

VECTOR GROUP LTD
Form 10-Q
May 06, 2010

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**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 March 31, 2010**

VECTOR GROUP LTD.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation

incorporation or organization)

1-5759

Commission File Number

65-0949535

(I.R.S. Employer Identification
No.)

**100 S.E. Second Street
Miami, Florida 33131
305/579-8000**

(Address, including zip code and telephone number, including area code,
of the principal executive offices)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended (the Exchange Act), during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. 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 the definition of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

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

(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. Yes No

At May 6, 2010, Vector Group Ltd. had 71,282,731 shares of common stock outstanding.

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VECTOR GROUP LTD. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(Dollars in Thousands, Except Per Share Amounts)
Unaudited

	March 31, 2010	December 31, 2009
ASSETS:		
Current assets:		
Cash and cash equivalents	\$ 202,957	\$ 209,454
Investment securities available for sale	61,615	51,743
Accounts receivable trade	7,154	8,098
Inventories	101,613	98,486
Deferred income taxes	16,409	14,154
Restricted assets	1,378	3,138
Other current assets	3,478	4,135
Total current assets	394,604	389,208
Property, plant and equipment, net	43,821	42,986
Investment in Escena, net	13,488	13,244
Long-term investments accounted for at cost	50,323	50,323
Investments in non-consolidated real estate businesses	51,809	49,566
Restricted assets	5,166	4,835
Deferred income taxes	38,580	39,838
Intangible asset	107,511	107,511
Prepaid pension costs	9,237	8,994
Other assets	28,541	29,037
Total assets	\$ 743,080	\$ 735,542
LIABILITIES AND STOCKHOLDERS DEFICIENCY:		
Current liabilities:		
Current portion of notes payable and long-term debt	\$ 29,787	\$ 21,889
Current portion of employee benefits	1,029	1,029
Accounts payable	4,819	4,355
Accrued promotional expenses	10,687	12,745
Income taxes payable, net	19,193	19,924
Accrued excise and payroll taxes payable, net	14,812	24,093
Settlement accruals	42,247	18,803
Deferred income taxes	22,283	17,254
Accrued interest	6,967	13,840
Other current liabilities	11,250	15,076
Total current liabilities	163,074	149,008
Notes payable, long-term debt and other obligations, less current portion	335,064	334,920

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Fair value of derivatives embedded within convertible debt	155,729	153,016
Non-current employee benefits	34,598	34,247
Deferred income taxes	44,286	45,120
Other liabilities	23,692	23,913
Total liabilities	756,443	740,224
Commitments and contingencies		
Stockholders' deficiency:		
Preferred stock, par value \$1.00 per share, 10,000,000 shares authorized		
Common stock, par value \$0.10 per share, 150,000,000 shares authorized, 74,520,642 and 74,510,595 shares issued and 71,272,731 and 71,262,684 shares outstanding	7,127	7,126
Additional paid-in capital		15,928
Accumulated deficit	(461)	
Accumulated other comprehensive loss	(7,172)	(14,879)
Less: 3,247,911 shares of common stock in treasury, at cost	(12,857)	(12,857)
Total stockholders' deficiency	(13,363)	(4,682)
Total liabilities and stockholders' deficiency	\$ 743,080	\$ 735,542

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 OPERATIONS
(Dollars in Thousands, Except Per Share Amounts)
Unaudited

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
Revenues*	\$ 222,087	\$ 121,216
Expenses:		
Cost of goods sold*	169,911	72,526
Operating, selling, administrative and general expenses	21,158	21,530
Gain on brand transaction		(5,000)
Restructuring charges		1,000
Operating income	31,018	31,160
Other income (expenses):		
Interest and dividend income	65	150
Interest expense	(18,805)	(16,074)
Change in fair value of derivatives embedded within convertible debt	(2,714)	(303)
Impairment charges on investments		(8,500)
Equity income (loss) from non-consolidated real estate businesses	4,571	(995)
Gain on the sale of investment securities available for sale	4,664	
Other, net	61	
Income before provision for income taxes	18,860	5,438
Income tax expense	6,922	2,338
Net income	\$ 11,938	\$ 3,100
Per basic common share:		
Net income applicable to common shares	\$ 0.17	\$ 0.04
Per diluted common share:		
Net income applicable to common shares	\$ 0.15	\$ 0.04
Cash distributions and dividends declared per share	\$ 0.40	\$ 0.38

* Revenues and
Cost of goods
sold include
excise taxes of
\$111,193 and
\$33,712,
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		Accumulated	Other	Treasury	
	Shares	Amount	Paid-In	Accumulated	Comprehensive	Loss	Stock	Total
			Capital	Deficit				
Balance, December 31, 2009	71,262,684	\$ 7,126	\$ 15,928	\$		\$ (14,879)	\$ (12,857)	\$ (4,682)
Net income				11,938				11,938
Pension-related minimum liability adjustments, net of income taxes						486		486
Forward contract adjustments, net of income taxes						9		9
Change in net unrealized gain on investment securities, net of income taxes						9,983		9,983
Net unrealized gains reclassified into net income, net of income taxes						(2,771)		(2,771)
Net unrealized gain on investment securities, net of income taxes						7,212		7,212
Total other comprehensive income								19,645
Total comprehensive income								14,963
Distributions and dividends on common stock			(16,755)	(12,399)				(29,154)
Exercise of stock options	10,047	1	138					139

Amortization of deferred compensation										689								689
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Balance, March 31, 2010	71,272,731	\$ 7,127	\$		\$	(461)	\$	(7,172)	\$	(12,857)	\$	(13,363)
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The accompanying notes are an integral part
of the condensed consolidated financial statements.

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

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
Net cash provided by operating activities	\$ 13,163	\$ 21,088
Cash flows from investing activities:		
Sale or maturity of investment securities	6,933	
Proceeds from sale or liquidation of long-term investments		908
Investments in non-consolidated real estate businesses	(605)	
Distributions from non-consolidated real estate businesses	2,154	1,182
Increase in cash surrender value of life insurance policies	(536)	(356)
(Increase) decrease in non-current restricted assets	(331)	452
Proceeds from sale of fixed assets	3	
Capital expenditures	(3,795)	(803)
Net cash provided by investing activities	3,823	1,383
Cash flows from financing activities:		
Proceeds from debt issuance	2,112	10
Repayments of debt	(1,168)	(1,604)
Borrowings under revolver	216,456	123,724
Repayments on revolver	(210,997)	(123,291)
Dividends and distributions on common stock	(30,024)	(30,076)
Proceeds from exercise of Vector options and warrants	138	10
Net cash used in financing activities	(23,483)	(31,227)
Net decrease in cash and cash equivalents	(6,497)	(8,756)
Cash and cash equivalents, beginning of period	209,454	211,105
Cash and cash equivalents, end of period	\$ 202,957	\$ 202,349

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

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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 Inc. (Liggett Vector Brands), New Valley LLC (New Valley) and other less significant subsidiaries. All significant intercompany balances and transactions have been eliminated.

Liggett is engaged in the manufacture and sale of cigarettes in the United States. Vector Tobacco is engaged in research related to reduced risk cigarette products. 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, 2009 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 2009 financial information to conform to the 2010 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, 2009. All per share amounts have been presented as if the stock dividends had occurred on January 1, 2009.

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

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
Net income	\$ 11,938	\$ 3,100
Income attributable to participating securities	(263)	(142)
Net income available to common stockholders	\$ 11,675	\$ 2,958

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VECTOR GROUP LTD.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Dollars in Thousands, Except Per Share Amounts)

Unaudited

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

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
Net income	\$ 11,938	\$ 3,100
Income attributable to 6.75% Variable Interest Senior Convertible Exchange Notes	(257)	
Income attributable to participating securities	(263)	(142)
Net income available to common stockholders	\$ 11,418	\$ 2,958

Basic and diluted EPS were calculated using the following shares:

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
Weighted-average shares for basic EPS	70,722,468	69,093,052
Plus incremental shares related to stock options	147,798	17,015
Plus incremental shares related to convertible debt	6,617,278	
Weighted-average shares for fully diluted EPS	77,487,544	69,110,067

The following stock options, non-vested restricted stock and shares issuable upon the conversion of convertible debt were outstanding during the three months ended March 31, 2010 and 2009 but were not included in the computation of diluted EPS.

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
Number of stock options	509,442	663,997
Weighted-average exercise price	\$ 18.14	\$ 17.44

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Weighted-average shares of non- vested restricted stock	15,440	221,880
Weighted-average expense per share	\$ 17.11	\$ 16.30
Weighted-average number of shares issuable upon conversion of debt	9,709,561	13,579,184
Weighted-average conversion price	\$ 16.48	\$ 16.34

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VECTOR GROUP LTD.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
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Unaudited

(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 (loss) was income of \$19,645 for the three months ended March 31, 2010 and a loss of \$1,213 for the three months ended March 31, 2009.

(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 Vector's stock price. The range of estimated fair market values of the Company's embedded derivatives was between \$159,252 and \$152,346. The Company recorded the fair market value of its embedded derivatives at the midpoint of the inputs at \$155,729 as of March 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 June 2009, the FASB issued an amendment to the accounting and disclosure requirements for transfers of financial assets. The guidance requires additional disclosures for transfers of financial assets and changes the requirements for derecognizing financial assets. The Company adopted this guidance for interim and annual reporting periods beginning on January 1, 2010. The adoption of this guidance did not impact the Company's condensed consolidated financial statements.

In June 2009, the FASB issued an amendment to the accounting and disclosure requirements for the consolidation of variable interest entities. The amended guidance eliminates exceptions to consolidating qualifying special purpose entities, contains new criteria for determining the primary beneficiary, and increases the frequency of required reassessments to determine whether a company is the primary beneficiary of a variable interest entity. This guidance also contains a new requirement that any term, transaction, or arrangement that does not have a substantive effect on an entity's status as a variable interest entity, a company's power over a variable interest entity, or a company's obligation to absorb losses or its right to receive benefits of an entity must be disregarded. The elimination of the qualifying special-purpose entity concept and its consolidation exception means more entities will be subject to consolidation assessments and reassessments. The Company adopted this guidance for interim and annual reporting periods beginning on January 1, 2010. The adoption of this guidance did not impact the Company's condensed consolidated financial statements.

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

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VECTOR GROUP LTD.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Dollars in Thousands, Except Per Share Amounts)

Unaudited

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.

2. INVENTORIES

Inventories consist of:

	March 31, 2010	December 31, 2009
Leaf tobacco	\$ 47,023	\$ 48,942
Other raw materials	3,916	3,497
Work-in-process	398	2,388
Finished goods	67,126	59,293
Inventories at current cost	118,463	114,120
LIFO adjustments	(16,850)	(15,635)
	\$ 101,613	\$ 98,485

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 March 31, 2010, Liggett had leaf tobacco purchase commitments of approximately \$30,300. During 2007, the Company entered into a single source supply agreement for fire safe cigarette paper through 2012.

All of the Company's inventories at March 31, 2010 and December 31, 2009 have been reported under the LIFO method.

3. LONG-TERM INVESTMENTS

Long-term investments consist of investments in the following:

	March 31, 2010		December 31, 2009	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Investment partnerships	\$ 49,486	\$ 69,699	\$ 49,486	\$ 68,679
Real estate partnership	837	1,259	837	1,261
	\$ 50,323	\$ 70,958	\$ 50,323	\$ 69,940

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

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

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VECTOR GROUP LTD.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Dollars in Thousands, Except Per Share Amounts)
Unaudited

	March 31, 2010	December 31, 2009
Vector:		
11% Senior Secured Notes due 2015, net of unamortized discount of \$4,655 and \$4,849	\$ 245,345	\$ 245,151
6.75% Variable Interest Senior Convertible Note due 2014, net of unamortized discount of \$39,491 and \$39,755*	10,509	10,245
6.75% Variable Interest Senior Convertible Exchange Notes due 2014, net of unamortized discount of \$68,702 and \$69,749*	38,828	37,781
3.875% Variable Interest Senior Convertible Debentures due 2026, net of unamortized discount of \$83,455 and \$83,589*	26,545	26,411
Liggett:		
Revolving credit facility	22,841	17,382
Term loan under credit facility	6,622	6,755
Equipment loans	6,073	4,852
V.T. Aviation:		
Note payable	3,520	3,882
VGR Aviation:		
Note payable	3,595	3,687
Other	973	663
Total notes payable, long-term debt and other obligations	364,851	356,809
Less:		
Current maturities	(29,787)	(21,889)
Amount due after one year	\$ 335,064	\$ 334,920

* The fair value of the derivatives embedded within the 6.75% Variable Interest Convertible Note (\$22,352 at March 31, 2010 and \$23,890 at December 31,

2009, respectively),
the 6.75% Variable
Interest Senior
Convertible
Exchange Notes
(\$42,373 at
March 31, 2010 and
\$47,552 at
December 31,
2009, respectively),
and the 3.875%
Variable Interest
Senior Convertible
Debentures
(\$91,004 at
March 31, 2010 and
\$81,574 at
December 31,
2009, 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) under which \$22,841 was outstanding at March 31, 2010. Availability as determined under the facility was approximately \$13,200 based on eligible collateral at March 31, 2010.

11% Senior Secured Notes due 2015 – Vector:

In September 2009, the Company sold an additional \$85,000 principal amount of its 11% Senior Secured Notes due 2015 (the Senior Secured Notes) at 94% of face value in a private offering to qualified institutional investors in accordance with Rule 144A of the Securities Act of 1933.

In April 2010, the Company sold an additional \$75,000 principal amount of the Senior Secured Notes at 101% of face value in a private offering to qualified institutional investors in accordance with Rule 144A of the Securities Act of 1933. The Company received net proceeds from the 2010 offering of approximately \$73,500.

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VECTOR GROUP LTD.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Dollars in Thousands, Except Per Share Amounts)

Unaudited

On May 6, 2010, the Company commenced an offer to exchange the Senior Secured Notes issued in September 2009 and April 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.

Non-cash Interest Expense – Vector:

Components of non-cash interest expense is as follows:

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
Amortization of debt discount	\$ 1,638	\$ 2,681
Amortization of deferred finance costs	1,002	954
	\$ 2,640	\$ 3,635

Fair Value of Notes Payable and Long-term Debt:

	March 31, 2010		December 31, 2009	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Notes payable and long-term debt	\$364,851	\$604,437	\$356,809	\$573,439

5. CONTINGENCIES**Tobacco-Related Litigation:***Overview*

Since 1954, Liggett and other United States cigarette manufacturers have been named as defendants in numerous direct, third-party and purported class actions predicated on the theory that cigarette manufacturers should be liable for damages alleged to have been caused by cigarette smoking or by exposure to secondary smoke from cigarettes. New cases continue to be commenced against Liggett and other cigarette manufacturers. The cases generally fall 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 and the effects of the tobacco litigation settlements discussed below are not quantifiable at this time. For the three months ended March 31, 2010 and 2009, Liggett incurred legal expenses and other litigation costs totaling approximately \$1,648 and \$1,387, respectively.

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VECTOR GROUP LTD.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Dollars in Thousands, Except Per Share Amounts)

Unaudited

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 or other litigation could encourage the commencement of additional litigation. Damages claimed in some tobacco-related or other 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 43 states now limit the dollar amount of bonds or require no bond at all. Liggett has secured approximately \$1,127 in bonds as of March 31, 2010.

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: (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. 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 the best interest of the Company to do so.

Individual Actions

As of March 31, 2010, there were 35 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 or exposure to secondary smoke and seek compensatory and, in some cases, punitive damages. In addition, there were approximately 7,160 *Engle* progeny cases (defined below) pending against Liggett and the Company, in state and federal courts in Florida, and 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 March 31, 2010 (excluding *Engle* progeny cases and the consolidated cases in West Virginia):

State	Number of Cases
Florida	15
New York	9
Louisiana	5
West Virginia	2
Maryland	2
Missouri	1
Ohio	1

Liggett Only Cases. There are currently five 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 of \$1,200 against Liggett, but found that the plaintiff was 40% at fault. Therefore, plaintiff was awarded \$720 in compensatory damages and \$96 in expenses. Punitive damages were not awarded. Liggett appealed the award. In May 2009, the court granted plaintiff's motion for an award of attorneys' fees but the amount has not yet been determined. In *Hausrath v. Philip Morris*, a case pending in New York state court, plaintiffs recently dismissed all defendants other than Liggett. The other three individual actions, in which Liggett is the only tobacco company defendant, are dormant.

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VECTOR GROUP LTD.
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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.

In addition to awards against Liggett, including *Ferlanti* (and the *Engle* progeny cases described below), jury awards in individual cases have also been returned against other cigarette manufacturers in recent years. The awards in these individual actions, often in excess of millions of dollars, may be for both compensatory and punitive damages. There are several significant jury awards against other cigarette manufacturers which are currently on appeal and several awards which are final and have been paid.

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 approximately 7,160 *Engle* progeny cases in both state and federal courts in Florida. Other cigarette manufacturers have also been named as defendants in these cases. These cases include approximately 8,500 plaintiffs, approximately 3,860 of whom have claims pending in federal court and 5,295 in state court. Duplicate cases were filed in federal and state court on behalf of approximately 660 plaintiffs. The federal court cases are stayed pending the outcome of an appeal to the United States Court of Appeals for the Eleventh Circuit of several district court orders in which it was found that the Florida Supreme Court's decision in *Engle* was unconstitutional. The number of *Engle* progeny cases will likely increase as the courts may require multi-plaintiff cases 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 April 30, 2010, in addition to the *Lukacs* case described below, the following *Engle* progeny cases have resulted in verdicts against Liggett:

Date of Verdict	Case Name	County	Verdict Against Liggett
August 2009	<i>Campbell, et al. v. R.J. Reynolds</i>	Escambia	\$ 156
March 2010	<i>Douglas v. R.J. Reynolds</i>	Hillsborough	\$1,350
April 2010	<i>Clay v. R.J. Reynolds</i>	Escambia	\$349 plus \$1,000 in punitive damages

April 2010	<i>Putney v. R.J. Reynolds</i>	Broward 13	\$3,017
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These verdicts are all currently on appeal or will be appealed. As of April 30, 2010, there were 38 *Engle* progeny cases scheduled for trial in 2010 and 2011, where Liggett and the Company are named defendants. For further information on the *Engle* case and on *Engle* progeny cases, including a description of the *Lukacs* case, see Class Actions *Engle* Case, below.

Class Actions

As of March 31, 2010, there were seven 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. Many of these actions purport to constitute statewide class actions and were filed after May 1996 when the United States Court of Appeals for the Fifth Circuit, in *Castano v. American Tobacco Co.*, reversed a federal district court's certification of a purported nationwide class action on behalf of persons who were allegedly addicted to tobacco products.

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 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

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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 8,500 former *Engle* class members have claims pending against the Company and Liggett and other cigarette manufacturers.

Three federal district courts (in the *Merlob*, *Brown* and *Burr* cases) have ruled that the findings in Phase I of the *Engle* proceedings cannot be used to satisfy elements of plaintiffs' claims, and two of those rulings (*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). Oral argument was held in January 2010. A decision is pending. *Engle* progeny cases pending in the federal district courts in the Middle District of Florida have been stayed pending interlocutory review by the Eleventh Circuit. Several state trial court judges have issued contrary rulings that allowed plaintiffs to use the *Engle* findings to establish elements of their claims and required certain defenses to be stricken.

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 (for which Liggett is 50% responsible), plus interest from June 2002 which, as of March 31, 2010, was in excess of \$15,000 (for which

Liggett is 50% responsible). Plaintiff filed a motion seeking an award of attorneys' fees from Liggett based on plaintiff's prior proposal for settlement. All proceedings relating to the motion for attorneys' fees are stayed pending a final resolution of appellate proceedings. Defendants filed a notice of appeal in December 2008. On March 17, 2010, the Third District Court of Appeal affirmed the decision, *per curiam*, which will not likely be reviewed by the Florida Supreme Court. The defendants have filed a petition for rehearing with the court of appeal.

In June 2009, Florida amended its existing bond cap statute by adding a \$200,000 bond cap that applies to all *Engle* progeny lawsuits 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, which became effective in June 2009, applies to judgments entered after the effective date and remains in effect until December 31, 2012.

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.

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, among other things. One such suit, *Schwab [McLaughlin] v. Philip Morris*, pending in federal court in New York since 2004, sought to create a nationwide class of "light" cigarette smokers. In September 2006, the United States District Court for the Eastern District of New York certified the class. In April 2008, the United States Court of Appeals for the Second Circuit decertified the class. The case was returned to the trial court for further proceedings. 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. This ruling has resulted in the filing of additional "lights" class action cases in other states against other cigarette manufacturers. Although Liggett was

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not a defendant in the *Good* case, 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 the appeal in *Scott v. American Tobacco Co.* (see discussion below).

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 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 light cigarettes. The case was then removed to federal court on the basis of this new claim. In September 2009, the court granted summary judgment to all defendants other than Philip Morris as to the lights claims. In November 2009, plaintiffs filed a revised motion for class certification as to the three proposed classes, which motion was denied by the court on February 22, 2010. On February 1, 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, if the plaintiffs identified another class representative, which they did on April 13, 2010. Defendants intend to move to dismiss the remaining addiction claim. The court plans to rule on that motion on or before June 9, 2010.

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 were preempted by federal law, in light of the recent United States Supreme Court decision in *Altria Group v. Good*. The court is reviewing the question. A hearing was held on March 11, 2010. A decision is pending.

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 is scheduled for June 2010. If the case were to proceed against Liggett, it is estimated that Liggett could be a defendant in approximately 100 of the individual cases.

Class certification motions are pending in a number of other cases and a number of orders denying class certification are on appeal. In addition to the cases described above, numerous class actions remain certified against other cigarette manufacturers, including *Scott*. In that case, a Louisiana jury returned a \$591,000 verdict (subsequently reduced by the court to \$263,500 plus interest from June 2004) against other cigarette manufacturers to fund medical monitoring or smoking cessation programs for members of the class. Oral argument on the appeal occurred in September 2009. In April 2010, the Louisiana Fourth Circuit Court of Appeal affirmed in part prior decisions ordering the defendants to fund a statewide 10-year smoking cessation program. The court of appeal lowered the amount of the judgment to approximately \$241,000, plus interest from July 2008.

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Health Care Cost Recovery Actions

As of March 31, 2010, there were three active Health Care Cost Recovery Actions pending against Liggett. Other cigarette manufacturers are also named in these cases. The claims asserted in health care cost recovery actions vary. Although, typically, no specific damage amounts are pled, it is possible that requested damages might be in the billions of dollars. In these cases, plaintiffs typically assert equitable claims that the tobacco industry was unjustly enriched by their payment of health care costs allegedly attributable to smoking and seek reimbursement of those costs. Relief sought by some, but not all, plaintiffs include punitive damages, multiple damages and other statutory damages and penalties, injunctions prohibiting alleged marketing and sales to minors, disclosure of research, disgorgement of profits, funding of anti-smoking programs, additional disclosure of nicotine yields, and payment of attorney and expert witness fees.

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

DOJ Case. 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 and Remedial Order 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 *writs of certiorari* to the United States Supreme Court. In the government's petition, it is seeking reinstatement of its claims for remedies, including disgorgement of industry profits. Although this case has been concluded as to Liggett, 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 *City of St. Louis v. American Tobacco Company*, a case pending in Missouri state court since December 1998, the City of St. Louis and approximately 40 hospitals seek recovery of costs expended by the hospitals on behalf of patients who suffer, or have suffered, from illnesses allegedly resulting from the use of cigarettes. In June 2005, the court granted defendants' motion for summary judgment as to claims for damages which accrued prior to November 16, 1993. The claims for damages which allegedly accrued after November 16, 1993 are pending. Discovery is ongoing. In September 2009, the defendants filed a motion for partial summary judgment on the plaintiffs' claims for future damages and for fraud. In December 2009, the defendants filed motions for summary judgment based upon, among other things, plaintiffs' failure to prove unreimbursed costs and plaintiffs' failure to show fact of injury or damage. These motions are pending before the court. Trial is scheduled to commence January 10, 2011.

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

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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. Motions filed by defendants are pending before the Israel Supreme Court seeking appeal from a lower court's decision granting leave to plaintiff for foreign service of process.

In May 2008, in *National Committee to Preserve Social Security and Medicare v. Philip Morris USA*, a case pending in the United States District Court for the Eastern District of New York, plaintiffs commenced an action to recover damages equal to twice the amount paid by Medicare for the smoking-related health care services provided from May 21, 2002 to the present, for which treatment defendants allegedly were required to make payment under the Medicare Secondary Payer provisions of the Social Security Act. In July 2008, defendants filed a motion to dismiss plaintiffs' claims and plaintiffs filed a motion for partial summary judgment. In March 2009, the court granted the defendants' motion and dismissed the case. In May 2009, plaintiffs noticed an appeal. In September 2009, defendants filed a motion for summary disposition of the appeal and for a stay of the briefing schedule. The stay was granted. In January 2010, the Second Circuit Court of Appeals referred the motion for summary affirmance to the Merits Panel and ordered briefing on the motion.

Upcoming Trials

In addition to the January 2011 trial in the *City of St. Louis* case discussed above, as of April 30, 2010, there were 38 *Engle* progeny cases that are scheduled for trial in 2010 and 2011. The Company and/or Liggett and other cigarette manufacturers are currently named as defendants in each of these cases. Cases against other cigarette manufacturers are also currently scheduled for trial in 2010 and 2011. 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

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

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

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

Liggett has no payment obligations under the MSA except to the extent its market share exceeds a market share exemption of approximately 1.65% of total cigarettes sold in the United States. Vector Tobacco has no 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., domestic shipments by Liggett and Vector Tobacco accounted for approximately 2.7% of the total cigarettes shipped in the United States in 2009. 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. Liggett and Vector Tobacco paid \$54,435 for their 2009 MSA obligations.

Certain MSA Disputes

NPM Adjustment. In March 2006, an economic consulting firm selected pursuant to the MSA rendered its final and non-appealable decision 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, 2005 and 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 through 2009, Liggett and Vector Tobacco disputed that they owe the Settling States the NPM Adjustments as calculated by the Independent Auditor. As permitted by the MSA, Liggett and Vector Tobacco have withheld payment associated with these NPM Adjustment amounts. The total amount withheld or paid into a disputed payment account by Liggett and Vector Tobacco for 2003 through 2009 is \$29,236. In 2003, Liggett and Vector Tobacco paid the NPM adjustment amount of \$9,345 to the Settling States although both companies continue to dispute this amount. At March 31, 2010, included in Other assets on the Company's condensed

consolidated balance sheet was a noncurrent receivable of \$6,542 relating to such payment.

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The following amounts have not been expensed by the Company as they relate to Liggett and Vector Tobacco's NPM Adjustment claims for 2003 through 2009: \$6,542 for 2003, \$3,789 for 2004 and \$800 for 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 and non-appealable. One court, the Montana Supreme Court, ruled that Montana's claim of diligent enforcement must be litigated. This decision has been appealed. 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. The agreement provides for selection of the arbitration panel beginning November 1, 2009 and that the parties and the arbitrators will thereafter establish the schedule and procedures for the arbitration. 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. It is anticipated that the arbitration will commence in 2010. There can be no assurance that Liggett or Vector Tobacco will receive any adjustment as a result of these proceedings.

Gross v. Net Calculations. In October 2004, the independent auditor notified Liggett and all other Participating Manufacturers that their payment obligations under the MSA, dating from the agreement's execution in late 1998, had been recalculated using net unit amounts, rather than gross unit amounts (which had been used since 1999). Liggett objected to this retroactive change and disputed the change in methodology. Liggett contends that the retroactive change from gross to net unit amounts is impermissible for several reasons, including:

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

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

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

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

The change in the method of calculation could result in Liggett owing, at a minimum, approximately \$9,500, 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 future MSA payments would be at least approximately \$2,250 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 material payments, which payments could adversely affect the Company's consolidated financial position, results of operations or cash flows.

Litigation Challenging the MSA. In *Freedom Holdings Inc. v. Cuomo*, litigation pending in federal court in New York, certain importers of cigarettes allege that the MSA and certain related New York statutes violate federal antitrust and constitutional law. The district court granted New York's motion to dismiss the complaint for failure to state a claim. On appeal, 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 on antitrust grounds.

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In January 2009, the district court granted New York's motion for summary judgment, dismissing all claims brought by the plaintiffs, and dissolving the preliminary injunction. Plaintiffs appealed the decision. Oral argument on the appeal occurred in December 2009. A decision is pending.

In *Grand River Enterprises Six Nations, Ltd. v. King*, another proceeding pending in federal court in New York, plaintiffs seek 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. Discovery is pending.

Similar challenges to the MSA and MSA-related state statutes are pending in Kentucky, Arkansas, Kansas, Louisiana, Tennessee and Oklahoma. Liggett and the other cigarette manufacturers are not defendants in these cases. 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 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.

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

In 2003, in order to resolve any potential issues with Minnesota as to Liggett's ongoing economic settlement obligations, Liggett negotiated a \$100 a year payment to Minnesota, to be paid any year cigarettes manufactured by Liggett are sold in that state. In 2004, the Attorneys General for Florida, Mississippi and Texas advised Liggett that they believed that Liggett had failed to make required payments under the respective settlement agreements with these states from 1998 through 2003 and that additional payments may be due for subsequent years. Liggett believes the states' allegations are without merit, based, among other things, on the language of the most favored nation provisions of the settlement agreements. There can be no assurance that Liggett will resolve these matters or that Liggett will not be required to make additional material payments, which payments could adversely affect the Company's consolidated financial position, results of operations or cash flows. During 2009, Liggett reversed a previously recorded accrual of \$2,500 with respect to this matter.

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 compensatory damages against Liggett and two other defendants and found
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Liggett 50% responsible for the damages. In November 2008, the court entered final judgment in favor of the plaintiff for \$24,835, plus interest from 2002 which, as of March 31, 2010, exceeded \$15,000. The *Lukacs* verdict was recently affirmed by the appellate court. Liggett has been found liable in four other *Engle* progeny cases, which are currently on appeal or will be appealed. As a result of the *Engle* decision, approximately 8,500 former *Engle* class members have claims pending against the Company and Liggett and other cigarette manufacturers. It is possible that other cases could be decided unfavorably against Liggett and that Liggett will be unsuccessful on appeal. Liggett may enter into discussions in an 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 and costs. 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 similar 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.

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.

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Other Matters:

In February 2004, Liggett Vector Brands and another cigarette manufacturer entered into a five year agreement with a subsidiary of the American Wholesale Marketers Association to support a program to permit certain tobacco distributors to secure, on reasonable terms, tax stamp bonds required by state and local governments for the distribution of cigarettes. This agreement has been extended through February 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 March 31, 2010. In December 2009, a complaint was filed against Liggett in Alabama state court by the estate of a woman who died, in 2007, in a house fire allegedly caused by the ignition of contents of the house by a Liggett cigarette. Plaintiff is suing under the Alabama Extended Manufacturers Liability Doctrine and for breach of warranty and negligence. The plaintiff seeks both punitive and compensatory damages. In February 2010, Liggett filed a notice of removal to federal court. Plaintiff filed a motion for remand. A hearing occurred in March 2010. A decision is pending. 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:

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	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
Income before provision for income taxes	\$ 18,860	\$ 5,438
Income tax expense using estimated annual effective income tax rate	7,422	2,338
Reduction of valuation allowance	(500)	
Income tax expense	\$ 6,922	\$ 2,338

The Company recorded a benefit of \$500 for the three months ended March 31, 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:

	March 31, 2010	December 31, 2009
Douglas Elliman Realty, LLC	\$ 38,696	\$ 36,086
Aberdeen Townhomes LLC	277	1,248
New Valley Oaktree Chelsea Eleven LLC	12,836	12,232
Investments in non-consolidated real estate businesses	\$ 51,809	\$ 49,566

Residential Brokerage Business. New Valley recorded income of \$4,571 and a loss of \$1,195 for the three months ended March 31, 2010 and 2009, respectively, associated with Douglas Elliman Realty, LLC. New Valley received cash distributions from Douglas Elliman Realty, LLC of \$1,962 and \$1,428 for the three months ended March 31, 2010 and 2009, respectively. The summarized financial information of Douglas Elliman Realty, LLC is as follows:

	March 31, 2010	December 31, 2009
Cash	\$ 30,836	\$ 26,920
Other current assets	7,243	6,664
Property, plant and equipment, net	13,525	13,498
Trademarks	21,663	21,663
Goodwill	38,349	38,601
Other intangible assets, net	1,550	742
Other non-current assets	2,638	2,871
Notes payable current	519	776

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Current portion of notes payable to member - Prudential Real Estate Financial Services of America, Inc.	1,360	2,487
Current portion of notes payable to member - New Valley	1,360	2,487
Other current liabilities	18,509	20,724
Notes payable - long term	1,132	2,136
Other long-term liabilities	9,965	7,747
Members' equity	82,959	74,602

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	Three Months Ended March	
	31,	
	2010	2009
Revenues	\$ 76,661	\$ 48,956
Costs and expenses	67,175	50,560
Depreciation expense	900	1,199
Amortization expense	77	64
Other income	397	
Interest expense, net	278	691
Income tax expense (benefit)	271	(310)
Net income (loss)	\$ 8,357	\$ (3,248)