VECTOR GROUP LTD
Form 10-Q
August 06, 2007

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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For The Quarterly Period Ended June 30, 2007

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

Delaware	**1-5759**	**65-0949535**
(State or other 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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

x Large accelerated filer o Accelerated filer o Non-accelerated filer

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 August 3, 2007, Vector Group Ltd. had 57,251,943 shares of common stock outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. Vector Group Ltd. Condensed Consolidated Financial Statements (Unaudited):

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

	June 30, 2007	December 31, 2006
ASSETS:		
Current assets:		
Cash and cash equivalents	$126,385	$146,769
Investment securities available for sale	50,614	18,960
Accounts receivable trade	15,642	15,480
Inventories	81,041	91,299
Deferred income taxes	8,372	27,580
Other current assets	3,270	3,068
Total current assets	285,324	303,156
Property, plant and equipment, net	57,552	59,921
Long-term investments accounted for at cost	33,012	32,971
Long-term investments accounted under the equity method	10,547	10,230
Investments in non-consolidated real estate businesses	32,855	28,416
Restricted assets	8,587	8,274
Deferred income taxes	39,437	43,973
Intangible asset	107,511	107,511
Prepaid pension costs	23,263	20,933
Other assets	22,038	22,077
Total assets	$620,126	$637,462
LIABILITIES AND STOCKHOLDERS EQUITY:		
Current liabilities:		
Current portion of notes payable and long-term debt	$ 33,950	$ 52,686
Accounts payable	7,358	7,203
Accrued promotional expenses	10,392	12,527
Income taxes payable, net	10,990	12,970
Accrued excise and payroll taxes payable, net	7,577	9,934
Settlement accruals	27,524	47,408
Deferred income taxes	5,020	5,020
Accrued interest	2,586	2,586
Other current liabilities	16,679	18,452
Total current liabilities	122,076	168,786

Notes payable, long-term debt and other obligations, less current portion	104,247	103,304
Fair value of derivatives embedded within convertible debt	93,357	95,473
Non-current employee benefits	38,583	36,050
Deferred income taxes	141,203	130,533
Other liabilities	13,511	8,339
Total liabilities	512,977	542,485
Commitments and contingencies		
Stockholders equity:		
Preferred stock, par value $1.00 per share, 10,000,000 shares authorized		
Common stock, par value $0.10 per share, 150,000,000 and 100,000,000 shares authorized, 60,054,691 and 59,843,379 shares issued and 57,249,022 and 57,031,269 shares outstanding	5,725	5,703
Additional paid-in capital	103,985	132,807
Retained earnings (accumulated deficit)		(28,192)
Accumulated other comprehensive income (loss)	10,296	(2,587)
Less: 2,805,669 and 2,812,110 shares of common stock in treasury, at cost	(12,857)	(12,754)
Total stockholders equity	107,149	94,977
Total liabilities and stockholders equity	$620,126	$637,462

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Revenues*	$140,351	$113,355	$274,243	$231,059
Expenses:				
Cost of goods sold*	87,222	69,304	171,907	142,645
Operating, selling, administrative and general expenses	23,946	21,591	47,433	45,727
Operating income	29,183	22,460	54,903	42,687
Other income (expenses):				
Interest and dividend income	1,561	2,321	3,417	4,102
Interest expense	(9,520)	(8,739)	(18,654)	(17,016)
Change in fair value of derivatives embedded within convertible debt	2,089	1,015	2,116	2,239
Loss on extinguishment of debt		(14,860)		(14,860)
Loss on sale of investments, net		(17)		(47)
Provision for loss on investments			(1,158)	
Gain from exchange of LTS notes	8,121		8,121	
Equity income from non-consolidated real estate businesses	6,927	3,870	9,337	7,605
Income from lawsuit settlement			20,000	
Other, net	(31)	31	(36)	77
Income before provision for income taxes	38,330	6,081	78,046	24,787
Income tax expense	16,949	8,790	33,538	17,483
Net income (loss)	$ 21,381	$ (2,709)	$ 44,508	$ 7,304
Per basic common share:				
Net income applicable to common shares	$ 0.35	$ (0.05)	$ 0.73	$ 0.13
Per diluted common share:				
Net income applicable to common shares	$ 0.34	$ (0.05)	$ 0.71	$ 0.13

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 $44,795, $39,686, $89,280 and $79,804, respectively.

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

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VECTOR GROUP LTD. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY
(Dollars in Thousands)
Unaudited

	Common Stock		Additional Paid-in	Retained Earnings (Accumulated	Accumulated Other Comprehensive Income	Treasury	
	Shares	Amount	Capital	Deficit)	(Loss)	Stock	Total
Balance, December 31, 2006	57,031,269	$5,703	$132,807	$(28,192)	$ (2,587)	$(12,754)	$ 94,977
Net income				44,508			44,508
Pension related minimum liability adjustments, net of taxes					597		597
Forward contract adjustments, net of taxes					(7)		(7)
Unrealized gain on long-term investments accounted for under the equity method, net of taxes					240		240
Unrealized gain on investment securities, net of taxes					12,053		12,053
Total other comprehensive income							12,883
Total comprehensive income							57,391
Distributions and dividends on common stock			(32,623)	(16,316)			(48,939)
	40,000	4	(4)				

Restricted stock grants							
Exercise of options, net of 7,627 shares delivered to pay exercise price	177,753	18	2,063			(103)	1,978
Amortization of deferred compensation			1,742				1,742
Balance, June 30, 2007	57,249,022	$5,725	$103,985	$	$ 10,296	$(12,857)	$107,149

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

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

	Six Months Ended June 30, 2007	Six Months Ended June 30, 2006
Net cash provided by operating activities	$ 57,360	$ 11,907
Cash flows from investing activities:		
Proceeds from sale or maturity of investment securities		3,321
Purchase of investment securities	(6,032)	(3,466)
Proceeds from sale or liquidation of long-term investments	50	176
Purchase of long-term investments	(91)	(186)
Return of contributions from non-consolidated real estate businesses	1,000	
Investments in non-consolidated real estate businesses	(750)	(6,425)
Increase in cash surrender value of life insurance policies	(524)	(408)
Increase in non-current restricted assets	(313)	(34)
Capital expenditures	(2,716)	(2,675)
Net cash used in investing activities	(9,376)	(9,697)
Cash flows from financing activities:		
Proceeds from debt	1,576	78
Repayments of debt	(38,205)	(3,269)
Deferred financing charges		(100)
Borrowings under revolver	275,062	257,391
Repayments on revolver	(258,419)	(238,107)
Dividends and distributions on common stock	(50,360)	(44,283)
Proceeds from exercise of options	1,978	773
Net cash used in financing activities	(68,368)	(27,517)
Net decrease in cash and cash equivalents	(20,384)	(25,307)
Cash and cash equivalents, beginning of period	146,769	181,059
Cash and cash equivalents, end of period	$ 126,385	$ 155,752

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

Liggett is engaged in the manufacture and sale of cigarettes in the United States. Vector Tobacco is engaged in the development and marketing of low nicotine and nicotine-free cigarette products and the development of reduced risk cigarette products. New Valley is engaged in the real estate business and is seeking to acquire additional operating companies and real estate properties.

The interim condensed consolidated financial statements of the Company are unaudited and, in the opinion of management, reflect all adjustments necessary (which are normal and recurring) to state fairly the Company s consolidated financial position, results of operations and cash flows. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2006, as amended, 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 amounts in the Company s consolidated balance sheet as of December 31, 2006 have been reclassified to conform to the current year s presentation. This reclassification includes bifurcating Accrued taxes payable, net as of December 31, 2006 into Income taxes payable, net and Accrued excise and payroll taxes payable, net .

(b) Estimates and Assumptions:

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities and the reported amounts of revenues and expenses. Significant estimates subject to material changes in the near term include restructuring and impairment charges, inventory valuation, deferred tax assets, allowance for doubtful accounts, promotional accruals, sales returns and allowances, actuarial assumptions of pension plans, embedded derivative liability, the tobacco quota buy-out, settlement accruals and litigation and defense costs. Actual results could differ from those estimates.

(c) Investment in Non-Consolidated Real Estate Businesses:

In accounting for its investment in non-consolidated real estate businesses, the Company applies the Financial Accounting Standards Board s (FASB) Interpretation No. 46(R) (FIN 46(R)), Consolidation of Variable Interest Entities, which clarified the application of Accounting Research Bulletin No. 51 (ARB No. 51), Consolidated Financial Statements. FIN 46(R) requires the Company to identify its participation in Variable Interest Entities (VIE),

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

which are defined as entities with a level of invested equity insufficient to fund future activities to operate on a stand-alone basis, or whose equity holders lack certain characteristics of a controlling financial interest. For entities identified as VIEs, FIN 46(R) sets forth a model to evaluate potential consolidation based on an assessment of which party, if any, bears a majority of the exposure to the expected losses, or stands to gain from a majority of the expected returns. FIN 46(R) also sets forth certain disclosures regarding interests in VIEs that are deemed significant, even if consolidation is not required.

New Valley accounts for its 50% interests in Douglas Elliman Realty LLC, Koa Investors LLC and 16^{th} & K Holdings LLC, as well as its 22.22% interest in Ceebraid Acquisition Corporation (Ceebraid) on the equity method because it is not each respective entity s primary beneficiary, as defined in FIN 46(R).

In addition, FIN 46(R) includes a scope exception for certain entities that are deemed to be businesses and meet certain other criteria. Entities that meet this scope exception are not subject to the accounting and disclosure rules of FIN 46(R), but are subject to the pre-existing consolidation rules under ARB No. 51, which are based on an analysis of voting rights. This scope exception applies to New Valley s investment in Douglas Elliman Realty LLC and, as a result, under the applicable ARB 51 rules, the Company is not required to consolidate this business.

(d) <u>Distributions and dividends on common stock:</u>

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

(e) <u>Earnings per share:</u>

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, 2006. The dividend was recorded at par value of $271 since the Company reported an accumulated deficit in 2006. In connection with the 5% stock dividend, the Company increased the number of outstanding stock options by 5% and reduced the exercise prices accordingly. All per share amounts have been presented as if the stock dividend had occurred on January 1, 2006.

In March 2004, the FASB s Emerging Issue Task Force (EITF) reached a final consensus on Issue No. 03-6, Participating Securities and the Two-Class Method under FASB Statement 128 , which established standards regarding the computation of earnings per share (EPS) by companies that have issued securities other than common stock that contractually entitle the holder to participate in dividends and earnings of the company. For purposes of calculating basic EPS, earnings available to common stockholders for the period are reduced by the contingent interest and the non-cash interest expense associated with the discounts created by the beneficial conversion features and embedded derivatives related to the Company s convertible notes issued in 2004, 2005 and 2006. The convertible debt issued by the Company in 2004, 2005 and 2006, which are participating securities due to the contingent interest feature, had no impact on EPS for the three and six months ended June 30, 2007 and 2006, as the dividends on the common stock reduced earnings available to common stockholders so there were no unallocated earnings under EITF Issue No. 03-6.

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As discussed in Note 10, the Company has stock option awards which provide for common stock dividend equivalents at the same rate as paid on the common stock with respect to the shares underlying the unexercised portion of the options. These outstanding options represent participating securities under EITF Issue No. 03-6. Effective with the adoption of Statement of Financial Accounting Standards (SFAS) No. 123(R), Share-Based Payment using the modified prospective method with guidance provided by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure on January 1, 2006, the Company recognizes payments of the dividend equivalent rights ($1,605 and $1,578 for the three months ended June 30, 2007 and 2006, respectively, and $3,210 and $3,156 for the six months ended June 30, 2007 and 2006, respectively) on these options as Distributions and dividends on common stock on the Company s condensed consolidated statement of changes in stockholders equity. There was no adjustment to income attributable to participating securities because the adjustment was anti-dilutive for the three months ended June 30, 2006 as a result of the Company s net loss. However, in its calculation of basic EPS for the three months ended June 30, 2007 and the six months ended June 30, 2007 and 2006, the Company has adjusted its net income (loss) for the effect of these participating securities as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Net income (loss)	$21,381	$(2,709)	$44,508	$7,304
Income attributable to participating securities	(1,400)		(2,916)	(480)
Net income (loss) available to common stockholders	$19,981	$(2,709)	$41,592	$6,824

Basic EPS is computed by dividing net income available to common stockholders by the weighted-average number of shares outstanding, which includes vested restricted stock.

Diluted EPS includes the dilutive effect of stock options, unvested restricted stock grants and convertible securities. However, in its calculation of diluted EPS for the three months ended June 30, 2007 and the six months ended June 30, 2007 and 2006, the Company has adjusted its net income (loss) for the effect of the participating securities, stock options, unvested restricted stock grants and convertible securities as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Net income (loss)	$21,381	$(2,709)	$44,508	$7,304
Expenses attributable to 3.875% convertible debentures	1,578		3,903	
Income attributable to participating securities	(1,502)		(3,172)	(480)
	$21,457	$(2,709)	$45,239	$6,824

Net income (loss) available to
common stockholders

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Basic EPS is computed by dividing net income available to common stockholders by the weighted-average number of shares outstanding, which includes vested restricted stock, unvested restricted stock grants, stock options and convertible securities.

Basic and diluted EPS were calculated using the following shares for the three months ended June 30, 2007 and 2006:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Weighted-average shares for basic EPS	56,642,673	52,661,507	56,590,534	52,174,171
Plus incremental shares related to stock options	1,300,979		1,365,492	1,503,376
Plus incremental shares related to convertible debt	5,371,094		5,371,094	
Weighted-average shares for diluted EPS	63,314,746	52,661,507	63,327,120	53,677,547

The following stock options, non-vested restricted stock and shares issuable upon the conversion of convertible debt were outstanding during the three months ended June 30, 2007 and the six months ended June 30, 2007 and 2006 but were not included in the computation of diluted EPS because the exercise prices of the options and the per share expense associated with the restricted stock were greater than the average market price of the common shares during the respective periods, and the impact of common shares issuable under the convertible debt were anti-dilutive to EPS. Amounts presented for the three months ended June 30, 2006 were not included in the computation of diluted EPS because the Company reported a loss during such period and the impact was anti-dilutive.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Number of stock options	476,873	8,868,204	476,873	228,665
Weighted-average exercise price	$ 21.33	$ 10.05	$ 21.33	$ 26.51

Weighted-average shares of non- vested restricted stock	11,429	685,724	106,995	659,999
Weighted-average expense per share	$ 19.81	$ 18.54	$ 19.17	$ 18.72
Weighted-average number of shares issuable upon conversion of debt	6,355,909	12,140,684	6,355,909	12,456,386
Weighted-average conversion price	$ 17.60	$ 18.88	$ 17.60	$ 19.01

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

(f) Share-Based Payments:

Effective January 1, 2006, the Company adopted SFAS No. 123(R). Under the modified prospective method, the share-based compensation cost recognized beginning January 1, 2006 includes compensation cost for (i) all share-based payments granted prior to, but not vested as of January 1, 2006, based on the grant date fair value originally estimated in accordance with the provisions of SFAS No. 123, Accounting for Stock-Based Compensation (SFAS No. 123) and (ii) all share-based payments granted subsequent to December 31, 2005, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123(R). Compensation cost under SFAS No. 123(R) is recognized ratably using the straight-line attribution method over the expected vesting period. In addition, pursuant to SFAS No. 123(R), the Company is required to estimate the amount of expected forfeitures when calculating the compensation costs, instead of accounting for forfeitures as incurred, which was the Company s previous method. As of January 1, 2006, the cumulative effect of adopting the estimated forfeiture method was not significant. Prior periods were not restated under this transition method.

(g) Comprehensive Income:

Other comprehensive income is a component of stockholders equity and includes such items as the unrealized gains and losses on investment securities available for sale, forward foreign contracts and minimum pension liability adjustments. Total comprehensive income (loss) applicable to common shares for the three and six months ended June 30, 2007 and 2006 is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Net income (loss)	$21,381	$(2,709)	$44,508	$ 7,304
Forward contract adjustments, net of income taxes	(8)	208	(7)	277
Pension related minimum liability adjustments, net of income taxes	298		597	
Net unrealized gains on long-term investments accounted under the equity method	33		240	
Net unrealized gains on investment securities available for sale:	(2,254)	(3,380)	11,369	3,740

Change in net unrealized gains				
Net unrealized gains reclassified into net income, net of income taxes		10	684	28
Change in unrealized gains	(2,254)	(3,370)	12,053	3,768
Total comprehensive income (loss)	$19,450	$(5,871)	$57,391	$11,349

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

The components of accumulated other comprehensive income (loss), net of income taxes, were as follows as of June 30, 2007 and December 31, 2006:

	June 30, 2007	December 31, 2006
Net unrealized gains on investment securities available for sale, net of income taxes of $12,079 and $3,737, respectively	$17,453	$ 5,400
Net unrealized gains on long term investments accounted for under the equity method, net of income taxes of $285 and $120, respectively	413	173
Forward contracts adjustment, net of income taxes of $243 and $226, respectively	(352)	(345)
Additional pension liability, net of income taxes of $4,672 and $5,076, respectively	(7,218)	(7,815)
Accumulated other comprehensive income (loss)	$10,296	$ (2,587)

(h) Financial Instruments:

The carrying values of cash and cash equivalents, investment securities available for sale and restricted assets approximate their fair value.

As required by SFAS No. 133, derivatives embedded within the Company s convertible debt are recognized on the Company s balance sheet and are stated at estimated fair value as determined by a third party at each reporting period. Changes in the fair value of the embedded derivatives are reflected quarterly as Change in fair value of derivatives embedded within convertible debt.

The methods and assumptions used by the Company s management in estimating fair values for financial instruments presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair values.

The Company uses forward foreign exchange contracts to mitigate its exposure to changes in exchange rates relating to purchases of equipment from third parties. The primary currency to which the Company is exposed is the euro. A substantial portion of the Company s foreign exchange contracts is effective as hedges. The fair value of forward foreign exchange contracts designated as hedges is reported in other current assets or current liabilities and is recorded in other comprehensive income. All forward foreign exchange contracts had been settled at June 30, 2007.

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

(i) Revenue Recognition:

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 buydowns, are classified as reductions of net sales in accordance with EITF of the FASB Issue No. 01-9, Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor s Products). In accordance with EITF Issue No. 06-3, How Sales Taxes Should be Presented in the Income Statement (Gross versus Net) , the Company s accounting policy is to include federal excise taxes in revenues and cost of goods sold. Such revenues totaled $44,795 and $89,280 for the three and six months ended June 30, 2007 and $39,686 and $79,804 for the three and six months ended June 30, 2006, respectively. Since the Company s primary 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, litigation and defense costs, increased tobacco costs or reductions in the selling price of cigarettes in the near term.

Shipping and handling fees related to sales transactions are neither billed to customers nor recorded as revenue. Shipping and handling costs are recorded as operating, selling, administrative and general expenses.

(j) Contingencies:

The Company records Liggett s product liability legal expenses and other litigation costs as operating, selling, general and administrative expenses as those costs are incurred. As discussed in Note 9, legal proceedings covering a wide range of matters are pending or threatened in various jurisdictions against Liggett.

The Company records provisions in the condensed consolidated financial statements for pending litigation when it determines that an unfavorable outcome is probable and the amount of the loss can be reasonably estimated. Except as discussed in Note 9, (i) management has not concluded that it is probable that a loss has been incurred in any of the pending smoking-related litigation; (ii) management is unable to make a meaningful estimate of the amount or range of loss that could result from an unfavorable outcome of pending smoking-related litigation; and (iii) accordingly, management has not provided any amounts in the condensed consolidated financial statements for unfavorable outcomes, if any. Litigation is subject to many uncertainties, and it is possible that the Company s consolidated financial position, results of operations or cash flows could be materially adversely affected by an unfavorable outcome in any such smoking-related litigation.

(k) New Accounting Pronouncements:

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Instruments (SFAS No. 155). SFAS No. 155 amends SFAS Nos. 133 and 140 and relates to the financial reporting of certain hybrid financial instruments. SFAS No. 155 allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. SFAS No. 155 is effective for all financial instruments acquired or issued after the

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VECTOR GROUP LTD.
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beginning of fiscal years commencing after September 15, 2006. The Company did not elect to retroactively apply SFAS No. 155 and, as a result, it did not have an impact on the Company s condensed consolidated financial statements.

In June 2006, the FASB issued FIN 48, Accounting for Uncertainty in Income Taxes (an interpretation of FASB Statement No. 109), which is effective for fiscal years beginning after December 15, 2006 with earlier adoption encouraged. This interpretation was issued to clarify the accounting for uncertainty in income taxes recognized in the financial statements by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The adoption of FIN 48 is discussed in Note 11.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements , which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS No. 157 clarifies that fair value should be based on assumptions that market participants would use when pricing an asset or liability and establishes a fair value hierarchy of three levels that prioritizes the information used to develop those assumptions. The fair value hierarchy gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data. SFAS No. 157 requires fair value measurements to be separately disclosed by level within the fair value hierarchy. The provisions of SFAS No. 157 will become effective for the Company beginning January 1, 2008. Generally, the provisions of this statement are to be applied prospectively. Certain situations, however, require retrospective application as of the beginning of the year of adoption through the recognition of a cumulative effect of accounting change. Such retrospective application is required for financial instruments, including derivatives and certain hybrid instruments with limitations on initial gains or losses under EITF Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities". The Company has not completed its assessment of the impact of this standard on its consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities. SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007, with early adoption permitted provided the entity also elects to apply the provisions of SFAS No. 157. The Company is currently evaluating the impact of adopting SFAS No. 159 on its consolidated financial statements.

2. RESTRUCTURING

The components of the combined pre-tax restructuring charges relating to the 2006 Vector Research restructuring for the six months ended June 30, 2007 are as follows:

	Employee Severance and Benefits	Contract Termination/ Exit Costs	Total
Balance, December 31, 2006	$ 484	$ 338	$ 822
Utilized	(233)	(245)	(478)

Balance, June 30, 2007	$ 251	$ 93	$ 344

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The only remaining component of the 2004 Liggett Vector Brands restructuring at December 31, 2006 and June 30, 2007 was contract termination and exit costs of $850 and $752, respectively. Approximately $98 was utilized for the six months ended June 30, 2007.

3. INVESTMENT SECURITIES AVAILABLE FOR SALE

Investment securities classified as available for sale are carried at fair value, with net unrealized gains or losses included as a component of stockholders equity, net of income taxes. Net realized losses on the sale of investments were $0 and $17 for the three months ended June 30, 2007 and 2006, respectively, and $0 and $47 for the six months ended June 30, 2007 and 2006, respectively. In addition, the Company recorded a loss related to other-than-temporary declines in the fair value of its marketable equity securities totaling $1,158 for the six months ended June 30, 2007.

The components of investment securities available for sale at June 30, 2007 are as follows:

	Cost	Gross Unrealized Gain	Gross Unrealized Loss	Fair Value
Marketable equity securities	$21,082	$29,565	$ (33)	$50,614

Investment securities available for sale as of June 30, 2007 and December 31, 2006 include New Valley LLC s 13,888,889 and 11,111,111 shares, respectively, of Ladenburg Thalmann Financial Services Inc. (LTS), which were carried at $31,944 and $13,556, respectively (see Note 12). Investment securities available for sale as of June 30, 2007 also include 2,257,110 shares of Opko Health Inc. (Opko), which were carried at $8,238. The Opko shares were acquired in a private placement and have not been registered for resale.

4. INVENTORIES

Inventories consist of:

	June 30, 2007	December 31, 2006
Leaf tobacco	$32,354	$ 33,363
Other raw materials	3,774	2,725
Work-in-process	69	1,348
Finished goods	50,339	57,485
Inventories at current cost	86,536	94,921
LIFO adjustments	(5,495)	(3,622)
	$81,041	$ 91,299

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,

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established at the commitment date. At June 30, 2007, Liggett had leaf tobacco purchase commitments of approximately $29,020. There were no leaf tobacco purchase commitments at Vector Tobacco at that date.

The Company capitalizes the incremental prepaid cost of the Master Settlement Agreement in ending inventory (see Note 9).

LIFO inventories represent approximately 93% of total inventories at June 30, 2007 and 91% of total inventories at December 31, 2006.

5. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consist of:

	June 30, 2007	December 31, 2006
Land and improvements	$ 1,418	$ 1,418
Buildings	13,519	13,366
Machinery and equipment	104,764	103,241
Leasehold improvements	1,887	2,017
Construction-in-progress	694	525
	122,282	120,567
Less accumulated depreciation	(64,730)	(60,646)
	$ 57,552	$ 59,921

Depreciation and amortization expense on property, plant and equipment for the three and six months ended June 30, 2007 was $2,456 and $5,085, respectively. Depreciation and amortization expense on property, plant and equipment for the three and six months ended June 30, 2006 was $2,518 and $4,991, respectively. Future machinery and equipment purchase commitments at Liggett were $249 at June 30, 2007.

During the second quarter of 2006, Liggett recognized an impairment charge of $324 associated with its decision to dispose of an asset to an unrelated third party and was recorded as part of operating, selling, general and administrative expenses on the Company s condensed consolidated statement of operations.

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6. LONG-TERM INVESTMENTS

Long-term investments consist of investments in the following:

	June 30, 2007		December 31, 2006	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Investment partnerships accounted for at cost	$33,012	$51,642	$32,971	$47,560
Investments accounted for on the equity method	$10,547	$10,547	$10,230	$10,230

The principal business of these investment partnerships is investing in investment securities and real estate. The estimated fair value of the investment partnerships was provided by the partnerships based on the indicated market values of the underlying assets or investment portfolio. New Valley is an investor in real estate partnerships where it has committed to make additional investments of up to an aggregate of $172 at June 30, 2007. The investments in these investment partnerships are illiquid and the ultimate realization of these investments is subject to the performance of the underlying partnership and its management by the general partners.

In August 2006, the Company invested $25,000 in Icahn Partners, LP, a privately managed investment partnership, of which Carl Icahn is the portfolio manager and the controlling person of the general partner, and manager of the partnership. Affiliates of Mr. Icahn are the beneficial owners of approximately 20.3% of Vector s common stock.

On November 1, 2006, the Company invested $10,000 in Jefferies Buckeye Fund, LLC (Buckeye Fund), a privately managed investment partnership, of which Jefferies Asset Management, LLC is the portfolio manager. Affiliates of Jefferies Asset Management, LLC beneficially own approximately 8.2% of Vector s common stock. The Company s investment in the Buckeye Fund represented approximately 15% of the amounts invested in the Buckeye Fund at June 30, 2007. In accordance with EITF Issue No. 03-16, Accounting for Investments in Limited Liability Companies , the Company has accounted for its investment in Buckeye Fund using the equity method of accounting and carried its investment in the Buckeye Fund at $10,547 as of June 30, 2007, which includes $698 ($413 net of income taxes) of unrealized gains on investment securities. The Company recorded losses of $18 and $89 associated with the Buckeye Fund for the three and six months ended June 30, 2007, respectively.

The Company s investments constituted less than 3% of the invested funds in each of the other partnerships at June 30, 2007 and, in accordance with EITF Topic No. D-46, Accounting for Limited Partnership Investments , the Company has accounted for such investments using the cost method of accounting.

In the future, the Company may invest in other investments including limited partnerships, real estate investments, equity securities, debt securities, derivatives and certificates of deposit depending on risk factors and potential rates of return.

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

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

	June 30, 2007	December 31, 2006
Vector:		
3.875% Variable Interest Senior Convertible Debentures due 2026, net of unamortized discount of $84,404 and $84,056*	$ 25,596	$ 25,944
5% Variable Interest Senior Convertible Notes due 2011, net of unamortized net discount of $51,363 and $53,904*	60,501	57,960
Liggett:		
Revolving credit facility	28,629	11,986
Equipment loans	11,733	12,660
Vector Tobacco:		
Notes payable Medallion acquisition due 2007		35,000
V.T. Aviation:		
Note payable	6,969	7,448
VGR Aviation:		
Note payable	4,515	4,655
Other	254	337
Total notes payable, long-term debt and other obligations	138,197	155,990
Less:		
Current maturities	(33,950)	(52,686)
Amount due after one year	$104,247	$103,304

* The fair value of the derivatives embedded within the 3.875% Variable Interest Senior Convertible Debentures ($59,913 and $59,807 at

June 30, 2007 and December 31, 2006, respectively) and the 5% Variable Interest Senior Convertible Notes ($33,444 at June 30, 2007 and $35,666 at December 31, 2006, respectively) is separately classified as a derivative liability in the condensed consolidated balance sheets.

Variable Interest Senior Convertible Debt Vector:

Vector has issued two series of variable interest senior convertible debt. Both series of debt pay interest on a quarterly basis at a stated rate plus an additional amount of interest on each payment date. The additional amount 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 (the Additional Interest).

3.875% Variable Interest Senior Convertible Debentures due 2026:

In July 2006, the Company sold $110,000 of its 3.875% variable interest senior convertible debentures due 2026 in a private offering to qualified institutional buyers in accordance with Rule 144A under the Securities Act of 1933. The Company used the net proceeds of the offering to redeem its remaining 6.25% convertible subordinated notes due 2008 and for general corporate purposes.

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The debentures pay interest on a quarterly basis at a rate of 3.875% per annum plus Additional Interest (the Debenture Total Interest). Notwithstanding the foregoing, however, the interest payable on each interest payment date shall be the higher of (i) the Debenture Total Interest and (ii) 5.75% per annum. The debentures are convertible into the Company s common stock at the holder s option. The conversion price, which was $20.48 per share at June 30, 2007, is subject to adjustment for various events, including the issuance of stock dividends.

The debentures will mature on June 15, 2026. The Company must redeem 10% of the total aggregate principal amount of the debentures outstanding on June 15, 2011. In addition to such redemption amount, the Company will also redeem on June 15, 2011 and at the end of each interest accrual period thereafter an additional amount, if any, of the debentures necessary to prevent the debentures from being treated as an Applicable High Yield Discount Obligation under the Internal Revenue Code. The holders of the debentures will have the option on June 15, 2012, June 15, 2016 and June 15, 2021 to require the Company to repurchase some or all of their remaining debentures. The redemption price for such redemptions will equal 100% of the principal amount of the debentures plus accrued interest. If a fundamental change (as defined in the Indenture) occurs, the Company will be required to offer to repurchase the debentures at 100% of their principal amount, plus accrued interest and, under certain circumstances, a make-whole premium .

5% Variable Interest Senior Convertible Notes Due November 2011:

In November 2004, the Company sold $65,500 of its 5% variable interest senior convertible notes due November 15, 2011 in a private offering to qualified institutional investors in accordance with Rule 144A under the Securities Act of 1933. The buyers of the notes had the right, for a 120-day period ending March 18, 2005, to purchase up to an additional $16,375 of the notes. At
December 31, 2004, buyers had exercised their rights to purchase an additional $1,405 of the notes, and the remaining $14,959 principal amount of notes were purchased during the first quarter of 2005. In April 2005, Vector issued an additional $30,000 principal amount of 5% variable interest senior convertible notes due November 15, 2011 in a separate private offering to qualified institutional investors in accordance with Rule 144A. These notes, which were issued under a new indenture at a net price of 103.5%, were on the same terms as the $81,864 principal amount of notes previously issued in connection with the November 2004 placement.

The notes pay interest on a quarterly basis at a rate of 5% per annum plus Additional Interest (the Notes Total Interest). Notwithstanding the foregoing, however, during the period prior to November 15, 2006, the interest payable on each interest payment date was the higher of (i) the Notes Total Interest and (ii) 6.75% per year. The notes are convertible into the Company s common stock at the holder s option. The conversion price, which was $17.60 at June 30, 2007, is subject to adjustment for various events, including the issuance of stock dividends.

The notes will mature on November 15, 2011. The Company must redeem 12.5% of the total aggregate principal amount of the notes outstanding on November 15, 2009. In addition to such redemption amount, the Company will also redeem on November 15, 2009 and at the end of each interest accrual period thereafter an additional amount, if any, of the notes necessary to prevent the notes from being treated as an Applicable High Yield Discount Obligation under the Internal Revenue Code. The holders of the notes will have the option on November 15, 2009 to require the Company to repurchase some or all of their remaining notes. The redemption price for such redemptions will equal 100% of the principal amount of the notes plus accrued interest. 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 interest and, under certain circumstances, a make-whole premium .

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Embedded Derivatives on the Variable Interest Senior Convertible Debt:

The portion of the Debenture Total Interest and the Notes Total Interest which is computed by reference to the cash dividends paid on the Company s common stock is considered an embedded derivative within the convertible debt, which the Company is required to separately value. Pursuant to SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities , as amended by SFAS No. 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities , the Company has bifurcated these embedded derivatives and, based on a valuation by a third party, estimated the fair value of the embedded derivative liability. The resulting discount created by allocating a portion of the issuance proceeds to the embedded derivative is then amortized to interest expense over the term of the debt using the effective interest method. Changes to the fair value of these embedded derivatives are reflected quarterly in the Company s consolidated statements of operations as Change 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.

The estimated initial fair values of the embedded derivates associated with the 3.875% convertible debentures and the 5% convertible notes were $56,214 and $42,041, respectively, at the date of issuance.

A summary of non-cash interest expense associated with the embedded derivative liability for the three and six months ended June 30, 2007 and 2006 is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
3.875% convertible debentures	$ 73	$	$ (168)	$
5% convertible notes	940	732	1,648	1,411
	$1,013	$732	$1,480	$1,411

A summary of non-cash changes in fair value of derivatives embedded within convertible debt is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
3.875% convertible debentures	$ 785	$	$ (106)	$
5% convertible notes	1,304	1,015	2,222	2,239
	$2,089	$1,015	$2,116	$2,239

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The following table reconciles the fair value of derivatives embedded within convertible debt at June 30, 2007.

	3.875% Convertible Debentures	5% Convertible Notes	Total
Balance at December 31, 2006	$59,807	$35,666	$95,473
Loss (gain) from changes in fair value of embedded derivatives	106	(2,222)	(2,116)
Balance at June 30, 2007	$59,913	$33,444	$93,357

Beneficial Conversion Feature on Variable Interest Senior Convertible Debt:

After giving effect to the recording of the embedded derivative liability as a discount to the convertible debt, the Company s common stock had a fair value at the issuance date of the debt in excess of the effective conversion price resulting in a beneficial conversion feature. EITF Issue No. 98-5, Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Convertible Ratios , requires that the intrinsic value of the beneficial conversion feature be recorded to additional paid-in capital and as a discount on the debt. The discount is amortized to interest expense over the term of the debt using the effective interest method.

The initial intrinsic value of the beneficial conversion feature associated with the 3.875% convertible debentures and the 5% convertible notes was $28,381 and $22,138, respectively. In accordance with EITF Issue No. 05-8, the beneficial conversion feature has been recorded, net of income taxes, as an increase to stockholders equity.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Amortization of beneficial conversion feature:				
3.875% convertible debentures	$ (12)	$	$(180)	$
5% convertible notes	517	405	893	781
Interest expense associated with beneficial conversion feature	$505	$405	$ 713	$781

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Unamortized Debt Discount:

The following table reconciles unamortized debt discount at June 30, 2007.

	3.875% Convertible Debentures	5% Convertible Notes	Total
Balance at December 31, 2006	$84,056	$53,904	$137,960
Amortization of embedded derivative	168	(1,648)	(1,480)
Amortization of beneficial conversion feature	180	(893)	(713)
Balance at June 30, 2007	$84,404	$51,363	$135,767

6.25% Convertible Subordinated Notes Due July 15, 2008 Vector:

In July 2001, Vector completed the sale of $172,500 (net proceeds of approximately $166,400) of its 6.25% convertible subordinated notes due July 15, 2008 through a private offering to qualified institutional investors in accordance with Rule 144A under the Securities Act of 1933. The notes paid interest at 6.25% per annum and were convertible into Vector s common stock, at the option of the holder. The conversion price was subject to adjustment for various events, and any cash distribution on Vector s common stock resulted in a corresponding decrease in the conversion price. In December 2001, $40,000 of the notes were converted into Vector s common stock, in October 2004, $8 of the notes were converted and, in June 2006, $70,000 of the notes were converted. The Company recorded a loss of $14,860 for the three and six months ended June 30, 2006 on the conversion of the $70,000 of notes principally as a result of the issuance of 962,531 shares of common stock as an inducement for conversion. In August 2006, Vector redeemed the remaining outstanding notes at a redemption price of 101.042% of the principal amount plus accrued interest. The Company recorded a loss of $1,306 in August 2006 on the retirement of the notes.

Revolving Credit Facility Liggett:

Liggett has a $50,000 credit facility with Wachovia Bank, N.A. (Wachovia) under which $28,629 was outstanding at June 30, 2007. Availability as determined under the facility was approximately $9,000 based on eligible collateral at June 30, 2007. The facility is collateralized by all inventories and receivables of Liggett. The facility requires Liggett s compliance with certain financial and other covenants including a restriction on Liggett s ability to pay cash dividends unless Liggett s borrowing availability under the facility for the 30-day period prior to the payment of the dividend, and after giving effect to the dividend, is at least $5,000 and no event of default has occurred under the agreement, including Liggett s compliance with the covenants in the credit facility.

In February 2007, Liggett entered into an amendment (the Amendment) to the Wachovia credit facility. The Amendment extended the term of the facility from March 8, 2008 to March 8, 2010, subject to automatic renewal for additional one year periods unless a notice of termination is given by Wachovia or Liggett at least 60 days prior to such date or the anniversary of such date. The Amendment also reduced the interest rates payable on borrowings under the facility and revised certain financial covenants. Prime rate loans under the facility now bear interest at a rate equal to the prime rate of Wachovia, as compared to the previous interest rate of 1.0% above the prime rate. Further, Eurodollar rate loans will now bear interest at a rate of 2.0% above Wachovia s adjusted

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Eurodollar rate, as compared to the previous interest rate of 3.5% above the adjusted Eurodollar rate. The Amendment also eliminated the minimum adjusted working capital and net working capital requirements previously imposed by the facility and replaced those requirements with new covenants based on Liggett s earnings before interest, taxes, depreciation and amortization (EBITDA), as defined in the Amendment, and Liggett s capital expenditures, as defined in the Amendment. The revised covenants provide that Liggett s EBITDA, on a trailing twelve month basis, shall not be less than $100,000 if Liggett s excess availability, as defined, under the facility is less than $20,000. The revised covenants also require that annual capital expenditures (before a maximum carryover amount of $2,500) shall not exceed $10,000 during any fiscal year. At June 30, 2007, management believed that Liggett was in compliance with all covenants under the credit facility.

Equipment Loans Liggett:

In March 2002, Liggett purchased equipment for $3,023 through the issuance of a note, payable in 30 monthly installments of $62 and then 30 monthly installments of $51. Interest was calculated at LIBOR plus 2.8%. The notes were paid in full in the first quarter of 2007.

In May 2002, Liggett purchased equipment for $2,871 through the issuance of a note, payable in 30 monthly installments of $59 and then 30 monthly installments of $48. Interest is calculated at LIBOR plus 2.8%. The notes were paid in full in the second quarter of 2007.

In September 2002, Liggett purchased equipment for $1,573 through the issuance of a note guaranteed by the Company, payable in 60 monthly installments of $26 plus interest calculated at LIBOR plus 4.31%.

In October 2005, Liggett purchased equipment for $4,441 through a financing agreement payable in 24 installments of $112 and then 24 installments of $90. Interest is calculated at 4.89%. Liggett was required to provide a security deposit equal to 25% of the funded amount ($1,110).

In December 2005, Liggett purchased equipment for $2,273 through a financing agreement payable in 24 installments of $58 and then 24 installments of $46. Interest is calculated at 5.03%. Liggett was required to provide a security deposit equal to 25% of the funded amount ($568).

In August 2006, Liggett purchased equipment for $7,922 through a financing agreement payable in 30 installments of $191 and then 30 installments of $103. Interest is calculated at 5.15%. Liggett was required to provide a security deposit equal to 20% of the funded amount ($1,584).

In May 2007, Liggett purchased equipment for $1,576 through a financing agreement payable in 60 installments of $32. Interest is calculated at 7.99%.

Each of these equipment loans is collateralized by the purchased equipment.

Notes for Medallion Acquisition Vector Tobacco:

The purchase price for the 2002 acquisition of The Medallion Company, Inc. (Medallion) included $60,000 in notes of Vector Tobacco, guaranteed by the Company and Liggett. Of the notes, $25,000 have been repaid with the final quarterly principal payment of $3,125 made on March 31, 2004. The remaining $35,000 of notes bore interest at 6.5% per year, payable semiannually, and was paid in full on April 2, 2007.

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Note Payable V.T. Aviation:

In February 2001, V.T. Aviation LLC, a subsidiary of Vector Research Ltd., purchased an airplane for $15,500 and borrowed $13,175 to fund the purchase. The loan, which is collateralized by the airplane and a letter of credit from the Company for $775, is guaranteed by Vector Research, VGR Holding and the Company. The loan is payable in 119 monthly installments of $125, including annual interest of 2.31% above the 30-day commercial paper rate, with a final payment of $2,880 based on current interest rates.

Note Payable VGR Aviation:

In February 2002, V.T. Aviation LLC purchased an airplane for $6,575 and borrowed $5,800 to fund the purchase. The loan is guaranteed by the Company. The loan is payable in 119 monthly installments of $40, including annual interest of 2.75% above the 30-day average commercial paper rate, with a final payment of $3,856 based on current interest rates. During the fourth quarter of 2003, this airplane was transferred to the Company s direct subsidiary, VGR Aviation LLC, which assumed the debt.

8. EMPLOYEE BENEFIT PLANS

Defined Benefit and Postretirement Plans:

Net periodic benefit cost for the Company s pension and other postretirement benefit plans for the three and six months ended June 30, 2007 and 2006 consists of the following:

	Pension Benefits Three Months Ended		Pension Benefits Six Months Ended	
	June 30, 2007	June 30, 2006	June 30, 2007	June 30, 2006
Service cost benefits earned during the period	$ 1,062	$ 1,225	$ 2,124	$ 2,450
Interest cost on projected benefit Obligation	2,281	2,250	4,562	4,500
Expected return on plan assets	(3,183)	(3,145)	(6,366)	(6,290)
Amortization of prior service cost	351	262	702	524
Amortization of net loss	176	435	352	870
Net expense	$ 687	$ 1,027	$ 1,374	$ 2,054

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	Other Postretirement Benefits Three Months Ended		Other Postretirement Benefits Six Months Ended	
	June 30, 2007	June 30, 2006	June 30, 2007	June 30, 2006
Service cost benefits earned during the period	$ 4	$ 5	$ 8	$ 10
Interest cost on projected benefit Obligation	148	150	296	300
Amortization of net loss	(26)	3	(52)	6
Net expense	$126	$ 158	$252	$ 316

The Company did not make contributions to its pension benefits plans for the three and six months ended June 30, 2007 and does not anticipate making any contributions to such plans in 2007. The Company anticipates paying approximately $775 in other postretirement benefits in 2007.

9. CONTINGENCIES

Tobacco-Related Litigation:

Overview. Since 1954, Liggett and other United States cigarette manufacturers have been named as defendants in numerous direct and third-party actions predicated on the theory that cigarette manufacturers should be liable for damages alleged to have been caused by cigarette smoking or by exposure to secondary smoke from cigarettes. New cases continue to be commenced against Liggett and other cigarette manufacturers. The cases generally fall into the following categories: (i) smoking and health cases alleging personal injury brought on behalf of individual plaintiffs (Individual Actions); (ii) smoking and health cases primarily alleging personal injury or seeking court-supervised programs for ongoing medical monitoring and purporting to be brought on behalf of a class of individual plaintiffs (Class Actions); (iii) health care cost recovery actions brought by various foreign and domestic governmental entities (Governmental Actions); and (iv) health care cost recovery actions brought by third-party payors including insurance companies, union health and welfare trust funds, asbestos manufacturers and others (Third-Party Payor Actions). As new cases are commenced, the costs associated with defending these cases and the risks relating to the inherent unpredictability of litigation continue to increase. The future financial impact of the risks and expenses of litigation and the effects of the tobacco litigation settlements discussed below are not quantifiable at this time. Liggett incurred legal expenses and other litigation costs totaling approximately $3,206 and $1,090 for the three months ended June 30, 2007 and 2006 respectively, and $4,237 and $2,463 for the six months ended June 30, 2007 and 2006, respectively.

Individual Actions. As of June 30, 2007, there were approximately 150 cases pending against Liggett (excluding approximately 950 individual cases pending in West Virginia state court as a consolidated action), and in most cases other tobacco companies, 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. Of these, 83 were pending in Florida (53 of which are abated pending resolution of *Engle*), 16 in Missouri, 14 in Mississippi and 11 in New York. The balance of the individual cases was pending in nine states and territories.

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There are currently three individual cases pending where Liggett is the only tobacco company defendant. In April 2004, in *Davis v. Liggett Group Inc.,* a Florida state court jury awarded compensatory damages of $540 against Liggett. In addition, plaintiff s counsel was awarded legal fees of $752. Liggett has appealed both the verdict and the award of legal fees. In March 2005, in *Ferlanti v. Liggett Group Inc.,* a Florida state court granted Liggett s motion for summary judgment. The plaintiff appealed and in June 2006, the appellate court reversed and remanded back to the trial court. The court has recently granted leave to plaintiff to add a claim for punitive damages. Discovery is ongoing. The case has been set for trial in January 2008. There is no activity in the other case where Liggett is the sole tobacco company defendant.

The plaintiffs allegations of liability in those 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 by defendants in these cases include lack of proximate cause, assumption of the risk, comparative fault and/or contributory negligence, lack of design defect, statute of limitations, equitable defenses such as unclean hands and lack of benefit, failure to state a claim and federal preemption.

Jury awards representing material amounts of damages have been returned against other cigarette manufacturers in recent years. The awards in these individual actions are for both compensatory and punitive damages. Over the last several years, after conclusion of all appeals, damage awards have been paid to several individual plaintiffs by other cigarette manufacturers including an award of $5,500 in compensatory damages and $50,000 in punitive damages, plus $27,000 in interest, paid in 2006 by Philip Morris in *Boeken v. Philip Morris*. Liggett was not a party to those actions. The following is a brief description of several of the pending cases where jury awards against other manufacturers are on appeal:

In March 1999, an Oregon state court jury found in favor of the plaintiff in *Williams v. Philip Morris*. The jury awarded $800 in compensatory damages and $79,500 in punitive damages which was subsequently reduced by the trial court to $32,000. In June 2002, the Oregon Court of Appeals reinstated the $79,500 punitive damages award. In October 2003, the United States Supreme Court set aside the Oregon appellate court s ruling and directed the Oregon court to reconsider the case in light of the *State Farm* decision limiting punitive damages. In June 2004, the Oregon appellate court reinstated the original jury verdict. In February 2006, the Oregon Supreme Court reaffirmed the $79,500 punitive damages jury verdict. In February 2007, the United States Supreme Court vacated the punitive damages award and remanded the case to the Oregon Supreme Court.

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In March 2002, an Oregon state court jury found in favor of the plaintiff in *Schwarz v. Philip Morris* and awarded $169 in compensatory damages and $150,000 in punitive damages. In May 2002, the trial court reduced the punitive damages award to $100,000. In May 2006, the Oregon Court of Appeals affirmed the compensatory damages award, vacated the punitive damages award and remanded for a new trial on the amount of punitive damages. The plaintiffs petitioned the Oregon Supreme Court to review the decision. It deferred further action pending the United States Supreme Court s decision on punitive damages in the *Williams* case, discussed above.

In October 2002, a California state court jury found in favor of the plaintiff in *Bullock v. Philip Morris* and awarded $850 in compensatory damages and $28,000,000 in punitive damages. In December 2002, the trial court reduced the punitive damages award to $28,000. In August 2006, the California Supreme Court denied plaintiff s petition to overturn the trial court s reduction of the punitive damage award and granted defendant s petition for review of the punitive damage award, with further action deferred pending the United States Supreme Court s decision on punitive damages in the *Williams* case, discussed above.

In December 2003, a New York state court jury found in favor of the plaintiff in *Frankson v. Brown & Williamson Tobacco Corp.* and awarded $350 in compensatory damages. In January 2004, the jury awarded $20,000 in punitive damages. The deceased smoker was found to be 50% at fault. In June 2004, the court increased the compensatory damages to $500 and decreased the punitive damages to $5,000. The defendants filed a notice of appeal on January 25, 2007.

In February 2005, a Missouri state court jury found in favor of the plaintiff in *Smith v. Brown & Williamson Tobacco Corp.* and awarded $2,000 in compensatory damages and $20,000 in punitive damages. The defendants have appealed to the Missouri Court of Appeals. Oral argument occurred in October 2006. A decision is pending.

In March 2005, a New York state court jury found in favor of the plaintiff in *Rose v. Brown & Williamson Tobacco Corp.* and awarded $3,400 in compensatory damages and $17,100 in punitive damages. The defendants have appealed to the Supreme Court of New York, Appellate Division, First Department. Oral argument occurred in December 2006. A decision is pending.

Class Actions. As of June 30, 2007, there were 11 actions pending for which either a class has been certified or plaintiffs are seeking class certification, where Liggett, among others, was a named defendant. Many of these actions purport to constitute statewide class actions and were filed after May 1996 when the Fifth Circuit Court of Appeals, in *Castano v. American Tobacco Co.*, reversed a federal district court s certification of a purported nationwide class action on behalf of persons who were allegedly addicted to tobacco products.

Since the Fifth Circuit s *Castano* ruling, in *Scott v. American Tobacco Co., Inc.,* (Liggett is not a defendant in this proceeding) a Louisiana court certified an addiction-as-injury class action that covered only citizens in that state. In May 2004, the *Scott* jury returned a verdict in the amount of $591,000, plus prejudgment interest, on the class claim for a smoking cessation program. In February 2007, the appellate court upheld $279,000 of the $591,000 verdict, finding that certain smokers were entitled to damages. The trial court s award of prejudgment interest was overturned by the appellate court and the case was remanded to the trial court. In February 2007, the

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defendants filed a motion for rehearing. Two other class actions, *Broin v. Philip Morris Companies Inc.,* (Liggett was dismissed from this case) and *Engle v. R.J. Reynolds Tobacco Co.,* were certified in state court in Florida prior to the *Castano* decision.

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 tobacco companies 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 against all defendants, including $790,000 against Liggett.

In November 2000, Liggett filed a $3,450 bond in order to stay execution of the *Engle* judgment pending appeal. In May 2001, Liggett, Philip Morris and Lorillard Tobacco Company reached an agreement with the *Engle* class, which provided assurance of Liggett s ability to appeal the jury s July 2000 punitive damage verdict. As required by the agreement, Liggett released the existing $3,450 bond and paid $6,273 into an escrow account to be distributed to the class, upon completion of the appellate process, regardless of the outcome of the appeal. Entitlement to the escrowed monies will have to be determined by the court at that time.

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

In July 2006, the Florida Supreme Court affirmed in part and reversed in part the May 2003 Third District Court of Appeal s decision. Among other things, the Florida Supreme Court affirmed the decision vacating the punitive damages award and held that the class should be decertified prospectively, but preserved several of the Phase I findings (including that: (i) smoking causes lung cancer, among other diseases; (ii) nicotine in cigarettes is addictive; (iii) defendants placed cigarettes on the market that were defective and unreasonably dangerous; (iv) the defendants concealed material information; (v) the defendants agreed to misrepresent information relating to the health effects of cigarettes with the intention that the public would rely on this information to its detriment; (vi) all defendants sold or supplied cigarettes that were defective; and (vii) all defendants were negligent) and allowed former class members to proceed to trial on individual liability issues (utilizing the above findings) and compensatory and punitive damage issues, provided they commence their individual lawsuits within one year from January 11, 2007. In December 2006, the Florida Supreme Court refused to revise its July 2006 ruling, except that it vacated finding (v) listed above and 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. The Florida Supreme Court issued its mandate on that decision on January 11, 2007, at which time the case was remanded to the Third District Court of Appeal for further proceedings consistent with the Florida Supreme Court s opinion. The Third District Court of Appeal remanded the case to the trial court. On May 21, 2007, the defendants, including Liggett, filed a petition for writ of certiorari with the United States Supreme Court. Opposition papers are due August 6, 2007. Class counsel has filed motions for attorneys

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fees and costs. If allowed to stand, the Florida Supreme Court s decision could result in the filing of a large number of individual personal injury cases in Florida before January 11, 2008. There have been approximately 20 *Engle* progeny cases filed and served where either Liggett or Vector, or both, have been named as defendants.

In June 2002, the jury in a Florida state court action entitled *Lukacs v. R.J. Reynolds Tobacco Company,* awarded $37,500 in compensatory damages in a case involving Liggett and two other tobacco manufacturers. In March 2003, the court reduced the amount of the compensatory damages to $24,860. The jury found Liggett 50% responsible for the damages incurred by the plaintiff. The *Lukacs* case was the first case to be tried as an individual *Engle* class member suit following entry of final judgment by the *Engle* trial court. After the verdict was returned, the case was abated pending completion of the *Engle* appeal. After the issuance of the Florida Supreme Court s opinion, the plaintiff filed a motion requesting that the trial court enter partial final judgment, tax costs and attorneys fees and schedule trial on the punitive damages claims. Oral argument on that motion occurred on March 15, 2007, but, to date, the court has not ruled on the motion. Liggett may ultimately be required to bond the amount of the judgment against it to perfect its appeal. Other Florida plaintiffs will likely move to lift the order of abatement in their individual actions in light of the Florida Supreme Court s *Engle* decision.

Classes also remain certified against Liggett in West Virginia *(Blankenship),* Kansas (*Smith*), New Mexico (*Romero*) and New York (*Schwab*). *Blankenship* is dormant. *Smith* and *Romero* are two class actions pending against Liggett, and other cigarette manufacturers, in which plaintiffs allege that cigarette manufacturers conspired to fix cigarette prices in violation of antitrust laws. Class certification was granted in *Smith v. Philip Morris,* in November 2001. Discovery is ongoing in that matter. Class certification was granted in *Romero v. Philip Morris* in April 2003 and was affirmed by the New Mexico Supreme Court in February 2005. In June 2006, the trial court in *Romero* granted defendants motions for summary judgment. Plaintiffs appealed the decision.

Class action suits have been filed in a number of states against cigarette manufacturers, alleging, among other things, that the use of the terms light and ultra light constitutes unfair and deceptive trade practices, among other things. One such suit, *Schwab v. Philip Morris,* pending in federal court in New York since 2004, seeks to create a nationwide class of light cigarette smokers. The action asserts claims under RICO. The proposed class is seeking as much as $200,000,000 in damages, which could be trebled under RICO. In November 2005, the court ruled that if the class is certified, the plaintiffs would be permitted to calculate damages on an aggregate basis and use fluid recovery theories to allocate them among class members. Fluid recovery would permit potential damages to be paid out in ways other than merely giving cash directly to plaintiffs, such as establishing a pool of money that could be used for public purposes. In September 2006, the court granted plaintiff s motion for class certification. In November 2006, the United States Court of Appeals for the Second Circuit granted the defendants motions to stay the district court proceedings and for review of the class certification ruling. Oral argument was held on July 10, 2007 and the parties are awaiting a decision. Liggett is a defendant in the case.

In June 1998, in *Cleary v. Philip Morris, Inc.* a putative class action was brought in Illinois state court on behalf of persons who have allegedly been injured by (i) the defendants purported conspiracy pursuant to which defendants allegedly concealed material facts regarding the addictive nature of nicotine; (ii) the defendants alleged acts of targeting their advertising and marketing to minors; and (iii) the defendants claimed breach of the public s right to defendants compliance with laws prohibiting the distribution of cigarettes to minors. The plaintiffs request that the defendants be

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required to disgorge all profits unjustly received through their sale of cigarettes to plaintiffs, which in no event will be greater than $75,000 each, inclusive of punitive damages, interest and costs. In July 2006, the plaintiffs filed a motion for class certification. A class certification hearing is scheduled for September 6, 2007. Merits discovery is stayed pending a ruling by the court on class certification. Liggett is a defendant in the case.

In April 2001, in *Brown v. The American Tobacco Co., Inc.,* a California state court granted in part plaintiffs motion for class certification and certified a class comprised of adult residents of California who smoked at least one of defendants cigarettes during the applicable time period and who were exposed to defendants marketing and advertising activities in California. In March 2005, the court granted defendants motion to decertify the class based on a recent change in California law. In October 2006, the plaintiffs filed a petition for review with the California Supreme Court, which was granted in November 2006. Briefing is complete. Liggett is a defendant in the case.

In March 2003, in *Price v. Philip Morris*, a putative class action brought on behalf of smokers of light and ultra light cigarettes, an Illinois state court judge awarded $7,100,500 in actual damages to the class members, $3,000,000 in punitive damages to the State of Illinois (which was not a plaintiff), and approximately $1,800,000 in attorneys fees and costs. In December 2005, the Illinois Supreme Court reversed the lower state court s decision and remanded, with instructions to dismiss the case. In November 2006, the United States Supreme Court declined to review the decision. Judgment was entered by the Illinois state court dismissing the case. In January 2007, plaintiffs filed a motion to vacate and/or withhold judgment in the circuit court pending the United States Supreme Court s decision in *Watson v. Philip Morris Co.* In May 2007, the state court found that an immediate appeal may be appropriate and the plaintiffs asked the Illinois Fifth District Court of Appeals to review the issue. Liggett is not a defendant in the case. Although not technically a class action, in *In Re: Tobacco Litigation (Personal Injury Cases)*, a West Virginia State court consolidated approximately 950 individual smoker actions that were pending prior to 2001 for trial of certain common issues. The consolidation was affirmed on appeal by the West Virginia Supreme Court. The first phase of the trial is scheduled for March 2008 on certain liability and punitive damages claims allegedly common to the consolidated claims. In January 2002, the court severed Liggett from the trial of the consolidated action.

Class certification motions are pending in a number of other cases and a number of orders denying class certification are on appeal. In addition to the cases described above, a number of class actions remain certified against other cigarette manufacturers.

Governmental Actions. As of June 30, 2007, there were three Governmental Actions pending against Liggett. The claims asserted in these health care cost recovery actions vary. In most of these cases, the governmental entities 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. Other claims made by some but not all plaintiffs 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.

In September 1999, the United States government commenced litigation against Liggett and other tobacco companies in the United States District Court for the District of Columbia. The action sought to recover an unspecified amount of health care costs paid for and furnished, and to be paid for and

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furnished, 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. The action asserted claims under three federal statutes, the Medical Care Recovery Act (MCRA), the Medicare Secondary Payer provisions of the Social Security Act (MSP) and RICO. In September 2000, the court dismissed the government s claims based on MCRA and MSP. Trial of the case concluded in June 2005.

In August 2006, the trial court entered a Final Judgment and Remedial Order against each of the cigarette manufacturing defendants, except Liggett. The Final Judgment, among other things, ordered the following relief against the non-Liggett defendants: (i) the defendants are enjoined from committing any act of racketeering concerning the manufacturing, marketing, promotion, health consequences or sale of cigarettes in the United States; (ii) the defendants are enjoined from making any material false, misleading, or deceptive statement or representation concerning cigarettes that persuades people to purchase cigarettes; (iii) the defendants are enjoined from utilizing lights , low tar , ultra lights , mild , or natural descriptors, or conveying any other express or impli health messages in connection with the marketing or sale of cigarettes, domestically and internationally, as of January 1, 2007; (iv) the defendants must make certain corrective statements on their websites, and in television and print media advertisements; (v) the defendants must maintain internet document websites until 2016 with access to smoking and health related documents; (vi) the defendants must disclose all disaggregated marketing data to the government on a confidential basis; (vii) the defendants are not permitted to sell or otherwise transfer any of their cigarette brands, product formulas or businesses to any person or entity for domestic use without a court order, and unless the acquiring person or entity agrees to be bound by the terms of the Final Judgment; and (viii) the defendants must pay the appropriate costs incurred by the government in prosecuting the action, in an amount to be determined by the trial court.

No monetary damages were awarded other than the government s costs. In October 2006, the United States Court of Appeals for the District of Columbia stayed the Final Judgment pending appeal. The defendants filed amended notices of appeal in March 2007. In May 2007, the court of appeals issued a briefing schedule that extends into the second quarter of 2008. It is unclear what impact, if any, the Final Judgment will have on the cigarette industry as a whole. While Liggett was excluded from the Final Judgment, to the extent that the Final Judgment leads to a decline in industry-wide shipments of cigarettes in the United States, Liggett s sales volume, operating income and cash flows could be materially adversely affected.

A case is pending in Missouri state court brought by the City of St. Louis and approximately 50 hospitals against Liggett and other cigarette manufacturers. Plaintiffs seek recovery of costs expended by the hospitals on behalf of patients who suffer, or have suffered, from illnesses allegedly resulting from the use of cigarettes. In June 2005, the court granted defendants motion for summary judgment as to claims for damages which accrued prior to November 16, 1993. The claims for damages which accrued after November 16, 1993 are pending. Discovery is ongoing.

Third-Party Payor Actions. As of June 30, 2007, there were two Third-Party Payor Actions pending against Liggett. The Third-Party Payor Actions typically have been commenced by insurance companies, union health and welfare trust funds, asbestos manufacturers and others. In Third-Party Payor Actions, plaintiffs seek damages for: funding of corrective public education campaigns relating to issues of smoking and health; funding for clinical smoking cessation programs; disgorgement of

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profits from sales of cigarettes; restitution; treble damages; and attorneys fees. Although no specific amounts are provided, it is understood that requested damages against the tobacco company defendants in these cases might be in the billions of dollars.

Several federal circuit courts of appeals and state appellate courts have ruled that Third-Party Payors did not have standing to bring lawsuits against cigarette manufacturers, relying primarily on grounds that plaintiffs claims were too remote. The United States Supreme Court has refused to consider plaintiffs appeals from the cases decided by five federal circuit courts of appeals.

In June 2005, the Jerusalem District Court in Israel added Liggett as a defendant in an action commenced in 1998 by the largest private insurer in that country, General Health Services, against the major United States tobacco manufacturers. The plaintiff seeks to recover the past and future value of the total expenditures for health care services provided to residents of Israel resulting from tobacco related diseases, court ordered interest for past expenditures from the date of filing the statement of claim, increased and/or punitive and/or exemplary damages and costs. The court ruled that, although Liggett had not sold product in Israel since at least 1978, it might still have liability for cigarettes sold prior to that time. Motions filed by the defendants are pending before the Israel Supreme Court seeking appeal from a lower court s decision granting leave to plaintiffs for foreign service of process.

In August 2005, the United Seniors Association, Inc. filed a lawsuit in federal court in Massachusetts pursuant to the private cause of action provisions of the MSP seeking to recover for the Medicare program all expenditures on smoking-related diseases since August 1999. In August 2006, the court granted the defendants motion to dismiss the complaint. The plaintiff appealed and oral argument was held on March 6, 2007.

State Settlements. 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 within those states and territories, including claims for health care cost reimbursement and claims concerning sales of cigarettes to minors.

In the settling jurisdictions, the MSA 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.

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

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and certain other claims of those Settling States. The MSA received final judicial approval in each settling jurisdiction.

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 the exception of signs 14 square feet or less, at retail establishments that sell tobacco products; 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 usage of tobacco products and imposes restrictions on lobbying activities conducted on behalf of Participating Manufacturers.

Liggett has no payment obligations under the MSA except to the extent its market share exceeds a market share exemption of approximately 1.65% of total cigarettes sold in the United States. Vector Tobacco has no payment obligations under the MSA, except to the extent its market share exceeds a market share exemption of approximately 0.28% of total cigarettes sold in the United States. According to data from Management Science Associates, Inc., domestic shipments by Liggett and Vector Tobacco accounted for approximately 2.3% of the total cigarettes shipped in the United States during 2004, 2.2% during 2005 and 2.4% during 2006. 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, would pay on each excess unit an amount equal (on a per-unit basis) to that due by the OPMs for that year, subject to applicable adjustments, offsets and reductions. In April 2004, Liggett and Vector Tobacco paid $50,322 for their 2003 MSA obligations. In April 2005, Liggett and Vector Tobacco paid $20,982 for their 2004 MSA obligations. In April 2006, Liggett and Vector Tobacco paid $10,637 for their 2005 MSA obligations. In April 2007, Liggett and Vector Tobacco paid $38,743 for their 2006 MSA obligations. Liggett and Vector Tobacco expensed $14,317 and $25,784 for the three and six months ended June 30, 2007, respectively, and $4,119 and $11,707 for the three and six months ended June 30, 2006, as part of cost of goods sold.

Under the payment provisions of the MSA, the Participating Manufacturers are required to pay the following base annual amounts (subject to applicable adjustments, offsets and reductions):

Payment Year	Base Amount
2007	$ 8,000,000
2008 and each year thereafter	$ 9,000,000

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, obligations of each Participating Manufacturer and are not the responsibility of any parent or affiliate of a Participating Manufacturer.

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In 2005, the independent auditor, appointed under the provisions of the MSA, calculated that Liggett owed $28,668 for its 2004 sales. Liggett paid $11,678 and disputed the balance, as permitted by the MSA. Liggett paid an additional $9,304, although Liggett continues to dispute that this amount is owed. The $9,304 dispute relates to an adjustment to its 2003 payment obligation claimed by Liggett for the market share loss to non-participating manufacturers, which is known as the NPM Adjustment. At June 30, 2007, included in Other assets on the company s condensed consolidated balance sheet, was a receivable of $6,513 relating to such amount. The remaining balance in dispute of $7,686, which was withheld from payment, is comprised of $5,318 claimed for a 2004 NPM Adjustment and $2,368 relating to the independent auditor s retroactive change from gross to net units in calculating MSA payments, which Liggett contends is improper, as discussed below. From its April 2006 payment, Liggett and Vector Tobacco withheld approximately $1,600 claimed for the 2005 NPM Adjustment and $2,612 relating to the retroactive change from gross to net units. Liggett and Vector Tobacco withheld approximately $4,200 from their April 2007 payments related to the 2006 NPM Adjustment and approximately $3,000 relating to the retroactive change from gross to net units.

The following amounts have not been expensed in the accompanying consolidated financial statements as they relate to Liggett s and Vector Tobacco s claim for an NPM adjustment: $6,513 for 2003, $3,789 for 2004 and $800 for 2005.

In March 2006, an economic consulting firm selected pursuant to the MSA rendered its final and non-appealable decision that the MSA was a significant factor contributing to the loss of market share of Participating Manufacturers for 2003. In February 2007, the economic consulting firm rendered the same decision with respect to 2004. As a result, the manufacturers are entitled to potential NPM Adjustments to their 2003 and 2004 MSA payments. A Settling State that has diligently enforced its qualifying escrow statute in the year in question may be able to avoid application of the NPM Adjustment to the payments made by the manufacturers for the benefit of that state or territory.

Since April 2006, notwithstanding provisions in the MSA requiring arbitration, litigation has been commenced in 49 Settling States over the issue of whether the application of the NPM Adjustment for 2003 is to be determined through litigation or arbitration. These actions relate to the potential NPM Adjustment for 2003, which the independent auditor under the MSA previously determined to be as much as $1,200,000. To date, 44 of 45 courts that have decided the issue have ruled that the 2003 NPM Adjustment dispute is arbitrable and 23 of those decisions are final. In Louisiana, the only court where a decision that the dispute was not arbitrable is pending, Participating Manufacturers have moved for reconsideration. There can be no assurance that Liggett or Vector Tobacco will receive any adjustment as a result of these proceedings.

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, were going to be recalculated using net unit amounts, rather than gross unit amounts (which had been used since 1999). The change in the method of calculation could, among other things, require additional payments by Liggett under the MSA of approximately $14,200 for the periods 2001 through 2006, and require Liggett to pay an additional amount of approximately $3,300 in 2007 and additional amounts in future periods by lowering Liggett s market share exemption under the MSA.

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

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

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

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

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

No amounts have been expensed or accrued in the accompanying consolidated financial statements for any potential liability relating to the gross versus net dispute.

The MSA replaces Liggett s prior settlements with all states and territories except for Florida, Mississippi, Texas and Minnesota. Each of these four states, prior to the effective date of the MSA, negotiated and executed settlement agreements with each of the other major tobacco companies, separate from those settlements reached previously with Liggett. Liggett s agreements with these states remain in full force and effect, and Liggett made various payments to these states during 1996, 1997 and 1998 under the agreements. These states settlement agreements with Liggett contained most favored nation provisions which could reduce Liggett s payment obligations based on subsequent settlements or resolutions by those states with certain other tobacco companies. Beginning in 1999, Liggett determined that, based on each of these four states settlements or resolutions 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 is entitled to the most favorable provisions as between the MSA and each state s respective settlement with the other major tobacco companies. Therefore, Liggett s non-economic obligations to all states and territories are now defined by the MSA.

In 2003, in order to resolve any potential issues with Minnesota as to Liggett s settlement obligations, Liggett negotiated a $100 a year payment to Minnesota, to be paid any year cigarettes manufactured by Liggett are sold in that state. In 2004, the Attorneys General for Florida, Mississippi and Texas advised Liggett that they believed that Liggett had failed to make all required payments under the respective settlement agreements with these states for the period 1998 through 2003 and that additional payments may be due for 2004 and subsequent years. Liggett believes these allegations are without merit, based, among other things, on the language of the most favored nation provisions of the settlement agreements. In December 2004, Florida offered to settle all amounts allegedly owed by Liggett for the period through 2003 for the sum of $13,500. In March 2005, Florida reaffirmed its December 2004 offer to settle and provided Liggett with a 60 day notice to cure the alleged defaults. Liggett offered Florida $2,500 in a lump sum to settle all alleged obligations through December 31, 2006 and $100 per year thereafter in any year in which cigarettes manufactured by Liggett are sold in Florida, to resolve all alleged future obligations under the settlement agreement. In November 2004, Mississippi offered to settle all amounts allegedly owed by Liggett for the period through 2003 for the sum of $6,500. In April 2005, Mississippi reaffirmed its November 2004 offer to settle and provided Liggett with a 60 day notice to cure the alleged defaults. No specific monetary demand has been made by Texas. Liggett has met with representatives of

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Mississippi and Texas to discuss the issues relating to the alleged defaults, although no resolution has been reached.

Except for $2,500 accrued at June 30, 2007, in connection with the foregoing matters, no other amounts have been accrued in the accompanying condensed consolidated financial statements for any additional amounts that may be payable by Liggett under the settlement agreements with Florida, Mississippi and Texas. There can be no assurance that Liggett will resolve these matters or that Liggett will not be required to make additional material payments, which payments could adversely affect the Company s consolidated financial position, results of operations or cash flows.

In August 2004, the Company announced that Liggett and Vector Tobacco had notified the Attorneys General of 46 states that they intended to initiate proceedings against one or more of the Settling States for violating the terms of the MSA. The Company s subsidiaries alleged that the Settling States violated their rights and the MSA by extending unauthorized favorable financial terms to Miami-based Vibo Corporation d/b/a General Tobacco when, in August 2004, the Settling States entered into an agreement with General Tobacco purporting to allow it to become an SPM under the MSA. General Tobacco imports discount cigarettes manufactured in Colombia, South America.

In the notice sent to the Attorneys General, the Company s subsidiaries indicated that they sought to enforce the terms of the MSA, void the General Tobacco agreement and enjoin the Settling States and National Association of Attorneys General from listing General Tobacco as a Participating Manufacturer on their websites. Several SPMs, including Liggett and Vector Tobacco, filed a motion in state court in Kentucky seeking to enforce the terms of the MSA with respect to General Tobacco or, alternatively, to receive the same treatment as General Tobacco under the MSA s most favored nation clause. In January 2006, the court entered an order denying the motion and finding that the terms of the General Tobacco settlement agreement were not in violation of the MSA. The judge also found that the SPMs, under these circumstances, were not entitled to most favored nation treatment. These SPMs appealed to the Kentucky court of appeals. Oral argument occurred on March 13, 2007.

There is a suit pending against New York state officials, in federal court in New York, in which importers of cigarettes allege that the MSA and certain New York statutes enacted in connection with the MSA violate federal antitrust and constitutional law. The United States Court of Appeals for the Second Circuit has held that plaintiffs have stated a claim for relief on antitrust grounds. In September 2004, the court denied plaintiffs motion to preliminarily enjoin the MSA and certain related New York statutes, but the court issued a preliminary injunction against an amendment repealing the allocable share provision of the New York escrow statute. The parties motions for summary judgment are pending. Additionally, in another proceeding pending in New York federal court, plaintiffs seek to enjoin the statutes enacted by New York and other states in connection with the MSA on the grounds that the statutes violate the Commerce Clause of the United States Constitution and federal antitrust laws. In September 2005, the United States Court of Appeals for the Second Circuit held that plaintiffs stated a claim for relief and that the New York federal court had jurisdiction of the other defendant state attorneys general. In October 2006, the United States Supreme Court denied the attorneys generals petition for writ of certiorari. Similar lawsuits are pending in Kentucky, Arkansas, Kansas, Louisiana, Tennessee and Oklahoma. Liggett and the other tobacco companies are not defendants in these cases.

Upcoming Trials. There are five individual actions in New York state court, where Liggett is a defendant along with other tobacco companies, that may be set for trial in 2007 or 2008. Three individual actions in Florida are likely to be set for trial in 2008. One individual action in Florida is set

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for trial in January 2008. Liggett is the sole tobacco company defendant in this case. There are several other cases against other tobacco companies which are scheduled for trial in 2007. Trial dates, however, are subject to change.

Management is not able to predict the outcome of the litigation pending or threatened against Liggett. Litigation is subject to many uncertainties. In July 2006, the Florida Supreme Court affirmed in part and reversed in part the May 2003 intermediate appellate court decision in the *Engle* case. Although the Florida Supreme Court affirmed the decision to decertify the class on a prospective basis and the order vacating the punitive damages award, the court upheld certain of the trial court s Phase I determinations. In June 2002, the jury in the *Lukacs* case, an individual case brought under the third phase of the *Engle* case, awarded $37,500 (subsequently reduced by the court to $24,860) of compensatory damages against Liggett and two other defendants and found Liggett 50% responsible for the damages. The plaintiff filed a motion for the trial court to enter partial final judgment, tax costs and attorneys fees, and schedule trial on the punitive damages claim. Oral argument on the motion occurred on March 15, 2007. Liggett may ultimately be required to bond the amount of the judgment entered against it to perfect its appeal. In April 2004, a jury in a Florida state court action awarded compensatory damages of approximately $540 against Liggett in an individual action. In addition, plaintiff s counsel was awarded legal fees of $752. Liggett has appealed both the verdict and the award of legal fees. In August 2006, the trial court in the Department of Justice case entered a Final Judgment and Remedial Order against certain cigarette manufacturers. It is unclear what impact, if any, the Final Judgment will have on the cigarette industry as a whole. It is possible that additional cases could be decided unfavorably and that there could be further adverse developments as a result of the decision in the *Engle* case, including the filing of a large number of individual personal injury cases in Florida before January 11, 2008. Liggett may enter into discussions in an attempt to settle particular cases if it believes it is appropriate to do so.

Management cannot predict the cash requirements related to any future defense costs, settlements or judgments, including cash required to bond any appeals, and there is a risk that those requirements will not be able to be met. An unfavorable outcome of a pending smoking and health case could encourage the commencement of additional similar litigation. Management is unable to make a meaningful estimate with respect to the amount or range of loss that could result from an unfavorable outcome of the cases pending against Liggett or the costs of defending such cases. The complaints filed in these cases rarely detail alleged damages. Typically, the claims set forth in an individual s complaint against the tobacco industry seek money damages in an amount to be determined by a jury, plus punitive damages and costs.

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

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

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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.

Other Litigation:

In 1994, New Valley commenced an action against the United States government seeking damages for breach of a launch services agreement covering the launch of one of the Westar satellites owned by New Valley s former Western Union satellite business. In March 2007, the parties entered into a Stipulation for Entry of Judgment to settle New Valley s claims. In May 2007, New Valley received a $20,000 payment from the government in connection with the settlement. The Company recognized a pre-tax gain in 2007 of $19,590, net of operating, selling, administrative and general expenses of $410, in connection with the settlement.

Beginning in 2002, Liggett was served in three class actions filed on behalf of purported descendants of slaves, seeking reparations from defendants, including Liggett, for alleged profits arising from the use of slave labor. In October 2002, these three actions were consolidated by the court. In July 2005, the district court granted defendants motions to dismiss these actions. Thereafter, plaintiffs appealed. Oral argument was held in September 2006 and on December 13, 2006, the appellate court affirmed in part and reversed in part the district court s decision. The court affirmed the district court s dismissal without prejudice, for lack of standing, of all claims except those brought by putative legal representatives. The dismissal of claims brought by the putative legal representatives was affirmed on the merits, and therefore, those claims were dismissed with prejudice. The dismissal of the consumer protection claims was reversed and the case was remanded to the district court for further proceedings on those claims.

In October 2005, Lorillard Tobacco Company advised Liggett that it believed that certain styles of Liggett s Grand Prix brand cigarettes created a likelihood of confusion among consumers with Lorillard s Newport cigarette brand because of similarities in packaging. In December 2006, Lorillard commenced an action in the United States District Court for the Middle District of North Carolina seeking, among other things: an injunction against Liggett s sale of certain brand styles of Grand Prix; an order directing the recall of the relevant brand styles; an accounting of profits for the relevant brand styles; treble damages; and interest, attorneys fees and costs. Discovery is ongoing. Counsel has advised Liggett that it has meritorious defenses to the action.

Other Matters:

In May 1999, in connection with the Philip Morris brand transaction, Eve Holdings Inc., a subsidiary of Liggett, guaranteed a $134,900 bank loan to Trademarks LLC. The loan is secured by Trademarks three premium cigarette brands and Trademarks interest in the exclusive license of the three brands by Philip Morris. The license provides for a minimum annual royalty payment equal to the annual debt service on the loan plus $1,000. Trademarks future royalties have been guaranteed by Altria Group Inc., the parent of Philip Morris. As a result of Altria Group s investment-grade debt

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rating, the Company believes that no premium would be required by Eve to issue the same guarantee in a standalone arm s length transaction. Thus, the Company believes the fair value of Eve s guarantee was negligible at June 30, 2007.

In December 2001, New Valley s subsidiary, Western Realty Development LLC, sold all the membership interests in Western Realty Investments LLC to Andante Limited. In August 2003, Andante submitted an indemnification claim to Western Realty Development LLC alleging losses of $1,225 from breaches of various representations made in the purchase agreement. Under the terms of the purchase agreement, Western Realty Development LLC has no obligation to indemnify Andante unless the aggregate amount of all claims for indemnification made by Andante exceeds $750, and Andante is required to bear the first $200 of any proven loss. New Valley would be responsible for 70% of any damages payable by Western Realty Development LLC. New Valley contested the indemnification claim and has not received any response from Andante.

In February 2004, Liggett Vector Brands and another cigarette manufacturer entered into a five year agreement with a subsidiary of the American Wholesale Marketers Association to support a program to permit certain tobacco distributors to secure, on reasonable terms, tax stamp bonds required by state and local governments for the distribution of cigarettes. Under the agreement, Liggett Vector Brands has agreed to pay a portion of losses, if any, incurred by the surety under the bond program, with a maximum loss exposure of $500 for Liggett Vector Brands. To secure its potential obligations under the agreement, Liggett Vector Brands has delivered to the subsidiary of the Association a $100 letter of credit and agreed to fund up to an additional $400. Liggett Vector Brands has incurred no losses to date under this agreement, and the Company believes the fair value of Liggett Vector Brands obligation under the agreement was immaterial at June 30, 2007.

There are 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.