

VECTOR GROUP LTD  
Form 10-Q  
November 09, 2016

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

FORM 10-Q

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

For The Quarterly Period Ended September 30, 2016

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

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

4400 Biscayne Boulevard  
Miami, Florida 33137  
305-579-8000  
(Address, including zip code and telephone number, including area code,  
of the principal executive offices)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

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

Accelerated filer  Non-accelerated filer

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Large accelerated  
filer

Smaller reporting  
company

(Do not check if a smaller reporting  
company)

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

At November 8, 2016, Vector Group Ltd. had 127,839,497 shares of common stock outstanding.

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VECTOR GROUP LTD.

FORM 10-Q

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VECTOR GROUP LTD. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED BALANCE SHEETS

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

|  | September 30,<br>2016 | December 31,<br>2015 |
|--|-----------------------|----------------------|
| <b>ASSETS:</b>   |                       |                      |
| Current assets:  |                       |                      |
| Cash and cash equivalents  | \$ 445,874            | \$ 240,368           |
| Investment securities available for sale   | 175,653               | 181,976              |
| Accounts receivable - trade, net   | 23,371                | 23,889               |
| Inventories  | 87,622                | 86,516               |
| Income taxes receivable, net   | 7,287                 | 2,841                |
| Restricted assets  | 4,749                 | 9,195                |
| Other current assets   | 39,169                | 38,954               |
| Total current assets   | 783,725               | 583,739              |
| Property, plant and equipment, net   | 77,887                | 75,632               |
| Investments in real estate, net  | 23,630                | 23,318               |
| Long-term investments  | 54,005                | 62,726               |
| Investments in real estate ventures  | 211,825               | 217,168              |
| Restricted assets  | 8,134                 | 12,303               |
| Goodwill and other intangible assets, net  | 261,919               | 263,959              |
| Prepaid pension costs  | 21,628                | 20,650               |
| Other assets   | 21,977                | 21,120               |
| Total assets   | \$ 1,464,730          | \$ 1,280,615         |
| <b>LIABILITIES AND STOCKHOLDERS' DEFICIENCY:</b>   |                       |                      |
| Current liabilities:   |                       |                      |
| Current portion of notes payable and long-term debt  | \$ 16,280             | \$ 8,919             |
| Current payments due under the Master Settlement Agreement   | 82,759                | 29,241               |
| Current portion of employee benefits   | 914                   | 915                  |
| Income taxes payable, net  | —                     | 96                   |
| Litigation accruals  | 3,539                 | 22,904               |
| Other current liabilities  | 113,865               | 154,217              |
| Total current liabilities  | 217,357               | 216,292              |
| Notes payable, long-term debt and other obligations, less current portion  | 1,121,433             | 856,108              |
| Fair value of derivatives embedded within convertible debt   | 120,820               | 144,042              |
| Non-current employee benefits  | 55,451                | 55,055               |
| Deferred income taxes, net   | 89,557                | 79,429               |
| Payments due under the Master Settlement Agreement   | 22,257                | 20,094               |
| Litigation accruals  | 23,225                | 24,718               |
| Other liabilities  | 13,227                | 7,038                |
| Total liabilities  | 1,663,327             | 1,402,776            |
| Commitments and contingencies (Note 7)   |                       |                      |
| Stockholders' deficiency:  |                       |                      |
| Preferred stock, par value \$1.00 per share, 10,000,000 shares authorized  | —                     | —                    |
| Common stock, par value \$0.10 per share, 250,000,000 shares authorized, 127,839,497 and 123,792,329 shares issued and outstanding | 12,784                | 12,379               |
| Accumulated deficit  | (287,060              | ) (210,113 )         |
| Accumulated other comprehensive loss   | (6,856                | ) (8,313 )           |
| Total Vector Group Ltd. stockholders' deficiency   | (281,132              | ) (206,047 )         |

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|  |              |              |
|--|--------------|--------------|
| Non-controlling interest                       | 82,535       | 83,886       |
| Total stockholders' deficiency                 | (198,597 )   | (122,161 )   |
| Total liabilities and stockholders' deficiency | \$ 1,464,730 | \$ 1,280,615 |

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<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|---|-------------------------------------|-----------|------------------------------------|-----------|
|   | 2016                                | 2015      | 2016                               | 2015      |
| Revenues  |                                     |           |                                    |           |
| Tobacco*  | \$274,164                           | \$264,170 | \$750,677                          | \$747,145 |
| Real estate   | 184,936                             | 185,563   | 527,448                            | 478,841   |
| E-Cigarettes  | 4                                   | 201       | 52                                 | 881       |
| Total Revenues  | 459,104                             | 449,934   | 1,278,177                          | 1,226,867 |
| Expenses:   |                                     |           |                                    |           |
| Cost of sales:  |                                     |           |                                    |           |
| Tobacco*  | 186,343                             | 174,418   | 491,688                            | 506,315   |
| Real estate   | 117,089                             | 121,078   | 331,784                            | 309,306   |
| E-Cigarettes  | 10                                  | 421       | 23                                 | 1,518     |
| Total cost of sales   | 303,442                             | 295,917   | 823,495                            | 817,139   |
| Operating, selling, administrative and general expenses               | 86,298                              | 79,352    | 250,048                            | 233,449   |
| Litigation settlement and judgment expense                            | —                                   | 3,750     | 2,350                              | 5,843     |
| Restructuring charges   | —                                   | 1,548     | 41                                 | 1,548     |
| Operating income  | 69,364                              | 69,367    | 202,243                            | 168,888   |
| Other income (expenses):  |                                     |           |                                    |           |
| Interest expense  | (37,365 )                           | (32,898 ) | (104,454 )                         | (96,405 ) |
| Change in fair value of derivatives embedded within convertible debt  | 6,112                               | 7,044     | 23,222                             | 18,760    |
| Equity in earnings (losses) from real estate ventures                 | 1,022                               | (916 )    | 3,328                              | 1,278     |
| Equity in losses from investments                                     | (1,526 )                            | (1,103 )  | (2,108 )                           | (2,654 )  |
| Gain (loss) on sale of investment securities available for sale       | 142                                 | (821 )    | 848                                | 12,018    |
| Impairment of investment securities available for sale                | (54 )                               | (12,211 ) | (4,916 )                           | (12,211 ) |
| Other, net  | 1,328                               | 1,342     | 2,956                              | 5,100     |
| Income before provision for income taxes                              | 39,023                              | 29,804    | 121,119                            | 94,774    |
| Income tax expense  | 13,316                              | 13,694    | 46,682                             | 37,739    |
| Net income  | 25,707                              | 16,110    | 74,437                             | 57,035    |
| Net income attributed to non-controlling interest                     | (2,532 )                            | (3,644 )  | (7,909 )                           | (5,741 )  |
| Net income attributed to Vector Group Ltd.                            | \$23,175                            | \$12,466  | \$66,528                           | \$51,294  |
| Per basic common share:   |                                     |           |                                    |           |
| Net income applicable to common share attributed to Vector Group Ltd. | \$0.18                              | \$0.10    | \$0.52                             | \$0.40    |
| Per diluted common share:   |                                     |           |                                    |           |

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|   |        |        |        |        |
|---|--------|--------|--------|--------|
| Net income applicable to common share attributed to Vector Group Ltd. | \$0.18 | \$0.10 | \$0.52 | \$0.40 |
| Dividends declared per share  | \$0.38 | \$0.36 | \$1.14 | \$1.09 |

\* Revenues and cost of sales include federal excise taxes of \$116,024, \$112,773, \$313,731 and \$319,044, respectively.

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

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VECTOR GROUP LTD. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(Dollars in Thousands)

Unaudited

|  | Three Months<br>Ended<br>September 30,<br>2016 |           | Nine Months<br>Ended<br>September 30,<br>2016 |           |
|--|--|-----------|---|-----------|
|  | 2015   |           | 2015  |           |
| Net income   | \$25,707                                       | \$16,110  | \$74,437                                      | \$57,035  |
| Net unrealized gains (losses) on investment securities available for sale:                                       |  |           |   |           |
| Change in net unrealized gains (losses)  | 2,501  | (33,796 ) | (2,953 )                                      | (17,379 ) |
| Net unrealized (gains) losses reclassified into net income   | (88 )  | 13,032    | 4,068   | 193       |
| Net unrealized gains (losses) on investment securities available for sale  | 2,413  | (20,764 ) | 1,115   | (17,186 ) |
| Net unrealized gains on long-term investments accounted for under the equity method:                             |  |           |   |           |
| Change in net unrealized gains   | —  | —         | —   | 1,190     |
| Net unrealized losses reclassified into net income   | —  | —         | —   | 1,624     |
| Net unrealized gains on long-term investments accounted for under the equity method                              | —  | —         | —   | 2,814     |
| Net change in forward contracts  | 9  | 15        | 27  | 47        |
| Net change in pension-related amounts  |  |           |   |           |
| Net loss arising during the year   | —  | —         | —   | 1,607     |
| Amortization of loss   | 445  | 229       | 1,335   | 750       |
| Net change in pension-related amounts  | 445  | 229       | 1,335   | 2,357     |
| Other comprehensive income (loss)  | 2,867  | (20,520 ) | 2,477   | (11,968 ) |
| Income tax effect on:  |  |           |   |           |
| Change in net unrealized gains (losses) on investment securities   | (1,033 )                                       | 1,728     | 1,212   | (4,875 )  |
| Net unrealized (gains) losses reclassified into net income on investment securities                              | 36   | (5,389 )  | (1,672 )                                      | (80 )     |
| Change in unrealized gains on long-term investments accounted for under the equity method                        | —  | —         | —   | (484 )    |
| Net unrealized gains reclassified into net income on long-term investments accounted for under the equity method | —  | —         | —   | (672 )    |
| Forward contracts  | (4 )   | (6 )      | (11 )   | (19 )     |
| Pension-related amounts  | (183 )   | (95 )     | (549 )  | (975 )    |
| Income tax provision on other comprehensive income (loss)  | (1,184 )                                       | (3,762 )  | (1,020 )                                      | (7,105 )  |
| Other comprehensive income (loss), net of tax  | 1,683  | (24,282 ) | 1,457   | (19,073 ) |
| Comprehensive income (loss)  | 27,390   | (8,172 )  | 75,894  | 37,962    |



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|   |          |            |          |          |
|---|----------|------------|----------|----------|
| Comprehensive income attributed to non-controlling interest | (2,532 ) | (3,644 )   | (7,909 ) | (5,741 ) |
| Comprehensive income (loss) attributed to Vector Group Ltd. | \$24,858 | \$(11,816) | \$67,985 | \$32,221 |

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

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

|   | Vector Group Ltd. Stockholders' Deficiency |          |                       |              |             |                 | Total       |
|---|--|----------|-----------------------|--------------|-------------|-----------------|-------------|
|   | Common Stock                               |          | Additional<br>Paid-In | Accumulated  | Other       | Non-controlling |             |
|   | Shares                                     | Amount   | Capital               | Deficit      | Loss        | Interest        |             |
| Balance as of January 1, 2016                                   | 123,792,329                                | \$12,379 | \$ —                  | \$(210,113 ) | \$ (8,313 ) | \$ 83,886       | \$(122,161) |
| Net income  | —  | —        | —                     | 66,528       | —           | 7,909           | 74,437      |
| Total other comprehensive income                                | —  | —        | —                     | —            | 1,457       | —               | 1,457       |
| Total comprehensive income                                      | —  | —        | —                     | —            | —           | —               | 75,894      |
| Distributions and dividends on common stock                     | —  | —        | (6,323                | (142,866 )   | —           | —               | (149,189 )  |
| Restricted stock grant  | 50,000                                     | 5        | (5 )                  | —            | —           | —               | —           |
| Surrender of shares in connection with restricted stock vesting | (87,561 )                                  | (8 )     | (1,960                | —            | —           | —               | (1,968 )    |
| Effect of stock dividend  | 6,087,035                                  | 609      | —                     | (609 )       | —           | —               | —           |
| Cancellation of shares under share lending agreement            | (2,034,212 )                               | (204 )   | 204                   | —            | —           | —               | —           |
| Exercise of stock options                                       | 31,906                                     | 3        | 395                   | —            | —           | —               | 398         |
| Tax benefit of options exercised                                | —  | —        | 412                   | —            | —           | —               | 412         |
| Stock-based compensation  | —  | —        | 7,277                 | —            | —           | —               | 7,277       |
| Contributions from non-controlling interest                     | —  | —        | —                     | —            | —           | 248             | 248         |
| Distributions to non-controlling interest                       | —  | —        | —                     | —            | —           | (9,508 )        | (9,508 )    |
| Balance as of September 30, 2016                                | 127,839,497                                | \$12,784 | \$ —                  | \$(287,060 ) | \$ (6,856 ) | \$ 82,535       | \$(198,597) |

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

VECTOR GROUP LTD. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in Thousands)

Unaudited

|   | Nine Months<br>Ended<br>September 30,<br>2016 | Nine Months<br>Ended<br>September 30,<br>2015 |
|---|---|---|
| Net cash provided by operating activities                   | \$ 121,443                                    | \$ 140,018                                    |
| Cash flows from investing activities:                       |   |   |
| Sale of investment securities                               | 81,235  | 161,029                                       |
| Maturities of investment securities                         | 4,343   | 2,653   |
| Purchase of investment securities                           | (90,106)                                      | (162,845)                                     |
| Proceeds from sale or liquidation of long-term investments  | 1,000   | 1,288   |
| Purchase of long-term investments                           | (50)  | (10,000)                                      |
| Investments in real estate ventures                         | (23,358)                                      | (43,280)                                      |
| Distributions from investments in real estate ventures      | 23,041  | 11,205  |
| Increase in cash surrender value of life insurance policies | (451)   | (1,225)                                       |
| Decrease (increase) in restricted assets                    | 8,615   | (6,872)                                       |
| Issuance of notes receivable                                | —   | (4,410)                                       |
| Proceeds from sale of fixed assets                          | 45  | 3   |
| Capital expenditures  | (19,157)                                      | (7,859)                                       |
| Repayments of notes receivable                              | 4,410   | 4,000   |
| Pay downs of investment securities                          | 7,842   | 5,743   |
| Proceeds from sale of preferred securities                  | —   | 1,000   |
| Investments in real estate, net                             | (130)   | (12,512)                                      |
| Net cash used in investing activities                       | (2,721)                                       | (62,082)                                      |
| Cash flows from financing activities:                       |   |   |
| Proceeds from issuance of debt                              | 243,620                                       | 1,519   |
| Deferred financing costs                                    | (6,600)                                       | (624)   |
| Repayments of debt  | (4,698)                                       | (4,968)                                       |
| Borrowings under revolver                                   | 104,826                                       | 130,691                                       |
| Repayments on revolver                                      | (94,644)                                      | (146,655)                                     |
| Dividends and distributions on common stock                 | (147,270)                                     | (139,430)                                     |
| Contributions from non-controlling interest                 | 248   | —   |
| Distributions to non-controlling interest                   | (9,508)                                       | (564)   |
| Proceeds from exercise of Vector options                    | 398   | 1,321   |
| Tax benefit of options exercised                            | 412   | 756   |
| Net cash provided by (used in) financing activities         | 86,784  | (157,954)                                     |
| Net increase (decrease) in cash and cash equivalents        | 205,506                                       | (80,018)                                      |
| Cash and cash equivalents, beginning of period              | 240,368                                       | 326,365                                       |
| Cash and cash equivalents, end of period                    | \$ 445,874                                    | \$ 246,347                                    |

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

VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Basis of Presentation:

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

Liggett and Vector Tobacco are engaged in the manufacture and sale of cigarettes in the United States. Zoom is engaged in the sale of electronic cigarettes in the United States. New Valley is engaged in the real estate business.

The unaudited, interim condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“U.S. GAAP”) for interim financial information and, in management’s opinion, contain all adjustments, consisting only of normal recurring items, necessary for a fair statement of the results for the periods presented. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2015 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.

Revisions to December 31, 2015 Consolidated Balance Sheet. In April 2015, the Financial Accounting Standards Board (“FASB”) issued Accounting Standard Update (“ASU”) No. 2015-03, “Interest-Imputation of Interest”, which requires debt issuance costs to be reported in the balance sheet as a direct deduction from the face amount of the note. The guidance is effective for financial statements issued for fiscal years beginning after December 15, 2015. This amendment must be applied retrospectively to all periods presented. The Company adopted the provisions of this ASU retrospectively in the first quarter of 2016, and adjusted all prior periods accordingly. The adoption of this ASU will simplify the presentation of debt issuance costs and reduce complexity without decreasing the usefulness of information provided to users of financial statements.

VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

The cumulative impacts of the application of the new ASU are presented in the table below:

|   | December 31, 2015            |                 |             |
|---|------------------------------|-----------------|-------------|
|   | As<br>Previously<br>Reported | ASU<br>Adoption | As Revised  |
| Other assets  | \$51,261                     | \$(30,141)      | \$21,120    |
| Total assets  | \$1,310,756                  | \$(30,141)      | \$1,280,615 |
| Notes payable, long-term debt and other obligations, less current portion | \$886,249                    | \$(30,141)      | \$856,108   |
| Total liabilities   | 1,432,917                    | (30,141 )       | 1,402,776   |
| Total stockholders' deficiency  | (122,161 )                   | —               | (122,161 )  |
| Total liabilities and stockholders' deficiency                            | \$1,310,756                  | \$(30,141)      | \$1,280,615 |

Adoption of Equity Method. The Company adopted the equity method of accounting for its investments in Ladenburg Thalmann Financial Services Inc. (“LTS”) and Castle Brands Inc. (“Castle”) in 2015 because the Company determined that it had significant influence due to the evolution of the relationships with each company. In accordance with ASC 323-35-33, the Company has adjusted its condensed consolidated financial statements, retrospectively, on a step-by-step basis as if the equity method had been in effect since inception.

The cumulative impact of the retrospective application of the equity method of accounting for the two investments are presented in the table below:

## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

|   | Three Months Ended<br>September 30, 2015 |          |               | Nine Months Ended<br>September 30, 2015 |          |               |
|---|--|----------|---------------|---|----------|---------------|
|   | As<br>Previously<br>Reported             | Revision | As<br>Revised | As<br>Previously<br>Reported            | Revision | As<br>Revised |
| Operating, selling, administrative and general expenses     | \$79,114                                 | \$ 238   | \$79,352      | \$232,737                               | \$ 712   | \$233,449     |
| Operating income  | 69,605                                   | (238 )   | 69,367        | 169,600                                 | (712 )   | 168,888       |
| Equity in losses from investments                           | (579 )                                   | (524 )   | (1,103 )      | (2,273 )                                | (381 )   | (2,654 )      |
| Other, net  | 133                                      | 1,209    | 1,342         | 3,554                                   | 1,546    | 5,100         |
| Income before provision for income taxes                    | 29,357                                   | 447      | 29,804        | 94,321                                  | 453      | 94,774        |
| Income tax expense  | 13,508                                   | 186      | 13,694        | 37,551                                  | 188      | 37,739        |
| Net income  | 15,849                                   | 261      | 16,110        | 56,770                                  | 265      | 57,035        |
| Net income attributed to Vector Group Ltd.                  | 12,205                                   | 261      | 12,466        | 51,029                                  | 265      | 51,294        |
| Other comprehensive loss, net of tax                        | (23,890 )                                | (392 )   | (24,282 )     | (24,672 )                               | 5,599    | (19,073 )     |
| Comprehensive (loss) income                                 | (8,041 )                                 | (131 )   | (8,172 )      | 32,098                                  | 5,864    | 37,962        |
| Comprehensive (loss) income attributed to Vector Group Ltd. | \$(11,685)                               | \$(131 ) | \$(11,816)    | \$26,357                                | \$5,864  | \$32,221      |

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

The Company records distributions on its common stock as dividends in its condensed consolidated statement of stockholders' deficiency to the extent of retained earnings and accumulated paid-in capital. Any amounts exceeding retained earnings are recorded as a reduction to additional paid-in capital to the extent paid-in-capital is available. The Company's stock dividends are recorded as stock splits and given retroactive effect to earnings per share for all periods presented.

## (c) Revenue Recognition:

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

in revenues and cost of goods sold. 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 at the Company and industry levels, regulation, litigation and defense costs, increased tobacco costs or reductions in the selling price of cigarettes in the near term.

Real estate sales: Revenue is recognized only when persuasive evidence of an arrangement exists, the price is fixed or determinable, the transaction has been completed and collectibility of the resulting receivable is reasonably assured.

Real estate commissions earned by the Company's real estate brokerage businesses are recorded as revenue on a gross basis upon the closing of a real estate transaction as evidenced when the escrow or similar account is closed, the transaction documents have been recorded and funds are distributed to all appropriate parties. Commission expenses are recognized concurrently with related revenues.

VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

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Property management fees and rental commissions earned are recorded as revenue when the related services are performed and the earnings process is complete.

## (d) Earnings Per Share (“EPS”):

Information concerning the Company's common stock has been adjusted to give retroactive effect to the 5% stock dividend paid to Company stockholders on September 29, 2016. All per share amounts and references to share amounts have been updated to reflect the retrospective effect of the stock dividends.

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

|   | Three Months<br>Ended<br>September 30, |          | Nine Months<br>Ended<br>September 30, |          |
|---|--|----------|---------------------------------------|----------|
|   | 2016                                   | 2015     | 2016                                  | 2015     |
| Net income attributed to Vector Group Ltd.                            | \$23,175                               | \$12,466 | \$66,528                              | \$51,294 |
| Income attributed to participating securities                         | (750 )                                 | (367 )   | (2,167 )                              | (1,518 ) |
| Net income available to common shares attributed to Vector Group Ltd. | \$22,425                               | \$12,099 | \$64,361                              | \$49,776 |

Basic and diluted EPS were calculated using the following common shares:

|  | Three Months Ended<br>September 30, |             | Nine Months Ended<br>September 30, |             |
|--|-------------------------------------|-------------|------------------------------------|-------------|
|  | 2016                                | 2015        | 2016                               | 2015        |
| Weighted-average shares for basic EPS  | 124,066,347                         | 123,924,385 | 123,999,345                        | 123,543,001 |
| Plus incremental shares related to stock options and non-vested restricted stock | 211,903                             | 141,031     | 214,225                            | 183,852     |
| Weighted-average shares for diluted EPS  | 124,278,250                         | 124,065,416 | 124,213,570                        | 123,726,853 |

The following were outstanding during the three and nine months ended September 30, 2016 and 2015, but were not included in the computation of diluted EPS because the effect was anti-dilutive.

|  | Three Months<br>Ended<br>September 30, |            | Nine Months<br>Ended<br>September 30, |            |
|--|--|------------|---------------------------------------|------------|
|  | 2016                                   | 2015       | 2016                                  | 2015       |
| Weighted-average number of shares issuable upon conversion of debt | 26,140,270                             | 26,140,251 | 26,140,270                            | 26,140,251 |
| Weighted-average conversion price                                  | \$18.70                                | \$18.70    | \$18.70                               | \$18.60    |





VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

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

The Company has estimated the fair value of the embedded derivatives based principally on the results of a valuation model. A readily determinable fair value of the embedded derivatives is not available. The estimated fair value of the derivatives embedded within the convertible debt is based principally on the present value of future dividend payments expected to be received by the convertible debt holders over the term of the debt. The discount rate applied to the future cash flows is estimated based on a spread in the yield of the Company's debt when compared to risk-free securities with the same duration. The valuation model assumes future dividend payments by the Company and utilizes interest rates and credit spreads for secured to unsecured debt, unsecured to subordinated debt and subordinated debt to preferred stock to determine the fair value of the derivatives embedded within the convertible debt. At September 30, 2016, the range of estimated fair values of the Company's embedded derivatives was between \$119,621 and \$121,299. The Company recorded the fair value of its embedded derivatives at the approximate midpoint of the range at \$120,820 as of September 30, 2016. At December 31, 2015, the range of estimated fair values of the Company's embedded derivatives was between \$143,422 and \$144,660. The Company recorded the fair value of its embedded derivatives at the midpoint of the range at \$144,042 as of December 31, 2015. The estimated fair value of the Company's embedded derivatives could change significantly based on future market conditions. (See Note 6.)

(f) Investment in Real Estate Ventures:

The Company's investment in real estate ventures are subject to evaluation under ASU No. 2015-02, "Consolidation" which requires all legal entities to be evaluated as either a voting interest entity or a Variable Interest Entities ("VIE"). The guidance is effective for financial statements of public companies issued for fiscal years beginning after December 15, 2015. The Company has followed the decision tree set forth in ASC 810-10-05-6 in analyzing each of its investments in real estate ventures. The Company examines specific criteria and uses judgment when determining if the real estate venture is a VIE and then if the Company is the primary beneficiary of a VIE. Factors considered in the qualification of a VIE include sufficient equity investment at risk, disproportionate voting rights and substantially all of the activities are conducted on behalf of an investor with disproportionately few voting rights, and characteristics of a controlling financial interest.

Accounting guidance requires the Company to perform the VIE primary-beneficiary assessment for entities determined to be VIEs. The Company is required to consolidate all VIEs in which the Company is the primary beneficiary. The guidance requires consolidation of VIEs that a reporting entity has a controlling financial interest. A controlling financial interest will have both of the following characteristics: (a) the power to direct the activities of a VIE that most significantly affect the VIE's economic performance and (b) the obligation to absorb losses or the right to receive residual returns of the VIE that could potentially be significant to the VIE.

The Company's maximum exposure to loss in its investments in unconsolidated VIEs is limited to its investment in the unconsolidated VIEs which is the carrying value. The Company's maximum exposure to loss in its investment in its consolidated VIEs is limited to its investment which is the carrying value of the investment net of the non-controlling interest. Creditors of the consolidated VIEs have no recourse to the general credit of the primary beneficiary.

(g) Other, Net:

Other, net consisted of:

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|   | Three Months<br>Ended<br>September 30, |         | Nine Months<br>Ended<br>September 30, |         |
|---|--|---------|---------------------------------------|---------|
|   | 2016                                   | 2015    | 2016                                  | 2015    |
| Interest and dividend income                    | \$1,489                                | \$1,510 | \$4,265                               | \$5,045 |
| Gain on long-term investment                    | 190                                    | 137     | 190                                   | 361     |
| Provision for loss on real estate held for sale | —                                      | (229 )  | —                                     | (229 )  |
| Loss on sale of assets                          | —                                      | (75 )   | —                                     | (75 )   |
| Impairment of long-term investments             | —                                      | —       | (1,203 )                              | —       |
| Other expense                                   | (351 )                                 | (1 )    | (296 )                                | (2 )    |
| Other, net                                      | \$1,328                                | \$1,342 | \$2,956                               | \$5,100 |

## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

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## (h) Other Current Liabilities:

Other current liabilities consisted of:

|   | September 30, December 31, |            |
|---|----------------------------|------------|
|   | 2016                       | 2015       |
| Accounts payable                              | \$ 13,441                  | \$ 19,639  |
| Accrued promotional expenses                  | 16,763                     | 24,816     |
| Accrued excise and payroll taxes payable, net | 3,792                      | 26,556     |
| Accrued interest                              | 18,850                     | 28,147     |
| Commissions payable                           | 8,949                      | 11,008     |
| Accrued salary and benefits                   | 27,401                     | 22,774     |
| Other current liabilities                     | 24,669                     | 21,277     |
| Total other current liabilities               | \$ 113,865                 | \$ 154,217 |

(i) Goodwill and Other Intangible Assets,  
Net:

The components of “Goodwill and other intangible assets, net” were as follows:

|  | September 30, December 31, |            |
|--|----------------------------|------------|
|  | 2016                       | 2015       |
| Goodwill   | \$ 70,406                  | \$ 70,791  |
| Indefinite life intangibles:                           |                            |            |
| Intangible asset associated with benefit under the MSA | 107,511                    | 107,511    |
| Trademark - Douglas Elliman                            | 80,000                     | 80,000     |
| Intangibles with a finite life, net                    | 4,002                      | 5,657      |
| Total goodwill and other intangible assets, net        | \$ 261,919                 | \$ 263,959 |

## (j) Commitments:

Douglas Elliman Lease Extension. On March 31, 2016, Douglas Elliman extended the duration of an existing lease and entered into a sublease for additional space in New York. The agreement extended the lease term from 2018 to 2032. The new agreements increase the Company’s lease commitments by \$0 in 2016, \$1,164 in 2017, \$1,412 in 2018, \$3,733 in 2019, \$5,394 in 2020 and \$69,460 thereafter.

## (k) New Accounting Pronouncements:

In October 2016, the FASB issued ASU 2016-17, Interests Held through Related Parties That Are under Common Control (“ASU 2016-17”). ASU 2016-17 modifies existing guidance with respect to how a decision maker that holds an indirect interest in a VIE through a common control party determines whether it is the primary beneficiary of the VIE as part of the analysis of whether the VIE would need to be consolidated. Under ASU 2016-17, a decision maker

would need to consider only its proportionate indirect interest in the VIE held through a common control party. As a result of ASU 2016-17, in certain cases, previous consolidation conclusions may change. ASU 2016-17 is effective for the Company's fiscal year beginning January 1, 2017 with retrospective

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application to January 1, 2016. The Company is currently assessing the impact the adoption of ASU 2016-17 will have on the Company's condensed consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, Classification of Certain Cash Receipts and Cash Payments ("ASU 2016-15"). ASU 2016-15 is intended to reduce diversity in practice on how certain cash receipts and payments are presented and classified in the statement of cash flows. The standard provides guidance in a number of situations including, among others, settlement of zero-coupon bonds, contingent consideration payments made after a business combination, proceeds from the settlement of insurance claims, and distributions received from equity method investees. ASU 2016-15 also provides guidance for classifying cash receipts and payments that have aspects of more than one class of cash flows. ASU 2016-15 is effective for the Company's fiscal year beginning January 1, 2018. Early adoption is permitted. The standard requires application using a retrospective transition method. The Company is currently assessing the impact the adoption of ASU 2016-15 will have on the Company's condensed consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting ("ASU 2016-09"). ASU 2016-09 modifies U.S. GAAP by requiring the following, among others: (1) all excess tax benefits and tax deficiencies are to be recognized as income tax expense or benefit on the income statement (excess tax benefits are recognized regardless of whether the benefit reduces taxes payable in the current period); (2) excess tax benefits are to be classified along with other income tax cash flows as an operating activity in the statement of cash flows; (3) in the area of forfeitures, an entity can still follow the current U.S. GAAP practice of making an entity-wide accounting policy election to estimate the number of awards that are expected to vest or may instead account for forfeitures when they occur; and (4) classification as a financing activity in the statement of cash flows of cash paid by an employer to the taxing authorities when directly withholding shares for tax withholding purposes. ASU 2016-09 is effective for the Company's fiscal year beginning January 1, 2017, including interim periods. Early application is permitted. The Company is currently assessing the impact the adoption of ASU 2016-09 will have on the Company's condensed consolidated financial statements.

In March 2016, the FASB issued ASU 2016-08, Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net) ("ASU 2016-08"). ASU 2016-08 does not change the core principle of the guidance stated in ASU 2014-09, instead, the amendments in this ASU are intended to improve the operability and understandability of the implementation guidance on principal versus agent considerations and whether an entity reports revenue on a gross or net basis. ASU 2016-08 will have the same effective date and transition requirements as the new revenue standard issued in ASU 2014-09. The Company is currently evaluating the method and impact the adoption of ASU 2016-08 and ASU 2014-09 will have on the Company's condensed consolidated financial statements.

In March 2016, the FASB issued ASU 2016-07, Investments- Equity Method and Joint Ventures: Simplifying the Transition to the Equity Method of Accounting ("ASU 2016-07"). ASU 2016-07 eliminates the requirement to apply the equity method of accounting retrospectively when a reporting entity obtains significant influence over a previously held investment. ASU 2016-07 will be effective for the Company's fiscal year beginning January 1, 2017 and subsequent interim periods. The adoption of ASU 2016-07 is not expected to have a material effect on the Company's condensed consolidated financial statements.

In March 2016, the FASB issued ASU 2016-06, Derivatives and Hedging (Topic 815): Contingent Put and Call Options in Debt Instruments (a consensus of the Emerging Issues Task Force) ("ASU 2016-06"). ASU 2016-06 clarifies the requirement for assessing whether contingent call (put) options that can accelerate the payment of principal on debt instruments are clearly and closely related to their debt hosts. An entity performing the assessment under ASU 2016-06 is required to assess the embedded call (put) options solely in accordance with the four-step decision sequence. Consequently, when a call (put) option is contingently exercisable, an entity does not have to assess

whether the event that triggers the ability to exercise a call (put) option is related to interest rates or credit risks. The amendments in ASU 2016-06 are effective for the Company's fiscal year beginning January 1, 2017, including interim periods. The Company is currently evaluating the method and impact the adoption of ASU 2016-06 will have on the Company's condensed consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, Leases (“ASU 2016-02”), which provides guidance for accounting for leases. ASU 2016-02 requires lessees to classify leases as either finance or operating leases and to record a right-of-use asset and a lease liability for all leases with a term greater than 12 months regardless of the lease classification. The lease classification will determine whether the lease expense is recognized based on an effective interest rate method or on a straight line basis over the term of the lease. Accounting for lessors remains largely unchanged from current U.S. GAAP. ASU 2016-02 will be effective for the Company’s fiscal year beginning January 1, 2019 and subsequent interim periods. The Company is currently evaluating the impact the adoption of ASU 2016-02 will have on the Company's condensed consolidated financial statements.

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In January 2016, the FASB issued ASU 2016-01, Financial Instruments - Overall: Recognition and Measurement of Financial Assets and Financial Liabilities (“ASU 2016-01”). ASU 2016-01 modifies how entities measure equity investments and present changes in the fair value of financial liabilities. Under the new guidance, entities will have to measure equity investments that do not result in consolidation and are not accounted for under the equity method at fair value and recognize any changes in fair value in net income unless the investments qualify for the new practicality exception. A practicality exception will apply to those equity investments that do not have a readily determinable fair value and do not qualify for the practical expedient to estimate fair value under ASC 820, Fair Value Measurements, and as such these investments may be measured at cost. ASU 2016-01 will be effective for the Company’s fiscal year beginning January 1, 2018 and subsequent interim periods. The Company is currently evaluating the impact the adoption of ASU 2016-01 will have on the Company’s condensed consolidated financial statements.

In May 2014, FASB issued ASU 2014-9, Revenue from Contracts with Customers (Topic 606), (“ASU 2014-9”). ASU 2014-9 outlines a new, single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance. Under the new model, recognition of revenue occurs when a customer obtains control of promised goods or services in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In addition, the new standard requires that reporting companies disclose the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. As amended by ASU 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date the new standard is effective for annual reporting periods beginning after December 15, 2017, with early adoption permitted for annual reporting periods beginning subsequent to December 15, 2016. The new standard is required to be applied retrospectively to each prior reporting period presented or with the cumulative effect of initially applying it recognized at the date of initial application. The Company has not yet selected a transition method and it has not determined the impact of the new standard on the Company's condensed consolidated financial statements.

## 2. INVENTORIES

Inventories consist of:

|                             | September 30,<br>2016 | December 31,<br>2015 |
|-----------------------------|-----------------------|----------------------|
| Leaf tobacco                | \$ 45,564             | \$ 49,856            |
| Other raw materials         | 4,150                 | 3,578                |
| Work-in-process             | 422                   | 789                  |
| Finished goods              | 65,200                | 61,493               |
| E-Cigarettes                | 66                    | 80                   |
| Inventories at current cost | 115,402               | 115,796              |
| LIFO adjustments            | (27,780 )             | (29,280 )            |
|                             | \$ 87,622             | \$ 86,516            |

All of the Company's inventories at September 30, 2016 and December 31, 2015 are reported under the LIFO method. The \$27,780 LIFO adjustment as of September 30, 2016 decreases the current cost of inventories by \$18,363 for Leaf tobacco, \$643 for Other raw materials, \$33 for Work-in-process, \$8,736 for Finished goods and \$5 for E-Cigarettes. The \$29,280 LIFO adjustment as of December 31, 2015 decreased the current cost of inventories by \$19,863 for Leaf tobacco, \$643 for Other raw materials, \$33 for Work-in-Process, \$8,736 for Finished goods and \$5 for E-Cigarettes.



Liggett enters into purchase commitments with third party providers for leaf tobacco that will be used entirely for future production. The future quantities of leaf tobacco and prices are established at the date of the commitments. At September 30, 2016, Liggett had tobacco purchase commitments of approximately \$16,906. Liggett has a single source supply agreement for reduced ignition propensity cigarette paper through 2019.

Each period, the Company capitalizes in inventory that portion of its MSA liability that relates to cigarettes shipped to public warehouses but not sold. The amount of capitalized MSA cost in "Finished goods" inventory was \$16,428 and \$15,796 at September 30, 2016 and December 31, 2015, respectively. Federal excise tax in inventory was \$26,531 and \$23,455 at September 30, 2016 and December 31, 2015.

VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

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## 3. INVESTMENT SECURITIES AVAILABLE FOR SALE

The components of investment securities available for sale at September 30, 2016 were as follows:

|  | Cost      | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|--|-----------|------------------------------|-------------------------------|---------------|
| Marketable equity securities                     | \$38,113  | \$ 19,835                    | \$                            | —\$57,948     |
| Mutual funds invested in fixed income securities | 20,405    | 262                          | —                             | 20,667        |
| Marketable debt securities                       | 96,212    | 826                          | —                             | 97,038        |
| Total investment securities available for sale   | \$154,730 | \$ 20,923                    | \$                            | —\$175,653    |

The components of investment securities available for sale at December 31, 2015 were as follows:

|  | Cost      | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|--|-----------|------------------------------|-------------------------------|---------------|
| Marketable equity securities                     | \$47,502  | \$ 19,833                    | \$ (62 )                      | \$67,273      |
| Mutual funds invested in fixed income securities | 20,126    | —                            | (15 )                         | 20,111        |
| Marketable debt securities                       | 94,540    | 52                           | —                             | 94,592        |
| Total investment securities available for sale   | \$162,168 | \$ 19,885                    | \$ (77 )                      | \$181,976     |

The table below summarizes the maturity dates of marketable debt securities at September 30, 2016.

| Investment Type:                                   | Market<br>Value | Under 1<br>Year | 1 Year<br>up to 5<br>Years | More<br>than 5<br>Years |
|--|-----------------|-----------------|----------------------------|-------------------------|
| U.S. Government securities                         | \$30,985        | \$—             | \$30,985                   | \$—                     |
| Corporate securities                               | 35,669          | 3,366           | 31,871                     | 432                     |
| U.S. mortgage-backed securities                    | 8,293           | —               | 819                        | 7,474                   |
| Commercial mortgage-backed securities              | 1,776           | —               | —                          | 1,776                   |
| U.S. asset-backed securities                       | 891             | —               | 891                        | —                       |
| Commercial paper                                   | 19,424          | 19,424          | —                          | —                       |
| Total marketable debt securities by maturity dates | \$97,038        | \$22,790        | \$64,566                   | \$9,682                 |

## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

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The available-for-sale investment securities with continuous unrealized losses for less than 12 months and 12 months or greater and their related fair values were as follows:

|  | In loss position for   |                      |               |                      | Total<br>Fair<br>Value | Total<br>Unrealized<br>Losses |
|--|------------------------|----------------------|---------------|----------------------|------------------------|-------------------------------|
|  | Less than 12<br>months | 12 months or<br>more | Fair<br>Value | Unrealized<br>Losses |                        |                               |
| December 31, 2015                                |                        |                      |               |                      |                        |                               |
| Marketable equity securities                     | \$5,938                | \$ (62 )             | \$ —          | —                    | \$5,938                | \$ (62 )                      |
| Mutual funds invested in fixed income securities | 10,053                 | (15 )                | —             | —                    | 10,053                 | (15 )                         |
|  | \$15,991               | \$ (77 )             | \$ —          | —                    | \$15,991               | \$ (77 )                      |

Unrealized losses from mutual funds invested in fixed-income securities are primarily attributable to changes in interest rates. Unrealized losses from equity securities are due to market price movements. The Company believes the unrealized losses associated with the Company's equity securities will be recovered in the future.

Gross realized gains and losses on available-for-sale investment securities were as follows:

|  | Three Months<br>Ended |                       | Nine Months Ended     |                       |
|--|-----------------------|-----------------------|-----------------------|-----------------------|
|  | September 30,<br>2016 | September 30,<br>2015 | September 30,<br>2016 | September 30,<br>2015 |
| Gross realized gains on sales                                      | \$224                 | \$129                 | \$1,157               | \$13,601              |
| Gross realized losses on sales                                     | (82 )                 | (950 )                | (309 )                | (1,583 )              |
| Gains (losses) on sale of investment securities available for sale | \$142                 | \$(821 )              | \$848                 | \$12,018              |
| Gross realized losses on other-than-temporary impairments          | \$(54 )               | \$(12,211)            | \$(4,916)             | \$(12,211)            |

The Company recorded an "Other-than-temporary impairment" charge of \$54 and \$4,916 during the three and nine months ended September 30, 2016. The Company recorded an "Other-than-temporary impairment" charge of \$12,211 during the three and nine months ended September 30, 2015. The largest component of the charge for the nine months ended September 30, 2016 and 2015 was \$4,772 and \$6,895, respectively, related to an investment in the common stock of Morgans Hotel Group Co., a company where Vector's President and Chief Executive Officer also serves as Chairman of the Board of Directors.

Although management generally does not have the intent to sell any specific securities at the end of the period, in the ordinary course of managing the Company's investment securities portfolio, management may sell securities prior to their maturities for a variety of reasons, including diversification, credit quality, yield and liquidity requirements. Proceeds from investment securities sales totaled \$81,235 and \$161,029 and proceeds from early redemptions by issuers totaled \$12,185 and \$8,396 in the nine months ended September 30, 2016 and 2015, respectively, mainly from sales of Corporate securities and U.S. Government securities.



VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

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## 4. LONG-TERM INVESTMENTS

Long-term investments consisted of the following:

|   | September<br>30, 2016 | December<br>31, 2015 |
|---|-----------------------|----------------------|
| Investments accounted at cost                     | \$ 35,476             | \$ 41,231            |
| Investments accounted for under the equity method | 18,529                | 21,495               |
|   | \$ 54,005             | \$ 62,726            |

## (a) Cost-Method Investments:

Long-term investments accounted at cost consisted of the following:

|                         | September 30,<br>2016 |               | December 31,<br>2015 |               |
|-------------------------|-----------------------|---------------|----------------------|---------------|
|                         | Carrying<br>Value     | Fair<br>Value | Carrying<br>Value    | Fair<br>Value |
| Investment partnerships | \$34,975              | \$39,300      | \$40,730             | \$44,217      |
| Real estate partnership | 501                   | 511           | 501                  | 552           |
|                         | \$35,476              | \$39,811      | \$41,231             | \$44,769      |

The principal business of the 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. 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 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.

If it is determined that an other-than-temporary decline in fair value exists in long-term investments, the Company records an impairment charge with respect to such investment in its consolidated statements of operations. The Company will continue to perform additional assessments to determine the impact, if any, on the Company's condensed consolidated financial statements. Thus, future impairment charges may occur.

The Company has accounted for these investments using the cost method of accounting because the investments did not meet the requirements for equity method accounting.

The Company received cash distributions of \$1,000 and \$543 from the Company's investments in long-term investments under the cost method for the nine months ended September 30, 2016 and 2015, respectively. The Company invested \$10,000 in a reinsurance company and three investment funds during the nine months ended September 30, 2015.

The long-term investments are carried on the consolidated balance sheet at cost. The fair value determination disclosed above

would be classified as Level 3 under fair value hierarchy disclosed in Note 11 if such assets were recorded on the consolidated balance sheet at fair value. The fair value determinations disclosed above were based on company assumptions, and information obtained from the partnerships based on the indicated market values of the underlying

assets of the investment portfolio.

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VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

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## (b) Equity-Method Investments:

Long-term investments accounted for under the equity method consisted of the following:

|  | September 30,<br>2016 | December 31,<br>2015 |
|--|-----------------------|----------------------|
| Indian Creek Investors LP                  | \$ 5,004              | \$ 4,989             |
| Boyar Value Fund                           | 7,368                 | 7,302                |
| Ladenburg Thalmann Financial Services Inc. | 6,157                 | 9,204                |
| Castle Brands, Inc.                        | —                     | —                    |
|  | \$ 18,529             | \$ 21,495            |

The Company's investments accounted for under the equity method include the following: Indian Creek Investors LP (“Indian Creek”), Boyar Value Fund (“Boyar”), LTS and Castle. At September 30, 2016, the Company's ownership percentages in Indian Creek, Boyar, LTS and Castle were 20.07%, 31.18%, 7.75% and 7.89%, respectively. The Company accounted for its Indian Creek and Boyar interests as equity-method investments because the Company's ownership percentage meets the threshold for equity-method accounting. The Company accounted for its LTS and Castle interests as equity-method investments because, in accordance with U.S. GAAP, the Company has the ability to exercise significant influence over their operating and financial policies.

The principal business of Indian Creek is investing in investment securities. Fair value approximates carrying value. The estimated fair value of the investment partnership was provided by the partnership based on the indicated market values of the underlying assets or investment portfolio. The investment in the investment partnership is illiquid and the ultimate realization of the investment is subject to the performance of the underlying partnership and its management by the general partners.

The Company's investments under the equity method include an investment in Boyar. The value of the investment based on the quoted market price as of September 30, 2016 was \$7,368, equal to its carrying value. Ladenburg Thalmann Fund Management, LLC, an indirect subsidiary of LTS, is the manager of Boyar.

At September 30, 2016, the aggregate values of the LTS and Castle investments based on the quoted market price were \$32,781 and \$11,024, respectively.

The Company received cash distributions of \$834 and \$2,052 from the Company's investments in long-term investments under the equity method for the nine months ended September 30, 2016 and 2015, respectively. The Company recognized equity in losses from investments under the equity method of \$1,526 and \$2,108 for the three and nine months ended September 30, 2016, respectively. The Company recognized equity in losses from investments under the equity method of \$1,103 and \$2,654 for the three and nine months ended September 30, 2015, respectively. The Company has suspended its recognition of equity in losses from Castle to the extent such losses exceed its basis. If it is determined that an other-than-temporary decline in fair value exists in long-term investments, the Company records an impairment charge with respect to such investment in its consolidated statements of operations. The Company will continue to perform additional assessments to determine the impact, if any, on the Company's condensed consolidated financial statements. Thus, future impairment charges may occur.

5. NEW VALLEY LLC

Residential Brokerage Business. New Valley is engaged in the real estate business and is seeking to acquire or invest in additional real estate properties or projects. The Company owns a 70.59% interest in Douglas Elliman and the condensed consolidated financial statements of the Company include the account balances of Douglas Elliman.

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## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

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

|  | September 30, December 31, |            |
|--|----------------------------|------------|
|  | 2016                       | 2015       |
| 10 Madison Square Park (1107 Broadway)         | \$ 1,596                   | \$ 11,391  |
| The Marquand (11 East 68th Street)             | 9,310                      | 13,900     |
| 11 Beach Street                                | 13,989                     | 13,209     |
| 20 Times Square (701 Seventh Avenue)           | 19,886                     | 14,985     |
| 111 Murray Street                              | 25,176                     | 25,567     |
| 160 Leroy Street                               | 4,547                      | 3,952      |
| 215 Chrystie Street                            | 5,856                      | 5,592      |
| The Dutch (25-19 43rd Avenue)                  | 1,157                      | 1,077      |
| 1 QPS Tower (23-10 Queens Plaza South)         | 17,224                     | 16,177     |
| 87 Park (8701 Collins Avenue)                  | 11,313                     | 8,658      |
| 125 Greenwich Street                           | 9,865                      | 9,750      |
| West Hollywood Edition (9040 Sunset Boulevard) | 13,549                     | 10,510     |
| 76 Eleventh Avenue                             | 19,379                     | 17,967     |
| Monad Terrace                                  | 7,924                      | 6,608      |
| Takanasee                                      | 5,169                      | 4,680      |
| Condominium and Mixed Use Development          | 165,940                    | 164,023    |
| Maryland Portfolio                             | —                          | —          |
| ST Portfolio                                   | 9,122                      | 15,754     |
| Apartment Buildings                            | 9,122                      | 15,754     |
| Park Lane Hotel                                | 20,620                     | 19,697     |
| Hotel Taiwana                                  | 7,322                      | 7,069      |
| Coral Beach and Tennis Club                    | 3,401                      | 3,159      |
| Hotels   | 31,343                     | 29,925     |
| The Plaza at Harmon Meadow                     | 3,461                      | 5,449      |
| Commercial                                     | 3,461                      | 5,449      |
| Other  | 1,959                      | 2,017      |
| Investments in real estate ventures            | \$ 211,825                 | \$ 217,168 |

## Condominium and Mixed-Use Development:

Condominium and mixed-use development investments range in ownership percentage from 3.1% to 49.5%. New Valley recorded net equity in earnings from real estate ventures of \$1,568 and \$3,347 for the three and nine months ended September 30, 2016 from its condominium and mixed-used developments. For the three months ended September 30, 2016 equity in earnings from real estate related to \$2,410 in equity earnings from New Valley's proportionate share of the sale of condominium units at 10 Madison Square Park offset by equity in losses of \$842 from the other condominiums and mixed-use development projects. For the nine months ended September 30, 2016

equity in earnings from real estate was related to \$6,621 in equity earnings from New Valley's proportionate share of the sale of condominium units at 10 Madison Square Park offset by equity losses of \$986 at

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VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

the Marquand, \$243 at 11 Beach Street, \$378 at 111 Murray Street, \$176 at 215 Chrystie Street, \$175 at 1 QPS Tower, \$347 at 87 Park, \$435 at West Hollywood Edition, \$465 at Monad Terrace and \$69 equity in losses from other condominiums and mixed-use development projects. New Valley recorded equity in earnings from real estate ventures of \$248 and \$923 for the three and nine months ended September 30, 2015. The Company recorded \$1,900 of equity in earnings related to its proportionate share of the Marquand's equity earnings from the sale of five of its units, \$236 of equity in earnings from Chelsea Eleven for a distribution of excess amounts held back in 2012 for final expenses of the investment and \$20 equity in earnings from other condominium and mixed-use development projects offset by losses of \$78 at 10 Madison Square Park, \$400 at 11 Beach Street, \$490 at 87 Park and \$265 at 125 Greenwich Street for the nine months ended September 30, 2015.

In July 2016, New Valley entered into a newly created joint venture related to the 20 Times Square project. The joint venture is a variable interest entity, however, New Valley is not the primary beneficiary. New Valley accounts for its interest in the joint venture under the equity method of accounting and has combined this investment with the existing 20 Times Square venture carrying balance.

In August 2016, New Valley entered into a newly created joint venture related to the 87 Park project. The joint venture is a variable interest entity, however, New Valley is not the primary beneficiary. New Valley accounts for its interest in the joint venture under the equity method of accounting and has combined this investment with the existing 87 Park venture carrying balance.

During the nine months ended September 30, 2016, New Valley made capital contributions totaling \$20,353 related to ventures where New Valley previously held an investment, primarily at 20 Times Square, 160 Leroy Street, West Hollywood Edition, 87 Park, Takanasee and Monad Terrace. During the nine months ended September 30, 2016, New Valley did not make certain capital contributions to Monad Terrace. This resulted in a change in ownership percentage from 31.3% to 24.3%. For other ventures where New Valley previously held an investment, New Valley contributed its proportionate share of additional capital along with contributions by the other investment partners. New Valley's direct investment percentage for these ventures did not change. During the nine months ended September 30, 2015, New Valley made capital contributions totaling \$35,776 primarily related to 10 Madison Square West, 1 QPS Tower, 125 Greenwich Street, 76 Eleventh Avenue and Monad Terrace. New Valley contributed its proportionate share of additional capital along with contributions by the other investment partners. New Valley's investment percentages did not change.

During the nine months ended September 30, 2016, New Valley received distributions of \$29,894 related to 10 Madison Square West, the Marquand, West Hollywood Edition, 111 Murray Street and income from marketing fees paid by 125 Greenwich Street. During the nine months ended September 30, 2015, New Valley received distributions of \$11,441 from a return of capital from 111 Murray Street and its investment in Chelsea Eleven, which sold its last unit in 2012, for excess amounts held back in 2012 for final expenses of the investment.

New Valley's maximum exposure to loss, net of non-controlling interest, as a result of its investments in condominium and mixed-use developments was \$143,899 at September 30, 2016.

New Valley capitalized \$8,111 of interest expense into the carrying value of its ventures whose projects were currently under development during the nine months ended September 30, 2016.

Douglas Elliman has been engaged by the developers as the sole broker or the co-broker for several of the real estate development projects that New Valley owns an interest in through its joint venture investments. Douglas Elliman had gross commissions of approximately \$5,118 and \$13,197 for the three and nine months ended September 30, 2016 from these projects.



## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

**Apartment Buildings:**

Apartment building investments range in ownership percentage from 7.6% to 16.3%. New Valley recorded equity in earnings from real estate ventures of \$43 and \$2,189 for the three and nine months ended September 30, 2016, related to the ST Portfolio and Maryland Portfolio. In the fourth quarter of 2015, ST Portfolio sold one (Highgrove) of its two remaining Class A multi-family buildings. New Valley recorded equity in losses from real estate ventures of \$72 and equity in earnings of \$1,730 for the three and nine months ended September 30, 2015, related to the ST Portfolio. In the second quarter of 2015, ST Portfolio sold one (Phoenix) of its three remaining Class A multi-family buildings. New Valley received distributions of \$8,821 during the nine months ended September 30, 2016, related to ST Portfolio and Maryland Portfolio. New Valley received distributions of \$1,989 during the nine months ended September 30, 2015, primarily related to the Maryland Portfolio. New Valley has suspended its recognition of equity losses in Maryland Portfolio to the extent such losses exceed its basis. New Valley's maximum exposure to loss as a result of its investment in apartment buildings was \$9,122 at September 30, 2016.

**Hotels:**

Hotel investments range in ownership percentage from 5.2% to 49.0%. New Valley recorded equity in losses from real estate ventures of \$743 and \$1,587 for the three and nine months ended September 30, 2016, related to hotel operations. New Valley recorded equity in losses from real estate ventures of \$1,323 and \$2,330 for the three and nine months ended September 30, 2015. New Valley made capital contributions totaling \$3,005 for the nine months ended September 30, 2016, related to the Park Lane Hotel and Coral Beach and Tennis Club. New Valley made capital contributions totaling \$2,277 for the nine months ended September 30, 2015, related to the Park Lane Hotel and Coral Beach and Tennis Club. New Valley's maximum exposure to loss as a result of its investments in hotels was \$31,343 at September 30, 2016.

**Commercial:**

New Valley recorded equity in losses from real estate ventures of \$81 and \$1,613 for the three and nine months ended September 30, 2016, related to shopping center rental operations. New Valley recorded equity in earnings from real estate ventures of \$20 and \$47 for the three and nine months ended September 30, 2015, related to shopping center rental operations. New Valley received distributions totaling \$375 for the nine months ended September 30, 2016, related to Harmon Meadow. New Valley received distributions of \$340 for the nine months ended September 30, 2015, related to Harmon Meadow. New Valley's maximum exposure to loss as a result of its investments in commercial ventures was \$3,461 at September 30, 2016.

**Other:**

Other investments in real estate ventures relate to a 50% investment in an insurance consulting company owned by Douglas Elliman.

**Investments in Real Estate, net:**

The components of "Investments in real estate, net" were as follows:

|                                 | September 30,<br>2016 | December 31,<br>2015 |
|---------------------------------|-----------------------|----------------------|
| Escena, net                     | \$ 10,897             | \$ 10,716            |
| Sagaponack                      | 12,733                | 12,602               |
| Investments in real estate, net | \$ 23,630             | \$ 23,318            |

Escena. The assets of “Escena, net” were as follows:

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## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

|                                    | September 30,<br>2016 | December 31,<br>2015 |
|------------------------------------|-----------------------|----------------------|
| Land and land improvements         | \$ 8,908              | \$ 8,907             |
| Building and building improvements | 1,878                 | 1,875                |
| Other                              | 2,028                 | 1,923                |
|                                    | 12,814                | 12,705               |
| Less accumulated depreciation      | (1,917 )              | (1,989 )             |
|                                    | \$ 10,897             | \$ 10,716            |

New Valley recorded operating losses of \$803 and \$779 for the three months ended September 30, 2016 and 2015, respectively, from Escena. New Valley recorded operating losses of \$594 and \$227 for the nine months ended September 30, 2016 and 2015, respectively, from Escena.

Investment in Sagaponack. In April 2015, New Valley invested \$12,502 in a residential real estate project located in Sagaponack, NY. The project is wholly owned and the balances of the project are included in the condensed consolidated financial statements of the Company. As of September 30, 2016, the assets of Sagaponack consisted of land and land improvements of \$12,733.

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

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

|  | September 30,<br>2016 | December 31,<br>2015 |
|--|-----------------------|----------------------|
| Vector:  |                       |                      |
| 7.75% Senior Secured Notes due 2021, including premium of \$14,675 and \$8,014                                       | \$ 849,675            | \$ 608,014           |
| 7.5% Variable Interest Senior Convertible Notes due 2019, net of unamortized discount of \$115,479 and \$132,119*    | 114,521               | 97,881               |
| 5.5% Variable Interest Senior Convertible Debentures due 2020, net of unamortized discount of \$75,153 and \$86,136* | 183,597               | 172,614              |
| Liggett:   |                       |                      |
| Revolving credit facility  | 13,591                | 3,213                |
| Term loan under credit facility  | 3,073                 | 3,269                |
| Equipment loans  | 5,136                 | 9,716                |
| Other  | 641                   | 461                  |
| Notes payable, long-term debt and other obligations  | 1,170,234             | 895,168              |
| Less:  |                       |                      |
| Debt issuance costs  | (32,521 )             | (30,141 )            |
| Total notes payable, long-term debt and other obligations  | 1,137,713             | 865,027              |
| Less:  |                       |                      |
| Current maturities   | (16,280 )             | (8,919 )             |
| Amount due after one year  | \$ 1,121,433          | \$ 856,108           |

\* The fair value of the derivatives embedded within the 7.5% Variable Interest Senior Convertible Notes (\$57,901 at September 30, 2016 and \$72,083 at December 31, 2015, respectively) and the 5.5% Variable Interest Senior Convertible Debentures (\$62,919 at September 30, 2016 and \$71,959 at December 31, 2015, respectively), is separately classified as a derivative liability in the condensed consolidated balance sheets.



VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

7.75% Senior Secured Notes due 2021 - Vector:

The Company has outstanding \$835,000 principal amount of its 7.75% Senior Secured Notes due 2021 that are guaranteed subject to certain customary automatic release provisions on a joint and several basis by all of the 100% owned domestic subsidiaries of the Company that are engaged in the conduct of its tobacco businesses.

The indenture contains covenants that restrict the payment of dividends by the Company if the Company's consolidated earnings before interest, taxes, depreciation and amortization ("Consolidated EBITDA"), as defined in the indenture, for the most recently ended four full quarters is less than \$75,000. The indenture also restricts the incurrence of debt if the Company's Leverage Ratio and its Secured Leverage Ratio, as defined in the indenture, exceed 3.0 and 1.5, respectively. The Company's Leverage Ratio is defined in the indenture as the ratio of the Company's and the guaranteeing subsidiaries' total debt less the fair market value of the Company's cash, investments in marketable securities and long-term investments to Consolidated EBITDA, as defined in the indenture. The Company's Secured Leverage Ratio is defined in the indenture in the same manner as the Leverage Ratio, except that secured indebtedness is substituted for indebtedness.

At September 30, 2016, management believed that the Company was in compliance with all covenants under the indentures of the 7.75% Senior Secured Notes due 2021.

On May 9, 2016, the Company completed the sale of an additional \$235,000 principal amount of its 7.75% Senior Secured Notes due 2021 for a price of 103.50% in a private offering to qualified institutional investors in accordance with Rule 144A of the Securities Act of 1933 (the "Securities Act"). The Company received net proceeds of approximately \$236,900 after deducting underwriting discounts, commissions, fees and offering expenses. The net proceeds will be used for general corporate purposes, including for additional investments in real estate and in the Company's cigarette business. The Company will amortize the deferred costs and debt premium related to the additional Senior Secured Notes over the estimated remaining life of the debt.

In August 2016, the Company completed an offer to exchange the 7.75% Senior Secured Notes issued in May 2016 for an equal amount of newly issued 7.75% Senior Secured Notes due 2021. The new 7.75% Senior Secured Notes have substantially the same terms as the original notes, except that the new 7.75% Senior Secured Notes have been registered under the Securities Act.

6.75% Variable Interest Senior Convertible Note due 2015 - Vector:

On February 3, 2015, the holder of the 6.75% Variable Interest Senior Convertible Note due 2015, converted the remaining \$25,000 principal balance of the \$50,000 Note into 2,455,877 of the Company's common shares. The debt conversion resulted in a reduction of debt and an increase to equity in the amount of \$25,000.

Share Lending Agreement

In connection with the offering of its 2019 Convertible Notes in November 2012, the Company lent Jefferies & Company ("Jefferies"), the underwriter for the offering, shares of the Company's common stock under the Share Lending Agreement. 3,715,802 shares were outstanding as of December 31, 2015. Jefferies is entitled to offer and sell such shares and use the sale to facilitate the establishment of a hedge position by investors in the notes and will receive all proceeds from the common stock offerings and lending transactions under the Share Lending Agreement. The Company received a nominal lending fee of \$0.10 per share for each share of common stock that the Company lent pursuant to the Share Lending Agreement.

The Share Lending Agreement requires that the shares borrowed be returned upon the maturity of the related debt, January 2019, or earlier, including the redemption of the notes or the conversion of the notes to shares of common stock pursuant to the terms of the indenture governing the notes. Borrowed shares are issued and outstanding for corporate law purposes and, accordingly, the holders of the borrowed shares will have all of the rights of a holder of the Company's outstanding shares. However, because the share borrower must return to the Company all borrowed shares (or identical shares), the borrowed shares are not considered outstanding for purposes of computing and reporting the Company's earnings per share in accordance with U.S. GAAP. Jefferies agreed to pay to the Company an amount equal to any dividends or other distributions that the Company pays on the borrowed shares.

The Company received a nominal fee for the loaned shares and determined the fair value of the Share Lending Agreement was \$3,204 at the date of issuance based on the present value of the future cash flows attributed to an estimated reduction in stated interest due to the presence of the Share Lending Agreement. The \$3,204 fair value was recognized as a debt financing charge and amortized to interest expense over the term of the notes. In September 2016, 2,135,923 shares were returned but no cash was

## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

exchanged. As of September 30, 2016, 1,579,879 shares were outstanding on the Share Lending Agreement and had a fair value of \$34,015. The issuance costs associated with the Share Lending Agreement were presented on the balance sheet as a direct deduction from the face amount of the related debt. The unamortized amount of these issuance costs was \$2,278 and \$2,607 at September 30, 2016 and December 31, 2015, respectively.

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

As of September 30, 2016, a total of \$16,664 was outstanding under the revolving and term loan portions of the credit facility. Availability, as determined under the facility, was approximately \$40,200 based on eligible collateral at September 30, 2016.

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

The conversion rates for all convertible debt outstanding as of September 30, 2016 and December 31, 2015, are summarized below:

|   | September 30,<br>2016 |                          | December 31,<br>2015 |                          |
|---|-----------------------|--------------------------|----------------------|--------------------------|
|   | Conversion<br>Price   | Shares<br>per<br>\$1,000 | Conversion<br>Price  | Shares<br>per<br>\$1,000 |
| 7.5% Variable Interest Senior Convertible Notes due 2019      | \$15.22               | 65.7030                  | \$15.22              | 65.7030                  |
| 5.5% Variable Interest Senior Convertible Debentures due 2020 | \$23.46               | 42.6185                  | \$23.46              | 42.6185                  |

## Non-Cash Interest Expense - Vector:

|                                     | Three Months<br>Ended<br>September 30,<br>2016 |         | Nine Months<br>Ended<br>September 30,<br>2015 |          |
|-------------------------------------|--|---------|---|----------|
| Amortization of debt discount, net  | \$9,450  | \$6,868 | \$26,059                                      | \$18,708 |
| Amortization of debt issuance costs | 1,650  | 1,085   | 4,220   | 3,073    |
|                                     | \$11,100                                       | \$7,953 | \$30,279                                      | \$21,781 |

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

|                                  | September 30, 2016         |               | December 31, 2015        |               |
|----------------------------------|----------------------------|---------------|--------------------------|---------------|
|                                  | Carrying<br>Value          | Fair<br>Value | Carrying<br>Value        | Fair<br>Value |
| Notes payable and long-term debt | \$1,170,234 <sup>(1)</sup> | \$1,538,419   | \$895,168 <sup>(1)</sup> | \$1,297,875   |

<sup>(1)</sup> The carrying value does not include the carrying value of the embedded derivative. See Note 11.

Notes payable and long-term debt are carried on the condensed consolidated balance sheet at amortized cost. The fair value determinations disclosed above are classified as Level 2 under the fair value hierarchy disclosed in Note 11 if such liabilities were recorded on the condensed consolidated balance sheet at fair value. The estimated fair value of the Company's notes payable and long-term debt has been determined by the Company using available market information and appropriate valuation methodologies including the evaluation of the Company's credit risk as described in the Company's Form 10-K. The Company used a derived price based upon quoted market prices and trade activity as of September 30, 2016 to determine the fair value of its publicly-traded notes and debentures. The carrying value of the revolving credit facility and term loan is equal to the fair value. The fair value of the equipment loans and other obligations was determined by calculating the present value of the required future cash flows.

VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

However, considerable judgment is required to develop the estimates of fair value and, accordingly, the estimate presented herein is not necessarily indicative of the amount that could be realized in a current market exchange.

## 7. CONTINGENCIES

### Tobacco-Related Litigation:

Overview. Since 1954, Liggett and other United States cigarette manufacturers have been named as defendants in numerous direct, third-party and purported class actions predicated on the theory that cigarette manufacturers should be liable for damages alleged to have been caused by cigarette smoking or by exposure to secondary smoke from cigarettes. The cases have generally fallen into the following categories: (i) smoking and health cases alleging personal injury brought on behalf of individual plaintiffs (“Individual Actions”); (ii) lawsuits by individuals requesting the benefit of the Engle ruling (“Engle progeny cases”); (iii) smoking and health cases primarily alleging personal injury or seeking court-supervised programs for ongoing medical monitoring, as well as cases alleging that use of the terms “lights” and/or “ultra lights” constitutes a deceptive and unfair trade practice, common law fraud or violation of federal law, purporting to be brought on behalf of a class of individual plaintiffs (“Class Actions”); and (iv) health care cost recovery actions brought by various foreign and domestic governmental plaintiffs and non-governmental plaintiffs seeking reimbursement for health care expenditures allegedly caused by cigarette smoking and/or disgorgement of profits (“Health Care Cost Recovery Actions”). The future financial impact of the risks and expenses of litigation are not quantifiable. For the three months ended September 30, 2016 and 2015, Liggett incurred tobacco product liability legal expenses and costs totaling \$1,500 and \$5,355, respectively. For the nine months ended September 30, 2016 and 2015, Liggett incurred tobacco product liability legal expenses and costs totaling \$7,378 and \$11,068, respectively. The tobacco product liability legal expenses and costs are included in the operating, selling, administrative and general expenses and litigation settlement and judgment expense line items in the Condensed Consolidated Statements of Operations.

Litigation is subject to uncertainty and it is possible that there could be adverse developments in pending cases. With the commencement of new cases, the defense costs and the risks relating to the unpredictability of litigation increase. Management reviews on a quarterly basis with counsel all pending litigation and evaluates the probability of a loss being incurred and whether an estimate can be made of the possible loss or range of loss that could result from an unfavorable outcome. An unfavorable outcome or settlement of pending tobacco-related litigation could encourage the commencement of additional litigation. Damages awarded in tobacco-related litigation can be significant.

Bonds. Although Liggett has been able to obtain required bonds or relief from bonding requirements in order to prevent plaintiffs from seeking to collect judgments while adverse verdicts are on appeal, there remains a risk that such relief may not be obtainable in all cases. This risk has been reduced given that a majority of states now limit the dollar amount of bonds or require no bond at all. To obtain stays on judgments pending current appeals of the Putney, Calloway, Boatright and Ward cases Liggett, as of September 30, 2016, had secured \$5,258 in bonds.

In June 2009, Florida amended its existing bond cap statute by adding a \$200,000 bond cap that applies to all Engle progeny cases in the aggregate and establishes individual bond caps for individual Engle progeny cases in amounts that vary depending on the number of judgments in effect at a given time. The maximum amount of any such bond for an appeal in the Florida state courts will be no greater than \$5,000. In several cases, plaintiffs challenged the constitutionality of the bond cap statute, but to date the courts have upheld the constitutionality of the statute. It is possible that the Company’s consolidated financial position, results of operations, and cash flows could be materially adversely affected by an unfavorable outcome of such challenges.

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

Cautionary Statement About Engle Progeny Cases. Judgments have been entered against Liggett and other industry defendants in more than 100 Engle progeny cases. A number of the judgments have been affirmed on appeal and satisfied by the defendants. Many have been overturned on appeal. As of September 30, 2016, 24 Engle progeny cases where Liggett was a defendant at trial resulted in verdicts. Fifteen verdicts were returned in favor of the plaintiffs (although in two of these cases

## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

(Irimi and Cohen) the court granted defendants' motion for a new trial) and nine in favor of Liggett. In four of the cases, punitive damages were awarded against Liggett (although in Calloway, both the punitive and compensatory damages award were reversed and the case was remanded to the trial court for a new trial). In certain cases, the judgments were entered jointly and severally with other defendants and Liggett may face the risk that one or more co-defendants decline or otherwise fail to participate in the bonding required for an appeal or to pay their proportionate or jury-allocated share of a judgment. As a result, under certain circumstances, Liggett may have to pay more than its proportionate share of any bonding or judgment related amounts. Several of the judgments against Liggett remain on appeal. Except as discussed in this Note 7 regarding the cases where an adverse verdict against Liggett remains on appeal, management is unable to estimate the possible loss or range of loss from the remaining Engle progeny cases as there are currently multiple defendants in each case and, in most cases, discovery has not occurred or is limited. As a result, the Company lacks information about whether plaintiffs are in fact Engle class members (non-class members' claims are generally time-barred), the relevant smoking history, the nature of the alleged injury and the availability of various defenses, among other things. Further, plaintiffs typically do not specify their demand for damages.

Although Liggett has generally been successful in managing litigation, litigation is subject to uncertainty and significant challenges remain, including with respect to the remaining Engle progeny cases. There can be no assurances that Liggett's past litigation experience will be representative of future results. Judgments have been entered against Liggett in the past, in Individual Actions and Engle progeny cases, and several of those judgments were affirmed on appeal and satisfied by Liggett. It is possible that the consolidated financial position, results of operations and cash flows of the Company could be materially adversely affected by an unfavorable outcome or settlement of any of the remaining smoking-related litigation. Liggett believes, and has been so advised by counsel, that it has valid defenses to the litigation pending against it, as well as valid bases for appeal of adverse verdicts. All such cases are and will continue to be vigorously defended, however, Liggett has entered into settlement discussions in individual cases or groups of cases where Liggett has determined it was in its best interest to do so, and it may continue to do so in the future, including with respect to the remaining Engle progeny cases. In October 2013, Liggett announced a settlement of the claims of over 4,900 Engle progeny plaintiffs (see Engle Progeny Settlement below). As of September 30, 2016, Liggett (and in certain cases the Company) had, on an individual basis, settled 175 Engle progeny cases for approximately \$6,000 in the aggregate. There were no settlements in the third quarter of 2016.

## Individual Actions

As of September 30, 2016, there were 33 Individual Actions pending against Liggett and, in certain cases, the Company, where one or more individual plaintiffs allege injury resulting from cigarette smoking, addiction to cigarette smoking or exposure to secondary smoke and seek compensatory and, in some cases, punitive damages. These cases do not include the remaining Engle progeny cases or the individual cases pending in West Virginia state court as part of a consolidated action. The following table lists the number of Individual Actions by state:

| State         | Number<br>of Cases |
|---------------|--------------------|
| Maryland      | 13                 |
| Florida       | 7                  |
| New York      | 6                  |
| Louisiana     | 3                  |
| West Virginia | 2                  |
| Missouri      | 1                  |
| Ohio          | 1                  |

The plaintiffs' allegations of liability in cases in which individuals seek recovery for injuries allegedly caused by cigarette smoking are based on various theories of recovery, including negligence, gross negligence, breach of special duty, strict liability, fraud, concealment, misrepresentation, design defect, failure to warn, breach of express and implied warranties, conspiracy, aiding and abetting, concert of action, unjust enrichment, common law public nuisance, property damage, invasion of privacy, mental anguish, emotional distress, disability, shock, indemnity, 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



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and punitive damages have been specifically pleaded in a number of cases, sometimes in amounts ranging into the hundreds of millions and even billions of dollars.

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

Engle Progeny Cases

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

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

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

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

Engle Progeny Settlement. In October 2013, the Company entered into a settlement with approximately 4,900 Engle progeny plaintiffs and their counsel. Pursuant to the terms of the settlement, Liggett agreed to pay a total of approximately \$110,000, with approximately \$61,600 paid in a lump sum and the balance to be paid in installments over 14 years, starting in February 2015. In exchange, the claims of over 4,900 plaintiffs, including the claims of all plaintiffs with cases pending in federal court, were dismissed with prejudice against the Company and Liggett. Due to

the settlement, in 2013, the Company recorded a charge of \$86,213 of which approximately \$25,000 is related to certain payments discounted to their present value using an 11% annual discount rate. The installment payments total approximately \$48,000 on an undiscounted basis. The Company's future payments will be approximately \$3,400 per annum through 2028, with a cost of living increase beginning in 2021.

Notwithstanding the comprehensive nature of the Engle Progeny Settlement, approximately 240 plaintiffs' claims remain pending in state court. Therefore, the Company and Liggett may still be subject to periodic adverse judgments which could have a material adverse affect on the Company's consolidated financial position, results of operations and cash flows.

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As of September 30, 2016, the following Engle progeny cases have resulted in judgments against Liggett:

| Date            | Case Name                       | County       | Liggett<br>Compensatory<br>Damages (as<br>adjusted) <sup>(1)</sup> | Liggett<br>Punitive<br>Damages | Status <sup>(2)</sup>   |
|-----------------|---------------------------------|--------------|--|--------------------------------|---|
| June 2002       | Lukacs v.<br>R.J.<br>Reynolds   | Miami-Dade   | \$12,418   | \$—                            | Liggett satisfied the judgment and the case is concluded.   |
| August<br>2009  | Campbell v.<br>R.J.<br>Reynolds | Escambia     | 156  | —                              | Liggett satisfied the judgment and the case is concluded.   |
| March<br>2010   | Douglas v.<br>R.J.<br>Reynolds  | Hillsborough | 1,350  | —                              | Liggett satisfied the judgment and the case is concluded.   |
| April<br>2010   | Clay v. R.J.<br>Reynolds        | Escambia     | 349  | 1,000                          | Liggett satisfied the judgment and the case is concluded.<br>On June 12, 2013, the Fourth District Court of Appeal reversed and remanded the case for further proceedings regarding the amount of the award. Both sides sought discretionary review from the Florida Supreme Court. In February 2016, the Florida Supreme Court reinstated the jury's verdict. The defendants moved for clarification of that order. The court clarified that it reversed the district court's decision regarding the statute of repose only, leaving the remaining portions of the decision intact. The case was remanded to the trial court for proceedings consistent with those portions of the district court's decision that were not reversed. |
| April<br>2010   | Putney v.<br>R.J.<br>Reynolds   | Broward      | 3,008  | —                              | Liggett satisfied the judgment and other than an issue with respect to the calculation of interest on the judgment and the amount of costs owed by Liggett, the case is concluded.  |
| April<br>2011   | Tullo v. R.J.<br>Reynolds       | Palm Beach   | 225  | —                              | Liggett satisfied the merits judgment. Subsequently, the trial court entered a joint and several final judgment on attorneys' fees and costs for \$981 and defendants appealed that judgment. Briefing is underway.   |
| January<br>2012 | Ward v. R.J.<br>Reynolds        | Escambia     | 1  | —                              | A joint and several judgment for \$16,100 was entered against R.J. Reynolds, Philip Morris, Lorillard and Liggett. On January 6, 2016, the Fourth District Court of Appeal reversed in part, including the \$7,600 punitive damages award   |
| May 2012        | Calloway v.<br>R.J.<br>Reynolds | Broward      | —  | —                              |   |

|               |                            |            |       |       |   |
|---------------|----------------------------|------------|-------|-------|---|
|               |                            |            |       |       | against Liggett, and remanded the case to the trial court for a new trial on certain issues. Both sides moved for rehearing and in September 2016, the appellate court reversed the judgment in its entirety and remanded the case for a new trial. As a result, the \$1,530 compensatory award against Liggett was reversed. The plaintiff filed a notice to invoke the discretionary jurisdiction of the Florida Supreme Court.   |
| December 2012 | Buchanan v. R.J. Reynolds  | Leon       | 2,750 | —     | Liggett satisfied the judgment and the case is concluded.   |
| May 2013      | D. Cohen v. R.J. Reynolds  | Palm Beach | —     | —     | In May 2013, the jury awarded compensatory damages in the amount of \$2,055 and apportioned 10% of the fault to Liggett (\$205). Defendants' motion seeking a new trial was granted by the trial court. Plaintiff appealed and defendants cross-appealed. The Fourth District Court of Appeal affirmed the granting of a new trial. The plaintiff filed a notice to invoke the discretionary jurisdiction of the Florida Supreme Court.   |
| August 2013   | Rizzuto v. R.J. Reynolds   | Hernando   | 3,479 | —     | Liggett settled its portion of the judgment for \$1,500 and the case is concluded as to Liggett.  |
| August 2014   | Irimi v. R.J. Reynolds     | Broward    | —     | —     | In August 2014, the jury awarded compensatory damages in the amount of \$3,123 and apportioned 1% of the fault to Liggett (\$31). In January 2015, the trial court granted defendants' motion for a new trial. Plaintiff appealed and the defendants cross appealed. Briefing is underway.  |
| October 2014  | Lambert v. R.J. Reynolds   | Pinellas   | 3,600 | 9,500 | Liggett satisfied the judgment and the case is concluded.   |
| November 2014 | Boatright v. R.J. Reynolds | Polk       | —     | 300   | In November 2014, the jury awarded compensatory damages in the amount of \$15,000 with 15% fault apportioned to plaintiff and 85% to Philip Morris. The jury further assessed punitive damages against Philip Morris for \$19,700 and Liggett for \$300. Post trial motions were denied. A joint and several judgment was entered in the amount of \$12,750 on the compensatory damages. Judgment was further entered against Liggett for \$300 in punitive damages. Defendants appealed and plaintiff cross-appealed. Oral argument occurred on October 18, 2016. A decision is pending. |

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| Date                                     | Case Name                     | County  | Liggett<br>Compensatory<br>Damages (as<br>adjusted) <sup>(1)</sup> | Liggett<br>Punitive<br>Damages | Status <sup>(2)</sup>   |
|--|-------------------------------|---------|--|--------------------------------|---|
| June<br>2015                             | Caprio v.<br>R.J.<br>Reynolds | Broward | —  | —                              | In February 2015, the jury answered certain questions on the verdict form, but were deadlocked as to others. The jury returned a verdict of \$559 in economic damages. The court entered a partial judgment and ordered a new trial on the remaining issues, including comparative fault and punitive damages. Defendants appealed. Briefing is complete. |
| Total Damages Awarded:                   |                               |         | 27,336   | 10,800                         |   |
| Amounts accrued, paid or<br>compromised: |                               |         | (24,328)   | (10,500)                       |   |
| Damages remaining on<br>Appeal:          |                               |         | \$3,008  | \$300                          |   |

(1) Compensatory damages are adjusted to reflect the jury's allocation of comparative fault and only include Liggett's jury allocated share, regardless of whether a judgment was joint and several. The amounts listed above do not include attorneys' fees or statutory interest.

(2) See Exhibit 99.1 for a more complete description of the cases currently on appeal.

Through September 30, 2016, Liggett paid \$39,773, including interest and attorneys' fees, to satisfy the judgments in the following Engle progeny cases: Lukacs, Campbell, Douglas, Clay, Tullo, Ward, Rizzuto, Lambert and Buchanan. The Company's current potential range of loss, related to awarded damages only, is between \$0 and \$3,308 in the aggregate, plus interest and attorneys' fees, however, this is only an estimate and final damages in any case might increase as a result of pending appeals. In determining the range of loss, the Company considers potential settlements as well as future appellate relief. Except as disclosed elsewhere in this Note 7, the Company is unable to determine a range of loss related to the remaining Engle progeny cases. As cases proceed through the appellate process, the Company will consider accruals on a case-by-case basis if an unfavorable outcome becomes probable and the amount can be reasonably estimated.

Appeals of Engle Progeny Judgments. In December 2010, in the Martin case, a state court case against R.J. Reynolds, the First District Court of Appeal held that the trial court correctly construed the Florida Supreme Court's 2006 decision in Engle in instructing the jury on the preclusive effect of the Phase I Engle findings. In July 2011, the Florida Supreme Court declined to review the First District Court of Appeal's decision. In March 2012, the United States Supreme Court declined to review the Martin case, along with the Campbell case and two other Engle progeny cases. The Martin decision has led to additional adverse rulings by other state appellate courts.

In Jimmie Lee Brown, a state court case against R.J. Reynolds, the trial court tried the case in two phases. In the first phase, the jury determined that the smoker was addicted to cigarettes that contained nicotine and that his addiction was a legal cause of his death, thereby establishing he was an Engle class member. In the second phase, the jury determined whether the plaintiff established legal cause and damages with regard to each of the underlying claims. The jury found in favor of plaintiff in both phases. In September 2011, the Fourth District Court of Appeal affirmed the judgment entered in plaintiff's favor and approved the trial court's procedure of bifurcating the trial. The Fourth District Court of Appeal agreed with Martin that individual post-Engle plaintiffs need not prove conduct elements as part of their burden of proof, but disagreed with Martin to the extent that the First District Court of Appeal only

required a finding that the smoker was a class member to establish legal causation as to addiction and the underlying claims. The Fourth District Court of Appeal held that in addition to establishing class membership, Engle progeny plaintiffs must also establish legal causation and damages as to each claim asserted. In so finding, the Fourth District Court of Appeal's decision in Jimmie Lee Brown is in conflict with Martin.

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

In *Douglas*, a state court case, the Second District Court of Appeal issued a decision affirming the judgment of the trial court in favor of the plaintiff and upholding the use of the Engle jury findings, but certified to the Florida Supreme Court the question of whether granting res judicata effect to the Engle jury findings violates defendants' federal due process rights. In March 2013, the Florida Supreme Court affirmed the use of Engle jury findings and determined that there is no violation of the

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defendants' due process rights. This was the first time the Florida Supreme Court addressed the merits of an Engle progeny case. In October 2013, the United States Supreme Court declined to review the decision and Liggett satisfied the judgment. To date, the United States Supreme Court has declined to review any Engle progeny decisions.

In Hess, a state court case, in April 2015, the Florida Supreme Court held that Engle defendants cannot raise a statute of repose defense to claims for concealment or conspiracy.

In April 2015, in Graham, a federal case, the Eleventh Circuit held that federal law impliedly preempts use of the res judicata Engle findings to establish claims for strict liability or negligence. In January 2016, the Eleventh Circuit Court of Appeals granted the plaintiff's motion for rehearing en banc and vacated the panel's decision. Defendants filed a motion requesting that the court enter a briefing order directing the parties to address both implied preemption and whether the application of the Engle findings violates federal due process. Oral argument on rehearing occurred in June 2016 and a decision is pending.

In January 2016, in Marotta, the Fourth District Court of Appeal disagreed with the Graham panel's decision. The Florida Supreme Court has accepted jurisdiction in Marotta. Oral argument occurred on November 1, 2016.

In March 2016, the Florida Supreme Court held that Engle progeny plaintiffs may seek punitive damages on their claims for non-intentional torts, rejecting the argument that plaintiffs are precluded from doing so because the Engle class did not pursue such damages on those claims.

#### Maryland Cases

Liggett is currently a defendant in 13 multi-defendant personal injury cases in Maryland that allege claims arising from asbestos and tobacco exposure. The tobacco defendants, including Liggett, moved (or are in the process of moving) to dismiss the cases. In the past, motions to dismiss have generally been successful, typically resulting in the dismissal without prejudice of the tobacco company defendants, including Liggett. Recently, however, a Maryland intermediate appellate court ruled, in Stidham, et al. v. R. J. Reynolds Tobacco Company, et al., that dismissal of tobacco company defendants may not be appropriate where the asserted injury is based on both asbestos and tobacco exposure ("synergy cases"). On May 9, 2016, the Court of Appeals for Maryland (Maryland's highest court) heard oral argument on the appeal of the intermediate appellate court's decision. On July 5, 2016, the Court of Appeals ruled that joinder of tobacco and asbestos cases may be possible in certain circumstances, but plaintiffs must demonstrate at the trial court level how such cases may be joined while providing appropriate safeguards to prevent embarrassment, delay, expense or prejudice to defendants and "the extent to which, if at all, the special procedures applicable to asbestos cases should extend to tobacco companies." Other than providing guidance, the Court of Appeals remanded these issues to be determined at the trial court level. It is possible that Liggett and other tobacco company defendants will not be dismissed from pending synergy cases, and may be named as defendants in asbestos-related personal injury actions in Maryland going forward, including approximately 20 additional synergy cases currently pending in Maryland state court.

#### Liggett Only Cases

There are currently four cases pending where Liggett is the only remaining defendant. Three of these cases are Individual Actions and one is an Engle progeny case. In November 2015, in Hausrath (NY state court), the court entered a case management order providing discovery deadlines. There has been no further activity in the other three cases. It is possible that cases where Liggett is the only defendant could increase as a result of the remaining Engle progeny cases.

Class Actions

As of September 30, 2016, three actions were pending for which either a class had been certified or plaintiffs were seeking class certification where Liggett is a named defendant. Other cigarette manufacturers are also named in these actions.

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



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Defenses raised in these cases include, among others, lack of proximate cause, individual issues predominate, assumption of the risk, comparative fault and/or contributory negligence, statute of limitations and federal preemption. In November 1997, in *Young v. American Tobacco Co.*, a purported personal injury class action was commenced on behalf of plaintiff and all similarly situated residents in Louisiana who, though not themselves cigarette smokers, allege they were exposed to secondhand smoke from cigarettes that were manufactured by the defendants, including Liggett, and suffered injury as a result of that exposure. The plaintiffs seek to recover an unspecified amount of compensatory and punitive damages. No class certification hearing has been held. The case has been stayed for a number of years, with the stay renewed every few years. The last stay was entered on March 16, 2016 and stays the case, including all discovery, pending the completion of the smoking cessation program ordered by the court in *Scott v. The American Tobacco Co.*

In February 1998, in *Parsons v. AC & S Inc.*, a purported class action was commenced on behalf of all West Virginia residents who allegedly have personal injury claims arising from exposure to cigarette smoke and asbestos fibers. The complaint seeks to recover \$1,000 in compensatory and punitive damages individually and unspecified compensatory and punitive damages for the class. The case is stayed due to the December 2000 bankruptcy of three of the defendants.

Although not technically a class action, in *In Re: Tobacco Litigation (Personal Injury Cases)*, a West Virginia state court consolidated approximately 750 individual smoker actions that were pending prior to 2001 for trial of certain "common" issues. Liggett was severed from trial of the consolidated action. After two mistrials, in May 2013, the jury rejected all but one of the plaintiffs' claims, finding in favor of plaintiffs on the claim that ventilated filter cigarettes between 1964 and July 1, 1969 should have included instructions on how to use them. The issue of damages was reserved for further proceedings. The court entered judgment in October 2013, dismissing all claims except the ventilated filter claim. The judgment was affirmed on appeal and remanded to the trial court for further proceedings. In April 2015, the plaintiffs filed a petition for writ of certiorari to the United States Supreme Court which subsequently declined review. In July 2015, the trial court ruled on the scope of the ventilated filter claim and determined that only 30 plaintiffs have potentially viable claims against the non-Liggett defendants, which may be pursued in a second phase of the trial. The court intends to try the claims of these plaintiffs in six consolidated trials, each with five plaintiffs. The trial court set the first date for the consolidated trials for January 9, 2017. With respect to Liggett, the trial court requested that Liggett and plaintiffs brief whether any claims against Liggett survive given the outcome of the first phase of the trial. On May 23, 2016, the trial court ruled that the case may proceed against Liggett. Liggett requested that the trial court certify the matter to the West Virginia Supreme Court of Appeals for review, but the trial court refused. It is estimated that Liggett could be a defendant in approximately 75 individual cases.

In addition to the cases described above, numerous class actions remain certified against other cigarette manufacturers including cases alleging, among other things, that use of the terms "lights" and "ultra lights" constitutes unfair and deceptive trade practices. Adverse decisions in these cases could have a material adverse affect on Liggett's sales volume, operating income and cash flows.

#### Health Care Cost Recovery Actions

As of September 30, 2016, one Health Care Cost Recovery Action was pending against Liggett, *Crow Creek Sioux Tribe v. American Tobacco Company*, a South Dakota case filed in 1997, where the plaintiff seeks to recover damages based on various theories of recovery as a result of alleged sales of tobacco products to minors. The case is inactive. Other cigarette manufacturers are also named as defendants.

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

Department of Justice Lawsuit

In September 1999, the United States government commenced litigation against Liggett and other cigarette manufacturers

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

In August 2006, the trial court entered a Final Judgment against each of the cigarette manufacturing defendants, except Liggett. In May 2009, the United States Court of Appeals for the District of Columbia affirmed most of the district court's decision. The United States Supreme Court denied review. As a result, the cigarette manufacturing defendants, other than Liggett, are now subject to the trial court's Final Judgment which ordered the following relief: (i) an injunction against "committing any act of racketeering" relating to the manufacturing, marketing, promotion, health consequences or sale of cigarettes in the United States; (ii) an injunction against participating directly or indirectly in the management or control of the Council for Tobacco Research, the Tobacco Institute, or the Center for Indoor Air Research, or any successor or affiliated entities of each; (iii) an injunction against "making, or causing to be made in any way, any material false, misleading, or deceptive statement or representation or engaging in any public relations or marketing endeavor that is disseminated to the United States' public and that misrepresents or suppresses information concerning cigarettes"; (iv) an injunction against conveying any express or implied health message through use of descriptors on cigarette packaging or in cigarette advertising or promotional material, including "lights," "ultra lights," and "low tar," which the court found could cause consumers to believe one cigarette brand is less hazardous than another brand; (v) the issuance of "corrective statements" in various media regarding the adverse health effects of smoking, the addictiveness of smoking and nicotine, the lack of any significant health benefit from smoking "low tar" or "lights" cigarettes, defendants' manipulation of cigarette design to ensure optimum nicotine delivery and the adverse health effects of exposure to environmental tobacco smoke; (vi) the disclosure of defendants' public document websites and the production of all documents produced to the government or produced in any future court or administrative action concerning smoking and health; (vii) the disclosure of disaggregated marketing data to the government in the same form and on the same schedules as defendants now follow in disclosing such data to the Federal Trade Commission for a period of ten years; (viii) certain restrictions on the sale or transfer by defendants of any cigarette brands, brand names, formulas or cigarette business within the United States; and (ix) payment of the government's costs in bringing the action. In June 2014, the court approved a consent agreement between the defendants and the Department of Justice regarding the "corrective statements" to be issued by the defendants. In May 2015, the court of appeals issued an opinion on the legality of the "corrective statements," affirming them in part and reversing them in part. The implementation of the "corrective statements" is uncertain as proceedings are ongoing. It is unclear what impact, if any, the Final Judgment will have on the cigarette industry as a whole. To the extent that the Final Judgment leads to a decline in industry-wide shipments of cigarettes in the United States or otherwise results in restrictions that adversely affect the industry, Liggett's sales volume, operating income and cash flows could be materially adversely affected.

#### Upcoming Trials

As of September 30, 2016, there were 17 Engle progeny cases and one Individual Action scheduled for trial through September 30, 2017, where Liggett (and/or the Company) is a named defendant. Trial dates are, however, subject to change.

#### MSA and Other State Settlement Agreements

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

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

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

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

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

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

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

Liggett has no payment obligations under the MSA except to the extent its market share exceeds a market share exemption of approximately 1.65% of total cigarettes sold in the United States. Vector Tobacco has no payment obligations under the MSA except to the extent its market share exceeds a market share exemption of approximately 0.28% of total cigarettes sold in the United States. Liggett and Vector Tobacco's domestic shipments accounted for 3.3% of the total cigarettes sold in the United States in 2015. If Liggett's or Vector Tobacco's market share exceeds their respective market share exemption in a given year, then on April 15 of the following year, Liggett and/or Vector Tobacco, as the case may be, must pay on each excess unit an amount equal (on a per-unit basis) to that due from the OPMs for that year. On December 30, 2015, Liggett and Vector Tobacco pre-paid \$100,000 of their approximate \$115,000 2015 MSA obligation, the balance of which was paid in April 2016.

Certain MSA Disputes

NPM Adjustment. Liggett and Vector Tobacco contend that they are entitled to an NPM Adjustment for each year from 2003 - 2015. The NPM Adjustment is a potential adjustment to annual MSA payments, available when the Participating Manufacturers suffer a market share loss to NPMs for a particular year and an economic consulting firm selected pursuant to the MSA determines that the MSA was a "significant factor contributing to" that loss. A Settling State that has "diligently enforced" its qualifying escrow statute in the year in question may be able to avoid its allocable share of the NPM Adjustment. For 2003 - 2015, Liggett and Vector Tobacco, as applicable, disputed that they owed the Settling States the NPM Adjustments as calculated by the Independent Auditor. As permitted by the MSA, Liggett

and Vector Tobacco either paid subject to dispute, withheld payment or paid into a disputed payment account, the amounts associated with these NPM Adjustments.

The two requirements for application of the NPM Adjustment, a market share loss and a finding or agreement that the MSA was a significant factor in that loss, have been satisfied, and the Participating Manufacturers are engaged in disputes with certain of the Settling States over whether they diligently enforced their respective escrow statutes in each of the years from 2003 - 2014. After several years of litigation over whether the MSA's arbitration clause required a multistate arbitration of the NPM Adjustment dispute, 48 of 49 state courts ultimately compelled the states to participate in a single, multistate arbitration of the 2003 NPM Adjustment. Notwithstanding, many states continued to refuse to arbitrate and agreed to do so only after the Participating Manufacturers agreed to a 20% reduction in their 2003 NPM Adjustment claims.

VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

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The arbitration for the 2003 NPM Adjustment began in June 2010. During the proceedings, the Participating Manufacturers decided not to contest the diligent enforcement of 16 states, with a combined allocable share of approximately 14%.

While the 2003 arbitration was underway, the Participating Manufacturers entered into a term sheet with 22 states settling the NPM Adjustment for 2003 - 2012 and agreed to terms to address the NPM Adjustment with respect to those states for future years. The parties have been working towards converting the term sheet into a final settlement agreement.

The Participating Manufacturers continued to contest the diligence of 15 states relating to the 2003 NPM Adjustment. In September 2013, the panel found that six of those states did not diligently enforce their MSA escrow statutes in 2003.

Two of the states found non-diligent, Kentucky and Indiana, agreed to settle the dispute and enter into the term sheet described above. The remaining four non-diligent states pursued motions in their respective state courts seeking to vacate or reduce the amount of the arbitration award. The Pennsylvania and Maryland courts refused to vacate the award but reduced the recovery by approximately 50%. In October 2016, the United States Supreme Court denied the Participating Manufacturers' petitions for certiorari. The remaining two challenges to the 2003 arbitration award, in Missouri and New Mexico, remain pending in state court. In Missouri, the appellate court reversed the trial court, which had reduced the arbitration award, and reinstated the full award. The Missouri Supreme Court granted a discretionary appeal of that decision. Oral argument is set for November 8, 2016. On September 27, 2013, the New Mexico trial court refused to vacate the award but reduced the recovery. Notice of appeal from that decision was due by October 27, 2016.

In October 2015, substantially all of the Participating Manufacturers settled the NPM Adjustment dispute with the state of New York for 2004 - 2014 and agreed to a mechanism for potential future credits against the Participating Manufacturers' MSA payments for 2015 forward.

As a result of the settlements and arbitration award described above, Liggett and Vector Tobacco reduced cost of sales in the aggregate by \$22,356 for years 2013 - 2015. Liggett and Vector Tobacco may be entitled to further adjustments for 2015 forward. The remaining NPM Adjustment accrual of approximately \$20,000 at September 30, 2016 relates to the disputed amounts Liggett withheld from the non-settling states for 2004 - 2010, which may be subject to payment, with interest, if Liggett loses the disputes for those years. As of September 30, 2016, there remains approximately \$28,600 in the disputed payments account relating to Liggett's 2011 - 2015 NPM Adjustment disputes with the non-settling states.

Disputes over the NPM Adjustments for 2004-2014 remain to be arbitrated with the states that have not joined the settlement. The dispute over the NPM Adjustment for 2015 remains to be arbitrated with all the states.

The arbitration for the 2004 NPM Adjustment dispute has commenced. Courts in two states, Pennsylvania and Maryland, rejected arguments that those states' claims of diligent enforcement should be addressed by a separate state-specific panel and they are participating in the multistate arbitration. New Mexico has refused to participate, and a motion to compel is pending. The Missouri court of appeals ruled that Missouri was entitled to a state-specific arbitration, and that issue is pending in the Missouri Supreme Court, with oral argument set for November 8, 2016. Discovery is underway in the 2004 NPM Adjustment proceeding and evidentiary hearings are possible in 2017.

“Gross” v. “Net” Calculations. In October 2004, the independent auditor notified all Participating Manufacturers that their payment obligations under the MSA, dating from the agreement's execution in late 1998, had been recalculated using “net” units, rather than “gross” units (which had been used since 1999). Liggett objected to this retroactive change and disputed the change in methodology.

In December 2012, the parties arbitrated the dispute. In February 2013, the arbitrators ruled that the independent auditor was precluded from recalculating Liggett's grandfathered market share (“GFMS”) exemption. The arbitrators

further ruled that, for purposes of calculating Liggett's payment obligations, Liggett's market share, calculated on a net basis, should be increased by a factor of 1.25%. Liggett filed a motion seeking correction of the part of the arbitrators' decision that would require the 1.25% increase in Liggett's market share. The states opposed Liggett's motion. In October 2014, the panel issued a Corrected Final Award that eliminated the 1.25% adjustment increase. The panel further determined that the independent auditor shall compute Liggett's market share for all years after 2000 on a "net" basis, but adjust that computation to approximate "gross" market share by using actual returned product data for each year. In July 2015, the independent auditor issued calculations, purportedly based on the Corrected Final Award, which indicated that Liggett owed approximately \$16,000 for years 2001 - 2013. In June 2016, the independent auditor issued revised calculations indicating that Liggett owed approximately \$8,100 for years 2001 - 2013. In September 2016, Liggett paid \$8,100 and reduced cost of sales by \$370 but continued to dispute certain aspects of the independent auditor's calculation.



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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

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

In 2003, as a result of a dispute with Minnesota regarding its settlement agreement, Liggett agreed to pay \$100 a year in any year cigarettes manufactured by Liggett are sold in that state. Further, the Attorneys General for Florida, Mississippi and Texas advised Liggett that they believed Liggett had failed to make payments under the respective settlement agreements with those states. In 2010, Liggett settled with Florida and agreed to pay \$1,200 and to make further annual payments of \$250 for a period of 21 years, starting in March 2011, with the payments from year 12 forward being subject to an inflation adjustment. These payments are in lieu of any other payments allegedly due to Florida.

On January 12, 2016, the Attorney General for Mississippi filed a motion in state court in Jackson County, Mississippi (Chancery Division) to enforce the March 1996 settlement agreement alleging that Liggett owes Mississippi at least \$26,000 (including interest) plus attorneys' fees and punitive damages. Discovery is underway.

Liggett may be required to make additional payments to Texas and Mississippi which could adversely affect the Company's consolidated financial position, results of operations and cash flows.

#### Cautionary Statement

Management is not able to reasonably predict the outcome of the litigation pending or threatened against Liggett or the Company. Litigation is subject to many uncertainties. Liggett has been found liable in multiple Engle progeny cases and Individual Actions, several of which were affirmed on appeal and satisfied by Liggett. It is possible that other cases could be decided unfavorably against Liggett and that Liggett will be unsuccessful on appeal. Liggett may attempt to settle particular cases if it believes it is in its best interest to do so.

Management cannot predict the cash requirements related to any future defense costs, settlements or judgments, including cash required to bond any appeals, and there is a risk that those requirements will not be able to be met. An unfavorable outcome of a pending smoking-related case could encourage the commencement of additional litigation. Except as discussed in this Note 7, management is unable to estimate the loss or range of loss that could result from an unfavorable outcome of the cases pending against Liggett or the costs of defending such cases and as a result has not provided any amounts in its consolidated financial statements for unfavorable outcomes.

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

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

The activity in the Company's accruals for the MSA and tobacco litigation for the nine months ended September 30, 2016 were as follows:

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## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

|  | Current Liabilities   |                        |           | Non-Current Liabilities                                       |                        |          |
|--|---|------------------------|-----------|---|------------------------|----------|
|  | Payments<br>due<br>under<br>Master<br>Settlement<br>Agreement | Litigation<br>Accruals | Total     | Payments<br>due<br>under<br>Master<br>Settlement<br>Agreement | Litigation<br>Accruals | Total    |
| Balance at January 1, 2016                         | \$29,241  | \$22,904               | \$52,145  | \$20,094  | \$24,718               | \$44,812 |
| Expenses   | 75,989  | 2,623                  | 78,612    | —   | —                      | —        |
| Change in MSA obligations capitalized as inventory | 633   | —                      | 633       | —   | —                      | —        |
| Payments   | (20,976 )   | (25,652 )              | (46,628 ) | —   | —                      | —        |
| Reclassification to/(from) non-current liabilities | (2,163 )  | 3,252                  | 1,089     | 2,163   | (3,252 )               | (1,089 ) |
| Interest on withholding                            | 35  | 412                    | 447       | —   | 1,759                  | 1,759    |
| Balance as of September 30, 2016                   | \$82,759  | \$3,539                | \$86,298  | \$22,257  | \$23,225               | \$45,482 |

The activity in the Company's accruals for the MSA and tobacco litigation for the nine months ended September 30, 2015 were as follows:

|  | Current Liabilities   |                        |           | Non-Current Liabilities                                       |                        |          |
|--|---|------------------------|-----------|---|------------------------|----------|
|  | Payments<br>due<br>under<br>Master<br>Settlement<br>Agreement | Litigation<br>Accruals | Total     | Payments<br>due<br>under<br>Master<br>Settlement<br>Agreement | Litigation<br>Accruals | Total    |
| Balance at January 1, 2015                         | \$26,322  | \$3,149                | \$29,471  | \$25,809  | \$25,700               | \$51,509 |
| Expenses   | 83,236  | 6,371                  | 89,607    | —   | (195 )                 | (195 )   |
| NPM Settlement adjustment                          | —   | —                      | —         | (5,715 )  | —                      | (5,715 ) |
| Change in MSA obligations capitalized as inventory | 1,536   | —                      | 1,536     | —   | —                      | —        |
| Payments   | (18,142 )   | (5,851 )               | (23,993 ) | —   | —                      | —        |
| Reclassification from non-current liabilities      | —   | 3,305                  | 3,305     | —   | (3,305 )               | (3,305 ) |
| Interest on withholding                            | —   | 666                    | 666       | —   | 1,872                  | 1,872    |
| Balance as of September 30, 2015                   | \$92,952  | \$7,640                | \$100,592 | \$20,094  | \$24,072               | \$44,166 |

## Other Matters:

Liggett's and Vector Tobacco's management are unaware of any material environmental conditions affecting their existing facilities. Liggett's and Vector Tobacco's management believe that current operations are conducted in material compliance with all environmental laws and regulations and other laws and regulations governing cigarette manufacturers. Compliance with federal, state and local provisions regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, has not had a material affect on the capital expenditures, results of operations or competitive position of Liggett or Vector Tobacco.

Liggett Vector Brands entered into an agreement with a subsidiary of the Convenience Distribution 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 incurred by the surety under the bond program, with a maximum loss exposure of \$500. The Company believes the fair value of Liggett Vector Brands' obligation under the agreement was immaterial at September 30, 2016.

## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

In addition to the foregoing, Douglas Elliman Realty, LLC and its subsidiaries are subject to numerous proceedings, lawsuits and claims in connection with their ordinary business activities. Many of these matters are covered by insurance.

Liggett was contacted in October 2015, by one of its software vendors, who suggested that Liggett needed to purchase additional software licenses from it. Liggett believes that its use of the vendor's software is in compliance with the licenses previously purchased by Liggett. In January 2016, the software vendor requested to audit Liggett's use of the relevant software. Liggett has provided details of its use of the software and is continuing to cooperate with requests for information.

Management is of the opinion that the liabilities, if any, resulting from other proceedings, lawsuits and claims pending against the Company and its consolidated subsidiaries, unrelated to tobacco product liability, should not materially affect the Company's condensed consolidated financial position, results of operations or cash flows.

## 8. EMPLOYEE BENEFIT PLANS

The following table summarizes key information related to the Company's pension plans and other postretirement benefits:

|  | Pension Benefits                      |                                       | Pension Benefits                     |                                      | Other Postretirement Benefits         |                                       | Other Postretirement Benefits        |                                      |
|--|---------------------------------------|---------------------------------------|--------------------------------------|--------------------------------------|---------------------------------------|---------------------------------------|--------------------------------------|--------------------------------------|
|  | Three Months Ended September 30, 2016 | Three Months Ended September 30, 2015 | Nine Months Ended September 30, 2016 | Nine Months Ended September 30, 2015 | Three Months Ended September 30, 2016 | Three Months Ended September 30, 2015 | Nine Months Ended September 30, 2016 | Nine Months Ended September 30, 2015 |
| Service cost — benefits earned during the period | \$ 137                                | \$ 133                                | \$ 411                               | \$ 398                               | \$ 1                                  | \$ 2                                  | \$ 3                                 | \$ 6                                 |
| Interest cost on projected benefit obligation    | 1,355                                 | 1,205                                 | 4,065                                | 3,803                                | 97                                    | 93                                    | 291                                  | 278                                  |
| Expected return on assets                        | (1,519)                               | (1,814)                               | (4,557)                              | (5,627)                              | —                                     | —                                     | —                                    | —                                    |
| Settlement loss                                  | —                                     | —                                     | —                                    | 1,607                                | —                                     | —                                     | —                                    | —                                    |
| Amortization of net loss (gain)                  | 464                                   | 254                                   | 1,392                                | 823                                  | (19)                                  | (24)                                  | (57)                                 | (73)                                 |
| Net expense (income)                             | \$ 437                                | \$ (222)                              | \$ 1,311                             | \$ 1,004                             | \$ 79                                 | \$ 71                                 | \$ 237                               | \$ 211                               |

## 9. RESTRUCTURING

The following table presents the activity under the Tobacco segment restructuring plan for the nine months ended September 30, 2016:

|                                       | Employee Severance and Benefits | Contract Termination/Exit Costs | Other | Total  |
|---------------------------------------|---------------------------------|---------------------------------|-------|--------|
| Accrual balance as of January 1, 2016 | \$ 422                          | \$ 48                           | \$ 20 | \$ 490 |
| Restructuring charges                 | —                               | 41                              | —     | 41     |

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|  |        |       |       |        |
|--|--------|-------|-------|--------|
| Utilized                                 | (415 ) | (89 ) | (20 ) | (524 ) |
| Accrual balance as of September 30, 2016 | \$ 7   | \$ —  | \$ —  | \$7    |

VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## 10. INCOME TAXES

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

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

|   | Three Months<br>Ended |                       | Nine Months Ended     |                       |
|---|-----------------------|-----------------------|-----------------------|-----------------------|
|   | September 30,<br>2016 | September 30,<br>2015 | September 30,<br>2016 | September 30,<br>2015 |
| Income before provision for income taxes                            | \$39,023              | \$29,804              | \$121,119             | \$94,774              |
| Income tax expense using estimated annual effective income tax rate | 15,306                | 11,743                | 47,474                | 37,426                |
| Changes in effective tax rates                                      | (1,149 )              | 1,539                 | —                     | —                     |
| Impact of discrete items, net                                       | (841 )                | 412                   | (792 )                | 313                   |
| Income tax expense  | \$13,316              | \$13,694              | \$46,682              | \$37,739              |

The discrete items for the nine months ended September 30, 2016 are primarily related to the results of recent state income tax audits and a change in the marginal state tax rate as a result of recent state legislation changes. The discrete items for the nine months ended September 30, 2015 are primarily related to the rate differential in other comprehensive income and the results of a recent state income tax audit.

## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## 11. INVESTMENTS AND FAIR VALUE MEASUREMENTS

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

| Description  | Fair Value Measurements as of September 30, 2016 |  |   |   | Total Gains (Losses) |
|--|--|--|---|---|----------------------|
|  | Total  | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |                      |
| <b>Assets:</b>   |  |  |   |   |                      |
| Money market funds <sup>(1)</sup>                          | \$310,826  | \$310,826  | \$—   | \$—                                       |                      |
| Commercial paper <sup>(1)</sup>                            | 30,704   | —  | 30,704  | —   |                      |
| Certificates of deposit <sup>(2)</sup>                     | 2,978  | —  | 2,978   | —   |                      |
| Bonds <sup>(2)</sup>                                       | 5,258  | 5,258  | —   | —   |                      |
| <b>Investment securities available for sale</b>            |  |  |   |   |                      |
| Equity securities  | 57,948   | 57,948   | —   | —   |                      |
| Mutual funds invested in fixed income securities           | 20,667   | 20,667   | —   | —   |                      |
| <b>Fixed income securities</b>                             |  |  |   |   |                      |
| U.S. government securities                                 | 30,985   | —  | 30,985  | —   |                      |
| Corporate securities                                       | 35,669   | —  | 35,669  | —   |                      |
| U.S. government and federal agency                         | 8,293  | —  | 8,293   | —   |                      |
| Commercial mortgage-backed securities                      | 1,776  | —  | 1,776   | —   |                      |
| U.S. asset-backed securities                               | 891  | —  | 891   | —   |                      |
| Commercial paper   | 19,424   | —  | 19,424  | —   |                      |
| Total fixed income securities                              | 97,038   | —  | 97,038  | —   |                      |
| Total investment securities available for sale             | 175,653  | 78,615   | 97,038  | —   |                      |
| Total  | \$525,419  | \$394,699  | \$130,720                                     | \$—                                       |                      |
| <b>Liabilities:</b>  |  |  |   |   |                      |
| Fair value of derivatives embedded within convertible debt | \$120,820  | \$—  | \$—   | \$120,820                                 |                      |



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|                                      |         |          |           |
|--------------------------------------|---------|----------|-----------|
| Nonrecurring fair value measurements |         |          |           |
| Long-term investments <sup>(3)</sup> | \$6,396 | \$ 6,396 | \$(1,203) |

(1) Amounts included in cash and cash equivalents on the condensed consolidated balance sheet.

(2) Amounts included in current restricted assets and restricted assets on the condensed consolidated balance sheet.

(3) Long-term investments with a carrying amount of \$7,599 were written down to their fair value of \$6,396, resulting in an impairment charge of \$1,203, which was included in earnings.

## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

| Description  | Fair Value Measurements as of December 31, 2015 |  |   |   | Total Gains (Losses) |
|--|---|--|---|---|----------------------|
|  | Total   | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |                      |
| <b>Assets:</b>   |   |  |   |   |                      |
| Money market funds <sup>(1)</sup>                          | \$93,915  | \$93,915   | \$ —  | \$ —                                      |                      |
| Certificates of deposit <sup>(2)</sup>                     | 3,469   | —  | 3,469   | —   |                      |
| Bonds <sup>(2)</sup>                                       | 12,767  | 12,767   | —   | —   |                      |
| <b>Investment securities available for sale</b>            |   |  |   |   |                      |
| Equity securities  | 67,273  | 67,273   | —   | —   |                      |
| Mutual funds invested in fixed income securities           | 20,111  | 20,111   | —   | —   |                      |
| <b>Fixed income securities</b>                             |   |  |   |   |                      |
| U.S. government securities                                 | 28,132  | —  | 28,132  | —   |                      |
| Corporate securities                                       | 41,561  | —  | 41,561  | —   |                      |
| U.S. government and federal agency                         | 5,790   | —  | 5,790   | —   |                      |
| Commercial mortgage-backed securities                      | 8,728   | —  | 8,728   | —   |                      |
| U.S. asset-backed securities                               | 8,276   | —  | 8,276   | —   |                      |
| Index-linked U.S. bonds                                    | 2,105   | —  | 2,105   | —   |                      |
| Total fixed income securities                              | 94,592  | —  | 94,592  | —   |                      |
| Total investment securities available for sale             | 181,976   | 87,384   | 94,592  | —   |                      |
| Total  | \$292,127                                       | \$194,066  | \$ 98,061                                     | \$ —                                      |                      |
| <b>Liabilities:</b>  |   |  |   |   |                      |
| Fair value of derivatives embedded within convertible debt | \$144,042                                       | \$—  | \$ —  | \$ 144,042                                |                      |
| <b>Nonrecurring fair value measurements</b>                |   |  |   |   |                      |
| Long-term investments <sup>(3)</sup>                       | \$11,189  |  |   | \$ 11,189                                 | \$(811 )             |
| Investments in real estate, net <sup>(4)</sup>             | 3,780   |  |   | 3,780                                     | (230 )               |
|  | \$14,969  |  |   | \$ 14,969                                 | \$(1,041)            |

- (1) Amounts included in cash and cash equivalents on the condensed consolidated balance sheet
- (2) Amounts included in current restricted assets and restricted assets on the condensed consolidated balance sheet.
- (3) Long-term investments with a carrying amount of \$12,000 were written down to their fair value of \$11,189, resulting in an impairment charge of \$811, which was included in earnings.
- (4) Investments in real estate, net with a carrying value of \$4,010 were written down to its fair value of \$3,780, resulting in an impairment charge of \$230, which was included in earnings.

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## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

The fair value of the Level 2 certificates of deposit is based on the discounted value of contractual cash flows. The discount rate is the rate offered by the financial institution. The fair value of investment securities available for sale included in Level 1 are based on quoted market prices from various stock exchanges. The Level 2 investment securities available for sale are based on quoted market prices of securities that are thinly traded.

The fair value of derivatives embedded within convertible debt was derived using a valuation model. These derivatives have been classified as Level 3. The valuation model assumes future dividend payments by the Company and utilizes interest rates and credit spreads based upon the implied credit spread of the 5.50% Convertible Notes due 2020 to determine the fair value of the derivatives embedded within the convertible debt. The changes in fair value of derivatives embedded within convertible debt are presented on the consolidated statements of operations.

The value of the embedded derivatives is contingent on changes in implied interest rates of the convertible debt, the Company's stock price, stock volatility as well as projections of future cash and stock dividends over the term of the debt. The interest rate component of the value of the embedded derivative is computed by calculating an equivalent non-convertible, unsecured and subordinated borrowing cost. This rate is determined by calculating the implied rate on the Company's 2020 Convertible Notes when removing the embedded option value within the convertible security. This rate is based upon market observable inputs and influenced by the Company's stock price, convertible bond trading price, risk free interest rates and stock volatility.

The unobservable inputs related to the valuations of the Level 3 assets and liabilities were as follows at September 30, 2016:

| Quantitative Information about Level 3 Fair Value Measurements |                                  |                      |  |  |
|--|----------------------------------|----------------------|--|--|
|  | Fair Value at September 30, 2016 | Valuation Technique  | Unobservable Input                                       | Range (Actual)                                     |
| Fair value of derivatives embedded within convertible debt     | \$120,820                        | Discounted cash flow | Assumed annual stock dividend                            | 5 %  |
|  |                                  |                      | Assumed annual cash dividend                             | \$ 1.60  |
|  |                                  |                      | Stock price  | \$ 21.53   |
|  |                                  |                      | Convertible trading price (as a percentage of par value) | 113.94 %   |
|  |                                  |                      | Volatility   | 18.87 %  |
|  |                                  |                      | Risk-free rate   | Term structure of US Treasury Securities<br>5.0% - |
|  |                                  |                      | Implied credit spread                                    | 6.0% -<br>(5.5%)                                   |

VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

The unobservable inputs related to the valuations of the Level 3 assets and liabilities were as follows at December 31, 2015:

|  | Quantitative Information about Level 3 Fair Value Measurements |                      |  |  |
|--|--|----------------------|--|--|
|  | Fair Value at December 2015                                    | Valuation Technique  | Unobservable Input                                       | Range (Actual)                           |
| Fair value of derivatives embedded within convertible debt | \$ 144,042   | Discounted cash flow | Assumed annual stock dividend                            | 5 %                                      |
|  |  |                      | Assumed annual cash dividend                             | \$ 1.60                                  |
|  |  |                      | Stock price  | \$ 23.59                                 |
|  |  |                      | Convertible trading price (as a percentage of par value) | 114.31 %                                 |
|  |  |                      | Volatility   | 18.30 %                                  |
|  |  |                      | Risk-free rate   | Term structure of US Treasury Securities |
| Implied credit spread                                      | 5.0% - 5.5% (5.25%)  |                      |  |  |

## 12. SEGMENT INFORMATION

The Company's significant business segments for the three and nine months ended September 30, 2016 and 2015 were Tobacco, E-Cigarettes and Real Estate. The Tobacco segment consists of the manufacture and sale of conventional cigarettes. The E-Cigarettes segment includes the operations of the Company's e-cigarette business. The Real Estate segment includes the Company's investment in New Valley LLC, which includes Douglas Elliman, Escena, Sagaponack and investments in real estate ventures. The accounting policies of the segments are the same as those described in the summary of significant accounting policies.

## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

Financial information for the Company's operations before taxes and non-controlling interests for the three and nine months ended September 30, 2016 and 2015 were as follows:

|  | Tobacco   | E-Cigarettes | Real Estate | Corporate and Other | Total       |
|--|-----------|--------------|-------------|---------------------|-------------|
| Three months ended September 30, 2016        |           |              |             |                     |             |
| Revenues                                     | \$274,164 | \$ 4         | \$184,936   | \$ —                | \$459,104   |
| Operating income (loss)                      | 66,974    | (1)(165)     | ) 8,844     | (6,289)             | 69,364      |
| Equity in earnings from real estate ventures | —         | —            | 1,022       | —                   | 1,022       |
| Depreciation and amortization                | 2,796     | —            | 2,647       | 390                 | 5,833       |
| Three months ended September 30, 2015        |           |              |             |                     |             |
| Revenues                                     | \$264,170 | \$ 201       | \$185,563   | \$ —                | \$449,934   |
| Operating income (loss)                      | 63,630    | (2)(2,146)   | ) 12,227    | (4,344)             | 69,367      |
| Equity in losses from real estate ventures   | —         | —            | (916)       | ) —                 | (916)       |
| Depreciation and amortization                | 2,850     | —            | 3,388       | 435                 | 6,673       |
| Nine months ended September 30, 2016         |           |              |             |                     |             |
| Revenues                                     | \$750,677 | \$ 52        | \$527,448   | \$ —                | \$1,278,177 |
| Operating income (loss)                      | 194,473   | (3)(449)     | ) 28,224    | (20,005)            | 202,243     |
| Equity in earnings from real estate ventures | —         | —            | 3,328       | —                   | 3,328       |
| Depreciation and amortization                | 7,735     | —            | 7,872       | 1,260               | 16,867      |
| Capital expenditures                         | 5,619     | —            | 13,505      | 33                  | 19,157      |
| Nine months ended September 30, 2015         |           |              |             |                     |             |
| Revenues                                     | \$747,145 | \$ 881       | \$478,841   | \$ —                | \$1,226,867 |
| Operating income (loss)                      | 169,515   | (4)(7,710)   | ) 21,270    | (14,187)            | 168,888     |
| Equity in earnings from real estate ventures | —         | —            | 1,278       | —                   | 1,278       |
| Depreciation and amortization                | 8,717     | —            | 9,372       | 1,307               | 19,396      |
| Capital expenditures                         | 3,305     | —            | 4,554       | —                   | 7,859       |

(1) Operating income includes \$370 of income from MSA Settlement.

(2) Operating income includes \$5,715 of income from MSA Settlement, \$3,750 of litigation settlement and judgment expense and \$1,548 of restructuring expense.

(3) Operating income includes \$370 of income from MSA Settlement, \$2,350 of litigation settlement and judgment expense, and \$41 of restructuring expense.

(4) Operating income includes \$5,715 of income from MSA Settlement, \$5,843 of litigation settlement and judgment expense, \$1,548 of restructuring expense, and \$1,607 of pension settlement expense.



VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

### 13. CONDENSED CONSOLIDATING FINANCIAL INFORMATION

The accompanying condensed consolidating financial information has been prepared and presented pursuant to Securities and Exchange Commission (“SEC”) Regulation S-X, Rule 3-10, “Financial Statements of Guarantors and Affiliates Whose Securities Collateralize an Issue Registered or Being Registered.” Each of the subsidiary guarantors is 100% owned, directly or indirectly, by the Company, and all guarantees are full and unconditional and joint and several.

The Company’s investments in its consolidated subsidiaries are presented under the equity method of accounting. The Company has outstanding \$835,000 principal amount of its 7.75% Senior Secured Notes due 2021 that are guaranteed subject to certain customary automatic release provisions on a joint and several basis by all of the 100% owned domestic subsidiaries of the Company that are engaged in the conduct of its cigarette businesses. (See Note 6). The notes are not guaranteed by any of the Company’s subsidiaries engaged in the real estate businesses conducted through its subsidiary New Valley.

Presented herein are Condensed Consolidating Balance Sheets as of September 30, 2016 and December 31, 2015, the related Condensed Consolidating Statements of Operations for the three and nine months ended September 30, 2016 and the related Condensed Consolidating Statements of Cash Flows for the nine months ended September 30, 2016 and 2015 of Vector Group. (Parent/Issuer), the guarantor subsidiaries (Subsidiary Guarantors) and the subsidiaries that are not guarantors (Subsidiary Non-Guarantors).



## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## CONDENSED CONSOLIDATING BALANCE SHEETS

|  | September 30, 2016 |                          |                    |                              | Consolidated<br>Vector<br>Group<br>Ltd. |
|--|--------------------|--------------------------|--------------------|------------------------------|---|
|  | Parent/<br>Issuer  | Subsidiary<br>Guarantors | Non-<br>Guarantors | Consolidating<br>Adjustments |   |
| <b>ASSETS:</b>   |                    |                          |                    |                              |   |
| Current assets:  |                    |                          |                    |                              |   |
| Cash and cash equivalents  | \$287,097          | \$44,934                 | \$ 113,843         | \$ —                         | \$ 445,874                              |
| Investment securities available for sale   | 132,849            | 42,804                   | —                  | —                            | 175,653                                 |
| Accounts receivable - trade, net   | —                  | 13,766                   | 9,605              | —                            | 23,371                                  |
| Intercompany receivables   | 19,347             | —                        | —                  | (19,347 )                    | —                                       |
| Inventories  | —                  | 87,622                   | —                  | —                            | 87,622                                  |
| Income taxes receivable, net   | 17,277             | —                        | —                  | (9,990 )                     | 7,287                                   |
| Restricted assets  | —                  | 3,835                    | 914                | —                            | 4,749                                   |
| Other current assets   | 4,411              | 3,611                    | 31,147             | —                            | 39,169                                  |
| Total current assets   | 460,981            | 196,572                  | 155,509            | (29,337 )                    | 783,725                                 |
| Property, plant and equipment, net   | 1,270              | 50,146                   | 26,471             | —                            | 77,887                                  |
| Investments in real estate, net  | —                  | —                        | 23,630             | —                            | 23,630                                  |
| Long-term investments  | 53,091             | 413                      | 501                | —                            | 54,005                                  |
| Investments in real estate ventures  | —                  | —                        | 211,825            | —                            | 211,825                                 |
| Investments in consolidated subsidiaries   | 511,298            | —                        | —                  | (511,298 )                   | —                                       |
| Restricted assets  | 1,724              | 6,410                    | —                  | —                            | 8,134                                   |
| Goodwill and other intangible assets, net  | —                  | 107,511                  | 154,408            | —                            | 261,919                                 |
| Prepaid pension costs  | —                  | 21,628                   | —                  | —                            | 21,628                                  |
| Other assets   | 7,575              | 12,053                   | 2,349              | —                            | 21,977                                  |
| Total assets   | \$1,035,939        | \$394,733                | \$574,693          | \$ (540,635 )                | \$1,464,730                             |
| <b>LIABILITIES AND STOCKHOLDERS' DEFICIENCY:</b>                                   |                    |                          |                    |                              |   |
| Current liabilities:   |                    |                          |                    |                              |   |
| Current portion of notes payable and long-term debt                                | \$—                | \$16,106                 | \$ 174             | \$ —                         | \$ 16,280                               |
| Current portion of employee benefits   | —                  | 914                      | —                  | —                            | 914                                     |
| Intercompany payables  | —                  | 1                        | 19,346             | (19,347 )                    | —                                       |
| Income taxes payable, net  | —                  | 9,057                    | 933                | (9,990 )                     | —                                       |
| Litigation accruals and current payments due under the Master Settlement Agreement | —                  | 86,298                   | —                  | —                            | 86,298                                  |
| Other current liabilities  | 29,948             | 39,149                   | 44,768             | —                            | 113,865                                 |
| Total current liabilities  | 29,948             | 151,525                  | 65,221             | (29,337 )                    | 217,357                                 |
| Notes payable, long-term debt and other obligations, less current portion          | 1,115,272          | 5,726                    | 435                | —                            | 1,121,433                               |
| Fair value of derivatives embedded within convertible debt                         | 120,820            | —                        | —                  | —                            | 120,820                                 |
| Non-current employee benefits  | 40,490             | 14,961                   | —                  | —                            | 55,451                                  |
| Deferred income taxes, net   | 8,002              | 35,407                   | 46,148             | —                            | 89,557                                  |

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|   |             |           |           |             |             |
|---|-------------|-----------|-----------|-------------|-------------|
| Other liabilities, primarily litigation accruals and payments due under the Master Settlement Agreement | 2,539       | 45,597    | 10,573    | —           | 58,709      |
| Total liabilities   | 1,317,071   | 253,216   | 122,377   | (29,337)    | 1,663,327   |
| Commitments and contingencies   |             |           |           |             |             |
| Stockholders' (deficiency) equity attributed to Vector Group Ltd.                                       | (281,132)   | 141,517   | 369,781   | (511,298)   | (281,132)   |
| Non-controlling interest  | —           | —         | 82,535    | —           | 82,535      |
| Total stockholders' (deficiency) equity   | (281,132)   | 141,517   | 452,316   | (511,298)   | (198,597)   |
| Total liabilities and stockholders' deficiency  | \$1,035,939 | \$394,733 | \$574,693 | \$(540,635) | \$1,464,730 |

## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## CONDENSED CONSOLIDATING BALANCE SHEETS

|  | December 31, 2015 |                          |                    |                              | Consolidated<br>Vector<br>Group<br>Ltd. |
|--|-------------------|--------------------------|--------------------|------------------------------|---|
|  | Parent/<br>Issuer | Subsidiary<br>Guarantors | Non-<br>Guarantors | Consolidating<br>Adjustments |   |
| <b>ASSETS:</b>   |                   |                          |                    |                              |   |
| Current assets:  |                   |                          |                    |                              |   |
| Cash and cash equivalents  | \$ 111,470        | \$ 12,375                | \$ 116,523         | \$ —                         | \$ 240,368                              |
| Investment securities available for sale   | 131,810           | 50,166                   | —                  | —                            | 181,976                                 |
| Accounts receivable - trade, net   | —                 | 15,913                   | 7,976              | —                            | 23,889                                  |
| Intercompany receivables   | 11,293            | —                        | —                  | (11,293)                     | —                                       |
| Inventories  | —                 | 86,516                   | —                  | —                            | 86,516                                  |
| Income taxes receivable, net   | 8,213             | —                        | —                  | (5,372)                      | 2,841                                   |
| Restricted assets  | —                 | 7,781                    | 1,414              | —                            | 9,195                                   |
| Other current assets   | 575               | 3,747                    | 34,632             | —                            | 38,954                                  |
| Total current assets   | 263,361           | 176,498                  | 160,545            | (16,665)                     | 583,739                                 |
| Property, plant and equipment, net   | 1,711             | 54,097                   | 19,824             | —                            | 75,632                                  |
| Investments in real estate, net  | —                 | —                        | 23,318             | —                            | 23,318                                  |
| Long-term investments  | 61,747            | 478                      | 501                | —                            | 62,726                                  |
| Investments in real estate ventures  | —                 | —                        | 217,168            | —                            | 217,168                                 |
| Investments in consolidated subsidiaries   | 532,501           | —                        | —                  | (532,501)                    | —                                       |
| Restricted assets  | 1,713             | 10,590                   | —                  | —                            | 12,303                                  |
| Goodwill and other intangible assets, net  | —                 | 107,511                  | 156,448            | —                            | 263,959                                 |
| Prepaid pension costs  | —                 | 20,650                   | —                  | —                            | 20,650                                  |
| Other assets   | 7,582             | 11,769                   | 1,769              | —                            | 21,120                                  |
| Total assets   | \$ 868,615        | \$ 381,593               | \$ 579,573         | \$ (549,166)                 | \$ 1,280,615                            |
| <b>LIABILITIES AND STOCKHOLDERS'</b>   |                   |                          |                    |                              |   |
| <b>DEFICIENCY:</b>   |                   |                          |                    |                              |   |
| Current liabilities:   |                   |                          |                    |                              |   |
| Current portion of notes payable and long-term debt                                | \$ —              | \$ 8,733                 | \$ 186             | \$ —                         | \$ 8,919                                |
| Current portion of employee benefits   | —                 | 915                      | —                  | —                            | 915                                     |
| Intercompany payables  | —                 | 586                      | 10,707             | (11,293)                     | —                                       |
| Income taxes payable, net  | —                 | 5,464                    | 4                  | (5,372)                      | 96                                      |
| Litigation accruals and current payments due under the Master Settlement Agreement | —                 | 52,145                   | —                  | —                            | 52,145                                  |
| Other current liabilities  | 38,140            | 74,083                   | 41,994             | —                            | 154,217                                 |
| Total current liabilities  | 38,140            | 141,926                  | 52,891             | (16,665)                     | 216,292                                 |
| Notes payable, long-term debt and other obligations, less current portion          | 848,368           | 7,519                    | 221                | —                            | 856,108                                 |
| Fair value of derivatives embedded within convertible debt                         | 144,042           | —                        | —                  | —                            | 144,042                                 |
| Non-current employee benefits  | 39,244            | 15,811                   | —                  | —                            | 55,055                                  |
| Deferred income taxes, net   | 2,675             | 33,791                   | 42,963             | —                            | 79,429                                  |

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|   |            |           |           |            |               |
|---|------------|-----------|-----------|------------|---------------|
| Other liabilities, primarily litigation accruals and payments due under the Master Settlement Agreement | 2,193      | 44,982    | 4,675     | —          | 51,850        |
| Total liabilities   | 1,074,662  | 244,029   | 100,750   | (16,665    | ) 1,402,776   |
| Commitments and contingencies   |            |           |           |            |               |
| Stockholders' (deficiency) equity attributed to Vector Group Ltd.                                       | (206,047 ) | 137,564   | 394,937   | (532,501   | ) (206,047 )  |
| Non-controlling interest  | —          | —         | 83,886    | —          | 83,886        |
| Total stockholders' (deficiency) equity   | (206,047 ) | 137,564   | 478,823   | (532,501   | ) (122,161 )  |
| Total liabilities and stockholders' deficiency  | \$868,615  | \$381,593 | \$579,573 | \$(549,166 | ) \$1,280,615 |

VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS

|  | Three Months Ended September 30,<br>2016 |                          |                                  |                              |                                      |
|--|--|--------------------------|----------------------------------|------------------------------|--------------------------------------|
|  | Parent/<br>Issuer                        | Subsidiary<br>Guarantors | Subsidiary<br>Non-<br>Guarantors | Consolidating<br>Adjustments | Consolidated<br>Vector Group<br>Ltd. |
| Revenues   | \$—                                      | \$274,297                | \$184,936                        | \$ (129 )                    | \$ 459,104                           |
| Expenses:  |  |                          |                                  |                              |                                      |
| Cost of sales  | —  | 186,353                  | 117,089                          | —                            | 303,442                              |
| Operating, selling, administrative and general expenses              | 8,726                                    | 18,658                   | 59,043                           | (129 )                       | 86,298                               |
| Management fee expense   | —  | 2,662                    | —                                | (2,662 )                     | —                                    |
| Operating (loss) income  | (8,726 )                                 | 66,624                   | 8,804                            | 2,662                        | 69,364                               |
| Other income (expenses):   |  |                          |                                  |                              |                                      |
| Interest expense   | (36,531 )                                | (827 )                   | (7 )                             | —                            | (37,365 )                            |
| Change in fair value of derivatives embedded within convertible debt | 6,112                                    | —                        | —                                | —                            | 6,112                                |
| Equity in earnings from real estate ventures                         | —  | —                        | 1,022                            | —                            | 1,022                                |
| Equity in losses from investments                                    | (1,485 )                                 | (41 )                    | —                                | —                            | (1,526 )                             |
| Gain on sale of investment securities available for sale             | 142                                      | —                        | —                                | —                            | 142                                  |
| Impairment of investment securities available for sale               | (54 )                                    | —                        | —                                | —                            | (54 )                                |
| Equity in earnings in consolidated subsidiaries                      | 49,447                                   | —                        | —                                | (49,447 )                    | —                                    |
| Management fee income  | 2,662                                    | —                        | —                                | (2,662 )                     | —                                    |
| Other, net   | 1,205                                    | 259                      | (136 )                           | —                            | 1,328                                |
| Income before provision for income taxes                             | 12,772                                   | 66,015                   | 9,683                            | (49,447 )                    | 39,023                               |
| Income tax benefit (expense)   | 10,403                                   | (21,289 )                | (2,430 )                         | —                            | (13,316 )                            |
| Net income   | 23,175                                   | 44,726                   | 7,253                            | (49,447 )                    | 25,707                               |
| Net income attributed to non-controlling interest                    | —  | —                        | (2,532 )                         | —                            | (2,532 )                             |
| Net income attributed to Vector Group Ltd.                           | \$23,175                                 | \$44,726                 | \$4,721                          | \$ (49,447 )                 | \$ 23,175                            |
| Comprehensive income attributed to non-controlling interest          | \$—                                      | \$—                      | \$(2,532 )                       | \$—                          | \$(2,532 )                           |
| Comprehensive income attributed to Vector Group Ltd.                 | \$24,858                                 | \$46,197                 | \$4,721                          | \$ (50,918 )                 | \$ 24,858                            |

VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS

|  | Three Months Ended September 30,<br>2015 |                          |                                  |                              | Consolidated<br>Vector Group<br>Ltd. |
|--|--|--------------------------|----------------------------------|------------------------------|--------------------------------------|
|  | Parent/<br>Issuer                        | Subsidiary<br>Guarantors | Subsidiary<br>Non-<br>Guarantors | Consolidating<br>Adjustments |                                      |
| Revenues   | \$—                                      | \$264,480                | \$185,563                        | \$ (109 )                    | \$ 449,934                           |
| Expenses:  |  |                          |                                  |                              |                                      |
| Cost of sales  | —  | 174,839                  | 121,078                          | —                            | 295,917                              |
| Operating, selling, administrative and general expenses              | 6,610                                    | 20,712                   | 52,139                           | (109 )                       | 79,352                               |
| Litigation settlement and judgment expense                           | —  | 3,750                    | —                                | —                            | 3,750                                |
| Management fee expense   | —  | 2,562                    | —                                | (2,562 )                     | —                                    |
| Restructuring charges  | —  | 1,548                    | —                                | —                            | 1,548                                |
| Operating (loss) income  | (6,610 )                                 | 61,069                   | 12,346                           | 2,562                        | 69,367                               |
| Other income (expenses):   |  |                          |                                  |                              |                                      |
| Interest expense   | (31,609 )                                | (1,288 )                 | (1 )                             | —                            | (32,898 )                            |
| Change in fair value of derivatives embedded within convertible debt | 7,044                                    | —                        | —                                | —                            | 7,044                                |
| Equity in losses from real estate ventures                           | —  | —                        | (916 )                           | —                            | (916 )                               |
| Equity in losses from investments                                    | (1,087 )                                 | (16 )                    | —                                | —                            | (1,103 )                             |
| Loss on sale of investment securities available for sale             | (821 )                                   | —                        | —                                | —                            | (821 )                               |
| Impairment of investment securities available for sale               | (4,224 )                                 | (7,987 )                 | —                                | —                            | (12,211 )                            |
| Equity in earnings in consolidated subsidiaries                      | 32,326                                   | —                        | —                                | (32,326 )                    | —                                    |
| Management fee income  | 2,562                                    | —                        | —                                | (2,562 )                     | —                                    |
| Other, net   | 1,148                                    | (111 )                   | 305                              | —                            | 1,342                                |
| (Loss) income before provision for income taxes                      | (1,271 )                                 | 51,667                   | 11,734                           | (32,326 )                    | 29,804                               |
| Income tax benefit (expense)   | 13,737                                   | (24,036 )                | (3,395 )                         | —                            | (13,694 )                            |
| Net income   | 12,466                                   | 27,631                   | 8,339                            | (32,326 )                    | 16,110                               |
| Net income attributed to non-controlling interest                    | —  | —                        | (3,644 )                         | —                            | (3,644 )                             |
| Net income attributed to Vector Group Ltd.                           | \$12,466                                 | \$27,631                 | \$4,695                          | \$ (32,326 )                 | \$ 12,466                            |
| Comprehensive income attributed to non-controlling interest          | \$—                                      | \$—                      | \$(3,644 )                       | \$—                          | \$(3,644 )                           |
| Comprehensive (loss) income attributed to Vector Group Ltd.          | \$(11,816)                               | \$9,469                  | \$4,695                          | \$(14,164 )                  | \$(11,816 )                          |

## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS

|  | Nine Months Ended September 30,<br>2016 |                          |                                  |                              | Consolidated<br>Vector Group<br>Ltd. |
|--|---|--------------------------|----------------------------------|------------------------------|--------------------------------------|
|  | Parent/<br>Issuer                       | Subsidiary<br>Guarantors | Subsidiary<br>Non-<br>Guarantors | Consolidating<br>Adjustments |                                      |
| Revenues   | \$—                                     | \$751,087                | \$527,448                        | \$ (358 )                    | \$ 1,278,177                         |
| Expenses:  |   |                          |                                  |                              |                                      |
| Cost of sales  | —                                       | 491,711                  | 331,784                          | —                            | 823,495                              |
| Operating, selling, administrative and general expenses              | 26,941                                  | 55,874                   | 167,591                          | (358 )                       | 250,048                              |
| Litigation settlement and judgment expense                           | —                                       | 2,350                    | —                                | —                            | 2,350                                |
| Management fee expense   | —                                       | 7,987                    | —                                | (7,987 )                     | —                                    |
| Restructuring charges  | —                                       | 41                       | —                                | —                            | 41                                   |
| Operating (loss) income  | (26,941 )                               | 193,124                  | 28,073                           | 7,987                        | 202,243                              |
| Other income (expenses):   |   |                          |                                  |                              |                                      |
| Interest expense   | (101,811)                               | (2,629 )                 | (14 )                            | —                            | (104,454 )                           |
| Change in fair value of derivatives embedded within convertible debt | 23,222                                  | —                        | —                                | —                            | 23,222                               |
| Equity in earnings from real estate ventures                         | —                                       | —                        | 3,328                            | —                            | 3,328                                |
| Equity in losses from investments                                    | (2,043 )                                | (65 )                    | —                                | —                            | (2,108 )                             |
| Gain on sale of investment securities available for sale             | 457                                     | 391                      | —                                | —                            | 848                                  |
| Impairment of investment securities available for sale               | (144 )                                  | (4,772 )                 | —                                | —                            | (4,916 )                             |
| Equity in earnings in consolidated subsidiaries                      | 131,498                                 | —                        | —                                | (131,498 )                   | —                                    |
| Management fee income  | 7,987                                   | —                        | —                                | (7,987 )                     | —                                    |
| Other, net   | 1,512                                   | 740                      | 704                              | —                            | 2,956                                |
| Income before provision for income taxes                             | 33,737                                  | 186,789                  | 32,091                           | (131,498 )                   | 121,119                              |
| Income tax benefit (expense)   | 32,791                                  | (69,582 )                | (9,891 )                         | —                            | (46,682 )                            |
| Net income   | 66,528                                  | 117,207                  | 22,200                           | (131,498 )                   | 74,437                               |
| Net income attributed to non-controlling interest                    | —                                       | —                        | (7,909 )                         | —                            | (7,909 )                             |
| Net income attributed to Vector Group Ltd.                           | \$66,528                                | \$117,207                | \$14,291                         | \$(131,498 )                 | \$66,528                             |
| Comprehensive income attributed to non-controlling interest          | \$—                                     | \$—                      | \$(7,909 )                       | \$—                          | \$(7,909 )                           |
| Comprehensive income attributed to Vector Group Ltd.                 | \$67,985                                | \$118,700                | \$14,291                         | \$(132,991 )                 | \$67,985                             |

VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS

|  | Nine Months Ended September 30,<br>2015 |                          |                    |                              |                      |
|--|---|--------------------------|--------------------|------------------------------|----------------------|
|  | Parent/<br>Issuer                       | Subsidiary<br>Guarantors | Non-<br>Guarantors | Consolidating<br>Adjustments | Vector Group<br>Ltd. |
| Revenues   | \$—                                     | \$748,394                | \$478,841          | \$ (368 )                    | \$ 1,226,867         |
| Expenses:  |   |                          |                    |                              |                      |
| Cost of sales  | —                                       | 507,833                  | 309,306            | —                            | 817,139              |
| Operating, selling, administrative and general expenses              | 20,978                                  | 64,604                   | 148,235            | (368 )                       | 233,449              |
| Litigation settlement and judgment expense                           | —                                       | 5,843                    | —                  | —                            | 5,843                |
| Management fee expense   | —                                       | 7,687                    | —                  | (7,687 )                     | —                    |
| Restructuring charges  | —                                       | 1,548                    | —                  | —                            | 1,548                |
| Operating (loss) income  | (20,978 )                               | 160,879                  | 21,300             | 7,687                        | 168,888              |
| Other income (expenses):   |   |                          |                    |                              |                      |
| Interest expense   | (93,243 )                               | (3,158 )                 | (4 )               | —                            | (96,405 )            |
| Change in fair value of derivatives embedded within convertible debt | 18,760                                  | —                        | —                  | —                            | 18,760               |
| Equity in earnings from real estate ventures                         | —                                       | —                        | 1,278              | —                            | 1,278                |
| (Loss) gain on sale of investment securities available for sale      | (1,157 )                                | 13,175                   | —                  | —                            | 12,018               |
| Impairment of investment securities available for sale               | (4,224 )                                | (7,987 )                 | —                  | —                            | (12,211 )            |
| Equity in losses from investments                                    | (2,630 )                                | (24 )                    | —                  | —                            | (2,654 )             |
| Equity in earnings in consolidated subsidiaries                      | 104,070                                 | —                        | —                  | (104,070 )                   | —                    |
| Management fee income  | 7,687                                   | —                        | —                  | (7,687 )                     | —                    |
| Other, net   | 3,405                                   | 409                      | 1,286              | —                            | 5,100                |
| Income before provision for income taxes                             | 11,690                                  | 163,294                  | 23,860             | (104,070 )                   | 94,774               |
| Income tax benefit (expense)   | 39,604                                  | (69,439 )                | (7,904 )           | —                            | (37,739 )            |
| Net income   | 51,294                                  | 93,855                   | 15,956             | (104,070 )                   | 57,035               |
| Net income attributed to non-controlling interest                    | —                                       | —                        | (5,741 )           | —                            | (5,741 )             |
| Net income attributed to Vector Group Ltd.                           | \$51,294                                | \$93,855                 | \$10,215           | \$ (104,070 )                | \$51,294             |
| Comprehensive income attributed to non-controlling interest          | \$—                                     | \$—                      | \$ (5,741 )        | \$—                          | \$ (5,741 )          |
| Comprehensive income attributed to Vector Group Ltd.                 | \$32,221                                | \$72,867                 | \$10,215           | \$ (83,082 )                 | \$32,221             |



VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## CONDENSED CONSOLIDATING STATEMENTS OF CASH FLOWS

|   | Nine Months Ended September 30,<br>2016 |                          |                    |                              | Consolidated<br>Vector<br>Group<br>Ltd. |
|---|---|--------------------------|--------------------|------------------------------|---|
|   | Parent/<br>Issuer                       | Subsidiary<br>Guarantors | Non-<br>Guarantors | Consolidating<br>Adjustments |   |
| Net cash provided by operating activities                   | \$87,016                                | \$136,255                | \$54,807           | \$ (156,635 )                | \$121,443                               |
| Cash flows from investing activities:                       |   |                          |                    |                              |   |
| Sale of investment securities                               | 76,514                                  | 4,721                    | —                  | —                            | 81,235                                  |
| Maturities of investment securities                         | 4,343                                   | —                        | —                  | —                            | 4,343                                   |
| Purchase of investment securities                           | (90,106 )                               | —                        | —                  | —                            | (90,106 )                               |
| Proceeds from sale or liquidation of long-term investments  | 1,000                                   | —                        | —                  | —                            | 1,000                                   |
| Purchase of long-term investments                           | —                                       | —                        | (50 )              | —                            | (50 )                                   |
| Investments in real estate ventures                         | —                                       | —                        | (23,358 )          | —                            | (23,358 )                               |
| Distributions from investments in real estate ventures      | —                                       | —                        | 23,041             | —                            | 23,041                                  |
| Increase in cash surrender value of life insurance policies | —                                       | (451 )                   | —                  | —                            | (451 )                                  |
| (Increase) decrease in restricted assets                    | (11 )                                   | 8,126                    | 500                | —                            | 8,615                                   |
| Investments in subsidiaries                                 | (1,103 )                                | —                        | —                  | 1,103                        | —                                       |
| Proceeds from sale of fixed assets                          | —                                       | 32                       | 13                 | —                            | 45                                      |
| Capital expenditures  | (33 )                                   | (5,619 )                 | (13,505 )          | —                            | (19,157 )                               |
| Repayments of notes receivable                              | —                                       | —                        | 4,410              | —                            | 4,410                                   |
| Pay downs of investment securities                          | 7,842                                   | —                        | —                  | —                            | 7,842                                   |
| Investments in real estate, net                             | —                                       | —                        | (130 )             | —                            | (130 )                                  |
| Net cash (used in) provided by investing activities         | (1,554 )                                | 6,809                    | (9,079 )           | 1,103                        | (2,721 )                                |
| Cash flows from financing activities:                       |   |                          |                    |                              |   |
| Proceeds from issuance of debt                              | 243,225                                 | —                        | 395                | —                            | 243,620                                 |
| Deferred financing costs                                    | (6,600 )                                | —                        | —                  | —                            | (6,600 )                                |
| Repayments of debt  | —                                       | (4,602 )                 | (96 )              | —                            | (4,698 )                                |
| Borrowings under revolver                                   | —                                       | 104,826                  | —                  | —                            | 104,826                                 |
| Repayments on revolver                                      | —                                       | (94,644 )                | —                  | —                            | (94,644 )                               |
| Capital contributions received                              | —                                       | 700                      | 403                | (1,103 )                     | —                                       |
| Intercompany dividends paid                                 | —                                       | (116,785 )               | (39,850 )          | 156,635                      | —                                       |
| Dividends and distributions on common stock                 | (147,270 )                              | —                        | —                  | —                            | (147,270 )                              |
| Contributions from non-controlling interest                 | —                                       | —                        | 248                | —                            | 248                                     |
| Distributions to non-controlling interest                   | —                                       | —                        | (9,508 )           | —                            | (9,508 )                                |
| Proceeds from exercise of Vector options                    | 398                                     | —                        | —                  | —                            | 398                                     |
| Tax benefit of options exercised                            | 412                                     | —                        | —                  | —                            | 412                                     |
| Net cash provided by (used in) financing activities         | 90,165                                  | (110,505 )               | (48,408 )          | 155,532                      | 86,784                                  |
| Net increase (decrease) in cash and cash equivalents        | 175,627                                 | 32,559                   | (2,680 )           | —                            | 205,506                                 |
| Cash and cash equivalents, beginning of period              | 111,470                                 | 12,375                   | 116,523            | —                            | 240,368                                 |

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|  |           |          |           |     |           |
|--|-----------|----------|-----------|-----|-----------|
| Cash and cash equivalents, end of period | \$287,097 | \$44,934 | \$113,843 | \$— | \$445,874 |
|--|-----------|----------|-----------|-----|-----------|

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## VECTOR GROUP LTD.

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

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

## CONDENSED CONSOLIDATING STATEMENTS OF CASH FLOWS

|   | Nine Months Ended September 30,<br>2015 |                          |                    |                              | Consolidated<br>Vector<br>Group<br>Ltd. |
|---|---|--------------------------|--------------------|------------------------------|---|
|   | Parent/<br>Issuer                       | Subsidiary<br>Guarantors | Non-<br>Guarantors | Consolidating<br>Adjustments |   |
| Net cash provided by operating activities                   | \$84,832                                | \$168,095                | \$31,660           | \$ (144,569 )                | \$ 140,018                              |
| Cash flows from investing activities:                       |   |                          |                    |                              |   |
| Sale of investment securities                               | 146,614                                 | 14,415                   | —                  | —                            | 161,029                                 |
| Maturities of investment securities                         | 2,653                                   | —                        | —                  | —                            | 2,653                                   |
| Purchase of investment securities                           | (156,521)                               | (6,324 )                 | —                  | —                            | (162,845 )                              |
| Proceeds from sale or liquidation of long-term investments  | 1,106                                   | —                        | 182                | —                            | 1,288                                   |
| Purchase of long-term investments                           | (10,000 )                               | —                        | —                  | —                            | (10,000 )                               |
| Investments in real estate ventures                         | —                                       | —                        | (43,280 )          | —                            | (43,280 )                               |
| Investments in real estate, net                             | —                                       | —                        | (12,512 )          | —                            | (12,512 )                               |
| Distributions from investments in real estate ventures      | —                                       | —                        | 11,205             | —                            | 11,205                                  |
| Increase in cash surrender value of life insurance policies | (766 )                                  | (459 )                   | —                  | —                            | (1,225 )                                |
| Increase in restricted assets                               | (2 )                                    | (6,870 )                 | —                  | —                            | (6,872 )                                |
| Issuance of notes receivable                                | —                                       | —                        | (4,410 )           | —                            | (4,410 )                                |
| Repayments of notes receivable                              | —                                       | —                        | 4,000              | —                            | 4,000                                   |
| Pay downs of investment securities                          | 5,743                                   | —                        | —                  | —                            | 5,743                                   |
| Proceeds from sale of fixed assets                          | —                                       | 3                        | —                  | —                            | 3                                       |
| Investments in subsidiaries                                 | (53,511 )                               | —                        | —                  | 53,511                       | —                                       |
| Proceeds from sale of preferred securities                  | —                                       | —                        | 1,000              | —                            | 1,000                                   |
| Capital expenditures  | —                                       | (3,305 )                 | (4,554 )           | —                            | (7,859 )                                |
| Net cash used in investing activities                       | (64,684 )                               | (2,540 )                 | (48,369 )          | 53,511                       | (62,082 )                               |
| Cash flows from financing activities:                       |   |                          |                    |                              |   |
| Proceeds from issuance of debt                              | —                                       | 1,519                    | —                  | —                            | 1,519                                   |
| Deferred financing costs                                    | —                                       | (624 )                   | —                  | —                            | (624 )                                  |
| Repayments of debt  | —                                       | (4,786 )                 | (182 )             | —                            | (4,968 )                                |
| Borrowings under revolver                                   | —                                       | 130,691                  | —                  | —                            | 130,691                                 |
| Repayments on revolver                                      | —                                       | (146,655 )               | —                  | —                            | (146,655 )                              |
| Capital contributions received                              | —                                       | 5,633                    | 47,878             | (53,511 )                    | —                                       |
| Intercompany dividends paid                                 | —                                       | (134,215 )               | (10,354 )          | 144,569                      | —                                       |
| Dividends and distributions on common stock                 | (139,430)                               | —                        | —                  | —                            | (139,430 )                              |
| Distributions to non-controlling interest                   | —                                       | —                        | (564 )             | —                            | (564 )                                  |
| Proceeds from exercise of Vector options                    | 1,321                                   | —                        | —                  | —                            | 1,321                                   |
| Tax benefit of options exercised                            | 756                                     | —                        | —                  | —                            | 756                                     |
| Net cash (used in) provided by financing activities         | (137,353)                               | (148,437 )               | 36,778             | 91,058                       | (157,954 )                              |
| Net (decrease) increase in cash and cash equivalents        | (117,205)                               | 17,118                   | 20,069             | —                            | (80,018 )                               |

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|  |          |          |           |     |           |
|--|----------|----------|-----------|-----|-----------|
| Cash and cash equivalents, beginning of period | 211,751  | 9,724    | 104,890   | —   | 326,365   |
| Cash and cash equivalents, end of period       | \$94,546 | \$26,842 | \$124,959 | \$— | \$246,347 |

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

(Dollars in Thousands, Except Per Share Amounts)

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

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

Please read this discussion along with our MD&A and audited financial statements as of and for the year ended December 31, 2015 and Notes thereto, included in our 2015 Annual Report on Form 10-K, and our Consolidated Condensed Financial Statements and related Notes as of and for the quarterly period September 30, 2016.

### Overview

We are a holding company and are engaged principally in:

the manufacture and sale of cigarettes in the United States through our Liggett Group LLC and Vector Tobacco Inc. subsidiaries,

the sale of electronic cigarettes in the United States through our Zoom E-Cigs LLC subsidiary, and the real estate business through our New Valley LLC subsidiary, which is seeking to acquire or invest in additional real estate properties or projects. New Valley owns 70.59% of Douglas Elliman, which operates the largest residential brokerage company in the New York metropolitan area.

Zoom entered the United States e-cigarette market in limited retail distribution outlets in 2013. Zoom's operations are included in our "E-Cigarettes" reporting segment. We have seen significant changes in the e-cigarette market since entering the market with declines in the sales of disposable and rechargeable e-cigarettes while open-system vapor products that feature refillable tanks and use low-cost flavored liquids have demonstrated mixed results. Additionally, we believe uncertainties exist related to the impact of recent regulation of e-cigarettes, including open-system vapor products. Given the current market situation, our primary focus on e-cigarettes is to pursue opportunities if they occur.

### Recent Developments

Investments in Ladenburg Thalmann Financial Services ("LTS") and Castle Brands Inc. ("Castle"). We adopted the equity method of accounting for our investments in LTS and Castle in 2015 because we determined that we had significant influence due to the evolution of the relationships with each company. We have adjusted our condensed consolidated financial statements, retrospectively, as if the equity method had been in effect since inception. On October 26, 2016, we exercised warrants to purchase 1,000,000 LTS shares at \$1.68 per share. Our ownership percentage increased to 7.8%.

Issuance of Senior Secured Notes due 2021. On May 9, 2016, we completed the sale of an additional \$235,000 principal amount of our 7.75% Senior Secured Notes due 2021 for a price of 103.50% in a private offering to qualified institutional investors in accordance with Rule 144A of the Securities Act of 1933 (the "Securities Act"). We received net proceeds of approximately \$236,900. The net proceeds will be used for general corporate purposes, including for additional investments in real estate and in our tobacco business. In August 2016, we completed an offer to exchange

the 7.75% senior secured notes issued in May 2016 for an equal amount of newly issued 7.75% senior secured notes due 2021. The new 7.75% senior secured notes have substantially the same terms as the original notes, except that the new 7.75% senior secured notes have been registered under the Securities Act.

### Recent Developments in Smoking-Related Litigation

There are no material changes from the Recent Developments in Smoking-Related Litigation set forth in Item 7, “Management's Discussion and Analysis of Financial Condition and Results of Operations,” of our Annual Report on Form 10-K, for the year ended December 31, 2015. Please refer to that section and the information below for disclosures regarding the critical accounting policies related to our business.

### Critical Accounting Policies

There are no material changes from the critical accounting policies set forth in Item 7, “Management's Discussion and Analysis of Financial Condition and Results of Operations,” of our Annual Report on Form 10-K, for the year ended December 31, 2015. Please refer to that section and the information below for disclosures regarding the critical accounting policies related to our business.

### Results of Operations

The following discussion provides an assessment of our results of operations, capital resources and liquidity and should be read in conjunction with our condensed consolidated financial statements included elsewhere in this report. The condensed consolidated financial statements include the accounts of VGR Holding, Liggett, Vector Tobacco, Liggett Vector Brands, New Valley, Zoom and other less significant subsidiaries.

For purposes of this discussion and other consolidated financial reporting, our significant business segments for the three and nine months ended September 30, 2016 and 2015 were Tobacco, E-Cigarettes and Real Estate. The Tobacco segment consists of the manufacture and sale of cigarettes. The E-Cigarettes segment includes the operations of Zoom. The Real Estate segment includes our investment in New Valley LLC, which includes Douglas Elliman, Escena, Sagaponack and investments in real estate ventures.

|                          | Three Months Ended<br>September 30, |                         | Nine Months Ended<br>September 30, |                          |
|--------------------------|-------------------------------------|-------------------------|------------------------------------|--------------------------|
|                          | 2016                                | 2015                    | 2016                               | 2015                     |
| Revenues:                |                                     |                         |                                    |                          |
| Tobacco                  | \$274,164                           | \$264,170               | \$750,677                          | \$747,145                |
| E-Cigarettes             | 4                                   | 201                     | 52                                 | 881                      |
| Real Estate              | 184,936                             | 185,563                 | 527,448                            | 478,841                  |
| Total revenues           | \$459,104                           | \$449,934               | \$1,278,177                        | \$1,226,867              |
| Operating income (loss): |                                     |                         |                                    |                          |
| Tobacco                  | \$66,974                            | <sup>(1)</sup> \$63,630 | <sup>(2)</sup> \$194,473           | <sup>(3)</sup> \$169,515 |
| E-Cigarettes             | (165)                               | (2,146)                 | (449)                              | (7,710)                  |
| Real Estate              | 8,844                               | 12,227                  | 28,224                             | 21,270                   |
| Corporate and Other      | (6,289)                             | (4,344)                 | (20,005)                           | (14,187)                 |
| Total operating income   | \$69,364                            | \$69,367                | \$202,243                          | \$168,888                |

(1) Operating income includes \$370 of income from MSA Settlement.

(2) Operating income includes \$5,715 of income from MSA Settlement, \$3,750 of litigation settlement and judgment expense and \$1,548 of restructuring expense.

(3) Operating income includes \$370 of income from MSA Settlement, \$2,350 of litigation settlement and judgment expense, and \$41 of restructuring expense.

- (4) Operating income includes \$5,715 of income from MSA Settlement, \$5,843 of litigation settlement and judgment expense, \$1,548 of restructuring expense, and \$1,607 of pension settlement expense.



Three Months Ended September 30, 2016 Compared to Three Months Ended September 30, 2015

Revenues. Total revenues were \$459,104 for the three months ended September 30, 2016 compared to \$449,934 for the three months ended September 30, 2015. The \$9,170 (2.0%) increase in revenues was due to a \$9,994 increase in Tobacco revenues offset by a \$627 decline in Real Estate revenues primarily related to Douglas Elliman's brokerage revenues and a \$197 decline in E-Cigarettes revenues.

Cost of sales. Total cost of sales were \$303,442 for the three months ended September 30, 2016 compared to \$295,917 for the three months ended September 30, 2015. The \$7,525 (2.5%) increase in cost of sales was due to an \$11,925 increase in Tobacco cost of sales primarily related to an increased sales volume and the \$5,715 of income from MSA settlements realized in the third quarter. This was offset by a \$3,989 decline in Real Estate cost of sales primarily related to a decline of real estate commission expense at Douglas Elliman as well as a \$411 decline in E-Cigarettes cost of sales. The calculation of our benefit from the MSA is an estimate based upon taxable unit shipments of cigarettes in the U.S. As of September 30, 2016, we estimated taxable shipments in the U.S. will decline by 3.5% in 2016. Our annual MSA expense changes by approximately \$1,800 for each percentage change in the estimated shipment volumes in the U.S. market.

Expenses. Operating, selling, general and administrative expenses were \$86,298 for the three months ended September 30, 2016 compared to \$79,352 for the same period last year. The \$6,946 (8.8%) increase in operating, selling and administrative expenses was due to an \$6,745 increase in Real Estate operating, selling, general and administrative expenses primarily at Douglas Elliman and a \$1,945 increase in Corporate and Other expense primarily due to an increase in stock-based compensation expense, executive pension expense and increased professional fees. This was offset by a \$1,767 decline in E-Cigarettes operating, selling, general and administrative expenses.

Operating income. Operating income was \$69,364 for the three months ended September 30, 2016 compared to \$69,367 for the same period last year. Tobacco operating income increased by \$3,344, E-Cigarettes operating losses declined by \$1,981 and this was offset by a \$3,383 decline in Real Estate operating income and an increase of \$1,945 in Corporate and Other expenses.

Other income (expenses). Other expenses were \$30,341 and \$39,563 for the three months ended September 30, 2016 and 2015, respectively. For the three months ended September 30, 2016, other expenses primarily consisted of interest expense of \$37,365, equity in losses from investments of \$1,526 and impairment of investment securities available for sale of \$54. This was offset by income of \$6,112 from changes in fair value of derivatives embedded within convertible debt, other income of \$1,328, equity in earnings from real estate ventures of \$1,022, and gain on sale of investment securities available for sale of \$142. For the three months ended September 30, 2015, other expenses primarily consisted of interest expense of \$32,898, impairment of investment securities available for sale of \$12,211, equity in losses from investments of \$1,103, equity in losses from real estate ventures of \$916, and a loss on sale of investment securities available for sale of \$821. This was offset by income of \$7,044 from changes in fair value of derivatives embedded within convertible debt and other income of \$1,342.

Income before provision for income taxes. Income before income taxes was \$39,023 and \$29,804 for the three months ended September 30, 2016 and 2015, respectively.

Income tax expense. Income tax expense was \$13,316 and \$13,694 for the three months ended September 30, 2016 and 2015, respectively. Our provision for income taxes in interim periods is based on an estimated annual effective income tax rate derived, in part, from estimated annual income before provision for income taxes in accordance with guidance on accounting for income taxes on interim periods. For the three months ended September 30, 2016, our income tax expense was decreased by \$1,149 due primarily to a change in the estimated annual effective income tax rate.

Tobacco.

Tobacco revenues. Liggett increased the list price of PYRAMID, LIGGETT SELECT, EVE and GRAND PRIX by \$0.70 per carton in May 2015, November 2015, and May 2016. Liggett increased the list price of EAGLE 20's by \$1.00 per carton in December 2015.

All of our Tobacco sales were in the discount category in 2016 and 2015. For the three months ended September 30, 2016, Tobacco revenues were \$274,164 compared to \$264,170 for the three months ended September 30, 2015.

Revenues increased by \$9,994 (3.8%) due to a favorable net pricing variance of \$8,287 and \$1,707 related to a 2.9%

increase in unit sales volume (approximately 64.2 million units).

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Tobacco cost of sales. The major components of our Tobacco cost of sales were as follows:

| Three Months Ended        |                |
|---------------------------|----------------|
| September 30,             |                |
| 2016                      | 2015           |
| Manufacturing overhead,   |                |
| raw materials and labor   |                |
| \$ 32,203                 | \$ 33,143      |
| Federal Excise Taxes, net |                |
| 116,024                   | 112,773        |
| FDA expense               |                |
| 4,763                     | 4,416          |
| MSA expense, net          |                |
| of 33,353                 | (1) 24,086 (2) |
| market share exemption    |                |
| Total cost of sales       |                |
| \$ 186,343                | \$ 174,418     |

(1) Includes \$370 reduction in expense from MSA Settlement.

(2) Includes \$5,715 reduction in expense from MSA Settlement.

Tobacco gross profit was \$87,821 for the three months ended September 30, 2016 compared to \$89,752 for the three months ended September 30, 2015. The \$1,931 (2.2%) decline was due primarily to the absence of a \$5,715 reduction in costs of sales related to the settlement of a MSA dispute in the third quarter of 2015, offset with higher margins associated with price increases primarily on the PYRAMID brand and lower manufacturing unit costs. As a percentage of revenues (excluding Federal Excise Taxes), Tobacco gross profit was 55.5% in the 2016 period and 59.3% in the 2015 period.

Tobacco expenses. Tobacco operating, selling, general and administrative expenses were \$20,847 and \$20,824 for the three months ended September 30, 2016 and 2015, respectively. The increase in expenses was due to decreased sales and marketing expenses primarily as a result of Liggett's restructuring in the third quarter of 2015 and a decline in pension expense in 2016, offset by an increase in legal and professional fees.

Total tobacco product liability legal expenses, including settlements and judgments, were \$1,500 and \$5,355 for the three months ended September 30, 2016 and 2015, respectively.

Tobacco operating income. Tobacco operating income was \$66,974 for the three months ended September 30, 2016 compared to \$63,630 for the same period last year. The Tobacco operating income increase of \$3,344 (5.3%) was primarily due to decreased product liability settlement costs and restructuring expenses partially offset by decreased margins discussed above.

E-Cigarettes.

E-Cigarettes revenues. E-Cigarettes revenues were \$4 for the three months ended September 30, 2016 compared to \$201 for three months ended September 30, 2015. Revenues declined by \$197 due to lower sales volumes.

E-Cigarettes cost of sales. Our E-Cigarettes cost of sales were \$10 for the three months ended September 30, 2016 compared to \$421 for the three months ended September 30, 2015. Cost of sales declined by \$411 due to lower sales volume.

E-Cigarettes expenses. E-Cigarettes operating, selling, general and administrative expenses were \$159 and \$1,926 for the three months ended September 30, 2016 and 2015, respectively. The decline was due to primarily lower sales and marketing expenses. Operating loss from E-Cigarettes were \$165 and \$2,146 for the three months ended September 30, 2016 and 2015, respectively.

Real Estate.

Real Estate revenues. Real Estate revenues were \$184,936 and \$185,563 for the three months ended ended September 30, 2016 and 2015, respectively. Real Estate revenues declined by \$627 (0.3%), primarily related to a decrease of \$1,108 in Douglas Elliman's Commission and other brokerage income.

Real Estate revenues and cost of sales for the three months ended September 30, 2016 and 2015 were as follows:

|   | Three Months<br>Ended<br>September 30, |            |
|---|--|------------|
|   | 2016                                   | 2015       |
| Real Estate Revenues:                             |  |            |
| Commission and other brokerage income             | \$ 175,634                             | \$ 176,742 |
| Property management income                        | 7,751                                  | 6,906      |
| Title fees  | 1,068                                  | 1,352      |
| Sales on facilities primarily from Escena         | 483                                    | 481        |
| Other   | —                                      | 82         |
| Total real estate revenues                        | \$ 184,936                             | \$ 185,563 |
| Real Estate Cost of Sales:                        |  |            |
| Commission and other brokerage income             | \$ 116,031                             | \$ 120,021 |
| Cost of sales on facilities primarily from Escena | 877                                    | 840        |
| Title fees  | 181                                    | 217        |
| Total real estate cost of sales                   | \$ 117,089                             | \$ 121,078 |

Brokerage cost of sales. Douglas Elliman commission cost of sales decreased by \$3,990 due to higher margins as a result of a higher percentage of Douglas Elliman commission income originating from its development marketing division in the 2016 period and decreased commission revenue.

Real Estate expenses. Real Estate operating, selling, general and administrative expenses were \$59,003 and \$52,258 for the three months ended September 30, 2016 and 2015, respectively. The increase of \$6,745 was primarily due to increased expenses at Douglas Elliman from its development marketing division and its continued expansion into new markets as well as incremental professional fees in 2016 associated with the costs of being a subsidiary of a public company.

Real Estate operating income. The Real Estate segment had operating income of \$8,844 and \$12,227 for the three months ended September 30, 2016 and 2015, respectively. The decline in operating income of \$3,383 was primarily related an increase in Douglas Elliman operating, selling, general and administrative expenses offset by higher profits. Corporate and Other.

Corporate and other operating loss. The operating loss at the corporate segment was \$6,289 for the three months ended September 30, 2016 compared to \$4,344 for the same period in 2015. The increase of \$1,945 was primarily due to increased stock-based compensation expense, executive pension expense and increased professional fees for the three months ended September 30, 2016.

#### Nine Months Ended September 30, 2016 Compared to Nine Months Ended September 30, 2015

Revenues. Total revenues were \$1,278,177 for the nine months ended September 30, 2016 compared to \$1,226,867 for the nine months ended September 30, 2015. The \$51,310 (4.2%) increase in revenues was due to a \$48,607 increase in Real Estate revenues primarily related to Douglas Elliman's brokerage revenues and a \$3,532 increase in Tobacco revenues offset by an \$829 decline in E-Cigarettes revenues.

Cost of sales. Total cost of sales were \$823,495 for the nine months ended September 30, 2016 compared to \$817,139 for the nine months ended September 30, 2015. The \$6,356 (0.8%) increase in cost of sales was due to a \$22,478 increase in Real Estate cost of sales related to an increase of real estate commission expense at Douglas Elliman. This was offset by a \$14,627 decline in Tobacco cost of sales primarily related to decreased sales volume and lower per unit manufacturing costs as well as a \$1,495 decline in E-Cigarettes cost of sales. The Tobacco segment's MSA expense declined by \$1,531 for the nine months ended September 30, 2016 due primarily to lower unit sales volumes and lower per unit MSA expenses. The calculation of our benefit from the MSA is an estimate based upon taxable unit shipments of cigarettes in the U.S. For the nine months ended September 30, 2016, we estimated taxable shipments in the U.S. would decline by 3.5% in 2016. Our annual MSA expense changes by approximately \$1,800 for each percentage change in the estimated shipment volumes in the U.S. market.

Expenses. Operating, selling, general and administrative expenses were \$250,048 for the nine months ended September 30, 2016 compared to \$233,449 for the same period last year. The \$16,599 (7.1%) increase was due to a \$19,175 increase in Real Estate operating, selling, general and administrative expenses primarily at Douglas Elliman and a \$5,818 increase in Corporate and Other expense. This was offset by a \$6,595 decline in E-Cigarettes operating, selling, general and administrative expenses of and a \$1,799 decline in Tobacco operating, selling, general and administrative expenses.

Operating income. Operating income was \$202,243 for the nine months ended September 30, 2016 compared to \$168,888 for the same period last year, an increase of \$33,355 (19.7%). Tobacco operating income increased by \$24,958, Real Estate operating income increased by \$6,954 primarily related to Douglas Elliman, and E-Cigarettes operating losses declined by \$7,261. This was offset by an increase of \$5,818 in Corporate and Other expenses.

Other income (expenses). Other expenses were \$81,124 and \$74,114 for the nine months ended September 30, 2016 and 2015, respectively. For the nine months ended September 30, 2016, other expenses primarily consisted of interest expense of \$104,454, impairment of investment securities available for sale of \$4,916 (primarily related to our investment in Morgans Hotel Group Co.) and equity in losses from investments of \$2,108. This was offset by income of \$23,222 from changes in fair value of derivatives embedded within convertible debt, equity in earnings from real estate ventures of \$3,328, other income of \$2,956 and gain on sale of investment securities available for sale of \$848. For the nine months ended September 30, 2015, other expenses primarily consisted of interest expense of \$96,405, impairment of investment securities available for sale of \$12,211, and equity in losses from investments of \$2,654. This was offset by income of \$18,760 from changes in fair value of derivatives embedded within convertible debt, gain on sale of investment securities available for sale of \$12,018, equity in earnings from real estate ventures of \$1,278 and other income of \$5,100.

Income before provision for income taxes. Income before income taxes was \$121,119 and \$94,774 for the nine months ended September 30, 2016 and 2015, respectively.

Income tax expense. Income tax expense was \$46,682 and \$37,739 for the nine months ended September 30, 2016 and 2015, respectively. Our provision for income taxes in interim periods is based on an estimated annual effective income tax rate derived, in part, from estimated annual income before provision for income taxes in accordance with guidance on accounting for income taxes on interim periods. For the nine months ended September 30, 2016, our income tax expense was declined by \$792 due primarily to the results of a recent state income tax audit.

Tobacco.

Tobacco revenues. Liggett increased the list price of PYRAMID, LIGGETT SELECT, EVE and GRAND PRIX by \$0.70 per carton in May 2015, November 2015, and May 2016. Liggett increased the list price of EAGLE 20's by \$1.00 per carton in December 2015.

All of our Tobacco sales were in the discount category in 2016 and 2015. For the nine months ended September 30, 2016, Tobacco revenues were \$750,677 compared to \$747,145 for the nine months ended September 30, 2015. Revenues increased by \$3,532 (0.5%) due to a 1.7% decline in sales volume of \$21,762 (approximately 105.8 million units), offset by a favorable price variance of \$25,294.

Tobacco cost of sales. The major components of our Tobacco cost of sales were as follows:

|   | Nine Months Ended     |                       |
|---|-----------------------|-----------------------|
|   | September 30,         |                       |
|   | 2016                  | 2015                  |
| Manufacturing overhead, raw materials and labor | \$87,572              | \$95,106              |
| Federal Excise Taxes, net                       | 313,731               | 319,044               |
| Tobacco quota buyout expense                    | —                     | 664 <sup>(1)</sup>    |
| FDA expense                                     | 14,395                | 13,980                |
| MSA expense, net of market share exemption      | 75,990 <sup>(2)</sup> | 77,521 <sup>(3)</sup> |
| Total cost of sales                             | \$491,688             | \$506,315             |

The quarterly assessments due under the Fair and Equitable Tobacco Reform Act (shown as “Tobacco quota buyout expense” above) expired at the end of 2014. The \$664 for the nine months ended September 30, 2015 represents a final assessment for the fourth quarter of 2014, which was received in 2015.

<sup>(2)</sup> Includes \$370 reduction in expense from MSA Settlement.

<sup>(3)</sup> Includes \$5,715 reduction in expense from MSA Settlement.

Tobacco gross profit was \$258,989 for the nine months ended September 30, 2016 compared to \$240,830 for the nine months ended September 30, 2015. The \$18,159 (7.5%) increase was due to higher margins associated with the price increases primarily on the PYRAMID brand, lower manufacturing unit costs and lower estimated MSA unit costs. As a percentage of revenues (excluding Federal Excise Taxes), Tobacco gross profit was 59.3% in the 2016 period and 56.3% in the 2015 period.

Tobacco expenses. Tobacco operating, selling, general and administrative expenses were \$62,125 for the nine months ended September 30, 2016 compared to \$63,924 for the nine months ended September 30, 2015. The \$1,799 decline in expenses was due to a decline in sales and marketing expenses primarily as a result of Liggett's restructuring in the third quarter of 2015 and a decrease in pension expense, offset by an increase in legal and professional fees. Tobacco product liability legal expenses, including settlements and judgments, were \$7,378 and \$11,068 for the nine months ended September 30, 2016 and 2015, respectively.

Tobacco operating income. Tobacco operating income was \$194,473 for the nine months ended September 30, 2016 compared to \$169,515 for the same period last year. The Tobacco operating income increase of \$24,958 (14.7%) was primarily due to higher margins and lower operating expenses discussed above.

#### E-Cigarettes.

E-Cigarettes revenues. E-Cigarettes revenues were \$52 for the nine months ended September 30, 2016 compared to \$881 for the nine months ended September 30, 2015. Revenues declined by \$829 due to lower sales volumes.

E-Cigarettes cost of sales. Our E-Cigarettes cost of sales were \$23 for the nine months ended September 30, 2016 compared to \$1,518 for the nine months ended September 30, 2015. Cost of sales declined by \$1,495 due to lower sales volumes.

E-Cigarettes expenses. E-Cigarettes operating, selling, general and administrative expenses were \$478 and \$7,073 for the nine months ended September 30, 2016 and 2015, respectively. The decline was due to lower sales and marketing expenses. Operating losses from E-Cigarettes were \$449 and \$7,710 for the nine months ended September 30, 2016 and 2015, respectively.

Real Estate.

Real Estate revenues. Real Estate revenues were \$527,448 and \$478,841 for the nine months ended ended September 30, 2016 and 2015, respectively. Real Estate revenues increased by \$48,607 (10.2%), primarily related to an increase of \$48,888 in Douglas Elliman's Commission and other brokerage income which was primarily due to increased closings in its development marketing division.

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Real Estate revenues and cost of sales for the nine months ended ended September 30, 2016 were as follows:

|   | Nine Months Ended     |           |
|---|-----------------------|-----------|
|   | September 30,<br>2016 | 2015      |
| Real Estate Revenues:                     |                       |           |
| Commission and other brokerage income     | \$498,356             | \$449,468 |
| Property management income                | 22,215                | 21,592    |
| Title fees                                | 3,196                 | 3,303     |
| Sales on facilities primarily from Escena | 3,678                 | 4,005     |
| Other                                     | 3                     | 473       |
| Total real estate revenues                | \$527,448             | \$478,841 |

Real Estate Cost of Sales:

|   |           |           |
|---|-----------|-----------|
| Commission and other brokerage income             | \$328,396 | \$305,885 |
| Cost of sales on facilities primarily from Escena | 2,887     | 2,895     |
| Title fees  | 501       | 526       |
| Total real estate cost of sales                   | \$331,784 | \$309,306 |

Brokerage cost of sales. Douglas Elliman commission cost of sales increased by \$22,511 due to increased sales volume.

Real Estate expenses. Real Estate operating, selling, general and administrative expenses were \$167,440 and \$148,265 for the nine months ended September 30, 2016 and 2015, respectively. The increase of \$19,175 was primarily due to increased expenses at Douglas Elliman from Douglas Elliman's development marketing division and continued expansion into new markets as well as incremental professional fees in 2016 associated with the costs of being a subsidiary of a public company.

Real Estate operating income. The Real Estate segment had operating income of \$28,224 and \$21,270 for the nine months ended September 30, 2016 and 2015, respectively. The increase in operating income of \$6,954 was primarily related to higher profits offset by an increase in Douglas Elliman operating, selling, general and administrative expenses.

Corporate and other.

Corporate and other loss. The operating loss at the corporate segment was \$20,005 for the nine months ended September 30, 2016 compared to \$14,187 for the same period in 2015. The increase of \$5,818 was primarily due to increased stock-based compensation expense, executive pension expense and increased professional fees for the nine months ended September 30, 2016.

Summary of Real Estate Investments

We own, and seek to acquire investment interests in various domestic and international real estate projects through debt and equity investments. Our real estate investments primarily include the following projects as of September 30, 2016:

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

| Location                               | Date of Initial Investment   | Percentage Owned | Net Cash Invested | Cumulative Earnings (Losses) | Carrying Value as of September 30, 2016 | Future Capital Expenditures from Residential and/or Hotel Area Valley (1) | Projected Commercial Space | Projected Residential Lots, Units and/or Hotel Rooms | Actual/Start Date |     |                |
|--|--|------------------|-------------------|------------------------------|---|---|----------------------------|--|-------------------|-----|----------------|
| Sagaponack                             | Sagaponack, NY   | April 2015       | 100 %             | \$12,733                     | \$—                                     | \$12,733  | \$ TBD                     | N/A  | 1                 | N/A |                |
| Escena, net                            | Master planned community, golf course, restaurant and shop in Palm Springs, CA | March 2008       | 100 %             | 2,644                        | 8,253                                   | 10,897  | —450 Acres                 | 667<br>450   | R<br>Lots<br>H    | N/A |                |
| Investments in real estate, net        |  |                  | \$15,377          | \$8,253                      | \$23,630                                | \$—   |                            |  |                   |     |                |
| Investments in real estate ventures:   |  |                  |                   |                              |   |   |                            |  |                   |     |                |
| 10 Madison Square West (1107 Broadway) | Flatiron District/NoMad neighborhood, Manhattan, NY                            | October 2011     | 5.0 %             | \$(8,559)                    | \$10,155                                | \$1,596   | \$260,000 SF               | 20,000 SF  | 124               | R   | August 2011    |
| The Marquand (11 East 68th Street)     | Upper East Side, Manhattan, NY   | December 2011    | 18.0 %            | 3,396                        | 5,914                                   | 9,310   | —90,000 SF                 | —  | 29                | R   | June 2011      |
| 11 Beach Street                        | TriBeCa, Manhattan, NY   | June 2012        | 49.5 %            | 12,328                       | 1,661                                   | 13,989  | —97,000 SF                 | —  | 27                | R   | May 2012       |
| 20 Times Square (701 Seventh Avenue)   | Times Square, Manhattan, NY  | August 2012      | 7.9 %             | 17,144                       | 2,742                                   | 19,886  | —252,000 SF                | 80,000 SF  | 452               | H   | September 2012 |
| 111 Murray Street                      | TriBeCa, Manhattan, NY West  | May 2013         | 9.5 %             | 25,719                       | (543)                                   | 25,176  | —330,000 SF                | 1,700 SF   | 157               | R   | September 2013 |
| 160 Leroy Street (2)                   | Greenwich Village, Manhattan, NY   | March 2013       | 3.1 %             | 2,664                        | 1,883                                   | 4,547   | —130,000 SF                | —  | 57                | R   | Fall 2013      |

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|   |                                    |               |       |           |           |           |              |           |        |   |                |
|---|------------------------------------|---------------|-------|-----------|-----------|-----------|--------------|-----------|--------|---|----------------|
| 215 Chrystie Street                             | Lower East Side, Manhattan, NY     | December 2012 | 18.4% | 5,297     | 559       | 5,856     | −246,000 SF  | —         | 11,367 | R | June 2013      |
| The Dutch (25-19 43rd Avenue)                   | Long Island City, NY               | May 2014      | 9.9%  | 980       | 177       | 1,157     | 65,000 SF    | —         | 86     | R | September 2014 |
| 1 QPS Tower (23-10 Queens Plaza South)          | Long Island City, NY               | December 2012 | 45.4% | 14,711    | 2,513     | 17,224    | −260,000 SF  | 25,000 SF | 391    | R | March 2013     |
| 87 Park (8701 Collins Avenue)                   | Miami Beach, FL                    | December 2013 | 15.0% | 10,588    | 725       | 11,313    | −160,000 SF  | TBD       | 70     | R | October 2013   |
| 125 Greenwich Street (2) West                   | Financial District, Manhattan, NY  | August 2014   | 13.3% | 7,992     | 1,873     | 9,865     | −306,000 SF  | 16,000 SF | 273    | R | March 2014     |
| Hollywood Edition (9040 Sunset Boulevard)       | West Hollywood, CA                 | October 2014  | 48.5% | 12,288    | 1,261     | 13,549    | −210,000 SF  | —         | 20,190 | R | May 2014       |
| 76 Eleventh Avenue                              | West Chelsea, Manhattan, NY        | May 2015      | 5.1%  | 17,000    | 2,379     | 19,379    | −620,000 SF  | 48,000 SF | 250    | H | September 2015 |
| Monad Terrace                                   | Miami Beach, FL                    | May 2015      | 24.3% | 7,635     | 289       | 7,924     | −160,000 SF  | —         | TBD    | R | May 2015       |
| Takanasee Condominium and Mixed Use Development | Long Branch, NJ                    | December 2015 | 22.8% | 4,544     | 625       | 5,169     | −63,000 SF   | —         | 13     | R | TBD            |
|   |                                    |               |       | \$133,727 | \$32,213  | \$165,940 | \$—          |           |        |   |                |
| Maryland Portfolio                              | Primarily Baltimore County, MD     | July 2012     | 7.6%  | \$1,281   | \$(1,281) | \$—       | \$N/A        | N/A       | 5,517  | R | N/A            |
| ST Portfolio                                    | Houston, TX                        | November 2013 | 16.3% | 5,976     | 3,146     | 9,122     | −640,576 SF  | 20,065 SF | 488    | R | N/A            |
| Apartment Buildings                             |                                    |               |       | \$7,257   | \$1,865   | \$9,122   | \$—          |           |        |   |                |
| Park Lane Hotel                                 | Central Park South, Manhattan, NY  | November 2013 | 5.2%  | \$26,211  | \$(5,591) | \$20,620  | \$445,600 SF | —         | 628    | H | N/A            |
| Hotel Taiwana                                   | St. Barthelemy, French West Indies | October 2011  | 17.0% | 7,941     | (619)     | 7,322     | −61,300 SF   | 4,300 SF  | 22     | H | N/A            |
| Coral Beach and Tennis Club Hotels              | Coral Beach, Bermuda               | December 2013 | 49.0% | 6,048     | (2,647)   | 3,401     | −52 Acres    | —         | 101    | H | N/A            |
|   |                                    |               |       | \$40,200  | \$(8,857) | \$31,343  | \$—          |           |        |   |                |

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|                                       |              |            |       |           |           |           |     |   |           |   |   |     |
|---------------------------------------|--------------|------------|-------|-----------|-----------|-----------|-----|---|-----------|---|---|-----|
| The Plaza at Harmon Meadow Commercial | Secaucus, NJ | March 2015 | 49.0% | \$5,076   | \$(1,615) | \$3,461   | \$— | — | 219,382SF | — | — | N/A |
|                                       |              |            |       | \$5,076   | \$(1,615) | \$3,461   | \$— |   |           |   |   |     |
| Investments in real estate ventures   |              |            |       | \$186,260 | \$23,606  | \$209,866 |     |   |           |   |   |     |
| Total Carrying Value                  |              |            |       | \$201,637 | \$31,859  | \$233,496 |     |   |           |   |   |     |

(1) This column only represents capital commitments required under the various joint venture agreements. However, many of the agreements provide for the operating partner to call capital. If a joint venture partner, such as New Valley, declines to fund the partner's ownership percentage could either be diluted or, in some situations, the character of a funding member's contribution from a capital contribution to a member loan.

(2) Carrying value as of September 30, 2016, includes non-controlling interest of \$2,172 and \$1,831, respectively.

N/A - Not applicable SF - Square feet H - Hotel rooms

TBD - To be determined R - Residential Units R Lots - Residential lots

Other investments in real estate ventures relate to an investment in an insurance consulting company by Douglas Elliman with a carrying value of \$1,959 as of September 30, 2016. New Valley has capitalized \$18,040 of net interest expense since inception into the carrying value of its ventures whose projects were under development as of September 30, 2016. This amount is captured in the "Cumulative Earnings (Losses)" column in the table above.

## Liquidity and Capital Resources

Cash and cash equivalents increased by \$205,506 for the nine months ended September 30, 2016 and decreased by \$80,018 for the nine months ended September 30, 2015.

Cash provided from operations was \$121,443 and \$140,018 for the nine months ended September 30, 2016 and 2015, respectively. The change primarily related to higher payments of tobacco litigation settlements and judgments and income taxes in the 2016 period, as well as increases in the payments of prior year promotional and excise tax liabilities in the tobacco segment in the 2016. These were offset by an increase of operating income.

Cash used in investing activities was \$2,721 and \$62,082 for the nine months ended September 30, 2016 and 2015. In the first nine months of 2016, cash used in investing activities was for the purchase of investment securities of \$90,106, investments in real estate ventures of \$23,358, capital expenditures of \$19,157, investments in real estate, net of \$130, an increase in cash surrender value of corporate-owned life insurance policies of \$451 and purchase of long-term investments of \$50. This was offset by the sale of investment securities of \$81,235, pay downs of investment securities of \$7,842, the proceeds from sale or liquidation of long-term investments of \$1,000, the maturities of investment securities of \$4,343, distributions from investments in real estate ventures of \$23,041, a decrease in restricted assets of \$8,615, repayments of notes receivable of \$4,410 and proceeds from the sale of fixed assets of \$45. In the first nine months of 2015, cash used in investing activities was for the purchase of investment securities of \$162,845, investments in real estate ventures of \$43,280, investments in real estate, net of \$12,512, purchase of long-term investments of \$10,000, capital expenditures of \$7,859, an increase in restricted assets of \$6,872, issuance of notes receivable of \$4,410 and an increase in cash surrender value of corporate-owned life insurance policies of \$1,225. This was offset by the sale of investment securities of \$161,029, distributions from investments in real estate ventures of \$11,205, pay downs of investment securities of \$5,743, repayments of notes receivable of \$4,000, maturities of investment securities of \$2,653, proceeds from the sale or liquidation of long-term investments of \$1,288, proceeds from sale of preferred securities of \$1,000 and proceeds from the sale of fixed assets of \$3.

Our investment philosophy is to maximize return on investments using a reasonable expectation for return. For example, we expect our investment returns to exceed the comparable return on cash or short-term U.S. Treasury Bills when investing in equity and debt securities and more than our weighted average cost of capital when investing in non-consolidated real estate businesses and capital expenditures.

Cash provided by financing activities was \$86,784 for the nine months ended September 30, 2016 compared to cash used in financing activities of \$157,954 for the nine months ended September 30, 2015. In the first nine months of 2016, cash provided by financing activities was from proceeds of debt issuance of \$243,620, proceeds from net borrowings of debt under the revolver of \$10,182, tax benefit of options exercised of \$412, proceeds from the exercise of Vector options of \$398 and contributions from non-controlling interest of \$248. This was offset by cash used for the dividends and distributions on common stock of \$147,270, repayments of debt of \$4,698, distributions to non-controlling interest of \$9,508 and payment of deferred financing costs of \$6,600. In the first nine months of 2015, cash was used for dividends and distributions on common stock of \$139,430, net repayments of debt under the revolver of \$15,964, repayment of debt of \$4,968, payment of deferred financing costs of \$624 and distributions to non-controlling interest of \$564. This was offset by proceeds from issuance of debt of \$1,519, proceeds from the exercise of Vector options of \$1,321 and the tax benefit of options exercised of \$756.

In recent years, we have taken advantage of historically low interest rates and lowered our weighted average cost of capital by issuing debt at lower interest rates than our historical borrowing levels and on May 9, 2016, we issued \$235,000 of our 7.75% Senior Secured Notes for a price of 103.5%. We will continue to evaluate current market conditions related to our capital structure. For example, based on quoted market prices, our 7.75% Senior Secured Notes were yielding approximately 6.0% on a “yield to worst” basis, or approximately 5.1% more than the comparable U.S. Treasury Bond at September 30, 2016. The Company is presently able to redeem such bonds at price of 105.813% and the redemption price declines to 103.875% on February 15, 2017, 101.938% on February 15, 2018 and 100% on February 15, 2019. There can be no assurance that we would be able to continue to issue debt at a lower interest rate than our historical borrowing levels in the future and, in the event we pursue any capital markets

activities, our ability to complete any offering would be subject to market conditions.

Liggett Credit Facility and Liggett Term Loan Under Credit Facility. As of September 30, 2016, \$16,664 was outstanding under the revolving and term loan portions of the credit facility. Availability as determined under the Credit Facility was approximately \$40,158 based on eligible collateral at September 30, 2016. At September 30, 2016, management believed that Liggett was in compliance with all covenants under the credit facility; Liggett's EBITDA, as defined, were approximately \$231,804 for the last twelve months ended September 30, 2016.

Vector. The indenture of our 7.75% senior secured notes due 2021 contains covenants that restrict the payment of dividends if our consolidated earnings before interest, taxes, depreciation and amortization ("Consolidated EBITDA"), as defined in the indenture, for the most recently ended four full quarters is less than \$75,000. The indenture also restricts the incurrence of debt if our Leverage Ratio and our Secured Leverage Ratio, as defined in the indenture, exceed 3.0 and 1.5, respectively. Our Leverage

Ratio is defined in the indenture as the ratio of our guaranteeing subsidiaries' total debt less the fair market value of our cash, investments in marketable securities and long-term investments to Consolidated EBITDA, as defined in the indenture. Our Secured Leverage Ratio is defined in the indenture in the same manner as the Leverage Ratio, except that secured indebtedness is substituted for indebtedness. The following table summarizes the requirements of financial covenants and the results of the calculation, as defined by the indenture.

| Covenant                           | Indenture Requirement | September 30, 2016 | December 31, 2015 |
|------------------------------------|-----------------------|--------------------|-------------------|
| Consolidated EBITDA, as defined    | \$75,000              | \$307,338          | \$268,870         |
| Leverage ratio, as defined         | <3.0 to 1             | 1.86 to 1          | 1.95 to 1         |
| Secured leverage ratio, as defined | <1.5 to 1             | 0.9 to 1           | 0.9 to 1          |

We and our subsidiaries have significant indebtedness and debt service obligations. At September 30, 2016, we and our subsidiaries had total outstanding indebtedness of \$1,346,191, of which \$230,000 of our 7.5% convertible notes mature in 2019, \$258,750 of our 5.5% variable interest senior convertible notes mature in 2020, and \$835,000 of our 7.75% senior secured notes mature in 2021. In addition, subject to the terms of any future agreements, we and our subsidiaries will be able to incur additional indebtedness in the future. There is a risk that we will not be able to generate sufficient funds to repay our debt. If we cannot service our fixed charges, it would have a material adverse effect on our business and results of operations.

We believe that our cigarette and real estate operations are positive cash-flow-generating units and will continue to be able to sustain their operations without any significant liquidity concerns.

In order to meet the above liquidity requirements as well as other anticipated liquidity needs in the normal course of business, we had cash and cash equivalents of approximately \$445,900, investment securities available for sale of approximately \$175,700, long-term investments with an estimated value of approximately \$58,300 and availability under Liggett's credit facility of approximately \$40,200 at September 30, 2016. Management currently anticipates that these amounts, as well as expected cash flows from our operations, management fees and other payments from subsidiaries should be sufficient to meet our liquidity needs over the next 12 months. We may acquire or seek to acquire additional operating businesses through merger, purchase of assets, stock acquisition or other means, or to make other investments, which may limit our liquidity otherwise available.

On a quarterly basis, we evaluate our investments to determine whether an impairment has occurred. If so, we also make a determination if such impairment is considered temporary or other-than-temporary. We believe that the assessment of temporary or other-than-temporary impairment is facts and circumstances driven. However, among the matters that are considered in making such a determination are the period of time the investment has remained below its cost or carrying value, the likelihood of recovery given the reason for the decrease in market value and our original expected holding period of the investment.

#### Market Risk

We are exposed to market risks principally from fluctuations in interest rates, foreign currency exchange rates and equity prices. We seek to minimize these risks through our regular operating and financing activities and our long-term investment strategy. Our market risk management procedures cover all market risk sensitive financial instruments.

As of September 30, 2016, approximately \$16,700 of our outstanding debt at face value had variable interest rates determined by various interest rate indices, which increases the risk of fluctuating interest rates. Our exposure to market risk includes interest rate fluctuations in connection with our variable rate borrowings, which could adversely affect our cash flows. As of September 30, 2016, we had no interest rate caps or swaps. Based on a hypothetical 100 basis point increase or decrease in interest rates (1%), our annual interest expense could increase or decrease by approximately \$167.

In addition, as of September 30, 2016, \$298,118 (\$488,750 principal amount) of outstanding debt had a variable interest rate determined by the amount of the dividends on our common stock. The difference between the stated value

of the debt and carrying value is due principally to certain embedded derivatives, which were separately valued and recorded upon issuance, and debt issuance costs. Changes to the estimated fair value of these embedded derivatives are reflected within our statements of operations as “Changes in fair value of derivatives embedded within convertible debt.” The value of the embedded derivative is contingent on changes in interest rates of debt instruments maturing over the duration of the convertible debt as well as projections of future cash and stock dividends over the term of the debt and changes in the closing stock price at the end of each quarterly period. Based on a hypothetical 100 basis point increase or decrease in interest rates (1%), our annual “Changes in fair value of derivatives embedded within convertible debt” could increase or decrease by approximately \$1,703 with approximately \$639 resulting from the embedded derivative associated with the 7.5% variable interest senior convertible notes, and the remaining \$1,064 resulting



from the embedded derivative associated with our 5.5% variable interest senior convertible debentures due 2020. An increase in our quarterly dividend rate by \$0.10 per share would increase interest expense by approximately \$10,400 per year.

We have estimated the fair market value of the embedded derivatives based principally on the results of a valuation model. The value of the embedded derivatives is contingent on changes in interest rates of debt instruments maturing over the duration of the convertible debt, our stock price as well as projections of future cash and stock dividends over the term of the debt. The interest rate component of the value of the embedded derivative is computed by calculating an equivalent non-convertible, unsecured and subordinated borrowing cost. This rate is determined by calculating the implied rate on our 7.5% Convertible Notes when removing the embedded option value within the convertible security. This rate is based upon market observable inputs and influenced by our stock price, convertible bond trading price, risk-free interest rates and stock volatility. The range of estimated fair market values of our embedded derivatives was between \$121,299 and \$119,621. We recorded the fair market value of our embedded derivatives at the approximate midpoint of the range at \$120,820 as of September 30, 2016. The estimated fair market value of our embedded derivatives could change significantly based on future market conditions.

We and New Valley also hold long-term investments in various investment partnerships. These investments are illiquid, and their ultimate realization is subject to the performance of the underlying entities.

#### New Accounting Pronouncements

Refer to Note 1, Summary of Significant Accounting Policies, to our financial statements for further information on New Accounting Pronouncements.

#### Legislation and Regulation

There are no material changes other than those set forth below from the Legislation and Regulation section set forth in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations," of our Annual Report on Form 10-K, for the year ended December 31, 2015. Please refer to that section and the information below for disclosures regarding the critical accounting policies related to our business.

On May 5, 2016, the United States Food and Drug Administration ("FDA") issued a final "deeming" regulation that extends the agency's authority under the Tobacco Control Act to other tobacco products not currently regulated by the agency, such as e-cigarettes, cigars, pipe tobacco and hookah. With respect to these newly-regulated tobacco products, the deeming regulation, among other things:

- establishes a minimum age of 18 years to purchase the products;
- establishes identification restrictions to prevent underage sales of the products;
- requires specific health warnings on product packages and advertisements;
- requires registration with FDA and reporting of product and ingredient listings;
- prohibits distribution of free samples of the products;
- prohibits the sale of modified risk tobacco products (including those described as "light," "low," or "mild") unless authorized by FDA;
- prohibits vending machine sales (unless in an adult-only facility); and
- requires FDA review to market new tobacco products introduced after the proposed grandfathered date of February 15, 2007.

Under the new "deeming" rule, manufacturers of the newly-regulated products, including e-cigarettes, will be subject to the same Tobacco Control Act provisions and relevant regulatory requirements that already apply to cigarettes. As of August 8, 2016, domestic manufacturers must register and list the tobacco products with FDA and obtain premarket market authorization for any product introduced after this date. For products introduced between February 15, 2007 and August 8, 2016, the premarket authorization requirements are subject to certain staggered compliance periods.

Requests for exemption from the substantial equivalence requirement must be submitted by August 8, 2017. Substantial equivalence reports must be submitted by February 8, 2018. Premarket tobacco product applications must be submitted by August 8, 2018. Unless FDA issues an order denying or refusing to accept an application, FDA will not take enforcement action against the product for one year after the application deadline. However, at the end of that period, even if FDA has not completed its review, the product will be subject to enforcement action unless FDA determines that “substantial progress” is being made towards completion and decides to defer enforcement for a reasonable time period. FDA has not set deadlines for its own review.

#### SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

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

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

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

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

- general economic and market conditions and any changes therein, due to acts of war and terrorism or otherwise,
- governmental regulations and policies,
- effects of industry competition,
- impact of business combinations, including acquisitions and divestitures, both internally for us and externally in the tobacco industry,
- impact of legislation on our competitors’ payment obligations, results of operations and product costs, i.e. the impact of federal legislation eliminating the federal tobacco quota system and providing for regulation of tobacco products by the FDA,
- impact of substantial increases in federal, state and local excise taxes,
- uncertainty related to product liability and other tobacco-related litigations including the Engle progeny cases pending in Florida and other individual and class action cases where certain plaintiffs have alleged compensatory and punitive damage amounts ranging into the hundreds of million and even billions of dollars; and,
- potential additional payment obligations for us under the MSA and other settlement agreements with the states.

Further information on the risks and uncertainties to our business include the risk factors discussed above in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and under Item 1A, “Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2015 filed with the Securities and Exchange Commission.

Although we believe the expectations reflected in these forward-looking statements are based on reasonable assumptions, there is a risk that these expectations will not be attained and that any deviations will be material. The forward-looking statements speak only as of the date they are made.

#### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The information under the caption “Management’s Discussion and Analysis of Financial Condition and Results of Operations - Market Risk” is incorporated herein by reference.



## ITEM 4. CONTROLS AND PROCEDURES

### Evaluation of Disclosure Controls and Procedures

The Company has established disclosure controls and procedures that are designed to ensure that information required to be disclosed in its reports filed or submitted under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and such information is accumulated and communicated to the Company's management, including its Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), as appropriate to allow timely decisions regarding required disclosure.

In connection with the preparation of this Quarterly Report on Form 10-Q, the Company carried out an evaluation under the supervision of and with the participation of the Company's management, including the CEO and CFO, as of September 30, 2016, of the effectiveness of the design and operation of the Company's disclosure controls and procedures, as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act. Based upon this evaluation, the CEO and CFO concluded that, as of September 30, 2016, the Company's disclosure controls and procedures were not effective because of the material weaknesses in internal control over financial reporting described in Part II, Item 9A of the 2015 Form 10-K. Management has concluded that the material weaknesses that were present at December 31, 2015 continued to exist as of September 30, 2016, as discussed below.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of our annual or interim financial statements will not be prevented or detected on a timely basis.

These material weaknesses did not result in any material misstatements to the financial statements in any accounting periods ending prior to January 1, 2016 or for the nine months ended September 30, 2016. However, these material weaknesses could result in misstatement of the aforementioned account balances or disclosures that would result in material misstatements to the annual or interim consolidated financial statements that would not be prevented or detected.

### Status of Remediation

The Company identified five material weaknesses related to its Douglas Elliman subsidiary as of December 31, 2014 and two material weaknesses related to its Douglas Elliman subsidiary as of December 31, 2015. Beginning in 2015, at the direction of the Audit Committee of the Company's Board of Directors, as well as the Company's CEO and CFO, the Company has made and continues to make substantial progress in remediating these material weakness including:

In June 2015, Douglas Elliman employed a new Chief Financial Officer, who is a licensed Certified Public Accountant ("CPA") with more than 30 years of experience in the financial departments of publicly-traded companies. In addition, in 2015, Douglas Elliman also added a Director of Sarbanes-Oxley Section 404 Compliance, a corporate controller, who is licensed as a CPA and previously served as a senior manager at a Big Four accounting firm, two regional controllers who are both licensed as CPAs, and two accounting managers who are both licensed as CPAs. In August 2015, Douglas Elliman employed a new Chief Technology Officer ("CTO") who was previously a technology executive with a large U.S. financial institution. Douglas Elliman's new CTO oversees, among other things, security of the accuracy and completeness of the Company's financial reporting.

During 2015, Douglas Elliman improved its documentation of internal controls into a more robust format that has been designed to detect errors that could lead to material misstatements in the Company's consolidated financial statements.

During 2015, the Company redesigned and implemented a series of newly-created internal controls related to previously improper internal controls related to segregation of duties by accounting and finance personnel at Douglas Elliman.

The result of these efforts led to the remediation of the following material weaknesses as of December 31, 2015:

- (i) Douglas Elliman's previous failure to monitor controls in certain areas relating to the period-end financial reporting process,

- Douglas Elliman's previous failure to maintain effective controls over period-end financial reporting processes, including controls over the preparation, analysis and review of certain significant account reconciliations required
- (ii) to assess the appropriateness of account balances at period-end, as well as controls over the preparation and review of the interim and annual financial statements; and,
  - (iii) Douglas Elliman's previous ineffective controls over the processing and recording of recurring and non-recurring journal entries.

Further, with the enhancements and focus described above, the Company is vigorously continuing its remediation efforts in 2016 related to the following material weaknesses:

(i) Certain controls at Douglas Elliman related to segregation of duties with accounting and finance personnel were designed, but not operating, properly at December 31, 2015; and,

Douglas Elliman did not maintain effective controls over access to its information technology system for finance and accounting (“IT System”). Specifically, root level access to Douglas Elliman’s IT System was shared with the (ii) third party software provider that allowed unrestricted and unmonitored access to the application and its database.

Further, the Company did not have an effective change management process to reasonably assure that changes to the IT System were properly documented, tracked, reviewed, tested and approved.

The Company’s management, Audit Committee and Board of Directors are committed to maintaining a strong and sustainable internal control environment and believe that these remediation efforts represent significant improvements in the Company’s control environment as well as its internal controls over the financial reporting of Douglas Elliman. Nonetheless, the Company continues to address the two remaining material weaknesses and evaluate the effectiveness of its new internal controls to confirm that a sustainable, controlled process is fully in place. In 2016, the Company has continued to introduce processes to help ensure that Douglas Elliman’s financial reporting is complete and accurate. Further, the identified material weaknesses in internal controls will not be considered fully addressed until the internal controls over these areas have been in operation for a sufficient period of time for management to conclude that the material weaknesses have been fully remediated. Management continues to work on implementing and testing the new controls in order to make this final determination.

#### Changes in Internal Control Over Financial Reporting

The Company’s Board of Directors and its management, including the CEO and CFO, evaluated the changes in the Company’s internal control over financial reporting during the quarter ended September 30, 2016 and concluded there were no changes in the Company’s internal control over financial reporting during the quarter ended September 30, 2016 that have materially affected, or are reasonably likely to materially affect, its internal control over financial reporting.

## PART II

## OTHER INFORMATION

## Item 1. Legal Proceedings

Reference is made to Note 7, incorporated herein by reference, to our condensed consolidated financial statements included elsewhere in this report which contains a general description of certain legal proceedings to which our company, or its subsidiaries are a party and certain related matters. Reference is also made to Exhibit 99.1 for additional information regarding the pending smoking-related legal proceedings to which Liggett or us is a party. A copy of Exhibit 99.1 will be furnished without charge upon written request to us at our principal executive offices, 4400 Biscayne Boulevard, 10th Floor, Miami, Florida 33137, Attn. Investor Relations.

## Item 1A. Risk Factors

There are no material changes from the risk factors set forth in Item 1A, "Risk Factors," of our Annual Report on 10-K for the year ended December 31, 2015.

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

No equity securities of ours which were not registered under a private offering of the Securities Act of 1933 have been issued or sold by us during the three months ended September 30, 2016 except for approximately 6,087,035 shares of our common stock issued as a stock dividend on September 29, 2016.

## Issuer Purchase of Equity Securities

Our purchase of our common stock during the three months ended September 30, 2016 were as follows:

| Period                            | Total<br>Number of<br>Shares<br>Purchased | Average<br>Price<br>Paid per<br>Share | Total<br>Number of<br>Shares<br>Purchased<br>as Part of<br>Publicly<br>Announced<br>Plans or<br>Programs | Maximum<br>Number of<br>Shares that<br>May Yet<br>Be<br>Purchased<br>Under the<br>Plans or<br>Programs |
|-----------------------------------|---|---------------------------------------|--|--|
| July 1 to July 31, 2016           | 87,561                                    | (1)\$ 22.47                           | (1)—   | —  |
| August 1 to August 31, 2016       | —   | —                                     | —  | —  |
| September 1 to September 30, 2016 | —   | —                                     | —  | —  |
| Total                             | 87,561                                    | \$ 22.47                              | —  | —  |

Delivery of shares to us in payment of tax withholding in connection with an employee's vesting in restricted stock.

(1) The shares were immediately canceled. The number of shares and average price paid per share have not been adjusted for the impact of our 5% stock dividend, payable on September 29, 2016.





Item 6. Exhibits:

- 12.1 Computation of Ratio of Earnings to Fixed Charges for each of the five years within the period ended December 31, 2015 and for each of the nine months within the periods ended September 30, 2016 and 2015.
- 31.1 Certification of Chief Executive Officer, Pursuant to Exchange Act Rule 13a-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer, Pursuant to Exchange Act Rule 13a-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer, Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Chief Financial Officer, Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 99.1 Material Legal Proceedings
- 101.INS XBRL Instance Document
- 101.SCHXBRL Taxonomy Extension Schema
- 101.CALXBRL Taxonomy Extension Calculation Linkbase
- 101.DEF XBRL Taxonomy Extension Definition Linkbase
- 101.LABXBRL Taxonomy Extension Label Linkbase
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase

SIGNATURE

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

VECTOR GROUP LTD.  
(Registrant)

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

Date: November 8, 2016