

VECTOR GROUP LTD  
Form 10-Q  
October 31, 2014

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, 2014

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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4400 Biscayne Boulevard  
Miami, Florida 33137  
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.

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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 October 31, 2014, Vector Group Ltd. had 109,125,587 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, 2014	December 31, 2013
<b>ASSETS:</b>		
Current assets:		
Cash and cash equivalents	\$380,416	\$234,466
Investment securities available for sale	333,883	172,534
Accounts receivable - trade, net	13,607	12,159
Inventories	100,874	93,496
Deferred income taxes	25,540	50,479
Income taxes receivable, net	14,812	—
Restricted assets	2,780	1,785
Other current assets	34,226	23,392
Total current assets	906,138	588,311
Property, plant and equipment, net	86,622	79,258
Real estate held for sale, net	10,643	20,911
Long-term investments accounted for at cost	32,239	20,788
Long-term investments accounted for under the equity method	13,977	8,595
Investments in real estate ventures	154,281	128,202
Restricted assets	12,063	11,981
Deferred income taxes	70,316	51,474
Goodwill, trademarks and other intangible assets, net	268,141	271,111
Prepaid pension costs	28,165	26,080
Other assets	60,798	53,553
Total assets	\$1,643,383	\$1,260,264
<b>LIABILITIES AND STOCKHOLDERS' DEFICIENCY:</b>		
Current liabilities:		
Current portion of notes payable and long-term debt	\$101,158	\$151,577
Current portion of fair value of derivatives embedded within convertible debt	2,996	19,128
Current payments due under the Master Settlement Agreement	91,590	25,348
Current portion of employee benefits	939	939
Accounts payable	10,845	10,260
Accrued promotional expenses	20,010	18,655
Income taxes payable, net	3,174	6,423
Accrued excise and payroll taxes payable, net	861	11,621
Litigation accruals	3,307	59,310
Deferred income taxes	57,763	45,734
Accrued interest	17,721	21,968
Other current liabilities	34,256	34,147
Total current liabilities	344,620	405,110
Notes payable, long-term debt and other obligations, less current portion	857,107	540,766
Fair value of derivatives embedded within convertible debt	180,474	92,934
Non-current employee benefits	48,608	47,917
Deferred income taxes	165,726	137,650
Payments due under the Master Settlement Agreement	25,809	27,571
Litigation accruals	25,029	27,058
Other liabilities	3,877	2,867

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Total liabilities	1,651,250	1,281,873
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, 250,000,000 and 150,000,000 shares authorized, 113,270,834 and 101,430,853 shares issued and 109,125,587 and 97,482,998 shares outstanding	10,912	9,748
Additional paid-in capital	—	—
Accumulated deficit	(126,739)	(114,787)
Accumulated other comprehensive income	38,694	22,860
Less: 4,145,247 and 3,947,855 shares of common stock in treasury, at cost	(12,857)	(12,857)
Total Vector Group Ltd. stockholders' deficiency	(89,990)	(95,036)
Non-controlling interest	82,123	73,427
Total stockholders' deficiency	(7,867)	(21,609)
Total liabilities and stockholders' deficiency	\$1,643,383	\$1,260,264

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,	
	2014	2013	2014	2013
Revenues:				
Tobacco*	\$264,520	\$271,516	\$748,468	\$761,038
Real estate	153,748	6,425	415,280	19,298
E-Cigarettes	1,608	—	9,977	—
Total revenues	419,876	277,941	1,173,725	780,336
Expenses:				
Cost of sales:				
Tobacco*	189,728	194,991	537,667	548,377
Real estate	96,442	5,844	261,531	16,080
E-Cigarettes	1,066	—	6,357	—
Total cost of sales	287,236	200,835	805,555	564,457
Operating, selling, administrative and general expenses	69,431	26,478	200,431	77,915
Litigation settlement and judgment expense	225	87,913	1,725	87,913
Operating income (loss)	62,984	(37,285 )	166,014	50,051
Other income (expenses):				
Interest expense	(44,034 )	(33,583 )	(123,670 )	(99,045 )
Loss on extinguishment of debt	—	—	—	(21,458 )
Change in fair value of derivatives embedded within convertible debt	7,127	2,800	7,447	8,299
Acceleration of interest expense related to debt conversion	(994 )	—	(5,112 )	—
Equity income from real estate ventures	3,258	9,489	3,002	16,774
Equity income (loss) on long-term investments	829	(53 )	1,462	770
Gain (loss) on sale of investment securities available for sale	33	(99 )	(38 )	5,110
Other, net	2,466	2,871	8,167	5,151
Income (loss) before provision for income taxes	31,669	(55,860 )	57,272	(34,348 )
Income tax expense (benefit)	11,964	(18,969 )	21,007	(9,287 )
Net income (loss)	19,705	(36,891 )	36,265	(25,061 )
Net income attributed to non-controlling interest	(4,826 )	—	(10,881 )	—
Net income (loss) attributed to Vector Group Ltd.	\$14,879	\$(36,891 )	\$25,384	\$(25,061 )
Per basic common share:				
Net income (loss) applicable to common shares attributed to Vector Group Ltd.	\$0.14	\$(0.39 )	\$0.24	\$(0.26 )
Per diluted common share:				

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Net income (loss) applicable to common shares attributed to Vector Group Ltd.	\$0.14	\$(0.39 )	\$0.24	\$(0.26 )
Cash distributions and dividends declared per share	\$0.38	\$0.36	\$1.14	\$1.09

\* Revenues and cost of sales include excise taxes of \$115,323, \$121,787, \$327,434 and \$343,294, respectively.

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

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

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2013	
Net income (loss)	\$ 19,705	\$(36,891 )	\$ 36,265	\$(25,061 )
Net unrealized gains on investment securities available for sale:				
Change in net unrealized gains	19,184	11,848	22,292	28,752
Net unrealized (losses) gains reclassified into net income	(33 )	99	38	(5,110 )
Net unrealized gains on investment securities available for sale	19,151	11,947	22,330	23,642
Net unrealized (losses) gains on long-term investments accounted for under the equity method:				
Change in net unrealized (losses) gains	(4,694 )	1,754	3,920	1,170
Net unrealized (losses) gains reclassified into net income	—	—	—	—
Net unrealized (losses) gains on long-term investments accounted for under the equity method	(4,694 )	1,754	3,920	1,170
Net change in forward contracts	16	16	48	47
Net change in pension-related amounts	147	350	442	1,052
Other comprehensive income	14,620	14,067	26,740	25,911
Income tax effect on:				
Change in net unrealized gains on investment securities	(7,438 )	(4,810 )	(9,218 )	(11,673 )
Net unrealized (losses) gains reclassified into net income on investment securities	13	(41 )	(16 )	2,074
Change in unrealized (losses) gains on long-term investments	1,933	(712 )	(1,621 )	(475 )
Net unrealized (losses) gains reclassified into net income on long-term investments accounted for under the equity method	—	—	—	—
Forward contracts	(8 )	(7 )	(20 )	(19 )
Pension-related amounts	(105 )	(142 )	(31 )	(427 )
Income tax provision on other comprehensive income	(5,605 )	(5,712 )	(10,906 )	(10,520 )
Other comprehensive income, net of tax	9,015	8,355	15,834	15,391



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Comprehensive income (loss)	28,720	(28,536 )	52,099	(9,670 )
Comprehensive income attributed to non-controlling interest	(4,826 )	—	(10,881 )	—
Comprehensive income (loss) attributed to Vector Group Ltd.	\$23,894	\$(28,536 )	\$41,218	\$(9,670 )

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

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

	Vector Group Ltd. Stockholders' Deficiency							
	Common Shares	Stock Amount	Additional Paid-In Capital	Accumulated Deficit	Accumulated Comprehensive Income	Treasury Stock	Non-controlling Interest	Total
Balance, January 1, 2014	97,482,998	\$9,748	\$ —	\$(114,787)	\$ 22,860	\$(12,857)	\$ 73,427	\$(21,609 )
Net income	—	—	—	25,384	—	—	10,881	36,265
Change in net loss and prior service cost, net of income taxes	—	—	—	—	411	—	—	411
Forward contract adjustments, net of income taxes	—	—	—	—	28	—	—	28
Unrealized gain on long-term investment securities accounted for under the equity method, net of income taxes	—	—	—	—	2,299	—	—	2,299
Change in net unrealized gain on investment securities available for sale, net of income taxes	—	—	—	—	13,074	—	—	13,074
Net unrealized loss on investment securities available for sale reclassified into net income, net of income taxes	—	—	—	—	22	—	—	22
Unrealized gain on investment securities, net of income taxes	—	—	—	—	—	—	—	13,096
Total other comprehensive income	—	—	—	—	—	—	—	15,834
Total comprehensive income	—	—	—	—	—	—	—	52,099
Distributions and dividends on common stock	—	—	(84,524)	(36,816 )	—	—	—	(121,340 )
Restricted stock grant	1,000,000	100	—	—	—	—	—	100
Effect of stock dividend	5,195,856	520	—	(520 )	—	—	—	—
Note conversions, inclusive of taxes \$1,000	5,107,050	510	62,639	—	—	—	—	63,149

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Beneficial conversion feature of notes payable, net of income taxes of \$10,327	—	—	14,648	—	—	—	14,648
Exercise of stock options	339,683	34	4,273	—	—	—	4,307
Tax benefit of options exercised	—	—	937	—	—	—	937
Stock-based compensation	—	—	2,027	—	—	—	2,027
Contributions made by non-controlling interest	—	—	—	—	—	2,676	2,676
Distributions to non-controlling interest	—	—	—	—	—	(4,861)	(4,861)
Balance as of September 30, 2014	109,125,587	\$10,912	\$ —	\$(126,739)	\$ 38,694	\$(12,857)	\$ 82,123
							\$(7,867)

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, 2014	Nine Months Ended September 30, 2013	
Net cash provided by operating activities	\$100,044	\$55,244	
Cash flows from investing activities:			
Sale of investment securities	174,253	82,649	
Purchase of investment securities	(312,919)	(129,483)	)
Proceeds from sale or liquidation of long-term investments	549	75	
Purchase of long-term investments	(12,000)	(5,000)	)
Investments in real estate ventures	(29,378)	(45,977)	)
Investments in consolidated real estate businesses	—	(7,697)	)
Distributions from real estate ventures	5,540	2,463	
Increase in cash surrender value of life insurance policies	(435)	(470)	)
Increase in restricted assets	(1,108)	(553)	)
Issuance of notes receivable	(250)	—	
Proceeds from sale of fixed assets	4	11	
Capital expenditures	(20,746)	(8,686)	)
Repayments of notes receivable	933	9,460	
Purchase of subsidiaries	(250)	—	
Net cash used in investing activities	(195,807)	(103,208)	)
Cash flows from financing activities:			
Proceeds from debt issuance	413,918	454,200	
Financing costs	(12,360)	(11,750)	)
Repayments of debt	(10,305)	(420,710)	)
Borrowings under revolver	645,894	723,578	
Repayments on revolver	(673,866)	(736,007)	)
Dividends and distributions on common stock	(122,051)	(107,302)	)
Distributions to non-controlling interest	(4,861)	—	
Proceeds from exercise of Vector options	4,407	528	
Tax benefit of options exercised	937	33	
Net cash provided by (used in) financing activities	241,713	(97,430)	)
Net increase (decrease) in cash and cash equivalents	145,950	(145,394)	)
Cash and cash equivalents, beginning of period	234,466	405,855	
Cash and cash equivalents, end of period	\$380,416	\$260,461	

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

## VECTOR GROUP LTD.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(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"), Zoom E-Cigs LLC ("Zoom"), New Valley LLC ("New Valley") and other less significant subsidiaries. New Valley includes the accounts of Douglas Elliman Realty, LLC ("Douglas Elliman") 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. Zoom is engaged in the sale of electronic cigarettes in the United States. New Valley is engaged in the real estate business.

The accompanying unaudited, interim condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and, in management's opinion, contain all adjustments, consisting only of normal recurring items, necessary for a fair statement of the results for the periods presented. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. 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, 2013 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 2013 financial information to conform to the 2014 presentation.

In connection with the December 13, 2013 acquisition of Douglas Elliman, the Company was required to disclose Douglas Elliman's revenues and costs separately on the face of its condensed consolidated statements of operation. Consequently, the Company also revised the prior period in order to correctly present the gross revenues and costs of the other consolidated real estate investments as follows:

	Three Months Ended September 30, 2013			Nine Months Ended September 30, 2013		
	As Previously Reported	Revision	As Revised	As Previously Reported	Revision	As Revised
Revenues	\$271,516	\$(271,516)	\$—	\$761,038	\$(761,038)	\$—
Tobacco revenues	—	271,516	271,516	—	761,038	761,038
Real estate revenues	—	6,425	6,425	—	19,298	19,298
Total revenue	271,516	6,425	277,941	761,038	19,298	780,336
Cost of Sales	194,991	(194,991)	—	548,377	(548,377)	—
Tobacco cost of sales	—	194,991	194,991	—	548,377	548,377
Real estate cost of sales	—	5,844	5,844	—	16,080	16,080
Total cost of sales	194,991	5,844	200,835	548,377	16,080	564,457

Operating, selling, administrative and general expenses	\$25,897	\$581	\$26,478	\$74,697	\$3,218	\$77,915
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VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

In addition, the preliminary fair values of the assets acquired, liabilities assumed and the non-controlling interest recorded for Douglas Elliman as of December 13, 2013 were adjusted during the first quarter of 2014. Goodwill and current liabilities were reduced by \$454 and \$105, respectively, while intangible assets related to favorable lease agreements were increased by \$559. The amounts are preliminary as management is still evaluating the valuations of certain assets acquired in the acquisition. These adjustments have been reflected in the Company's condensed consolidated balance sheet as of December 31, 2013.

During the second quarter of 2014, Douglas Elliman accounts payable as of December 31, 2013, was reduced by \$16,434, while current liabilities were increased by \$16,434. Thus, prior period information has been recast to conform to the current presentation. This change did not have an impact to the Company's historical consolidated results.

As a result of the amount of operating losses of Zoom as of September 30, 2014 when compared to the remaining components of Corporate and Other segment, the Company has reevaluated its operating segments and has separated Zoom's operations from the Corporate and Other segment for previously reported 2014 periods and from the Tobacco segment for the previously reported 2013 periods. Thus, prior period information has been recast to conform to the current presentation. This change did not have an impact to the Company's historical consolidated results.

(b) Distributions and Dividends on Common Stock:

The Company records distributions on its common stock as dividends in its condensed consolidated statement of stockholders' deficiency 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) Revenue Recognition:

Tobacco sales: Revenues from sales are recognized upon the shipment of finished goods when title and risk of loss have passed to the customer, there is persuasive evidence of an arrangement, the sale price is determinable and collectibility is reasonably assured. The Company provides an allowance for expected sales returns, net of any related inventory cost recoveries. Certain sales incentives, including promotional price discounts, are classified as reductions of net sales. The Company's accounting policy is to include federal excise taxes in revenues and cost of goods sold. Since the Company's significant line of business is tobacco, the Company's financial position and its results of operations and cash flows have been and could continue to be materially adversely affected by significant unit sales volume declines at the Company and industry levels, regulation, litigation and defense costs, increased tobacco costs or reductions in the selling price of cigarettes in the near term.

Real estate sales: Revenue is recognized when persuasive evidence of an arrangement exists, the price is fixed or determinable, the transaction has been completed and collectibility of the resulting receivable is reasonably assured. Real estate and mortgage commissions earned by the Company's real estate and mortgage brokerage businesses are recorded as revenue on a gross basis upon the closing of a real estate transaction as evidenced when the escrow or similar account is closed, the transaction documents have been recorded and funds are distributed to all appropriate parties. Commissions and royalties expenses are recognized concurrently with related revenues. Property management

fees earned are recorded as revenue when the related services are performed.

E-Cigarettes: Revenues from sales are recognized upon the shipment of finished goods when title and risk of loss have passed to the customer, there is persuasive evidence of an arrangement, the sale price is determinable and collectibility is reasonably assured. The Company provides an allowance for expected sales returns, net of any related inventory cost recoveries. Certain sales incentives, including promotional price discounts, are classified as reductions of net sales.

(d)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 26, 2014. All per share amounts and references to share amounts have been updated to reflect the retrospective effect of the stock dividends.



## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2014	2013	2014	2013
Net income (loss) attributed to Vector Group Ltd.	\$ 14,879	\$(36,891 )	\$ 25,384	\$(25,061 )
Expense attributed to participating securities	(423 )	—	(739 )	—
Net income (loss) attributed to Vector Group Ltd. available to common stockholders	\$ 14,456	\$(36,891 )	\$ 24,645	\$(25,061 )

Basic and diluted EPS were calculated using the following shares:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2014	2013	2014	2013
Weighted-average shares for basic EPS	103,213,667	95,775,444	101,395,081	95,741,318
Plus incremental shares related to stock options and non-vested restricted stock	114,623	—	113,070	—
Weighted-average shares for basic and fully diluted EPS	103,328,290	95,775,444	101,508,151	95,741,318

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, 2014 and 2013 but were not included in the computation of diluted EPS because the effect was anti-dilutive.

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2014	2013	2014	2013
Number of stock options	N/A	524,887	N/A	524,887
Weighted-average exercise price	N/A	\$11.88	N/A	\$11.88
Weighted-average shares of non-vested restricted stock	N/A	55,125	N/A	55,125
Weighted-average expense per share	N/A	\$15.52	N/A	\$15.52
Weighted-average number of shares issuable upon conversion of debt	32,599,702	29,726,047	31,257,300	29,726,047
Weighted-average conversion price	\$18.36	\$14.50	\$17.30	\$14.50

## 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. At September 30, 2014, the range of estimated fair market values of the Company's embedded derivatives was between \$181,403 and \$185,583. The Company recorded the fair market value of its embedded derivatives at the midpoint of the range at \$183,470 as of September 30, 2014. At December 31, 2013, the range of estimated fair market values of the Company's embedded derivatives was between \$110,758 and \$113,392. The Company recorded the fair market value of its embedded derivatives at the midpoint of the range at \$112,062 as of December 31, 2013. The estimated fair market value of the Company's embedded derivatives could change significantly based on future market conditions. (See Note 6.)

## (f) Other Income, Net:

Other income, net consists of:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2014	2013	2014	2013
Gain on warrants	\$991	\$135	\$868	\$172
Interest income	1,476	2,647	3,665	4,123
Accretion of interest income from debt discount on notes receivable	11	81	87	704
Out-of-period adjustment	—	—	1,231	—
Acceleration of closing fee related to termination of Douglas Elliman joint venture	—	—	2,335	—
Gain on long-term investment	—	—	—	142
Other (expense) income	(12	) 8	(19	) 10
Other income, net	\$2,466	\$2,871	\$8,167	\$5,151

The out-of-period adjustment, recording for the period ending March 31, 2014, related to a non-accrual of a receivable from Douglas Elliman in the fourth quarter of 2013 and would have increased the Company's gain on acquisition of Douglas Elliman in 2013. The Company assessed the materiality of this error on all previously issued financial statements and concluded that the error was immaterial to all previously issued financial statements. The impact of correcting this error in the current year is not expected to be material to the Company's 2014 consolidated financial statements.



VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

(g) Goodwill, Trademarks and Other Intangible Assets:

The components of "Goodwill, trademarks and other intangible assets, net" were as follows:

	September 30, 2014	December 31, 2013
Intangible assets, net	\$7,649	\$11,919
Goodwill	72,976	71,681
Trademarks	80,005	80,000
Intangible asset associated with benefit under the Master Settlement Agreement	107,511	107,511
	\$268,141	\$271,111

The preliminary fair values of the assets acquired, liabilities assumed and the non-controlling interest recorded for Douglas Elliman as of December 13, 2013 were adjusted during the first quarter of 2014. Goodwill and current liabilities were reduced by \$454 and \$105, respectively, while intangible assets related to favorable lease agreements were increased by \$559. The amounts are preliminary as management is still evaluating the valuations of certain assets acquired in the acquisition. These adjustments have been reflected in the Company's condensed consolidated balance sheet as of December 31, 2013.

(h) Restricted Stock Grant

On July 23, 2014, the Company granted its President and Chief Executive Officer an award of 1,050,000 shares of its Common Stock subject to service and performance-based vesting. The Award Shares will be issued pursuant to the terms of an agreement that provides that both a performance requirement and a continued employment requirement must be met over a seven-year performance period to earn vested rights with respect to the Award Shares. The maximum potential amount of the Award Shares reflects recognition of the CEO's contributions as CEO since January 1, 2006 and the value of his management and real estate expertise to the Company.

(i) New Accounting Pronouncements:

In August 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-15, Presentation of Financial Statements-Going Concern (Subtopic 205-40)-Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern ("ASU 2014-15"). ASU 2014-15 provides guidance to United States Generally Accepted Accounting Principles ("U.S. GAAP") about management's responsibility to evaluate whether there is a substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. Specifically, ASU 2014-15 (1) defines the term substantial doubt, (2) requires an evaluation of every reporting period including interim periods, (3) provides principles for considering the mitigating effect of management's plan, (4) requires certain disclosures when substantial doubt is alleviated as a result of consideration of management's plans, (5) requires an express statement and other disclosures when substantial doubt is not alleviated, and (6) requires an assessment for a period of one year after the date that the financial statements are issued (or available to be issued). The amendments in this update are effective for annual periods beginning after December 15, 2016 and interim periods within those reporting periods. Earlier adoption is permitted. This ASU is not anticipated to have a material impact on the Company's consolidated financial statements and notes to the consolidated financial

statements.

In May 2014, the FASB issued ASU No. 2014-09, "Revenue from Contracts with Customers." This ASU is the result of a convergence project between the FASB and the International Accounting Standards Board. The core principle behind ASU 2014-09 is that an entity should recognize revenue to depict the transfer of promised goods and services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for delivering those goods and services. This model involves a five-step process that includes identifying the contract with the customer, identifying the performance obligations in the contract, determining the transaction price, allocating the transaction prices to the performance obligations in the contract and recognizing revenue when (or as) the entity satisfies the performance obligations. The guidance in the ASU supersedes existing revenue recognition guidance and is effective for annual reporting periods beginning after December 15, 2016 with early application not permitted. The ASU allows two methods of adoption; a full retrospective approach where three years of financial information are presented in accordance with the new standard, and a modified retrospective approach where the ASU is applied as a cumulative

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VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

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effect adjustment as of the date of adoption. The Company is currently evaluating the impact of adopting the new standard but does not anticipate it will have a material impact on the Company's consolidated financial statements or notes to the consolidated financial statements.

In April 2014, the Financial Accounting Standards Board issued final guidance to change the criteria for reporting discontinued operations while enhancing disclosures in this area (ASU No. 2014-08). Under the new guidance, only disposals representing a strategic shift, such as a major line of business, a major geographical area or a major equity investment, should be presented as discontinued operations. The guidance will be applied prospectively to new disposals and new classifications of disposal groups as held for sale after the effective date. The guidance is effective for annual financial statements with fiscal years beginning on or after December 15, 2014 with early adoption permitted for disposals or classifications as held for sale which have not been reported in financial statements previously issued or available for issuance. The Company will adopt the guidance effective January 1, 2015 and the guidance is not anticipated to have a material impact on the Company's consolidated financial statements and notes to the consolidated financial statements.

In March 2014, the Emerging Issues Task Force (the “Task Force”) reached a final consensus to amend the accounting guidance for stock compensation tied to performance targets (Issue No. 13-D). The objective of this guidance is to clarify the accounting treatment of certain types of performance conditions in stock-based compensation awards, more specifically, when performance targets can be achieved after the requisite service period. The Task Force concluded that performance criteria subsequent to a service period vesting requirement should be treated as vesting conditions, and as a result, this type of performance condition may delay expense recognition until achievement of the performance target is probable. Issue No. 13-D will be effective for all entities for reporting periods (including interim periods) beginning after December 15, 2015, and early adoption is permitted. The Company is currently evaluating the impact of adopting the new standard but does not anticipate it will have a material impact on the Company's consolidated financial statements or notes to the consolidated financial statements.

## 2. INVENTORIES

Inventories consist of:

	September 30, 2014	December 31, 2013
Leaf tobacco	\$55,769	\$49,140
Other raw materials	3,402	3,161
Work-in-process	606	353
Finished goods	63,628	67,201
E-Cigarettes	7,963	839
Inventories at current cost	131,368	120,694
LIFO adjustments	(30,494	) (27,198
	\$ 100,874	\$ 93,496

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, 2014, Liggett had tobacco purchase commitments of approximately \$11,948 and E-Cigarettes purchase commitments of

\$389. The Company has a single source supply agreement for fire safe cigarette paper through 2015.

All of the Company's inventories at September 30, 2014 and December 31, 2013 have been reported under the LIFO method.

## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## 3. INVESTMENT SECURITIES AVAILABLE FOR SALE

The components of investment securities available for sale at September 30, 2014 were as follows:

	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Marketable equity securities	\$56,098	\$88,913	\$(1,047)	) \$143,964
Mutual funds invested in fixed income securities	60,637	—	(586)	) 60,051
Marketable debt securities	129,432	1,616	(1,180)	) 129,868
Total investment securities available for sale	\$246,167	\$90,529	\$(2,813)	) \$333,883

The components of investment securities available for sale at December 31, 2013 were as follows:

	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Marketable equity securities	\$53,586	\$65,851	\$(963)	) \$118,474
Marketable debt securities	53,063	1,497	(500)	) 54,060
Total investment securities available for sale	\$106,649	\$67,348	\$(1,463)	) \$172,534

The table below summarizes the maturity dates of marketable debt securities at September 30, 2014.

Investment Type:	Market Value	Under 1 Year	1 Year up to 5 Years	More than 5 Years
U.S. Government securities	\$44,220	\$—	\$44,220	\$—
Corporate securities	50,913	3,480	40,031	7,402
U.S. mortgage backed securities	297	—	297	—
Commercial mortgage-backed securities	15,561	2,261	13,300	—
U.S. asset backed securities	14,671	3,980	10,691	—
Government agencies	2,900	731	2,169	—
Index-linked U.S. bonds	1,306	—	1,306	—
Total marketable debt securities by maturity dates	\$129,868	\$10,452	\$112,014	\$7,402



## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## 4. LONG-TERM INVESTMENTS

Long-term investments accounted for at cost:

	September 30, 2014		December 31, 2013	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Investment partnerships	\$31,541	\$36,735	\$20,041	\$24,095
Real estate partnership	698	1,102	747	1,067
Investments accounted for at cost	\$32,239	\$37,837	\$20,788	\$25,162

The Company contributed an additional \$12,000 to Investment Partnerships during the nine months ended September 30, 2014.

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

	September 30, 2014	December 31, 2013
Investment partnership	\$13,977	\$8,595

The Company recorded equity income of \$829 and an equity loss of \$53 for the three months ended September 30, 2014 and 2013, respectively, related to the limited partnership. The Company recorded equity income of \$1,462 and \$770 for the nine months ended September 30, 2014 and 2013, respectively, related to the limited partnership.

The carrying value of the investment was approximately \$13,977 and \$8,595 as of September 30, 2014 and December 31, 2013, respectively, which approximated the investment's fair value.

## 5. NEW VALLEY LLC

**Residential Brokerage Business Acquisition.** New Valley is engaged in the real estate business and is seeking to acquire additional real estate properties and operating companies. As of January 1, 2013, the Company owned a 50% interest in Douglas Elliman, and the Company accounted for its 50% using the equity method of accounting. On December 13, 2013, an affiliate of New Valley acquired an additional 20.59% interest in Douglas Elliman from Prudential Real Estate Financial Services of America, Inc. for a purchase price of \$60,000 in cash. The acquisition increased the Company's ownership position in Douglas Elliman from 50% to 70.59% and resulted in the Company having control.

The transaction was accounted for as an acquisition of a business in the fourth quarter of 2013. The preliminary fair values of the assets acquired, liabilities assumed and the non-controlling interest recorded for Douglas Elliman as of December 13, 2013 were adjusted during the first quarter of 2014. Goodwill and current liabilities were reduced by \$454 and \$105, respectively, while intangible assets related to favorable lease agreements were increased by \$559. The amounts are preliminary as management is still evaluating the valuations of certain assets acquired in the acquisition. These adjustments have been reflected in the Company's condensed consolidated balance sheet as of December 31, 2013 and September 30, 2014.

**Equity Method of Accounting.** Prior to December 13, 2013, New Valley accounted for its 50% interest in Douglas Elliman under the equity method of accounting. New Valley recorded income associated with Douglas Elliman of \$9,075 and \$16,513 for the three and nine months ended September 30, 2013, respectively, which included

management fees earned by New Valley from Douglas Elliman.

Summarized income statement information for Douglas Elliman for the three and nine months ended September 30, 2013, is presented below.

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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 September 30, 2013		Nine Months Ended September 30, 2013
Revenues	\$ 127,537		\$ 315,721
Costs and expenses	109,178		282,885
Depreciation expense	986		2,944
Amortization expense	56		167
Other income	(109	)	(512
Interest income, net	(14	)	(22
Income tax expense	442		684
Net income	\$ 16,998		\$ 29,575

New Valley received cash distributions from Douglas Elliman of \$2,961 for the nine months ended September 30, 2013.

## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

Investments in real estate ventures. New Valley also holds equity investments in various real estate projects domestically and internationally. The components of “Investments in real estate ventures” were as follows:

	September 30, 2014	December 31, 2013
Milanosesto Holdings (f/k/a Sesto Holdings)	\$5,037	\$5,037
Land Development	5,037	5,037
10 Madison Square Park West (f/k/a 1107 Broadway)	6,384	6,579
The Whitman	526	1,165
The Marquand	12,000	7,000
11 Beach Street	12,328	11,160
20 Times Square (f/k/a 701 Seventh Avenue)	12,481	11,148
101 Murray Street	25,269	19,256
160 Leroy Street	1,353	1,150
PUBLIC Chrystie House (f/k/a Chrystie Street)	3,180	2,048
25-19 43rd Avenue	733	—
Queens Plaza (f/k/a 23-10 Queens Plaza South)	12,590	8,058
8701 Collins Avenue	4,634	3,794
125 Greenwich Street	9,308	—
Condominium and Mixed Use Development	100,786	71,358
Maryland Portfolio	3,348	3,498
ST Portfolio	15,508	15,984
Apartment Buildings	18,856	19,482
Park Lane Hotel	18,097	19,514
Hotel Taiwana	6,850	7,428
Coral Beach and Tennis Club	2,708	2,964
Hotels	27,655	29,906
Other	1,947	2,419
Investments in real estate ventures	\$154,281	\$128,202

## Condominium and Mixed Use Development:

Condominium and mixed use developments investments range in ownership percentage from 5% to 49.5%. New Valley recorded equity income of \$5,090 and \$7,389 during the three and nine months ended September 30, 2014, respectively. The Company recorded \$5,000 of income from real estate ventures for the three and nine months ended September 30, 2014 in connection with its proportionate share of the Marquand’s income from the sale of approximately 40% of its units during the quarter. In addition, during the nine months ended September 30, 2014, the Company recorded \$2,254 of income in connection with its proportionate share of the sale of a commercial unit at 10

Madison Square Park West (f/k/a 1107 Broadway). New Valley recorded equity income of \$526 and \$656 for the three and nine months ended September 30, 2013. During the nine months ended September 30, 2014, New Valley made capital contributions totaling \$27,154, primarily related to 101 Murray Street, 23-10

VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

Queens Plaza South and a new investment, 125 Greenwich Street. New Valley contributed its proportionate share of additional capital along with contributions by the other investment partners. New Valley's investment percentage did not change. During the nine months ended September 30, 2014, New Valley and received distributions of \$7,791. During the nine months ended September 30, 2013, New Valley made capital contributions totaling \$23,984 primarily related to its investment in 101 Murray Street, and received distributions of \$2,593. New Valley's maximum exposure to loss as a result of its investments in condominium and mixed use developments was \$100,786 at September 30, 2014.

**Apartment Buildings:**

Apartment buildings investments range in ownership percentage from 7.5% to 16.4%. New Valley recorded net equity losses of \$87 and \$111 for the three months ended September 30, 2014 and 2013, respectively, related to the apartment portfolios. New Valley recorded equity losses of \$251 and \$394 for nine months ended September 30, 2014 and 2013, respectively, primarily related to an apartment portfolio. New Valley received distributions of \$375 and \$250 during the nine months ended September 30, 2014 and 2013, respectively, related to an apartment portfolio. New Valley's maximum exposure to loss as a result of its investment in apartment buildings was \$18,856 at September 30, 2014.

**Hotels:**

Hotel investments range in ownership percentage from 5% to 49%. During the three and nine months ended September 30, 2014, New Valley recorded net equity losses of \$2,053 and \$4,224. New Valley made capital contributions totaling \$1,973 for the nine months ended September 30, 2014, primarily related to Park Lane Hotel. New Valley made capital contributions totaling \$21,992 for the nine months ended September 30, 2013, primarily related to the initial investment in Park Lane Hotel. New Valley's maximum exposure to loss as a result of its investments in hotels was \$27,655 at September 30, 2014.

**Other:**

Other investments in real estate ventures relate to an investment in a mortgage company and an insurance company partially owned by Douglas Elliman.

**Real Estate Held for Sale:**

The components of "Real estate held for sale, net" were as follows:

	September 30, 2014	December 31, 2013
Escena, net	\$ 10,643	\$ 10,625
Indian Creek	—	10,286
Real estate held for sale, net	\$ 10,643	\$ 20,911

Escena. In October 2013, the Company sold 200 of the 867 residential lots. The remaining project consists of 667 residential lots, consisting of both single family and multi-family lots, an 18-hole golf course, clubhouse restaurant and golf shop, and a seven-acre site approved for a 450-room hotel.

VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

The assets of "Escena, net" are as follows:

	September 30, 2014	December 31, 2013
Land and land improvements	\$8,930	\$8,930
Building and building improvements	1,832	1,530
Other	1,577	1,577
	12,339	12,037
Less accumulated depreciation	(1,696	) (1,412
	\$10,643	\$10,625

The Company recorded an operating loss of \$804 and \$845 for the three months ended September 30, 2014 and 2013, respectively, from Escena. The Company recorded an operating loss of \$571 and \$769 for the nine months ended September 30, 2014 and 2013, respectively, from Escena.

Investment in Indian Creek. In March 2013, New Valley invested \$7,616 for an 80% interest in Timbo LLC ("Indian Creek") which owns a residential real estate project located on Indian Creek, Florida. As a result of the 80% ownership interest, the consolidated financial statements of the Company included the balances of Indian Creek.

In May 2014, the Indian Creek property was sold for \$14,400 and New Valley received a distribution of approximately \$7,100. New Valley recognized income of approximately \$2,400 from the sale for the nine months ended September 30, 2014.

## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

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

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

	September 30, 2014	December 31, 2013
Vector:		
7.75% Senior Secured Notes due 2021, including premium of \$9,577 and \$0	\$609,577	\$450,000
6.75% Variable Interest Senior Convertible Note due 2014, net of unamortized discount of \$1,733 and \$19,311*	23,267	30,689
6.75% Variable Interest Senior Convertible Exchange Notes due 2014, net of unamortized discount of \$2,713 and \$25,944*	64,902	81,586
7.5% Variable Interest Senior Convertible Notes due 2019, net of unamortized discount of \$149,342 and \$155,817*	80,658	74,183
5.5% Variable Interest Senior Convertible Debentures due 2020, net of unamortized discount of \$101,667 and \$0*	157,083	—
Liggett:		
Revolving credit facility	2,452	30,424
Term loan under credit facility	3,663	3,884
Equipment loans	16,128	17,252
Other	535	4,325
Total notes payable, long-term debt and other obligations	958,265	692,343
Less:		
Current maturities	(101,158	) (151,577
Amount due after one year	\$857,107	\$540,766

\* The fair value of the derivatives embedded within the 6.75% Variable Interest Senior Convertible Note (\$885 at September 30, 2014 and \$6,607 at December 31, 2013, respectively), the 6.75% Variable Interest Senior Convertible Exchange Notes (\$2,110 at September 30, 2014 and \$12,521 at December 31, 2013, respectively), the 5.50% Variable Interest Senior Convertible Debentures (\$86,228 at September 30, 2014 and \$0 at December 31, 2013, respectively), and the 7.50% Variable Interest Senior Convertible Notes (\$94,247 at September 30, 2014 and \$92,934 at December 31, 2013, respectively), is separately classified as a derivative liability in the condensed consolidated balance sheets.

## 7.75% Senior Secured Notes due 2021 - Vector:

On April 15, 2014, the Company completed the sale of \$150,000 principal amount of its 7.75% Senior Secured Notes due 2021 for a price of 106.750% in a private offering to qualified institutional investors in accordance with Rule 144A of the Securities Act of 1933. The Company received net proceeds of approximately \$158,700 after deducting underwriting discounts, commissions, fees and offering expenses. The Company will amortize the deferred costs and debt premium related to the additional Senior Secured Notes over the estimated life of the debt.

In August 2014, the Company completed an offer to exchange the 7.75% senior secured notes issued in April 2014 for an equal amount of newly issued 7.75% senior secured notes due 2021. The new 7.75% senior secured notes have substantially the same terms as the original notes, except that the new 7.75% senior secured notes have been registered



under the Securities Act.

6.75% Variable Interest Senior Convertible Note due 2014 - Vector:

On March 14, 2014, the holder of the 6.75% Variable Interest Senior Convertible Note due 2014 converted \$25,000 principal balance of the \$50,000 Note into 2,121,479 of the Company's common shares. The Company recorded non-cash accelerated interest expense related to the converted debt of \$3,679 for the nine months ended September 30, 2014. The debt conversion resulted in a reduction of debt and an increase to equity in the amount of \$25,000. The outstanding principal balance due November 15, 2014 is \$25,000.

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VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

6.75% Variable Interest Senior Convertible Exchange Notes due 2014 - Vector:

On May 20, 2014, a holder of the 6.75% Variable Interest Senior Convertible Exchange Notes due 2014 converted \$7,500 principal balance of the \$107,530 Notes into 560,987 of the Company's common shares. The debt conversion resulted in a reduction of debt and an increase to equity in the amount of \$7,500.

In August, 2014, holders of the 6.75% Variable Interest Senior Convertible Exchange Notes due 2014 converted \$32,415 principal balance of the \$107,530 Notes into 2,424,584 of the Company's common shares. The debt conversion resulted in a reduction of debt and an increase to equity in the amount of \$32,415. The outstanding principal balance due November 15, 2014 is \$67,615.

The Company recorded non-cash accelerated interest expense related to the converted debt of \$994 and \$1,433 for the three and nine months ended September 30, 2014.

5.5% Variable Interest Senior Convertible Notes due 2020 - Vector:

On March 24, 2014, the Company completed the sale of \$258,750 of its 5.5% Variable Interest Convertible Senior Notes due 2020 (the "2020 Convertible Notes"). The 2020 Convertible Notes are the Company's senior unsecured obligations and are effectively subordinated to any of its secured indebtedness to the extent of the assets securing such indebtedness. The 2020 Convertible Notes are also structurally subordinated to all liabilities and commitments of the Company's subsidiaries.

The aggregate net proceeds from the sale of the 2020 Convertible Notes were approximately \$250,300 after deducting underwriting discounts, commissions, fees and offering expenses. The net proceeds will be used for general corporate purposes, including for additional investments in real estate and in the Company's tobacco business. The Company may also consider using a portion of the net proceeds from the sale of the notes to address upcoming debt maturities. The 2020 Convertible Notes pay interest ("Total Interest") on a quarterly basis beginning April 15, 2014 at a rate of 1.75% per annum plus additional interest, which is based on the amount of cash dividends paid during the prior three-month period ending on the record date for such interest payment multiplied by the total number of shares of its common stock into which the debt will be convertible on such record date. Notwithstanding the foregoing, however, the interest payable on each interest payment date after April 15, 2014 shall be the higher of (i) the Total Interest and (ii) 5.5% per annum with the interest payment on April 15, 2014 being based on 5.5% per annum. The notes are convertible into the Company's common stock at the holder's option. The conversion price at September 30, 2014 was \$25.87 per share (approximately 38.6563 shares of common stock per \$1,000 principal amount of the note), and is subject to adjustment for various events, including the issuance of stock dividends. The notes will mature on April 15, 2020. If a fundamental change (as defined in the indenture) occurs, the Company will be required to offer to repurchase the notes at 100% of their principal amount, plus accrued and unpaid interest to, but excluding, the fundamental change repurchase date.

Revolving Credit Facility and Term Loan Under Credit Facility - Liggett:

As of September 30, 2014, a total of \$6,115 was outstanding under the revolving and term loan portions of the credit facility. Availability as determined under the facility was approximately \$43,885 based on eligible collateral at September 30, 2014.

Shares of Common Stock per \$1,000 Principal Amount due on Convertible Notes:

The conversion rates for all convertible debt outstanding as of September 30, 2014 are summarized below:

September 30, 2014

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	Conversion Price	Shares per \$1,000
6.75% Variable Interest Senior Convertible Note due 2014	\$11.22	89.1021
6.75% Variable Interest Senior Convertible Exchange Notes due 2014	\$12.73	78.5381
7.5% Variable Interest Senior Convertible Notes due 2019	\$16.78	59.5946
5.5% Variable Interest Senior Convertible Debentures due 2020	\$25.87	38.6563

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## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## Non-Cash Interest Expense - Vector:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2014	2013	2014	2013
Amortization of debt discount	\$14,277	\$9,620	\$41,180	\$25,432
Amortization of deferred finance costs	1,147	549	2,910	1,593
Loss on extinguishment of 11% Senior Secured Notes	—	—	—	3,638
Accelerated interest expense on 6.75% Variable Interest Senior Convertible Note converted	—	—	3,679	—
Accelerated interest expense on 6.75% Variable Interest Senior Convertible Exchange Notes converted	994	—	1,433	—
	\$16,418	\$10,169	\$49,202	\$30,663

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

	September 30, 2014		December 31, 2013	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Notes payable and long-term debt	\$958,265	\$1,445,085	\$692,343	\$1,006,562

Notes payable and long-term debt are carried on the condensed consolidated balance sheet at amortized cost. The fair value determination disclosed above would be classified as Level 2 under the fair value hierarchy disclosed in Note 9 if such liabilities were recorded on the condensed consolidated balance sheet at fair value. The estimated fair value of the Company's notes payable and long-term debt has been determined by the Company using available market information and appropriate valuation methodologies including the evaluation of the Company's credit risk as described in the Company's Form 10-K. However, considerable judgment is required to develop the estimates of fair value and, accordingly, the estimate presented herein are not necessarily indicative of the amount that could be realized in a current market exchange.

## 7. 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. The cases have generally fallen into the following categories: (i) smoking and health cases alleging personal injury brought on behalf of individual plaintiffs ("Individual Actions"); (ii) lawsuits by individuals requesting the benefit of the Engle ruling ("Engle progeny cases"); (iii) smoking and health cases primarily alleging personal injury or seeking court-supervised programs for ongoing medical monitoring, as well as cases alleging that use of the terms "lights" and/or "ultra lights" constitutes a deceptive and unfair trade practice, common law fraud or violation of

federal law, purporting to be brought on behalf of a class of individual plaintiffs (“Class Actions”); and (iv) health care cost recovery actions brought by various foreign and domestic governmental plaintiffs and non-governmental plaintiffs seeking reimbursement for health care expenditures allegedly caused by cigarette smoking and/or disgorgement of profits (“Health Care Cost Recovery Actions”). With the commencement of new cases, the defense costs and the risks relating to the unpredictability of litigation increase. The future financial impact of the risks and expenses of litigation are not quantifiable. For the nine months ended September 30, 2014 and 2013, Liggett incurred tobacco product liability legal expenses and other litigation costs totaling \$7,282 and \$7,334, respectively. The 2013 costs exclude a charge of \$86,213 associated with the Engle progeny settlement discussed below.

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

**Bonds.** Although Liggett has been able to obtain required bonds or relief from bonding requirements in order to prevent plaintiffs from seeking to collect judgments while adverse verdicts are on appeal, there remains a risk that such relief may not be obtainable in all cases. This risk has been reduced given that a majority of states now limit the dollar amount of bonds or require no bond at all. To obtain stays on judgments pending current appeals, Liggett has secured approximately \$5,093 in bonds as of September 30, 2014.

In June 2009, Florida amended its existing bond cap statute by adding a \$200,000 bond cap that applies to all Engle progeny cases 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. In several cases, 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. It is possible that the Company's consolidated financial position, results of operations, and cash flows could be materially adversely affected by an unfavorable outcome of such challenges.

**Accounting Policy.** The Company and its subsidiaries record provisions in their consolidated financial statements for pending litigation when they determine that an unfavorable outcome is probable and the amount of loss can be reasonably estimated. At the present time, while it is reasonably possible that an unfavorable outcome in a case may occur, except as disclosed in this Note 7: (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 reasonably estimate the possible loss or range of loss that could result from an unfavorable outcome of any of the pending tobacco-related cases and, therefore, management has not provided any amounts in the consolidated financial statements for unfavorable outcomes, if any. Legal defense costs are expensed as incurred.

**Cautionary Statement About Engle Progeny Cases.** Judgments have been entered against Liggett and other industry defendants in Engle progeny cases. A number of the judgments have been affirmed on appeal and satisfied by the defendants. As of October 27, 2014, 19 Engle progeny cases where Liggett was a defendant at trial resulted in verdicts. Thirteen verdicts were returned in favor of the plaintiffs and six in favor of Liggett. Excluding the Lukacs case, which was tried in 2002, seven years before the trials of Engle progeny cases commenced, the compensatory verdicts against Liggett have ranged from \$1 to \$3,600. In certain cases, the judgments entered have been joint and several with other defendants. In three of the cases, punitive damages were awarded against Liggett. Except as discussed in this Note 7 regarding the cases where an adverse verdict was entered against Liggett and that remain on appeal, management is unable to estimate the possible loss or range of loss from the remaining Engle progeny cases as there are currently multiple defendants in each case and, in most cases, discovery has not occurred or is limited. As a result, the Company lacks information about whether plaintiffs are in fact Engle class members (non-class members' claims are generally time-barred), the relevant smoking history, the nature of the alleged injury and the availability of various defenses, among other things. Further, plaintiffs typically do not specify their demand for damages.

Although Liggett has generally been successful in managing litigation, litigation is subject to uncertainty and significant challenges remain, including with respect to the remaining Engle progeny cases. There can be no assurances that Liggett's past litigation experience will be representative of future results. Judgments have been entered against Liggett in the past, in Individual Actions and Engle progeny cases, and several of those judgments were affirmed on appeal and satisfied by Liggett. It is possible that the consolidated financial position, results of operations and cash flows of the Company could be materially adversely affected by an unfavorable outcome or settlement of any of the remaining smoking-related litigation. Liggett believes, and has been so advised by counsel,

that it has valid defenses to the litigation pending against it, as well as valid bases for appeal of adverse verdicts. All such cases are, and will continue to be, vigorously defended. Liggett may, however, enter into settlement discussions in particular cases if it believes it is in its best interest to do so, including the remaining Engle progeny cases. As of September 30, 2014, Liggett (and in certain cases the Company) had, on an individual basis, settled 144 Engle progeny cases for approximately \$1,170 in the aggregate. There were no settlements in the third quarter of 2014. In addition, in October 2013, Liggett announced a settlement of the claims of over 4,900 Engle progeny plaintiffs (see Engle Progeny Settlement below).

## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

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## Individual Actions

As of September 30, 2014, there were 48 Individual Actions pending against Liggett and, in certain cases, the Company, where one or more individual plaintiffs allege injury resulting from cigarette smoking, addiction to cigarette smoking or exposure to secondary smoke and seek compensatory and, in some cases, punitive damages. These cases do not include Engle progeny cases or the approximately 100 individual cases pending in West Virginia state court as part of a consolidated action. The following table lists the number of Individual Actions, by state, that are pending against Liggett or the Company as of September 30, 2014:

State	Number of Cases
Florida	30
New York	8
Maryland	4
Louisiana	2
West Virginia	2
Missouri	1
Ohio	1

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

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

## Engle Progeny Cases

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



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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

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

Pursuant to the Florida Supreme Court's July 2006 ruling in Engle, which decertified the class on a prospective basis, and affirmed the appellate court's reversal of the punitive damages award, former class members had until January 2008 in which to file individual lawsuits. As a result, Liggett and the Company, and other cigarette manufacturers, were named defendants in thousands of Engle progeny cases in both federal and state courts in Florida. Although the Company was not named as a defendant in the Engle case, it was named as a defendant in substantially all of the Engle progeny cases where Liggett was named as a defendant.

**Engle Progeny Settlement.** On October 23, 2013, the Company entered into a settlement with approximately 4,900 Engle progeny plaintiffs and their counsel. Pursuant to the terms of the settlement, Liggett agreed to pay a total of approximately \$110,000, with approximately \$61,600 paid in a lump sum and the balance to be paid in installments over 14 years. In exchange, the claims of over 4,900 plaintiffs were dismissed with prejudice against the Company and Liggett. In 2013 the Company recorded a charge of \$86,213 in connection with the settlement. Of this amount, \$25,213 is related to certain payments discounted to their present value because the timing and amounts of such payments are fixed and determinable. The present value of the installment payments was computed using an 11% annual discount rate. The installment payments total approximately \$48,000 on an undiscounted basis. The Company's future payments will be approximately \$3,500 per annum through 2028, with a cost of living increase beginning in 2021.

Notwithstanding the comprehensive nature of the Engle Progeny Settlement, approximately 330 plaintiffs' claims remain outstanding. Therefore, the Company and Liggett may still be subject to periodic adverse judgments which could have a material adverse affect on the Company's consolidated financial position, results of operations and cash flows.

## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

As of October 27, 2014, the following Engle progeny cases have resulted in judgments against Liggett:

Date	Case Name	County	Liggett Compensatory Damages	Liggett Punitive Damages	Status
June 2002	Lukacs v. R.J. Reynolds	Miami-Dade	\$12,418	None	Liggett satisfied the judgment and the case is concluded.
August 2009	Campbell v. R.J. Reynolds	Escambia	\$156	None	Liggett satisfied the judgment and the case is concluded.
March 2010	Douglas v. R.J. Reynolds	Hillsborough	\$1,350	None	Liggett satisfied the judgment and the case is concluded.
April 2010	Clay v. R.J. Reynolds	Escambia	\$349	\$1,000	Liggett satisfied the judgment and the case is concluded. On June 12, 2013, the Fourth District Court of Appeal reversed and remanded the case for further proceedings. Plaintiff filed a motion for rehearing which was denied. Both sides sought discretionary review from the Florida Supreme Court. The appeal is stayed pending the outcome of the Hess appeal.
April 2010	Putney v. R.J. Reynolds	Broward	\$3,008	None	Affirmed by the Fourth District Court of Appeal. Discretionary review from the Florida Supreme Court was denied. Liggett satisfied the judgment and the case is concluded, other than an issue with respect to the calculation of interest on the judgment and the amount of costs owed by Liggett.
April 2011	Tullo v. R.J. Reynolds	Palm Beach	\$225	None	Liggett satisfied the merits judgment and other than an issue regarding attorneys' fees, the case is concluded.
January 2012	Ward v. R.J. Reynolds	Escambia	\$1	None	A joint and several judgment for \$16,100 was entered against R.J. Reynolds, Philip Morris, Lorillard and Liggett. On appeal to the Fourth District Court of Appeal.
May 2012	Calloway v. R.J. Reynolds	Broward	\$1,947	\$7,600	
December 2012	Buchanan v. R.J. Reynolds	Leon	\$2,035	None	A joint and several judgment for \$5,500 was entered against

					Liggett and Philip Morris. Affirmed by the First District Court of Appeal, but, the court certified an issue of conflict with another case. The defendants sought discretionary review by the Florida Supreme Court. The appeal is stayed pending the outcome of Hess.
May 2013	Cohen v. R.J. Reynolds	Palm Beach	\$205	None	Defendants' motion seeking a new trial was granted by the trial court. Plaintiff appealed to the Fourth District Court of Appeal.
August 2013	Rizzuto v. R.J. Reynolds	Hernando	\$3,479	None	Liggett settled its portion of the judgment for \$1,500 and the case is concluded.
August 2014	Irimi v. R.J. Reynolds	Broward	\$31	None	The verdict has not been reduced to a judgment. Post trial motions are pending.
October 2014	Lambert v. R.J. Reynolds	Pinellas	\$3,600	\$9,500	The verdict has not been reduced to a judgment. Post trial motions are pending.
Total Damages Awarded:			\$28,804	\$18,100	
Amounts paid or compromised:			\$(17,978)	\$(1,000)	
Damages remaining on Appeal:			\$10,826	\$17,100	

Through September 30, 2014, Liggett has paid \$20,040, including interest and legal fees, to satisfy the judgments in six Engle progeny cases (Lukacs, Campbell, Douglas, Clay, Ward and Rizzuto). The Tullo judgment was satisfied on October 22, 2014. Liggett paid \$272, including interest.

The Company's potential range of loss in the Putney, Calloway, Buchanan, Cohen, Irimi and Lambert cases is between \$0 and \$27,926 in the aggregate, plus accrued interest and legal fees. In determining the range of loss, the Company considers potential settlements as well as future appellate relief. Except as disclosed elsewhere in this Note 7, the Company is unable to determine a range of loss related to the remaining Engle progeny cases. Other than \$272 accrued for Tullo, no amounts have been expensed or accrued in the accompanying condensed consolidated financial statements for the cases described above. However, as cases proceed through the appellate process, the Company will consider accruals on a case-by-case basis if an unfavorable outcome becomes probable and the amount can be reasonably estimated.

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

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March 2012, the United States Supreme Court declined to review the Martin case, along with the Campbell case and two other Engle progeny cases. This decision has led to other adverse rulings by other state appellate courts.

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

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

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

In March 2012, in Douglas, the Second District Court of Appeal issued a decision affirming the judgment of the trial court in favor of the plaintiff and upholding the use of the Engle jury findings but certified to the Florida Supreme Court the question of whether granting res judicata effect to the Engle jury findings violates defendants' federal due process rights. In March 2013, the Florida Supreme Court affirmed the use of Engle jury findings and determined that there is no violation of the defendants' due process rights. This was the first time the Florida Supreme Court addressed the merits of an Engle progeny case. In October 2013, the United States Supreme Court declined to review the decision and Liggett satisfied the judgment. Recently, the United States Supreme Court declined to review the decisions in several other Engle progeny cases.

In Hess, a case pending in Broward County, the jury returned a verdict finding that decedent relied to his detriment on an omission by the defendant before May 5, 1982 (twelve years prior to the filing of the Engle Complaint). Defendant moved for judgment as a matter of law on plaintiff's fraudulent concealment claim on the basis that the claim was barred by Florida's statute of repose. The trial court denied the motion and was reversed by the Fourth District Court of Appeal, which held that any fraud committed before May 5, 1982 is barred. This decision conflicts with decisions from other district courts of appeal and is before the Florida Supreme Court pursuant to its conflict jurisdiction. Oral argument occurred on April 30, 2014. A decision is pending.

Liggett Only Cases. There are currently five cases pending where Liggett is the only remaining defendant. These cases consist of three Individual Actions and two Engle progeny cases. In one of the Individual Actions, Hausrath (NY state court), plaintiff moved to restore the case to the active docket calendar after it was removed by the court. The motion was granted and Liggett appealed. There has been no recent activity in the other two Individual Actions.

Trial in Lambert, an Engle progeny case, concluded on September 30, 2014 and resulted in a jury verdict against Liggett for \$13,100. Post trial motions are pending. The other Engle progeny case is not currently set for trial. Cases where Liggett is the only defendant could increase as a result of the remaining Engle progeny cases.

#### Class Actions

As of September 30, 2014, there were four actions pending for which either a class had been certified or plaintiffs were seeking class certification where Liggett is a named defendant, including one alleged price fixing case. Other cigarette manufacturers are also named in these actions.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

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

Defenses raised in these cases include, among others, lack of proximate cause, individual issues predominate, assumption of the risk, comparative fault and/or contributory negligence, statute of limitations and federal preemption. In 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, allege they were exposed to secondhand smoke from cigarettes that were manufactured by the defendants, including Liggett, and suffered injury as a result of that exposure. The plaintiffs seek to recover an unspecified amount of compensatory and punitive damages. No class certification hearing has been held. In June 2013, plaintiffs' counsel moved for an indefinite stay of the case. The defendants did not oppose the stay and it was entered by the court. In February 1998, in *Parsons v. AC & S Inc.*, a class was commenced on behalf of all West Virginia residents who allegedly have personal injury claims arising from exposure to cigarette smoke and asbestos fibers. The complaint seeks to recover \$1,000 in compensatory and punitive damages individually and unspecified compensatory and punitive damages for the class. The case is stayed due to the December 2000 bankruptcy of three of the defendants. In February 2000, in *Smith v. Philip Morris*, a case pending in Kansas, a class was commenced against cigarette manufacturers alleging they 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. In January 2012, the trial court heard oral argument on defendants' motions for summary judgment and in March 2012, the court granted the motions and dismissed plaintiffs' claims with prejudice. In July 2014, the court of appeals affirmed the lower court's decision. On August 18, 2014, plaintiffs submitted a petition for review to the Kansas Supreme Court. 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. After two mistrials, on May 15, 2013, the jury rejected all but one of the plaintiffs' claims, finding for the plaintiffs on the claim that ventilated filter cigarettes, sold between 1964 and 1969, should have included instructions on how to use them. The issue of damages was reserved for further proceedings that have not yet been scheduled. Final judgment as to liability was issued in October 2013, after which the plaintiffs filed a notice of appeal to the West Virginia Supreme Court of Appeals. The defendants did not appeal the verdict in favor of the plaintiffs on the "failure to instruct" claim which impacted less than 30 plaintiffs. If the case were to proceed against Liggett, it is estimated that Liggett could be a defendant in approximately 100 of the individual cases.

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

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

**Health Care Cost Recovery Actions**

As of September 30, 2014, there was one remaining Health Care Cost Recovery Action pending against Liggett, Crow Creek Sioux Tribe v. American Tobacco Company, a South Dakota case filed in 1997, where the plaintiff seeks to recover damages based on various theories of recovery as a result of alleged sales of tobacco products to minors. The case is inactive. Other cigarette manufacturers are also named as defendants.



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The claims asserted in health care cost recovery actions vary. Although, typically, no specific damage amounts are pled, it is possible that requested damages might be in the billions of dollars. In these cases, plaintiffs typically assert equitable claims that the tobacco industry was “unjustly enriched” by their payment of health care costs allegedly attributable to smoking and seek reimbursement of those costs. Relief sought by some, but not all, plaintiffs include punitive damages, multiple damages and other statutory damages and penalties, injunctions prohibiting alleged marketing and sales to minors, disclosure of research, disgorgement of profits, funding of anti-smoking programs, additional disclosure of nicotine yields, and payment of attorney and expert witness fees.

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

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

In August 2006, the trial court entered a Final Judgment against each of the cigarette manufacturing defendants, except Liggett. In May 2009, the United States Court of Appeals for the District of Columbia affirmed most of the district court's decision. The United States Supreme Court denied review. As a result, the cigarette manufacturing defendants, other than Liggett, are now subject to the trial court's Final Judgment which ordered the following relief: (i) an injunction against “committing any act of racketeering” relating to the manufacturing, marketing, promotion, health consequences or sale of cigarettes in the United States; (ii) an injunction against participating directly or indirectly in the management or control of the Council for Tobacco Research, the Tobacco Institute, or the Center for Indoor Air Research, or any successor or affiliated entities of each; (iii) an injunction against “making, or causing to be made in any way, any material false, misleading, or deceptive statement or representation or engaging in any public relations or marketing endeavor that is disseminated to the United States' public and that misrepresents or suppresses information concerning cigarettes”; (iv) an injunction against conveying any express or implied health message through use of descriptors on cigarette packaging or in cigarette advertising or promotional material, including “lights,” “ultra lights,” and “low tar,” which the court found could cause consumers to believe one cigarette brand is less hazardous than another brand; (v) the issuance of “corrective statements” in various media regarding the adverse health effects of smoking, the addictiveness of smoking and nicotine, the lack of any significant health benefit from smoking “low tar” or “lights” cigarettes, defendants' manipulation of cigarette design to ensure optimum nicotine delivery and the adverse health effects of exposure to environmental tobacco smoke; (vi) the disclosure of defendants' public document websites and the production of all documents produced to the government or produced in any future court or administrative action concerning smoking and health; (vii) the disclosure of disaggregated marketing data to the government in the same form and on the same schedules as defendants now follow in disclosing such data to the Federal Trade Commission for a period of ten years; (viii) certain restrictions on the sale or transfer by defendants of any cigarette brands, brand names, formulas or cigarette business within the United States; and (ix) payment of the government's costs in bringing the action. In June 2014, the court approved a consent agreement between the defendants and the Department of Justice regarding the “corrective statements” to be issued by the defendants. The implementation of the “corrective statements” is uncertain as the defendants are appealing the specific language of the statements.

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

Upcoming Trials

As of September 30, 2014, there were 16 Engle progeny cases scheduled for trial through September 30, 2015, where Liggett (and in many cases, the Company) is a named defendant. Trial dates are, however, subject to change.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

#### MSA and Other State Settlement Agreements

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

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

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

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

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

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

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

Liggett has no payment obligations under the MSA except to the extent its market share exceeds a market share exemption of approximately 1.65% of total cigarettes sold in the United States. Vector Tobacco has no payment obligations under the MSA except to the extent its market share exceeds a market share exemption of approximately 0.28% of total cigarettes sold in the United States. Liggett and Vector Tobacco's domestic shipments accounted for 3.3% of the total cigarettes sold in the United States in 2013. 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, 2013, Liggett pre-paid \$95,000 of its 2013 MSA obligation. On April 15, 2014, Liggett and Vector Tobacco paid approximately \$16,300 for the balance of their 2013 MSA obligation.

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

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same decision with respect to 2004 and 2005. In March 2009, a different economic consulting firm made the same determination for 2006. As a result, the manufacturers are entitled to potential NPM Adjustments to each of their 2003 - 2006 MSA payments. The Participating Manufacturers are also entitled to potential NPM Adjustments to their 2007 - 2013 payments pursuant to agreements entered into between the OPMs and the Settling States under which the OPMs agreed to make certain payments for the benefit of the Settling States, in exchange for which the Settling States stipulated that the MSA was a “significant factor contributing to” the loss of market share of Participating Manufacturers for each of those years. A Settling State that has diligently enforced its qualifying escrow statute in the year in question may be able to avoid allocation of the NPM Adjustment to the payments made by the manufacturers for the benefit of that Settling State.

For 2003 - 2013, 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 in many cases Vector Tobacco) paid subject to dispute, withheld payment or paid into a disputed payment account the amounts associated with these NPM Adjustments.

Notwithstanding provisions in the MSA requiring arbitration, litigation was filed in 49 Settling States involving the application of the NPM Adjustment for 2003 and whether it was to be determined through litigation or arbitration. These actions related to the potential NPM Adjustment for 2003, which the independent auditor under the MSA previously determined to be as much as \$1,200,000 for all Participating Manufacturers. All but one of the 48 courts that decided the issue ruled that the 2003 NPM Adjustment dispute was arbitrable.

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 exchange the OPMs and SPMs agreed to a 20% reduction in amounts recovered for the NPM Adjustment for 2003. In June 2010, the three person arbitration panel was selected. In November 2011, the Participating Manufacturers advised the arbitration panel that they were not contesting diligent enforcement of 16 Settling States for 2003. Substantive hearings commenced in April 2012 and were completed in June 2013.

In December 2012, the Participating Manufacturers entered into a “term sheet” with 20 Settling States setting out terms for settlement of the NPM Adjustment for 2003 - 2012 and addressing the NPM Adjustment with respect to those states for future years. Certain of the non-settling states objected to the settlement. In March 2013, the arbitration panel entered a Stipulated Partial Settlement and Award which, among other things, overruled the objections of the non-settling states and directed the independent auditor to implement certain terms of the term sheet effective with the 2013 MSA payments. In May 2013, two additional states joined the settlement. In June 2014, two additional states joined the settlement. Several non-settling states are attempting to vacate the settlement award by filing state court actions. In Idaho, a trial court denied that state's motion to vacate, and the state noticed an appeal of that denial. In Colorado, a trial court also denied that state's motion to vacate; Colorado has not filed an appeal, and the time period for appeal has passed. Although certain terms of the settlement were implemented by the independent auditor on April 15, 2013, no assurance can be given as to the ultimate outcome of the non-settling states' challenges.

As a result of the settlement, in the first nine months of 2013 Liggett recognized income of \$6,947. Finally, Liggett received credits of \$1,733 in April 2014 from these settling states related to the 2013 NPM Adjustment. The remaining NPM Adjustment accrual of \$25,809 at September 30, 2014 relates to the disputed amounts Liggett withheld from the non-settling states for 2004 - 2010, which may be subject to payment, with interest, if Liggett loses the disputes for those years. Approximately \$24,400 currently remains in the disputed payments accounts relating to the 2011, 2012 and 2013 NPM Adjustment dispute with the non-settling states.

In September 2013, the panel issued its decisions with respect to the 15 states that did not enter into the Stipulated Partial Settlement and Award, finding that six states did not diligently enforce their MSA escrow statutes in 2003. As

a result of this ruling Liggett recognized income of \$5,987 including interest, in the third quarter of 2013. All six of the states that were found to be non-diligent filed motions in state court seeking to vacate or reduce the amount of the arbitration award. A trial court in one of those states, Pennsylvania, rejected the state's motion to vacate the award but granted its motion to reduce the award. As a result, in April 2014, Liggett received a credit in the amount of \$6,441 for the 2003 NPM Adjustment (as calculated by the independent auditor). It subsequently reimbursed the six states 20% of that credit, pursuant to the agreement discussed above, bringing its net recovery to \$5,152, which is approximately \$1,315 lower than the amount Liggett believes it's entitled to. Subsequent to the April 15, 2014 MSA payment date, a state court in Missouri ruled similarly to the ruling in Pennsylvania. As such, Liggett's 2003 NPM credit adjustment could be reduced by an additional \$521. In June 2014, Kentucky and Indiana agreed to settle the dispute. As a result, Liggett recognized income of approximately \$1,400 in the second quarter of 2014. The Participating Manufacturers, including Liggett, appealed the Pennsylvania and Missouri decisions. If Liggett is unsuccessful

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in its appeals or if other states are successful with respect to any such motions, the amount of the 2003 NPM Adjustment and any interest or earnings to which Liggett is entitled could be lower than the amounts described above and Liggett would be obligated to pay the difference.

Disputes over the NPM Adjustments for 2004-2013 remain to be arbitrated with the states that have not joined the settlement.

"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 re-calculated using "net" units, rather than "gross" units (which had been used since 1999). Liggett objected to this retroactive change and disputed the change in methodology.

In December 2012, the parties arbitrated the dispute before a panel of three arbitrators. In February 2013, the arbitrators ruled that the limitations provisions of the MSA precluded the independent auditor from recalculating Liggett's grandfathered market share ("GFMS") exemption or Liggett's payment obligations beyond the last four years. The arbitrators further ruled that, for purposes of calculating Liggett's payment obligations for the applicable years, Liggett's market share, calculated on a net basis, should be increased by a factor of 1.25%. Liggett filed a motion seeking correction of the part of the arbitrators' decision that would require the 1.25% increase in Liggett's market share. The states objected to Liggett's motion and sought additional relief from the panel declaring that any adjustment ordered by the panel is not limited by the four years limitations set forth in the MSA.

A hearing on the motions was held on September 16, 2014. On October 8, 2014 the panel issued its Corrected Final Award, which eliminated the 1.25% adjustment increase and reaffirmed that Liggett is entitled to have its GFMS calculated on a "gross" basis (1.645%). Instead of the 1.25% adjustment increase the panel determined that the independent auditor shall compute Liggett's market share for all years after March 30, 2000 on a "net" basis but adjust that computation to approximate "gross" market share by using actual returned product data for each year. Liggett plans to work with the independent auditor to determine the amount owed for years 2001 - 2013. Liggett had previously accrued \$8,500 for this matter.

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

In 2003, as a result of a dispute with Minnesota regarding its settlement agreement, Liggett agreed to pay \$100 a year, in any year cigarettes manufactured by Liggett are sold in that state. In 2003 and 2004, the Attorneys General for Florida, Mississippi and Texas advised Liggett that they believed that Liggett had failed to make certain required payments under the respective settlement agreements with these states. In December 2010, Liggett settled with Florida and agreed to pay \$1,200 and to make further annual payments of \$250 for a period of 21 years, starting in March 2011. The payments in years 12 – 21 will be subject to an inflation adjustment. These payments are in lieu of any other payments allegedly due to Florida under the original settlement agreement. In February 2012, Mississippi provided Liggett with a 60-day notice that the state intended to pursue its remedies if Liggett did not cure the alleged defaults.

Liggett responded to Mississippi's letter denying the existence of any defaults. There can be no assurance that Liggett will be able to resolve the matters with Texas and Mississippi or that Liggett will not be required to make additional payments which could adversely affect the Company's consolidated financial position, results of operations and cash flows.

Cautionary Statement. Management is not able to reasonably predict the outcome of the litigation pending or threatened against Liggett or the Company. Litigation is subject to many uncertainties. Liggett has been found liable in several Engle progeny cases and in Individual Actions, several of which were affirmed on appeal and 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



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of a pending smoking-related case could encourage the commencement of additional litigation. Except as discussed in this Note 7, management is unable to estimate the loss or range of loss that could result from an unfavorable outcome of the cases pending against Liggett or the costs of defending such cases and as a result has not provided any amounts in its consolidated financial statements for unfavorable outcomes.

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

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

The activity in the Company's accruals for the MSA and tobacco litigation for the nine months ended September 30, 2014 were as follows:

	Current Liabilities			Non-Current Liabilities		
	Payments due under Master Settlement Agreement	Litigation Accruals	Total	Payments due under Master Settlement Agreement	Litigation Accruals	Total
Balance at January 1, 2014	\$25,348	\$59,310	\$84,658	\$27,571	\$27,058	\$54,629
Expenses	83,159	2,041	85,200	—	—	—
NPM Settlement adjustment	—	—	—	(1,419 )	—	(1,419 )
Change in MSA obligations capitalized as inventory	(917 )	—	(917 )	—	—	—
Payments	(16,343 )	(61,822 )	(78,165 )	—	—	—
Reclassification from non-current liabilities	343	3,575	3,918	(343 )	(3,575 )	(3,918 )
Interest on withholding	—	203	203	—	1,546	1,546
Balance as of September 30, 2014	\$91,590	\$3,307	\$94,897	\$25,809	\$25,029	\$50,838

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The activity in the Company's accruals for the MSA and tobacco litigation for the nine months ended September 30, 2013 were as follows:

	Current Liabilities			Non-Current Liabilities		
	Payments due under Master Settlement Agreement	Litigation Accruals	Total	Payments due under Master Settlement Agreement	Litigation Accruals	Total
Balance at January 1, 2013	\$32,970	\$1,470	\$34,440	\$52,639	\$1,862	\$54,501
Expenses	87,770	62,872	150,642	—	25,219	25,219
NPM Settlement adjustment	(5,987 )	—	(5,987 )	(13,489 )	—	(13,489 )
Change in MSA obligations capitalized as inventory	675	—	675	—	—	—
Payments	(34,077 )	(1,685 )	(35,762 )	—	—	—
Reclassification from non-current liabilities	3,520	223	3,743	(3,520 )	(223 )	(3,743 )
Interest on withholding	—	321	321	—	150	150
Balance as of September 30, 2013	\$84,871	\$63,201	\$148,072	\$35,630	\$27,008	\$62,638

## 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.

Liggett Vector Brands entered into an 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. The agreement expires in February 2016. Under the agreement, Liggett Vector Brands has agreed to pay a portion of losses incurred by the surety under the bond program, with a maximum loss exposure of \$500. To secure its potential obligations under the agreement, Liggett Vector Brands posted a \$100 letter of credit and agreed to fund up to an additional \$400. In the third quarter of 2013, Liggett paid \$83 for obligations under this program, and therefore, is only committed to fund an additional \$317 over the letter of credit. The Company believes the fair value of Liggett Vector Brands' obligation under the agreement was immaterial at September 30, 2014.

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.



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## 8. INCOME TAXES

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

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2014	2013	2014	2013
Income (loss) before provision for income taxes	\$31,669	\$(55,860)	\$57,272	\$(34,348)
Income tax expense using estimated annual effective income tax rate	9,932	(22,763)	17,962	(13,997)
Changes in effective tax rates	(374)	1,181	—	1,159
Increase in unrecognized tax benefits	—	251	—	373
Impact of discrete items, net	1,305	—	1,944	816
Impact of discrete item associated with litigation settlement	—	2,362	—	2,362
Inclusion of tax liabilities from unincorporated entities	1,101	—	1,101	—
Income tax expense (benefit)	\$11,964	\$(18,969)	\$21,007	\$(9,287)

In the first quarter of 2014, the Company properly determined an adjustment for \$1,944 related to its marginal tax rate was required as a result of its acquisition of 20.59% of Douglas Elliman Realty, LLC. This amount was originally recorded as additional income tax expense of \$639, a reduction of Additional Paid-In Capital of \$865 and a reduction of Other Comprehensive Income of \$440. During the three months ended September 30, 2014 the Company reassessed the treatment of the previously recorded reductions to Additional Paid-In-Capital and Accumulated Other Comprehensive Income and reclassified such amounts as an increase to income tax expense. The Company assessed the materiality of the misclassifications on the financial statements in the prior quarters of 2014 and concluded that it was immaterial to all previously issued quarterly financial statements and the three and nine months ended September 30, 2014.

The discrete item for the nine months ended September 30, 2013 is related to the impact of the Company's loss on the extinguishment of the 11% Senior Secured Notes due to the differences in the Company's marginal tax rate and its anticipated effective annual income tax rate at September 30, 2013 and the accrual of an unrecognized tax benefit.

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## 9. INVESTMENTS AND FAIR VALUE MEASUREMENTS

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

Description	Fair Value Measurements as of September 30, 2014			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets:</b>				
Money market funds	\$220,197	\$220,197	\$—	\$—
Certificates of deposit	3,462	—	3,462	—
Bonds	5,093	5,093	—	—
Investment securities available for sale				
Equity securities	143,964	143,403	561	—
Mutual funds invested in fixed income securities	60,051	60,051	—	—
Fixed income securities				
U.S. Government securities	44,220	—	44,220	—
Corporate securities	50,913	6,525	44,388	—
U.S. mortgage backed securities	297	—	297	—
Commercial mortgage-backed securities	15,561	—	15,561	—
U.S. asset backed securities	14,671	—	14,671	—
U.S. Government agencies	2,900	—	2,900	—
Index-linked U.S. bonds	1,306	—	1,306	—
Total fixed income securities	129,868	6,525	123,343	—
Warrants (1)	2,638	—	—	2,638
Total	\$565,273	\$435,269	\$127,366	\$2,638
<b>Liabilities:</b>				
Fair value of derivatives embedded within convertible debt	\$183,470	\$—	\$—	\$183,470

Warrants include 1,000,000 of LTS Warrants received on November 4, 2011 which were carried at \$2,638 as of (1) September 30, 2014 and are included in "Other assets". The Company recognized income of \$868 for the nine months ended September 30, 2014 related to the change in fair value of the Warrants.

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## Fair Value Measurements as of December 31, 2013

Description	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets:</b>				
Money market funds	\$ 130,733	\$ 130,733	\$—	\$—
Certificates of deposit	2,961	—	2,961	—
Bonds	5,337	5,337	—	—
Investment securities available for sale				—
Equity securities	118,474	117,737	737	—
Fixed income securities				—
U.S. Government securities	13,990	—	13,990	—
Corporate securities	29,923	6,497	23,426	—
U.S. mortgage backed securities	495	—	495	—
Commercial mortgage-backed securities	6,822	—	6,822	—
U.S. asset backed securities	2,081	—	2,081	—
Index-linked U.S. bonds	749	—	749	—
Total fixed income securities	54,060	6,497	47,563	—
Warrants (1)	1,935	—	—	1,935
Total	\$ 313,500	\$ 260,304	\$ 51,261	\$ 1,935
<b>Liabilities:</b>				
Fair value of derivatives embedded within convertible debt	\$ 112,062	\$—	\$—	\$ 112,062

Warrants include 1,000,000 of LTS Warrants received on November 4, 2011 which were carried at \$1,758 as of (1)December 31, 2013 and are included in "Other assets". The Company recognized income of \$172 for the nine months ended September 30, 2013 related to the change in fair value of the Warrants.

The fair value of the Level 2 certificates of deposit are based on prices posted by the financial institutions. The fair value of investment securities available for sale included in Level 1 are based on quoted market prices from various stock exchanges. The Level 2 investment securities available for sale are equity securities based on quoted market prices of securities that are thinly traded and debt securities based on evaluated prices using observable, market-based inputs.

The fair value of derivatives embedded within convertible debt was derived using a valuation model and have been classified as Level 3. The valuation model assumes future dividend payments by the Company and utilizes interest rates and credit spreads based upon the implied debt rate of the 5.50% Convertible Notes to determine the fair value

of the derivatives embedded within the convertible debt. The changes in fair value of derivatives embedded within convertible debt are presented on the Condensed Consolidated Statements of Operations.

The value of the embedded derivatives is based on changes in implied interest rates of the convertible debt, the Company's stock price, stock volatility as well as projections of future cash and stock dividends over the term of the debt. The interest rate component of the value of the embedded derivative is computed by calculating an equivalent non-convertible, unsecured and subordinated borrowing cost. This rate is determined by calculating the implied rate on the Company's 2019 Convertible Notes

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when removing the embedded option value within the convertible security. This rate is based upon market observable inputs and influenced by the Company's stock price, convertible bond trading price, risk free interest rates and stock volatility.

The Company recognized income of \$7,447 and \$8,299 for the nine months ended September 30, 2014 and 2013, respectively, related to the change in fair value of the embedded derivatives.

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

The unobservable inputs related to the valuations of the Level 3 assets and liabilities are as follows at September 30, 2014:

Quantitative Information about Level 3 Fair Value Measurements					
	Fair Value at September 30, 2014	Valuation Technique	Unobservable Input	Range (Actual)	
Warrants	\$2,638	Option model	Stock price	\$4.24	
			Exercise price	\$1.68	
			Term (in years)	2.1	
			Volatility	44.76	%
			Dividend rate	—	
			Risk-free return	0.70	%
Fair value of derivatives embedded within convertible debt	\$183,470	Discounted cash flow	Assumed annual stock dividend	5	%
			Assumed annual cash dividend	\$1.60	
			Stock price	\$22.18	
			Convertible trading price	111.63	%
			Volatility	16	%
			Implied credit spread	5.0% - 6.0% (5.5%)	



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The unobservable inputs related to the valuations of the Level 3 assets and liabilities are as follows at December 31, 2013:

Quantitative Information about Level 3 Fair Value Measurements					
	Fair Value at December 31, 2013	Valuation Technique	Unobservable Input	Range (Actual)	
Warrants	\$1,935	Option model	Stock price	\$3.13	
			Exercise price	\$1.68	
			Term (in years)	2.8	
			Volatility	53.82	%
			Dividend rate	—	
			Risk-free return	0.72	%
Fair value of derivatives embedded within convertible debt	\$112,062	Discounted cash flow	Assumed annual stock dividend	5	%
			Assumed annual cash dividend	\$1.60	
			Stock price	\$16.37	
			Convertible trading price	118.70	%
			Volatility	18	%
			Implied credit spread	7.5% - 8.5% (8.0%)	

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 or acquisitions. The Company had no nonrecurring nonfinancial assets subject to fair value measurements as of September 30, 2014 and December 31, 2013.

## 10. SEGMENT INFORMATION

The Company's significant business segments for the three and nine months ended September 30, 2014 and 2013 were Tobacco, E-Cigarettes and Real Estate. The Tobacco segment consists of the manufacture and sale of conventional cigarettes. The E-Cigarettes segment includes the operations of the Company's e-cigarette business. The Real Estate segment includes the Company's investment in New Valley LLC, which includes Douglas Elliman, Escena, Indian Creek and investments in real estate ventures. The accounting policies of the segments are the same as those described in the summary of significant accounting policies. As a result of the amount of operating losses of Zoom as of September 30, 2014, when compared to the remaining components of the Company's Corporate and Other segment, the Company has reevaluated its operating segments and has separated Zoom's operations from the Corporate and Other segment for previously reported 2014 periods and from the Tobacco segment for the previously reported 2013 periods. Thus, prior period information has been recast to conform to the current presentation. This change did not have an impact to the Company's historical consolidated results.



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Financial information for the Company's operations before taxes for the three and nine months ended September 30, 2014 and 2013 follows:

	Tobacco	E-Cigarettes	Real Estate	Corporate and Other	Total
Three months ended September 30, 2014					
Revenues	\$264,520	\$1,608	\$153,748	\$—	\$419,876
Operating income (loss)	52,993	(1) (2,910)	16,222	(3,321)	62,984
Equity income from real estate ventures	—	—	3,258	—	3,258
Depreciation and amortization	2,853	—	2,740	452	6,045
Three months ended September 30, 2013					
Revenues	\$271,516	\$—	\$6,425	\$—	\$277,941
Operating loss	(32,414)	(2) (560)	(806)	(3,505)	(37,285)
Equity income from real estate ventures	—	—	9,489	—	9,489
Depreciation and amortization	2,361	—	160	251	2,772
Nine months ended September 30, 2014					
Revenues	\$748,468	\$9,977	\$415,280	\$—	\$1,173,725
Operating income (loss)	147,395	(3) (7,100)	36,867	(11,148)	166,014
Equity income from real estate ventures	—	—	3,002	—	3,002
Identifiable assets	445,914	10,657	483,330	703,482	1,643,383
Depreciation and amortization	7,934	—	9,709	956	18,599
Capital expenditures	7,911	—	5,614	7,221	20,746
Nine months ended September 30, 2013					
Revenues	\$761,038	\$—	\$19,298	\$—	\$780,336
Operating income (loss)	63,040	(4) (560)	(1,423)	(11,006)	50,051
Equity income from real estate ventures	—	—	16,774	—	16,774
Identifiable assets	425,186	3,834	208,339	483,596	1,120,955
Depreciation and amortization	7,114	—	440	451	8,005
Capital expenditures	5,813	—	553	2,320	8,686

(1) Operating income includes \$225 of litigation judgment expense.

(2) Operating income includes \$4,016 of income from NPM Settlement, \$86,213 of Engle progeny settlement charge and \$1,700 of litigation judgment expense.

(3) Operating income includes \$1,419 of income from NPM Settlement and \$1,725 of litigation settlement charges and judgment expense.

(4) Operating income includes \$10,963 of income from NPM Settlement, \$86,213 of Engle progeny settlement charge and \$1,700 of litigation judgment expense.



VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## 11. CONDENSED CONSOLIDATING FINANCIAL INFORMATION

The accompanying condensed consolidating financial information has been prepared and presented pursuant to Securities and Exchange Commission Regulation S-X, Rule 3-10, "Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered". Each of the subsidiary guarantors are 100% owned, directly or indirectly, by the Company, and all guarantees are joint and several and subject to certain automatic release provisions. Relief from the financial statement requirements under Rule 3-10 is being provided because the Company's guarantee release provisions are considered customary. Such release provisions are as follows:

- the sale or other disposition of all or substantially all of the assets or all of the capital stock of any subsidiary guarantor; and
- the satisfaction of the requirements for legal defeasance or the satisfaction and discharge of the indenture.

The Company's investments in its consolidated subsidiaries are presented under the equity method of accounting. The indenture of the 7.75% Senior Secured Notes contains covenants that restrict the payment of dividends by the Company if the Company's consolidated earnings before interest, taxes, depreciation and amortization, as defined in the indenture, for the most recently ended four full quarters is less than \$75,000 and the indenture also restricts the incurrence of debt if the Company's Leverage Ratio and its Secured Leverage Ratio, as defined in the indenture, exceed 3.0 and 1.5, respectively.

At September 30, 2014, management believed that the Company was in compliance with all covenants under the indentures of the 7.75% Senior Secured Notes.

## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## CONDENSED CONSOLIDATING BALANCE SHEETS

	September 30, 2014				Consolidated Vector Group Ltd.
	Parent/ Issuer	Subsidiary Guarantors	Non- Guarantors	Consolidating Adjustments	
<b>ASSETS:</b>					
Current assets:					
Cash and cash equivalents	\$257,309	\$19,498	\$103,609	\$—	\$380,416
Investment securities available for sale	274,249	59,634	—	—	333,883
Accounts receivable - trade, net	—	11,231	2,376	—	13,607
Intercompany receivables	472	158	—	(630 )	—
Inventories	—	100,874	—	—	100,874
Deferred income taxes	21,497	4,043	—	—	25,540
Income taxes receivable, net	23,429	—	—	(8,617 )	14,812
Restricted assets	—	1,366	1,414	—	2,780
Other current assets	478	12,676	21,072	—	34,226
Total current assets	577,434	209,480	128,471	(9,247 )	906,138
Property, plant and equipment, net	2,896	62,940	20,786	—	86,622
Real estate held for sale, net	—	—	10,643	—	10,643
Long-term investments accounted for at cost	31,541	—	698	—	32,239
Long-term investments accounted for under the equity method	13,977	—	—	—	13,977
Investments in real estate ventures	—	—	154,281	—	154,281
Investments in consolidated subsidiaries	478,744	—	—	(478,744 )	—
Restricted assets	1,707	10,356	—	—	12,063
Deferred income taxes	56,586	8,174	5,556	—	70,316
Goodwill, trademarks and other intangible assets, net	—	107,511	160,630	—	268,141
Prepaid pension costs	—	28,165	—	—	28,165
Other assets	47,873	10,595	2,330	—	60,798
Total assets	\$1,210,758	\$437,221	\$483,395	\$(487,991 )	\$1,643,383
<b>LIABILITIES AND STOCKHOLDERS' DEFICIENCY:</b>					
Current liabilities:					
Current portion of notes payable and long-term debt	\$88,169	\$12,781	\$208	\$—	\$101,158
Current portion of fair value of derivatives embedded within convertible debt	2,996	—	—	—	2,996
Current portion of employee benefits	—	939	—	—	939
Accounts payable	902	4,778	5,165	—	10,845
Intercompany payables	—	—	630	(630 )	—
Accrued promotional expenses	—	20,010	—	—	20,010
Income taxes payable, net	—	11,791	—	(8,617 )	3,174

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Accrued excise and payroll taxes payable, net	—	861	—	—	861
Litigation accruals and current payments due under the Master Settlement Agreement	—	94,897	—	—	94,897
Deferred income taxes	44,164	13,599	—	—	57,763
Accrued interest	17,721	—	—	—	17,721
Other current liabilities	5,131	9,232	19,893	—	34,256
Total current liabilities	159,083	168,888	25,896	(9,247 )	344,620
Notes payable, long-term debt and other obligations, less current portion	847,318	9,517	272	—	857,107
Fair value of derivatives embedded within convertible debt	180,474	—	—	—	180,474
Non-current employee benefits	32,562	16,046	—	—	48,608
Deferred income taxes	80,046	39,867	45,813	—	165,726
Other liabilities, primarily litigation accruals and payments due under the Master Settlement Agreement	1,265	51,133	2,317	—	54,715
Total liabilities	1,300,748	285,451	74,298	(9,247 )	1,651,250
Commitments and contingencies					
Stockholders' (deficiency) equity attributed to Vector Group Ltd.	(89,990 )	151,770	326,974	(478,744 )	(89,990 )
Non-controlling interest	—	—	82,123	—	82,123
Total stockholders' (deficiency) equity	(89,990 )	151,770	409,097	(478,744 )	(7,867 )
Total liabilities and stockholders' deficiency	\$1,210,758	\$437,221	\$483,395	\$ (487,991 )	\$1,643,383

## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## CONDENSED CONSOLIDATING BALANCE SHEETS

	December 31, 2013				Consolidated Vector Group Ltd.
	Parent/ Issuer	Subsidiary Guarantors	Non- Guarantors	Consolidating Adjustments	
<b>ASSETS:</b>					
Current assets:					
Cash and cash equivalents	\$ 151,342	\$ 11,812	\$ 71,312	\$ —	\$ 234,466
Investment securities available for sale	114,886	57,648	—	—	172,534
Accounts receivable - trade, net	—	10,154	2,005	—	12,159
Intercompany receivables	509	—	—	(509 )	—
Inventories	—	93,496	—	—	93,496
Deferred income taxes	45,578	4,901	—	—	50,479
Income taxes receivable, net	—	10,447	—	(10,447 )	—
Restricted assets	—	1,060	725	—	1,785
Other current assets	513	12,579	10,300	—	23,392
Total current assets	312,828	202,097	84,342	(10,956 )	588,311
Property, plant and equipment, net	3,641	55,093	20,524	—	79,258
Real estate held for sale, net	—	—	20,911	—	20,911
Long-term investments accounted for at cost	20,041	—	747	—	20,788
Long-term investments accounted for under the equity method	8,595	—	—	—	8,595
Investments in real estate ventures	—	—	128,202	—	128,202
Investments in consolidated subsidiaries	410,442	—	—	(410,442 )	—
Restricted assets	1,895	10,086	—	—	11,981
Deferred income taxes	35,000	12,766	3,708	—	51,474
Goodwill, trademarks and other intangible assets, net	—	107,511	163,600	—	271,111
Prepaid pension costs	—	26,080	—	—	26,080
Other assets	38,374	10,126	5,053	—	53,553
Total assets	\$ 830,816	\$ 423,759	\$ 427,087	\$ (421,398 )	\$ 1,260,264
<b>LIABILITIES AND STOCKHOLDERS' DEFICIENCY:</b>					
Current liabilities:					
Current portion of notes payable and long-term debt	\$ 112,275	\$ 39,013	\$ 289	\$ —	\$ 151,577
Current portion of fair value of derivatives embedded within convertible debt	19,128	—	—	—	19,128
Current portion of employee benefits	—	939	—	—	939
Accounts payable	1,509	4,136	4,615	—	10,260
Intercompany payables	—	39	470	(509 )	—
Accrued promotional expenses	—	18,655	—	—	18,655
Income taxes payable, net	16,870	—	—	(10,447 )	6,423



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Accrued excise and payroll taxes payable, net	—	11,621	—	—	11,621
Litigation accruals and current payments due under the Master Settlement Agreement	—	84,658	—	—	84,658
Deferred income taxes	32,309	13,425	—	—	45,734
Accrued interest	21,968	—	—	—	21,968
Other current liabilities	6,103	10,495	17,549	—	34,147
Total current liabilities	210,162	182,981	22,923	(10,956 )	405,110
Notes payable, long-term debt and other obligations, less current portion	524,182	12,573	4,011	—	540,766
Fair value of derivatives embedded within convertible debt	92,934	—	—	—	92,934
Non-current employee benefits	31,462	16,455	—	—	47,917
Deferred income taxes	65,759	37,602	34,289	—	137,650
Other liabilities, primarily litigation accruals and payments due under the Master Settlement Agreement	1,353	54,924	1,219	—	57,496
Total liabilities	925,852	304,535	62,442	(10,956 )	1,281,873
Commitments and contingencies					
Stockholders' (deficiency) equity attributed to Vector Group Ltd.	(95,036 )	119,224	291,218	(410,442 )	(95,036 )
Non-controlling interest	—	—	73,427	—	73,427
Total stockholders' (deficiency) equity	(95,036 )	119,224	364,645	(410,442 )	(21,609 )
Total liabilities and stockholders' deficiency	\$ 830,816	\$ 423,759	\$ 427,087	\$ (421,398 )	\$ 1,260,264

## 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, 2014				
	Parent/ Issuer	Subsidiary Guarantors	Subsidiary Non- Guarantors	Consolidating Adjustments	Consolidated Vector Group Ltd.
Revenues	\$—	\$266,328	\$153,748	\$(200)	) \$419,876
Expenses:					
Cost of sales	—	190,794	96,442	—	287,236
Operating, selling, administrative and general expenses	6,099	22,395	41,137	(200)	) 69,431
Litigation settlement and judgment expense	—	225	—	—	225
Management fee expense	—	2,467	—	(2,467)	) —
Operating (loss) income	(6,099)	) 50,447	16,169	2,467	62,984
Other income (expenses):					
Interest expense	(43,005)	) (1,026)	) (3)	) —	(44,034)
Change in fair value of derivatives embedded within convertible debt	7,127	—	—	—	7,127
Acceleration of interest expense related to debt conversion	(994)	) —	—	—	(994)
Equity income from real estate ventures	—	—	3,258	—	3,258
Equity income on long-term investments	829	—	—	—	829
Gain on sale of investment securities available for sale	33	—	—	—	33
Equity income in consolidated subsidiaries	36,428	—	—	(36,428)	) —
Management fee income	2,467	—	—	(2,467)	) —
Other, net	1,936	296	234	—	2,466
Income (loss) before provision for income taxes	(1,278)	) 49,717	19,658	(36,428)	) 31,669
Income tax benefit (expense)	16,157	(21,491)	) (6,630)	) —	(11,964)
Net income	14,879	28,226	13,028	(36,428)	) 19,705
Net income attributed to non-controlling interest	—	—	(4,826)	) —	(4,826)
Net income attributed to Vector Group Ltd.	14,879	28,226	8,202	(36,428)	) 14,879
Comprehensive income attributed to non-controlling interest	—	—	(4,826)	) —	(4,826)
Comprehensive income attributed to Vector Group	\$23,894	\$28,367	\$8,202	\$(36,569)	) \$23,894



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, 2013				Consolidated Vector Group Ltd.
	Parent/ Issuer	Subsidiary Guarantors	Subsidiary Non- Guarantors	Consolidating Adjustments	
Revenues	\$—	\$271,516	\$6,425	\$—	\$277,941
Expenses:					
Cost of sales	—	194,991	5,844	—	200,835
Operating, selling, administrative and general expenses	4,968	19,990	1,520	—	26,478
Litigation judgment expense	—	87,913	—	—	87,913
Management fee expense	—	2,377	—	(2,377)	—
Operating (loss) income	(4,968)	(33,755)	(939)	2,377	(37,285)
Other income (expenses):					
Interest expense	(32,978)	(602)	(3)	—	(33,583)
Change in fair value of derivatives embedded within convertible debt	2,800	—	—	—	2,800
Equity income from real estate ventures	—	—	9,489	—	9,489
Equity loss on long-term investments	(53)	—	—	—	(53)
Loss on sale of investment securities available for sale	(99)	—	—	—	(99)
Equity loss in consolidated subsidiaries	(11,514)	—	—	11,514	—
Management fee income	2,377	—	—	(2,377)	—
Other, net	603	2,270	(2)	—	2,871
(Loss) income before provision for income taxes	(43,832)	(32,087)	8,545	11,514	(55,860)
Income tax benefit (expense)	6,941	15,521	(3,493)	—	18,969
Net (loss) income	(36,891)	(16,566)	5,052	11,514	(36,891)
Comprehensive (loss) income	\$(28,536)	\$(11,923)	\$5,052	\$6,871	\$(28,536)

## 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, 2014				
	Parent/ Issuer	Subsidiary Guarantors	Subsidiary Non- Guarantors	Consolidating Adjustments	Consolidated Vector Group Ltd.
Revenues	\$—	\$758,645	\$415,280	\$(200 )	\$1,173,725
Expenses:					
Cost of sales	—	544,024	261,531	—	805,555
Operating, selling, administrative and general expenses	17,315	66,270	117,046	(200 )	200,431
Litigation settlement and judgment expense	—	1,725	—	—	1,725
Management fee expense	—	7,402	—	(7,402 )	—
Operating (loss) income	(17,315 )	139,224	36,703	7,402	166,014
Other income (expenses):					
Interest expense	(120,977 )	(3,265 )	(40 )	612	(123,670 )
Change in fair value of derivatives embedded within convertible debt	7,447	—	—	—	7,447
Acceleration of interest expense related to debt conversion	(5,112 )	—	—	—	(5,112 )
Equity income from real estate ventures	—	—	3,002	—	3,002
Equity income on long-term investments	1,462	—	—	—	1,462
Loss on sale of investment securities available for sale	(38 )	—	—	—	(38 )
Equity income in consolidated subsidiaries	96,554	—	—	(96,554 )	—
Management fee income	7,402	—	—	(7,402 )	—
Other, net	3,702	780	4,297	(612 )	8,167
(Loss) income before provision for income taxes	(26,875 )	136,739	43,962	(96,554 )	57,272
Income tax benefit (expense)	52,259	(57,846 )	(15,420 )	—	(21,007 )
Net income	25,384	78,893	28,542	(96,554 )	36,265
Net income attributed to non-controlling interest	—	—	(10,881 )	—	(10,881 )
Net income attributed to Vector Group Ltd.	25,384	78,893	17,661	(96,554 )	25,384
Comprehensive income attributed to non-controlling interest	—	—	(10,881 )	—	(10,881 )
Comprehensive income attributed to Vector Group Ltd.	\$41,218	\$79,026	\$17,661	\$(96,687 )	\$41,218



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, 2013				
	Parent/ Issuer	Subsidiary Guarantors	Non- Guarantors	Consolidating Adjustments	Vector Group Ltd.
Revenues	\$—	\$761,038	\$19,298	\$—	\$780,336
Expenses:					
Cost of sales	—	548,377	16,080	—	564,457
Operating, selling, administrative and general expenses	16,350	56,939	4,626	—	77,915
Litigation judgment expense	—	87,913			87,913
Management fee expense	—	7,131	—	(7,131)	—
Operating (loss) income	(16,350)	) 60,678	(1,408)	) 7,131	50,051
Other income (expenses):					
Interest expense	(97,661)	) (1,374)	) (10)	) —	(99,045)
Change in fair value of derivatives embedded within convertible debt	8,299	—	—	—	8,299
Loss on extinguishment of debt	(21,458)	) —	—	—	(21,458)
Equity income from real estate ventures	—	—	16,774	—	16,774
(Loss) gain on sale of investment securities available for sale	(296)	) 5,406	—	—	5,110
Equity income on long-term investments	770	—	—	—	770
Equity income in consolidated subsidiaries	52,051	—	—	(52,051)	—
Management fee income	7,131	—	—	(7,131)	—
Other, net	2,550	2,475	126	—	5,151
(Loss) income before provision for income taxes	(64,964)	) 67,185	15,482	(52,051)	) (34,348)
Income tax benefit (expense)	39,903	(24,270)	) (6,346)	) —	9,287
Net (loss) income	(25,061)	) 42,915	9,136	(52,051)	) (25,061)
Comprehensive (loss) income	\$(9,670)	) \$49,701	\$9,136	\$(58,837)	) \$(9,670)

## 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, 2014				Consolidated Vector Group Ltd.
	Parent/ Issuer	Subsidiary Guarantors	Non- Guarantors	Consolidating Adjustments	
Net cash provided by operating activities	\$23,189	\$98,319	\$53,475	\$ (74,939 )	\$ 100,044
Cash flows from investing activities:					
Sale of investment securities	174,253	—	—	—	174,253
Purchase of investment securities	(310,934 )	(1,985 )	—	—	(312,919 )
Proceeds from sale or liquidation of long-term investments	500	—	49	—	549
Purchase of long-term investments	(12,000 )	—	—	—	(12,000 )
Investments in real estate ventures	—	—	(29,378 )	—	(29,378 )
Purchase of subsidiaries	—	—	(250 )	—	(250 )
Distributions from real estate ventures	—	—	5,540	—	5,540
Increase in cash surrender value of life insurance policies	—	(435 )	—	—	(435 )
Decrease (increase) in restricted assets	188	(607 )	(689 )	—	(1,108 )
Issuance of notes receivable	(35,000 )	—	(250 )	35,000	(250 )
Investments in subsidiaries	(49,834 )	—	—	49,834	—
Proceeds from sale of fixed assets	—	4	—	—	4
Capital expenditures	(11 )	(15,121 )	(5,614 )	—	(20,746 )
Repayments of notes receivable	35,933	—	—	(35,000 )	933
Net cash used in investing activities	(196,905 )	(18,144 )	(30,592 )	49,834	(195,807 )
Cash flows from financing activities:					
Proceeds from debt issuance	408,750	40,168	—	(35,000 )	413,918
Financing costs	(12,360 )	—	—	—	(12,360 )
Repayments of debt	—	(41,485 )	(3,820 )	35,000	(10,305 )
Borrowings under revolver	—	645,894	—	—	645,894
Repayments on revolver	—	(673,866 )	—	—	(673,866 )
Capital contributions received	—	10,800	39,034	(49,834 )	—
Intercompany dividends paid	—	(54,000 )	(20,939 )	74,939	—
Dividends and distributions on common stock	(122,051 )	—	—	—	(122,051 )
Distributions to non-controlling interest	—	—	(4,861 )	—	(4,861 )
Proceeds from exercise of Vector options	4,407	—	—	—	4,407
Tax benefit of options exercised	937	—	—	—	937
Net cash provided by (used in) financing activities	279,683	(72,489 )	9,414	25,105	241,713
Net increase in cash and cash equivalents	105,967	7,686	32,297	—	145,950
Cash and cash equivalents, beginning of period	151,342	11,812	71,312	—	234,466
Cash and cash equivalents, end of period	\$257,309	\$ 19,498	\$ 103,609	\$ —	\$ 380,416





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, 2013				Consolidated Vector Group Ltd.
	Parent/ Issuer	Subsidiary Guarantors	Non- Guarantors	Consolidating Adjustments	
Net cash provided by operating activities	\$44,750	\$127,382	\$1,524	\$ (118,412 )	\$55,244
Cash flows from investing activities:					
Sale of investment securities	76,067	6,582	—	—	82,649
Purchase of investment securities	(117,982 )	(11,501 )	—	—	(129,483 )
Proceeds from sale of or liquidation of long-term investments	—	—	75	—	75
Purchase of long-term investments	(5,000 )	—	—	—	(5,000 )
Investments in real estate ventures	—	—	(45,977 )	—	(45,977 )
Investments in real estate held for sale	—	—	(7,697 )	—	(7,697 )
Distributions from real estate ventures	—	—	2,463	—	2,463
Increase in cash surrender value of life insurance policies	(20 )	(450 )	—	—	(470 )
Decrease (increase) in restricted assets	5	(558 )	—	—	(553 )
Repayments of notes receivable	9,460	—	—	—	9,460
Proceeds from sale of fixed assets	—	11	—	—	11
Investments in subsidiaries	(72,962 )	—	—	72,962	—
Capital expenditures	(2,320 )	(5,813 )	(553 )	—	(8,686 )
Net cash used in investing activities	(112,752 )	(11,729 )	(51,689 )	72,962	(103,208 )
Cash flows from financing activities:					
Proceeds from debt issuance	450,000	1,120	3,080	—	454,200
Financing costs	(11,750 )	—	—	—	(11,750 )
Repayments of debt	(415,000 )	(5,604 )	(106 )	—	(420,710 )
Borrowings under revolver	—	723,578	—	—	723,578
Repayments on revolver	—	(736,007 )	—	—	(736,007 )
Capital contributions received	—	13,250	59,712	(72,962 )	—
Intercompany dividends paid	—	(105,882 )	(12,530 )	118,412	—
Dividends and distributions on common stock	(107,302 )	—	—	—	(107,302 )
Proceeds from exercise of Vector options	528	—	—	—	528
Tax benefits from exercise of Vector options	33	—	—	—	33
Net cash (used in) provided by financing activities	(83,491 )	(109,545 )	50,156	45,450	(97,430 )
Net (decrease) increase in cash and cash equivalents	(151,493 )	6,108	(9 )	—	(145,394 )
Cash and cash equivalents, beginning of period	401,344	3,776	735	—	405,855
Cash and cash equivalents, end of period	\$249,851	\$9,884	\$726	\$—	\$260,461



## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

(Dollars in Thousands, Except Per Share Amounts)

Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") is designed to provide a reader of Vector Group Ltd.'s financial statements with a narrative from our management's perspective. Our MD&A is divided into the following sections:

- Overview and Recent Developments
- Results of Operations
- Summary of Real Estate Investments
- Liquidity and Capital Resources

Please read this discussion along with our MD&A and audited financial statements as of and for the year ended December 31, 2013 and Notes thereto, included in the our 2013 Annual Report on Form 10-K, and our Consolidated Condensed Financial Statements and related Notes as of and for the quarterly period ended September 30, 2014.

### 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,

• the sale of electronic cigarettes ("e-cigarettes") in the United States market through our Zoom E-Cigs LLC ("Zoom") subsidiary, 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 70.59% of Douglas Elliman, which operates the largest residential brokerage company in the New York metropolitan area.

On December 13, 2013, an affiliate of New Valley LLC acquired an additional 20.59% interest in Douglas Elliman from Prudential Real Estate Financial Services of America, Inc. The acquisition increased our ownership of Douglas Elliman from 50% to 70.59%. Consequently, after December 13, 2013, we consolidate the operations and financial position of Douglas Elliman.

Zoom entered the United States e-cigarette market in limited retail distribution outlets in 2014. Zoom's operations are included in our "E-Cigarettes" reporting segment. Our exposure to Zoom, as of September 30, 2014, was approximately \$10,700, which was primarily comprised of Zoom's inventory.

### Recent Developments

On March 14, 2014, the holder of the 6.75% Variable Interest Senior Convertible Note due 2014 converted \$25,000 principal balance of the \$50,000 Note into 2,121,479 of our common shares.

On March 24, 2014, we completed the sale of \$258,750 of our 5.5% Variable Interest Convertible Senior Notes due 2020 and received net proceeds from the sale of the Notes of approximately \$250,300. On April 15, 2014, we completed the sale of \$150,000 principal amount of our 7.75% Senior Secured Notes due 2021 for a price of 106.750% in a private offering to qualified institutional investors in accordance with Rule 144A of the Securities Act of 1933. We received net proceeds of approximately \$158,700. The net proceeds of both issuances will be used for general corporate purposes, including for additional investments in real estate and in our tobacco business. In August 2014, we completed an offer to exchange the 7.75% senior secured notes issued in April 2014 for an equal amount of newly issued 7.75% senior secured notes due 2021. The new 7.75% senior secured notes have substantially the same

terms as the original notes, except that the new 7.75% senior secured notes have been registered under the Securities Act.

In May 2014, the Indian Creek property was sold for approximately \$14,400 and New Valley received a distribution of approximately \$7,100.

In May 2014 and August 2014, holders of the 6.75% Variable Interest Senior Convertible Exchange Notes due 2014 converted \$7,500 and \$32,415 principal balance of the \$107,530 Notes into 2,985,571 of our common shares. On July 23, 2014, we granted our President and Chief Executive Officer an award of 1,050,000 shares of our Common Stock subject to performance-based vesting. The Award shares will be issued pursuant to the terms of an agreement that provides that both a performance requirement and a continued employment requirement must be met over a seven-year performance period to earn vested rights with respect to the Award Shares. The maximum potential amount of the Award Shares reflects recognition of the CEO's contributions as CEO since January 1, 2006 and the value of his management and real estate expertise to us. We anticipate expensing the value of the grant of approximately \$20,780 over an estimated seven-year period.

#### Recent Developments in Smoking-Related Litigation

There are no material changes from the Recent Developments in Smoking-Related Litigation 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, 2013, other than in October 2014, in an Engle progeny case, an adverse verdict was entered against Liggett in the amount of \$13,100, including \$9,500 in punitive damages. The verdict has not been reduced to a judgment. Post trial motions are pending. Please refer to that section and the information below for disclosures regarding the critical accounting policies related to our business.

#### 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, 2013. 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, Zoom, 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, 2014 and 2013 were Tobacco, E-Cigarettes and Real Estate. The Tobacco segment consists of the manufacture and sale of cigarettes. The E-Cigarettes segment includes the operations of Zoom. The Real Estate segment includes our investment in New Valley LLC, which includes Douglas Elliman, Escena, Indian Creek and investments in non-consolidated real estate businesses. As a result of the amount of operating losses of Zoom as of September 30, 2014 when compared to the remaining components of our Corporate and Other segment, we have reevaluated our operating segments and have separated our E-Cigarettes operations from the Corporate and Other segment for previously reported 2014 periods and from the Tobacco segment for the previously reported 2013 periods. Thus, prior period information has been recast to conform to the current presentation.



	Three Months Ended September 30,		Nine Months Ended September 30,		
	2014	2013	2014	2013	
Revenues:					
Tobacco	\$264,520	\$271,516	\$748,468	\$761,038	
E-Cigarettes	1,608	—	9,977	—	
Real Estate	153,748	6,425	415,280	19,298	
Corporate and Other	—	—	—	—	
Total revenues	\$419,876	\$277,941	\$1,173,725	\$780,336	
Operating income (loss):					
Tobacco	\$52,993	(1) \$(32,414)	(2) \$147,395	(3) \$63,040	(4)
E-Cigarettes	(2,910)	) (560)	) (7,100)	) (560)	)
Real Estate	16,222	) (806)	) 36,867	) (1,423)	)
Corporate and Other	(3,321)	) (3,505)	) (11,148)	) (11,006)	)
Total operating income (loss)	\$62,984	) \$(37,285)	) \$166,014	) \$50,051	)

(1) Operating income includes \$225 of litigation judgment expense.

(2) Operating income includes \$4,016 of income from NPM Settlement, \$86,213 of Engle progeny settlement charge and \$1,700 of litigation judgment expense.

(3) Operating income includes \$1,419 of income from NPM Settlement and \$1,725 of litigation settlement charges and judgment expense

(4) Operating income includes \$10,963 of income from NPM Settlement, \$86,213 of Engle progeny settlement charge and \$1,700 of litigation judgment expense.

#### Three Months Ended September 30, 2014 Compared to Three Months Ended September 30, 2013

Revenues: Total Revenues were \$419,876 for the three months ended September 30, 2014 compared to \$277,941 for the three months ended September 30, 2013. Total Revenues increased by \$141,935 (51.1%) due to an increase in Real Estate revenues of \$147,323 primarily related to the addition of the Douglas Elliman revenues in 2014 and the addition of the Zoom e-cigarette revenues of \$1,608. This was offset by a decline in Tobacco revenues of \$6,996. Cost of Sales. Total cost of sales were \$287,236 for the three months ended September 30, 2014 compared to \$200,835 for the three months ended September 30, 2013. The \$86,401 (43.0%) increase in cost of sales was due to an increase in real estate cost of sales of \$90,598 related to the Douglas Elliman real estate commissions expense and \$1,066 of cost of sales associated with the Zoom e-cigarette brand. This was offset by a \$5,263 decline in Tobacco cost of sales.

Expenses. Operating, selling, general and administrative expenses were \$69,431 for the three months ended September 30, 2014 compared to \$26,478 for the same period last year. This was an increase of \$42,953 (162.2%) of which \$39,697 was primarily related to the operating, selling and administrative expenses of Real Estate, \$548 of Tobacco operating, selling, general and administrative expenses, \$2,894 of Zoom operating, selling, general and administrative expense offset by a decline in Corporate and Other expense of \$186.

Operating income (loss). Operating income was \$62,984 for the three months ended September 30, 2014 compared to an operating loss of \$37,285 for the same period last year, an increase of \$100,269 (268.9%). Tobacco operating income increased by \$85,407, due to the absence in the 2014 period of \$87,688 of litigation and judgment expense offset by the absence of \$4,016 of income from the NPM Settlement. Real Estate operating income increased by \$17,028 and Corporate and Other expenses declined by \$186. This was offset by an increase in operating losses related to Zoom of \$2,352.



Other income (expenses). Other expenses were \$31,315 and \$18,575 for the three months ended September 30, 2014 and 2013, respectively. For the three months ended September 30, 2014, other expenses primarily consisted of interest expense of \$44,034, acceleration of interest expense related to the debt conversion of the 6.75% Variable Interest Senior Convertible Exchange Notes of \$994, and an equity loss on real estate ventures of \$3,258. This was offset by income of \$7,127 from changes in fair value of derivatives embedded within convertible debt, other income of \$2,466, equity income on long-term investments of \$829 and a gain on sale of investment securities available for sale of \$33. For the three months ended September 30, 2013, other expenses primarily consisted of interest expense of \$33,583, loss on sale of investments available for sale of \$99 and equity loss

on long-term investments of \$53. This was offset by equity income from real estate ventures of \$9,489, income of \$2,800 from changes in fair value of derivatives embedded within convertible debt and other income of \$2,871. The increase in interest expense in 2014 was primarily attributable to an increase in non-cash interest expenses associated with the amortization of debt discount of our convertible debt and increased debt.

Income (loss) before provision for income taxes. Income before income taxes for the three months ended September 30, 2014 was \$31,669 compared to a loss of \$55,860 for the three months ended September 30, 2013. The increase is attributable to the items discussed above.

Income tax expense (benefit). Income tax expense was \$11,964 for the three months ended September 30, 2014 compared to a benefit of \$18,969 for the three months ended September 30, 2013. Our provision for income taxes in interim periods is based on an estimated annual effective income tax rate derived, in part, from estimated annual income before provision for income taxes in accordance with guidance on accounting for income taxes on interim periods. The discrete item for the three months ended September 30, 2014 related to an adjustment to the Corporation's marginal tax rate as a result of its acquisition of 20.59% of Douglas Elliman Realty, LLC in December 2013. For the three months ended September 30, 2013, our income tax benefit was primarily decreased by \$2,362 due to the impact of the Engle progeny settlement due to differences in the Company's marginal tax rate and its anticipated effective annual income tax rate at September 30, 2013 and \$251 due to an increase in our unrecognized tax benefits during the three-month period.

Tobacco.

Tobacco Revenues. Liggett increased the list price of PYRAMID, LIGGETT SELECT, EVE and GRAND PRIX by \$0.70 per carton in December 2013 and \$0.60 per carton in June 2013 and May 2014.

All of our Tobacco sales were in the discount category in 2014 and 2013. For the three months ended September 30, 2014, tobacco revenues were \$264,520 compared to \$271,516 for the three months ended September 30, 2013.

Revenues declined by 2.6% (\$6,996) due to a decline in sales volume of \$16,736 (approximately 128.4 million units) offset by a favorable price variance of \$9,740.

Tobacco Cost of Sales. Our Tobacco cost of sales declined from \$194,991 for the three months ended September 30, 2013 to \$189,728 for the three months ended September 30, 2014. The major components of our Tobacco cost of sales are as follows:

	Three Months Ended September 30,	
	2014	2013
Manufacturing overhead, raw materials and labor	\$33,315	\$35,957
Federal Excise Taxes, net	115,326	121,787
Tobacco quota buyout expense	6,425	6,547
FDA expense	4,012	3,855
MSA expense, net of market share exemption	30,650	26,845
Total cost of sales	\$ 189,728	\$ 194,991

Tobacco gross profit was \$74,792 for the three months ended September 30, 2014 compared to \$72,509 (adjusting for the NPM Settlement) for the three months ended September 30, 2013. The \$2,283 (3.1%) increase was due to higher margins associated with price increases. As a percentage of revenues (excluding Federal Excise Taxes), Tobacco gross profit was 50.1% in the 2014 period. Tobacco gross profit was 48.4%, adjusting for the NPM Settlement, in the 2013 period.

Tobacco expenses. Tobacco operating, selling, general and administrative expenses, excluding litigation settlement and judgment expenses, were \$21,574 and \$21,026 for the three months ended September 30, 2014 and 2013, respectively. The increase of \$548 was due to an increase in legal expenses.



Tobacco operating income. Tobacco operating income was \$52,993 for the three months ended September 30, 2014 compared to an operating loss of \$32,414 for the same period last year. The Tobacco operating income increase of \$85,407 was primarily associated with improved margins and the absence of the \$86,213 Engle progeny settlement charge and a decrease in litigation settlement and judgment charges of \$1,475, offset by the income from the NPM Settlement of \$4,016 in 2013.

#### E-Cigarettes.

Zoom entered the United States e-cigarette market in limited retail distribution outlets in 2013 and expanded distribution in 2014. E-Cigarettes revenues were \$1,608 and E-Cigarettes cost of sales were \$1,066 for the three months ended September 30, 2014. E-Cigarettes operating, selling, general and administrative expenses were \$3,454 for the three months ended September 30, 2014 compared to \$560 for the three months ended September 30, 2013. The increase was due to additional selling and administrative costs in 2014 associated with marketing and promotions activity. E-Cigarettes operating losses were \$2,912 and \$560 for the three months ended September 30, 2014 and 2013, respectively.

#### Real Estate.

Real Estate Revenues. Real Estate revenues were \$153,748 and \$6,425 for the three months ended ended September 30, 2014 and 2013, respectively. Real Estate revenues increased by \$147,323, primarily related to Douglas Elliman. Douglas Elliman became a consolidated subsidiary of ours in December 2013.

Real Estate revenues and cost of sales for the three months ended September 30, 2014 were as follows:

	Three Months Ended September 30,	
	2014	2013
Real Estate Revenues:		
Commission and other brokerage income	\$145,407	\$5,850
Property management income	6,998	—
Title fees	800	—
Sales on facilities primarily from Escena	543	575
Total real estate revenues	\$153,748	\$6,425
Real Estate Cost of Sales:		
Commission and other brokerage income	\$95,434	\$4,914
Cost of sales on facilities primarily from Escena	905	930
Other	103	—
Total real estate cost of sales	\$96,442	\$5,844

Real Estate expenses. Real Estate operating, selling, general and administrative expenses were \$41,084 and \$1,387 for the three months ended September 30, 2014 and 2013, respectively. Real Estate operating, selling, general and administrative expenses increased by \$39,697 primarily related to the Douglas Elliman operations.

Real Estate operating income (loss). The Real Estate segment had operating income of \$16,222 for the three months ended September 30, 2014 and an operating loss of \$806 for the three months ended September 30, 2013. The increase of \$17,028 was primarily related to the Douglas Elliman operations.

Corporate and Other.

Corporate and Other operating loss. Corporate and Other operating loss was \$3,319 for the three months ended September 30, 2014 compared to \$3,505 for 2013. Corporate and Other operating losses declined by \$186 primarily as a result of lower rent expense in 2014 offset by increased stock compensation expense in the 2014 period.

Nine Months Ended September 30, 2014 Compared to Nine Months Ended September 30, 2013

Revenues. Total Revenues were \$1,173,725 for the nine months ended September 30, 2014 compared to \$780,336 for the nine months ended September 30, 2013. The \$393,389 (50.4%) increase in revenues was due to an increase in Real Estate revenues of \$395,982 primarily related to the addition of the Douglas Elliman revenues in 2014 and an increase of \$9,977 in E-Cigarettes revenues associated with Zoom. This was offset by a \$12,570 decrease in Tobacco revenues.

Cost of Sales. Total cost of sales were \$805,555 for the nine months ended September 30, 2014 compared to \$564,457 for the nine months ended September 30, 2013. The \$241,098 (42.7%) increase in cost of sales was due to an increase in Real Estate cost of sales of \$245,451 related to the Douglas Elliman real estate commissions expense and \$6,357 of E-Cigarettes cost of sales associated with the Zoom e-cigarette brand. This was offset by a \$10,710 decline in Tobacco cost of sales.

Expenses. Operating, selling, general and administrative expenses, net of the Engle progeny settlement charge and litigation settlement and judgment expense, were \$200,431 for the nine months ended September 30, 2014 compared to \$77,915 for the same period last year. This was an increase of \$122,516 (157.2%) of which \$112,241 was related to the operating, selling and administrative expenses of Real Estate, \$10,160 was related to E-Cigarettes and \$142 of Corporate and Other expenses. This was offset by a decline in Tobacco operating, selling and administrative expenses of \$26.

Operating income (loss). Operating income was \$166,014 for the nine months ended September 30, 2014 compared to \$50,051 for the same period last year, an increase of \$115,963 (231.7%). Tobacco operating income increased by \$84,355 and real estate operating income increased by \$38,290. This was offset by an increase in operating losses related to E-Cigarettes of \$6,540 and an increase in Corporate and Other expenses of \$142.

Other income (expenses). Other expenses were \$108,742 and \$84,399 for the nine months ended September 30, 2014 and 2013, respectively. For the nine months ended September 30, 2014, other expenses primarily consisted of interest expense of \$123,670, acceleration of interest expense related to the debt conversion of the 6.75% Variable Interest Senior Convertible Exchange Notes of \$5,112, equity loss on real estate ventures of \$3,002 and a loss on sale of investment securities available for sale of \$38. This was offset by income of \$7,447 from changes in fair value of derivatives embedded within convertible debt, equity income on long-term investments of \$1,462 and interest and other income of \$8,167. For the nine months ended September 30, 2013, other expenses primarily consisted of interest expense of \$99,045 and loss on the extinguishment of debt of \$21,458. This was offset by equity income from real estate ventures of \$16,774, income of \$8,299 from changes in fair value of derivatives embedded within convertible debt, gain on sale of investment securities available for sale of \$5,110, other income of \$5,151 and equity income on long-term investments of \$770. The increase in interest expense in 2014 was primarily attributable to an increase in non-cash interest expenses associated with the amortization of debt discount of our convertible debt and increased debt.

Income (loss) before provision for income taxes. Income before income taxes was \$57,272 for the nine months ended September 30, 2014, compared to a loss of \$34,348 for the same periods in 2013. The increase is attributable to the items discussed above.

Income tax expense (benefit). Income tax expense was \$21,007 for the nine months ended September 30, 2014 compared to an income tax benefit of \$9,287 for the same period in 2013. Our provision for income taxes in interim periods is based on an estimated annual effective income tax rate derived, in part, from estimated annual income before provision for income taxes in accordance with guidance on accounting for income taxes on interim periods. For the nine months ended September 30, 2014, our income tax expense was increased by \$1,944 due primarily to a change in the blended state tax rate that resulted in the Company's reevaluation of its deferred taxes. For the nine

months ended September 30, 2013, our income tax benefit was primarily decreased by \$3,178 related to the Engle progeny settlement and our loss on the extinguishment of our 11% Senior Secured Notes due to the differences in our marginal tax rate and our anticipated effective annual income tax rate at September 30, 2013 and \$373 due to an increase in our unrecognized tax benefits during the nine-month period.

## Tobacco.

Tobacco Revenues. Liggett increased the list price of PYRAMID, LIGGETT SELECT, EVE and GRAND PRIX by \$0.70 per carton in December 2013 and \$0.60 per carton in June 2013 and May 2014.

All of our Tobacco sales were in the discount category in 2014 and 2013. For the nine months ended September 30, 2014, tobacco revenues were \$748,468 compared to \$761,038 for the nine months ended September 30, 2013.

Revenues declined by 1.7% (\$12,570) due to a decline in sales volume of \$40,267 (approximately 315.2 million units) offset by a favorable price variance of \$27,697.

Tobacco Cost of Sales. Our Tobacco cost of sales declined from \$548,377 for the nine months ended September 30, 2013 to \$537,667 for the nine months ended September 30, 2014. The major components of our Tobacco cost of sales are as follows:

	Nine Months Ended September 30,	
	2014	2013
Manufacturing overhead, raw materials and labor	\$94,779	\$93,961
Federal Excise Taxes, net	327,434	343,294
Tobacco quota buyout expense	20,697	21,553
FDA expense	13,017	12,765
MSA expense, net of market share exemption	81,740	76,804
Total cost of sales	\$537,667	\$548,377

Adjusting for the NPM Settlement, Tobacco gross profit was \$209,382 for the nine months ended September 30, 2014 compared to \$201,698 for the nine months ended September 30, 2013. The \$7,684 (3.8%) increase was due to higher margins associated with price increases primarily on the PYRAMID brand. As a percentage of revenues (excluding Federal Excise Taxes and adjusting for the NPM Settlements), Tobacco gross profit was 49.7% in the 2014 period and 48.3% in the 2013 period.

Tobacco expenses. Tobacco operating, selling, general and administrative expenses excluding litigation settlement judgment expenses were \$61,682 for the nine months ended September 30, 2014 compared to \$61,708 for the nine months ended September 30, 2013.

Tobacco operating income. Tobacco operating income was \$147,395 for the nine months ended September 30, 2014 compared to \$63,040 for the same period last year. The Tobacco operating income increase of \$84,355 was primarily associated with improved margins and the the absence of the \$86,213 Engle progeny settlement charge offset by a decrease in income from the NPM Settlement of \$9,544 in 2013.

## E-Cigarettes.

Zoom entered the emerging United States electronic cigarette ("e-cigarette") market in limited retail distribution outlets in 2013 and expanded distribution in 2014. E-Cigarettes revenues were \$9,977 and our E-Cigarettes cost of sales were \$6,357 for the nine months ended September 30, 2014. E-Cigarettes operating, selling, general and administrative expenses were \$10,720 and \$560 for the nine months ended September 30, 2014 and 2013, respectively. The increase was due to additional selling and administrative costs in 2014 associated with marketing and promotions activity. E-Cigarettes operating losses were \$7,100 and \$560 for the nine months ended September 30, 2014 and 2013, respectively.

## Real Estate.

Real Estate Revenues. Real Estate revenues were \$415,280 and \$19,298 for the nine months ended ended September 30, 2014 and 2013, respectively. Real Estate revenues increased by \$395,982 primarily related to the Douglas Elliman operations. Douglas Elliman became a consolidated subsidiary of ours in December 2013.





Real Estate revenues and cost of sales for the nine months ended ended September 30, 2014 were as follows:

	Nine Months Ended September 30,	
	2014	2013
Real Estate Revenues:		
Commission and other brokerage income	\$372,738	\$15,368
Property management income	22,111	—
Title fees	2,134	—
Indian Creek	14,400	—
Sales on facilities primarily from Escena	3,897	3,930
Total real estate revenues	\$415,280	\$19,298
Real Estate Cost of Sales:		
Commission and other brokerage income	\$248,213	\$12,874
Indian Creek cost of sales	9,987	—
Cost of sales on facilities primarily from Escena	3,052	3,206
Title fees	279	—
Total real estate cost of sales	\$261,531	\$16,080

Real Estate expenses. Real estate operating, selling, general and administrative expenses were \$116,882 and \$4,641 for the nine months ended September 30, 2014 and 2013, respectively. Real estate operating, selling, general and administrative expenses increased by \$112,241 primarily related to the Douglas Elliman operations.

Real Estate operating income (loss). The real estate segment had operating income of \$36,867 for the nine months ended September 30, 2014 compared to an operating loss of \$1,423 for the nine months ended September 30, 2013. The increase in operating income of \$38,290 was primarily related to the Douglas Elliman operations.

Corporate and other.

Corporate and other loss. The operating loss at the corporate segment was \$11,148 for the nine months ended September 30, 2014 compared to \$11,006 for the same period in 2013.

Summary of Real Estate Investments

We own, and seek to acquire investment interests in various domestic and international real estate projects through debt and equity investments. Our current real estate investments primarily include the following projects as of September 30, 2014:

(Dollars in Thousands. Area and Unit Information in Ones)

Location	Date of Initial Investment	Percentage Owned	Net Amount Invested	Earnings (Losses)	Carrying Value as of September 30, 2014	Future Capital Projected Commitments and/or New Area Valley	Projected Residential and/or Hotel	Projected Retail Area	Projected Number of Residential Lots, Units and/or Hotel Rooms	Projected Start Date	
Escena, net	Master planned community, golf course, restaurant and shop in Palm Springs, CA March 2008	100 %	N/A	N/A	\$10,643	\$450	Acres	667 450	R Lots H	N/A	
Real estate held for sale, net			—	—	10,643						
10 Madison Square Park West (f/k/a 1107 Broadway)	Flatiron District/NoMad neighborhood, Manhattan, NY June 2011	5.0 %	\$4,130	\$2,254	\$6,384	—260,000	SF	17,000	SF124	R	August 2014
The Whitman	Flatiron District/NoMad neighborhood, Manhattan, NY October 2011	12.0 %	—	526	526	—24,279	SF	4,698	SF4	R	October 2014
The Marquand	Upper East Side, Manhattan, NY December 2011	18.0 %	7,000	5,000	12,000	—87,887	SF	—	28	R	June 2012
11 Beach Street	TriBeCa, Manhattan, NY June 2012	49.5 %	12,328	—	12,328	—97,090	SF	—	27	R	May 2014
20 Times Square (f/k/a 701 Seventh Avenue)	Times Square, Manhattan, NY October 2012	11.5 %	12,481	—	12,481	—280,000	SF	80,000	SF452	H	September 2013
101 Murray Street	TriBeCa, Manhattan, NY West July 2013	25.0 %	25,269	—	25,269	—320,000	SF	TBD	139	R	September 2014
160 Leroy Street	Greenwich Village, Manhattan, NY January 2013	5.0 %	1,353	—	1,353	—130,137	SF	—	30 to 50	R	July 2015
PUBLIC Chrystie	Lower East Side, December 2012	18.4 %	3,180	—	3,180	—217,000	SF	43,000	SF11 367	R H	June 2014

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House (f/k/a Chrystie Street) 25-19 43rd Avenue Queens Plaza (f/k/a 23-10 Queens Plaza South)	Manhattan, NY Long Island City, NY Long Island City, NY	May 2014 December 2012	9.9 %	733	—	733	87,000	SF	—	86	R	September 2014
8701 Collins Avenue 125 Greenwich Street Condominium and Mixed Use Development	Miami Beach, FL Financial District, Manhattan, NY	December 2013 August 2014	15.0 %	4,455	179	4,634	—262,000	SF	TBD	TBD		October 2013
			13.3 %	9,308	—	9,308	—359,000	SF	TBD	TBD	R	March 2014
				\$92,827	\$7,959	\$100,786						
Maryland Portfolio	Primarily Baltimore County, MD Houston, TX; Phoenix, AZ;	July 2012	7.5 %	\$3,933	\$(585)	\$3,348	—N/A		N/A	5,517	R	N/A
ST Portfolio	San Pedro, CA and Stamford, CT	November 2013	16.4 %	16,365	(857)	15,508	—1,018,404	SF	24,987	SF761	R	N/A
Apartment Buildings				\$20,298	\$(1,442)	\$18,856						
Park Lane Hotel	Central Park South, Manhattan, NY	November 2013	5.0 %	\$20,716	\$(2,619)	\$18,097	—445,600	SF	—	628	H	N/A
Hotel Taiwana	St. Barthelemy, French West Indies	October 2011	17.0 %	7,426	(576)	6,850	—61,300	SF	4,300	SF30	H	N/A
Coral Beach Hotels	Coral Beach, Bermuda	December 2013	49.0 %	3,618	(910)	2,708	—52	Acres	—	87	H	N/A
				\$31,760	\$(4,105)	\$27,655						
Milano Sesto Holdings Land Development	Milan, Italy	October 2011	7.2 %	\$5,037	\$—	\$5,037	—322	Acres	TBD	TBD		2014
				\$5,037	\$—	\$5,037						

N/A - Not  
applicable

SF - Square feet H - Hotel rooms

TBD - To be  
determined

R - Residential  
Units

R Lots - Residential lots

Other investments in real estate ventures relate to an investment in a mortgage company and an insurance company by Douglas Elliman with a carrying value of \$1,947 as of September 30, 2014.



## Liquidity and Capital Resources

Cash and cash equivalents increased by \$145,950 for the nine months ended September 30, 2014 and decreased by \$145,394 for the nine months ended September 30, 2013.

Cash provided from operations was \$100,044 and \$55,244 for the nine months ended September 30, 2014 and 2013, respectively. The change primarily related to cash payments in the 2013 period associated with the extinguishment of our 11% Senior Secured Notes due 2015, increased operating income in the 2014 period and the timing of payments of accruals. The amount was partially offset by the Engle progeny settlement payment.

Cash used in investing activities was \$195,807 and \$103,208 for the nine months ended September 30, 2014 and 2013, respectively. In the first nine months of 2014, cash used in investing activities was for the purchase of investment securities of \$312,919, investment in real estate ventures of \$29,378, capital expenditures of \$20,746, purchase of long-term investments of \$12,000, an increase in non-current restricted assets of \$1,108, an increase in cash surrender value of corporate-owned life insurance policies of \$435, an issuance of notes receivable of \$250 and purchase of subsidiaries of \$250. This was offset by the sale of investment securities of \$174,253, distributions from real estate ventures of \$5,540, proceeds from the liquidation of long-term investments of \$549, collections of notes receivable of \$933 and proceeds from the sale of fixed assets of \$4. In the first nine months of 2013, cash used in investing activities was for the purchase of investment securities of \$129,483, investment in real estate ventures of \$45,977, capital expenditures of \$8,686, investments in consolidated real estate business of \$7,697, purchase of long-term investments of \$5,000, an increase in non-current restricted assets of \$553 and an increase in cash surrender value of corporate-owned life insurance policies of \$470. This was offset by the sale of investment securities of \$82,649, collections of notes receivable of \$9,460, distributions from real estate ventures of \$2,463, the proceeds from the sale or liquidation of long-term investments of \$75 and the proceeds from the sale of fixed assets of \$11.

Cash provided by financing activities was \$241,713 for the nine months ended September 30, 2014 compared to cash used in financing activities of \$97,430 for the nine months ended September 30, 2013. In the first nine months of 2014, cash was provided by the proceeds from debt issuance of \$413,918, proceeds from the exercise of Vector options of \$4,407 and tax benefit of options exercised of \$937. This was offset by cash used for the distributions on common stock of \$122,051, payment of deferred financing costs of \$12,360, repayment of debt of \$10,305, net repayments of debt under the revolver of \$27,972 and distributions to non-controlling interest of \$4,861. In the first nine months of 2013, cash used in financing activities was used for the repayment of debt of \$420,710, distributions on common stock of \$107,302, net repayments of debt under the revolver of \$12,429 and deferred financing costs of \$11,750. This was offset by proceeds from debt issuance of \$454,200, proceeds from the exercise of Vector options of \$528, and tax benefit of options exercised of \$33.

Liggett Credit Facility and Liggett Term Loan Under Credit Facility. As of September 30, 2014, \$6,115 was outstanding under the revolving and term loan portions of the credit facility. Availability as determined under the Credit Facility was approximately \$43,885 based on eligible collateral at September 30, 2014. At September 30, 2014, management believed that Liggett was in compliance with all covenants under the credit facility; Liggett's EBITDA, as defined, were approximately \$125,687 for the twelve months ended September 30, 2014.

Vector. On March 14, 2014, the holder of the 6.75% Variable Interest Senior Convertible Note due 2014 converted \$25,000 principal balance of the \$50,000 Note into 2,121,479 of our common shares. On May 20, 2014, a holder of the 6.75% Variable Interest Senior Convertible Exchange Notes due 2014 converted \$7,500 principal balance of the \$107,530 Notes into 560,987 of our common shares. In August 2014, holders of the 6.75% Variable Interest Senior Convertible Exchange Notes due 2014 converted \$32,415 principal balance of the \$107,530 Notes into 2,424,584 of our common shares.

On March 24, 2014, we completed the sale of \$258,750 of our Variable Interest Convertible Senior Notes due 2020 and received net proceeds from the sale of the Notes of approximately \$250,300. On April 15, 2014, we completed the sale of principal amount of our 7.75% Senior Secured Notes due 2021 for a price of 106.750% in a private offering to qualified institutional investors in accordance with Rule 144A of the Securities Act of 1933. We received net proceeds of approximately \$158,700. In August 2014, we completed an offer to exchange the 7.75% senior secured notes issued in April 2014 for an equal amount of newly issued 7.75% senior secured notes due 2021. The new 7.75% senior

secured notes have substantially the same terms as the original notes, except that the new 7.75% senior secured notes have been registered under the Securities Act.

The net proceeds of both issuances will be used for general corporate purposes, including for additional investments in real estate and in our tobacco business. We may also consider using a portion of the net proceeds from the sale of the Notes to address upcoming debt maturities.

The indenture of our 7.75% senior secured notes due 2021 contains covenants that restrict the payment of dividends if our consolidated earnings before interest, taxes, depreciation and amortization ("Consolidated EBITDA"), as defined in the indenture, for the most recently ended four full quarters is less than \$75,000. 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 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 financial covenants and the results of the calculation, as defined by the indenture.

Covenant	Indenture Requirement	September 30, 2014	December 31, 2013
Consolidated EBITDA, as defined	\$75,000	\$254,694	\$264,958
Leverage ratio, as defined	<3.0 to 1	1.17 to 1	1.22 to 1
Secured leverage ratio, as defined	<1.5 to 1	Negative	0.5 to 1

We and our subsidiaries have significant indebtedness and debt service obligations. At September 30, 2014, we and our subsidiaries had total outstanding indebtedness of \$1,204,143. Approximately \$92,615 of our 6.75% convertible notes mature in 2014, \$230,000 of our 7.5% convertible notes mature in 2019, \$258,750 of our 5.5% variable interest senior convertible notes mature in 2020, and \$600,000 of our 7.75% senior secured notes mature in 2021. 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 and real estate 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 \$380,400, investment securities available for sale of approximately \$333,900, long-term investments with an estimated value of approximately \$51,800 and availability under Liggett's credit facility of approximately \$43,900 at September 30, 2014. 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, 2014, approximately \$6,100 of our outstanding debt at face value had variable interest rates determined by various interest rate indices, which increases the risk of fluctuating interest rates. Our exposure to market risk includes interest rate fluctuations in connection with our variable rate borrowings, which could adversely affect our cash flows. As of September 30, 2014, 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 \$61.

In addition, as of September 30, 2014, \$325,910 (\$581,365 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 \$4,098 with approximately \$1 resulting from the embedded



derivative associated with our 6.75% note due 2014, \$3 resulting from the embedded derivative associated with our 6.75% exchange notes due 2014, \$1,895 resulting from the embedded derivative associated with the 7.5% variable interest senior convertible notes, and the remaining \$2,199 resulting from the embedded derivative associated with our 5.5% variable interest senior convertible debentures due 2020. An increase in our quarterly dividend rate by \$0.10 per share would increase interest expense by approximately \$9,800 per year.

We have estimated the fair market value of the embedded derivatives based principally on the results of a valuation model. The value of the embedded derivatives is based on changes in interest rates of debt instruments maturing over the duration of the convertible debt, our stock price as well as projections of future cash and stock dividends over the term of the debt. The interest rate component of the value of the embedded derivative is computed by calculating an equivalent non-convertible, unsecured and subordinated borrowing cost. This rate is determined by calculating the implied rate on our 7.5% Convertible Notes when removing the embedded option value within the convertible security. This rate is based upon market observable inputs and influenced by our stock price, convertible bond trading price, risk free interest rates and stock volatility. The range of estimated fair market values of our embedded derivatives was between \$185,583 and \$181,403. We recorded the fair market value of our embedded derivatives at the midpoint of the range at \$183,470 as of September 30, 2014. The estimated fair market value of our embedded derivatives could change significantly based on future market conditions.

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

There are no material changes from the Legislation and Regulation section 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, 2013. Please refer to that section and the information below for disclosures regarding the critical accounting policies related to our business.

#### SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

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

- economic outlook,
- capital expenditures,
- cost reduction,
- legislation and regulations,
- cash flows,
- operating performance,
- litigation,
- impairment charges and cost saving associated with restructurings of our tobacco operations, and
- related industry developments (including trends affecting our business, financial condition and results of operations).

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

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

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

Further information on the risks and uncertainties to our business include the risk factors discussed above in "Management's Discussion and Analysis of Financial Condition and Results of Operations" and under Item 1A, "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2013 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 third quarter of 2014 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 7, 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, 4400 Biscayne Boulevard, 10th Floor, Miami, Florida 33137, Attn. Investor Relations.

#### Item 1A. Risk Factors

Except as set forth below, there are no material changes from the risk factors set forth in Item 1A, "Risk Factors," of our Annual Report on 10-K, as amended, for the year ended December 31, 2013.

Liggett faces intense competition in the domestic tobacco industry.

Liggett is considerably smaller and has fewer resources than its major competitors, and, as a result, has a more limited ability to respond to market developments. Management Science Associates' data indicate that the three largest cigarette manufacturers controlled approximately 85.3% of the United States cigarette market during 2013. Philip Morris is the largest manufacturer in the market, and its profits are derived principally from its sale of premium cigarettes. Philip Morris had approximately 61.2% of the premium segment and 47.4% of the total domestic market during 2013. During 2013, all of Liggett's sales were in the discount segment, and its share of the total domestic cigarette market was 3.3%. Philip Morris and RJ Reynolds, the two largest cigarette manufacturers, historically, because of their dominant market share, have been able to determine cigarette prices for the various pricing tiers within the industry.

Consolidation in the industry could adversely affect our ability to compete in the U.S. cigarette market. For example, RJ Reynolds' proposed merger with Lorillard Tobacco Company, which would consolidate more than 80% of the United States cigarette market within the control of two cigarette manufacturers, could make it more difficult for Liggett and Vector Tobacco to compete for shelf space in retail outlets and could impact price competition in the market, either of which could have a material adverse effect on our sales volume, operating income and cash flows.

We have significant liquidity commitments

We have certain liquidity commitments that could require the use of our existing cash resources. As of September 30, 2014, our corporate expenditures (exclusive of Liggett, Vector Tobacco and New Valley) and other potential liquidity requirements over the next 12 months could include the following:

- cash interest expense of approximately \$98.0 million,
- retirement of our 6.75% variable interest senior convertible notes of \$92.6 million;
- dividends on our outstanding common shares (currently at an annual rate of approximately \$191.6 million),
- single progeny installment payment of \$3.5 million, and
- other corporate expenses and taxes.

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

We and our subsidiaries have a substantial amount of indebtedness.

We and our subsidiaries have significant indebtedness and debt service obligations. At September 30, 2014, we and our subsidiaries had total outstanding indebtedness of \$1.2 billion. Approximately \$92.6 million of our 6.75% convertible notes mature in 2014, \$230 million of our 7.5% convertible notes mature in 2019 and \$600 million of our 7.75% senior secured notes mature in 2021. The \$600 million of our 7.75% senior secured notes due 2021 includes an additional \$150 million of indebtedness we incurred in connection with the April 2014 offering. We incurred an additional \$258.8 million of indebtedness in connection with the March 2014 offering of our 5.5% variable interest senior convertible notes due 2020. 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.

Other

Zoom's e-cigarette business is subject to substantial risks, uncertainties and contingencies which include, without limitation, the challenges inherent in new product development initiatives, the ability to raise capital and manage the growth of its business, potential disputes concerning Zoom's intellectual property, potential extensive government regulation or prohibition, technology

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obsolescence, market acceptance of Zoom's products and competition from companies with greater resources. Our exposure to Zoom, as of September 30, 2014, was approximately \$10.7 million which was comprised primarily of Zoom's inventory.

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 three months ended September 30, 2014, except for approximately 5,195,856 shares of our common stock issued as a stock dividend on September 26, 2104. The issuance of the shares in connection with the stock dividend did not involve a "sale" under the Securities Act of 1933.

Item 6. Exhibits

- 10.1 Performance-Based Restricted Share Award Agreement, pursuant to Vector Group Ltd. Management Incentive Plan, dated as of July 23, 2014 by and between Vector Group Ltd. and Howard M. Lorber.
- 12.1 Computation of Ratio of Earnings to Fixed Charges for each of the five years within the period ended December 31, 2013 and for each of the nine months within the periods ended September 30, 2014 and 2013.
- 31.1 Certification of Chief Executive Officer, Pursuant to Exchange Act Rule 13a-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer, Pursuant to Exchange Act Rule 13a-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer, Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Chief Financial Officer, Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 99.1 Material Legal Proceedings
- 101.INS XBRL Instance Document
- 101.SCH XBRL Taxonomy Extension Schema
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase
- 101.DEF XBRL Taxonomy Extension Definition Linkbase
- 101.LAB XBRL Taxonomy Extension Label Linkbase
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase



SIGNATURE

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

VECTOR GROUP LTD.  
(Registrant)

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

Date: October 31, 2014