VECTOR GROUP LTD
Form 10-Q
July 31, 2012

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

FORM 10-Q

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

For The Quarterly Period Ended June 30, 2012

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

Delaware	1-5759	65-0949535
(State or other jurisdiction of incorporation incorporation or organization)	Commission File Number	(I.R.S. Employer Identification No.)

100 S.E. Second Street
Miami, Florida 33131
305/579-8000
(Address, including zip code and telephone number, including area code,
of the principal executive offices)

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

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

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

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

(Do not check if a smaller reporting company)

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

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

VECTOR GROUP LTD.

FORM 10-Q

TABLE OF CONTENTS

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

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

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

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

2

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(Dollars in Thousands, Except Per Share Amounts)
Unaudited

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Basis of Presentation:

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

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

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

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

(b) Distributions and Dividends on Common Stock:

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

(c) Earnings Per Share (“EPS”):

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

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

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

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

(Dollars in Thousands, Except Per Share Amounts)
Unaudited

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

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

Basic and diluted EPS were calculated using the following shares:

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

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

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

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

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

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

(Dollars in Thousands, Except Per Share Amounts)
Unaudited

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

(e) New Accounting Pronouncements:

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

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

2. INVENTORIES

Inventories consist of:

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

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

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

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

(Dollars in Thousands, Except Per Share Amounts)
Unaudited

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

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

3. LONG-TERM INVESTMENTS

Long-term investments accounted for at cost:

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

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

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

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

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

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

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

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

(Dollars in Thousands, Except Per Share Amounts)
Unaudited

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

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

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

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

Credit Facility - Liggett:

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

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

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

Term Loan under Credit Facility

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

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

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

11% Senior Secured Notes due 2015 - Vector:

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

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

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

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

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

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

12

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

(Dollars in Thousands, Except Per Share Amounts)
Unaudited

Non-cash Interest Expense - Vector:

Components of non-cash interest expense are as follows:

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

Fair Value of Notes Payable and Long-term Debt:

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

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

5. CONTINGENCIES

Tobacco-Related Litigation:

Overview

Since 1954, Liggett and other United States cigarette manufacturers have been named as defendants in numerous direct, third-party and purported class actions predicated on the theory that cigarette manufacturers should be liable for damages alleged to have been caused by cigarette smoking or by exposure to secondary smoke from cigarettes. New cases continue to be commenced against Liggett and other cigarette manufacturers. The cases have generally fallen into the following categories: (i) smoking and health cases alleging personal injury brought on behalf of individual plaintiffs (“Individual Actions”); (ii) lawsuits by individuals requesting the benefit of the Engle ruling ("Engle progeny cases"); (iii) smoking and health cases primarily alleging personal injury or seeking court-supervised programs for ongoing medical monitoring, as well as cases alleging the use of the terms “lights” and/or “ultra lights” constitutes a deceptive and unfair trade practice, common law fraud or violation of federal law, purporting to be brought on behalf of a class of individual plaintiffs (“Class Actions”); and (iv) health care cost recovery actions brought by various foreign and domestic governmental plaintiffs and non-governmental plaintiffs seeking reimbursement for health care expenditures allegedly caused by cigarette smoking and/or disgorgement of profits (“Health Care Cost Recovery Actions”). As new cases are commenced,

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

(Dollars in Thousands, Except Per Share Amounts)
Unaudited

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

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

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

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

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

Cautionary Statement About Engle Progeny Cases. Judgments have been entered against Liggett and other industry defendants in Engle progeny cases. Several of the judgments have been affirmed on appeal. To date, the United States Supreme Court has declined to review these cases. At June 30, 2012, Liggett and the Company are currently defendants in 3,007 state court and 2,642 federal court Engle progeny cases. As of June 30, 2012, 12 Engle progeny cases involving Liggett have resulted in verdicts, exclusive of the Lukacs case, discussed below. Seven verdicts were returned in favor of the plaintiffs and five were returned in favor of Liggett. Other cases have either been voluntarily dismissed by plaintiffs, dismissed by the court on summary judgment or a mistrial was declared. Excluding the Lukacs case, the verdicts against Liggett have ranged from $1 to $3,008. In two of these cases, punitive damages were also awarded for $1,000 and $7,600. Since Engle progeny trials started in February 2009, 66 cases have been tried to a verdict. Based on the current rate of trials per year, it would require decades to resolve the remaining Engle progeny cases. Except as discussed in this Note 5 with respect to the seven cases where an adverse verdict was entered against Liggett, management is unable to estimate the possible loss or range of loss from the remaining Engle progeny cases as there are currently multiple defendants in each case and discovery has not occurred or is limited. As a result, the Company lacks information about whether plaintiffs are in fact Engle class members (non-class members' claims are generally time-barred), the relevant smoking history, the nature of the alleged injury and the availability of various defenses, among other things. Further, plaintiffs typically do not specify their demand for damages. The Company believes that the process under which Engle progeny cases are tried is unconstitutional and continues to pursue its appellate rights.

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

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

(Dollars in Thousands, Except Per Share Amounts)
Unaudited

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

Non-Engle Individual Actions

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

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

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

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

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

(Dollars in Thousands, Except Per Share Amounts)
Unaudited

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 o