VECTOR GROUP LTD
Form 10-Q
July 30, 2014

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

FORM 10-Q

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

For The Quarterly Period Ended June 30, 2014

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

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

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.
x Yes o No

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

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

x Large accelerated filer	o Accelerated filer	o Non-accelerated filer (Do not check if a smaller reporting company)	o Smaller reporting company

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

At July 30, 2014, Vector Group Ltd. had 100,437,406 shares of common stock outstanding.

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

	June 30, 2014	December 31, 2013
ASSETS:		
Current assets:		
Cash and cash equivalents	$506,423	$234,466
Investment securities available for sale	237,767	172,534
Accounts receivable - trade, net	15,753	12,159
Inventories	108,257	93,496
Deferred income taxes	28,264	50,479
Income tax receivable, net	12,769	—
Restricted assets	2,555	1,785
Other current assets	28,532	23,392
Total current assets	940,320	588,311
Property, plant and equipment, net	80,332	79,258
Real estate held for sale, net	10,669	20,911
Long-term investments accounted for at cost	27,239	20,788
Long-term investments accounted for under the equity method	17,842	8,595
Investments in non-consolidated real estate businesses	133,629	128,202
Restricted assets	11,581	11,981
Deferred income taxes	64,712	51,474
Intangible assets, net	8,755	11,919
Goodwill	72,976	71,681
Trademarks	80,005	80,000
Intangible asset associated with benefit under the Master Settlement Agreement	107,511	107,511
Prepaid pension costs	27,663	26,080
Other assets	59,428	53,553
Total assets	$1,642,662	$1,260,264
LIABILITIES AND STOCKHOLDERS' DEFICIENCY:		
Current liabilities:		
Current portion of notes payable and long-term debt	$141,808	$151,577
Current portion of fair value of derivatives embedded within convertible debt	7,768	19,128
Current payments due under the Master Settlement Agreement	62,009	25,348
Current portion of employee benefits	939	939
Accounts payable	10,180	10,260
Accrued promotional expenses	20,040	18,655
Income taxes payable, net	3,156	6,423
Accrued excise and payroll taxes payable, net	16,809	11,621
Litigation accruals	4,536	59,310
Deferred income taxes	51,433	45,734
Accrued interest	29,926	21,968
Other current liabilities	31,708	34,147
Total current liabilities	380,312	405,110
Notes payable, long-term debt and other obligations, less current portion	853,669	540,766
Fair value of derivatives embedded within convertible debt	183,786	92,934
Non-current employee benefits	48,564	47,917
Deferred income taxes	153,481	137,650

Payments due under the Master Settlement Agreement	25,809	27,571
Litigation accruals	24,376	27,058
Other liabilities	3,778	2,867
Total liabilities	1,673,775	1,281,873
Commitments and contingencies		
Stockholders' deficiency:		
Preferred stock, par value $1.00 per share, 10,000,000 shares authorized	—	—
Common stock, par value $0.10 per share, 250,000,000 and 150,000,000 shares authorized, 104,385,261 and 101,430,853 shares issued and 100,437,406 and 97,482,998 shares outstanding	10,043	9,748
Additional paid-in capital	—	—
Accumulated deficit	(134,385)	(114,787)
Accumulated other comprehensive income	29,679	22,860
Less: 3,947,855 and 3,947,855 shares of common stock in treasury, at cost	(12,857)	(12,857)
Total Vector Group Ltd. stockholders' deficiency	(107,520)	(95,036)
Non-controlling interest	76,407	73,427
Total stockholders' deficiency	(31,113)	(21,609)
Total liabilities and stockholders' deficiency	$1,642,662	$1,260,264

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Revenues:				
Tobacco*	$250,556	$249,120	$483,948	$489,522
Real estate	153,488	7,106	261,532	12,873
E-Cigarettes	2,569	—	8,369	—
Total revenues	406,613	256,226	753,849	502,395
Expenses:				
Cost of sales:				
Tobacco*	179,773	180,430	347,939	353,386
Real estate	97,763	6,015	165,087	10,236
E-Cigarettes	1,746	—	5,293	—
Total cost of sales	279,282	186,445	518,319	363,622
Operating, selling, administrative and general expenses	67,023	25,541	132,500	51,437
Operating income	60,308	44,240	103,030	87,336
Other income (expenses):				
Interest expense	(44,183)	(32,086)	(79,636)	(65,462)
Loss on extinguishment of debt	—	—	—	(21,458)
Change in fair value of derivatives embedded within convertible debt	1,970	2,450	320	5,499
Acceleration of interest expense related to debt conversion	(439)	—	(4,118)	—
Equity (loss) income from non-consolidated real estate businesses	(1,808)	6,804	(256)	7,285
Equity (loss) income on long-term investments	(273)	846	633	823
(Loss) gain on sale of investment securities available for sale	(18)	(197)	(71)	5,209
Other, net	3,575	1,471	5,701	2,280
Income before provision for income taxes	19,132	23,528	25,603	21,512
Income tax expense	6,101	10,017	9,043	9,682
Net income	13,031	13,511	16,560	11,830
Net income attributed to non-controlling interest	(5,106)	—	(6,055)	—
Net income attributed to Vector Group Ltd.	$7,925	$13,511	$10,505	$11,830
Per basic common share:				
Net income applicable to common shares attributed to Vector Group Ltd.	$0.08	$0.14	$0.11	$0.13
Per diluted common share:				

Net income applicable to common shares attributed to Vector Group Ltd.	$0.08	$0.14	$0.11	$0.13
Cash distributions and dividends declared per share	$0.40	$0.38	$0.80	$0.76

* Revenues and cost of sales include excise taxes of $109,695, $112,596, $212,108 and $221,507, respectively.

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Net income	$13,031	$13,511	$16,560	$11,830
Net unrealized (losses) gains on investment securities available for sale:				
Change in net unrealized (losses) gains	(2,886)	2,866	3,108	16,904
Net unrealized losses (gains) reclassified into net income	18	197	71	(5,209)
Net unrealized (losses) gains on investment securities available for sale	(2,868)	3,063	3,179	11,695
Net unrealized gains (losses) on long-term investments accounted for under the equity method:				
Change in net unrealized gains (losses)	5,282	(1,542)	8,614	(584)
Net unrealized gains (losses) reclassified into net income	—	—	—	—
Net unrealized gains (losses) on long-term investments accounted for under the equity method	5,282	(1,542)	8,614	(584)
Net change in forward contracts	15	16	32	31
Net change in pension-related amounts	147	351	295	702
Other comprehensive income	2,576	1,888	12,120	11,844
Income tax effect on:				
Change in net unrealized (losses) gains on investment securities	1,193	(1,163)	(1,780)	(6,863)
Net unrealized losses (gains) reclassified into net income on investment securities	(7)	(80)	(29)	2,115
Change in unrealized gains (losses) on long-term investments	(2,184)	626	(3,554)	237
Net unrealized gains (losses) on long-term investments accounted for under the equity method	—	—	—	—
Forward contracts	(6)	(6)	(12)	(12)
Pension-related amounts	(61)	(143)	74	(285)
Income tax provision on other comprehensive income	(1,065)	(766)	(5,301)	(4,808)
Other comprehensive income, net of tax	1,511	1,122	6,819	7,036

Comprehensive income	14,542	14,633	23,379	18,866
Comprehensive income attributed to non-controlling interest	(5,106)	—	(6,055)	—
Comprehensive income attributed to Vector Group Ltd.	$9,436	$14,633	$17,324	$18,866

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

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

	Vector Group Ltd. Stockholders' Deficiency							
	Common Stock		Additional Paid-In	Accumulated	Accumulated Other Comprehensive	Treasury	Non-controlling	
	Shares	Amount	Capital	Deficit	Income	Stock	Interest	Total
Balance, January 1, 2014	97,482,998	$9,748	$ —	$ (114,787)	$ 22,860	$(12,857)	$ 73,427	$(21,609)
Net income	—	—	—	10,505	—	—	6,055	16,560
Change in net loss and prior service cost, net of income taxes	—	—	—	—	369	—	—	369
Forward contract adjustments, net of income taxes	—	—	—	—	20	—	—	20
Unrealized gain on long-term investment securities accounted for under the equity method, net of income taxes	—	—	—	—	5,060	—	—	5,060
Change in net unrealized gain on investment securities, net of income taxes	—	—	—	—	1,328	—	—	1,328
Net unrealized loss reclassified into net income, net of income taxes	—	—	—	—	42	—	—	42
Unrealized gain on investment securities, net of income taxes	—	—	—	—	—	—	—	1,370
Total other comprehensive income	—	—	—	—	—	—	—	6,819
Total comprehensive income	—	—	—	—	—	—	—	23,379
Distributions and dividends on common stock	—	—	(49,756)	(30,103)	—	—	—	(79,859)
Note conversions, net of income taxes	2,682,466	268	30,928	—	—	—	—	31,196
Beneficial conversion feature of notes payable, net of income	—	—	14,648	—	—	—	—	14,648

taxes of $10,327								
Exercise of stock options	271,942	27	3,378	—	—	—	—	3,405
Tax benefit of options exercised	—	—	680	—	—	—	—	680
Stock-based compensation	—	—	987	—	—	—	—	987
Tax rate adjustment	—	—	(865)	—	—	—	—	(865)
Distributions to non-controlling interest	—	—	—	—	—	—	(3,075)	(3,075)
Balance as of June 30, 2014	100,437,406	$10,043	$ —	$ (134,385)	$ 29,679	$(12,857)	$ 76,407	$(31,113)

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

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

	Six Months Ended June 30, 2014	Six Months Ended June 30, 2013
Net cash provided by operating activities	$53,995	$5,190
Cash flows from investing activities:		
Sale of investment securities	49,296	43,115
Purchase of investment securities	(110,419)	(90,368)
Proceeds from sale or liquidation of long-term investments	549	75
Purchase of long-term investments	(7,000)	(5,000)
Investments in non-consolidated real estate businesses	(12,534)	(19,048)
Investments in consolidated real estate businesses	—	(7,657)
Distributions from non-consolidated real estate businesses	3,539	—
Increase in cash surrender value of life insurance policies	(395)	(303)
Increase in restricted assets	(371)	(1,268)
Issuance of notes receivable	(250)	—
Proceeds from sale of fixed assets	4	13
Capital expenditures	(10,144)	(5,995)
Repayments of notes receivable	933	8,433
Purchase of subsidiaries	(250)	—
Net cash used in investing activities	(87,042)	(78,003)
Cash flows from financing activities:		
Proceeds from debt issuance	413,916	453,080
Deferred financing costs	(12,360)	(11,663)
Repayments of debt	(8,051)	(418,833)
Borrowings under revolver	429,188	474,493
Repayments on revolver	(437,736)	(476,888)
Dividends and distributions on common stock	(80,963)	(71,518)
Distributions to non-controlling interest	(3,075)	—
Proceeds from exercise of Vector options	3,405	—
Tax benefit of options exercised	680	—
Net cash provided by (used in) financing activities	305,004	(51,329)
Net increase (decrease) in cash and cash equivalents	271,957	(124,142)
Cash and cash equivalents, beginning of period	234,466	405,855
Cash and cash equivalents, end of period	$506,423	$281,713

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

VECTOR GROUP LTD.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in Thousands, Except Per Share Amounts)
Unaudited

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Basis of Presentation:

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

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

The accompanying unaudited, interim condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and, in management's opinion, contain all adjustments, consisting only of normal recurring items, necessary for a fair statement of the results for the periods presented. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2013 filed with the Securities and Exchange Commission. The consolidated results of operations for interim periods should not be regarded as necessarily indicative of the results that may be expected for the entire year.

Certain reclassifications have been made to the 2013 financial information to conform to the 2014 presentation.

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

	Three Months Ended June 30, 2013			Six Months Ended June 30, 2013		
	As Previously Reported	Revision	As Revised	As Previously Reported	Revision	As Revised
Revenues	$249,120	$(249,120)	$—	$489,522	$(489,522)	$—
Tobacco revenues	—	249,120	249,120	—	489,522	489,522
Real estate revenues	—	7,106	7,106	—	12,873	12,873
Total revenue	249,120	7,106	256,226	489,522	12,873	502,395
Cost of Sales	180,430	(180,430)	—	353,386	(353,386)	—
Tobacco cost of sales	—	180,430	180,430	—	353,386	353,386
Real estate cost of sales	—	6,015	6,015	—	10,236	10,236
Total cost of sales	180,430	6,015	186,445	353,386	10,236	363,622

Operating, selling, administrative and general expenses	$24,450	$1,091	$25,541	$48,800	$2,637	$51,437

In addition, the preliminary fair values of the assets acquired, liabilities assumed and the non-controlling interest recorded for Douglas Elliman as of December 13, 2013 were adjusted during the first quarter of 2014. Goodwill and current liabilities were

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

(Dollars in Thousands, Except Per Share Amounts)
Unaudited

reduced by $454 and $105, respectively, while intangible assets related to favorable lease agreements were increased by $559. The amounts are preliminary as management is still evaluating the valuations of certain assets acquired in the acquisition. These adjustments have been reflected in the Company's condensed consolidated balance sheet as of December 31, 2013.

(b) Distributions and Dividends on Common Stock:

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

(c) Revenue Recognition:

Tobacco sales: Revenues from sales are recognized upon the shipment of finished goods when title and risk of loss have passed to the customer, there is persuasive evidence of an arrangement, the sale price is determinable and collectibility is reasonably assured. The Company provides an allowance for expected sales returns, net of any related inventory cost recoveries. Certain sales incentives, including promotional price discounts, are classified as reductions of net sales. The Company’s accounting policy is to include federal excise taxes in revenues and cost of goods sold. Since the Company’s significant line of business is tobacco, the Company’s financial position and its results of operations and cash flows have been and could continue to be materially adversely affected by significant unit sales volume declines at the Company and industry levels, regulation, litigation and defense costs, increased tobacco costs or reductions in the selling price of cigarettes in the near term.
Real estate sales: Revenue is recognized when persuasive evidence of an arrangement exists, the price is fixed or determinable, the transaction has been completed and collectibility of the resulting receivable is reasonably assured. Real estate and mortgage commissions earned by the Company’s real estate and mortgage brokerage businesses are recorded as revenue on a gross basis upon the closing of a real estate transaction as evidenced when the escrow or similar account is closed, the transaction documents have been recorded and funds are distributed to all appropriate parties. Commissions and royalties expenses are recognized concurrently with related revenues. Property management fees earned are recorded as revenue when the related services are performed.
E-Cigarettes: Revenues from sales are recognized upon the shipment of finished goods when title and risk of loss have passed to the customer, there is persuasive evidence of an arrangement, the sale price is determinable and collectibility is reasonably assured. The Company provides an allowance for expected sales returns, net of any related inventory cost recoveries. Certain sales incentives, including promotional price discounts, are classified as reductions of net sales.

(d) Earnings Per Share (“EPS”):

Information concerning the Company's common stock has been adjusted to give retroactive effect to the 5% stock dividend paid to Company stockholders on September 27, 2013. 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 Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Net income attributed to Vector Group Ltd.	$7,925	$13,511	$10,505	$11,830
Income attributed to participating securities	(231)	(374)	(309)	(328)
Net income attributed to Vector Group Ltd. available to common stockholders	$7,694	$13,137	$10,196	$11,502

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

(Dollars in Thousands, Except Per Share Amounts)
Unaudited

Basic and diluted EPS were calculated using the following shares:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Weighted-average shares for basic EPS	96,760,894	91,167,749	95,686,399	91,165,686
Plus incremental shares related to stock options and non-vested restricted stock	101,258	216,890	112,293	205,721
Weighted-average shares for basic and fully diluted EPS	96,862,152	91,384,639	95,798,692	91,371,407

The following stock options, non-vested restricted stock and shares issuable upon the conversion of convertible debt were outstanding during the three and six months ended June 30, 2014 and 2013 but were not included in the computation of diluted EPS because the effect was anti-dilutive.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Number of stock options	—	N/A	—	N/A
Weighted-average exercise price	N/A	N/A	N/A	N/A
Weighted-average shares of non-vested restricted stock	—	56,175	—	56,175
Weighted-average expense per share	N/A	$15.58	N/A	$15.58
Weighted-average number of shares issuable upon conversion of debt	32,493,002	28,310,522	29,105,625	28,310,522
Weighted-average conversion price	$19.02	$15.22	$17.56	$15.22

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

(Dollars in Thousands, Except Per Share Amounts)
Unaudited

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

The Company has estimated the fair market value of the embedded derivatives based principally on the results of a valuation model. The estimated fair value of the derivatives embedded within the convertible debt is based principally on the present value of future dividend payments expected to be received by the convertible debt holders over the term of the debt. The discount rate applied to the future cash flows is estimated based on a spread in the yield of the Company's debt when compared to risk-free securities with the same duration; thus, a readily determinable fair market value of the embedded derivatives is not available. The valuation model assumes future dividend payments by the Company and utilizes interest rates and credit spreads for secured to unsecured debt, unsecured to subordinated debt and subordinated debt to preferred stock to determine the fair value of the derivatives embedded within the convertible debt. The valuation also considers other items, including current and future dividends and the volatility of the Company's stock price. At June 30, 2014, the range of estimated fair market values of the Company's embedded derivatives was between $189,358 and $193,797. The Company recorded the fair market value of its embedded derivatives at the midpoint of the range at $191,554 as of June 30, 2014. At December 31, 2013, the range of estimated fair market values of the Company's embedded derivatives was between $110,758 and $113,392. The Company recorded the fair market value of its embedded derivatives at the midpoint of the range at $112,062 as of December 31, 2013. The estimated fair market value of the Company's embedded derivatives could change significantly based on future market conditions. (See Note 6.)

(f) Other Income, Net:

Other income, net consists of:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Gain (loss) on warrants	$45	$(28)	$(123)	$37
Interest income	1,189	826	2,189	1,476
Accretion of interest income from debt discount on notes receivable	10	588	76	623
Out-of-period adjustment	—	—	1,231	—
Acceleration of closing fee related to termination of Douglas Elliman joint venture	2,335	—	2,335	—
Gain on long-term investment	—	142	—	142
Other (expense) income	(4)	(57)	(7)	2
Other income, net	$3,575	$1,471	$5,701	$2,280

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

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

(Dollars in Thousands, Except Per Share Amounts)
Unaudited

(g) Subsequent Events:

On July 23, 2014, the Company granted its President and Chief Executive Officer an award of 1,000,000 shares of its Common Stock subject to performance-based vesting. The Award shares will be issued pursuant to the terms of an agreement that provides that both a performance requirement and a continued employment requirement must be met over a seven-year performance period to earn vested rights with respect to the Award Shares. The maximum potential amount of the Award Shares reflects recognition of the CEO's contributions as CEO since January 1, 2006 and the value of his management and real estate expertise to the Company. The Company anticipates expensing the value of the grant of approximately $20,660 over the seven-year term of the grant.

(h) New Accounting Pronouncements:

On April 10, 2014, the Financial Accounting Standards Board issued final guidance to change the criteria for reporting discontinued operations while enhancing disclosures in this area (Accounting Standards Update (“ASU”) No. 2014-08). Under the new guidance, only disposals representing a strategic shift, such as a major line of business, a major geographical area or a major equity investment, should be presented as discontinued operations. The guidance will be applied prospectively to new disposals and new classifications of disposal groups as held for sale after the effective date. The guidance is effective for annual financial statements with fiscal years beginning on or after December 15, 2014 with early adoption permitted for disposals or classifications as held for sale which have not been reported in financial statements previously issued or available for issuance. The Company will adopt the guidance effective January 1, 2015 and the guidance is not anticipated to have a material impact on the Company's consolidated financial statements and notes to the consolidated financial statements.

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

In May 2014, the Financial Accounting Standards Board issued Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (Topic 606) (“ASU 2014-09”), which amends the existing accounting standards for revenue recognition. ASU 2014-09 is based on principles that govern the recognition of revenue at an amount an entity expects to be entitled when products are transferred to customers. ASU 2014-09 will be effective for the Company on January 1, 2017. Early adoption is not permitted. The new revenue standard may be applied retrospectively to each prior period presented or retrospectively with the cumulative effect recognized as of the date of adoption. The Company is currently evaluating the impact of adopting the new revenue standard on its consolidated financial statements.

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

(Dollars in Thousands, Except Per Share Amounts)
Unaudited

2. INVENTORIES

Inventories consist of:

	June 30, 2014	December 31, 2013
Leaf tobacco	$59,506	$49,140
Other raw materials	3,196	3,161
Work-in-process	388	353
Finished goods	65,021	67,201
E-Cigarettes	9,705	839
Inventories at current cost	137,816	120,694
LIFO adjustments	(29,559)	(27,198)
	$108,257	$93,496

The Company has a leaf inventory management program whereby, among other things, it is committed to purchase certain quantities of leaf tobacco. The purchase commitments are for quantities not in excess of anticipated requirements and are at prices, including carrying costs, established at the commitment date. At June 30, 2014, Liggett had tobacco purchase commitments of approximately $17,277 and E-Cigarettes purchase commitments of $538. The Company has a single source supply agreement for fire safe cigarette paper through 2015.

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

3. INVESTMENT SECURITIES AVAILABLE FOR SALE

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

	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Marketable equity securities	$55,602	$68,738	$(1,306)	$123,034
Mutual funds invested in fixed income securities	60,217	305	—	60,522
Marketable debt securities	52,883	1,744	(416)	54,211
Total investment securities available for sale	$168,702	$70,787	$(1,722)	$237,767

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

	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Marketable equity securities	$53,586	$65,851	$(963)	$118,474

Marketable debt securities	53,063	1,497	(500	) 54,060
Total investment securities available for sale	$106,649	$67,348	$(1,463	) $172,534

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

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

Investment Type:	Market Value	Under 1 Year	1 Year up to 5 Years	More than 5 Years
U.S. Government securities	$11,197	$830	$10,367	$—
Corporate securities	30,648	2,906	20,206	7,536
U.S. mortgage backed securities	214	—	214	—
Commercial mortgage-backed securities	6,645	854	5,791	—
U.S. asset backed securities	5,061	—	5,061	—
Government agencies	192	—	192	—
Index-linked U.S. bonds	254	—	254	—
Total marketable debt securities by maturity dates	$54,211	$4,590	$42,085	$7,536

4. LONG-TERM INVESTMENTS

Long-term investments accounted for at cost:

	June 30, 2014		December 31, 2013	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Investment partnerships	$26,541	$32,619	$20,041	$24,095
Real estate partnership	698	1,148	747	1,067
Investments accounted for at cost	$27,239	$33,767	$20,788	$25,162

The Company contributed an additional $7,000 to Investment Partnerships during the six months ended June 30, 2014.

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

	June 30, 2014	December 31, 2013
Investment partnership	$17,842	$8,595

The Company recorded equity losses of $273 and equity income of $846 for the three months ended June 30, 2014 and 2013, respectively, related to the limited partnership. The Company recorded equity income of $633 and $823 for the six months ended June 30, 2014 and 2013, respectively, related to the limited partnership.

The carrying value of the investment was approximately $17,842 and $8,595 as of June 30, 2014 and December 31, 2013, respectively, which approximated the investment's fair value.

5. NEW VALLEY LLC

Residential Brokerage Business Acquisition. New Valley is engaged in the real estate business and is seeking to acquire additional real estate properties and operating companies. As of January 1, 2013, the Company owned a 50%

interest in Douglas Elliman, and the Company accounted for its 50% using the equity method of accounting. On December 13, 2013, an affiliate of New Valley acquired an additional 20.59% interest in Douglas Elliman from Prudential Real Estate Financial Services of America, Inc. for a purchase price of $60,000 in cash. The acquisition increased the Company's ownership position in Douglas Elliman from 50% to 70.59% and resulted in the Company having control.

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

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

Equity Method of Accounting. Prior to December 13, 2013, New Valley accounted for its 50% interest in Douglas Elliman under the equity method of accounting. New Valley recorded income associated with Douglas Elliman of $6,815 and $7,438 for the three and six months ended June 30, 2013, respectively, which included management fees earned by New Valley from Douglas Elliman.

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

	Three Months Ended June 30, 2013	Six Months Ended June 30, 2013
Revenues	$113,647	$188,184
Costs and expenses	100,093	173,707
Depreciation expense	985	1,958
Amortization expense	55	111
Other income	261	403
Interest income, net	8	8
Income tax expense	301	242
Net income	$12,482	$12,577

New Valley received cash distributions from Douglas Elliman of $2,636 for the six months ended June 30, 2013.

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

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Investments in non-consolidated real estate businesses. New Valley also holds equity investments in various real estate projects domestically and internationally. The components of "Investments in non-consolidated real estate businesses" were as follows:

	June 30, 2014	December 31, 2013
Sesto Holdings	$5,037	$5,037
Land Development	5,037	5,037
10 Madison Square Park West (f/k/a 1107 Broadway)	6,384	6,579
The Whitman	526	1,165
The Marquand	7,000	7,000
11 Beach Street	12,328	11,160
701 Seventh Avenue	11,324	11,148
101 Murray Street	23,006	19,256
Leroy Street	652	1,150
PUBLIC Chrystie House (f/k/a Chrystie Street)	3,081	2,048
25-19 43rd Avenue	733	—
23-10 Queens Plaza South	9,528	8,058
8701 Collins Avenue	4,000	3,794
Condominium and Mixed Use Development	78,562	71,358
Maryland Portfolio	3,518	3,498
ST Portfolio	15,550	15,984
Apartment Buildings	19,068	19,482
Park Lane Hotel	17,447	19,514
Hotel Taiwana	7,467	7,428
Coral Beach	3,410	2,964
Hotels	28,324	29,906
Other	2,638	2,419
Investments in non-consolidated real estate businesses	$133,629	$128,202

Condominium and Mixed Use Development:
Condominium and mixed use developments investments range in ownership percentage from 5% to 49.5%. New Valley recorded equity income of $7 and $2,299 during the three and six months ended June 30, 2014, respectively. The $2,299 equity income was primarily related to the sale of a commercial unit at 10 Madison Square Park West (f/k/a 1107 Broadway). New Valley recorded equity income of $130 and $130 for the three and six months ended June 30, 2013. During the six months ended June 30, 2014, New Valley made capital contributions totaling $10,696 and received distributions of $5,791. During the six months ended June 30, 2013, New Valley made capital

contributions totaling $15,392 and received distributions of $130. New Valley's maximum exposure to loss as a result of its investments in condominium and mixed use developments was $78,562 at June 30, 2014.

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

(Dollars in Thousands, Except Per Share Amounts)
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Apartment Buildings:
Apartment buildings investments range in ownership percentage from 7.5% to 16.4%. New Valley recorded equity net equity losses of $217 and $142 for the three months ended June 30, 2014 and 2013, respectively, related to the apartment portfolios. New Valley recorded equity losses of $164 and $283 for six months ended June 30, 2014 and 2013, respectively, primarily related to an apartment portfolio. New Valley received distributions of $250 and $125 during the six months ended June 30, 2014 and 2013, respectively, related to an apartment portfolio. New Valley's maximum exposure to loss as a result of its investment in apartment buildings was $19,068 at June 30, 2014.

Hotels:
Hotel investments range in ownership percentage from 5% to 49%. During the three and six months ended June 30, 2014, New Valley recorded net equity losses of $857 and $2,171. New Valley made capital contributions totaling $589 for the six months ended June 30, 2014, related to Coral Beach. New Valley made capital contributions totaling $3,655 for the six months ended June 30, 2013, primarily related to Hotel Taiwana. New Valley's maximum exposure to loss as a result of its investments in hotels was $28,324 at June 30, 2014.

Other:
Other non-consolidated real estate business relate to an investment in a mortgage company and an insurance company partially owned by Douglas Elliman.

Real Estate Held for Sale:
The components of “Real estate held for sale, net” were as follows:

	June 30, 2014	December 31, 2013
Escena, net	$10,669	$10,625
Indian Creek	—	10,286
Real estate held for sale, net	$10,669	$20,911

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

	June 30, 2014	December 31, 2013
Land and land improvements	$8,930	$8,930
Building and building improvements	1,830	1,530
Other	1,526	1,577
	12,286	12,037
Less accumulated depreciation	(1,617)	(1,412)
	$10,669	$10,625

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

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The Company recorded an operating loss of $287 and $307 for the three months ended June 30, 2014 and 2013, respectively, from Escena. The Company recorded operating income of $233 and $76 for the six months ended June 30, 2014 and 2013, respectively, from Escena.

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

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

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

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

	June 30, 2014	December 31, 2013
Vector:		
7.75% Senior Secured Notes due 2021, including premium of $9,879 and $0	$609,879	$450,000
6.75% Variable Interest Senior Convertible Note due 2014, net of unamortized discount of $4,895 and $19,311*	20,105	30,689
6.75% Variable Interest Senior Convertible Exchange Notes due 2014, net of unamortized discount of $11,569 and $25,944*	88,461	81,586
7.5% Variable Interest Senior Convertible Notes due 2019, net of unamortized discount of $151,675 and $155,817*	78,325	74,183
5.5% Variable Interest Senior Convertible Debentures due 2020, net of unamortized discount of $104,496 and $0*	154,254	—
Liggett:		
Revolving credit facility	21,876	30,424
Term loan under credit facility	3,737	3,884
Equipment loans	18,237	17,252
Other	603	4,325
Total notes payable, long-term debt and other obligations	995,477	692,343
Less:		
Current maturities	(141,808)	(151,577)
Amount due after one year	$853,669	$540,766

* The fair value of the derivatives embedded within the 6.75% Variable Interest Senior Convertible Note ($1,716 at June 30, 2014 and $6,607 at December 31, 2013, respectively), the 6.75% Variable Interest Senior Convertible Exchange Notes ($6,052 at June 30, 2014 and $12,521 at December 31, 2013, respectively), the 5.50% Variable Interest Senior Convertible Debentures ($87,217 at June 30, 2014 and $0 at December 31, 2013, respectively), and the 7.50% Variable Interest Senior Convertible Debentures ($96,569 at June 30, 2014 and $92,934 at December 31, 2013, respectively), is separately classified as a derivative liability in the condensed consolidated balance sheets.

7.75% Senior Secured Notes due 2021 - Vector:

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

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In connection with the issuance of the 7.75% Senior Secured Notes, the Company entered into a Registration Rights Agreement. The Company consummated a registered exchange offer for the 7.75% Senior Secured Notes on July 9, 2014. The new 7.75% Senior Secured Notes issued in the exchange offer have substantially the same terms as the original notes, except that the new 7.75% Senior Secured Notes have been registered under the Securities Act.

6.75% Variable Interest Senior Convertible Note due 2014 - Vector:
On March 14, 2014, the holder of the 6.75% Variable Interest Senior Convertible Note due 2014 converted $25,000 principal balance of the $50,000 Note into 2,121,479 of the Company's common shares. The Company recorded non-cash accelerated interest expense related to the converted debt of $3,679 for the six months ended June 30, 2014. The debt conversion resulted in a reduction of debt and an increase to equity in the amount of $25,000.
6.75% Variable Interest Senior Convertible Exchange Notes due 2014 - Vector:
On May 20, 2014, a holder of the 6.75% Variable Interest Senior Convertible Exchange Notes due 2014 converted $7,500 principal balance of the $107,530 Notes into 560,987 of the Company's common shares. The Company recorded non-cash accelerated interest expense related to the converted debt of $439 for the three and six months ended June 30, 2014. The debt conversion resulted in a reduction of debt and an increase to equity in the amount of $7,500.

5.5% Variable Interest Senior Convertible Notes due 2020 - Vector:
On March 24, 2014, the Company completed the sale of $258,750 of its Variable Interest Convertible Senior Notes due 2020 (the "2020 Convertible Notes"). The 2020 Convertible Notes are the Company's senior unsecured obligations and are effectively subordinated to any of its secured indebtedness to the extent of the assets securing such indebtedness. The 2020 Convertible Notes are also structurally subordinated to all liabilities and commitments of the Company's subsidiaries.
The aggregate net proceeds from the sale of the 2020 Convertible Notes were approximately $250,300 after deducting underwriting discounts, commissions, fees and offering expenses. The net proceeds will be used for general corporate purposes, including for additional investments in real estate and in the Company's tobacco business. The Company may also consider using a portion of the net proceeds from the sale of the notes to address upcoming debt maturities. The 2020 Convertible Notes pay interest (“Total Interest”) on a quarterly basis beginning April 15, 2014 at a rate of 1.75% per annum plus additional interest, which is based on the amount of cash dividends paid during the prior three-month period ending on the record date for such interest payment multiplied by the total number of shares of its common stock into which the debt will be convertible on such record date. Notwithstanding the foregoing, however, the interest payable on each interest payment date after April 15, 2014 shall be the higher of (i) the Total Interest and (ii) 5.5% per annum with the interest payment on April 15, 2014 being based on 5.5% per annum. The notes are convertible into the Company’s common stock at the holder’s option. The conversion price at June 30, 2014 was $27.16 per share (approximately 36.8155 shares of common stock per $1,000 principal amount of the note), and is subject to adjustment for various events, including the issuance of stock dividends. The notes will mature on April 15, 2020. If a fundamental change (as defined in the indenture) occurs, the Company will be required to offer to repurchase the notes at 100% of their principal amount, plus accrued and unpaid interest to, but excluding, the fundamental change repurchase date.

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

As of June 30, 2014, a total of $25,613 was outstanding under the revolving and term loan portions of the credit facility. Availability as determined under the facility was approximately $24,387 based on eligible collateral at June 30, 2014.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

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Non-Cash Interest Expense - Vector:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Amortization of debt discount	$7,563	$8,464	$20,019	$15,812
Amortization of deferred finance costs	1,055	447	1,763	1,044
Loss on extinguishment of 11% Senior Secured Notes	—	—	—	3,638
Accelerated interest expense on 6.75% Variable Interest Senior Convertible Note converted	—	—	3,679	—
Accelerated interest expense on 6.75% Variable Interest Senior Convertible Exchange Notes converted	439	—	439	—
	$9,057	$8,911	$25,900	$20,494

Fair Value of Notes Payable and Long-Term Debt:

	June 30, 2014		December 31, 2013	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Notes payable and long-term debt	$995,477	$1,473,738	$692,343	$1,006,562

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

7. CONTINGENCIES

Tobacco-Related Litigation:

Overview
Since 1954, Liggett and other United States cigarette manufacturers have been named as defendants in numerous direct, third-party and purported class actions predicated on the theory that cigarette manufacturers should be liable for damages alleged to have been caused by cigarette smoking or by exposure to secondary smoke from cigarettes. The cases have generally fallen into the following categories: (i) smoking and health cases alleging personal injury brought on behalf of individual plaintiffs (“Individual Actions”); (ii) lawsuits by individuals requesting the benefit of the Engle ruling ("Engle progeny cases"); (iii) smoking and health cases primarily alleging personal injury or seeking

court-supervised programs for ongoing medical monitoring, as well as cases alleging that use of the terms “lights” and/or “ultra lights” constitutes a deceptive and unfair trade practice, common law fraud or violation of federal law, purporting to be brought on behalf of a class of individual plaintiffs (“Class Actions”); and (iv) health care cost recovery actions brought by various foreign and domestic governmental plaintiffs and non-governmental plaintiffs seeking reimbursement for health care expenditures allegedly caused by cigarette smoking and/or disgorgement of profits (“Health Care Cost Recovery Actions”). As new cases are commenced, the costs associated with defending these cases and the risks relating to the inherent unpredictability of litigation increase. The future financial impact of the risks and expenses of litigation are not quantifiable. For the six months ended June 30, 2014 and 2013, Liggett incurred tobacco product liability legal expenses and other litigation costs totaling $5,174 and $3,562, respectively.

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

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

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

In June 2009, Florida amended its existing bond cap statute by adding a $200,000 bond cap that applies to all Engle progeny cases in the aggregate and establishes individual bond caps for individual Engle progeny cases in amounts that vary depending on the number of judgments in effect at a given time. In several cases, plaintiffs have challenged the constitutionality of the bond cap statute, but to date the courts that have addressed the issue have upheld the constitutionality of the statute. It is possible that the Company's consolidated financial position, results of operations, and cash flows could be materially adversely affected by an unfavorable outcome of such challenges.

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

Cautionary Statement About Engle Progeny Cases. Judgments have been entered against Liggett and other industry defendants in Engle progeny cases. A number of the judgments have been affirmed on appeal and satisfied by the defendants. As of June 30, 2014, 16 Engle progeny cases where Liggett was a defendant at trial resulted in verdicts. Eleven verdicts were returned in favor of the plaintiffs and five in favor of Liggett. Excluding the Lukacs case, which was tried in 2002, seven years before the trials of Engle progeny cases commenced, the compensatory verdicts against Liggett have ranged from $1 to $3,479. In certain cases, the judgments entered have been joint and several with other defendants. In two of the cases, punitive damages were awarded against Liggett. Except as discussed in this Note 7 regarding the cases where an adverse verdict was entered against Liggett and that remain on appeal, management is unable to estimate the possible loss or range of loss from the remaining Engle progeny cases as there are currently multiple defendants in each case and, in most cases, discovery has not occurred or is limited. As a result, the Company lacks information about whether plaintiffs are in fact Engle class members (non-class members' claims are generally time-barred), the relevant smoking history, the nature of the alleged injury and the availability of various defenses, among other things. Further, plaintiffs typically do not specify their demand for damages.

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

that it has valid defenses to the litigation pending against it, as well as valid bases for appeal of adverse verdicts. All such cases are, and will continue to be, vigorously defended. Liggett may, however, enter into settlement discussions in particular cases if it believes it is in its best interest to do so, including the remaining Engle progeny cases. As of June 30, 2014, Liggett (and in certain cases the Company) had, on an individual basis, settled 144 Engle progeny cases for approximately $1,170 in the aggregate. Seven of those cases were settled in the second quarter of 2014. In addition, in October 2013, Liggett announced a settlement of the claims of over 4,900 Engle progeny plaintiffs (see Engle Progeny Settlement below).

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

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Individual Actions

As of June 30, 2014, there were 49 Individual Actions pending against Liggett and, in certain cases, the Company, where one or more individual plaintiffs allege injury resulting from cigarette smoking, addiction to cigarette smoking or exposure to secondary smoke and seek compensatory and, in some cases, punitive damages. These cases do not include Engle progeny cases or the approximately 100 individual cases pending in West Virginia state court as part of a consolidated action. The following table lists the number of Individual Actions, by state, that are pending against Liggett or the Company as of June 30, 2014:

State	Number of Cases
Florida	30
New York	9
Maryland	4
Louisiana	2
West Virginia	2
Missouri	1
Ohio	1

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

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

Engle Progeny Cases

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

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

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

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

Engle Progeny Settlement. On October 23, 2013, the Company entered into a settlement with approximately 4,900 Engle progeny plaintiffs and their counsel. Pursuant to the terms of the settlement, Liggett agreed to pay a total of approximately $110,000, with approximately $61,600 paid in a lump sum ($2,100 was paid in December 2013 and approximately $59,500 was paid in February 2014) and the balance to be paid in installments over 14 years, subject to a cost of living adjustment beginning in year eight. In exchange, the claims of over 4,900 plaintiffs were dismissed with prejudice against the Company and Liggett. In 2013 the Company recorded a charge of $86,213 in connection with the settlement. Of this amount, $25,213 is related to certain payments discounted to their present value because the timing and amounts of such payments are fixed and determinable. The present value of the installment payments was computed using an 11% annual discount rate. The installment payments total approximately $48,000 on an undiscounted basis. The Company’s future payments will be approximately $3,500 per annum through 2028, with a cost of living increase beginning in 2021.

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

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As of June 30, 2014, the following Engle progeny cases have resulted in judgments against Liggett:

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

May 2013	Cohen v. R.J. Reynolds	Palm Beach	$205	None	Defendants' motion seeking a new trial was granted by the trial court. Plaintiff appealed to the Fourth District Court of Appeal.
August 2013	Rizzuto v. R.J. Reynolds	Hernando	$3,479	None	A joint and several judgment for $11,132 was entered against Philip Morris and Liggett. The court denied defendants' request to reduce the compensatory damages by the plaintiff's comparative fault. Liggett entered into a settlement agreement to resolve its portion of the judgment for $1,500. The settlement is subject to bankruptcy court approval.
Total Damages Awarded:			$25,173	$8,600	
Amounts paid or compromised:			$(14,274)	$(1,000)	
Damages remaining on Appeal:			$10,899	$7,600	

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Through June 30, 2014, Liggett has paid $18,540, including interest and legal fees, to satisfy the judgments in five Engle progeny cases (Lukacs, Campbell, Douglas, Clay and Ward).

The Company's potential range of loss in the Putney, Tullo, Calloway, Buchanan, Cohen and Rizzuto cases is between $0 and $18,499 in the aggregate, plus accrued interest and legal fees. In determining the range of loss, the Company considers potential settlements as well as future appellate relief. Except as disclosed elsewhere in this Note 7, the Company is unable to determine a range of loss related to the remaining Engle progeny cases. Other than $1,500 accrued for Rizzuto, no amounts have been expensed or accrued in the accompanying condensed consolidated financial statements for the cases described above. However, as cases proceed through the appellate process, the Company will consider accruals on a case-by-case basis if an unfavorable outcome becomes probable and the amount can be reasonably estimated.

Federal Engle Progeny Cases. Three federal judges (in the Merlob, B. Brown and Burr cases) ruled that the findings in Phase I of the Engle proceedings could not be used to satisfy elements of plaintiffs' claims, and two of those rulings (B. Brown and Burr) were certified by the trial court for interlocutory review. The certification was granted by the United States Court of Appeals for the Eleventh Circuit and the appeals were consolidated (in February 2009, the appeal in Burr was dismissed for lack of prosecution). In July 2010, the Eleventh Circuit ruled that plaintiffs do not have an unlimited right to use the findings from the original Engle trial to meet their burden of establishing the elements of their claims at trial. Rather, plaintiffs may only use the findings to establish specific facts that they demonstrate with a reasonable degree of certainty were actually decided by the original Engle jury. The Eleventh Circuit remanded the case to the district court to determine what specific factual findings the Engle jury actually made. That determination was never undertaken. Instead, in the Waggoner case, the United States District Court for the Middle District of Florida ruled that the application of the Phase I findings did not deprive defendants of any constitutional due process rights. The court ruled, however, that plaintiffs must establish legal causation to establish liability. With respect to punitive damages, the district court held that the plaintiffs could rely on the findings in support of their punitive damages claims but that, in addition, plaintiffs must demonstrate specific conduct by specific defendants, independent of the Engle findings, that satisfies the standards for awards of punitive damages. The Waggoner ruling applies to all of the cases pending in the Middle District of Florida. Subsequently, in September 2013 the United States Court of Appeals for the Eleventh Circuit affirmed the judgments in two lower court cases, holding that giving full faith and credit to the Florida Supreme Court's Engle decision would not deprive defendant R.J. Reynolds of due process of law. Pursuant to the Engle progeny settlement, Liggett and the Company are no longer defendants in any federal Engle progeny cases.

Appeals of Engle Progeny Verdicts. In December 2010, in the Martin case, a state court case against R.J. Reynolds, the First District Court of Appeal issued the first ruling by a Florida intermediate appellate court to address the B. Brown decision discussed above. The panel held that the trial court correctly construed the Florida Supreme Court's 2006 decision in Engle in instructing the jury on the preclusive effect of the Phase I Engle proceedings, expressly disagreeing with certain aspects of the B. Brown decision. In July 2011, the Florida Supreme Court declined to review the First District Court of Appeal's decision. In March 2012, the United States Supreme Court declined to review the Martin case, along with the Campbell case and two other Engle progeny cases. This decision has led to other adverse rulings by other state appellate courts.

In Jimmie Lee Brown, a state court case against R.J. Reynolds, the trial court tried the case in two phases. In the first phase, the jury determined that the smoker was addicted to cigarettes that contained nicotine and that his addiction was a legal cause of his death, thereby establishing he was an Engle class member. In the second phase, the jury determined whether the plaintiff established legal cause and damages with regard to each of the underlying claims. The jury found in favor of plaintiff in both phases. In September 2011, the Fourth District Court of Appeal affirmed the judgment entered in plaintiff's favor and approved the trial court's procedure of bifurcating the trial. The Fourth

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

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

reversed in part holding that the defendants were entitled to summary judgment on all claims asserted against them other than the claim for civil conspiracy. Defendants' further appellate efforts were unsuccessful.

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

Liggett Only Cases. There are currently five cases pending where Liggett is the only remaining defendant. These cases consist of three Individual Actions and two Engle progeny cases. In one of the Individual Actions, Hausrath (NY state court), plaintiff moved to restore the case to the active docket calendar after it was removed by the court. The motion was granted and Liggett appealed. There has been no recent activity in the other two Individual Actions. Lambert, an Engle progeny case, is set for trial on September 15, 2014. The other Engle progeny case is not currently set for trial. Cases where Liggett is the only defendant could increase as a result of the remaining Engle progeny cases.

Class Actions

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

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

Defenses raised in these cases include, among others, lack of proximate cause, individual issues predominate, assumption of the risk, comparative fault and/or contributory negligence, statute of limitations and federal preemption.

In November 1997, in Young v. American Tobacco Co., a purported personal injury class action was commenced on behalf of plaintiff and all similarly situated residents in Louisiana who, though not themselves cigarette smokers, allege they were exposed to secondhand smoke from cigarettes that were manufactured by the defendants, including Liggett, and suffered injury as a result of that exposure. The plaintiffs seek to recover an unspecified amount of compensatory and punitive damages. No class certification hearing has been held. In October 2004, the trial court stayed the Young case pending the outcome of an appeal in Scott v. The American Tobacco Co., a Louisiana case seeking medical monitoring for resident smokers. Liggett was not a party in the Scott case. The Scott case was tried to a jury which denied the medical monitoring claim but determined instead that the defendants must establish a smoking cessation program. Notwithstanding the fact that Scott is now concluded, in June 2013, plaintiffs' counsel moved for an indefinite stay of the Young case. The defendants did not oppose the stay and it was entered upon consent.

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

defendants.

In February 2000, in Smith v. Philip Morris, a case pending in Kansas, a class was commenced against cigarette manufacturers alleging they conspired to fix cigarette prices in violation of antitrust laws. Plaintiffs seek to recover an unspecified amount in actual and punitive damages. Class certification was granted in November 2001. In January 2012, the trial court heard oral argument on defendants' motions for summary judgment and in March 2012, the court granted the motions and dismissed plaintiffs' claims with prejudice. In July 2012, plaintiffs noticed an appeal. In July 2014, the court of appeals affirmed the lower court's decision.

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Although not technically a class action, in In Re: Tobacco Litigation (Personal Injury Cases), a West Virginia state court consolidated approximately 750 individual smoker actions that were pending prior to 2001 for trial of certain common issues. In January 2002, the court severed Liggett from the trial of the consolidated action. After two mistrials, on May 15, 2013, the jury rejected all but one of the plaintiffs' claims, finding for the plaintiffs on the claim that ventilated filter cigarettes, sold between 1964 and July 1, 1969, should have included instructions on how to use them. On July 15, 2013, plaintiffs filed a renewed motion for judgment as a matter of law and a motion for a new trial. Defendants filed a motion for judgment notwithstanding the verdict. All post-trial motions were denied and the issue of damages was reserved for further proceedings that have not yet been scheduled. Final judgment as to liability was issued on October 28, 2013, after which the plaintiffs filed a Notice of Appeal with respect to the defense verdicts obtained on five of the six claims. The defendants did not appeal the verdict in favor of the plaintiffs on the "failure to instruct" claim which impacted less than 30 plaintiffs. If the case were to proceed against Liggett, it is estimated that Liggett could be a defendant in approximately 100 of the individual cases.

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

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

Health Care Cost Recovery Actions

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

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

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

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

unlawful conduct in the future, and to compel defendants to disgorge the proceeds of their unlawful conduct. Claims were asserted under RICO.

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

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

Upcoming Trials

As of June 30, 2014, there were 16 Engle progeny cases scheduled for trial through June 30, 2015, where Liggett (and in many cases, the Company) is a named defendant. One of these cases, Lambert, is a Liggett only Engle progeny case. 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, Brown & Williamson, R.J. Reynolds and Lorillard (the “Original Participating Manufacturers” or “OPMs”) and Liggett (together with any other tobacco product manufacturer that becomes a signatory, the “Subsequent Participating Manufacturers” or “SPMs”) (the OPMs and SPMs are hereinafter referred to jointly as the “Participating Manufacturers”) entered into the Master Settlement Agreement (the “MSA”) with 46 states, the District of Columbia, Puerto Rico, Guam, the United States Virgin Islands, American Samoa and the Northern Mariana Islands (collectively, the “Settling States”) to settle the asserted and unasserted health care cost recovery and certain other

claims of the Settling States. The MSA received final judicial approval in each Settling State.

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

- all claims of the Settling States and their respective political subdivisions and other recipients of state health care funds, relating to: (i) past conduct arising out of the use, sale, distribution, manufacture, development, advertising and marketing of tobacco products; (ii) the health effects of, the exposure to, or research, statements or warnings about, tobacco products; and
- all monetary claims of the Settling States and their respective subdivisions and other recipients of state health care funds relating to future conduct arising out of the use of, or exposure to, tobacco products that have been manufactured in the ordinary course of business.

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

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

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

Liggett has no payment obligations under the MSA except to the extent its market share exceeds a market share exemption of 1.63% (approximately 1.65% if the "gross" vs "net" settlement, described below, is not concluded) of total cigarettes sold in the United States. Vector Tobacco has no payment obligations under the MSA except to the extent its market share exceeds a market share exemption of approximately 0.28% of total cigarettes sold in the United States. Liggett and Vector Tobacco's domestic shipments accounted for 3.3% of the total cigarettes sold in the United States in 2013. If Liggett’s or Vector Tobacco’s market share exceeds their respective market share exemption in a given year, then on April 15 of the following year, Liggett and/or Vector Tobacco, as the case may be, must pay on each excess unit an amount equal (on a per-unit basis) to that due from the OPMs for that year. On December 31, 2013, Liggett pre-paid $95,000 of its 2013 MSA obligation. On April 15, 2014, Liggett and Vector Tobacco paid approximately $16,300 for the balance of their 2013 MSA obligation.

Certain MSA Disputes

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

For 2003 through 2013, Liggett and Vector Tobacco, as applicable, disputed that they owed the Settling States the NPM Adjustments as calculated by the independent auditor. As permitted by the MSA, Liggett and Vector Tobacco

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

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

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In response to a proposal from the OPMs and many of the SPMs, 45 of the Settling States, representing approximately 90% of the allocable share of the Settling States, entered into an agreement providing for a nationwide arbitration of the dispute with respect to the NPM Adjustment for 2003. In exchange the OPMs and SPMs agreed to a 20% reduction in amounts recovered for the NPM Adjustment for 2003. In June 2010, the three person arbitration panel was selected. In November 2011, the Participating Manufacturers advised the arbitration panel that they were not contesting diligent enforcement of 16 Settling States for 2003. Substantive hearings commenced in April 2012 and were completed in June 2013.

In December 2012, the Participating Manufacturers entered into a “term sheet” with 20 Settling States setting out terms for settlement of the NPM Adjustment for 2003 through 2012 and addressing the NPM Adjustment with respect to those states for future years. Certain of the non-settling states objected to the settlement. In March 2013, the arbitration panel entered a Stipulated Partial Settlement and Award which, among other things, overruled the objections of the non-settling states and directed the independent auditor to implement certain terms of the term sheet effective with the April 15, 2013 MSA payments. In May 2013, two additional states joined the settlement. In June 2014, an additional two states joined. Several non-settling states are attempting to vacate the settlement award by filing state court actions. In Idaho, a trial court denied that state's motion to vacate, and the state noticed an appeal of that denial. In Colorado, a trial court also denied that state’s motion to vacate; Colorado has not filed an appeal, and the time period for appeal has passed. Although certain terms of the settlement were implemented by the independent auditor on April 15, 2013, no assurance can be given as to the ultimate outcome of the non-settling states' challenges. As a result of the settlement, in the first quarter of 2013 Liggett and Vector Tobacco recognized income of $5,602. Following the additional two states joining the settlement in May 2013, Liggett and Vector Tobacco recognized an additional $1,345 of income in the second quarter of 2013. Finally, Liggett and Vector Tobacco received credits of $1,733 in April 2014 from these settling states related to the 2013 NPM Adjustment. The remaining NPM Adjustment accrual of $25,809 at June 30, 2014 relates to the disputed amounts Liggett and Vector Tobacco have withheld from the non-settling states for 2004 through 2010, which may be subject to payment, with interest, if Liggett and Vector Tobacco lose the disputes for those years. Approximately $24,400 currently remains in the disputed payments accounts relating to the 2011, 2012 and 2013 NPM Adjustment dispute with these non-settling states.

In September 2013, the panel issued its decisions with respect to the 15 states that did not enter into the Stipulated Partial Settlement and Award, finding that six states did not diligently enforce their MSA escrow statutes in 2003. As a result of this ruling Liggett recognized income of $5,987 including interest, in the third quarter of 2013. All six of the states that were found to be non-diligent filed motions in state court seeking to vacate or reduce the amount of the arbitration award. A trial court in one of those states, Pennsylvania, rejected the state's motion to vacate the award but granted its motion to reduce the award. As a result, in April 2014, Liggett received a credit in the amount of $6,441 for the 2003 NPM Adjustment (as calculated by the independent auditor). It subsequently reimbursed the six states 20% of that credit, pursuant to the agreement discussed above, bringing its net recovery to $5,152, which is approximately $1,315 lower than the amount Liggett believes it’s entitled to. Subsequent to the April 15, 2014 MSA payment date, a state court in Missouri ruled similarly to the ruling in Pennsylvania. As such, Liggett's 2003 NPM credit adjustment could be reduced by an additional $521. In June 2014, Kentucky and Indiana agreed to settle the dispute. As a result, Liggett recognized income of approximately $1,400 in the second quarter of 2014. The Participating Manufacturers, including Liggett, appealed the Pennsylvania and Missouri decisions. If Liggett is unsuccessful in its appeals or if other states are successful with respect to any such motions, the amount of the 2003 NPM Adjustment and any interest or earnings to which Liggett is entitled could be lower than the amounts described above and Liggett would have to pay the difference.

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

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

The Company estimated that Liggett's future annual MSA payments would have been at least approximately $2,500 higher under the revised method of calculation because the proposed change from "gross" to "net" units would lower Liggett's grandfathered market share exemption under the MSA.

In December 2012, the parties arbitrated the dispute before a panel of three arbitrators. In February 2013, the arbitrators granted the relief sought by Liggett. The arbitrators ruled that the limitations provisions of the MSA precluded the independent auditor from recalculating Liggett's grandfathered market share exemption or Liggett's payment obligations beyond the last four

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years. The arbitrators further ruled that, for purposes of calculating Liggett's payment obligations for the applicable years, Liggett's market share, calculated on a net basis, should be increased by a factor of 1.25%. Liggett filed a motion seeking correction of the part of the arbitrators' decision that would require the 1.25% increase in Liggett's market share. The states objected to Liggett's motion and sought additional relief from the panel declaring that any adjustment ordered by the panel is not limited by the four years limitations set forth in the MSA. If the arbitrator's ruling is not modified, Liggett would be required to pay approximately $19,300. If the relief requested by the states is granted, Liggett could be required to pay up to approximately $40,900.

In June 2013, Liggett and a negotiating group on behalf of the Settling States reached an agreement in principle to resolve all disputes regarding "gross" v. "net", subject to definitive documentation and approval thereof by each Settling State. The proposed settlement would require Liggett to pay $8,500 to the Settling States and reduce its market share exemption from 1.645% to 1.63% starting in 2013 and for all years thereafter. In exchange, the Settling States would release Liggett from all claims in connection with the "gross" v. "net" dispute. The Company fully accrued the proposed settlement payment of $8,500 in 2013. In May 2014, the Settling States were advised by the OPMs that they would not waive their alleged most favored nation rights in connection with the proposed settlement. As a result, Liggett and the Settling States advised the arbitration panel that it will be necessary for the panel to rule on the motions filed by the parties. A hearing has been scheduled for September 16, 2014. There can be no assurance that the settlement will be concluded and if it is not, that Liggett will be successful in seeking modification of the award by the panel or that Liggett will not be required to make additional payments, which could adversely affect the Company’s consolidated financial position, results of operations and cash flows.

Litigation Challenging the MSA. Litigation challenging the validity of the MSA, including claims that the MSA violates antitrust laws, has not been successful to date, although several cases are pending. Participating Manufacturers are not typically named as defendants in these cases.

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

In 2003, as a result of a dispute with Minnesota regarding its settlement agreement, Liggett agreed to pay $100 a year, in any year cigarettes manufactured by Liggett are sold in that state. In 2003 and 2004, the Attorneys General for Florida, Mississippi and Texas advised Liggett that they believed that Liggett had failed to make certain required payments under the respective settlement agreements with these states. In December 2010, Liggett settled with Florida and agreed to pay $1,200 and to make further annual payments of $250 for a period of 21 years, starting in March 2011. The payments in years 12 – 21 will be subject to an inflation adjustment. These payments are in lieu of any other payments allegedly due to Florida under the original settlement agreement. In February 2012, Mississippi provided Liggett with a 60-day notice that the state intended to pursue its remedies if Liggett did not cure the alleged defaults. Liggett responded to Mississippi's letter denying the existence of any defaults. There can be no assurance that Liggett will be able to resolve the matters with Texas and Mississippi or that Liggett will not be required to make additional payments which could adversely affect the Company's consolidated financial position, results of operations and cash

flows.

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

Management cannot predict the cash requirements related to any future defense costs, settlements or judgments, including cash required to bond any appeals, and there is a risk that those requirements will not be able to be met. An unfavorable outcome 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

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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 six months ended June 30, 2014 were as follows:

	Current Liabilities			Non-Current Liabilities		
	Payments due under Master Settlement Agreement	Litigation Accruals	Total	Payments due under Master Settlement Agreement	Litigation Accruals	Total
Balance at January 1, 2014	$25,348	$59,310	$84,658	$27,571	$27,058	$54,629
Expenses	52,510	1,769	54,279	—	—	—
NPM Settlement adjustment	—	—	—	(1,419)	—	(1,419)
Change in MSA obligations capitalized as inventory	151	—	151	—	—	—
Payments	(16,343)	(60,201)	(76,544)	—	—	—
Reclassification from non-current liabilities	343	3,575	3,918	(343)	(3,575)	(3,918)
Interest on withholding	—	83	83	—	893	893
Balance as of June 30, 2014	$62,009	$4,536	$66,545	$25,809	$24,376	$50,185

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

	Current Liabilities			Non-Current Liabilities		
	Payments due under Master Settlement Agreement	Litigation Accruals	Total	Payments due under Master Settlement Agreement	Litigation Accruals	Total
Balance at January 1, 2013	$32,970	$1,470	$34,440	$52,639	$1,862	$54,501
Expenses	56,907	147	57,054	—	—	—
NPM Settlement adjustment	—	—	—	(13,489)	—	(13,489)
	364	—	364	—	—	—

Change in MSA obligations capitalized as inventory						
Payments	(34,077)	(1,577)	(35,654)	—	—	—
Reclassification from non-current liabilities	3,521	223	3,744	(3,520)	(223)	(3,743)
Interest on withholding	—	18	18	—	99	99
Balance as of June 30, 2013	$59,685	$281	$59,966	$35,630	$1,738	$37,368

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Other Matters:

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

Liggett Vector Brands entered into an agreement with a subsidiary of the American Wholesale Marketers Association to support a program to permit certain tobacco distributors to secure, on reasonable terms, tax stamp bonds required by state and local governments for the distribution of cigarettes. The agreement expires in February 2016. Under the agreement, Liggett Vector Brands has agreed to pay a portion of losses incurred by the surety under the bond program, with a maximum loss exposure of $500. To secure its potential obligations under the agreement, Liggett Vector Brands posted a $100 letter of credit and agreed to fund up to an additional $400. In the third quarter of 2013, Liggett paid $83 for obligations under this program, and therefore, is only committed to fund an additional $317 over the letter of credit. The Company believes the fair value of Liggett Vector Brands' obligation under the agreement was immaterial at June 30, 2014.

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

8. INCOME TAXES

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Income before provision for income taxes	$19,132	$23,528	$25,603	$21,512
Income tax expense using estimated annual effective income tax rate	6,279	9,575	8,404	8,755
Changes in effective tax rates	(178)	321	—	—
Impact of discrete items, net	—	121	639	927
Income tax expense	$6,101	$10,017	$9,043	$9,682

The discrete item for the six months ended June 30, 2014 is primarily related to an increase in the blended state tax rate that resulted in the Company's revaluation of its deferred taxes and the results of a recent state income tax audit.

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

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9. INVESTMENTS AND FAIR VALUE MEASUREMENTS

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

	Fair Value Measurements as of June 30, 2014			
Description	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Money market funds	$335,332	$335,332	$—	$—
Certificates of deposit	3,252	—	3,252	—
Bonds	5,093	5,093	—	—
Investment securities available for sale				—
Equity securities	123,034	122,262	772	—
Mutual funds invested in fixed income securities	60,522	60,522	—	—
Fixed income securities				
U.S. Government securities	11,197	—	11,197	—
Corporate securities	30,648	6,744	23,904	—
U.S. mortgage backed securities	214	—	214	—
Commercial mortgage-backed securities	6,645	—	6,645	—
U.S. asset backed securities	5,061	—	5,061	—
U.S. Government agencies	191	—	191	—
Index-linked U.S. bonds	255	—	255	—
Total fixed income securities	54,211	6,744	47,467	—
Warrants (1)	1,647	—	—	1,647
Total	$583,091	$529,953	$51,491	$1,647
Liabilities:				
Fair value of derivatives embedded within convertible debt	$191,554	$—	$—	$191,554

(1) Warrants include 1,000,000 of LTS Warrants received on November 4, 2011 which were carried at $1,647 as of June 30, 2014 and are included in "Other assets". The Company recognized a loss of $111 for the six months ended June 30, 2014 related to the change in fair value of the Warrants.

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	Fair Value Measurements as of December 31, 2013			
Description	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Money market funds	$130,733	$130,733	$—	$—
Certificates of deposit	2,961	—	2,961	—
Bonds	5,337	5,337	—	—
Investment securities available for sale				—
Equity securities	118,474	117,737	737	—
Fixed income securities				—
U.S. Government securities	13,990	—	13,990	—
Corporate securities	29,923	6,497	23,426	—
U.S. mortgage backed securities	495	—	495	—
Commercial mortgage-backed securities	6,822	—	6,822	—
U.S. asset backed securities	2,081	—	2,081	—
Index-linked U.S. bonds	749	—	749	—
Total fixed income securities	54,060	6,497	47,563	—
Warrants (1)	1,935	—	—	1,935
Total	$313,500	$260,304	$51,261	$1,935
Liabilities:				
Fair value of derivatives embedded within convertible debt	$112,062	$—	$—	$112,062

(1) Warrants include 1,000,000 of LTS Warrants received on November 4, 2011 which were carried at $1,758 as of December 31, 2013 and are included in "Other assets". The Company recognized income of $65 for the six months ended June 30, 2013 related to the change in fair value of the Warrants.

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

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

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

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

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The Company recognized income of $320 and $5,499 for the six months ended June 30, 2014 and 2013, respectively. The fair value of the warrants was derived using the Black-Scholes model and has been classified as Level 3. The assumptions used under the Black-Scholes model in computing the fair value of the warrants are based on contractual term of the warrants, volatility of the underlying stock based on the historical quoted prices of the underlying stock, assumed future dividend payments and a risk-free rate of return.
The unobservable inputs related to the valuations of the Level 3 assets and liabilities are as follows at June 30, 2014:

	Quantitative Information about Level 3 Fair Value Measurements				
	Fair Value at June 30, 2014	Valuation Technique	Unobservable Input	Range (Actual)	
Warrants	$1,647	Option model	Stock price	$3.15	
			Exercise price	$1.68	
			Term (in years)	2.4	
			Volatility	45.83	%
			Dividend rate	—	
			Risk-free return	0.70	%
Fair value of derivatives embedded within convertible debt	$191,554	Discounted cash flow	Assumed annual stock dividend	5	%
			Assumed annual cash dividend	$1.60	
			Stock price	$20.68	
			Convertible trading price	107.19	%
			Volatility	16	%
			Implied credit spread	5.5% - 6.5% (6.0%)	

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

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

In addition to assets and liabilities that are recorded at fair value on a recurring basis, the Company is required to record assets and liabilities at fair value on a nonrecurring basis. Generally, assets and liabilities are recorded at fair value on a nonrecurring basis as a result of impairment charges or acquisitions. The Company had no nonrecurring nonfinancial assets subject to fair value measurements as of June 30, 2014 and December 31, 2013.

10. SEGMENT INFORMATION

The Company's significant business segments for the three and six months ended June 30, 2014 and 2013 were Tobacco and Real Estate. The Tobacco segment consists of the manufacture and sale of conventional cigarettes. The Real Estate segment includes the Company’s investment in New Valley LLC, which includes Douglas Elliman, Escena, Indian Creek and investments in non-consolidated real estate businesses. Corporate and other includes the operations of the Company's e-cigarette business ("Zoom"). The accounting policies of the segments are the same as those described in the summary of significant accounting policies.

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

	Tobacco		Real Estate	Corporate and Other	Total
Three months ended June 30, 2014					
Revenues	$250,556		$153,488	$2,569	$406,613
Operating income (loss)	51,506	(1)	15,901	(7,099)	60,308
Equity loss from non-consolidated real estate businesses	—		(1,808)	—	(1,808)
Depreciation and amortization	2,588		2,622	252	5,462
Three months ended June 30, 2013					
Revenues	$249,120		$7,106	$—	$256,226
Operating income (loss)	48,294	(2)	(407)	(3,647)	44,240
Equity income from non-consolidated real estate businesses	—		6,804	—	6,804
Depreciation and amortization	2,368		152	117	2,637
Six months ended June 30, 2014					
Revenues	$483,948		$261,532	$8,369	$753,849
Operating income (loss)	94,402	(3)	20,645	(12,017)	103,030
Equity loss from non-consolidated real estate businesses	—		(256)	—	(256)
Depreciation and amortization	5,081		6,969	504	12,554
Capital expenditures	6,563		3,570	11	10,144
Six months ended June 30, 2013					
Revenues	$489,522		$12,873	$—	$502,395
Operating income (loss)	95,454	(4)	(321)	(7,797)	87,336
Equity income from non-consolidated real estate businesses	—		7,285	—	7,285
Depreciation and amortization	4,753		280	200	5,233
Capital expenditures	3,319		429	2,247	5,995

(1) Operating income includes $1,419 of income from NPM Settlement.
(2) Operating income includes $1,345 of income from NPM Settlement.
(3) Operating income includes $1,419 of income from NPM Settlement and $1,500 of litigation settlement charges.
(4) Operating income includes $6,947 of income from NPM Settlement.

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11. CONDENSED CONSOLIDATING FINANCIAL INFORMATION

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

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

The Company's investments in its consolidated subsidiaries are presented under the equity method of accounting.
The indenture of the 7.75% Senior Secured Notes contains covenants that restrict the payment of dividends by the Company if the Company's consolidated earnings before interest, taxes, depreciation and amortization, as defined in the indenture, for the most recently ended four full quarters is less than $75,000 and the indenture also restricts the incurrence of debt if the Company's Leverage Ratio and its Secured Leverage Ratio, as defined in the indenture, exceed 3.0 and 1.5, respectively.
At June 30, 2014, management believed that the Company was in compliance with all covenants under the indentures of the 7.75% Senior Secured Notes.

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CONDENSED CONSOLIDATING BALANCE SHEETS

	June 30, 2014				
	Parent/ Issuer	Subsidiary Guarantors	Subsidiary Non-Guarantors	Consolidating Adjustments	Consolidated Vector Group Ltd.
ASSETS:					
Current assets:					
Cash and cash equivalents	$398,119	$15,086	$93,218	$—	$506,423
Investment securities available for sale	178,626	59,141	—	—	237,767
Accounts receivable - trade, net	—	12,282	3,471	—	15,753
Intercompany receivables	516	20	—	(536)	—
Inventories	—	108,257	—	—	108,257
Deferred income taxes	23,164	5,100	—	—	28,264
Income taxes receivable, net	21,428	—	—	(8,659)	12,769
Restricted assets	—	1,141	1,414	—	2,555
Other current assets	724	7,988	19,820	—	28,532
Total current assets	622,577	209,015	117,923	(9,195)	940,320
Property, plant and equipment, net	3,148	56,644	20,540	—	80,332
Real estate held for sale, net	—	—	10,669	—	10,669
Long-term investments accounted for at cost	26,541	—	698	—	27,239
Long-term investments accounted for under the equity method	17,842	—	—	—	17,842
Investments in non-consolidated real estate businesses	—	—	133,629	—	133,629
Investments in consolidated subsidiaries	447,514	—	—	(447,514)	—
Restricted assets	1,596	9,985	—	—	11,581
Deferred income taxes	52,448	8,488	3,776	—	64,712
Goodwill and other intangible assets, net	—	107,511	161,736	—	269,247
Prepaid pension costs	—	27,663	—	—	27,663
Other assets	47,780	10,494	1,154	—	59,428
Total assets	$1,219,446	$429,800	$450,125	$(456,709)	$1,642,662
LIABILITIES AND STOCKHOLDERS' DEFICIENCY:					
Current liabilities:					
Current portion of notes payable and long-term debt	$108,566	$33,029	$213	$—	$141,808
Current portion of fair value of derivatives embedded within convertible debt	7,768	—	—	—	7,768
Current portion of employee benefits	—	939	—	—	939
Accounts payable	932	4,721	4,527	—	10,180
Intercompany payables	—	—	536	(536)	—
Accrued promotional expenses	—	20,040	—	—	20,040
Income taxes payable, net	—	11,815	—	(8,659)	3,156

Accrued excise and payroll taxes payable, net	—	16,809	—	—	16,809
Litigation accruals and current payments due under the Master Settlement Agreement	—	66,545	—	—	66,545
Deferred income taxes	37,862	13,571	—	—	51,433
Accrued interest	29,926	—	—	—	29,926
Other current liabilities	3,671	8,699	19,338	—	31,708
Total current liabilities	188,725	176,168	24,614	(9,195)	380,312
Notes payable, long-term debt and other obligations, less current portion	842,458	10,882	329	—	853,669
Fair value of derivatives embedded within convertible debt	183,786	—	—	—	183,786
Non-current employee benefits	32,195	16,369	—	—	48,564
Deferred income taxes	78,506	39,112	35,863	—	153,481
Other liabilities, primarily litigation accruals and payments due under the Master Settlement Agreement	1,296	50,597	2,070	—	53,963
Total liabilities	1,326,966	293,128	62,876	(9,195)	1,673,775
Commitments and contingencies					
Stockholders' (deficiency) equity attributed to Vector Group Ltd.	(107,520)	136,672	310,842	(447,514)	(107,520)
Non-controlling interest	—	—	76,407	—	76,407
Total stockholders' (deficiency) equity	(107,520)	136,672	387,249	(447,514)	(31,113)
Total liabilities and stockholders' deficiency	$1,219,446	$429,800	$450,125	$ (456,709)	$1,642,662

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

(Dollars in Thousands, Except Per Share Amounts)
Unaudited

CONDENSED CONSOLIDATING BALANCE SHEETS

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

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

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

(Dollars in Thousands, Except Per Share Amounts)
Unaudited

CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS

	Three Months Ended June 30, 2014				
	Parent/ Issuer	Subsidiary Guarantors	Subsidiary Non-Guarantors	Consolidating Adjustments	Consolidated Vector Group Ltd.
Revenues	$—	$253,125	$153,488	$—	$406,613
Expenses:					
Cost of sales	—	181,517	97,765	—	279,282
Operating, selling, administrative and general expenses	4,933	22,190	39,900	—	67,023
Management fee expense	—	2,468	—	(2,468)	—
Operating (loss) income	(4,933)	46,950	15,823	2,468	60,308
Other income (expenses):					
Interest expense	(43,190)	(1,284)	(3)	294	(44,183)
Change in fair value of derivatives embedded within convertible debt	1,970	—	—	—	1,970
Acceleration of interest expense related to debt conversion	(439)	—	—	—	(439)
Equity loss from non-consolidated real estate businesses	—	—	(1,808)	—	(1,808)
Equity loss on long-term investments	(273)	—	—	—	(273)
Loss on sale of investment securities available for sale	(18)	—	—	—	(18)
Equity income in consolidated subsidiaries	32,408	—	—	(32,408)	—
Management fee income	2,468	—	—	(2,468)	—
Other, net	1,068	224	2,577	(294)	3,575
(Loss) income before provision for income taxes	(10,939)	45,890	16,589	(32,408)	19,132
Income tax benefit (expense)	18,864	(19,716)	(5,249)	—	(6,101)
Net income	7,925	26,174	11,340	(32,408)	13,031
Net income attributed to non-controlling interest	—	—	(5,106)	—	(5,106)
Net income attributed to Vector Group Ltd.	7,925	26,174	6,234	(32,408)	7,925
Comprehensive income attributed to non-controlling interest	—	—	(5,106)	—	(5,106)
Comprehensive income attributed to Vector Group	$9,436	$25,464	$6,234	$(31,698)	$9,436

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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 OPERATIONS

	Three Months Ended June 30, 2013				
	Parent/ Issuer	Subsidiary Guarantors	Subsidiary Non-Guarantors	Consolidating Adjustments	Consolidated Vector Group Ltd.
Revenues	$—	$249,120	$7,106	$—	$256,226
Expenses:					
Cost of sales	—	180,430	6,015	—	186,445
Operating, selling, administrative and general expenses	5,506	18,455	1,580	—	25,541
Management fee expense	—	2,377	—	(2,377)	—
Operating (loss) income	(5,506)	47,858	(489)	2,377	44,240
Other income (expenses):					
Interest expense	(31,723)	(360)	(3)	—	(32,086)
Change in fair value of derivatives embedded within convertible debt	2,450	—	—	—	2,450
Equity income from non-consolidated real estate businesses	—	—	6,804	—	6,804
Equity income on long-term investments	846	—	—	—	846
Loss on sale of investment securities available for sale	(197)	—	—	—	(197)
Equity income in consolidated subsidiaries	32,277	—	—	(32,277)	—
Management fee income	2,377	—	—	(2,377)	—
Other, net	1,245	150	76	—	1,471
Income before provision for income taxes	1,769	47,648	6,388	(32,277)	23,528
Income tax benefit (expense)	11,742	(19,134)	(2,625)	—	(10,017)
Net income	13,511	28,514	3,763	(32,277)	13,511
Comprehensive income	$14,633	$27,179	$3,763	$(30,942)	$14,633

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

(Dollars in Thousands, Except Per Share Amounts)
Unaudited

CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS

	Six Months Ended June 30, 2014				
	Parent/ Issuer	Subsidiary Guarantors	Subsidiary Non-Guarantors	Consolidating Adjustments	Consolidated Vector Group Ltd.
Revenues	$—	$492,317	$261,532	$—	$753,849
Expenses:					
Cost of sales	—	353,230	165,089	—	518,319
Operating, selling, administrative and general expenses	11,216	45,375	75,909	—	132,500
Management fee expense	—	4,935	—	(4,935)	—
Operating (loss) income	(11,216)	88,777	20,534	4,935	103,030
Other income (expenses):					
Interest expense	(77,972)	(2,239)	(37)	612	(79,636)
Change in fair value of derivatives embedded within convertible debt	320	—	—	—	320
Acceleration of interest expense related to debt conversion	(4,118)	—	—	—	(4,118)
Equity loss from non-consolidated real estate businesses	—	—	(256)	—	(256)
Equity income on long-term investments	633	—	—	—	633
Loss on sale of investment securities available for sale	(71)	—	—	—	(71)
Equity income in consolidated subsidiaries	60,126	—	—	(60,126)	—
Management fee income	4,935	—	—	(4,935)	—
Other, net	1,766	484	4,063	(612)	5,701
(Loss) income before provision for income taxes	(25,597)	87,022	24,304	(60,126)	25,603
Income tax benefit (expense)	36,102	(36,355)	(8,790)	—	(9,043)
Net income	10,505	50,667	15,514	(60,126)	16,560
Net income attributed to non-controlling interest	—	—	(6,055)	—	(6,055)
Net income attributed to Vector Group Ltd.	10,505	50,667	9,459	(60,126)	10,505
Comprehensive income attributed to non-controlling interest	—	—	(6,055)	—	(6,055)
Comprehensive income attributed to Vector Group Ltd.	$17,324	$50,659	$9,459	$(60,118)	$17,324

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

(Dollars in Thousands, Except Per Share Amounts)
Unaudited

CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS

	Six Months Ended June 30, 2013				
	Parent/ Issuer	Subsidiary Guarantors	Non-Guarantors	Consolidating Adjustments	Vector Group Ltd.
Revenues	$—	$489,522	$12,873	$—	$502,395
Expenses:					
Cost of sales	—	353,386	10,236	—	363,622
Operating, selling, administrative and general expenses	11,382	36,949	3,106	—	51,437
Management fee expense	—	4,754	—	(4,754)	—
Operating (loss) income	(11,382)	94,433	(469)	4,754	87,336
Other income (expenses):					
Interest expense	(64,683)	(772)	(7)	—	(65,462)
Change in fair value of derivatives embedded within convertible debt	5,499	—	—	—	5,499
Loss on extinguishment of debt	(21,458)	—	—	—	(21,458)
Equity income from non-consolidated real estate businesses	—	—	7,285	—	7,285
(Loss) gain on sale of investment securities available for sale	(197)	5,406	—	—	5,209
Equity income on long-term investments	823	—	—	—	823
Equity income in consolidated subsidiaries	63,565	—	—	(63,565)	—
Management fee income	4,754	—	—	(4,754)	—
Other, net	1,947	205	128	—	2,280
(Loss) income before provision for income taxes	(21,132)	99,272	6,937	(63,565)	21,512
Income tax benefit (expense)	32,962	(39,791)	(2,853)	—	(9,682)
Net income	11,830	59,481	4,084	(63,565)	11,830
Comprehensive income	$18,866	$61,624	$4,084	$(65,708)	$18,866

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

(Dollars in Thousands, Except Per Share Amounts)
Unaudited

CONDENSED CONSOLIDATING STATEMENTS OF CASH FLOWS

	Six Months Ended June 30, 2014				
	Parent/ Issuer	Subsidiary Guarantors	Subsidiary Non-Guarantors	Consolidating Adjustments	Consolidated Vector Group Ltd.
Net cash provided by operating activities	$17,374	$46,294	$32,279	$ (41,952)	$53,995
Cash flows from investing activities:					
Sale of investment securities	49,296	—	—	—	49,296
Purchase of investment securities	(108,859)	(1,560)	—	—	(110,419)
Proceeds from sale or liquidation of long-term investments	500	—	49	—	549
Purchase of long-term investments	(7,000)	—	—	—	(7,000)
Investments in non-consolidated real estate businesses	—	—	(12,534)	—	(12,534)
Purchase of subsidiaries	—	—	(250)	—	(250)
Distributions from non-consolidated real estate businesses	—	—	3,539	—	3,539
Increase in cash surrender value of life insurance policies	—	(395)	—	—	(395)
Decrease (increase) in restricted assets	299	19	(689)	—	(371)
Issuance of notes receivable	(35,000)	—	(250)	35,000	(250)
Investments in subsidiaries	(25,267)	—	—	25,267	—
Proceeds from sale of fixed assets	—	4	—	—	4
Capital expenditures	(11)	(6,563)	(3,570)	—	(10,144)
Repayments of notes receivable	35,933	—	—	(35,000)	933
Net cash used in investing activities	(90,109)	(8,495)	(13,705)	25,267	(87,042)
Cash flows from financing activities:					
Proceeds from debt issuance	408,750	40,166	—	(35,000)	413,916
Deferred financing costs	(12,360)	—	—	—	(12,360)
Repayments of debt	—	(39,293)	(3,758)	35,000	(8,051)
Borrowings under revolver	—	429,188	—	—	429,188
Repayments on revolver	—	(437,736)	—	—	(437,736)
Capital contributions received	—	3,150	22,117	(25,267)	—
Intercompany dividends paid	—	(30,000)	(11,952)	41,952	—
Dividends and distributions on common stock	(80,963)	—	—	—	(80,963)
Distributions to non-controlling interest	—	—	(3,075)	—	(3,075)
Proceeds from exercise of Vector options	3,405	—	—	—	3,405
Tax benefit of options exercised	680	—	—	—	680
Net cash provided by (used in) financing activities	319,512	(34,525)	3,332	16,685	305,004
Net increase in cash and cash equivalents	246,777	3,274	21,906	—	271,957
	151,342	11,812	71,312	—	234,466

Cash and cash equivalents, beginning of period					
Cash and cash equivalents, end of period	$398,119	$15,086	$93,218	$ —	$506,423

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

(Dollars in Thousands, Except Per Share Amounts)
Unaudited

CONDENSED CONSOLIDATING STATEMENTS OF CASH FLOWS

	Six Months Ended June 30, 2013				
	Parent/ Issuer	Subsidiary Guarantors	Subsidiary Non-Guarantors	Consolidating Adjustments	Consolidated Vector Group Ltd.
Net cash provided by operating activities	$5,204	$57,823	$2,187	$ (60,024)	$5,190
Cash flows from investing activities:					
Sale of investment securities	36,533	6,582	—	—	43,115
Purchase of investment securities	(79,368)	(11,000)	—	—	(90,368)
Proceeds from sale of or liquidation of long-term investments	—	—	75	—	75
Purchase of long-term investments	(5,000)	—	—	—	(5,000)
Investments in non-consolidated real estate businesses	—	—	(19,048)	—	(19,048)
Investments in consolidated real estate businesses	—	—	(7,657)	—	(7,657)
Decrease (increase) in cash surrender value of life insurance policies	79	(382)	—	—	(303)
Decrease (increase) in restricted assets	6	(1,274)	—	—	(1,268)
Repayments of notes receivable	8,433	—	—	—	8,433
Proceeds from sale of fixed assets	—	13	—	—	13
Investments in subsidiaries	(43,584)	—	—	43,584	—
Capital expenditures	(2,247)	(3,319)	(429)	—	(5,995)
Net cash used in investing activities	(85,148)	(9,380)	(27,059)	43,584	(78,003)
Cash flows from financing activities:					
Proceeds from debt issuance	450,000	—	3,080	—	453,080
Deferred financing costs	(11,663)	—	—	—	(11,663)
Repayments of debt	(415,000)	(3,763)	(70)	—	(418,833)
Borrowings under revolver	—	474,493	—	—	474,493
Repayments on revolver	—	(476,888)	—	—	(476,888)
Capital contributions received	—	12,300	31,284	(43,584)	—
Intercompany dividends paid	—	(50,582)	(9,442)	60,024	—
Dividends and distributions on common stock	(71,518)	—	—	—	(71,518)
Net cash (used in) provided by financing activities	(48,181)	(44,440)	24,852	16,440	(51,329)
Net (decrease) increase in cash and cash equivalents	(128,125)	4,003	(20)	—	(124,142)
Cash and cash equivalents, beginning of period	401,344	3,776	735	—	405,855
Cash and cash equivalents, end of period	$273,219	$7,779	$715	$ —	$281,713

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

(Dollars in Thousands, Except Per Share Amounts)

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

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

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

Overview

We are a holding company and are engaged principally in:

- the manufacture and sale of cigarettes in the United States through our Liggett Group LLC and Vector Tobacco Inc. subsidiaries, and
- the real estate business through our New Valley LLC subsidiary, which is seeking to acquire additional operating companies and real estate properties. New Valley owns 70.59% of Douglas Elliman, which operates the largest residential brokerage company in the New York metropolitan area.

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

Our subsidiary, Zoom E-Cigs LLC ("Zoom"), entered the emerging United States electronic cigarette ("e-cigarette") market in limited retail distribution outlets. Zoom’s operations are included in our “Corporate and Other” reporting segment. Our exposure to Zoom, as of June 30, 2014, was approximately $13,400, which was primarily comprised of Zoom's inventory.

Recent Developments

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

On March 24, 2014, we completed the sale of $258,750 of our Variable Interest Convertible Senior Notes due 2020 and received net proceeds from the sale of the Notes of approximately $250,300. On April 15, 2014, we completed the sale of principal amount of our 7.75% Senior Secured Notes due 2021 for a price of 106.750% in a private offering to qualified institutional investors in accordance with Rule 144A of the Securities Act of 1933. We received net proceeds of approximately $158,700. The net proceeds of both issuances will be used for general corporate purposes, including for additional investments in real estate and in our tobacco business. We may also consider using a portion of the net proceeds from the sale of the Notes to address upcoming debt maturities. On July 7, 2014, we commenced an offer to exchange our 7.75% Senior Secured Notes 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 7.75% Senior Secured

Notes, except that our new 7.75% Senior Secured Notes have been registered under the Securities Act.

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

On July 23, 2014, we granted our President and Chief Executive Officer an award of 1,000,000 shares of our Common Stock subject to performance-based vesting. The Award shares will be issued pursuant to the terms of an agreement that provides that both a performance requirement and a continued employment requirement must be met over a seven-year performance period to earn vested rights with respect to the Award Shares. The maximum potential amount of the Award Shares reflects recognition of the CEO's contributions as CEO since January 1, 2006 and the value of his management and real estate expertise to us. We anticipate expensing the value of the grant of approximately $20,660 over the seven-year term of the grant.

Recent Developments in Smoking-Related Litigation

There are no material changes from the Recent Developments in Smoking-Related Litigation set forth in Item 7, “Management's Discussion and Analysis of Financial Condition and Results of Operations,” of our Annual Report on Form 10-K, for the year ended December 31, 2013. Please refer to that section and the information below for disclosures regarding the critical accounting policies related to our business.

Critical Accounting Policies

There are no material changes from the critical accounting policies set forth in Item 7, “Management's Discussion and Analysis of Financial Condition and Results of Operations,” of our Annual Report on Form 10-K, for the year ended December 31, 2013. Please refer to that section and the information below for disclosures regarding the critical accounting policies related to our business.

Results of Operations

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

For purposes of this discussion and other consolidated financial reporting, our significant business segments for the three and six months ended June 30, 2014 and 2013 were Tobacco and Real Estate. The Tobacco segment consists of the manufacture and sale of cigarettes. The Real Estate segment includes the Company’s investment in New Valley LLC, which includes Douglas Elliman, Escena, Indian Creek and investments in non-consolidated real estate businesses. Corporate and other includes the operations of our e-cigarette business ("Zoom").

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Revenues:				
Tobacco	$250,556	$249,120	$483,948	$489,522
Real estate	153,488	7,106	261,532	12,873
Corporate and other	2,569	—	8,369	—
Total revenues	$406,613	$256,226	$753,849	$502,395
Operating income (loss):				
Tobacco	$51,506 (1)	$48,294 (2)	$94,402 (3)	$95,454 (4)

Real Estate	15,901	(407)	20,645	(321)
Corporate and other	(7,099)	(3,647)	(12,017)	(7,797)
Total operating income	$60,308	$44,240	$103,030	$87,336

(1) Operating income includes $1,419 of income from NPM Settlement.
(2) Operating income includes $1,345 of income from NPM Settlement.
(3) Operating income includes $1,419 of income from NPM Settlement and $1,500 of litigation settlement charges.
(4) Operating income includes $6,947 of income from NPM Settlement.

Three Months Ended June 30, 2014 Compared to Three Months Ended June 30, 2013

Revenues: Total Revenues were $406,613 for the three months ended June 30, 2014 compared to $256,226 for the three months ended June 30, 2013. The $150,387 (58.7%) increase in revenues was due to an increase in real estate revenues of $146,382 primarily related to the addition of the Douglas Elliman revenues in 2014, an increase in Tobacco revenues of $1,436 and $2,569 of revenues in the corporate and other segment associated with the Zoom e-cigarette brand.

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

All of our Tobacco sales were in the discount category in 2014 and 2013. For the three months ended June 30, 2014, tobacco revenues were $250,556 compared to $249,120 for the three months ended June 30, 2013. Revenues increased by 0.6% ($1,436) due to a favorable price variance of $10,422 offset by a decline in sales volume of $8,986 (approximately 57.7 million units).

Real Estate Revenues. Real estate revenues were $153,488 and $7,106 for the three months ended ended June 30, 2014 and 2013, respectively. Real estate revenues increased by $146,382, primarily related to Douglas Elliman. Douglas Elliman became a consolidated subsidiary of ours in December 2013.

Real estate revenues for the three months ended June 30, 2014 were made up of commission income of $127,587, property management income of $7,796, the sale of Indian Creek in real estate held for sale of $14,400, sales on facilities (primarily Escena) of $1,168 and income from title fees of $2,537. Real estate revenues for the three months ended June 30, 2013 consisted of commission income of $5,891 and sales on facilities (primarily Escena) of $1,215.

Other Revenues. Corporate and other revenues were $2,569 for the three months ended June 30, 2014 and relate to Zoom, our e-cigarette brand.

Cost of Sales. Total cost of sales were $279,282 for the three months ended June 30, 2014 compared to $186,445 for the three months ended June 30, 2013. The $92,837 (49.8%) increase in cost of sales was due to an increase in real estate cost of sales of $91,748 related to the Douglas Elliman real estate commissions expense and $1,746 of cost of sales in the corporate and other segment associated with the Zoom e-cigarette brand. This was offset by a $657 decline in tobacco cost of sales.

Tobacco Cost of Sales. Our tobacco cost of sales declined from $180,430 for the three months ended June 30, 2013 to $179,773 for the three months ended June 30, 2014. The major components of our tobacco cost of sales are federal excise taxes, expenses under the MSA, FDA legislation and tobacco buyout, which are variable costs based on the number of units sold, and tobacco and other manufacturing costs, which are fixed and variable costs. Federal excise taxes declined from $112,596 for the three months ended June 30, 2013 to $109,695 for the three months ended June 30, 2014 as a result of decreased unit sales volume of 2.6%. Tobacco and other manufacturing costs were $32,196 and $29,177 for the three months ended June 30, 2014 and 2013, respectively. Expenses under the MSA were $26,547 and $27,171 for the three months ended June 30, 2014 and 2013, respectively.

Tobacco gross profit was $70,783 for the three months ended June 30, 2014 compared to $68,691 for the three months ended June 30, 2013. The $2,092 (3.0%) increase was due to higher selling prices. As a percentage of revenues (excluding federal excise taxes), Tobacco gross profit was 50.3% in the 2014 period. Tobacco gross profit was 50.3% in the 2013 period (49.3% adjusting for the NPM Settlement).

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Real Estate Cost of Sales. Real estate cost of sales were $97,763 and $6,015 for the three months ended June 30, 2014 and 2013, respectively. Real estate costs of sales increased by $91,748 primarily related to Douglas Elliman commission expense.

Real estate cost of sales for the three months ended June 30, 2014 consisted of commission expenses of $86,906, the cost of sale of Indian Creek of $9,987 and cost of sales on facilities (primarily Escena) of $870. Real estate cost of sales for the three months ended June 30, 2013 consisted of commission costs of $4,981 and cost of sales on facilities (primarily Escena) of $1,034.

Other Cost of Sales. Corporate and other cost of sales was $1,746 for the three months ended June 30, 2014 and relate to our Zoom operations.

Expenses. Operating, selling, general and administrative expenses were $67,023 for the three months ended June 30, 2014 compared to $25,541 for the same period last year. This was an increase of $41,482 (162.4%) of which $38,324 was primarily related to the operating, selling and administrative expenses of real estate and $4,278 of corporate and other expenses. This was offset by a decrease of $1,120 in Tobacco operating, selling, general and administrative expenses .

Tobacco expenses. Tobacco operating, selling, general and administrative expenses were $19,277 for the three months ended June 30, 2014 compared to $20,397 for the three months ended June 30, 2013. The decrease of $1,120 was due to a decline in legal expenses, certain freight costs and employee benefit costs. Tobacco product liability legal expenses were $1,817 and $1,953 for the three months ended June 30, 2014 and 2013, respectively.

Real Estate expenses. Real estate operating, selling, general and administrative expenses were $39,822 and $1,498 for the three months ended June 30, 2014 and 2013, respectively. Real estate operating, selling, general and administrative expenses increased by $38,324 primarily related to the Douglas Elliman operations.

Corporate and other expenses. Expenses at the corporate segment increased from $3,646 to $7,924 for the three months ended June 30, 2014. The $4,278 increase related primarily to expenses associated with the operations of Zoom.

Operating income. Operating income was $60,308 for the three months ended June 30, 2014 compared to $44,240 for the same period last year, an increase of $16,068 (36.3%). Tobacco operating income increased by $3,212 and real estate operating income increased by $16,308. This was offset by an increase in corporate and other expenses of $3,452.

Tobacco operating income. Tobacco operating income increased from $48,294 for the three months ended June 30, 2013 to $51,506 for the three months ended June 30, 2014. The Tobacco operating income increase of $3,212 was primarily associated with increased selling prices partially offset by a decline in unit volume.

Real Estate operating income (loss). The real estate segment had operating income of $15,901 for the three months ended June 30, 2014 and an operating loss of $407 for the three months ended June 30, 2013. The increase of $16,308 was primarily related to the Douglas Elliman operations.

Corporate and Other operating loss. The operating loss at the corporate segment was $7,099 for the three months ended June 30, 2014 compared to $3,647 for 2013. Corporate and other operating losses increased by $3,452 primarily as a result of Zoom operations.

Other income (expenses). Other expenses were $41,176 and $20,712 for the three months ended June 30, 2014 and 2013, respectively. For the three months ended June 30, 2014, other expenses primarily consisted of interest expense of $44,183, acceleration of interest expense related to the debt conversion of the 6.75% Variable Interest Senior Convertible Exchange Notes of $439, equity losses on long-term investments of $273, equity loss on non-consolidated real estate businesses of $1,808 and a loss on sale of investment securities available for sale of $18. The increase in interest expense in 2014 was primarily attributable to higher average debt balances. This was offset by income of $1,970 from changes in fair value of derivatives embedded within convertible debt and interest and other income of $3,575. For the three months ended June 30, 2013, other expenses primarily consisted of interest expense of $32,086 and a loss on the sale of investment securities available for sale of $197. This was offset by equity income from non-consolidated real estate businesses of $6,804, income of $2,450 from changes in fair value of derivatives

embedded within convertible debt, other income of $1,471 and equity income on long-term investments of $846.

Income before income taxes. Income before income taxes for the three months ended June 30, 2014 was $19,132 compared to $23,528 for the three months ended June 30, 2013. The decrease is attributable to the items discussed above.

Income tax expense. Income tax expense was $6,101 and $10,017 for the three months ended June 30, 2014 and 2013, 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.

Six Months Ended June 30, 2014 Compared to Six Months Ended June 30, 2013

Revenues: Total Revenues were $753,849 for the three months ended June 30, 2014 compared to $502,395 for the six months ended June 30, 2013. The $251,454 (50.1%) increase in revenues was due to an increase in real estate revenues of $248,659 primarily related to the addition of the Douglas Elliman revenues in 2014 and $8,369 of revenues in the corporate and other segment associated with the Zoom e-cigarette brand. This was offset by a $5,574 decrease in Tobacco revenues.

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

All of our Tobacco sales were in the discount category in 2014 and 2013. For the six months ended June 30, 2014, tobacco revenues were $483,948 compared to $489,522 for the six months ended June 30, 2013. Revenues declined by 1.1% ($5,574) due to a decline in sales volume of $23,572 (approximately 186.9 million units) offset by a favorable price variance of $17,998.

Real Estate Revenues. Real estate revenues were $261,532 and $12,873 for the six months ended ended June 30, 2014 and 2013, respectively. Real estate revenues increased by $248,659 primarily related to the Douglas Elliman operations. Douglas Elliman became a consolidated subsidiary of ours in December 2013.

Real estate revenues for the six months ended June 30, 2014 consisted of commission income of $223,704, property management income of $15,113, the sale of Indian Creek in real estate held for sale of $14,400, sales on facilities (primarily Escena) of $3,354 and income from title fees of $4,961. Real estate revenues for the six months ended June 30, 2013 consisted of commission income of $9,518 and sales on facilities (primarily Escena) of $3,355.

Other Revenues. Corporate and other revenues were $8,369 for the six months ended June 30, 2014 and relate to Zoom, our e-cigarette brand.

Cost of Sales. Total cost of sales were $518,319 for the six months ended June 30, 2014 compared to $363,622 for the six months ended June 30, 2013. The $154,697 (42.5%) increase in cost of sales was due to an increase in real estate cost of sales of $154,851 related to the Douglas Elliman real estate commissions expense and $5,293 of cost of sales in the corporate and other segment associated with the Zoom e-cigarette brand. This was offset by a $5,447 decline in tobacco cost of sales.

Tobacco Cost of Sales. Our tobacco cost of sales declined from $353,386 for the six months ended June 30, 2013 to $347,939 for the six months ended June 30, 2014. The major components of our tobacco cost of sales are federal excise taxes, expenses under the MSA, FDA legislation and tobacco buyout, which are variable costs based on the number of units sold, and tobacco and other manufacturing costs, which are fixed and variable costs. Federal excise taxes declined from $221,507 for the six months ended June 30, 2013 to $212,108 for the six months ended June 30, 2014 as a result of decreased unit sales volume of 4.2%. Tobacco and other manufacturing costs were $61,464 and $58,004 for the six months ended June 30, 2014 and 2013, respectively. Expenses under the MSA were $51,090 and $49,959 for the six months ended June 30, 2014 and 2013, respectively.

Tobacco gross profit was $136,009 for the six months ended June 30, 2014 compared to $136,136 for the six months ended June 30, 2013. The $127 (0.1%) decline was due to decreased unit volume sales offset by the absence of $5,528 of NPM Settlement in the 2014 period and price increases primarily on the PYRAMID brand. As a percentage of revenues (excluding federal excise taxes), Tobacco gross profit declined to 50.0% in the 2014 period compared to gross profit of 50.8% in the 2013 period (48.2% adjusting for the NPM Settlement) due to a decreased unit volume

sales offset by price increases primarily on the PYRAMID brand.

Real Estate Cost of Sales. Real estate cost of sales were $165,087 and $10,236 for the six months ended June 30, 2014 and 2013, respectively. Real estate costs of sales increased by $154,851 primarily related to Douglas Elliman commission expense.

Real estate cost of sales for the six months ended June 30, 2014 consisted of commission expenses of $152,953, the cost of sale of Indian Creek of $9,987 and cost of sales on facilities (primarily Escena) of $2,147. Real estate cost of sales for the six months ended June 30, 2013 consisted of $7,960 and cost of sales on facilities (primarily Escena) of $2,276.

Other Cost of Sales. Corporate and other cost of sales was $5,293 for the six months ended June 30, 2014 and relate to our Zoom operations.

Expenses. Operating, selling, general and administrative expenses were $132,500 for the six months ended June 30, 2014 compared to $51,437 for the same period last year. This was an increase of $81,063 (157.6%) of which $72,842 was related to the operating, selling and administrative expenses of real estate, $7,296 of corporate and other expenses and $925 of Tobacco operating, selling and administrative expenses.

Tobacco expenses. Tobacco operating, selling, general and administrative expenses were $41,607 for the six months ended June 30, 2014 compared to $40,682 for the six months ended June 30, 2013. The increase of $925 was primarily the result of increased product liability and legal expenses partially offset by a decline in employee benefit costs. Tobacco product liability legal expenses were $5,174 and $3,562 for the six months ended June 30, 2014 and 2013, respectively.

Real Estate expenses. Real estate operating, selling, general and administrative expenses were $75,800 and $2,958 for the six months ended June 30, 2014 and 2013, respectively. Real estate operating, selling, general and administrative expenses increased by $72,842 primarily related to the Douglas Elliman operations.

Corporate and other expenses. Expenses at the corporate segment increased from $7,797 to $15,093 for the six months ended June 30, 2014. The $7,296 increase related primarily to expenses associated with the operations of Zoom.

Operating income. Operating income was $103,030 for the six months ended June 30, 2014 compared to $87,336 for the same period last year, an increase of $15,694 (18.0%). Tobacco operating income declined by $1,052 offset by an increase in real estate operating income of $20,966 from the Douglas Elliman. Corporate and other expenses increased by $4,220.

Tobacco operating income. Tobacco operating income was $94,402 for the six months ended June 30, 2014 compared to $95,454 for the same period last year. The Tobacco operating income decline of $1,052 was primarily associated with the decrease in sales volume offset by the increased selling prices, increased legal expenses and the absence of $5,528 of NPM Settlements in the 2014 period.

Real Estate operating income (loss). The real estate segment had operating income of $20,645 for the six months ended June 30, 2014 compared to an operating loss of $321 for the six months ended June 30, 2013. The increase in operating income of $20,966 was primarily related to the Douglas Elliman operations.

Corporate and Other operating loss. The operating loss at the corporate segment was $12,017 for the six months ended June 30, 2014 compared to $7,797 for 2013. Corporate and other operating losses increased by $4,220 primarily as a result of Zoom operations.

Other income (expenses). Other expenses were $77,427 and $65,824 for the six months ended June 30, 2014 and 2013, respectively. For the six months ended June 30, 2014, other expenses primarily consisted of interest expense of $79,636, acceleration of interest expense related to the debt conversion of the 6.75% Variable Interest Senior Convertible Exchange Notes of $4,118, equity loss on non-consolidated real estate businesses of $256 and a loss on sale of investment securities available for sale of $71. The increase in interest expense in 2014 was primarily attributable to higher average debt balances. This was offset by equity income on long-term investments of $633, interest and other income of $5,701 and income of $320 from changes in fair value of derivatives embedded within convertible debt. For the six months

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ended June 30, 2013, other expenses primarily consisted of interest expense of $65,462 and loss on the extinguishment of debt of $21,458. This was offset by equity income from non-consolidated real estate businesses of $7,285, income of $5,499 from changes in fair value of derivatives embedded within convertible debt, gain on sale of investment securities available for sale of $5,209, other income of $2,280 and equity income on long-term investments of $823.

Income before income taxes. Income before income taxes was $25,603 and $21,512 for the six months ended June 30, 2014 and 2013, respectively. The increase is attributable to the items discussed above.

Income tax expense. The income tax expense was $9,043 and $9,682 for the six months ended June 30, 2014 and 2013, 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 six months ended June 30, 2014, our income tax expense was increased by $639 due primarily to a change in the blended state tax rate that resulted in the Company's reevaluation of its deferred taxes and the results of a recent state income tax audit.

Summary of Real Estate Investments

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

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

	Location	Date of Initial Investment	Percentage Owned	Net Amount Invested	Earnings	Carrying Value as of June 30, 2014	Future Capital Commitments from New Valley	Projected Residential and/or Hotel Area	Projected Retail Area	Projected Number of Residential Lots, Units and/or Hotel Rooms		Projected Construction Start Date
Escena, net	Master planned community, golf course, restaurant and shop in Palm Springs, CA	March 2008	100 %	N/A	N/A	$10,669	$450	Acres		667 450	R Lots H	N/A
Real estate held for sale, net				—	—	10,669						
10 Madison Square Park West (f/k/a 1107 Broadway)	Flatiron District/NoMad neighborhood, Manhattan, NY	June 2011	5.0 %	$4,130	$2,254	$6,384	—260,000	SF	17,000 SF	124	R	August 201
The Whitman	Flatiron District/NoMad neighborhood, Manhattan, NY	October 2011	12.0 %	—	526	526	—24,279	SF	4,698 SF	4	R	October 20
The Marquand	Upper East Side, Manhattan, NY	December 2011	18.0 %	7,000	—	7,000	—87,887	SF	—	28	R	June 2012
11 Beach Street	TriBeCa, Manhattan, NY	June 2012	49.5 %	12,328	—	12,328	—97,090	SF	—	27	R	May 2014
701 Seventh Avenue	Times Square, Manhattan, NY	October 2012	11.5 %	11,324	—	11,324	—280,000	SF	80,000 SF	452	H	September 2013
101 Murray Street	TriBeCa, Manhattan, NY	July 2013	25.0 %	23,006	—	23,006	—320,000	SF	TBD	139	R	September 2014
Leroy Street	West Greenwich Village, Manhattan, NY	January 2013	5.0 %	652	—	652	—130,137	SF	—	30 to 50	R	July 2015
PUBLIC Chrystie House (f/k/a Chrystie	Lower East Side, Manhattan, NY	December 2012	18.4 %	3,081	—	3,081	—217,000	SF	43,000 SF	11 367	R H	June 2014

Street)													
25-19 43rd Avenue	Long Island City, NY	May 2014	9.9	%	733	—	733	87,000	SF	—	86	R	September 2014
23-10 Queens Plaza South	Long Island City, NY	December 2012	45.4	%	9,528	—	9,528	472,574	SF	—	391	R	March 2014
8701 Collins Avenue Condominium and Mixed Use Development	Miami Beach, FL	December 2013	15.0	%	3,955	45	4,000	262,000	SF	TBD	TBD		October 20
					$75,737	$2,825	$78,562						
Maryland Portfolio	Primarily Baltimore County, MD	July 2012	7.5	%	$4,058	$(540)	$3,518	N/A		N/A	5,517	R	N/A
ST Portfolio	Houston, TX; Phoenix, AZ; San Pedro, CA and Stamford, CT	November 2013	16.4	%	16,365	(815)	15,550	1,018,404	SF	24,987 SF	761	R	N/A
Apartment Buildings					$20,423	$(1,355)	$19,068						
Park Lane Hotel	Central Park South, Manhattan, NY	November 2013	5.0	%	$19,331	$(1,884)	$17,447	445,600	SF	—	628	H	N/A
Hotel Taiwana	St. Barthelemy, French West Indies	October 2011	17.0	%	7,427	40	7,467	61,300	SF	4,300 SF	30	H	N/A
Coral Beach	Coral Beach, Bermuda	December 2013	49.0	%	3,618	(208)	3,410	52	Acres	—	87	H	N/A
Hotels					$30,376	$(2,052)	$28,324						
Sesto Holdings	Milan, Italy	October 2011	7.2	%	$5,037	$—	$5,037	322	Acres	TBD	TBD		2014
Land Development					$5,037	$—	$5,037						

N/A - Not applicable
SF - Square feet
H - Hotel rooms
TBD -To be determined
R - Residential Units
R Lots - Residential lots

Other non-consolidated real estate business relate to an investment in a mortgage company and an insurance company by Douglas Elliman with a carrying value of $2,638 as of June 30, 2014.

Liquidity and Capital Resources

Cash and cash equivalents increased by $271,957 for the six months ended June 30, 2014 and decreased by $124,142 for the six months ended June 30, 2013.

Cash provided from operations was $53,995 and $5,190 for the six months ended June 30, 2014 and 2013, respectively. The change primarily related to cash payments in the 2013 period associated with the extinguishment of our 11% Senior Secured Notes due 2015, increased operating income in the 2014 period and the timing of payments of accruals. The amount was partially offset by the Engle progeny settlement payment.

Cash used in investing activities was $87,042 and $78,003 for the six months ended June 30, 2014 and 2013, respectively. In the first six months of 2014, cash used in investing activities was for the purchase of investment securities of $110,419, investment in non-consolidated real estate businesses of $12,534, capital expenditures of $10,144, purchase of long-term investments of $7,000, an increase in non-current restricted assets of $371, an increase in cash surrender value of corporate-owned life insurance policies of $395, an issuance of notes receivable of $250 and purchase of subsidiaries of $250. This was offset by the sale of investment securities of $49,296, distributions from non-consolidated real estate of $3,539, proceeds from the liquidation of long-term investments of $549, collections of notes receivable of $933 and proceeds from the sale of fixed assets of $4. In the first six months of 2013, cash used in investing activities was for the purchase of investment securities of $90,368, investment in non-consolidated real estate businesses of $19,048, investments in consolidated real estate business of $7,657, capital expenditures of $5,995, purchase of long-term investments of $5,000, an increase in non-current restricted assets of $1,268 and an increase in cash surrender value of corporate-owned life insurance policies of $303. This was offset by the sale of investment securities of $43,115, collections of notes receivable of $8,433, the proceeds from the sale or liquidation of long-term investments of $75 and the proceeds from the sale of fixed assets of $13.

Cash provided by financing activities was $305,004 compared to cash used in financing activities of $51,329 for the six months ended June 30, 2014 and 2013, respectively. In the first six months of 2014, cash was provided by the proceeds from debt issuance of $413,916, proceeds from the exercise of Vector options of $3,405 and tax benefit of options exercised of $680. This was offset by cash used for the distributions on common stock of $80,963, payment of deferred financing costs of $12,360, repayment of debt of $8,051, net repayments of debt under the revolver of $8,548 and distributions to non-controlling interest of $3,075 . In the first six months of 2013, cash used in financing activities was used for the repayment of debt of $418,833, distributions on common stock of $71,518, net repayments of debt under the revolver of $2,395 and deferred financing costs of $11,663. This was offset by proceeds from debt issuance of $453,080.

Liggett Credit Facility and Liggett Term Loan Under Credit Facility. As of June 30, 2014, $25,613 was outstanding under the revolving and term loan portions of the credit facility. Availability as determined under the Credit Facility was approximately $24,387 based on eligible collateral at June 30, 2014. At June 30, 2014, management believed that Liggett was in compliance with all covenants under the credit facility; Liggett's EBITDA, as defined, were approximately $124,576 for the twelve months ended June 30, 2014.

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

On March 24, 2014, we completed the sale of $258,750 of our Variable Interest Convertible Senior Notes due 2020 and received net proceeds from the sale of the Notes of approximately $250,300. On April 15, 2014, we completed the sale of principal amount of our 7.75% Senior Secured Notes due 2021 for a price of 106.750% in a private offering to qualified institutional investors in accordance with Rule 144A of the Securities Act of 1933. We received net proceeds of approximately $158,700. The net proceeds of both issuances will be used for general corporate purposes, including for additional investments in real estate and in our tobacco business. We may also consider using a portion of the net proceeds from the sale of the Notes to address upcoming debt maturities.

The indenture of our 7.75% senior secured notes due 2021 contains covenants that restrict the payment of dividends if our consolidated earnings before interest, taxes, depreciation and amortization (“Consolidated EBITDA”), as defined in

the indenture, for the most recently ended four full quarters is less than $75,000. The indenture also restricts the incurrence of debt if our Leverage Ratio and our Secured Leverage Ratio, as defined in the indenture, exceed 3.0 and 1.5, respectively. Our Leverage Ratio is defined in the indenture as the ratio of our guaranteeing subsidiaries' total debt less the fair market value of our cash, investments in marketable securities and long-term investments to Consolidated EBITDA, as defined in the indenture. Our Secured Leverage Ratio is defined in the indenture in the same manner as the Leverage Ratio, except that secured indebtedness is substituted for indebtedness. The following table summarizes the requirements of financial covenants and the results of the calculation, as defined by the indenture.

Covenant	Indenture Requirement	June 30, 2014	December 31, 2013
Consolidated EBITDA, as defined	$75,000	$249,843	$264,958
Leverage ratio, as defined	<3.0 to 1	1.18 to 1	1.22 to 1
Secured leverage ratio, as defined	<1.5 to 1	Negative	0.5 to 1

We and our subsidiaries have significant indebtedness and debt service obligations. At June 30, 2014, we and our subsidiaries had total outstanding indebtedness of $1,258,233. Approximately $125,030 of our 6.75% convertible notes mature in 2014, $230,000 of our 7.5% convertible notes mature in 2019, $258,750 of our 5.5% variable interest senior convertible notes mature in 2020, and $600,000 of our 7.75% senior secured notes mature in 2021,. In addition, subject to the terms of any future agreements, we and our subsidiaries will be able to incur additional indebtedness in the future. There is a risk that we will not be able to generate sufficient funds to repay our debt. If we cannot service our fixed charges, it would have a material adverse effect on our business and results of operations.

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

In order to meet the above liquidity requirements as well as other anticipated liquidity needs in the normal course of business, we had cash and cash equivalents of approximately $506,400, investment securities available for sale of approximately $237,800, long-term investments with an estimated value of approximately $51,600 and availability under Liggett's credit facility of approximately $24,400 at June 30, 2014. Management currently anticipates that these amounts, as well as expected cash flows from our operations, proceeds from public and/or private debt and equity financing, management fees and other payments from subsidiaries should be sufficient to meet our liquidity needs over the next 12 months. We may acquire or seek to acquire additional operating businesses through merger, purchase of assets, stock acquisition or other means, or to make other investments, which may limit our liquidity otherwise available.

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

Market Risk

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

As of June 30, 2014, approximately $25,600 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 June 30, 2014, we had no interest rate caps or swaps. Based on a hypothetical 100 basis point increase or decrease in interest rates (1%), our annual interest expense could increase or decrease by approximately $256.

In addition, as of June 30, 2014, $341,145 ($613,780 principal amount) of outstanding debt had a variable interest rate determined by the amount of the dividends on our common stock. The difference between the stated value of the debt and carrying value is due principally to certain embedded derivatives, which were separately valued and recorded upon issuance. Changes to the estimated fair value of these embedded derivatives are reflected within our statements of operations as “Changes in fair value of derivatives embedded within convertible debt.” The value of the embedded derivative is contingent on changes in interest rates of debt instruments maturing over the duration of the convertible

debt as well as projections of future cash and stock dividends over the term of the debt and changes in the closing stock price at the end of each quarterly period. Based on a hypothetical 100 basis point increase or decrease in interest rates (1%), our annual “Changes in fair value of derivatives embedded within convertible debt” could increase or decrease by approximately $4,348 with approximately $4 resulting from the embedded derivative associated with our 6.75% note due 2014, $14 resulting from the embedded derivative associated with our 6.75% exchange notes due 2014, $2,031 resulting from the embedded derivative associated with the 7.5% variable interest senior convertible notes, and the remaining $2,299 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 $10,800 per year.

We have estimated the fair market value of the embedded derivatives based principally on the results of a valuation model. The value of the embedded derivatives is based on changes in interest rates of debt instruments maturing over the duration of the convertible debt, our stock price as well as projections of future cash and stock dividends over the term of the debt. The interest rate component of the value of the embedded derivative is computed by calculating an equivalent non-convertible, unsecured and subordinated borrowing cost. This rate is determined by calculating the implied rate on our 7.5% Convertible Notes when removing the embedded option value within the convertible security. This rate is based upon market observable inputs and influenced by our stock price, convertible bond trading price, risk free interest rates and stock volatility.The range of estimated fair market values of our embedded derivatives was between $193,797 and $189,358. We recorded the fair market value of our embedded derivatives at the midpoint of the range at $191,554 as of June 30, 2014. The estimated fair market value of our embedded derivatives could change significantly based on future market conditions.

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

New Accounting Pronouncements

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

Legislation and Regulation

There are no material changes from the Legislation and Regulation section set forth in Item 7, “Management's Discussion and Analysis of Financial Condition and Results of Operations,” of our Annual Report on Form 10-K, for the year ended December 31, 2013. Please refer to that section and the information below for disclosures regarding the critical accounting policies related to our business.

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

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

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

We identify forward-looking statements in this report by using words or phrases such as “anticipate”, “believe”, “estimate”, “expect”, “intend”, “may be”, “objective”, “plan”, “seek”, “predict”, “project” and “will be” and similar words or phrases or th 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 litigation including the Engle progeny cases pending in Florida; and,
- potential additional payment obligations for us under the MSA and other settlement agreements with the states.

Further information on the risks and uncertainties to our business include the risk factors discussed above in "Management's Discussion and Analysis of Financial Condition and Results of Operations" and under Item 1A, "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2013 filed with the Securities and Exchange Commission.

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

ITEM 4. CONTROLS AND PROCEDURES

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we have evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report, and, based on their evaluation, our principal executive officer and principal financial officer have concluded that these controls and procedures are effective.

There were no changes in our internal control over financial reporting during the second quarter of 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II

OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

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

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We have significant liquidity commitments

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

- cash interest expense of approximately $68.9 million,
- retirement of our 6.75% variable interest senior convertible notes of $125.0 million;
- dividends on our outstanding common shares (currently at an annual rate of approximately $162.0 million),
- Engle progeny installment payment of $3.5 million, and
- other corporate expenses and taxes.

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

We and our subsidiaries have a substantial amount of indebtedness.

We and our subsidiaries have significant indebtedness and debt service obligations. At June 30, 2014, we and our subsidiaries had total outstanding indebtedness of $1.3 billion. Approximately $125.0 million of our 6.75% convertible notes mature in 2014, $230 million of our 7.5% convertible notes mature in 2019 and $600 million of our 7.75% senior secured notes mature in 2021. The $600 million of our 7.75% senior secured notes due 2021 includes an additional $150 million of indebtedness we incurred in connection with the April 2014 offering. We incurred an additional $258.8 million of indebtedness in connection with the March 2014 offering of our 5.5% variable interest senior convertible notes due 2020. In addition, subject to the terms of any future agreements, we and our subsidiaries will be able to incur additional indebtedness in the future. There is a risk that we will not be able to generate sufficient funds to repay our debt. If we cannot service our fixed charges, it would have a material adverse effect on our business and results of operations.

Other

Zoom’s e-cigarette business is subject to substantial risks, uncertainties and contingencies which include, without limitation, the challenges inherent in new product development initiatives, the ability to raise capital and manage the growth of its business, potential disputes concerning Zoom’s intellectual property, potential extensive government regulation or prohibition, technology obsolescence, market acceptance of Zoom’s products and competition from companies with greater resources. Our exposure to Zoom, as of June 30, 2014, was approximately $13.4 million which was comprised primarily of Zoom’s inventory.

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

Except for and as discussed in our filing on Form 8-K dated April 15, 2014 related to an additional $150,000 principal amount of our 7.75% Senior Secured Notes, no securities of ours which were not registered under a private offering of the Securities Act of 1933 have been issued or sold by us during the three months ended June 30, 2014. We agreed to consummate a registered exchange offer for the 7.75% senior secured notes within 360 days after the date of the initial issuance of the 7.75% senior secured notes. On July 9, 2014, we commenced an offer to exchange our 7.75% Senior Secured Notes 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 7.75% Senior Secured Notes, except that our new 7.75% Senior Secured Notes have been registered and completed under the Securities Act.

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Item 6. Exhibits

3.1	Certificate of Amendment to the Amended and Restated Certificate of Incorporation of Vector Group Ltd.
4.1	Second Supplemental Indenture, dated as of April 15, 2014, among Vector Group Ltd., the guarantors named therein and U.S. Bank National Association, as trustee (incorporated by reference to Exhibit 4.3 in Vector's Form 8-K dated April 15, 2014).
4.2	Registration Rights Agreement, dated as of April 15, 2014, among Vector Group Ltd., the guarantors named therein and Jefferies LLC, as the initial purchaser (incorporated by reference to Exhibit 4.4 in Vector's Form 8-K dated April 15, 2014).
10.1	Stock Option Agreement, dated February 26, 2014, as amended on May 16, 2014, between Vector and Howard M. Lorber.
10.2	Stock Option Agreement, dated February 26, 2014, as amended on May 16, 2014, between Vector and Richard J. Lampen.
10.3	Stock Option Agreement, dated February 26, 2014, as amended on May 16, 2014, between Vector and J. Bryant Kirkland III.
10.4	Stock Option Agreement, dated February 26, 2014, as amended on May 16, 2014, between Vector and Marc N. Bell.
12.1	Computation of Ratio of Earnings to Fixed Charges for each of the five years within the period ended December 31, 2013 and for each of the six months within the periods ended June 30, 2014 and 2013.
31.1	Certification of Chief Executive Officer, Pursuant to Exchange Act Rule 13a-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer, Pursuant to Exchange Act Rule 13a-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer, Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer, Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
99.1	Material Legal Proceedings
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema

101.CAL XBRL Taxonomy Extension Calculation Linkbase

101.DEF XBRL Taxonomy Extension Definition Linkbase

101.LAB XBRL Taxonomy Extension Label Linkbase

101.PRE XBRL Taxonomy Extension Presentation Linkbase

SIGNATURE

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

VECTOR GROUP LTD.
(Registrant)

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

Date: July 30, 2014

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