets	\$692,149	\$365,831	\$123,656	\$ (232,041	) \$ 949,595
<b>LIABILITIES AND STOCKHOLDERS' DEFICIENCY:</b>					
Current liabilities:					
Current portion of notes payable and long-term debt	\$ 11,000	\$40,222	\$123	\$—	\$ 51,345
Current portion of fair value of derivatives embedded within convertible debt	480	—	—	—	480
Current portion of employee benefits	—	1,014	—	—	1,014
Accounts payable	1,098	6,405	1,524	—	9,027
Intercompany payables	—	62	—	(62	) —
Accrued promotional expenses	—	14,327	—	—	14,327
Income taxes payable, net	—	20,719	42,158	(51,260	) 11,617
Accrued excise and payroll taxes payable, net	—	18,523	—	—	18,523

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Settlement accruals	—	48,071	—	—	48,071
Deferred income taxes	28,317	8,646	—	—	36,963
Accrued interest	20,824	—	—	—	20,824
Other current liabilities	6,530	7,670	481	—	14,681
Total current liabilities	68,249	165,659	44,286	(51,322 )	226,872
Notes payable, long-term debt and other obligations, less current portion	484,675	21,020	357	—	506,052
Fair value of derivatives embedded within convertible debt	141,012	—	—	—	141,012
Non-current employee benefits	21,047	17,695	—	—	38,742
Deferred income taxes	23,262	28,118	435	—	51,815
Other liabilities	138	30,520	678	—	31,336
Total liabilities	738,383	263,012	45,756	(51,322 )	995,829
Commitments and contingencies					
Stockholders' deficiency	(46,234 )	102,819	77,900	(180,719 )	(46,234 )
Total liabilities and stockholders' deficiency	\$692,149	\$365,831	\$123,656	\$ (232,041 )	\$ 949,595

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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 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)
Changes in fair value of derivatives embedded within convertible debt	4,386	—	—	—	4,386
Loss on extinguishment of debt	—	—	—	—	—
Equity income on 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 investment	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

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, 2010				Consolidated Vector Group Ltd.
	Parent/ Issuer	Subsidiary Guarantors	Subsidiary Non- Guarantors	Consolidating Adjustments	
Revenues	\$—	\$295,124	\$—	\$—	\$295,124
Expenses:					
Cost of goods sold	—	239,160	—	—	239,160
Operating, selling, administrative and general expenses	5,579	19,792	717	—	26,088
Litigation judgment expense	—	—	—	—	—
Management fee expense	—	2,130	—	(2,130)	—
Operating (loss) income	(5,579)	34,042	(717)	2,130	29,876
Other income (expenses):					
Interest expense	(21,297)	(204)	(10)	—	(21,511)
Changes in fair value of derivatives embedded within convertible debt	1,660	—	—	—	1,660
Equity income on non-consolidated real estate businesses	—	—	7,060	—	7,060
Equity loss on long-term investments	(436)	—	—	—	(436)
Gain on investment securities available for sale	708	—	—	—	708
Equity income in consolidated subsidiaries	22,243	—	—	(22,243)	—
Management fee income	2,130	—	—	(2,130)	—
Other, net	168	11	—	—	179
Income before provision for income taxes	(403)	33,849	6,333	(22,243)	17,536
Income tax benefit (expense)	11,310	(15,368)	(2,571)	—	(6,629)
Net income	\$10,907	\$18,481	\$3,762	\$(22,243)	\$10,907

## 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

	Parent/ Issuer	Subsidiary Guarantors	Subsidiary Non- Guarantors	Consolidating Adjustments	Consolidated Vector Group Ltd.
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
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)
Changes in fair value of derivatives embedded within convertible debt	13,248	—	—	—	13,248
Loss on extinguishment of debt	(1,217)	—	—	—	(1,217)
Equity income on non-consolidated real estate businesses	—	—	17,597	—	17,597
Equity loss on long-term investments	(1,090)	—	—	—	(1,090)
Gain on investment securities available for sale	—	20,558	—	—	20,558
Gain on liquidation of long-term investment	25,832	—	—	—	25,832
Gain on sales of townhomes	—	—	3,722	—	3,722
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

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, 2010				
	Parent/ Issuer	Subsidiary Guarantors	Subsidiary Non- Guarantors	Consolidating Adjustments	Consolidated Vector Group Ltd.
Revenues	\$—	\$785,671	\$—	\$—	\$785,671
Expenses:					
Cost of goods sold	—	620,065	—	—	620,065
Operating, selling, administrative and general expenses	16,713	51,871	690	—	69,274
Litigation judgment expense	—	14,361	—	—	14,361
Management fee expense	—	6,391	—	(6,391)	—
Operating (loss) income	(16,713)	) 92,983	(690)	) 6,391	81,971
Other income (expenses):					
Interest expense	(60,412)	) (642)	) (32)	) —	(61,086)
Changes in fair value of derivatives embedded within convertible debt	12,735	—	—	—	12,735
Equity income on non-consolidated real estate businesses	—	—	18,838	—	18,838
Equity income on long-term investments	2,334	—	—	—	2,334
Gain on investment securities available for sale	11,819	—	—	—	11,819
Equity income in consolidated subsidiaries	83,164	—	—	(83,164)	—
Management fee income	6,391	—	—	(6,391)	—
Other, net	360	27	—	—	387
Income before provision for income taxes	39,678	92,368	18,116	(83,164)	) 66,998
Income tax benefit (expense)	2,390	(19,965)	) (7,355)	) —	(24,930)
Net income	\$42,068	\$72,403	\$10,761	\$(83,164)	) \$42,068



## 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	Subsidiary 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 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
Proceeds from sale of townhomes	—	—	19,629	—	19,629
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 )
Investments in subsidiaries	(3,463 )	—	—	3,463	—
Proceeds from sale of fixed assets	—	147	9	—	156
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	1,029	—	—	—	1,029
Tax benefit of options exercised	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
Cash and cash equivalents, beginning of period	283,409	16,214	202	—	299,825
Cash and cash equivalents, end of period	\$308,203	\$19,650	\$558	\$—	\$328,411



## 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, 2010				Consolidated Vector Group Ltd.
	Parent/ Issuer	Subsidiary Guarantors	Non- Guarantors	Subsidiary Consolidating Adjustments	
Net cash provided by (used in) operating activities	\$73,763	\$182,382	\$(6,030)	\$(149,052)	\$101,063
Cash flows from investing activities:					
Sale of investment securities	16,140	—	—	—	16,140
Purchase of investment securities	(7,414)	(1,980)	—	—	(9,394)
Proceeds from sale of or liquidation of long-term investments	1,106	—	—	—	1,106
Purchase of long-term investments	(5,000)	—	(62)	—	(5,062)
Investments in non-consolidated real estate businesses	—	—	(4,033)	—	(4,033)
Purchase of Aberdeen mortgages	(13,462)	—	—	—	(13,462)
Distributions from non-consolidated real estate businesses	—	—	3,539	—	3,539
Increase in cash surrender value of life insurance policies	(513)	(405)	—	—	(918)
(Increase) decrease in non-current restricted assets	449	370	(435)	—	384
Issuance of notes receivable	(720)	—	—	—	(720)
Cash acquired in Aberdeen consolidation	—	—	473	—	473
Proceeds from sale of fixed assets	—	187	—	—	187
Investments in subsidiaries	(5,805)	—	—	5,805	—
Capital expenditures	(63)	(15,319)	(348)	—	(15,730)
Net cash (used in) provided by investing activities	(15,282)	(17,147)	(866)	5,805	(27,490)
Cash flows from financing activities:					
Proceeds from debt issuance	75,000	14,373	—	—	89,373
Deferred financing costs	(2,582)	—	—	—	(2,582)
Repayments of debt	—	(7,090)	(85)	—	(7,175)
Borrowings under revolver	—	732,708	—	—	732,708
Repayments on revolver	—	(750,091)	—	—	(750,091)
Capital contributions received	—	5,805	—	(5,805)	—
Intercompany dividends paid	—	(156,400)	7,348	149,052	—
Dividends and distributions on common stock	(87,797)	—	—	—	(87,797)
Proceeds from exercise of Vector options and warrants.	980	—	—	—	980
Tax benefits from exercise of Vector options and warrants	121	—	—	—	121
	(14,278)	(160,695)	7,263	143,247	(24,463)

Net cash (used in) provided by financing activities					
Net increase in cash and cash equivalents	44,203	4,540	367	—	49,110
Cash and cash equivalents, beginning of period	204,133	5,004	317	—	209,454
Cash and cash equivalents, end of period	\$248,336	\$9,544	\$684	\$—	\$258,564

## 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 2010 and for the first nine months of 2011 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 136 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 9.1% for the nine months ended September 30, 2011 and 13.0% of Liggett's unit volume for the year ended December 31, 2010. In September 2005, Liggett repositioned GRAND PRIX to distributors and retailers nationwide. GRAND PRIX's unit volume was 13.3% of Liggett's unit volume for the nine months ended September 30, 2011 and 18.5% for the year ended December 31, 2010. 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 55.1% of Liggett's unit volume for the nine months ended September 30, 2011 and 42.6% for the year ended December 31, 2010.

Under the Master Settlement Agreement reached in November 1998 with 46 states and various territories, the three largest cigarette manufacturers must make settlement payments to the states and territories based on how many

cigarettes they sell annually. Liggett, however, is not required to make any payments unless its market share exceeds approximately 1.65% of the U.S. cigarette market. Additionally, Vector Tobacco has no payment obligation unless its market share exceeds approximately 0.28% of the U.S. market. Liggett's and Vector Tobacco's payments under the Master Settlement Agreement are based on each company's incremental market share above the minimum threshold applicable to such company. We believe that our tobacco subsidiaries have gained a sustainable cost advantage over their competitors as a result of the settlement.

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

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

#### Recent Developments

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

**Variable Interest Senior Convertible Debentures due 2026.** We were required to mandatorily redeem 10% of the total aggregate principal amount outstanding, or \$11,000, of our 3.875% Variable Interest Senior Convertible Debentures due 2026 on June 15, 2011. Other than the holders of \$7 principal amount of the Notes, who had 10% of their aggregate principal amount of Notes mandatorily redeemed, each holder of the notes chose to convert its pro-rata portion of the \$11,000 of principal into our common stock. We recorded a loss of \$0 and \$1,217 for the three and nine months ended September 30, 2011, on the conversion of the \$11,000 of notes into 685,005 shares of common stock.

**New Valley Oaktree Chelsea Eleven, LLC.** Chelsea sold two and twelve units during the three and nine months ended September 30, 2011. As of September 30, 2011, sales of 51 of the 54 luxury residential units have closed.

As of September 30, 2011, Chelsea Eleven LLC had approximately \$22,121 of total assets and \$1,524 of total liabilities, excluding amounts owed to New Valley Oaktree Chelsea Eleven LLC.

We received net distributions of \$4,327 and \$1,422 from New Valley Oaktree Chelsea Eleven LLC for the three months ended September 30, 2011 and 2010, respectively. We received net distributions of \$5,940 and \$498 from New Valley Oaktree Chelsea Eleven LLC for the nine months ended September 30, 2011 and 2010, respectively. 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. New Valley had no equity income for the three and nine months ended September 30, 2010, related to New Valley Chelsea.

**Aberdeen Townhomes LLC.** In February 2011 and June 2011, Aberdeen sold its two remaining townhomes for \$11,635 and \$7,994, respectively, net of closing costs, and recorded gain on sale of townhomes of \$10 and \$3,722 for the three and nine months ended September 30, 2011.

**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. On April 27, 2011, the court granted the JV's motion for summary judgment, dismissing certain substantive defenses raised by the borrower and the other named parties. The borrower has challenged the validity of the assignment from the previous lender to the JV and the litigation is ongoing.

**1107 Broadway.** In 2011, New Valley LLC 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's maximum exposure on its investment in MS/WG 1107 Broadway Holdings LLC is \$5,489 at September 30, 2011. New Valley LLC will account 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 LLC is not the primary beneficiary.

NV SOCAL LLC. On October 28, 2011, a newly-formed joint venture, between affiliates of New Valley LLC and Winthrop Realty Trust, entered into an agreement with Wells Fargo Bank to acquire a \$117,900 C-Note (the "C-Note") for a purchase price of \$96,700. The C-Note is the most junior tranche of a \$796,000 first mortgage loan originated in July 2007 which is collateralized by a 31 property portfolio of office properties situated throughout southern California, consisting of approximately 4.5 million square feet. The C-Note bears interest at a rate per annum of LIBOR plus 310



basis points, requires payments of interest only and matures on August 9, 2012. The transaction is scheduled to close on or before November 4, 2011. New Valley will initially invest \$25,000 and will own a 26% interest in the joint venture.

**Long-term Investments.** Two of our long-term investments were liquidated in January 2011 and April 2011, respectively. We 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. We recognized a gain of \$2,221 and \$25,832 for the three and nine months ended September 30, 2011, respectively.

#### Recent Developments in Tobacco-Related Litigation

The cigarette industry continues to be challenged on numerous fronts. New cases continue to be commenced against Liggett and other cigarette manufacturers. As of September 30, 2011, there were approximately 5,771 Engle progeny cases, 33 individual suits, six purported class actions and one healthcare cost recovery action pending in which Liggett or us, or both, were named as a defendant. To date, adverse verdicts have been entered against Liggett in six Engle progeny cases. As of September 30, 2011, 49 alleged Engle progeny cases, where Liggett is currently named as a defendant, were scheduled for trial through September 30, 2012.

**Liggett Only Cases.** There are currently seven 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.

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 March 2011. In September 2010, the court awarded plaintiff legal fees of \$996. Plaintiff is appealing the amount of the attorneys' fee award. Liggett previously accrued \$2,000 for the *Ferlanti* case. In *Welch v. R.J. Reynolds and Katz v. R.J. Reynolds*, both 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, in which Liggett is the only tobacco company defendant, are dormant.

**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 the Company have been named in 5,771 Engle progeny cases in both federal (2,755 cases) and state (3,016 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 8,000 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, 2010. 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, 2011 and 2010 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		Nine Months Ended	
	September 30, 2011	September 30, 2010	September 30, 2011	September 30, 2010
Revenues:				
Tobacco	\$288,995	\$295,124	\$840,553	\$785,671
Operating income:				
Tobacco	\$42,888	\$35,531	\$121,527	\$96,490
Real Estate	(947)	(682)	(1,277)	(564)
Corporate and other	(4,086)	(4,973)	(12,952)	(13,955)
Total operating income	\$37,855	\$29,876	\$107,298	\$81,971

(1) Operating income includes a non-recurring settlement charge of \$3,000.

(2) Operating income includes litigation judgment expense of \$14,361 and a non-recurring settlement charge of \$3,000.

#### Three Months Ended September 30, 2011 Compared to Three Months ended September 30, 2010

Revenues. All of our revenues were from the Tobacco segment for the third quarter of 2011 and 2010. Liggett increased the list price of LIGGETT SELECT, EVE, and GRAND PRIX by \$0.60 per carton in January 2010, an additional \$0.65 per carton in May 2010, an additional \$0.75 per carton in October 2010 and an additional \$0.80 per carton on October 31, 2011. 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. Liggett increased the list price of PYRAMID by \$1.30 per carton in January 2011 and \$1.10 per carton in August 2011 .

All of our sales in 2011 and 2010 were in the discount category. For the three months ended September 30, 2011, revenues were \$288,995 compared to \$295,124 for the three months ended September 30, 2010. Revenues decreased by 2.1% (\$6,129) due to a favorable price variance of \$19,096 primarily related to increases in price of the PYRAMID offset by an unfavorable sales volume of \$25,225 (approximately 177.4 million units).

Tobacco Gross Profit. Tobacco gross profit was \$61,132 for the three months ended September 30, 2011 compared to \$55,963 for the three months ended September 30, 2010. This represented an increase of \$5,169 (9.2%) from the 2010 period. This increase was due primarily to higher prices. As a percentage of revenues (excluding federal excise taxes), Tobacco gross profit increased to 41.4% in the 2011 period compared to gross profit of 38.7% in the 2010 period due to higher prices.

Expenses. Operating, selling, general and administrative expenses were \$23,277 for the three months ended September 30, 2011 compared to \$26,088 for the same period last year, a decrease of \$2,811 (10.8%). Tobacco expenses were \$18,244 for the three months ended September 30, 2011 compared to \$20,432 for the same period in the prior year. This is a decrease of \$2,188, which was primarily the result of higher sales force expenses due to an increase in sales force over the last twelve months offset by the absence of a \$3,000 non-recurring settlement charge that occurred in 2010. Tobacco product liability legal expenses and other litigation costs were \$1,498 and \$4,691 for the three months ended September 30, 2011 and 2010, respectively. Expenses at the corporate level decreased from

\$4,973 to \$4,086 due to the timing of expenses.

Operating income. Operating income was \$37,855 for the three months ended September 30, 2011 compared to \$29,876 for the same period last year, an increase of \$7,979 (26.7%). Tobacco segment operating income increased from \$35,531 in 2010 to \$42,888 in 2011 primarily due to higher prices in 2011. The real estate segment operating loss was \$947 and \$682 for the three months ended September 30, 2011 and 2010, respectively, related primarily to Escena's operations.

Other income (expenses). Other expenses were \$7,855 for the three months ended September 30, 2011 compared

to \$12,340 for the same period last year. 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 non-consolidated real estate businesses of \$6,496 and interest and other income of \$135. For the three months ended September 30, 2010, other expenses primarily consisted of interest expense of \$21,511 and an equity loss on a long-term investment of \$436 offset by equity income on non-consolidated real estate businesses of \$7,060, income of \$1,660 for changes in fair value of derivatives embedded within convertible debt, a realized gain on investments available for sale of \$708 and interest and other income of \$179.

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 income of \$4,386 and \$1,660 from the embedded derivatives in the three months ended September 30, 2011 and 2010, respectively, was primarily the result of increasing spreads 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, 2011 was \$30,000 compared to \$17,536 for the three months ended September 30, 2010.

Income tax provision. The income tax provision was \$12,451 and \$6,629 for the three months ended September 30, 2011 and 2010, 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 pre-tax results from ordinary operations in accordance with guidance on accounting for income taxes on interim periods. We recorded a benefit of approximately \$870 for the three months ended September 30, 2011 resulting from the reduction of a previously established valuation allowance of a deferred tax asset. 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, 2011 Compared to Nine Months Ended September 30, 2010

Revenues. All of our revenues were from the Tobacco segment in the first nine months of 2011 and 2010. Liggett increased the list price of LIGGETT SELECT, EVE, and GRAND PRIX by \$0.60 per carton in January 2010, an additional \$0.65 per carton in May 2010, an additional \$0.75 per carton in October 2010 and an additional \$0.80 per carton on October 31, 2011. 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. Liggett increased the list price of PYRAMID by \$1.30 per carton in January 2011 and \$1.10 per carton in August 2011 .

All of our sales were in the discount category in 2011 and 2010. For the nine months ended September 30, 2011, revenues were \$840,553 compared to \$785,671 for the nine months ended September 30, 2010. Revenues increased by 7.0% (\$54,882) due to a favorable price variance of \$47,763 primarily related to increases in the price of PYRAMID and a favorable sales volume of \$7,119 (approximately 304.0 million units).

Tobacco gross profit. Tobacco gross profit was \$176,440 for the nine months ended September 30, 2011 compared to \$165,607 for the nine months ended September 30, 2010. The \$10,833 (6.5%) increase was due primarily to higher volumes. As a percentage of revenues (excluding federal excise taxes), Tobacco gross profit decreased to 41.2% in the 2011 period compared to gross profit of 42.6% in the 2010 period due to sales mix.

Expenses. Operating, selling, general and administrative expenses were \$69,142 for the nine months ended September 30, 2011 compared to \$69,274 for the same period last year, a decrease of \$132 (0.2%). Tobacco expenses

were \$54,913 for the nine months ended September 30, 2011 compared to \$54,756, not including the \$14,361 litigation judgment expense, for the nine months ended September 30, 2010. The increase of \$157 was primarily the result of higher sales force expenses due to an increase in sales force over the last twelve months offset by the absence of a \$3,000 non-recurring settlement charge that occurred in 2010 . Tobacco product liability legal expenses and other litigation costs were \$5,216 and \$8,057 for the nine months ended September 30, 2011 and 2010, respectively. In addition, we recorded \$14,361 of expense associated with a litigation judgment paid in June 2010. Expenses at the corporate segment decreased from \$13,954 to \$12,952 in 2011 due to the timing of expenses.

Operating income. For the nine months ended September 30, 2011, Tobacco segment operating income increased from \$96,490 in 2010 to \$121,527 in 2011 primarily due to the absence of a \$14,361 litigation judgment expense paid

in 2010, and increased sales volume in 2011. The real estate segment's operating loss of \$1,277 and \$564 for the nine months ended September 30, 2011 and 2010, respectively, primarily related to Escena's operations.

Other income (expenses). Other income was \$3,570 for the nine months ended September 30, 2011 compared to other expenses of \$14,973 for the same period last year. 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 a loss of \$1,217 on the extinguishment of 10% principal (\$11,000) of the 3.875% Variable Interest Senior Convertible Debentures due 2026 on June 15, 2011. For the nine months ended September 30, 2010, other expenses primarily consisted of interest expense of \$61,086 offset by other income of \$12,735 for changes in fair value of derivatives embedded within convertible debt, a realized gain on investments available for sale of \$11,819, equity income on non-consolidated real estate businesses of \$18,838, equity income on a long-term investment of \$2,334 and interest and other income of \$387.

We recorded an equity loss of \$1,090 for the nine months ended September 30, 2011 and equity income of \$2,334 for the nine months ended September 30, 2010, related to limited partnerships accounted for under the equity method. Included in the amount for the nine months ended September 30, 2010 was the impact of an error we identified which resulted in an out-of-period adjustment of approximately \$1,650 (approximately \$980 after taxes). The error occurred because our ownership in the limited partnership increased from a nominal percentage to more than 10% during the fourth quarter of 2008 (due to significant withdrawals from other partners); thus, our investment should have been accounted for under the equity method for all previous periods in which the investment was held. We assessed the materiality of this error on all previously issued financial statements in accordance with ASC 250-10-S99-1 and concluded that the error was immaterial to all previously issued financial statements. The impact of correcting this error was not material to our 2010 consolidated financial statements. This adjustment was recognized within other income in the consolidated statements of operations.

The fair 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 income of \$13,248 and \$12,735 from the embedded derivative for the nine months ended September 30, 2011 and 2010, respectively, was primarily the result of increasing spreads 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 nine months ended September 30, 2011 was \$110,868 compared to \$66,998 for the nine months ended September 30, 2010.

Income tax provision. The income tax provision was \$43,645 for the nine months ended September 30, 2011, compared to \$24,930 for the nine months ended September 30, 2010. Our 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 in accordance with guidance on accounting for income taxes on interim periods. We recorded a benefit of approximately \$870 and \$500 for the nine months ended September 30, 2011 and 2010 resulting from the reduction of a previously established valuation allowance of a deferred tax asset. 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 increased \$28,586 for the nine months ended September 30, 2011 compared to an increase of \$49,110 for the nine months ended September 30, 2010.

Net cash provided from operations was \$64,015 and \$101,063 for the nine months ended September 30, 2011 and 2010, respectively. The change related to an increase in Liggett's accounts receivable in 2011, the absence of a litigation judgment expense in the 2011 period and increased payments of accounts payable and interest expense in 2011. The increase in accounts receivable was due to changes in customer buying patterns as well as an extension of collection terms on PYRAMID sales by five days in 2011. These changes were offset by increased operating income in 2011.



Cash provided by investing activities was \$92,117 for the nine months ended September 30, 2011 compared to cash used in investing activities of \$27,490 for the nine months ended September 30, 2010. 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 non-consolidated real estate businesses of \$6,752, proceeds from the sales of townhomes of \$19,629, decrease in non-current 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. In the first nine months of 2010, cash was used for the purchase of investment securities of \$9,394, long-term investments of \$5,062, purchase of Aberdeen mortgages of \$13,462, investments in non-consolidated real estate business of \$4,033, an increase in cash surrender value of life insurance policies of \$918, the issuance of notes receivable of \$720 and capital expenditures of \$15,730 offset by the proceeds from the sale or maturity of investment securities of \$16,140, proceeds from the sale or liquidation of long-term investments of \$1,106, and distributions from non-consolidated real estate businesses of \$3,539, a decrease in non-current restricted assets of \$384, cash acquired in Aberdeen consolidation of \$473, and proceeds from the sale of fixed assets of \$187.

Cash used in financing activities was \$127,546 and \$24,463 for the nine months ended September 30, 2011 and 2010, respectively. 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. In the first nine months of 2010, cash provided from financing activities was from the proceeds of debt issuance of \$89,373, and proceeds from the exercise of Vector options of \$980 offset by cash used for distributions on common stock of \$87,797, net repayments under the revolver of \$17,383, repayments of debt of \$7,175, and deferred finance charges of \$2,582.

Liggett. Liggett has a \$50,000 credit facility with Wachovia Bank, N.A. none of which was outstanding at September 30, 2011. Availability as determined under the facility was approximately \$36,000 based on eligible collateral at September 30, 2011. The facility contains covenants that provide that Liggett's earnings before interest, taxes, depreciation and amortization, as defined under the facility, on a trailing twelve-month basis, shall not be less than \$100,000 if Liggett's excess availability, as defined, under the facility is less than \$20,000. The covenants also require that annual capital expenditures, as defined under the facility, shall not exceed \$10,000 (before a maximum carryover amount of \$2,500) during any fiscal year; except in 2010, where Liggett was permitted capital expenditures up to \$33,000, as amended, as of August 31, 2010. At September 30, 2011, management believed that Liggett was in compliance with all covenants under the credit facility; Liggett's EBITDA, as defined, were approximately \$138,868 for the twelve months ended September 30, 2011. Liggett had future machinery and equipment purchase commitments of \$3,577 at September 30, 2011.

In June 2002, the jury in an individual case brought under the third phase of the Engle case awarded \$24,835 of compensatory damages against Liggett and two other defendants and found Liggett 50% responsible for the damages. In June 2010, Liggett satisfied its share of the judgment, including plaintiff's claim for interest and attorneys' fees (\$14,361). To date, five other verdicts have been entered in Engle progeny cases against Liggett in the total amount of approximately \$6,100, one of which has 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. 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. In December 2010, we sold at 103% of face value an additional \$90,000 principal amount of the Senior Secured Notes in a private offering to qualified institutional investors in accordance with Rule 144A of the Securities Act of 1933. We received net proceeds from the 2010 offering of approximately \$90,850. In May 2011, we completed an exchange offer to exchange the Senior Secured Notes issued in December 2010 for an equal amount of newly issued 11% Senior Secured Notes due 2015. The new Secured Notes have substantially the same terms as the original notes, except that the new Secured Notes have been registered under the Securities Act. Following the December 2010 offering, a total of \$415,000 principal amount of the Senior Secured Notes were 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 fully and unconditionally guaranteed 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, 2011	December 31, 2010
Consolidated EBITDA, as defined	\$50,000	\$225,488	\$184,151
Leverage ratio, as defined	<3.0 to 1	0.4 to 1	0.5 to 1
Secured leverage ratio, as defined	<1.5 to 1	0.1 to 1	0.1 to 1

We and our subsidiaries have significant indebtedness and debt service obligations. At September 30, 2011, we and our subsidiaries had total outstanding indebtedness with a total aggregate principal amount outstanding of approximately \$696,896. 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 on June 15, 2011. Other than the holders of \$7 principal amount of the Notes, who had 10% of their aggregate principal amount of Notes mandatorily redeemed, each holder of the notes chose to convert its pro-rata portion of the \$11,000 of principal into our common stock. We recorded a loss of \$1,217 for the nine months ended September 30, 2011, on the conversion of the \$11,000 of notes into 685,005 shares of common stock. We may be required to purchase \$99,000 of the debentures on June 15, 2012. 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 \$328,400, investment securities available for sale of

approximately \$58,900, long-term investments with an estimated value of approximately \$25,700 and availability under Liggett's credit facility of approximately \$36,000 at September 30, 2011. 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, 2011, approximately \$5,800 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, 2011, 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 \$60.

In addition, as of September 30, 2011, approximately \$77,900 (\$256,530 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 \$4,622 with approximately \$263 resulting from the embedded derivative associated with our 6.75% Note due 2014, \$498 resulting from the embedded derivative associated with our 6.75% exchange notes due 2014, and the remaining \$3,861 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 \$6,820 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 \$130,670 and \$125,889. We recorded the fair market value of our embedded derivatives at the midpoint of the inputs at \$128,236 as of September 30, 2011. The estimated fair market value of our embedded derivatives could change significantly based on future market conditions.

We held investment securities available for sale totaling approximately \$58,900 at September 30, 2011, which

includes 13,891,205 shares of Ladenburg Thalmann Financial Services Inc. carried at \$21,531.

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 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 physiologic 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.

The 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 the 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. The FDA user fees for Liggett and Vector Tobacco for 2010 were \$10,083 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 these regulations, including the ban on color and graphics, 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. On January 4, 2010, a federal judge 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. 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 is 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 is considering those issues, it intends 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, while FDA is in the process of evaluating these concerns. We cannot predict the future course or outcome of FDA's deliberations or this litigation.

On June 22, 2011, FDA issued a final rule that modifies the required warnings that appear on cigarette packages and in cigarette advertisements. The rule becomes effective September 22, 2012, and requires each cigarette package and advertisement to bear one of nine new textual warning statements accompanied by color graphic images. The warnings must 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 warning labels on First Amendment and other grounds. The manufacturers are also seeking a preliminary injunction staying implementation of the warning requirement, and other related labeling requirements, pending the court's ruling on the merits of the challenge. We cannot predict the outcome of this litigation or whether or how the inclusion of the new warnings, if ultimately required, will impact product sales or whether it will have a material adverse effect on us.

FDA law 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 95% 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 \$31,161 for 2010. Management anticipates that the assessment will

be higher 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 the FTC method. In its rescission notice, the FTC also indicated that advertisers should no longer use terms suggesting the 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, the FTC indicated that cigarette descriptors such as “light” and “ultra light” have not been defined by the FTC, nor has the FTC provided any guidance or authorization for their use. The 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. The 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 the 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 limit the advertising, sale and use of cigarettes, and these laws 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:

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economic outlook,  
capital expenditures,  
cost reduction,  
new legislation,  
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,  
impact of current crises in capital and credit markets, including any continued worsening,  
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 restructurings on our tobacco business and our ability to achieve any increases in profitability estimated to occur as a result of these restructurings,  
impact of new legislation on our competitors' payment obligations, results of operations and product costs, i.e. the impact of recent 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 Agreement and other settlement agreements with the states.

Further information on risks and uncertainties specific to our business include the risk factors discussed above in “Management's Discussion and Analysis of Financial Condition and Results Operations” and under Item 1A, “Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2010 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 for the year ended December 31, 2010. Please refer to that section for disclosures regarding the risks and uncertainties related to our business. The risk factors in the Annual Report on Form 10-K entitled "Litigation will continue to harm the tobacco industry", "Individual tobacco-related cases have increased as a result of the Florida Supreme Court's ruling in Engle" and "Liggett may have additional payment obligations under the Master Settlement Agreement and its other settlement agreements with the states" are revised to reflect the updated information concerning the number and status of cases and other matters discussed under Note 5 to our condensed consolidated financial statements and in "Management's Discussion and Analysis of Financial Condition - Recent Developments - Tobacco Settlement Agreements", "- Recent Developments in Legislation, Regulation and Tobacco-Related Litigation", and "- Legislation and Regulation."

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

No securities of ours which were not registered under a private offering of the Securities Act of 1933 have been issued or sold by us during the nine months ended September 30, 2011.

Our purchases of our common stock during the nine months ended September 30, 2011 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
January 1 to January 31, 2011	349,157	(1) \$15.81	(1) —	—
February 1 to February 28, 2011	—	—	—	—
March 1 to March 31, 2011	—	—	—	—
April 1 to April 30, 2011	—	—	—	—
May 1 to May 31, 2011	—	—	—	—
June 1 to June 30, 2011	—	—	—	—
July 1 to July 31, 2011	—	—	—	—
August 1 to August 31, 2011	—	—	—	—
September 1 to September 30, 2011	64,071	(2) 19.09	(2) —	—
Total	413,228	\$16.32	—	—

(1) Delivery of shares to us in payment of exercise price and tax withholding in connection with an employee's stock options. 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 29, 2011.

(2) Delivery of shares to us in payment of tax withholding in connection with an employee's vesting in restricted stock. 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 29, 2011.

#### Item 6. Exhibits

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

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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: November 3, 2011