

VECTOR GROUP LTD
Form 10-K
March 17, 2006

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**SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

Form 10-K

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934
For The Fiscal Year Ended December 31, 2005**

VECTOR GROUP LTD.

(Exact name of registrant as specified in its charter)

Delaware

*(State or other jurisdiction of
incorporation or organization)*

1-5759

Commission File Number

65-0949535

(I.R.S. Employer Identification No.)

100 S.E. Second Street, Miami, Florida

(Address of principal executive offices)

33131

(Zip Code)

(305) 579-8000

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, par value \$.10 per share	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes No

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of the Registrant's knowledge, in definitive proxy or information statement incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

The aggregate market value of the common stock held by non-affiliates of Vector Group Ltd. as of June 30, 2005 was approximately \$550 million.

At March 15, 2006, Vector Group Ltd. had 49,914,537 shares of common stock outstanding.

Documents Incorporated by Reference:

Part III (Items 10, 11, 12, 13 and 14) from the definitive Proxy Statement for the 2006 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission no later than 120 days after the end of the Registrant's fiscal year covered by this report.

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PART I

Item 1. Business

Overview

Vector Group Ltd., a Delaware corporation, is a holding company for a number of businesses. We are engaged principally in:

the manufacture and sale of cigarettes in the United States through our subsidiary Liggett Group LLC,

the development and marketing of the low nicotine and nicotine-free QUEST cigarette products and the development of reduced risk cigarette products through our subsidiary Vector Tobacco Inc., and

the real estate business through our subsidiary, New Valley LLC, which is seeking to acquire additional operating companies and real estate properties. New Valley owns 50% of Douglas Elliman Realty, LLC, which operates the largest residential brokerage company in the New York metropolitan area.

In recent years, we have undertaken a number of initiatives to streamline the cost structure of our tobacco business and improve operating efficiency and long-term earnings. During 2002, the sales and marketing functions, along with certain support functions, of our Liggett and Vector Tobacco subsidiaries were combined into a new entity, Liggett Vector Brands Inc. This company coordinates and executes the sales and marketing efforts for our tobacco operations.

Effective year-end 2003, we closed Vector Tobacco's Timberlake, North Carolina cigarette manufacturing facility in order to reduce excess cigarette production capacity and improve operating efficiencies company-wide. Production of QUEST and Vector Tobacco's other cigarette brands was transferred to Liggett's state-of-the-art manufacturing facility in Mebane, North Carolina. In July 2004, we completed the sale of the Timberlake facility and equipment.

In April 2004, we eliminated a number of positions in our tobacco operations and subleased excess office space. In October 2004, we announced a plan to restructure the operations of Liggett Vector Brands. Liggett Vector Brands has realigned its sales force and adjusted its business model to more efficiently serve its chain and independent customers nationwide. In connection with the restructuring, we eliminated approximately 330 full-time positions and 135 part-time positions as of December 15, 2004.

In December 2005, we completed an exchange offer and a subsequent short-form merger whereby we acquired the remaining 42.3% of the common shares of New Valley that we did not already own. As a result of these transactions, New Valley became our wholly-owned subsidiary and each outstanding New Valley common share was exchanged for 0.54 shares of our common stock. A total of approximately 5.05 million of our common shares were issued to the New Valley shareholders in the transactions.

Financial information relating to our business segments can be found in Note 20 to our consolidated financial statements. For the purposes of this discussion and segment reporting in this report, references to the Liggett segment encompass the manufacture and sale of conventional cigarettes and includes the former operations of The Medallion Company, Inc. acquired on April 1, 2002 (which operations are held for legal purposes as part of Vector Tobacco). References to the Vector Tobacco segment include the development and marketing of the low nicotine and nicotine-free cigarette products as well as the development of reduced risk cigarette products and, for these purposes, exclude the operations of Medallion.

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Strategy

Our strategy is to maximize shareholder value by increasing the profitability of our subsidiaries in the following ways:

Liggett

Capitalize upon Liggett's cost advantage in the U.S. cigarette market due to the favorable treatment that it receives under settlement agreements with the state attorneys general and the Master Settlement Agreement,

Focus marketing and selling efforts on the discount segment, continue to build volume and margin in core discount brands (LIGGETT SELECT, GRAND PRIX and EVE) and utilize core brand equity to selectively build distribution,

Continue product development to provide the best quality products relative to other discount products in the marketplace,

Increase efficiency by developing and adopting an organizational structure to maximize profit potential,

Selectively expand the portfolio of private and control label partner brands utilizing a pricing strategy that offers long-term list price stability for customers,

Identify, develop and launch relevant new brands to the market in the future, and

Pursue strategic acquisitions of smaller tobacco manufacturers.

Vector Tobacco

Take a measured approach to expanding the market presence of the QUEST brand,

Continue to pursue the QUEST technology as a smoking cessation aid, and

Continue to conduct appropriate studies relating the reduction of carcinogens in cigarettes to reduced risk in smoking.

New Valley

Continue to grow Douglas Elliman operations by utilizing its strong brand name recognition and pursuing strategic and financial opportunities,

Continue to leverage our expertise as direct investors by actively pursuing real estate investments in the United States and abroad which we believe will generate above-market returns,

Acquire operating companies through mergers, asset purchases, stock acquisitions or other means, and

Invest New Valley's excess funds opportunistically in situations that we believe can maximize shareholder value.

Liggett Group LLC

General. Liggett, which is the operating successor to the Liggett & Myers Tobacco Company, is currently the fifth largest manufacturer of cigarettes in the United States in terms of unit sales. Liggett's manufacturing facilities are located in Mebane, North Carolina.

Liggett manufactures and sells cigarettes in the United States. According to data from Management Science Associates, Inc., Liggett's domestic shipments of approximately 8.2 billion cigarettes during 2005 accounted for 2.2% of the total cigarettes shipped in the United States during such year. This market share percentage represents a decrease of 0.1% from 2004 and a decrease of 0.3% from 2003. Historically, Liggett produced premium cigarettes as well as discount cigarettes (which include among others, control label, private label, branded discount and generic

cigarettes). Premium cigarettes are generally marketed under well-

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recognized brand names at higher retail prices to adult smokers with a strong preference for branded products, whereas discount cigarettes are marketed at lower retail prices to adult smokers who are more cost conscious. In recent years, the discounting of premium cigarettes has become far more significant in the marketplace. This has led to some brands that were traditionally considered premium brands to become more appropriately categorized as branded discount, following list price reductions. Liggett's EVE brand would fall into that category. All of Liggett's unit volume in 2005 and 2004 was in the discount segment, which Liggett's management believes has been the primary growth segment in the industry for over a decade.

Liggett produces cigarettes in approximately 270 combinations of length, style and packaging. Liggett's current brand portfolio includes:

LIGGETT SELECT the third largest brand in the deep discount category,

GRAND PRIX the fastest growing brand in the deep discount segment,

EVE a leading brand of 120 millimeter cigarettes in the branded discount category,

PYRAMID the industry's first deep discount product with a brand identity, and

USA and various Partner Brands and private label brands.

In 1980, Liggett was the first major domestic cigarette manufacturer to successfully introduce discount cigarettes as an alternative to premium cigarettes. In 1989, Liggett established a new price point within the discount market segment by introducing PYRAMID, a branded discount product which, at that time, sold for less than most other discount cigarettes. In 1999, Liggett introduced LIGGETT SELECT, one of the leading brands in the deep discount category. LIGGETT SELECT is now the largest seller in Liggett's family of brands, comprising 44.6% of Liggett's unit volume in 2005, 55.8% in 2004 and 50.9% in 2003. In September 2005, Liggett repositioned GRAND PRIX to distributors and retailers nationwide. GRAND PRIX is marketed as the "lowest price fighter" to specifically compete with brands which are priced at the lowest level of the deep discount segment. According to Management Science Associates data, Liggett held a share of approximately 7.5% of the overall discount market segment for 2005 compared to 7.4% for 2004 and 7.3% for 2003.

Liggett's premium cigarettes represented approximately 6.2% in 2003 of Liggett's revenues. According to Management Science Associates data, Liggett's unit share of the premium market segment was approximately 0.3% in 2003. Until May 1999, Liggett produced four premium cigarette brands: L&M, CHESTERFIELD, LARK and EVE. As part of the Philip Morris brand transaction (which is further described below) which closed in May 1999, Liggett transferred the L&M, CHESTERFIELD and LARK brands.

Effective February 1, 2004, Liggett reduced the EVE list price from the premium price level to the branded discount level. During 2003, the net list price for EVE was at the discount level after giving effect to promotional spending.

In March 2005, Liggett Vector Brands announced an agreement with Circle K Stores, Inc., which operates over 2,200 convenience stores in the United States under the Circle K and Mac's names, to supply MONTEGO, a deep discount brand, exclusively for the Circle K and Mac's stores. The MONTEGO brand was the first to be offered under Liggett Vector Brands' new Partner Brands program which offers customers quality product with long-term price stability. In November 2005, Liggett Vector Brands announced an agreement with Sunoco Inc., which operates over 800 Sunoco APlus branded convenience stores in the United States, to manufacture SILVER EAGLE. SILVER EAGLE, a deep discount brand, is exclusive to Sunoco and is the second brand to be offered under Liggett Vector Brands' Partner Brands program.

The source of industry data in this report is Management Science Associates, Inc., an independent third-party database management organization that collects wholesale shipment data from various cigarette manufacturers and distributors and provides analysis of market share, unit sales volume and premium versus discount mix for individual companies and the industry as a whole. Management Science Associates' information relating to unit sales volume and

market share of certain of the smaller, primarily deep discount,

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cigarette manufacturers is based on estimates developed by Management Science Associates. Effective June 2004, Management Science Associates made three changes in the information it reports as noted below and these changes are reflected in the information presented in this report:

Management Science Associates is now reporting actual units shipped by Commonwealth Brands, Inc.

Management Science Associates has implemented a new model for estimating unit sales volume for certain of the smaller, primarily deep discount cigarette manufacturers.

Management Science Associates has restated volume and the resulting effects on share of market from January 2001 forward.

The effects of these changes are that total industry volume increased based on new smaller manufacturer estimates and actual reported volume for Commonwealth and, based on the revised industry volume number, market shares for the major tobacco companies, including Liggett, have been restated from January 2001 forward and will be lower. Under Management Science Associates' new method for computing market share, Liggett and Vector Tobacco accounted for approximately 2.2% of the total cigarettes shipped in the United States during 2001, 2.4% during 2002 and 2.5% during 2003, as compared to 2.2% during 2001, 2.5% during 2002 and 2.7% during 2003 under the past method.

We believe that Liggett has gained a sustainable cost advantage over its competitors through its various settlement agreements. Under the Master Settlement Agreement reached in November 1998 with 46 states and various territories, the three largest cigarette manufacturers must make settlement payments to the states and territories based on how many cigarettes they sell annually. Liggett, however, is not required to make any payments unless its market share exceeds approximately 1.65% of the U.S. cigarette market. Additionally, as a result of the Medallion acquisition, Vector Tobacco likewise has no payment obligation unless its market share exceeds approximately 0.28% of the U.S. cigarette market.

In November 1999, Liggett acquired an industrial facility in Mebane, North Carolina. Liggett completed the relocation of its tobacco manufacturing operations from its old plant in Durham, North Carolina to the Mebane facility in October 2000. Since January 1, 2004, all of Vector Tobacco's cigarette brands have been produced at the Mebane facility.

At the present time, Liggett has no foreign operations. Liggett does not own the international rights to EVE, which is marketed by Philip Morris in foreign markets.

Business Strategy. Liggett's business strategy is to capitalize upon its cost advantage in the United States cigarette market due to the favorable treatment Liggett receives under its settlement agreements with the states and the Master Settlement Agreement. Liggett's long-term business strategy is to continue to focus its marketing and selling efforts on the discount segment of the market, to continue to build volume and margin in its core discount brands (LIGGETT SELECT, GRAND PRIX and EVE) and to utilize its core brand equity to selectively build distribution. Liggett intends to continue its product development to provide the best quality products relative to other discount products in the market place. Liggett will continue to seek to increase efficiency by developing and adapting its organizational structure to maximize profit potential. Liggett intends to expand the portfolio of its private and control label and Partner Brands utilizing a pricing strategy that offers long-term list price stability for customers. In addition, Liggett may bring niche-driven brands to the market in the future.

Sales, Marketing and Distribution. Liggett's products are distributed from a central distribution center in Mebane to 18 public warehouses located throughout the United States. These warehouses serve as local distribution centers for Liggett's customers. Liggett's products are transported from the central distribution centers to the warehouses via third-party trucking companies to meet pre-existing contractual obligations to its customers.

Liggett's customers are primarily tobacco and candy distributors, the military, warehouse club chains, and large grocery, drug and convenience store chains. Liggett offers its customers discount payment terms, traditional rebates and promotional incentives. Customers typically pay for purchased goods within two weeks following delivery from Liggett, and approximately 90% of customers pay more rapidly through electronic

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funds transfer arrangements. Liggett's largest single customer, Speedway SuperAmerica LLC, accounted for approximately 11.9% of its revenues in 2005, 13.8% of its revenues in 2004 and 16.6% of its revenues in 2003. Sales to this customer were primarily in the private label discount segment. Liggett's contract with this customer currently extends through March 31, 2009.

During 2002, the sales and marketing functions, along with certain support functions, of our Liggett and Vector Tobacco subsidiaries were combined into a new entity, Liggett Vector Brands. This company coordinates and executes the sales and marketing efforts for all of our tobacco operations.

In April 2004, we eliminated a number of positions in our tobacco operations and subleased excess office space. In October 2004, we announced a plan to restructure the operations of Liggett Vector Brands. Liggett Vector Brands has realigned its sales force and adjusted its business model to more efficiently serve its chain and independent accounts nationwide. In connection with the restructuring, we eliminated approximately 330 full-time positions and 135 part-time positions as of December 15, 2004.

Trademarks. All of the major trademarks used by Liggett are federally registered or are in the process of being registered in the United States and other markets. Trademark registrations typically have a duration of ten years and can be renewed at Liggett's option prior to their expiration date. In view of the significance of cigarette brand awareness among consumers, management believes that the protection afforded by these trademarks is material to the conduct of its business. All of Liggett's trademarks are owned by its wholly-owned subsidiary, Eve Holdings Inc., except for the JADE trademark, which is licensed on a long-term exclusive basis from a third-party for use in connection with cigarettes.

Manufacturing. Liggett purchases and maintains leaf tobacco inventory to support its cigarette manufacturing requirements. Liggett believes that there is a sufficient supply of tobacco within the worldwide tobacco market to satisfy its current production requirements. Liggett stores its leaf tobacco inventory in warehouses in North Carolina and Virginia. There are several different types of tobacco, including flue-cured leaf, burley leaf, Maryland leaf, oriental leaf, cut stems and reconstituted sheet. Leaf components of American-style cigarettes are generally the flue-cured and burley tobaccos. While premium and discount brands use many of the same tobacco products, input ratios of tobacco products may vary between premium and discount products. Foreign flue-cured and burley tobaccos, some of which are used in the manufacture of Liggett's cigarettes, have historically been 30% to 35% less expensive than comparable domestic tobaccos. Liggett normally purchases all of its tobacco requirements from domestic and foreign leaf tobacco dealers, much of it under long-term purchase commitments. As of December 31, 2005, virtually all of Liggett's commitments were for the purchase of foreign tobacco.

Liggett's cigarette manufacturing facilities in Mebane, North Carolina were designed for the execution of short production runs in a cost-effective manner, which enable Liggett to manufacture and market a wide variety of cigarette brand styles. Liggett produces cigarettes in approximately 270 different brand styles under Eve's trademarks and brand names as well as private labels for other companies, typically retail or wholesale distributors who supply supermarkets and convenience stores.

The Mebane facility currently produces approximately 8.5 billion cigarettes per year, but maintains the capacity to produce approximately 16 billion cigarettes per year. Vector Tobacco has contracted with Liggett to produce its cigarettes and has transferred production from the Timberlake facility, which has been sold, to the manufacturing facility in Mebane. All production ceased at Timberlake by December 31, 2003. As part of the transition, approximately 150 manufacturing and administrative positions were eliminated.

While Liggett pursues product development, its total expenditures for research and development on new products have not been financially material over the past three years.

Competition. Liggett's competition is now divided into two segments. The first segment is made up of the three largest manufacturers of cigarettes in the United States: Philip Morris USA Inc., Reynolds American Inc. (following the combination of RJR Tobacco and Brown & Williamson's United States tobacco businesses in July 2004) and Lorillard Tobacco Company. The three largest manufacturers, while primarily premium cigarette based companies, also produce and sell discount cigarettes. The second segment of

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competition is comprised of a group of smaller manufacturers and importers, most of which sell lower quality, deep discount cigarettes.

Historically, there have been substantial barriers to entry into the cigarette business, including extensive distribution organizations, large capital outlays for sophisticated production equipment, substantial inventory investment, costly promotional spending, regulated advertising and, for premium brands, strong brand loyalty. However, in recent years, a number of these smaller companies have been able to overcome these competitive barriers due to excess production capacity in the industry and the cost advantage for certain manufacturers and importers resulting from the Master Settlement Agreement.

Many smaller manufacturers and importers that are not parties to the Master Settlement Agreement have only recently started to be impacted by the statutes enacted pursuant to the Master Settlement Agreement and to see a resultant decrease in volume after years of growth. Liggett's management believes, while these companies still have significant market share through competitive discounting in this segment, they are losing their cost advantage as their payment obligations under these statutes increase and are more effectively enforced by the states, through implementation of allocable share legislation.

In the cigarette business, Liggett competes on a dual front. The three major manufacturers compete among themselves for premium brand market share, and compete with Liggett and others for discount market share, on the basis of brand loyalty, advertising and promotional activities, and trade rebates and incentives. These three competitors all have substantially greater financial resources and most of their brands have greater sales and consumer recognition than Liggett's products. Liggett's discount brands must also compete in the marketplace with the smaller manufacturers' and importers' deep discount brands.

According to Management Science Associates' data, the unit sales of Philip Morris, Reynolds American and Lorillard accounted in the aggregate for approximately 86.1% of the domestic cigarette market in 2005. Liggett's domestic shipments of approximately 8.2 billion cigarettes during 2005 accounted for 2.2% of the approximately 381 billion cigarettes shipped in the United States during that year, compared to 9 billion cigarettes in 2004 (2.3%) and 9.8 billion cigarettes (2.4%) during 2003.

Industry-wide shipments of cigarettes in the United States have been generally declining for a number of years, with Management Science Associates' data indicating that domestic industry-wide shipments decreased by approximately 3.4% (13 billion units) in 2005. Liggett's management believes that industry-wide shipments of cigarettes in the United States will generally continue to decline as a result of numerous factors. These factors include health considerations, diminishing social acceptance of smoking, and a wide variety of federal, state and local laws limiting smoking in restaurants, bars and other public places, as well as federal and state excise tax increases and settlement-related expenses which have contributed to high cigarette price levels in recent years.

Historically, because of their dominant market share, Philip Morris and RJR Tobacco (which is now part of Reynolds American), the two largest cigarette manufacturers, have been able to determine cigarette prices for the various pricing tiers within the industry. Market pressures have historically caused the other cigarette manufacturers to bring their prices in line with the levels established by these two major manufacturers. Off-list price discounting and similar promotional activity by manufacturers, however, has substantially affected the average price differential at retail, which can be significantly less than the manufacturers' list price gap. Recent discounting by manufacturers has been far greater than historical levels, and the actual price gap between premium and deep-discount cigarettes has changed accordingly. This has led to shifts in price segment performance depending upon the actual price gaps of products at retail.

In July 2004, RJR Tobacco and Brown & Williamson, the second and third largest cigarette manufacturers, completed the combination of their United States tobacco businesses to create Reynolds American. This transaction will further consolidate the dominance of the domestic cigarette market by Philip Morris and the newly created Reynolds American, who had a combined market share of approximately 76.9% at December 31, 2005. This concentration of United States market share could make it more difficult for Liggett and Vector Tobacco to compete for shelf space in retail outlets and could impact price competition in the market, either of which could have a material adverse affect on their sales volume, operating income and cash flows.

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Acquisition of Medallion. In April 2002, a subsidiary of ours acquired the stock of The Medallion Company, Inc., and related assets from Gary L. Hall, Medallion's principal stockholder. The total purchase price consisted of \$50 million in cash and \$60 million in notes, with the notes guaranteed by us and Liggett. Medallion is a discount cigarette manufacturer selling product in the deep discount category, primarily under the USA brand name. Medallion is a participating manufacturer under the Master Settlement Agreement. Medallion has no payment obligations under the Master Settlement Agreement unless its market share exceeds approximately 0.28% of total cigarettes sold in the United States (approximately 1.1 billion cigarettes in 2005).

Following the purchase of the Medallion stock, Vector Tobacco merged into Medallion and Medallion changed its name to Vector Tobacco Inc. For purposes of this discussion and segment reporting in this report, references to the Liggett segment encompass the manufacture and sale of conventional cigarettes and include the former operations of Medallion (which operations are held for legal purposes as part of Vector Tobacco).

Philip Morris Brand Transaction. In November 1998, we and Liggett granted Philip Morris options to purchase interests in Trademarks LLC which holds three domestic cigarette brands, L&M, CHESTERFIELD and LARK, formerly held by Liggett's subsidiary, Eve.

Under the terms of the Philip Morris agreements, Eve contributed the three brands to Trademarks, a newly-formed limited liability company, in exchange for 100% of two classes of Trademarks' interests, the Class A Voting Interest and the Class B Redeemable Nonvoting Interest. Philip Morris acquired two options to purchase the interests from Eve. In December 1998, Philip Morris paid Eve a total of \$150 million for the options, \$5 million for the option for the Class A interest and \$145 million for the option for the Class B interest.

The Class A option entitled Philip Morris to purchase the Class A interest for \$10.1 million. On March 19, 1999, Philip Morris exercised the Class A option, and the closing occurred on May 24, 1999.

The Class B option entitles Philip Morris to purchase the Class B interest for \$139.9 million. The Class B option will be exercisable during the 90-day period beginning on December 2, 2008, with Philip Morris being entitled to extend the 90-day period for up to an additional six months under certain circumstances. The Class B interest will also be redeemable by Trademarks for \$139.9 million during the same period the Class B option may be exercised.

On May 24, 1999, Trademarks borrowed \$134.9 million from a lending institution. The loan is guaranteed by Eve and is collateralized by a pledge by Trademarks of the three brands and Trademarks' interest in the trademark license agreement (discussed below) and by a pledge by Eve of its Class B interest. In connection with the closing of the Class A option, Trademarks distributed the loan proceeds to Eve as the holder of the Class B interest. The cash exercise price of the Class B option and Trademarks' redemption price were reduced by the amount distributed to Eve. Upon Philip Morris' exercise of the Class B option or Trademarks' exercise of its redemption right, Philip Morris or Trademarks, as relevant, will be required to obtain Eve's release from its guaranty. The Class B interest will be entitled to a guaranteed payment of \$0.5 million each year with the Class A interest allocated all remaining income or loss of Trademarks.

Trademarks has granted Philip Morris an exclusive license of the three brands for an 11-year term expiring May 24, 2010 at an annual royalty based on sales of cigarettes under the brands, subject to a minimum annual royalty payment of not less than the annual debt service obligation on the loan plus \$1 million.

If Philip Morris fails to exercise the Class B option, Eve will have an option to put its Class B interest to Philip Morris, or Philip Morris' designees, at a put price that is \$5 million less than the exercise price of the Class B option (and includes Philip Morris' obtaining Eve's release from its loan guaranty). The Eve put option is exercisable at any time during the 90-day period beginning March 2, 2010.

If the Class B option, Trademarks' redemption right and the Eve put option expire unexercised, the holder of the Class B interest will be entitled to convert the Class B interest, at its election, into a Class A

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interest with the same rights to share in future profits and losses, the same voting power and the same claim to capital as the entire existing outstanding Class A interest, i.e., a 50% interest in Trademarks.

Upon the closing of the exercise of the Class A option and the distribution of the loan proceeds on May 24, 1999, Philip Morris obtained control of Trademarks, and we recognized a pre-tax gain of \$294.1 million in our consolidated financial statements and established a deferred tax liability of \$103.1 million relating to the gain. As discussed in Note 10 to our consolidated financial statements, the Internal Revenue Service has issued to us a notice of proposed adjustment asserting, for tax purposes, that the entire gain should have been recognized by the Company in 1998 and 1999.

Vector Tobacco Inc.

Vector Tobacco, a wholly-owned subsidiary of VGR Holding, is engaged in the development and marketing of the low nicotine and nicotine-free QUEST cigarette products and the development of reduced risk cigarette products.

QUEST. In January 2003, Vector Tobacco introduced QUEST, its brand of low nicotine and nicotine-free cigarette products. QUEST is designed for adult smokers who are interested in reducing their levels of nicotine intake and is available in both menthol and non-menthol styles. Each QUEST style (regular and menthol) offers three different packagings, with decreasing amounts of nicotine QUEST 1, 2 and 3. QUEST 1, the low nicotine variety, contains 0.6 milligrams of nicotine. QUEST 2, the extra-low nicotine variety, contains 0.3 milligrams of nicotine. QUEST 3, the nicotine-free variety, contains only trace levels of nicotine no more than 0.05 milligrams of nicotine per cigarette. QUEST cigarettes utilize proprietary, patented and patent pending processes and materials that enable the production of cigarettes with nicotine-free tobacco that tastes and smokes like tobacco in conventional cigarettes. All six QUEST varieties are being sold in box style packs and are priced comparably to other premium brands.

QUEST was initially available in New York, New Jersey, Pennsylvania, Ohio, Indiana, Illinois and Michigan. These seven states account for approximately 30% of all cigarette sales in the United States. A multi-million dollar advertising and marketing campaign, with advertisements running in magazines and regional newspapers, supported the product launch. The brand continues to be supported by point-of-purchase awareness campaigns. Vector Tobacco has established a website, www.questcigs.com, to provide adult smokers with additional information about QUEST.

The premium segment of the tobacco industry continues to experience intense competitive activity, with significant discounting of premium brands at all levels of retail. Given these marketplace conditions, and the results that we have seen to date with QUEST, we have taken a measured approach to expanding the market presence of the brand. In November 2003, Vector Tobacco introduced three menthol varieties of QUEST in the seven state market. In January 2004, QUEST and QUEST Menthol were introduced into an expansion market in Arizona, which accounts for approximately 2% of the industry volume nationwide.

During the second quarter 2004, based on an analysis of the market data obtained since the introduction of the QUEST product, we determined to postpone indefinitely the national launch of QUEST. Any determination as to future expansion of the market presence of QUEST will be based on the ongoing and projected demand for the product, market conditions in the premium segment and the prevailing regulatory environment, including any restrictions on the advertising of the product.

During the second quarter of 2004, we recognized a non-cash charge of \$37 million to adjust the carrying value of excess leaf tobacco inventory for the QUEST product, based on estimates of future demand and market conditions. If actual demand for the product or market conditions are less favorable than those estimated, additional inventory write-downs may be required.

QUEST brand cigarettes are currently marketed to permit adult smokers, who wish to continue smoking, to gradually reduce their intake of nicotine. The products are not labeled or advertised for smoking cessation and Vector Tobacco makes no claims that QUEST is safer than other cigarette products.

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In October 2003, we announced that Jed E. Rose, Ph.D., Director of Duke University Medical Center's Nicotine Research Program and co-inventor of the nicotine patch, had conducted a study at Duke University Medical Center to provide preliminary evaluation of the use of the QUEST technology as a smoking cessation aid. In the preliminary study on QUEST, 33% of QUEST 3 smokers were able to achieve four-week continuous abstinence, a standard threshold for smoking cessation. Management believes these results show real promise for the QUEST technology as a smoking cessation aid. We have received guidance from the Food and Drug Administration as to the additional clinical research and regulatory filings necessary to market QUEST as a smoking cessation product. We are currently conducting a multi-centered clinical trial with QUEST cigarettes, which should be completed by the end of the first quarter of 2006. Management believes that obtaining the Food and Drug Administration's approval to market QUEST as a smoking cessation product will be an important factor in the long-term commercial success of the QUEST brand. No assurance can be given that such approval can be obtained or as to the timing of any such approval if received.

The nicotine-free tobacco in QUEST cigarettes is produced by genetically modifying nicotine-producing tobacco plants, using a combination of patented and patent pending processes and materials to produce tobacco plants which are essentially nicotine-free. Management believes that, based on testing at Vector Tobacco's research facility, the QUEST 3 product will contain trace levels of nicotine that have no discernible physiological impact on the smoker, and that, consistent with other products bearing "free" claims, QUEST 3 may be labeled as "nicotine-free" with an appropriate disclosure of the trace levels. The QUEST 3 product is similarly referred to in this report as "nicotine-free". As the process genetically blocks formation of nicotine in the root of the plant, the tobacco leaf taste is not affected.

OMNI. In November 2001, Vector Tobacco launched OMNI nationwide, the first reduced carcinogen cigarette that smokes, tastes and burns like other premium cigarettes. In comparison to comparable styles of the leading U.S. cigarette brand, OMNI cigarettes produce significantly lower levels of many of the recognized carcinogens and toxins that the medical community has identified as major contributors to lung cancer and other diseases in smokers. While OMNI has not been proven to reduce health risks, management believes that the significant reduction of carcinogens is a step in the right direction. The data show lower levels in OMNI of the main carcinogens and toxins in both mainstream and sidestream tobacco smoke, including polycyclic aromatic hydrocarbons (PAHs), tobacco specific nitrosamines (TSNAs), catechols and organics, with somewhat increased levels of nitric oxide and formaldehyde. Mainstream smoke is what the smoker directly inhales and sidestream smoke, which is the major component of environmental tobacco smoke, is released from the burning end of a cigarette.

During 2002, acceptance of OMNI in the marketplace was limited, with revenues of approximately \$5.1 million on sales of 70.7 million units. During 2003, OMNI sales activity was minimal as Vector Tobacco was not actively marketing the OMNI product, and the product is not currently being distributed. Vector Tobacco was unable to achieve the anticipated breadth of distribution and sales of the OMNI product due, in part, to the lack of success of its advertising and marketing efforts in differentiating OMNI with consumers through the "reduced carcinogen" message. Over the next several years, our in-house research program, together with third-party collaborators, plans to conduct appropriate studies relating OMNI's reduction of carcinogens to reduced risk in smokers and, based on these studies, management will review the marketing and positioning of the OMNI brand in order to formulate a strategy for its long-term success.

OMNI cigarettes are produced using a patented technology developed by Vector Tobacco. Traditional tobacco is treated with a complex catalytic system that significantly reduces the levels of certain carcinogens and other toxins. Additionally, OMNI employs the use of an innovative carbon filter, which reduces a wide range of harmful compounds in smoke, yet has no impact on OMNI's premium taste. Vector Tobacco is committed to continuing its research to find new, innovative ways to further reduce carcinogens as well as other identified substances that may play a role in smoking-related diseases.

The relationship between smoking and disease occurrence is exceedingly complex. Vector Tobacco has begun the process of devising and funding studies of the health impact of the OMNI product. Vector Tobacco does not presently have any objective evidence that OMNI cigarettes will reduce the known health risks of

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cigarette smoking to the smoker or nonsmoking bystander, and no health claims are being made by Vector Tobacco.

Manufacturing and Marketing. The QUEST brands are priced as premium cigarettes and marketed by the sales representatives of Liggett Vector Brands, which coordinates and executes the sales and marketing efforts for all our tobacco operations. In the fourth quarter of 2002, Vector Tobacco began production of QUEST at a facility it had purchased in Timberlake, North Carolina, and converted into a modern cigarette manufacturing plant. In October 2003, we announced that we would close Vector Tobacco's Timberlake facility in order to reduce excess cigarette production capacity and improve operating efficiencies company-wide. As of January 1, 2004, production of QUEST and Vector Tobacco's other cigarette brands was moved to Liggett's state-of-the-art manufacturing facility in Mebane, North Carolina.

The Mebane facility currently produces approximately 8.5 billion cigarettes per year, but maintains the capacity to produce approximately 16 billion cigarettes per year. Vector Tobacco has contracted with Liggett to produce its cigarettes and has transferred production from Timberlake to Mebane. All production ceased at Timberlake by December 31, 2003. As part of the transition, approximately 150 manufacturing and administrative positions were eliminated.

As a result of these actions, we recognized pre-tax restructuring and impairment charges of \$21.3 million in 2003, and additional charges of \$0.4 million were recognized in 2004. Approximately \$2.2 million relate to employee severance and benefit costs, \$0.7 million to contract termination and exit and moving costs, and \$18.8 million to non-cash asset impairment charges. Machinery and equipment to be disposed of was reduced to fair value less costs to sell during 2003.

In July 2004, a wholly-owned subsidiary of Vector Tobacco completed the sale of the Timberlake, North Carolina manufacturing facility along with all equipment to an affiliate of the Flue-Cured Tobacco Cooperative Stabilization Corporation for \$25.8 million. In connection with the closing, the subsidiary of Vector Tobacco entered into a consulting agreement to provide certain services to the buyer for \$0.4 million, all of which was recognized by the Company in 2004. Approximately \$5.2 million of the proceeds from the sale were used at closing to retire debt secured by the Timberlake property.

We decreased the asset impairment accrual as of June 30, 2004 to reflect the actual amounts to be realized from the Timberlake sale and to reduce the values of other excess Vector Tobacco machinery and equipment in accordance with SFAS No. 144. We also adjusted the previously recorded restructuring accrual as of June 30, 2004 to reflect additional employee severance and benefits, contract termination and associated costs resulting from the Timberlake sale. No charge to operations resulted from these adjustments as there was no change to the total impairment and restructuring charges previously recognized.

Liggett Vector Brands, as part of the continuing effort to adjust the cost structure of our tobacco business and improve operating efficiency, eliminated 83 positions during April 2004, sublet its New York office space in July 2004 and relocated several employees. As a result of these actions, we recognized additional pre-tax restructuring charges of \$2.7 million in 2004, including \$0.8 million relating to employee severance and benefit costs and \$1.9 million for contract termination and other associated costs. Approximately \$0.5 million of these charges represent non-cash items.

Annual cost savings related to the Timberlake restructuring and impairment charges and the actions taken at Liggett Vector Brands in the first half of 2004 were estimated to be at least \$23 million beginning in 2004. Management believes that the anticipated annual cost savings have been achieved beginning in 2004.

On October 6, 2004, we announced an additional plan to restructure the operations of Liggett Vector Brands, our sales, marketing and distribution agent for our Liggett and Vector Tobacco subsidiaries. Liggett Vector Brands has realigned its sales force and adjusted its business model to more efficiently serve its chain and independent accounts nationwide. In connection with the restructuring, we eliminated approximately 330 full-time positions and 135 part-time positions as of December 15, 2004.

As a result of the actions announced in October 2004, management believes we have realized annual cost savings of approximately \$30 million beginning in 2005. We recognized pre-tax restructuring charges of

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\$10.6 million in 2004. Approximately \$5.7 million of the charges related to employee severance and benefit costs and approximately \$4.9 million to contract termination and other associated costs. Approximately \$2.5 million of these charges represented non-cash items. Additionally, we incurred other charges in 2004 for various compensation and related payments to employees which were related to the restructuring. These charges of \$1.7 million were included in operating, selling, administrative and general expenses. Management will continue to review opportunities for additional cost savings in our tobacco business.

The OMNI product used traditional tobaccos, and the QUEST 3 product uses genetically modified tobacco grown specifically for Vector Tobacco. The Quest 1 and 2 products use a mixture of genetically modified tobacco and traditional tobaccos.

The introduction of the QUEST and OMNI brands required the expenditure of substantial sums for advertising and sales promotion. The advertising media used included age appropriate magazines, newspapers, direct mail and point-of-sale display materials. Sales promotion activities were conducted by distribution of store coupons, point-of-sale display and advertising, advertising in print media, and personal contact with distributors, retailers and consumers.

Expenditures by Vector Tobacco for research and development activities were \$9.0 million in 2005, \$8.1 million in 2004 and \$9.8 million in 2003.

Competition. Vector Tobacco's competitors generally have substantially greater resources than it, including financial, marketing and personnel resources. Other major tobacco companies have stated that they are working on reduced risk cigarette products and have made publicly available at this time only limited additional information concerning their activities. Philip Morris has announced that it is developing products that potentially reduce smokers exposure to harmful compounds in cigarette smoke and have been pursuing patents for its technology. RJR Tobacco has disclosed that a primary focus for its research and development activity is the development of potentially reduced exposure products, which may ultimately be recognized as products that present reduced risks to health. RJR Tobacco has stated that it continues to sell in limited distribution throughout the country a brand of cigarettes that primarily heats rather than burns tobacco, which it claims reduces the toxicity of its smoke. There is a substantial likelihood that other major tobacco companies will continue to introduce new products that are designed to compete directly with the low nicotine, nicotine-free and reduced risk products that Vector Tobacco currently markets or may develop.

Intellectual Property. Vector Tobacco is the exclusive sublicensee of technology for reducing or eliminating nicotine in tobacco through certain genetic engineering techniques. Patents encompassing this technology have been issued in the United States and more than 70 countries. Patent applications encompassing this technology remain pending in the United States and various other countries around the world.

Vector Tobacco has filed patent applications in the United States, Europe, Japan and Hong Kong relating to the use of palladium and other compounds to reduce the presence of carcinogens and other toxins. Patents encompassing this technology have been issued in the United States.

Research related to the biological basis of tobacco-related disease is being conducted at Vector Tobacco and together with third-party collaborators. This research is being directed by Dr. Anthony P. Albino, Vector Tobacco's Senior Vice President of Public Health Affairs. Vector Tobacco believes that as this research progresses, it may generate additional intellectual property. Vector Tobacco has filed international patent applications directed to technology arising from this research.

Risks. Vector Tobacco's new product initiatives are 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, recovery of costs of inventory, the need to obtain Food and Drug Administration approval to market QUEST as a smoking cessation product, potential disputes concerning Vector Tobacco's intellectual property, intellectual property of third parties, potential extensive government regulation or prohibition, third party allegations that Vector Tobacco products are unlawful or bear deceptive or unsubstantiated product claims, potential delays in obtaining tobacco, other raw materials and any technology needed to produce Vector Tobacco's products, market acceptance of Vector

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Tobacco products, competition from companies with greater resources and the dependence on key employees. See Item 1A. Risk Factors .

Legislation, Regulation and Litigation

Reports with respect to the alleged harmful physical effects of cigarette smoking have been publicized for many years and, in the opinion of Liggett's management, have had and may continue to have an adverse effect on cigarette sales. Since 1964, the Surgeon General of the United States and the Secretary of Health and Human Services have released a number of reports which state that cigarette smoking is a causative factor with respect to a variety of health hazards, including cancer, heart disease and lung disease, and have recommended various government actions to reduce the incidence of smoking. In 1997, Liggett publicly acknowledged that, as the Surgeon General and respected medical researchers have found, smoking causes health problems, including lung cancer, heart and vascular disease, and emphysema.

Since 1966, federal law has required that cigarettes manufactured, packaged or imported for sale or distribution in the United States include specific health warnings on their packaging. Since 1972, Liggett and the other cigarette manufacturers have included the federally required warning statements in print advertising and on certain categories of point-of-sale display materials relating to cigarettes. The Federal Cigarette Labeling and Advertising Act requires that packages of cigarettes distributed in the United States and cigarette advertisements in the United States bear one of the following four warning statements: SURGEON GENERAL'S WARNING: Smoking Causes Lung Cancer, Heart Disease, Emphysema, and May Complicate Pregnancy ; SURGEON GENERAL'S WARNING: Quitting Smoking Now Greatly Reduces Serious Risks to Your Health ; SURGEON GENERAL'S WARNING: Smoking by Pregnant Women May Result in Fetal Injury, Premature Birth, and Low Birth Weight ; and SURGEON GENERAL'S WARNING: Cigarette Smoke Contains Carbon Monoxide . The law also requires that each person who manufactures, packages or imports cigarettes annually provide to the Secretary of Health and Human Services a list of ingredients added to tobacco in the manufacture of cigarettes. Annual reports to the United States Congress are also required from the Secretary of Health and Human Services as to current information on the health consequences of smoking and from the Federal Trade Commission on the effectiveness of cigarette labeling and current practices and methods of cigarette advertising and promotion. Both federal agencies are also required annually to make such recommendations as they deem appropriate with regard to further legislation. In addition, since 1997, Liggett has included the warning Smoking is Addictive on its cigarette packages.

In August 1996, the Food and Drug Administration filed in the Federal Register a final rule classifying tobacco as a drug or medical device , asserting jurisdiction over the manufacture and marketing of tobacco products and imposing restrictions on the sale, advertising and promotion of tobacco products. Litigation was commenced challenging the legal authority of the FDA to assert such jurisdiction, as well as challenging the constitutionality of the rules. In March 2000, the United States Supreme Court ruled that the FDA does not have the power to regulate tobacco. Liggett supported the FDA rule and began to phase in compliance with certain of the proposed FDA regulations.

Since the Supreme Court decision, various proposals and recommendations have been made for additional federal and state legislation to regulate cigarette manufacturers. Congressional advocates of FDA regulation have introduced legislation that would give the FDA authority to regulate the manufacture, sale, distribution and labeling of tobacco products to protect public health, thereby allowing the FDA to reinstate its prior regulations or adopt new or additional regulations. In October 2004, the Senate passed a bill, which did not become law, providing for FDA regulation of tobacco products. A substantially similar bill was reintroduced in Congress in March 2005. The ultimate outcome of these proposals cannot be predicted, but FDA regulation of tobacco products could have a material adverse effect on us.

In October 2004, federal legislation was enacted which abolished the federal tobacco quota and price support program. Pursuant to the legislation, manufacturers of tobacco products will be assessed \$10.1 billion over a ten year period to compensate tobacco growers and quota holders for the elimination of their quota rights. Cigarette manufacturers will initially be responsible for 96.3% of the assessment (subject to adjustment

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in the future), which will be allocated based on relative unit volume of domestic cigarette shipments. Liggett's assessment was approximately \$25 million for the first year of the program which began January 1, 2005, including a special federal quota stock liquidation assessment of \$5.2 million. The relative cost of the legislation to the three largest cigarette manufacturers will likely be less than the cost to smaller manufacturers, including Liggett and Vector Tobacco, because one effect of the legislation is that the three largest manufacturers will no longer be obligated to make certain contractual payments, commonly known as Phase II payments, they agreed in 1999 to make to tobacco-producing states. The ultimate impact of this legislation cannot be determined, but there is a risk that smaller manufacturers, such as Liggett and Vector Tobacco, will be disproportionately affected by the legislation, which could have a material adverse effect on us.

In August 1996, Massachusetts enacted legislation requiring tobacco companies to publish information regarding the ingredients in cigarettes and other tobacco products sold in that state. In December 2002, the United States Court of Appeals for the First Circuit ruled that the ingredients disclosure provisions violated the constitutional prohibition against unlawful seizure of property by forcing firms to reveal trade secrets. The decision was not appealed by the state. Liggett began voluntarily complying with this legislation in December 1997 by providing ingredient information to the Massachusetts Department of Public Health and, notwithstanding the appellate court's ruling, has continued to provide ingredient disclosure. Liggett also provides ingredient information annually, as required by law, to the states of Texas and Minnesota. Several other states are considering ingredient disclosure legislation, and the Senate bill providing for FDA regulation also calls for, among other things, ingredient disclosure.

In February 1996, the United States Trade Representative issued an advance notice of proposed rule making concerning how tobacco imported under a previously established tobacco tariff rate quota should be allocated. Currently, tobacco imported under the quota is allocated on a first-come, first-served basis, meaning that entry is allowed on an open basis to those first requesting entry in the quota year. Others in the cigarette industry have suggested an end-user licensing system under which the right to import tobacco under the quota would be initially assigned on the basis of domestic market share. Such an approach, if adopted, could have a material adverse effect on us.

A wide variety of federal, state and local laws limit the advertising, sale and use of cigarettes, and these laws have proliferated in recent years. For example, many local laws prohibit smoking in restaurants and other public places, and many employers have initiated programs restricting or eliminating smoking in the workplace. There are various other legislative efforts pending on the federal and state level which seek to, among other things, eliminate smoking in public places, further restrict displays and advertising of cigarettes, require additional warnings, including graphic warnings, on cigarette packaging and advertising, ban vending machine sales and curtail affirmative defenses of tobacco companies in product liability litigation. This trend has had, and is likely to continue to have, an adverse effect on us.

Cigarettes are subject to substantial and increasing federal, state and local excise taxes. The federal excise tax on cigarettes is currently \$0.39 per pack. State and local sales and excise taxes vary considerably and, when combined with the current federal excise tax, may currently exceed \$4.00 per pack. In 2005, nine states enacted increases in excise taxes. Further increases from other states are expected. Congress has considered significant increases in the federal excise tax or other payments from tobacco manufacturers, and various states and other jurisdictions have currently under consideration or pending legislation proposing further state excise tax increases. We believe that increases in excise and similar taxes have had an adverse effect on sales of cigarettes.

Various state governments have adopted or are considering adopting legislation establishing ignition propensity standards for cigarettes. Compliance with this legislation could be burdensome and costly. In June 2000, the New York State legislature passed legislation charging the state's Office of Fire Prevention and Control, referred to as the OFPC, with developing standards for self-extinguishing or reduced ignition propensity cigarettes. All cigarettes manufactured for sale in New York state must be manufactured to specific reduced ignition propensity standards set forth in the regulations. Liggett and Vector Tobacco are in compliance with the New York reduced ignition propensity regulatory requirements. Since the passage of the New York law, the states of Vermont and California have passed similar laws utilizing the same technical

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standards, to become effective on May 1, 2006 and June 1, 2007, respectively. Similar legislation is being considered by other state governments and at the federal level. Compliance with such legislation could harm the business of Liggett and Vector Tobacco, particularly if there are varying standards from state to state.

Federal or state regulators may object to Vector Tobacco's low nicotine and nicotine-free cigarette products and reduced risk cigarette products it may develop as unlawful or allege they bear deceptive or unsubstantiated product claims, and seek the removal of the products from the marketplace, or significant changes to advertising. Various concerns regarding Vector Tobacco's advertising practices have been expressed to Vector Tobacco by certain state attorneys general. Vector Tobacco has engaged in discussions in an effort to resolve these concerns and Vector Tobacco has, in the interim, suspended all print advertising for its QUEST brand. If Vector Tobacco is unable to advertise its QUEST brand, it could have a material adverse effect on sales of QUEST. Allegations by federal or state regulators, public health organizations and other tobacco manufacturers that Vector Tobacco's products are unlawful, or that its public statements or advertising contain misleading or unsubstantiated health claims or product comparisons, may result in litigation or governmental proceedings. Vector Tobacco's business may become subject to extensive domestic and international government regulation. Various proposals have been made for federal, state and international legislation to regulate cigarette manufacturers generally, and reduced constituent cigarettes specifically. It is possible that laws and regulations may be adopted covering matters such as the manufacture, sale, distribution and labeling of tobacco products as well as any express or implied health claims associated with reduced risk, low nicotine and nicotine-free cigarette products and the use of genetically modified tobacco. A system of regulation by agencies such as the FDA, the Federal Trade Commission and the United States Department of Agriculture may be established. In addition, a group of public health organizations submitted a petition to the FDA, alleging that the marketing of the OMNI product is subject to regulation by the FDA under existing law. Vector Tobacco has filed a response in opposition to the petition. The FTC has expressed interest in the regulation of tobacco products made by tobacco manufacturers, including Vector Tobacco, which bear reduced carcinogen claims. The outcome of any of the foregoing cannot be predicted, but any of the foregoing could have a material adverse effect on Vector Tobacco's business, operating results and prospects.

The cigarette industry continues to be challenged on numerous fronts. The industry is facing increased pressure from anti-smoking groups and continued smoking and health litigation, including private class action litigation and health care cost recovery actions brought by governmental entities and other third parties, the effects of which, at this time, we are unable to evaluate. As of December 31, 2005, there were approximately 268 individual suits, approximately 11 purported class actions or actions where class certification has been sought and approximately eight governmental and other third-party payor health care recovery actions pending in the United States in which Liggett was a named defendant. In addition to these cases, in 2000, an action against cigarette manufacturers involving approximately 1,000 named individual plaintiffs was consolidated for trial on some common related issues before a single West Virginia state court. Liggett is a defendant in most of the cases pending in West Virginia. In January 2002, the court severed Liggett from the trial of the consolidated action. There are five individual actions where Liggett is the only tobacco company defendant. In April 2004, in one of these cases, a jury in a Florida state court action awarded compensatory damages of \$0.5 million against Liggett. In addition, plaintiff's counsel was awarded legal fees of \$0.8 million. Liggett has appealed the verdict. The plaintiffs' allegations of liability in those cases in which individuals seek recovery for injuries allegedly caused by cigarette smoking are based on various theories of recovery, including negligence, gross negligence, breach of special duty, strict liability, fraud, misrepresentation, design defect, failure to warn, breach of express and implied warranties, conspiracy, aiding and abetting, concert of action, unjust enrichment, common law public nuisance, property damage, invasion of privacy, mental anguish, emotional distress, disability, shock, indemnity and violations of deceptive trade practice laws, the federal Racketeer Influenced and Corrupt Organizations Act (RICO), state racketeering 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. Defenses raised by defendants in these cases include lack of proximate cause, assumption of the risk, comparative fault and/or contributory negligence, lack of design defect, statutes of limitations, equitable defenses such as "unclean hands" and lack of benefit, failure to state a claim and federal preemption.

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The claims asserted in the health care cost recovery actions vary. In most of these cases, plaintiffs assert the equitable claim that the tobacco industry was unjustly enriched by plaintiffs' payment of health care costs allegedly attributable to smoking and seek reimbursement of those costs. Other claims made by some but not all plaintiffs include the equitable claim of indemnity, common law claims of negligence, strict liability, breach of express and implied warranty, breach of special duty, fraud, negligent misrepresentation, conspiracy, public nuisance, claims under state and federal statutes governing consumer fraud, antitrust, deceptive trade practices and false advertising, and claims under RICO.

In September 1999, the United States government commenced litigation against Liggett and the other major tobacco companies in the United States District Court for the District of Columbia. The action seeks to recover an unspecified amount of health care costs paid for and furnished, and to be paid for and furnished, by the federal government for lung cancer, heart disease, emphysema and other smoking-related illnesses allegedly caused by the fraudulent and tortious conduct of defendants, to restrain defendants and co-conspirators from engaging in fraud and other unlawful conduct in the future, and to compel defendants to disgorge the proceeds of their unlawful conduct. The complaint alleges that such costs total more than \$20 billion annually. The action asserted claims under three federal statutes: the Medical Care Recovery Act, the Medicare Secondary Payer provisions of the Social Security Act and RICO. In September 2000, the court dismissed the government's claims based on the Medical Care Recovery Act and the Medicare Secondary Payer provisions, reaffirming its decision in July 2001. In the September 2000 ruling, the court also determined not to dismiss the government's RICO claims, under which the government continues to seek court relief to restrain the defendant tobacco companies from allegedly engaging in fraud and other unlawful conduct and to compel disgorgement. In a January 2003 filing with the court, the government alleged that disgorgement by defendants of approximately \$289 billion is an appropriate remedy in the case. In February 2005, the United States Court of Appeals for the District of Columbia upheld the defendants' motion for summary judgment to dismiss the government's disgorgement claim, ruling that disgorgement is not an available remedy in a civil RICO action. In April 2005, the appellate court denied the government's request that the disgorgement ruling be reconsidered by the full court. In October 2005, the United States Supreme Court declined to review this decision, although the government could again seek review of this issue following a verdict.

Trial of the case concluded on June 15, 2005. On June 27, 2005, the government sought to restructure its potential remedies and filed a proposed Final Judgment and Order. The relief can be grouped into four categories: (1) \$14 billion for a cessation and counter marketing program; (2) so-called corrective statements; (3) disclosures; and (4) enjoined activities. Post-trial briefing was completed in October 2005.

Approximately 38 purported state and federal class action complaints were filed against the cigarette manufacturers, including Liggett, for alleged antitrust violations. The actions allege that the cigarette manufacturers have engaged in a nationwide and international conspiracy to fix the price of cigarettes in violation of state and federal antitrust laws. Plaintiffs allege that defendants' price-fixing conspiracy raised the price of cigarettes above a competitive level. Plaintiffs in the 31 state actions purport to represent classes of indirect purchasers of cigarettes in 16 states; plaintiffs in the seven federal actions purport to represent a nationwide class of wholesalers who purchased cigarettes directly from the defendants. The federal class actions were consolidated and, in July 2000, plaintiffs filed a single consolidated complaint that did not name Liggett as a defendant, although Liggett complied with discovery requests. In July 2002, the court granted defendants' motion for summary judgment in the consolidated federal cases, which decision was affirmed on appeal by the United States Court of Appeals for the Eleventh Circuit. All state court cases on behalf of indirect purchasers have been dismissed, except for two cases pending in Kansas and New Mexico. The Kansas state court, in the case of *Smith v. Philip Morris Companies Inc., et al.*, granted class certification in November 2001. In April 2003, plaintiffs' motion for class certification was granted in *Romero v. Philip Morris Companies Inc.*, the case pending in New Mexico state court. In February 2005, the New Mexico Supreme Court affirmed the trial court's certification order. Liggett is a defendant in both the Kansas and New Mexico cases.

In 1996, 1997 and 1998, Liggett entered into settlements of smoking-related litigation with the Attorneys General of 45 states and territories. The settlements released Liggett from all smoking-related claims within

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

In November 1998, Philip Morris, RJR Tobacco, Brown & Williamson, Lorillard and Liggett entered into the Master Settlement Agreement with 46 states, the District of Columbia, Puerto Rico, Guam, the United States Virgin Islands, American Samoa and the Northern Mariana Islands to settle the asserted and unasserted health care cost recovery and certain other claims of those settling jurisdictions. As described above, Liggett had previous settlements with a number of these settling states. The Master Settlement Agreement received final judicial approval in each settling jurisdiction.

Liggett has no payment obligations under the Master Settlement Agreement unless its market share exceeds a base share of 125% of its 1997 market share, or approximately 1.65% of total cigarettes sold in the United States. As a result of the Medallion acquisition in April 2002, Vector Tobacco has no payment obligations under the Master Settlement Agreement except to the extent its market share exceeds a base amount of approximately 0.28% of total cigarettes sold in the United States. During 1999 and 2000, Liggett's market share did not exceed the base amount. According to Management Science Associates data, domestic shipments by Liggett and Vector Tobacco accounted for 2.2% of the total cigarettes shipped in the United States during 2001, 2.4% during 2002, 2.5% during 2003, 2.3% during 2004 and 2.2% during 2005. On April 15 of any year following a year in which Liggett's and/or Vector Tobacco's market shares exceed their respective base shares, Liggett and/or Vector Tobacco will pay on each excess unit an amount equal (on a per-unit basis) to that paid during such following year by the original participating manufacturers under the payment provisions of the Master Settlement Agreement, subject to applicable adjustments, offsets and reductions. In March and April 2002, Liggett and Vector Tobacco paid a total of \$31.1 million for their 2001 Master Settlement Agreement obligations. In March and April 2003, Liggett and Vector Tobacco paid a total of \$37.5 million for their 2002 Master Settlement Agreement obligations. At that time, funds were held back based on Liggett's and Vector Tobacco's belief that their Master Settlement Agreement payments for 2002 should be reduced as a result of market share loss to non-participating manufacturers. In June 2003, Liggett and Vector Tobacco reached a settlement with the jurisdictions party to the Master Settlement Agreement whereby Liggett and Vector Tobacco agreed to pay \$2.5 million in April 2004 to resolve these claims. In April 2004, Liggett and Vector Tobacco paid a total of \$50.3 million for their 2003 Master Settlement Agreement obligations. In April 2005, Liggett and Vector Tobacco paid a total of \$20,982 for their 2004 Master Settlement Agreement obligations. Liggett and Vector Tobacco have expensed \$14,924 for their estimated Master Settlement Agreement obligations for 2005 as part of cost of goods sold. As of December 31, 2005, Liggett and Vector Tobacco have disputed assessments under the Master Settlement Agreement related to failure to receive credit for market share loss to non-participating manufacturers of \$6.5 million for 2003, \$3.7 million for 2004 and approximately \$0.8 million for 2005. These disputed amounts have not been accrued in the accompanying consolidated financial statements.

Under the payment provisions of the Master Settlement Agreement, participating manufacturers are required to pay the following base annual amounts (subject to applicable adjustments, offsets and reductions):

Year	Amount
2006 - 2007	\$ 8.0 billion
2008 and each year thereafter	\$ 9.0 billion

These annual payments will be allocated based on relative unit volume of domestic cigarette shipments. The payment obligations under the Master Settlement Agreement are the several, and not joint, obligations of each participating manufacturer and are not the responsibility of any parent or affiliate of a participating manufacturer.

In October 2004, Liggett was notified that all participating manufacturers' payment obligations under the Master Settlement Agreement, dating from the agreement's execution in late 1998, have been recalculated utilizing net unit amounts, rather than gross unit amounts (which have been utilized since 1999). The change in the method of calculation could, among other things, require additional payments by Liggett under the Master Settlement Agreement of approximately \$9.4 million for the periods 2001 through 2004, and

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require Liggett to pay an additional amount of approximately \$2.8 million in 2005 and in future periods by lowering Liggett's market share exemption under the Master Settlement Agreement.

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

utilization of net unit amounts is not required by the Master Settlement Agreement (as reflected by, among other things, the utilization of gross unit amounts for the past six years),

such a change is not authorized without the consent of affected parties to the Master Settlement Agreement,

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

Liggett and others have relied upon the calculations based on gross unit amounts for the past six years. No amounts have been accrued in the accompanying consolidated financial statements for any potential liability relating to the gross versus net dispute.

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

In 2003, in order to resolve any potential issues with the State of Minnesota as to Liggett's settlement obligations, Liggett negotiated a \$100,000 a year payment to Minnesota, to be paid any year cigarettes manufactured by Liggett are sold in that state. In 2004, the Attorneys General for each of Florida, Mississippi and Texas advised Liggett that they believed that Liggett has failed to make all required payments under the respective settlement agreements with these states for the period 1998 through 2003 and that additional payments may be due for 2004 and subsequent years. Liggett believes these allegations are without merit, based, among other things, on the language of the most favored nation provisions of the settlement agreements. In December 2004, the State of Florida offered to settle all amounts allegedly owed by Liggett for the period through 2003 for the sum of \$13.5 million. In March 2005, the State of Florida reaffirmed its December 2004 offer to settle and provided Liggett with a 60 day notice to cure the alleged defaults. In November 2005, Florida made a revised offer that Liggett pay Florida \$4.25 million to resolve all matters through December 31, 2005, and pay Florida \$0.17 per pack on all Liggett cigarettes sold in Florida beginning January 1, 2006. After further discussions, Florida's most recent offer is that Liggett pay a total of \$3.5 million in four annual payments, \$1 million for the first three years and \$0.5 million in the fourth year, and defer further discussion of any alleged future obligations until the end of Florida's 2006 legislative session. Liggett has not yet responded to this most recent offer from Florida and there can be no assurance that a settlement will be reached. In November 2004, the State of Mississippi offered to settle all amounts allegedly owed by Liggett for the period through 2003 for the sum of \$6.5 million. In April 2005, the State of Mississippi reaffirmed its November 2004 offer to settle and provided Liggett with a 60 day notice to cure the alleged

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defaults. No specific monetary demand has been made by the State of Texas. Liggett has met with representatives of Mississippi and Texas to discuss the issues relating to the alleged defaults, although no resolution has been reached.

Except for \$2.0 million accrued for the year ended December 31, 2005 in connection with the foregoing matters, no other amounts have been accrued in the accompanying consolidated financial statements for any additional amounts that may be payable by Liggett under the settlement agreements with Florida, Mississippi and Texas. There can be no assurance that Liggett will prevail in any of these matters and that Liggett will not be required to make additional material payments, which payments could adversely affect our consolidated financial position, results of operations or cash flows.

Cigarette manufacturers that have not signed the Master Settlement Agreement (non-participating manufacturers) are required by law to make escrow deposits in each settling state where they sell cigarettes. The amount of escrow deposit is based on the number of cigarettes the non-participating manufacturer sells in the settling state. The escrow deposits are intended as a source of funds to pay potential future judgments against the non-participating manufacturers for smoking-related healthcare costs. Forty-six states have passed legislation intended to prevent non-participating manufacturers from evading their escrow deposit obligations. Under this legislation, distributors are prohibited from selling or applying excise tax stamps to any cigarette brand that is not on a state-approved list. In order for a brand to be on the state-approved list, the manufacturer must be a compliant party to the Master Settlement Agreement, or must be a non-participating manufacturer that has made all required escrow deposits. Failure to make escrow deposits in a settling state could result in the loss of a non-participating manufacturer's ability to sell tobacco products in that state. Additionally, 44 states have enacted, and several other states have pending, legislation, known as an allocable share amendment, that is designed to correct a loophole in the settling states' escrow statutes. The loophole allows many non-participating manufacturers to obtain a refund of monies deposited into escrow, and thereby reduce, in many cases substantially, the amounts they deposit into escrow.

There is a suit pending against New York state officials, in which importers of cigarettes allege that the Master Settlement Agreement and certain New York statutes enacted in connection with the Master Settlement Agreement violate federal antitrust law. In September 2004, the court denied plaintiffs' motion to preliminarily enjoin the Master Settlement Agreement and certain related New York statutes, but the court issued a preliminary injunction against the allocable share provision of the New York escrow statute. In addition, similar lawsuits are pending in Kentucky, Arkansas, Kansas, Louisiana, Nebraska, Tennessee and Oklahoma. Liggett is not a defendant in these cases.

In August 2004, we announced that Liggett and Vector Tobacco had notified the Attorneys General of 46 states that they intend to initiate proceedings against one or more of settling states for violating the terms of the Master Settlement Agreement. Our subsidiaries allege that the settling states violated their rights and the Master Settlement Agreement by extending unauthorized favorable financial terms to Miami-based Vibo Corporation d/b/a/ General Tobacco when, on August 19, 2004, the settling states entered into an agreement with General Tobacco allowing it to become a subsequent participating manufacturer under the Master Settlement Agreement. General Tobacco imports discount cigarettes manufactured in Colombia, South America.

In the notice sent to the Attorneys General, our subsidiaries indicate that they will seek to enforce the terms of the Master Settlement Agreement, void the General Tobacco agreement and enjoin the settling states and National Association of Attorneys General from listing General Tobacco as a participating manufacturer on their websites. Several subsequent participating manufacturers, including Liggett and Vector Tobacco, filed a motion in state court in Kentucky seeking to enforce the terms of the Master Settlement Agreement with respect to General Tobacco. On January 26, 2006, the court entered an order denying the motion and finding that the terms of the General Tobacco settlement agreement were reasonable and not in violation of the Master Settlement Agreement. The judge also found that the subsequent participating manufacturers, under these circumstances, were not entitled to most favored nation treatment. These subsequent participating manufacturers have given notice of appeal in this case.

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In May 1994, an action entitled *Engle, et al. v. R.J. Reynolds Tobacco Company, et al.*, Circuit Court, Eleventh Judicial Circuit, Dade County, Florida, was filed against Liggett and others. The class consists of all Florida residents and citizens, and their survivors, who have suffered, presently suffer or have died from diseases and medical conditions caused by their addiction to cigarettes that contain nicotine. Phase I of the trial commenced in July 1998 and in July 1999, the jury returned the Phase I verdict. The Phase I verdict concerned certain issues determined by the trial court to be common to the causes of action of the plaintiff class. Among other things, the jury found that: smoking cigarettes causes 20 diseases or medical conditions, cigarettes are addictive or dependence producing, defective and unreasonably dangerous, defendants made materially false statements with the intention of misleading smokers, defendants concealed or omitted material information concerning the health effects and/or the addictive nature of smoking cigarettes and agreed to misrepresent and conceal the health effects and/or the addictive nature of smoking cigarettes, and defendants were negligent and engaged in extreme and outrageous conduct or acted with reckless disregard with the intent to inflict emotional distress. The jury also found that defendants' conduct rose to a level that would permit a potential award or entitlement to punitive damages. The court decided that Phase II of the trial, which commenced November 1999, would be a causation and damages trial for three of the class representatives and a punitive damages trial on a class-wide basis, before the same jury that returned the verdict in Phase I. Phase III of the trial was to be conducted before separate juries to address absent class members' claims, including issues of specific causation and other individual issues regarding entitlement to compensatory damages. In April 2000, the jury awarded compensatory damages of \$12.7 million to the three plaintiffs, to be reduced in proportion to the respective plaintiff's fault. The jury also decided that the claim of one of the plaintiffs, who was awarded compensatory damages of \$5.8 million, was not timely filed. In July 2000, the jury awarded approximately \$145 billion in the punitive damages portion of Phase II against all defendants including \$790 million against Liggett. The court entered a final order of judgment against the defendants in November 2000. The court's final judgment, which provided for interest at the rate of 10% per year on the jury's award, also denied various post-trial motions, including a motion for new trial and a motion seeking reduction of the punitive damages award. Liggett appealed the court's order.

In May 2003, Florida's Third District Court of Appeals decertified the *Engle* class and set aside the jury's decision in the case against Liggett and the other cigarette makers, including the \$145 billion punitive damages award. The intermediate appellate court ruled that there were multiple legal bases why the class action trial, including the punitive damages award, could not be sustained. The court found that the class failed to meet the legal requirements for class certification and that class members needed to pursue their claims on an individualized basis. The court also ruled that the trial plan violated Florida law and the appellate court's 1996 certification decision, and was unconstitutional. The court further found that the proceedings were irretrievably tainted by class counsel's misconduct and that the punitive damages award was bankrupting under Florida law.

In May 2004, the Florida Supreme Court agreed to review the case. Oral argument was held in November 2004. If the Third District Court's ruling is not upheld on further appeal, it will have a material adverse effect on us.

Management is not able to predict the outcome of the litigation pending against Liggett. Litigation is subject to many uncertainties. In May 2003, a Florida intermediate appellate court overturned a \$790 million punitive damages award against Liggett and decertified the *Engle* smoking and health class action. In May 2004, the Florida Supreme Court agreed to review the case. Oral argument was held in November 2004. If the intermediate appellate court's ruling is not upheld on further appeal, it will have a material adverse effect on us. In November 2000, Liggett filed the \$3.45 million bond required under the bonding statute enacted in 2000 by the Florida legislature which limits the size of any bond required, pending appeal, to stay execution of a punitive damages verdict. In May 2001, Liggett reached an agreement with the class in the *Engle* case, which provided assurance to Liggett that the stay of execution, in effect pursuant to the Florida bonding statute, would not be lifted or limited at any point until completion of all appeals, including to the United States Supreme Court. As required by the agreement, Liggett paid \$6.27 million into an escrow account to be held for the benefit of the *Engle* class, and released, along with Liggett's existing \$3.45 million statutory bond, to the court for the benefit of the class upon completion of the appeals process, regardless of the outcome of

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the appeal. As a result, we recorded a \$9.7 million pre-tax charge to the consolidated statement of operations for the first quarter of 2001. In June 2002, the jury in an individual case brought under the third phase of the *Engle* case awarded \$37.5 million (subsequently reduced by the court to \$25.1 million) of compensatory damages against Liggett and two other defendants and found Liggett 50% responsible for the damages. The verdict, which was subject to the outcome of the *Engle* appeal, has been overturned as a result of the appellate court's ruling discussed above. In April 2004, a jury in a Florida state court action awarded compensatory damages of approximately \$0.5 million against Liggett in an individual action. In addition, plaintiff's counsel was awarded legal fees of \$0.8 million. Liggett has appealed the verdict. It is possible that additional cases could be decided unfavorably and that there could be further adverse developments in the *Engle* case. Liggett may enter into discussions in an attempt to settle particular cases if it believes it is appropriate to do so. Management cannot predict the cash requirements related to any future settlements and judgments, including cash required to bond any appeals, and there is a risk that those requirements will not be able to be met. An unfavorable outcome of a pending smoking and health case could encourage the commencement of additional similar litigation. Management is unable to make a meaningful estimate with respect to the amount or range of loss that could result from an unfavorable outcome of the cases pending against Liggett or the costs of defending such cases. The complaints filed in these cases rarely detail alleged damages. Typically, the claims set forth in an individual's complaint against the tobacco industry pray for money damages in an amount to be determined by a jury, plus punitive damages and costs. These damage claims are typically stated as being for the minimum necessary to invoke the jurisdiction of the court.

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

Liggett's and Vector Tobacco's management is unaware of any material environmental conditions affecting its existing facilities. Liggett's and Vector Tobacco's management believes that current operations are conducted in accordance with all environmental laws and regulations. Compliance with federal, state and local provisions regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, have not had a material effect on the capital expenditures, earnings or competitive position of Liggett or Vector Tobacco.

Liggett's management believes that it is in compliance in all material respects with the laws regulating cigarette manufacturers.

See Note 13 to our consolidated financial statements, which contain a description of legislation, regulation and litigation and of the Master Settlement Agreement and Liggett's other settlements.

New Valley LLC

New Valley LLC, a Delaware limited liability company, is engaged in the real estate business and is seeking to acquire additional real estate properties and operating companies. New Valley owns a 50% interest in Douglas Elliman Realty, LLC, which operates the largest residential brokerage company in the New York City metropolitan area. New Valley also holds, through its New Valley Realty Division, a 50% interest in the Sheraton Keauhou Bay Resort & Spa in Kailua-Kona, Hawaii, and a 50% interest in the St. Regis Hotel in Washington, D.C. In February 2005, New Valley completed the sale of its two commercial office buildings in Princeton, New Jersey.

In December 2005, we completed an exchange offer and subsequent short-form merger whereby we acquired the remaining 42.3% of the common shares of New Valley Corporation that we did not already own. As result of these transactions, New Valley Corporation became our wholly-owned subsidiary and each outstanding New Valley Corporation common share was exchanged for 0.54 shares of our common stock. A total of approximately 5.05 million of our common shares were issued to the New Valley Corporation shareholders in the transactions. The surviving corporation in the short-form merger was subsequently merged into a new Delaware limited liability company named New Valley LLC, which conducts the business of the former New Valley Corporation. Prior to these transactions, New Valley Corporation was registered under the Securities Exchange Act of 1934 and filed periodic reports and other information with the SEC.

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New Valley Corporation was originally organized under the laws of New York in 1851 and operated for many years under the name Western Union Corporation. In 1991, bankruptcy proceedings were commenced against New Valley Corporation. In January 1995, New Valley Corporation emerged from bankruptcy. As part of the plan of reorganization, New Valley Corporation sold the Western Union money transfer and messaging services businesses and all allowed claims in the bankruptcy were paid in full.

Business Strategy

The business strategy of New Valley is to continue to operate its real estate business, to acquire additional real estate properties and to acquire operating companies through merger, purchase of assets, stock acquisition or other means, or to acquire control of operating companies through one of such means. New Valley may also seek from time to time to dispose of such businesses and properties when favorable market conditions exist. New Valley's cash and investments are available for general corporate purposes, including for acquisition purposes.

As a result of the sale of the office buildings in February 2005, New Valley's real estate leasing operations, which were the primary source of New Valley's revenues in 2003 and 2004, have been treated as discontinued operations in the accompanying consolidated financial statements.

Douglas Elliman Realty, LLC

During 2000 and 2001, New Valley acquired for approximately \$1.7 million a 37.2% ownership interest in B&H Associates of NY, which conducts business as Prudential Douglas Elliman Real Estate, formerly known as Prudential Long Island Realty, a residential real estate brokerage company on Long Island, and a minority interest in an affiliated mortgage company, Preferred Empire Mortgage Company. In December 2002, New Valley and the other owners of Prudential Douglas Elliman Real Estate contributed their interests in Prudential Douglas Elliman Real Estate to Douglas Elliman Realty, LLC, formerly known as Montauk Battery Realty, LLC, a newly formed entity. New Valley acquired a 50% interest in Douglas Elliman Realty as a result of an additional investment of approximately \$1.4 million by New Valley and the redemption by Prudential Douglas Elliman Real Estate of various ownership interests. As part of the transaction, Prudential Douglas Elliman Real Estate renewed its franchise agreement with The Prudential Real Estate Affiliates, Inc. for an additional ten-year term. In October 2004, upon receipt of required regulatory approvals, the former owners of Douglas Elliman Realty contributed to Douglas Elliman Realty their interests in the related mortgage company.

In March 2003, Douglas Elliman Realty purchased the New York City based residential brokerage firm, Douglas Elliman, LLC, formerly known as Insignia Douglas Elliman, and an affiliated property management company, for \$71.25 million. With that acquisition, the combination of Prudential Douglas Elliman Real Estate with Douglas Elliman created the largest residential brokerage company in the New York metropolitan area. Upon closing of the acquisition, Douglas Elliman entered into a ten-year franchise agreement with The Prudential Real Estate Affiliates, Inc. New Valley invested an additional \$9.5 million in subordinated debt and equity of Douglas Elliman Realty to help fund the acquisition. The subordinated debt, which had a principal amount of \$9.5 million, bears interest at 12% per annum and is due in March 2013. As part of the Douglas Elliman acquisition, Douglas Elliman Realty acquired Douglas Elliman's affiliate, Residential Management Group LLC, which conducts business as Douglas Elliman Property Management and is the New York metropolitan area's largest manager of rental, co-op and condominium housing.

We account for our interest in Douglas Elliman Realty on the equity method. We recorded income of \$11.2 million in 2005, \$11.6 million in 2004 and \$1.2 million in 2003 associated with Douglas Elliman Realty. Equity income from Douglas Elliman Realty includes interest earned by New Valley on the subordinated debt and, prior to October 1, 2004, 44% of the mortgage company's results from operations.

Real Estate Brokerage Business. Douglas Elliman Realty is engaged in the real estate brokerage business through its subsidiaries Douglas Elliman and Prudential Douglas Elliman Real Estate. The two brokerage companies have 66 offices with more than 3,300 real estate agents in the metropolitan New York area. The companies achieved combined sales of approximately \$11.1 billion of real estate in 2005,

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approximately \$10 billion of real estate in 2004 and approximately \$6.8 billion of real estate in 2003. In 2005, Douglas Elliman Realty was ranked as the seventh largest residential brokerage company in the United States based on closed sales volume by the *Real Trends* broker survey. Douglas Elliman Realty had revenues of \$330.0 million in 2005, \$286.8 million in 2004 and \$179.9 million in 2003.

Douglas Elliman was founded in 1911 and has grown to be one of Manhattan's leading residential brokers by specializing in the highest end of the sales and rental marketplaces. It has 16 New York City offices, with more than 1,375 real estate agents, and had sales volume of approximately \$6.3 billion of real estate in 2005, approximately \$5.9 billion of real estate in 2004 and approximately \$4 billion in 2003.

Prudential Douglas Elliman Real Estate is headquartered in Huntington, New York and is the largest residential brokerage company on Long Island with 50 offices and more than 1,934 real estate agents. During 2005, Prudential Douglas Elliman Real Estate closed approximately 8,254 transactions, representing sales volume of approximately \$4.7 billion of real estate. This compared to approximately 7,975 transactions closed in 2004, representing approximately \$4.2 billion of real estate, and approximately 6,955 transactions closed in 2003, representing approximately \$2.8 billion in real estate. Prudential Douglas Elliman Real Estate serves approximately 250 communities from Manhattan to Montauk.

Douglas Elliman and Prudential Douglas Elliman Real Estate both act as a broker or agent in residential real estate transactions. In performing these services, the companies have historically represented the seller, either as the listing broker, or as a co-broker in the sale. In acting as a broker for the seller, their services include assisting the seller in pricing the property and preparing it for sale, advertising the property, showing the property to prospective buyers, and assisting the seller in negotiating the terms of the sale and in closing the transaction. In exchange for these services, the seller pays to the companies a commission, which is generally a fixed percentage of the sales price. In a co-brokered arrangement, the listing broker typically splits its commission with the other co-broker involved in the transaction. The two companies also offer buyer brokerage services. When acting as a broker for the buyer, their services include assisting the buyer in locating properties that meet the buyer's personal and financial specifications, showing the buyer properties, and assisting the buyer in negotiating the terms of the purchase and closing the transaction. In exchange for these services a commission is paid to the companies which also is generally a fixed percentage of the purchase price and is usually, with the consent of the listing broker, deducted from, and payable out of, the commission payable to the listing broker. With the consent of a buyer and seller, subject to certain conditions, the companies may, in certain circumstances, act as a selling broker and as a buying broker in the same transaction. Their sales and marketing services are mostly provided by licensed real estate sales associates who have entered into independent contractor agreements with the companies. The companies recognize revenue and commission expenses upon the consummation of the real estate sale.

The two brokerage companies also offer relocation services to employers, which provide a variety of specialized services primarily concerned with facilitating the resettlement of transferred employees. These services include sales and marketing of transferees' existing homes for their corporate employer, assistance in finding new homes, moving services, educational and school placement counseling, customized videos, property marketing assistance, rental assistance, area tours, international relocation, group move services, marketing and management of foreclosed properties, career counseling, spouse/partner employment assistance, and financial services. Clients can select these programs and services on a fee basis according to their needs.

As part of the brokerage companies' franchise agreement with Prudential, its subsidiaries have an agreement with Prudential Relocation Services, Inc. to provide relocation services to the Prudential network. The companies anticipate that participation in Prudential network will continue to provide new relocation opportunities with firms on a national level.

Preferred Empire Mortgage Company is engaged in the residential mortgage brokerage business, which involves the origination of loans for one-to-four family residences. Preferred Empire primarily originates loans for purchases of properties located on Long Island and in New York City. Approximately one-half of these loans are for home sales transactions in which Prudential Douglas Elliman Real Estate acts as a broker. The term "origination" refers generally to the process of arranging mortgage financing for the purchase of property

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directly to the purchaser or for refinancing an existing mortgage. Preferred Empire's revenues are generated from loan origination fees, which are generally a percentage of the original principal amount of the loan and are commonly referred to as points, and application and other fees paid by the borrowers. Preferred Empire recognizes mortgage origination revenues and costs when the mortgage loan is consummated.

Marketing. As members of The Prudential Real Estate Affiliates, Inc., Douglas Elliman and Prudential Douglas Elliman Real Estate offer real estate sales and marketing and relocation services, which are marketed by a multimedia program. This program includes direct mail, newspaper, internet, catalog, radio and television advertising and is conducted throughout Manhattan and Long Island. In addition, the integrated nature of the real estate brokerage companies services is designed to produce a flow of customers between their real estate sales and marketing business and their mortgage business.

Competition. The real estate brokerage business is highly competitive. However, Douglas Elliman and Prudential Douglas Elliman Real Estate believe that their ability to offer their customers a range of inter-related services and their level of residential real estate sales and marketing help position them to meet the competition and improve their market share.

In the two brokerage companies' traditional business of residential real estate sales and marketing, they compete primarily with multi-office independent real estate organizations and, to some extent with franchise real estate organizations, such as Century-21, ERA, RE/MAX and Coldwell Banker. The companies believe that their major competitors in 2006 will also increasingly include multi-office real estate organizations, such as GMAC Home Services, NRT Inc. (whose affiliates include the New York City-based Corcoran Group) and other privately owned companies. Residential brokerage firms compete for sales and marketing business primarily on the basis of services offered, reputation, personal contacts, and, recently to a greater degree, price.

Both companies' relocation businesses are fully integrated with their residential real estate sales and marketing business. Accordingly, their major competitors are many of the same real estate organizations previously noted. Competition in the relocation business is likewise based primarily on level of service, reputation, personal contact and, recently to a greater degree, price.

In its mortgage loan origination business, Preferred Empire competes with other mortgage originators, such as mortgage brokers, mortgage bankers, state and national banks, and thrift institutions. Because Preferred Empire does not fund, sell or service mortgage loans, many of Preferred Empire's competitors for mortgage services have substantially greater resources than Preferred Empire.

Government Regulation. Several facets of real estate brokerage businesses are subject to government regulation. For example, their real estate sales and marketing divisions are licensed as real estate brokers in the states in which they conduct their real estate brokerage businesses. In addition, their real estate sales associates must be licensed as real estate brokers or salespersons in the states in which they do business. Future expansion of the real estate brokerage operations of Douglas Elliman and Prudential Douglas Elliman Real Estate into new geographic markets may subject them to similar licensing requirements in other states.

A number of states and localities have adopted laws and regulations imposing environmental controls, disclosure rules, zoning, and other land use restrictions, which can materially impact the marketability of certain real estate. However, Douglas Elliman and Prudential Douglas Elliman Real Estate do not believe that compliance with environmental, zoning and land use laws and regulations has had, or will have, a materially adverse effect on their financial condition or operations.

In Preferred Empire's mortgage business, mortgage loan origination activities are subject to the Equal Credit Opportunity Act, the Federal Truth-in-Lending Act, the Real Estate Settlement Procedures Act, and the regulations promulgated thereunder which prohibit discrimination and require the disclosure of certain information to borrowers concerning credit and settlement costs. Additionally, there are various state laws affecting Preferred Empire's mortgage operations, including licensing requirements and substantive limitations on the interest and fees that may be charged. States also have the right to conduct financial and regulatory audits of the loans under their jurisdiction. Preferred Empire is licensed as a mortgage broker in New York, and as a result, Preferred Empire is required to submit annual audited financial statements to the New York Commissioner of Banks and maintain a minimum net worth of \$50,000. As of December 31, 2005, Preferred

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Empire was in compliance with these requirements. Preferred Empire is also licensed as a mortgage broker in Connecticut and New Jersey.

Neither Douglas Elliman nor Prudential Douglas Elliman Real Estate is aware of any material licensing or other government regulatory requirements governing its relocation business, except to the extent that such business also involves the rendering of real estate brokerage services, the licensing and regulation of which are described above.

Franchises and Trade Names. In December 2002, Prudential Douglas Elliman Real Estate renewed for an additional ten-year term its franchise agreement with The Prudential Real Estate Affiliates, Inc. and has an exclusive franchise, subject to various exceptions and to meeting annual revenue thresholds, in New York for the counties of Nassau and Suffolk on Long Island. In addition, in June 2004, Prudential Douglas Elliman Real Estate was granted an exclusive franchise, subject to various exceptions and to meeting annual revenue thresholds, with respect to the boroughs of Brooklyn and Queens. In March 2003, Douglas Elliman entered into a ten-year franchise agreement with The Prudential Real Estate Affiliates, Inc. and has an exclusive franchise, subject to various exceptions and to meeting annual revenue thresholds, for Manhattan.

The Douglas Elliman trade name is a registered trademark in the United States. The name has been synonymous with the most exacting standards of excellence in the real estate industry since Douglas Elliman's formation in 1911. Other trademarks used extensively in Douglas Elliman's business, which are owned by Douglas Elliman Realty and registered in the United States, include "We are New York", "Bringing People and Places Together", "If You Clicked Here You'd Be Home Now" and "Picture Yourself in the Perfect Home".

The Prudential name and the tagline "From Manhattan to Montauk" are used extensively in both the Prudential Douglas Elliman Real Estate and Douglas Elliman businesses. In addition, Prudential Douglas Elliman Real Estate continues to use the trade names of certain companies that it has acquired.

Residential Property Management Business. Douglas Elliman Realty is also engaged in the management of cooperatives, condominiums and apartments through its subsidiary, Residential Management Group, LLC, which conducts business as Douglas Elliman Property Management and is the New York metropolitan area's largest manager of rental, co-op and condominium housing according to a survey in the February 2004 issue of *The Cooperator*. Residential Management Group provides full service third-party fee management for approximately 250 properties, representing approximately 45,000 units in New York City, Nassau County, Northern New Jersey and Westchester County. The company is seeking to continue to expand its property management business in the Long Island market during 2006. Among the notable properties currently managed are the Dakota, Museum Tower, Worldwide Plaza, London Terrace and West Village Houses buildings in New York City. Residential Management Group employs approximately 250 people, of whom approximately 150 work at the company's headquarters and the remainder at remote site offices in the New York metropolitan area.

New Valley Realty Division

Office Buildings. On December 13, 2002, New Valley completed the acquisition of two commercial office buildings in Princeton, N.J. for an aggregate purchase price of \$54.3 million. The two adjacent buildings, located at 100 and 150 College Road West, were constructed in July 2000 and June 2001 and have a total of approximately 225,000 square feet of rentable space.

In February 2005, New Valley completed the sale of the two office buildings for \$71.5 million to an entity advised by Falcon Real Estate Investment Company, L.P. New Valley retired the outstanding mortgage on the property (\$39.2 million principal amount at December 31, 2004) at closing with the proceeds of the sale. As a result of the sale, New Valley's real estate leasing operations have been treated as discontinued operations in the accompanying consolidated financial statements.

Hawaiian Hotel. In July 2001, Koa Investors, LLC, an entity owned by New Valley, developer Brickman Associates and other investors, acquired the leasehold interests in the former Kona Surf Hotel in Kailua-Kona, Hawaii in a foreclosure proceeding. New Valley, which holds a 50% interest in Koa Investors,

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had invested \$11.9 million in the project and had committed to make additional investments of up to an aggregate of \$0.6 million as of December 31, 2005. We account for our investment in Koa Investors under the equity method and recorded losses of \$3.5 million in 2005, \$1.8 million in 2004 and \$0.3 million in 2003 associated with the Kona Surf Hotel. Koa Investors' losses in 2004 primarily represented losses from operations and management fees. Koa Investors' losses in 2003 primarily represented management fees. Koa Investors capitalized all costs related to the acquisition and development of the property during the construction phase, which ceased in connection with the opening of the hotel in the fourth quarter of 2004. Koa anticipates that the hotel will continue to experience operating losses during its opening phase.

The hotel is located on a 20-acre tract, which is leased under two ground leases with Kamehameha Schools, the largest private land owner in Hawaii. In December 2002, Koa Investors and Kamehameha amended the leases to provide for significant rent abatements over the next ten years and extended the remaining term of the leases from 33 years to 65 years. In addition, Kamehameha granted Koa Investors various right of first offer opportunities to develop adjoining resort sites.

A subsidiary of Koa Investors has entered into an agreement with Sheraton Operating Corporation, a subsidiary of Starwood Hotels and Resorts Worldwide, Inc., for Sheraton to manage the hotel. Following a major renovation, the property reopened in the fourth quarter 2004 as the Sheraton Keauhou Bay Resort & Spa, a four star family resort with 521 rooms. The renovation of the property included comprehensive room enhancements, construction of a fresh water 13,000 square foot fantasy pool, lobby and entrance improvements, a new gym and spa, retail stores and new restaurants. A 10,000 square foot convention center, wedding chapel and other revenue producing amenities were also restored. In April 2004, a subsidiary of Koa Investors closed on a \$57 million construction loan to fund the renovation.

In August 2005, a wholly-owned subsidiary of Koa Investors borrowed \$82 million at an interest rate of LIBOR plus 2.45%. Koa Investors used the proceeds of the loan to repay its \$57 million construction loan and distributed a portion of the proceeds to its members, including \$5.5 million to New Valley. As a result of the refinancing, we suspended our recognition of equity losses in Koa Investors to the extent such losses exceed our basis plus any commitment to make additional investments, which totaled \$0.6 million at December 31, 2005.

St. Regis Hotel, Washington, D.C. In June 2005, affiliates of New Valley and Brickman Associates formed 16th & K Holdings LLC (Hotel LLC), which acquired the St. Regis Hotel, a 193 room luxury hotel in Washington, D.C., for \$47 million in August 2005. New Valley, which holds a 50% interest in Hotel LLC, had invested \$6.25 million in the project and had committed to make additional investments of up to \$3.75 million at December 31, 2005. The members of Hotel LLC currently plan to renovate the hotel commencing in 2006. In connection with the closing of the purchase of the hotel, a subsidiary of Hotel LLC entered into agreements to borrow up to \$50 million of senior and subordinated debt.

We account for our interest in Hotel LLC under the equity method and recorded a loss of \$0.2 million for 2005. Hotel LLC will capitalize all costs related to the renovation of the property during the renovation phase.

In the event that Hotel LLC makes distributions of cash, New Valley is entitled to 50% of the cash distributions until it has recovered its invested capital and achieved an annual 11% internal rate of return (IRR), compounded quarterly. New Valley is then entitled to 35% of subsequent cash distributions until it has achieved an annual 22% IRR. New Valley is then entitled to 30% of subsequent cash distributions until it has achieved an annual 32% IRR. After New Valley has achieved an annual 35% IRR, New Valley is then entitled to 25% of subsequent cash distributions.

Former Broker-Dealer Operations

In May 1995, New Valley acquired Ladenburg Thalmann & Co. Inc. for \$25.8 million, net of cash acquired. Ladenburg Thalmann & Co. is a full service broker-dealer, which has been a member of the New York Stock Exchange since 1879. In December 1999, New Valley sold 19.9% of Ladenburg Thalmann & Co. to Berliner Effektengesellschaft AG, a German public financial holding company. New Valley received \$10.2 million in cash and Berliner shares valued in accordance with the purchase agreement.

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On May 7, 2001, GBI Capital Management Corp. acquired all of the outstanding common stock of Ladenburg Thalmann & Co., and the name of GBI was changed to Ladenburg Thalmann Financial Services Inc. (LTS). New Valley received 18,598,098 shares, \$8.01 million in cash and \$8.01 million principal amount of senior convertible notes due December 31, 2005. The notes issued to New Valley bore interest at 7.5% per annum and were convertible into shares of LTS common stock. Upon closing, New Valley also acquired an additional 3,945,060 shares of LTS common stock from the former Chairman of LTS for \$1.00 per share. To provide the funds for the acquisition of the common stock of Ladenburg Thalmann & Co., LTS borrowed \$10 million from Frost-Nevada, Limited Partnership and issued to Frost-Nevada \$10 million principal amount of 8.5% senior convertible notes due December 31, 2005. Following completion of the transactions, New Valley owned 53.6% and 49.5% of the common stock of LTS, on a basic and fully diluted basis, respectively. LTS (AMEX: LTS) is registered under the Securities Act of 1934 and files periodic reports and other information with the SEC.

In December 2001, New Valley distributed its 22,543,158 shares of LTS common stock to holders of New Valley common shares through a special dividend. At the same time, we distributed the 12,694,929 shares of LTS common stock, that we received from New Valley, to the holders of our common stock as a special dividend. Our stockholders received 0.348 of a LTS share for each share of ours.

In 2002, LTS borrowed a total of \$5 million from New Valley. The loans, which bore interest at 1% above the prime rate, were due on the earlier of December 31, 2003 or the completion of one or more equity financings where LTS received at least \$5 million in total proceeds. In November 2002, New Valley agreed, in connection with a \$3.5 million loan to LTS by an affiliate of its clearing broker, to extend the maturity of its notes to December 31, 2006 and to subordinate its notes to the repayment of the loan from the clearing broker.

New Valley evaluated its ability to collect its notes receivable and related interest from LTS at September 30, 2002. These notes receivable included the \$5 million of notes issued in 2002 and the \$8.01 million convertible note issued to New Valley in May 2001. Management determined, based on the then current trends in the broker-dealer industry and LTS's operating results and liquidity needs, that a reserve for uncollectibility should be established against these notes and interest receivable. As a result, New Valley recorded a charge of \$13.2 million in the third quarter of 2002.

In November 2004, New Valley entered into a debt conversion agreement with LTS and the other remaining holder of the convertible notes. New Valley and the other holder agreed to convert their notes, with an aggregate principal amount of \$18 million, together with the accrued interest, into common stock of LTS. Pursuant to the debt conversion agreement, the conversion price of the note held by New Valley was reduced from the previous conversion price of approximately \$2.08 to \$0.50 per share, and New Valley and the other holder each agreed to purchase \$5 million of LTS common stock at \$0.45 per share.

The note conversion transaction was approved by the LTS shareholders in January 2005 and closed in March 2005. At the closing, New Valley's note, representing approximately \$9.9 million of principal and accrued interest, was converted into 19,876,358 shares of LTS common stock and New Valley purchased 11,111,111 LTS shares.

LTS borrowed \$1.75 million from New Valley in 2004 and an additional \$1.75 million in the first quarter 2005. At the closing of the note conversion agreement, New Valley delivered these notes for cancellation as partial payment for its purchase of LTS common stock.

On March 30, 2005, New Valley distributed the 19,876,358 shares of LTS common stock it acquired from the conversion of the notes to holders of New Valley common shares through a special dividend. On the same date, we distributed the 10,947,448 shares of LTS common stock that we received from New Valley to the holders of our common stock as a special dividend. Our stockholders of record on March 18, 2005 received approximately 0.23 of a LTS share for each share of ours.

Following the distribution, New Valley continues to hold the 11,111,111 shares of LTS common stock (approximately 7.8% of the outstanding shares), the \$5 million of LTS's notes due December 31, 2006 and a warrant to purchase 100,000 shares of LTS common stock at \$1.00 per share.

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Four of our directors, Howard M. Lorber, Henry C. Beinstein, Robert J. Eide and Jeffrey S. Podell, also serve as directors of LTS. Richard J. Lampen, who along with Mr. Lorber is an executive officer of ours, also serves as a director of LTS. Bennett S. LeBow, our Executive Chairman, served as a director of LTS until September 2003.

Long-Term Investments

As of December 31, 2005, long-term investments consisted primarily of investments in limited partnerships and limited liability companies of \$7.8 million. New Valley has committed to make an additional investment in one of these limited partnerships of up to \$0.6 million.

Employees

At December 31, 2005, we had approximately 450 employees, of whom approximately 277 were employed at Liggett's Mebane facility, approximately 30 were employed by Vector Tobacco and Vector Research and approximately 126 were employed by Liggett Vector Brands. Approximately 46% of our employees are hourly employees who are represented by unions. We have not experienced any significant work stoppages since 1977, and we believe that relations with our employees and their unions are satisfactory.

Available Information

Our website address is www.vectorgrouppltd.com. We make available free of charge on the Investor Relations section of our website (<http://vectorgrouppltd.com/invest.asp>) our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with the Securities and Exchange Commission. We also make available through our website other reports filed with the SEC under the Exchange Act, including our proxy statements and reports filed by officers and directors under Section 16(a) of that Act. Copies of our Code of Business Conduct and Ethics, Corporate Governance Guidelines, Audit Committee charter, Compensation Committee charter and Corporate Governance and Nominating Committee charter have been posted on the Investor Relations section of our website and are also available in print to any shareholder who requests it. We do not intend for information contained in our website to be part of this Annual Report on Form 10-K.

Table of Contents**Item 1A. Risk Factors**

Our business faces many risks. We have described below some of the more significant risks which we and our subsidiaries face. There may be additional risks that we do not yet know of or that we do not currently perceive to be significant that may also impact our business or the business of our subsidiaries. Each of the risks and uncertainties described below could lead to events or circumstances that have a material adverse effect on the business, results of operations, cash flows, financial condition or equity of us or one or more of our subsidiaries, which in turn could negatively affect the value of our common stock. You should carefully consider and evaluate all of the information included in this report and any subsequent reports that we may file with the Securities and Exchange Commission or make available to the public before investing in any securities issued by us.

We and our subsidiaries have a substantial amount of indebtedness.

We and our subsidiaries have significant indebtedness and debt service obligations. At December 31, 2005, we and our subsidiaries had total outstanding indebtedness (including embedded derivative liability and beneficial conversion feature related to convertible notes) of \$306.2 million. 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 are a holding company and depend on cash payments from our subsidiaries, which are subject to contractual and other restrictions, in order to service our debt and to pay dividends on our common stock.

We are a holding company and have no operations of our own. We hold our interests in our various businesses through our wholly-owned subsidiaries, VGR Holding and New Valley. In addition to our own cash resources, our ability to pay interest on our convertible notes and to pay dividends on our common stock depends on the ability of VGR Holding and New Valley to make cash available to us. VGR Holding's ability to pay dividends to us depends primarily on the ability of Liggett, its wholly-owned subsidiary, to generate cash and make it available to VGR Holding. Liggett's revolving credit agreement permits Liggett to pay cash dividends to VGR Holding only if Liggett's borrowing availability exceeds \$5 million for the 30 days prior to payment of the dividend and immediately after giving effect to the dividend, and so long as no event of default has occurred under the agreement, including Liggett's compliance with the covenants in the credit facility, including an adjusted net worth and working capital requirement.

Our receipt of cash payments, as dividends or otherwise, from our subsidiaries is an important source of our liquidity and capital resources. If we do not have sufficient cash resources of our own and do not receive payments from our subsidiaries in an amount sufficient to repay our debts and to pay dividends on our common stock, we must obtain additional funds from other sources. There is a risk that we will not be able to obtain additional funds at all or on terms acceptable to us. Our inability to service these obligations and to continue to pay dividends on our common stock would significantly harm us and the value of our common stock.

Our liquidity could be adversely affected if taxing authorities prevail in their assertion that we incurred a tax obligation in 1998 and 1999 in connection with the Philip Morris brand transaction.

In connection with the 1998 and 1999 transaction with Philip Morris Incorporated, in which a subsidiary of Liggett contributed three of its premium cigarette brands to Trademarks LLC, or Trademarks, a newly-formed limited liability company, we recognized in 1999 a pre-tax gain of \$294.1 million in our consolidated financial statements and established a deferred tax liability of \$103.1 million relating to the gain. In such transaction, Philip Morris acquired an option to purchase the remaining interest in Trademarks for a 90-day period commencing in December 2008, and we have an option to require Philip Morris to purchase the remaining interest for a 90-day period commencing in March 2010. Upon exercise of the options during either of the 90-day periods commencing in December 2008 or in March 2010, we will be

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required to pay tax in the amount of the deferred tax liability, which will be offset by the benefit of any deferred tax assets, including any net operating losses, available to us at that time. In connection with an examination of our 1998 and 1999 federal income tax returns, the Internal Revenue Service issued to us in September 2003 a notice of proposed adjustment. The notice asserts that, for tax reporting purposes, the entire gain should have been recognized in 1998 and in 1999 in the additional amounts of \$150 million and \$129.9 million, respectively, rather than upon the exercise of the options during either of the 90-day periods commencing in December 2008 or in March 2010. If the Internal Revenue Service were to ultimately prevail with the proposed adjustment, it would result in the potential acceleration of tax payments of approximately \$127 million, including interest, net of tax benefits, through December 31, 2005. These amounts have been previously recognized in our consolidated financial statements as tax liabilities. In addition, we have filed a protest with the Appeals Division of the Internal Revenue Service. Although no payment is due with respect to these matters during the appeal process, interest is accruing on the disputed amounts.

There is a risk that the taxing authorities will ultimately prevail in their assertion that we incurred a tax obligation prior to the exercise dates of these options and we will be required to make such tax payments prior to 2009 or 2010. If that were to occur and any necessary financing were not available to us, our liquidity could be materially adversely affected, which in turn would materially adversely affect the value of our common stock.

Liggett faces intense competition in the domestic tobacco industry.

Liggett is considerably smaller and has fewer resources than its major competitors and, as a result, has a more limited ability to respond to market developments. Management Science Associates data indicate that the three largest cigarette manufacturers controlled approximately 86.1% of the United States cigarette market during 2005. Philip Morris is the largest and most profitable manufacturer in the market, and its profits are derived principally from its sale of premium cigarettes. Philip Morris had approximately 62.7% of the premium segment and 48.7% of the total domestic market during 2005. During 2005, all of Liggett's sales were in the discount segment, and its share of the total domestic cigarette market was 2.2%. Philip Morris and RJR Tobacco (which is now part of Reynolds American), the two largest cigarette manufacturers, have historically, because of their dominant market share, been able to determine cigarette prices for the various pricing tiers within the industry. Market pressures have historically caused the other cigarette manufacturers to bring their prices into line with the levels established by these two major manufacturers.

In July 2004, RJR Tobacco and Brown & Williamson, the second and third largest cigarette manufacturers, completed the combination of their United States tobacco businesses to create Reynolds American. This transaction has further consolidated the dominance of the domestic cigarette market by Philip Morris and the newly created Reynolds American, who had a combined market share of approximately 76.9% at December 31, 2005. This concentration of United States market share could make it more difficult for Liggett and Vector Tobacco to compete for shelf space in retail outlets and could impact price competition in the market, either of which could have a material adverse affect on their sales volume, operating income and cash flows, which in turn could negatively affect the value of our common stock.

Liggett's business is highly dependent on the discount cigarette segment.

Liggett depends more on sales in the discount cigarette segment of the market, relative to the full-price premium segment, than its major competitors. All of Liggett's unit volume in 2005 and 2004 were generated in the discount segment. The discount segment is highly competitive, with consumers having less brand loyalty and placing greater emphasis on price. While the three major manufacturers all compete with Liggett in the discount segment of the market, the strongest competition for market share has recently come from a group of small manufacturers and importers, most of which sell low quality, deep discount cigarettes. While Liggett's share of the discount market increased to 7.5% in 2005 from 7.4% in 2004 and 7.3% in 2003, Management Science Associates data indicate that the discount market share of these other smaller manufacturers and importers was approximately 38.0% in 2005, 39.4% in 2004 and 37.8% in 2003. If pricing in the discount market continues to be impacted by these smaller manufacturers and importers, margins in Liggett's only

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current market segment could be negatively affected, which in turn could negatively affect the value of our common stock.

Liggett's market share is susceptible to decline.

In years prior to 2000, Liggett suffered a substantial decline in unit sales and associated market share. Liggett's unit sales and market share increased during each of 2000, 2001 and 2002, and its market share increased in 2003 while its unit sales declined. During 2004 and 2005, Liggett's unit sales and market share declined compared to the prior year. This earlier market share erosion resulted in part from Liggett's highly leveraged capital structure that existed until December 1998 and its limited ability to match other competitors' wholesale and retail trade programs, obtain retail shelf space for its products and advertise its brands. The decline in recent years also resulted from adverse developments in the tobacco industry, intense competition and changes in consumer preferences. According to Management Science Associates data, Liggett's overall domestic market share during 2005 was 2.2% compared to 2.3% during 2004 and 2.4% during 2003. Liggett's share of the premium segment was 0.2% in 2003, and its share of the discount segment during 2005 was 7.5%, up from 7.4% in 2004 and 7.3% in 2003. If Liggett's market share continues to decline, Liggett's sales volume, operating income and cash flows could be materially adversely affected, which in turn could negatively affect the value of our common stock.

The domestic cigarette industry has experienced declining unit sales in recent periods.

Industry-wide shipments of cigarettes in the United States have been generally declining for a number of years, with published industry sources estimating that domestic industry-wide shipments decreased by approximately 3.4% during 2005. According to Management Science Associates data, domestic industry-wide shipments decreased by 1.7% in 2004 compared to 2003. Liggett's management believes that industry-wide shipments of cigarettes in the United States will generally continue to decline as a result of numerous factors. These factors include health considerations, diminishing social acceptance of smoking, and a wide variety of federal, state and local laws limiting smoking in restaurants, bars and other public places, as well as federal and state excise tax increases and settlement-related expenses which have contributed to high cigarette price levels in recent years. If this decline in industry-wide shipments continues and Liggett is unable to capture market share from its competitors, or if the industry as a whole is unable to offset the decline in unit sales with price increases, Liggett's sales volume, operating income and cash flows could be materially adversely affected, which in turn could negatively affect the value of our common stock.

Litigation and regulation will continue to harm the tobacco industry.

The cigarette industry continues to be challenged on numerous fronts. New cases continue to be commenced against Liggett and other cigarette manufacturers. As of December 31, 2005, there were approximately 268 individual suits, 11 purported class actions and eight governmental and other third-party payor health care reimbursement actions pending in the United States in which Liggett was a named defendant. A civil lawsuit has been filed by the United States federal government seeking disgorgement of approximately \$289 billion from various cigarette manufacturers, including Liggett. A federal appellate court ruled in February 2005 that disgorgement is not an available remedy in the case. In October 2005, the United States Supreme Court declined to review this decision. Trial of the case concluded on June 15, 2005. On June 27, 2005, the government sought to restructure its potential remedies and filed a proposed Final Judgment and Order. That relief can be grouped into four categories: (1) \$14 billion for a cessation and counter marketing program; (2) so-called corrective statements; (3) disclosures; and (4) enjoined activities. Post-trial briefing was completed in October 2005. In one of the other cases pending against Liggett, in 2000, an action against cigarette manufacturers involving approximately 1,000 named individual plaintiffs was consolidated for trial on some common related issues before a single West Virginia state court. Liggett is a defendant in most of the cases pending in West Virginia. In January 2002, the court severed Liggett from the trial of the consolidated action. Two purported class actions have been certified in state court in Kansas and New Mexico alleging antitrust violations. As new cases are commenced, the costs associated with defending these cases and the risks relating to the inherent unpredictability of litigation continue to increase.

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Class action suits have been filed in a number of states against individual cigarette manufacturers, alleging that the use of the terms light and ultralights constitutes unfair and deceptive trade practices. One such suit (*Schwab v. Philip Morris, et al.*), pending in federal court in New York against the cigarette manufacturers, seeks to create a nationwide class of light cigarette smokers and includes Liggett as a defendant. Plaintiffs' motion for class certification and summary judgment motions by both sides were heard in September 2005. In November 2005, the Court issued an opinion permitting plaintiffs to seek fluid recovery damages if class certification is granted. Fluid recovery would permit potential damages to be paid out in ways other than merely giving cash directly to plaintiffs, such as establishing a pool of money that could be used for public purposes. Although trial was scheduled to commence in January 2006, the judge has allowed an additional period for discovery before deciding the class certification issue.

There are five individual actions where Liggett is the only tobacco company defendant. In April 2004, in one of these cases, a jury in a Florida state court action awarded compensatory damages of \$0.5 million against Liggett. In addition, plaintiff's counsel was awarded legal fees of \$0.8 million. Liggett has appealed the verdict. In March 2005, in another case in Florida state court in which Liggett is the only defendant, the court granted Liggett's motion for summary judgment disposing of the case in its entirety. The plaintiff has appealed. In March 2006, in another of these cases, a Florida state court jury returned a verdict in favor of Liggett. The plaintiff may appeal.

In May 2003, a Florida intermediate appellate court overturned a \$790 million punitive damages award against Liggett and decertified the *Engle* smoking and health class action. In May 2004, the Florida Supreme Court agreed to review the case. Oral argument was held in November 2004. If the intermediate appellate court's ruling is not upheld on appeal, it will have a material adverse effect on us. In November 2000, Liggett filed the \$3.45 million bond required under the bonding statute enacted in 2000 by the Florida legislature which limits the size of any bond required, pending appeal, to stay execution of a punitive damages verdict. In May 2001, Liggett reached an agreement with the class in the *Engle* case, which provided assurance to Liggett that the stay of execution, in effect under the Florida bonding statute, would not be lifted or limited at any point until completion of all appeals, including to the United States Supreme Court. As required by the agreement, Liggett paid \$6.27 million into an escrow account to be held for the benefit of the *Engle* class, and released, along with Liggett's existing \$3.45 million statutory bond, to the court for the benefit of the class upon completion of the appeals process, regardless of the outcome of the appeal. In June 2002, the jury in an individual case brought under the third phase of the *Engle* case awarded \$37.5 million (subsequently reduced by the court to \$25.1 million) of compensatory damages against Liggett and two other defendants and found Liggett 50% responsible for the damages. The verdict, which is subject to the outcome of the *Engle* appeal, has been overturned as a result of the appellate court's ruling discussed above. It is possible that additional cases could be decided unfavorably and that there could be further adverse developments in the *Engle* case. Liggett may enter into discussions in an attempt to settle particular cases if it believes it is appropriate to do so. We cannot predict the cash requirements related to any future settlements and judgments, including cash required to bond any appeals, and there is a risk that those requirements will not be able to be met.

In recent years, there have been a number of proposed restrictive regulatory actions from various federal administrative bodies, including the United States Environmental Protection Agency and the Food and Drug Administration. There have also been adverse political decisions and other unfavorable developments concerning cigarette smoking and the tobacco industry, including the commencement and certification of class actions and the commencement of third-party payor actions. These developments generally receive widespread media attention. We are not able to evaluate the effect of these developing matters on pending litigation or the possible commencement of additional litigation, but our consolidated financial position, results of operations or cash flows could be materially adversely affected by an unfavorable outcome in any smoking-related litigation, which in turn could negatively affect the value of our common stock.

Liggett may have additional payment obligations under the Master Settlement Agreement and its other settlement agreements with the states.

In October 2004, Liggett was notified that all participating manufacturers' payment obligations under the Master Settlement Agreement, dating from the agreement's execution in late 1998, have been recalculated

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utilizing net unit amounts, rather than gross unit amounts (which have been utilized since 1999). The change in the method of calculation could, among other things, require additional payments by Liggett under the Master Settlement Agreement of approximately \$9.4 million for the periods 2001 through 2004, and require Liggett to pay an additional amount of approximately \$2.8 million in 2005 and in future periods by lowering Liggett's market share exemption under the Master Settlement Agreement. Liggett contends that the retroactive change from utilizing gross unit amounts to net unit amounts is impermissible and has objected to the change. Liggett has disputed the change in methodology. No amounts have been accrued in the accompanying consolidated financial statements for any potential liability relating to the gross versus net dispute.

On March 30, 2005, the Independent Auditor under the Master Settlement Agreement calculated \$28.7 million in Master Settlement Agreement payments for Liggett's 2004 sales. On April 15, 2005, Liggett paid \$11.7 million of this amount and, in accordance with its rights under the Master Settlement Agreement, disputed the balance of \$17.0 million. Of the disputed amount, Liggett paid \$9.3 million into the disputed payments account under the Master Settlement Agreement and withheld from payment \$7.7 million. The \$9.3 million paid into the disputed payments account represents the amount claimed by Liggett as an adjustment to its 2003 payment obligation under the Master Settlement Agreement for market share loss to non-participating manufacturers. The \$7.7 million withheld from payment represents \$5.3 million claimed as an adjustment to Liggett's 2004 Master Settlement Agreement obligation for market share loss to non-participating manufacturers and \$2.4 million relating to the retroactive change, discussed above, to the method for computing payment obligations under the Master Settlement Agreement which Liggett contends, among other things, is not in accordance with the Master Settlement Agreement. On May 31, 2005, New York State filed a motion on behalf of the settling states in New York state court seeking to compel Liggett and the other subsequent participating manufacturers that paid into the disputed payments account to release to the settling states the amounts paid into such account. The settling states contend that Liggett had no right under the Master Settlement Agreement and related agreements to pay into the disputed payments account any amount claimed as an adjustment for market share loss to non-participating manufacturers for 2003, although they acknowledge that Liggett has the right to dispute such amounts. By stipulation among the parties dated July 25, 2005, New York's motion was dismissed and Liggett authorized the release to the settling states of the \$9.3 million it had paid into the account, although Liggett continues to dispute that it owes this amount. Liggett intends to withhold from its payment due under the Master Settlement Agreement on April 15, 2006 approximately \$1.6 million which Liggett claims as the non-participating manufacturers adjustment to its 2005 payment obligation. As of December 31, 2005, Liggett and Vector Tobacco have disputed the following assessments under the Master Settlement Agreement related to failure to receive credit for market share loss to non-participating manufacturers: \$6.5 million for 2003, \$3.7 million for 2004 and approximately \$0.8 for 2005. These disputed amounts have not been accrued in the accompanying consolidated financial statements.

In 2004, the Attorneys General for each of Florida, Mississippi and Texas advised Liggett that they believed that Liggett has failed to make all required payments under the respective settlement agreements with these states for the period 1998 through 2003 and that additional payments may be due for 2004 and subsequent years. Liggett believes these allegations are without merit, based, among other things, on the language of the most favored nation provisions of the settlement agreements. In December 2004, the State of Florida offered to settle all amounts allegedly owed by Liggett for the period through 2003 for the sum of \$13.5 million. In March 2005, the State of Florida reaffirmed its December 2004 offer to settle and provided Liggett with a 60 day notice to cure the alleged defaults. In November 2005, Florida made a revised offer that Liggett pay Florida \$4.25 million to resolve all matters through December 31, 2005, and pay Florida \$0.17 per pack on all Liggett cigarettes sold in Florida beginning January 1, 2006. After further discussions, Florida's most recent offer is that Liggett pay a total of \$3.5 million in four annual payments, \$1 million for the first three years and \$0.5 million in the fourth year, and defer further discussion of any alleged future obligations until the end of Florida's 2006 legislative session. Liggett has not yet responded to this most recent offer from Florida and there can be no assurance that a settlement will be reached. In November 2004, the State of Mississippi offered to settle all amounts allegedly owed by Liggett for the period through 2003 for the sum of \$6.5 million. In April 2005, the State of Mississippi reaffirmed its November 2004 offer to settle and provided Liggett with a 60 day notice to cure the alleged defaults. No specific monetary demand has been made by the

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State of Texas. Liggett has met with representatives of Mississippi and Texas to discuss the issues relating to the alleged defaults, although no resolution has been reached.

Except for \$2.0 million accrued for the year ended December 31, 2005 in connection with the foregoing matters, no other amounts have been accrued in our consolidated financial statements for any additional amounts that may be payable by Liggett under the settlement agreements with Florida, Mississippi and Texas. There can be no assurance that Liggett will prevail in any of these matters and that Liggett will not be required to make additional material payments, which payments could materially adversely affect our consolidated financial position, results of operations or cash flows and the value of our common stock.

Liggett has significant sales to a single customer.

During 2005, 11.9% of Liggett's total revenues and 11.7% of our consolidated revenues were generated by sales to Liggett's largest customer. Liggett's contract with this customer currently extends through March 31, 2009. If this customer discontinues its relationship with Liggett or experiences financial difficulties, Liggett's results of operations could be materially adversely affected.

Liggett may be adversely affected by recent legislation to eliminate the federal tobacco quota system.

In October 2004, federal legislation was enacted which abolished the federal tobacco quota system and price support system. Pursuant to the legislation, manufacturers of tobacco products will be assessed \$10.1 billion over a ten year period to compensate tobacco growers and quota holders for the elimination of their quota rights. Cigarette manufacturers will initially be responsible for 96.3% of the assessment (subject to adjustment in the future), which will be allocated based on relative unit volume of domestic cigarette shipments. Liggett's assessment was approximately \$25 million for the first year of the program which began January 1, 2005, including a special federal quota stock liquidation assessment of \$5.2 million. The relative cost of the legislation to each of the three largest cigarette manufacturers will likely be less than the cost to smaller manufacturers, including Liggett and Vector Tobacco, because one effect of the legislation is that the three largest manufacturers will no longer be obligated to make certain contractual payments, commonly known as Phase II payments, they agreed in 1999 to make to tobacco-producing states. The ultimate impact of this legislation cannot be determined, but there is a risk that smaller manufacturers, such as Liggett and Vector Tobacco, will be disproportionately affected by the legislation, which could have a material adverse effect on us.

Excise tax increases adversely affect cigarette sales.

Cigarettes are subject to substantial and increasing federal, state and local excise taxes. The federal excise tax on cigarettes is currently \$0.39 per pack. State and local sales and excise taxes vary considerably and, when combined with the current federal excise tax, may currently exceed \$4.00 per pack. In 2005, nine states enacted increases in excise taxes. Further increases from other states are expected. Congress has considered significant increases in the federal excise tax or other payments from tobacco manufacturers, and various states and other jurisdictions have currently under consideration or pending legislation proposing further state excise tax increases. We believe that increases in excise and similar taxes have had an adverse impact on sales of cigarettes. Further substantial federal or state excise tax increases could accelerate the trend away from smoking and could have a material adverse effect on Liggett's sales and profitability, which in turn could negatively affect the value of our common stock.

Vector Tobacco is subject to risks inherent in new product development initiatives.

We have made, and plan to continue to make, significant investments in Vector Tobacco's development projects in the tobacco industry. Vector Tobacco is in the business of developing and marketing the low nicotine and nicotine-free QUEST cigarette products and developing reduced risk cigarette products. These initiatives are subject to high levels of risk, uncertainties and contingencies, including the challenges inherent in new product development. There is a risk that continued investments in Vector Tobacco will harm our results of operations, liquidity or cash flow.

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The substantial risks facing Vector Tobacco include:

Risks of market acceptance of new products. In November 2001, Vector Tobacco launched nationwide its reduced carcinogen OMNI cigarettes. During 2002, acceptance of OMNI in the marketplace was limited, with revenues of only approximately \$5.1 million on sales of 70.7 million units. Since 2003, OMNI sales activity has been minimal as Vector Tobacco has not been actively marketing the OMNI product, and the product is not currently in distribution. Vector Tobacco was unable to achieve the anticipated breadth of distribution and sales of the OMNI product due, in part, to the lack of success of its advertising and marketing efforts in differentiating OMNI from other conventional cigarettes with consumers through the reduced carcinogen message. Over the next several years, our in-house research program, together with third-party collaborators, plans to conduct appropriate studies relating OMNI's reduction of carcinogens to reduced risk in smokers and, based on these studies, we will review the marketing and positioning of the OMNI brand in order to formulate a strategy for its long-term success. OMNI has not been a commercially successful product to date, and there is a risk that we will be unable to take action to significantly increase the level of OMNI sales in the future.

Vector Tobacco introduced its low nicotine and nicotine-free QUEST cigarettes in an initial seven-state market in January 2003 and in Arizona in January 2004. During the second quarter of 2004, based on an analysis of the market data obtained since the introduction of the QUEST product, we determined to postpone indefinitely the national launch of QUEST. A national launch of the QUEST brands would require the expenditure of substantial additional sums for advertising and sales promotion, with no assurance of consumer acceptance. Low nicotine and nicotine-free cigarettes may not ultimately be accepted by adult smokers and also may not prove to be commercially successful products. Adult smokers may decide not to purchase cigarettes made with low nicotine and nicotine-free tobaccos due to taste or other preferences, or due to the use of genetically modified tobacco or other product modifications.

Recoverability of costs of inventory. At December 31, 2005, approximately \$1.2 million of our leaf inventory was associated with Vector Tobacco's QUEST product. We estimate an inventory reserve for excess quantities and obsolete items, taking into account future demand and market conditions. During the second quarter of 2004, we recognized a non-cash charge of \$37 million to adjust the carrying value of excess leaf tobacco inventory for the QUEST product, based on estimates of future demand and market conditions. If actual demand or market conditions in the future are less favorable than those estimated, additional inventory write-downs may be required.

Third party allegations that Vector Tobacco products are unlawful or bear deceptive or unsubstantiated product claims. Vector Tobacco is engaged in the development and marketing of low nicotine and nicotine-free cigarettes and the development of reduced risk cigarette products. With respect to OMNI, which is not currently being distributed by Vector Tobacco, reductions in carcinogens have not yet been proven to result in a safer cigarette. Like other cigarettes, the OMNI and QUEST products also produce tar, carbon monoxide, other harmful by-products, and, in the case of OMNI, increased levels of nitric oxide and formaldehyde. There are currently no specific governmental standards or parameters for these products and product claims. There is a risk that federal or state regulators may object to Vector Tobacco's low nicotine and nicotine-free cigarette products and reduced risk cigarette products it may develop as unlawful or allege they bear deceptive or unsubstantiated product claims, and seek the removal of the products from the marketplace, or significant changes to advertising. Various concerns regarding Vector Tobacco's advertising practices have been expressed to Vector Tobacco by certain state attorneys general. Vector Tobacco has engaged in discussions in an effort to resolve these concerns and Vector Tobacco has, in the interim, suspended all print advertising for its QUEST brand. If Vector Tobacco is unable to advertise its QUEST brand, it could have a material adverse effect on sales of QUEST. Allegations by federal or state regulators, public health organizations and other tobacco manufacturers that Vector Tobacco's products are unlawful, or that its public statements or advertising contain misleading or unsubstantiated health claims or product comparisons, may result in litigation or governmental proceedings. Vector Tobacco's defense against such claims could require it to incur substantial expense and to divert significant efforts of its scientific and marketing personnel. An adverse determination in a judicial proceeding or by a regulatory agency could have a material and adverse impact on Vector Tobacco's business, operating results and prospects.

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Potential extensive government regulation. Vector Tobacco's business may become subject to extensive additional domestic and international government regulation. Various proposals have been made for federal, state and international legislation to regulate cigarette manufacturers generally, and reduced constituent cigarettes specifically. It is possible that laws and regulations may be adopted covering matters such as the manufacture, sale, distribution and labeling of tobacco products as well as any health claims associated with reduced risk and low nicotine and nicotine-free cigarette products and the use of genetically modified tobacco. A system of regulation by agencies such as the Food and Drug Administration, the Federal Trade Commission and the United States Department of Agriculture may be established. In addition, a group of public health organizations submitted a petition to the Food and Drug Administration, alleging that the marketing of the OMNI product is subject to regulation by the Food and Drug Administration under existing law. Vector Tobacco has filed a response in opposition to the petition. The Federal Trade Commission has expressed interest in the regulation of tobacco products made by tobacco manufacturers, including Vector Tobacco, which bear reduced carcinogen claims. The outcome of any of the foregoing cannot be predicted, but any of the foregoing could have a material adverse effect on Vector Tobacco's business, operating results and prospects.

Necessity of obtaining Food and Drug Administration approval to market QUEST as a smoking cessation product. In October 2003, we announced that Jed E. Rose, Ph.D., Director of Duke University Medical Center's Nicotine Research Program and co-inventor of the nicotine patch, had conducted a study at Duke University Medical Center to provide preliminary evaluation of the use of the QUEST technology as a smoking cessation aid. We have received guidance from the Food and Drug Administration as to the additional clinical research and regulatory filings necessary to market QUEST as a smoking cessation product. We are currently conducting a multi-centered clinical trial with QUEST cigarettes, which should be completed by the end of the first quarter of 2006. We believe that obtaining the Food and Drug Administration's approval to market QUEST as a smoking cessation product will be an important factor in the long-term commercial success of the QUEST brand. No assurance can be given that such approval can be obtained or as to the timing of any such approval if received.

Competition from other cigarette manufacturers with greater resources. Vector Tobacco's competitors generally have substantially greater resources than Vector Tobacco has, including financial, marketing and personnel resources. Other major tobacco companies have stated that they are working on reduced risk cigarette products and have made publicly available at this time only limited additional information concerning their activities. Philip Morris has announced it is developing products that potentially reduce smokers' exposure to harmful compounds in cigarette smoke. RJR Tobacco has disclosed that a primary focus for its research and development activity is the development of potentially reduced exposure products, which may ultimately be recognized as products that present reduced risks to health. RJR Tobacco has stated that it continues to sell in limited distribution throughout the country a brand of cigarettes that primarily heats rather than burns tobacco, which it claims reduces the toxicity of its smoke. There is a substantial likelihood that other major tobacco companies will continue to introduce new products that are designed to compete directly with the low nicotine, nicotine-free and reduced risk products that Vector Tobacco currently markets or may develop.

Potential disputes concerning intellectual property. Vector Tobacco's ability to commercially exploit its proprietary technology for its reduced carcinogen and low nicotine and nicotine-free products depends in large part on its ability to obtain and defend issued patents, to obtain further patent protection for its existing technology in the United States and other jurisdictions, and to operate without infringing on the patents and proprietary rights of others both in the United States and abroad. Additionally, it must be able to obtain appropriate licenses to patents or proprietary rights held by third parties if infringement would otherwise occur, both in the United States and in foreign countries.

Intellectual property rights, including Vector Tobacco's patents (owned or licensed), involve complex legal and factual issues. Any conflicts resulting from third party patent applications and granted patents could significantly limit Vector Tobacco's ability to obtain meaningful patent protection or to commercialize its technology. If patents currently exist or are issued to other companies that contain claims which encompass Vector Tobacco's products or the processes used by Vector Tobacco to manufacture or develop its products,

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Vector Tobacco may be required to obtain licenses to use these patents or to develop or obtain alternative technology. Licensing agreements, if required, may not be available on acceptable terms or at all. If licenses are not obtained, Vector Tobacco could be delayed in, or prevented from, pursuing the further development or marketing of its new cigarette products. Any alternative technology, if feasible, could take several years to develop.

Litigation which could result in substantial cost also may be necessary to enforce any patents to which Vector Tobacco has rights, or to determine the scope, validity and unenforceability of other parties' proprietary rights which may affect Vector Tobacco's rights. Vector Tobacco also may have to participate in interference proceedings declared by the U.S. Patent and Trademark Office to determine the priority of an invention or in opposition proceedings in foreign countries or jurisdictions, which could result in substantial costs. There is a risk that its licensed patents would be held invalid by a court or administrative body or that an alleged infringer would not be found to be infringing. The mere uncertainty resulting from the institution and continuation of any technology-related litigation or any interference or opposition proceedings could have a material and adverse effect on Vector Tobacco's business, operating results and prospects.

Vector Tobacco may also rely on unpatented trade secrets and know-how to maintain its competitive position, which it seeks to protect, in part, by confidentiality agreements with employees, consultants, suppliers and others. There is a risk that these agreements will be breached or terminated, that Vector Tobacco will not have adequate remedies for any breach, or that its trade secrets will otherwise become known or be independently discovered by competitors.

Dependence on key scientific personnel. Vector Tobacco's business depends on the continued services of key scientific personnel for its continued development and growth. The loss of Dr. Anthony Albino, Vector Tobacco's Senior Vice President of Public Health Affairs, could have a serious negative impact upon Vector Tobacco's business, operating results and prospects.

Ability to raise capital and manage growth of business. If Vector Tobacco succeeds in introducing to market and increasing consumer acceptance for its new cigarette products, Vector Tobacco will be required to obtain significant amounts of additional capital and manage substantial volume from its customers. There is a risk that adequate amounts of additional capital will not be available to Vector Tobacco to fund the growth of its business. To accommodate growth and compete effectively, Vector Tobacco will also be required to attract, integrate, motivate and retain additional highly skilled sales, technical and other employees. Vector Tobacco will face competition for these people. Its ability to manage volume also will depend on its ability to scale up its tobacco processing, production and distribution operations. There is a risk that it will not succeed in scaling its processing, production and distribution operations and that its personnel, systems, procedures and controls will not be adequate to support its future operations.

Potential delays in obtaining tobacco, other raw materials and any technology needed to produce products. Vector Tobacco is dependent on third parties to produce tobacco and other raw materials that Vector Tobacco requires to manufacture its products. In addition, the growing of new tobacco and new seeds is subject to adverse weather conditions. Vector Tobacco may also need to obtain licenses to technology subject to patents or proprietary rights of third parties to produce its products. The failure by such third parties to supply Vector Tobacco with tobacco, other raw materials and technology on commercially reasonable terms, or at all, in the absence of readily available alternative sources, would have a serious negative impact on Vector Tobacco's business, operating results and prospects. There is also a risk that interruptions in the supply of these materials and technology may occur in the future. Any interruption in their supply could have a serious negative impact on Vector Tobacco.

The actual costs and savings associated with restructurings of our tobacco business may differ materially from amounts we estimate.

In recent years, we have undertaken a number of initiatives to streamline the cost structure of our tobacco business and improve operating efficiency and long-term earnings. For example, during 2002, the sales, marketing and support functions of our Liggett and Vector Tobacco subsidiaries were combined. Effective year-end 2003, we closed Vector Tobacco's Timberlake, North Carolina manufacturing facility and moved all

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production to Liggett's facility in Mebane, North Carolina. In April 2004, we eliminated a number of positions in our tobacco operations and subleased excess office space. In October 2004, we announced a plan to restructure the operations of Liggett Vector Brands, effective December 15, 2004. We may consider various additional opportunities to further improve efficiencies and reduce costs. These prior and current initiatives have involved material restructuring and impairment charges, and any future actions taken are likely to involve material charges as well. These restructuring charges are based on our best estimate at the time of restructuring. The status of the restructuring activities is reviewed on a quarterly basis and any adjustments to the reserve, which could differ materially from previous estimates, are recorded as an adjustment to operating income. Although we may estimate that substantial cost savings will be associated with these restructuring actions, there is a risk that these actions could have a serious negative impact on our tobacco business and that any estimated increases in profitability cannot be achieved.

New Valley is subject to risks relating to the industries in which it operates.

Risks of real estate ventures. New Valley has three significant investments, Douglas Elliman Realty, LLC, the Sheraton Keauhou Bay Resort & Spa (which reopened in the fourth quarter 2004) and the St. Regis Hotel in Washington, D. C. (since August 2005), in each of which it holds only a 50% interest. New Valley must seek approval from other parties for important actions regarding these joint ventures. Since these other parties' interests may differ from those of New Valley, a deadlock could arise that might impair the ability of the ventures to function. Such a deadlock could significantly harm the ventures.

New Valley may pursue a variety of real estate development projects. Development projects are subject to special risks including potential increase in costs, changes in market demand, inability to meet deadlines which may delay the timely completion of projects, reliance on contractors who may be unable to perform and the need to obtain various governmental and third party consents.

Risks relating to the residential brokerage business. Through New Valley's investment in Douglas Elliman Realty, LLC, we are subject to the risks and uncertainties endemic to the residential brokerage business. Both Douglas Elliman and Prudential Douglas Elliman Real Estate operate as franchisees of The Prudential Real Estate Affiliates, Inc. Prudential Douglas Elliman operates each of its offices under its franchiser's brand name, but generally does not own any of the brand names under which it operates. The franchiser has significant rights over the use of the franchised service marks and the conduct of the two brokerage companies' business. The franchise agreements require the companies to:

coordinate with the franchiser on significant matters relating to their operations, including the opening and closing of offices;

make substantial royalty payments to the franchiser and contribute significant amounts to national advertising funds maintained by the franchiser;

indemnify the franchiser against losses arising out of the operations of their business under the franchise agreements; and

maintain standards and comply with guidelines relating to their operations which are applicable to all franchisees of the franchiser's real estate franchise system.

The franchiser has the right to terminate Douglas Elliman's and Prudential Douglas Elliman Real Estate's franchises, upon the occurrence of certain events, including a bankruptcy or insolvency event, a change in control, a transfer of rights under the franchise agreement and a failure to promptly pay amounts due under the franchise agreements. A termination of Douglas Elliman's or Prudential Douglas Elliman Real Estate's franchise agreement could adversely affect our investment in Douglas Elliman Realty.

The franchise agreements grant Douglas Elliman and Prudential Douglas Elliman Real Estate exclusive franchises in New York for the counties of Nassau and Suffolk on Long Island and for Manhattan, Brooklyn and Queens, subject to various exceptions and to meeting specified annual revenue thresholds. If the two companies fail to achieve these levels of revenues for two consecutive years or otherwise materially breach the

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franchise agreements, the franchisor would have the right to terminate their exclusivity rights. A loss of these rights could have a material adverse on Douglas Elliman Realty.

Interest rates in the United States are currently at historically low levels. The low interest rate environment in recent years has significantly contributed to high levels of existing home sales and residential prices and has positively impacted Douglas Elliman Realty's operating results. However, the residential real estate market tends to be cyclical and typically is affected by changes in the general economic conditions that are beyond Douglas Elliman Realty's control. Any of the following could have a material adverse effect on Douglas Elliman Realty's residential business by causing a general decline in the number of home sales and/or prices, which in turn, could adversely affect its revenues and profitability:

periods of economic slowdown or recession,

a change in the current low interest rate environment resulting in rising interest rates,

decreasing home ownership rates, or

declining demand for real estate.

All of Douglas Elliman Realty's current operations are located in the New York metropolitan area. Local and regional economic conditions in this market could differ materially from prevailing conditions in other parts of the country. A downturn in the residential real estate market or economic conditions in that region could have a material adverse effect on Douglas Elliman Realty and our investment in that company.

Potential new investments we may make are unidentified and may not succeed.

We currently hold a significant amount of marketable securities and cash not committed to any specific investments. This subjects a security holder to increased risk and uncertainty because a security holder will not be able to evaluate how this cash will be invested and the economic merits of particular investments. There may be substantial delay in locating suitable investment opportunities. In addition, we may lack relevant management experience in the areas in which we may invest. There is a risk that we will fail in targeting, consummating or effectively integrating or managing any of these investments.

We depend on our key personnel.

We depend on the efforts of our executive officers and other key personnel. While we believe that we could find replacements for these key personnel, the loss of their services could have a significant adverse effect on our operations.

While we believe our controls systems are effective, there are inherent limitations in all control systems, and misstatements due to error or fraud may occur and not be detected.

We continue to take action to assure compliance with the internal controls, disclosure controls and other requirements of the Sarbanes-Oxley Act. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. In addition, the design of a control system must reflect the fact that there are resource constraints and the benefit of controls must be relative to their costs. Because of the inherent limitations in all control systems, no system of controls can provide absolute assurance that all controls issues and instances of fraud, if any, within our company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Further, controls can be circumvented by individual acts of some persons, by collusion of two or more persons, or by management override of the controls. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, a control may be inadequate because of changes in conditions or the degree of compliance with the policies or procedures may deteriorate. Because of inherent

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limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

The price of our common stock may fluctuate significantly, and this may make it difficult for you to resell the shares of our common stock issuable upon exchange when you want or at prices you find attractive.

The trading price of our common stock has ranged between \$14.29 and \$20.82 per share over the past 52 weeks. We expect that the market price of our common stock will continue to fluctuate.

The market price of our common stock may fluctuate in response to numerous factors, many of which are beyond our control. These factors include the following:

actual or anticipated fluctuations in our operating results;

changes in expectations as to our future financial performance, including financial estimates by securities analysts and investors;

the operating and stock performance of our competitors;

announcements by us or our competitors of new products or services or significant contract, acquisitions, strategic partnerships, joint ventures or capital commitments;

the initiation or outcome of litigation;

changes in interest rates;

general economic, market and political conditions;

additions or departures of key personnel; and

future sales of our equity or convertible securities.

We cannot predict the extent, if any, to which future sales of shares of common stock or the availability of shares of common stock for future sale may depress the trading price of our common stock.

In addition, the stock market in recent years has experienced extreme price and trading volume fluctuations that often have been unrelated or disproportionate to the operating performance of individual companies. These broad market fluctuations may adversely affect the price of our common stock, regardless of our operating performance. Furthermore, stockholders may initiate securities class action lawsuits if the market price of our stock drops significantly, which may cause us to incur substantial costs and could divert the time and attention of our management. These factors, among others, could significantly depress the price of our common stock issued upon exchange.

We have many potentially dilutive securities outstanding.

At December 31, 2005, we had outstanding options granted to employees to purchase approximately 8,567,174 shares of our common stock, at prices ranging from \$6.93 to \$35.81 per share, of which options for 8,426,597 shares were exercisable at December 31, 2005. We also have outstanding two series of convertible notes maturing in July 2008 and November 2011, which are currently convertible into 12,153,247 shares of our common stock. The issuance of these shares will cause dilution which may adversely affect the market price of our common stock. The availability for sale of significant quantities of our common stock could adversely affect the prevailing market price of the stock.

Item *Unresolved Staff Comments*

1B.

None.

Table of Contents**Item 2. *Properties***

Our principal executive offices are located in Miami, Florida. We lease 13,849 square feet of office space from an unaffiliated company in an office building in Miami, which we share with various of our subsidiaries. The lease expires in November 2009.

We lease approximately 18,000 square feet of office space in New York, New York under leases that expire in 2013. Approximately 9,000 square feet of such space has been subleased to third parties for the balance of the term of the lease. New Valley's operating properties are discussed above under the description of New Valley's business.

Substantially all of Liggett's tobacco manufacturing facilities, consisting principally of factories and distribution and storage facilities, are currently located in or near Mebane, North Carolina. Various of such facilities are owned and others are leased. As of December 31, 2005, the principal properties owned or leased by Liggett are as follows:

Type	Location	Owned or Leased	Approximate Total Square Footage
Warehouse	Durham, NC	Leased	128,000
Storage Facilities	Danville, VA	Owned	578,000
Office and Manufacturing Complex	Mebane, NC	Owned	240,000
Warehouse	Mebane, NC	Owned	60,000
Warehouse	Mebane, NC	Leased	50,000
Warehouse	Mebane, NC	Leased	30,000

In December 2005, Liggett completed the sale for \$15.45 million of its former manufacturing plant, research facility and offices located in Durham, North Carolina. Vector Research Ltd. continues to lease through December 15, 2006 approximately 5% of the research facility and offices from the purchaser.

In November 1999, 100 Maple LLC, a newly formed entity owned by Liggett, purchased an approximately 240,000 square foot manufacturing facility located on 42 acres in Mebane, North Carolina. In October 2000, Liggett completed a 60,000 square foot warehouse addition at the Mebane facility, and finished the relocation of its tobacco manufacturing operations to Mebane. Liggett also leases two smaller warehouses in Mebane.

In June 2001, a subsidiary of Vector Tobacco purchased an approximately 350,000 square foot manufacturing facility located on approximately 56 acres in Timberlake, North Carolina. In the first quarter of 2002, Vector Tobacco began production at the facility. As of January 1, 2004, the Timberlake facility was closed, and production of Vector Tobacco's brands moved to Liggett's Mebane facility. In July 2004, the sale of the Timberlake property and equipment closed.

Liggett Vector Brands leases approximately 24,000 square feet of office space in Research Triangle Park, North Carolina. The lease expires in October 2007.

Liggett's management believes that its property, plant and equipment are well maintained and in good condition and that its existing facilities are sufficient to accommodate a substantial increase in production.

Item 3. *Legal Proceedings*

Liggett and other United States cigarette manufacturers have been named as defendants in numerous, direct, third-party and class actions predicated on the theory that they should be liable for damages from adverse health effects alleged to have been caused by cigarette smoking or by exposure to secondary smoke from cigarettes. See Item 1. Business - Liggett Group Inc. Legislation, Regulation and Litigation. Reference is made to Note 13 to our consolidated financial statements, which contains a general description of certain legal proceedings to which Liggett, New Valley or their subsidiaries are a party and certain related matters. Reference is also made to Exhibit 99.1, Material Legal Proceedings, incorporated herein, for additional information regarding the pending smoking-related material legal proceedings to which Liggett is a

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party. A copy of Exhibit 99.1 will be furnished without charge upon written request to us at our principal executive offices, 100 S.E. Second Street, Miami, Florida 33131, Attn: Investor Relations.

Item 4. Submission of Matters to a Vote of Security Holders

We held a special meeting of stockholders on December 8, 2005. There were 44,671,417 shares of our common stock entitled to be voted on the October 25, 2005 record date for the meeting. The matter submitted to our stockholders for a vote at the special meeting was to approve the issuance of shares of our common stock pursuant to our exchange offer for all the common shares of New Valley, not currently owned by us, and the subsequent merger. The votes cast were as follows:

For	Against	Abstain
32,694,429	304,241	67,555

Based on these voting results, the issuance of the shares was approved.

EXECUTIVE OFFICERS OF THE REGISTRANT

The table below, together with the accompanying text, presents certain information regarding all our current executive officers as of March 16, 2006. Each of the executive officers serves until the election and qualification of such individual's successor or until such individual's death, resignation or removal by the Board of Directors.

Name	Age	Position	Year Individual Became an Executive Officer
Bennett S. LeBow	68	Executive Chairman	1990
Howard M. Lorber	57	President and Chief Executive Officer	2001
Richard J. Lampen	52	Executive Vice President	1996
Joselynn D. Van Siclen	65	Vice President, Chief Financial Officer and Treasurer	1996
Marc N. Bell	45	Vice President, General Counsel and Secretary	1998
Ronald J. Bernstein	52	President and Chief Executive Officer of Liggett	2000

Bennett S. LeBow has been our Executive Chairman since January 2006. He served as our Chairman and Chief Executive Officer from June 1990 to December 31, 2005 and has been a director of ours since October 1986. Mr. LeBow has served as President and Chief Executive Officer of Vector Tobacco since January 2001 and as a director since October 1999. Mr. LeBow was Chairman of the Board of New Valley from January 1988 to December 2005 and served as its Chief Executive Officer from November 1994 to December 2005.

Howard M. Lorber has been our President and Chief Executive Officer since January 2006. He served as our President and Chief Operating Officer from January 2001 to December 2005 and has served as a director of ours since January 2001. From November 1994 to December 2005, Mr. Lorber served as President and Chief Operating Officer of New Valley, where he also served as a director. Mr. Lorber was Chairman of the Board of Hallman & Lorber Assoc., Inc., consultants and actuaries of qualified pension and profit sharing plans, and various of its affiliates from 1975 to December 2004 and has been a consultant to these entities since January 2005; a stockholder and a registered representative of Aegis Capital Corp., a broker-dealer and a member firm of the National Association of Securities Dealers, since 1984; Chairman of the Board of Directors since 1987 and Chief Executive Officer since November

1993 of Nathan's Famous, Inc., a chain of fast food restaurants; a consultant to us and Liggett from January 1994 to January 2001; a director of United Capital Corp., a real estate investment and diversified manufacturing company, since May 1991; and

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Chairman of the Board of Ladenburg Thalmann Financial Services since May 2001. He is also a trustee of Long Island University.

Richard J. Lampen has served as our Executive Vice President since July 1996. From October 1995 to December 2005, Mr. Lampen served as the Executive Vice President and General Counsel of New Valley, where he also served as a director. Since November 1998, he has served as President and Chief Executive Officer of CDSI Holdings Inc., an affiliate of New Valley with an interest in a direct mail and telemarketing services company. From May 1992 to September 1995, Mr. Lampen was a partner at Steel Hector & Davis, a law firm located in Miami, Florida. From January 1991 to April 1992, Mr. Lampen was a Managing Director at Salomon Brothers Inc, an investment bank, and was an employee at Salomon Brothers Inc from 1986 to April 1992. Mr. Lampen is a director of CDSI Holdings and Ladenburg Thalmann Financial Services. Mr. Lampen has served as a director of a number of other companies, including U.S. Can Corporation, The International Bank of Miami, N.A. and Specs Music Inc., as well as a court-appointed independent director of Trump Plaza Funding, Inc.

Joselynn D. Van Siclén has been our Vice President, Chief Financial Officer and Treasurer since May 1996, and currently holds various positions with our subsidiaries. Prior to May 1996, Ms. Van Siclén served as our Director of Finance and was employed in various accounting capacities with our subsidiaries since 1992. Since before 1990 to November 1992, Ms. Van Siclén was an audit manager for the accounting firm of Coopers & Lybrand L.L.P. Ms. Van Siclén will retire as our Chief Financial Officer effective April 1, 2006 and as an employee of ours on or before June 30, 2006.

Marc N. Bell has been a Vice President of ours since January 1998, our General Counsel and Secretary since May 1994 and the Senior Vice President and General Counsel of Vector Tobacco since April 2002. From November 1994 to December 2005, Mr. Bell served as Associate General Counsel and Secretary of New Valley and from February 1998 to December 2005, as a Vice President of New Valley. Prior to May 1994, Mr. Bell was with the law firm of Zuckerman Spaeder LLP in Miami, Florida and from June 1991 to May 1993, with the law firm of Fischbein Badillo Wagner Harding in New York, New York.

Ronald J. Bernstein has served as President and Chief Executive Officer of Liggett since September 1, 2000 and of Liggett Vector Brands since March 2002 and has been a director of ours since March 2004. From July 1996 to December 1999, Mr. Bernstein served as General Director and, from December 1999 to September 2000, as Chairman of Liggett-Ducat, our former Russian tobacco business sold in 2000. Prior to that time, Mr. Bernstein served in various positions with Liggett commencing in 1991, including Executive Vice President and Chief Financial Officer.

J. Bryant Kirkland III will become our Chief Financial Officer effective April 1, 2006, upon the retirement of Ms. Van Siclén. Mr. Kirkland, 40, has served as a Vice President of ours since January 2001 and served as New Valley's Vice President and Chief Financial Officer from January 1998 to December 2005. He has served since November 1994 in various financial capacities with us and New Valley. Mr. Kirkland has served as Vice President and Chief Financial Officer of CDSI Holdings Inc. since January 1998 and as a director of CDSI Holdings Inc. since November 1998.

Table of Contents**PART II****Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

Our common stock is listed and traded on the New York Stock Exchange under the symbol VGR. The following table sets forth, for the periods indicated, high and low sale prices for a share of its common stock on the NYSE, as reported by the NYSE, and quarterly cash dividends declared on shares of common stock:

Year	High	Low	Cash Dividends
2005:			
Fourth Quarter	\$ 20.82	\$ 17.94	\$.40
Third Quarter	20.27	17.01	.38
Second Quarter	18.78	14.29	.38
First Quarter	16.01	14.62	.38
2004:			
Fourth Quarter	\$ 15.95	\$ 14.02	\$.38
Third Quarter	15.80	13.49	.36
Second Quarter	15.56	13.07	.36
First Quarter	16.39	14.52	.36

At March 10, 2006, there were approximately 1,600 holders of record of our common stock.

The declaration of future cash dividends is within the discretion of our Board of Directors and is subject to a variety of contingencies such as market conditions, earnings and our financial condition as well as the availability of cash.

Liggett's revolving credit agreement currently prohibits Liggett from paying dividends to VGR Holding unless Liggett's borrowing availability exceeds \$5 million for the thirty days prior to payment of the dividend, and immediately after giving effect to the dividend, and it is in compliance with the covenants in the credit facility, including an adjusted net worth and working capital requirement.

We paid 5% stock dividends on September 29, 2003, September 29, 2004 and September 29, 2005 to the holders of our common stock. All information presented in this report is adjusted for the stock dividends.

A special dividend of 0.23 of a share of Ladenburg Thalmann Financial Services Inc. common stock was paid on each share of our common stock on March 30, 2005.

Issuer Purchases of Equity Securities

No securities of ours were repurchased by us or our affiliated purchasers during the fourth quarter of 2005.

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	2005	2004	2003	2002	2001
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(dollars in thousands, except per share amounts)

Statement of Operations Data:

Revenues(1),(3)	\$ 478,427	\$ 498,860	\$ 529,385	\$ 503,078	\$ 447,382
Income (loss) from continuing operations	38,198	4,039	(16,132)	(31,819)	21,200
Income (loss) from discontinued operations	3,034	2,689	522	25	(537)
Extraordinary item	7,850				
Net income (loss)	49,082	6,728	(15,610)	(31,794)	20,663

Per basic common share(2):

Income (loss) from continuing operations	\$ 0.86	\$ 0.09	\$ (0.38)	\$ 0.79	\$ 0.59
Income (loss) from discontinued operations	\$ 0.07	\$ 0.06	\$ 0.01		\$ (0.01)
Income from extraordinary item	\$ 0.18				
Net income (loss) applicable to common shares	\$ 1.11	\$ 0.15	\$ (0.37)	\$ 0.79	\$ 0.58

Per diluted common share(2):

Income (loss) from continuing operations	\$ 0.82	\$ 0.09	\$ (0.38)	\$ 0.79	\$ 0.49
Income (loss) from discontinued operations	\$ 0.07	\$ 0.06	\$ 0.01		\$ (0.01)
Income from extraordinary items	\$ 0.17				
Net income (loss) applicable to common shares	\$ 1.06	\$ 0.15	\$ (0.37)	\$ 0.79	\$ 0.48

Cash distributions declared per common share(2)	\$ 1.54	\$ 1.47	\$ 1.40	\$ 1.33	\$ 1.27
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Balance Sheet Data:

Current assets	\$ 319,099	\$ 242,124	\$ 314,741	\$ 376,815	\$ 515,727
Total assets	603,130	535,895	628,212	707,270	688,903
Current liabilities	128,100	119,835	173,086	184,384	141,629
Notes payable, embedded derivatives, long-term debt and other obligations, less current portion	282,961	280,289	299,977	307,028	225,415
Noncurrent employee benefits, deferred income taxes, minority interests and other long-term liabilities	158,666	220,574	201,624	193,561	208,501
Stockholders' equity (deficit)	33,403	(84,803)	(46,475)	22,297	113,358

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- (1) Revenues include excise taxes of \$161,753, \$175,674, \$195,342, \$192,664 and \$151,174, respectively.
- (2) Per share computations include the impact of 5% stock dividends on September 29, 2005, September 29, 2004, September 29, 2003, September 27, 2002 and September 28, 2001.
- (3) Revenues in 2002 include \$35,199 related to the Medallion acquisition.

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Item 7. *Management's Discussion and Analysis of Financial Condition and Results of Operations*
(Dollars in Thousands, Except Per Share Amounts)

Overview

We are a holding company for a number of businesses. We are engaged principally in:
the manufacture and sale of cigarettes in the United States through our subsidiary Liggett Group Inc.,

the development and marketing of the low nicotine and nicotine-free QUEST cigarette products and the development of reduced risk cigarette products through our subsidiary Vector Tobacco Inc., and

the real estate business through our subsidiary, New Valley LLC, which is seeking to acquire additional operating companies and real estate properties. New Valley owns 50% of Douglas Elliman Realty, LLC, which operates the largest residential brokerage company in the New York metropolitan area.

In recent years, we have undertaken a number of initiatives to streamline the cost structure of our tobacco business and improve operating efficiency and long-term earnings. During 2002, the sales and marketing functions, along with certain support functions, of our Liggett and Vector Tobacco subsidiaries were combined into a new entity, Liggett Vector Brands Inc. This company coordinates and executes the sales and marketing efforts for our tobacco operations.

Effective year-end 2003, we closed Vector Tobacco's Timberlake, North Carolina cigarette manufacturing facility in order to reduce excess cigarette production capacity and improve operating efficiencies company-wide. Production of QUEST and Vector Tobacco's other cigarette brands was transferred to Liggett's state-of-the-art manufacturing facility in Mebane, North Carolina. In July 2004, we completed the sale of the Timberlake facility and equipment.

In April 2004, we eliminated a number of positions in our tobacco operations and subleased excess office space. In October 2004, we announced a plan to restructure the operations of Liggett Vector Brands. Liggett Vector Brands has realigned its sales force and adjusted its business model to more efficiently serve its chain and independent customers nationwide. In connection with the restructuring, we eliminated approximately 330 full-time positions and 135 part-time positions as of December 15, 2004.

We may consider various additional opportunities to further improve efficiencies and reduce costs. These prior and current initiatives have involved material restructuring and impairment charges, and any further actions taken are likely to involve material charges as well. Although management may estimate that substantial cost savings will be associated with these restructuring actions, there is a risk that these actions could have a serious negative impact on our tobacco operations and that any estimated increases in profitability cannot be achieved.

In December 2005, we completed an exchange offer and a subsequent short-form merger whereby we acquired the remaining 42.3% of the common shares of New Valley that we did not already own. As a result of these transactions, New Valley became our wholly-owned subsidiary and each outstanding New Valley common share was exchanged for 0.54 shares of our common stock. A total of approximately 5.05 million of our common shares were issued to the New Valley shareholders in the transactions.

All of Liggett's unit sales volume in 2004 and 2005 was in the discount segment, which Liggett's management believes has been the primary growth segment in the industry for over a decade. The significant discounting of premium cigarettes in recent years has led to brands, such as EVE, that were traditionally considered premium brands to become more appropriately categorized as discount, following list price reductions. Effective February 1, 2004, Liggett reduced the EVE list price from the premium price level to the branded discount level.

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Liggett's cigarettes are produced in approximately 270 combinations of length, style and packaging. Liggett's current brand portfolio includes:

LIGGETT SELECT the third largest brand in the deep discount category,

GRAND PRIX the fastest growing brand in the deep discount segment,

EVE a leading brand of 120 millimeter cigarettes in the branded discount category,

PYRAMID the industry's first deep discount product with a brand identity, and

USA and various Partner Brands and private label brands.

In 1999, Liggett introduced LIGGETT SELECT, one of the leading brands in the deep discount category. LIGGETT SELECT is now the largest seller in Liggett's family of brands, comprising 44.6% of Liggett's unit volume in 2005, 55.8% in 2004 and 50.9% in 2003. In September 2005, Liggett repositioned GRAND PRIX to distributors and retailers nationwide. GRAND PRIX is marketed as the lowest price fighter to specifically compete with brands which are priced at the lowest level of the deep discount segment.

We believe that Liggett has gained a sustainable cost advantage over its competitors through its various settlement agreements. Under the Master Settlement Agreement reached in November 1998 with 46 states and various territories, the three largest cigarette manufacturers must make settlement payments to the states and territories based on how many cigarettes they sell annually. Liggett, however, is not required to make any payments unless its market share exceeds approximately 1.65% of the U.S. cigarette market. Additionally, as a result of the Medallion acquisition, Vector Tobacco likewise has no payment obligation unless its market share exceeds approximately 0.28% of the U.S. market.

The discount segment is highly competitive, with consumers having less brand loyalty and placing greater emphasis on price. While the three major manufacturers all compete with Liggett in the discount segment of the market, the strongest competition for market share has recently come from a group of small manufacturers and importers, most of which sell low quality, deep discount cigarettes.

In January 2003, Vector Tobacco introduced QUEST, its brand of low nicotine and nicotine-free cigarette products. QUEST is designed for adult smokers who are interested in reducing their levels of nicotine intake and is available in both menthol and non-menthol styles. Each QUEST style (regular and menthol) offers three different packagings, with decreasing amounts of nicotine QUEST 1, 2 and 3. QUEST 1, the low nicotine variety, contains 0.6 milligrams of nicotine. QUEST 2, the extra-low nicotine variety, contains 0.3 milligrams of nicotine. QUEST 3, the nicotine-free variety, contains only trace levels of nicotine no more than 0.05 milligrams of nicotine per cigarette. QUEST cigarettes utilize proprietary, patented and patent pending processes and materials that enables the production of cigarettes with nicotine-free tobacco that tastes and smokes like tobacco in conventional cigarettes. All six QUEST varieties are being sold in box style packs and are priced comparably to other premium brands.

QUEST was initially available in New York, New Jersey, Pennsylvania, Ohio, Indiana, Illinois and Michigan. These seven states account for approximately 30% of all cigarette sales in the United States. A multi-million dollar advertising and marketing campaign, with advertisements running in magazines and regional newspapers, supported the product launch. The brand continues to be supported by point-of-purchase awareness campaigns.

The premium segment of the industry continues to experience intense competitive activity, with significant discounting of premium brands at all levels of retail. Given these marketplace conditions, and the results that we have seen to date with QUEST, we have taken a measured approach to expanding the market presence of the brand. In November 2003, Vector Tobacco introduced three menthol varieties of QUEST in the seven state market. In January 2004, QUEST and QUEST Menthol were introduced into an expansion market in Arizona, which accounts for approximately 2% of the industry volume nationwide.

During the second quarter 2004, based on an analysis of the market data obtained since the introduction of the QUEST product, we determined to postpone indefinitely the national launch of QUEST. Any determination as to

future expansion of the market presence of QUEST will be based on the ongoing and

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projected demand for the product, market conditions in the premium segment and the prevailing regulatory environment, including any restrictions on the advertising of the product.

During the second quarter 2004, we recognized a non-cash charge of \$37,000 to adjust the carrying value of excess leaf tobacco inventory for the QUEST product, based on estimates of future demand and market conditions. If actual demand for the product or market conditions are less favorable than those estimated, additional inventory write-downs may be required.

QUEST brand cigarettes are currently marketed solely to permit adult smokers, who wish to continue smoking, to gradually reduce their intake of nicotine. The products are not labeled or advertised for smoking cessation or as a safer form of smoking.

In October 2003, we announced that Jed E. Rose, Ph.D., Director of Duke University Medical Center's Nicotine Research Program and co-inventor of the nicotine patch, had conducted a study at Duke University Medical Center to provide preliminary evaluation of the use of the QUEST technology as a smoking cessation aid. In the preliminary study on QUEST, 33% of QUEST 3 smokers were able to achieve four-week continuous abstinence, a standard threshold for smoking cessation. Management believes these results show real promise for the QUEST technology as a smoking cessation aid. We have received guidance from the Food and Drug Administration as to the additional clinical research and regulatory filings necessary to market QUEST as a smoking cessation product. We are currently conducting a multi-centered clinical trial with QUEST cigarettes, which should be completed by the end of the first quarter of 2006. Management believes that obtaining the Food and Drug Administration's approval to market QUEST as a smoking cessation product will be an important factor in the long-term commercial success of the QUEST brand. No assurance can be given that such approval can be obtained or as to the timing of any such approval if received.

Recent Developments

New Valley Exchange Offer. In December 2005, we completed an exchange offer and subsequent short-form merger whereby we acquired the remaining 42.3% of the common shares of New Valley Corporation that we did not already own. As result of these transactions, New Valley Corporation became our wholly-owned subsidiary and each outstanding New Valley Corporation common share was exchanged for 0.54 shares of our common stock. A total of approximately 5.05 million of our common shares were issued to the New Valley Corporation shareholders in the transactions. The surviving corporation in the short-form merger was subsequently merged into a new Delaware limited liability company named New Valley LLC, which conducts the business of the former New Valley Corporation. Prior to these transactions, New Valley Corporation was registered under the Securities Exchange Act of 1934 and filed periodic reports and other information with the SEC.

On or about September 29, 2005, an individual stockholder of New Valley filed a complaint in the Delaware Court of Chancery purporting to commence a class action lawsuit against us, New Valley and each of the individual directors of New Valley. The complaint was styled as *Pill v. New Valley Corporation, et al.* (C.A. No. 1678-N). A similar action was also filed in state court in Miami-Dade County, Florida, on September 29, 2005 by another individual stockholder of New Valley. This action has been stayed, pending final resolution of the *Pill* action, by agreement of the parties. On or about October 28, 2005, a separate action was filed in the Delaware Court of Chancery purporting to commence a class action lawsuit against us, New Valley and each of the individual directors of New Valley. The complaint was styled as *Lindstrom v. LeBow, et al.* (Civil Action No. 1745-N). On November 9, 2005, the Delaware Court of Chancery entered an order of consolidation providing that the *Pill* action and the *Lindstrom* action be consolidated for all purposes. On November 15, 2005, the Delaware Chancery Court entered an order certifying the *Pill* action as a class action comprised of all persons who owned common shares of New Valley on October 20, 2005.

On November 16, 2005, we and the plaintiff class in the *Pill* action reached an agreement in principle to settle the litigation, which was memorialized in a memorandum of understanding entered into on November 22, 2005. The memorandum of understanding provided, among other things, that (i) the consideration being offered be raised from 0.461 shares of our common stock per common share of New Valley to 0.54 shares of our common stock per common share of New Valley; (ii) the plaintiff acknowledged that

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0.54 shares of our common stock per common share of New Valley was adequate and fair consideration; (iii) we agreed to make supplemental disclosures in the Prospectus with respect to the offer to address claims raised in the *Pill* action; (iv) the plaintiff shall have the right to comment upon and suggest additional disclosures to be made to the public stockholders by New Valley prior to the filing of its amended Schedule 14D-9 with the SEC and such suggested additional disclosures will be considered in good faith for inclusion in such filing by New Valley; and (v) all claims, whether known or unknown, of the plaintiff shall be released as against all of the defendants in the *Pill* matter and the *Lindstrom* matter. On January 20, 2006, the parties executed a Stipulation of Settlement providing for, among other things, payment by us of up to \$860 in legal fees and costs. A hearing on the settlement, which is subject to court approval, is scheduled for April 10, 2006. We recorded a charge to operating, selling, administrative and general expense for 2005 of \$860 related to the settlement.

Sale of Durham Real Estate. In December 2005, Liggett completed the sale for \$15,450 of its former manufacturing plant, research facility and offices located in Durham, North Carolina. We recorded a gain of \$7,706, net of income taxes of \$5,042, in 2005 in connection with the sale.

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

Ladenburg Distribution. In March 2005, New Valley converted a convertible note of Ladenburg Thalmann Financial Services Inc. into 19,876,358 shares of Ladenburg common stock and purchased 11,111,111 Ladenburg shares for \$5,000. In the first quarter 2005, New Valley recorded a gain of \$9,461 which represented the fair value of the converted shares as determined by an independent appraisal firm. On March 30, 2005, New Valley distributed the 19,876,358 shares of Ladenburg common stock it acquired from the conversion of the note to holders of New Valley common shares through a special distribution. On the same date, we distributed the 10,947,448 shares of Ladenburg common stock that we received from New Valley to the holders of our common stock as a special distribution. New Valley stockholders of record on March 18, 2005 received 0.852 of a Ladenburg share for each share of New Valley, and our stockholders of record on that date received 0.23 of a Ladenburg share for each share of ours.

Lawsuit Settlement. In March 2005, we, along with New Valley and its directors, settled a stockholder derivative suit that alleged, among other things, that New Valley paid excessive consideration to purchase our BrookeMil Ltd. subsidiary in 1997. For additional information concerning the suit, see Note 13 to our consolidated financial statements. The defendants did not admit any wrongdoing as part of the settlement, which was approved by the court in June 2005. Under the agreement, we paid New Valley \$7,000 in July 2005, and New Valley paid legal fees and expenses of \$2,150. We recorded a charge to operating, selling, administrative and general expense in 2004 of \$4,177 (net of minority interests) related to the settlement.

Tobacco Quota Elimination. In October 2004, federal legislation was enacted which abolished the federal tobacco quota and price support program. Pursuant to the legislation, manufacturers of tobacco products will be assessed \$10,140,000 over a ten year period to compensate tobacco growers and quota holders for the elimination of their quota rights. Cigarette manufacturers will initially be responsible for 96.3% of the assessment (subject to adjustment in the future), which will be allocated based on relative unit volume of domestic cigarette shipments. Management currently estimates that Liggett's assessment will be approximately \$25,000 for the first year of the program which began January 1, 2005, including a special federal quota stock liquidation assessment of \$5,219. The cost of the legislation to the three largest cigarette manufacturers will likely be less than the cost to smaller manufacturers, including Liggett and Vector Tobacco, because one

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effect of the legislation is that the three largest manufacturers will no longer be obligated to make certain contractual payments, commonly known as Phase II payments, they agreed in 1999 to make to tobacco-producing states. The ultimate impact of this legislation cannot be determined, but there is a risk that smaller manufacturers, such as Liggett and Vector Tobacco, will be disproportionately affected by the legislation, which could have a material adverse effect on us.

Effective October 22, 2004, Liggett increased the list price of all its brands by \$.65 per carton. The increase was taken due to the federal tobacco buyout legislation.

Liggett Vector Brands Restructurings. Liggett Vector Brands, as part of the continuing effort to adjust the cost structure of our tobacco business and improve operating efficiency, eliminated 83 positions during April 2004, sublet its New York office space and relocated several employees. As a result of these actions, we recognized pre-tax restructuring charges of \$2,735 in 2004, including \$798 relating to employee severance and benefit costs and \$1,937 for contract termination and other associated costs. Approximately \$503 of these charges represent non-cash items.

On October 6, 2004, we announced an additional plan to restructure the operations of Liggett Vector Brands, our sales, marketing and distribution agent for our Liggett and Vector Tobacco subsidiaries. Liggett Vector Brands has realigned its sales force and adjusted its business model to more efficiently serve its chain and independent accounts nationwide. In connection with the restructuring, we eliminated approximately 330 full-time positions and 135 part-time positions as of December 15, 2004.

As a result of the actions announced in October 2004, we realized annual cost savings of approximately \$30,000 beginning in 2005. Expenses at Liggett, excluding the accrual for disputed settlement payments in 2005 and product liability legal expenses and other litigation costs, were \$49,415 for 2005, compared to \$78,954 for 2004, a decrease of \$29,539 primarily attributable to the restructuring announced in October 2004. We recognized pre-tax restructuring charges of \$10,583 in 2004, with \$5,659 of the charges related to employee severance and benefit costs and \$4,924 to contract termination and other associated costs. Approximately \$2,503 of these charges represented non-cash items. Additionally, we incurred other charges in 2004 for various compensation and related payments to employees which were related to the restructuring. These charges of \$1,670 were included in operating, selling, administrative and general expenses.

Timberlake Restructuring. In October 2003, we announced that we would close Vector Tobacco's Timberlake, North Carolina cigarette manufacturing facility in order to reduce excess cigarette production capacity and improve operating efficiencies company-wide. Production of the QUEST line of low nicotine and nicotine-free cigarettes, as well as production of Vector Tobacco's other cigarette brands, was moved to Liggett's state-of-the-art manufacturing facility in Mebane, North Carolina.

As a result of these actions, we recognized pre-tax restructuring and impairment charges of \$21,696, of which \$21,300 was recognized in 2003 and the remaining \$396 was recognized in 2004. Machinery and equipment to be disposed of was reduced to estimated fair value less costs to sell during 2003.

We decreased the asset impairment accrual as of June 30, 2004 to reflect the actual amounts realized from the sale of the Timberlake facility and to reduce the values of other excess Vector Tobacco machinery and equipment in accordance with SFAS No. 144. We further adjusted the previously recorded restructuring accrual as of June 30, 2004 to reflect additional employee severance and benefits, contract termination and associated costs resulting from the Timberlake sale. No charge to operations resulted from these adjustments as there was no change to the total impairment and restructuring charges previously recognized.

Annual cost savings related to the Timberlake restructuring and impairment charges and the actions taken at Liggett Vector Brands in the first half of 2004 were estimated to be at least \$23,000 beginning in 2004. Management believes the anticipated annual cost savings have been achieved beginning in 2004. Management will continue to review opportunities for additional cost savings in our tobacco business.

Tax Matters. In connection with the 1998 and 1999 transaction with Philip Morris Incorporated in which a subsidiary of Liggett contributed three of its premium cigarette brands to Trademarks LLC, a newly-formed limited liability company, we recognized in 1999 a pre-tax gain of \$294,078 in our consolidated

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financial statements and established a deferred tax liability of \$103,100 relating to the gain. In such transaction, Philip Morris acquired an option to purchase the remaining interest in Trademarks for a 90-day period commencing in December 2008, and we have an option to require Philip Morris to purchase the remaining interest for a 90-day period commencing in March 2010. Upon exercise of the options during the 90-day periods commencing in December 2008 or in March 2010, we will be required to pay tax in the amount of the deferred tax liability, which will be offset by the benefit of any deferred tax assets, including any net operating losses, available to us at that time. In connection with an examination of our 1998 and 1999 federal income tax returns, the Internal Revenue Service issued to us in September 2003 a notice of proposed adjustment. The notice asserts that, for tax reporting purposes, the entire gain should have been recognized in 1998 and in 1999 in the additional amounts of \$150,000 and \$129,900, respectively, rather than upon the exercise of the options during the 90-day periods commencing in December 2008 or in March 2010. If the Internal Revenue Service were to ultimately prevail with the proposed adjustment, it would result in the potential acceleration of tax payments of approximately \$127,000, including interest, net of tax benefits, through December 31, 2005. These amounts have been previously recognized in our consolidated financial statements as tax liabilities. As of December 31, 2005, we believe amounts potentially due have been fully provided for in our consolidated statements of operations.

We believe the positions reflected on our income tax returns are correct and intend to vigorously oppose any proposed adjustments to our returns. We have filed a protest with the Appeals Division of the Internal Revenue Service. No payment is due with respect to these matters during the appeals process. Interest currently is accruing on the disputed amounts at a rate of 9%, with the rate adjusted quarterly based on rates published by the U.S. Treasury Department. If taxing authorities were to ultimately prevail in their assertion that we incurred a tax obligation prior to the exercise dates of these options and we were required to make such tax payments prior to 2009 or 2010, and if any necessary financing were not available to us, our liquidity could be materially adversely affected.

Tobacco Settlement Agreements. In October 2004, Liggett was notified that all participating manufacturers payment obligations under the Master Settlement Agreement, dating from the agreement's execution in late 1998, have been recalculated utilizing net unit amounts, rather than gross unit amounts (which have been utilized since 1999). The change in the method of calculation could, among other things, require additional payments by Liggett under the Master Settlement Agreement of approximately \$9,400 for the periods 2001 through 2004, and require Liggett to pay an additional amount of approximately \$2,800 in 2005 and in future periods by lowering Liggett's market share exemption under the Master Settlement Agreement. Liggett contends that the retroactive change from utilizing gross unit amounts to net unit amounts is impermissible and has objected to the change. Liggett has disputed the change in methodology. No amounts have been accrued in the accompanying consolidated financial statements for any potential liability relating to the gross versus net dispute.

On March 30, 2005, the Independent Auditor under the Master Settlement Agreement calculated \$28,668 in Master Settlement Agreement payments for Liggett's 2004 sales. On April 15, 2005, Liggett paid \$11,678 of this amount and, in accordance with its rights under the Master Settlement Agreement, disputed the balance of \$16,990. Of the disputed amount, Liggett paid \$9,304 into the disputed payments account under the Master Settlement Agreement and withheld from payment \$7,686. The \$9,304 paid into the disputed payments account represents the amount claimed by Liggett as an adjustment to its 2003 payment obligation under the Master Settlement Agreement for market share loss to non-participating manufacturers. At December 31, 2005, included in Other current assets on our balance sheet was a receivable of \$6,513 relating to such amount. The \$7,686 withheld from payment represents \$5,318 claimed as an adjustment to Liggett's 2004 Master Settlement Agreement obligation for market share loss to non-participating manufacturers and \$2,368 relating to the retroactive change, discussed above, to the method for computing payment obligations under the Master Settlement Agreement which Liggett contends, among other things, is not in accordance with the Master Settlement Agreement. On May 31, 2005, New York State filed a motion on behalf of the settling states in New York state court seeking to compel Liggett and the other subsequent participating manufacturers that paid into the disputed payments account to release to the settling states the amounts paid into such account. The settling states contend that Liggett had no right under the Master

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Settlement Agreement and related agreements to pay into the disputed payments account any amount claimed as an adjustment for market share loss to non-participating manufacturers for 2003, although they acknowledge that Liggett has the right to dispute such amounts. By stipulation among the parties dated July 25, 2005, New York's motion was dismissed and Liggett authorized the release to the settling states of the \$9,304 it had paid into the account, although Liggett continues to dispute that it owes this amount. Liggett intends to withhold from its payment due under the Master Settlement Agreement on April 15, 2006 approximately \$1,600 which Liggett claims as the non-participating manufacturers adjustment to its 2005 payment obligation. As of December 31, 2005, Liggett and Vector Tobacco have disputed the following assessments under the Master Settlement Agreement related to failure to receive credit for market share loss to non-participating manufacturers: \$6,513 for 2003, \$3,723 for 2004 and approximately \$800 for 2005. These disputed amounts have not been accrued in the accompanying consolidated financial statements.

In 2004, the Attorneys General for each of Florida, Mississippi and Texas advised Liggett that they believed that Liggett has failed to make all required payments under the respective settlement agreements with these states for the period 1998 through 2003 and that additional payments may be due for 2004 and subsequent years. Liggett believes these allegations are without merit, based, among other things, on the language of the most favored nation provisions of the settlement agreements. In December 2004, the State of Florida offered to settle all amounts allegedly owed by Liggett for the period through 2003 for the sum of \$13,500. In March 2005, the State of Florida reaffirmed its December 2004 offer to settle and provided Liggett with a 60 day notice to cure the alleged defaults. In November 2005, Florida made a revised offer that Liggett pay Florida \$4,250 to resolve all matters through December 31, 2005, and pay Florida \$0.17 per pack on all Liggett cigarettes sold in Florida beginning January 1, 2006. After further discussions, Florida's most recent offer is that Liggett pay a total of \$3,500 in four annual payments, \$1,000 for the first three years and \$500 in the fourth year, and defer further discussion of any alleged future obligations until the end of Florida's 2006 legislative session. Liggett has not yet responded to this most recent offer from Florida and there can be no assurance that a settlement will be reached. In November 2004, the State of Mississippi offered to settle all amounts allegedly owed by Liggett for the period through 2003 for the sum of \$6,500. In April 2005, the State of Mississippi reaffirmed its November 2004 offer to settle and provided Liggett with a 60 day notice to cure the alleged defaults. No specific monetary demand has been made by the State of Texas. Liggett has met with representatives of Mississippi and Texas to discuss the issues relating to the alleged defaults, although no resolution has been reached.

Except for \$2,000 accrued for the year ended December 31, 2005 in connection with the foregoing matters, no other amounts have been accrued in the accompanying financial statements for any additional amounts that may be payable by Liggett under the settlement agreements with Florida, Mississippi and Texas. There can be no assurance that Liggett will prevail in any of these matters and that Liggett will not be required to make additional material payments, which payments could adversely affect our consolidated financial position, results of operations or cash flows.

Real Estate Activities. In December 2002, New Valley purchased two office buildings in Princeton, New Jersey for a total purchase price of \$54,000. New Valley financed a portion of the purchase price through a borrowing of \$40,500 from HSBC Realty Credit Corporation (USA). In February 2005, New Valley completed the sale of the office buildings for \$71,500. The mortgage loan on the properties was retired at closing with the proceeds of the sale.

New Valley accounts for its 50% interests in Douglas Elliman Realty LLC, Koa Investors LLC and 16th & K Holdings LLC on the equity method. Douglas Elliman Realty operates the largest residential brokerage company in the New York metropolitan area. Koa Investors LLC owns the Sheraton Keauhou Bay Resort & Spa in Kailua-Kona, Hawaii. Following a major renovation, the property reopened in the fourth quarter 2004 as a four star resort with 521 rooms. In August 2005, 16th & K Holdings LLC acquired the St. Regis Hotel, a 193 room luxury hotel in Washington, D.C., for \$47,000.

Table of Contents**Recent Developments in Legislation, Regulation and Litigation**

The cigarette industry continues to be challenged on numerous fronts. New cases continue to be commenced against Liggett and other cigarette manufacturers. As of December 31, 2005, there were approximately 268 individual suits, 11 purported class actions and eight governmental and other third-party payor health care reimbursement actions pending in the United States in which Liggett was a named defendant. A civil lawsuit was filed by the United States federal government seeking disgorgement of approximately \$289,000,000 from various cigarette manufacturers, including Liggett. A federal appellate court ruled in February 2005 that disgorgement is not an available remedy in the case. In October 2005, the United States Supreme Court declined to review this decision. Trial of the case concluded on June 15, 2005. On June 27, 2005, the government sought to restructure its potential remedies and filed a proposed Final Judgment and Order. That relief can be grouped into four categories: (1) \$14,000,000 for a cessation and counter marketing program; (2) so-called corrective statements; (3) disclosures; and (4) enjoined activities. Post-trial briefing was completed in October 2005. In one of the other cases pending against Liggett, in 2000, an action against cigarette manufacturers involving approximately 1,000 named individual plaintiffs was consolidated for trial on some common related issues before a single West Virginia state court. Liggett is a defendant in most of the cases pending in West Virginia. In January 2002, the court severed Liggett from the trial of the consolidated action. Two purported class actions have been certified in state court in Kansas and New Mexico against the cigarette manufacturers for alleged antitrust violations. As new cases are commenced, the costs associated with defending these cases and the risks relating to the inherent unpredictability of litigation continue to increase.

There are five individual smoking-related actions where Liggett is the only tobacco company defendant. In April 2004, in one of these cases, a Florida state court jury awarded compensatory damages of \$540 against Liggett. In addition, plaintiff's counsel was awarded legal fees of \$752. Liggett has appealed the verdict. In March 2005, in another case in Florida state court where Liggett is the only defendant, the court granted Liggett's motion for summary judgment disposing of the case in its entirety. The plaintiff has appealed. In March 2006, in another of these cases, a Florida state court jury returned a verdict in favor of Liggett. The plaintiff may appeal.

In May 2003, a Florida intermediate appellate court overturned a \$790,000 punitive damages award against Liggett and decertified the *Engle* smoking and health class action. In May 2004, the Florida Supreme Court agreed to review the case, and oral argument was held in November 2004. If the intermediate appellate court's ruling is not upheld on appeal, it will have a material adverse effect on us. In November 2000, Liggett filed the \$3,450 bond required under the bonding statute enacted in 2000 by the Florida legislature which limits the size of any bond required, pending appeal, to stay execution of a punitive damages verdict. In May 2001, Liggett reached an agreement with the class in the *Engle* case, which provided assurance to Liggett that the stay of execution, in effect under the Florida bonding statute, would not be lifted or limited at any point until completion of all appeals, including to the United States Supreme Court. As required by the agreement, Liggett paid \$6,273 into an escrow account to be held for the benefit of the *Engle* class, and released, along with Liggett's existing \$3,450 statutory bond, to the court for the benefit of the class upon completion of the appeals process, regardless of the outcome of the appeal. In June 2002, the jury in an individual case brought under the third phase of the *Engle* case awarded \$37,500 (subsequently reduced by the court to \$25,100) of compensatory damages against Liggett and two other defendants and found Liggett 50% responsible for the damages. The verdict, which is subject to the outcome of the *Engle* appeal, has been overturned as a result of the appellate court's ruling discussed above. It is possible that additional cases could be decided unfavorably and that there could be further adverse developments in the *Engle* case. Liggett may enter into discussions in an attempt to settle particular cases if it believes it is appropriate to do so. Management cannot predict the cash requirements related to any future settlements and judgments, including cash required to bond any appeals, and there is a risk that those requirements will not be able to be met.

Federal or state regulators may object to Vector Tobacco's low nicotine and nicotine-free cigarette products and reduced risk cigarette products it may develop as unlawful or allege they bear deceptive or unsubstantiated product claims, and seek the removal of the products from the marketplace, or significant changes to advertising. Various concerns regarding Vector Tobacco's advertising practices have been

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expressed to Vector Tobacco by certain state attorneys general. Vector Tobacco has engaged in discussions in an effort to resolve these concerns and Vector Tobacco has, in the interim, suspended all print advertising for its QUEST brand. If Vector Tobacco is unable to advertise its QUEST brand, it could have a material adverse effect on sales of QUEST. Allegations by federal or state regulators, public health organizations and other tobacco manufacturers that Vector Tobacco's products are unlawful, or that its public statements or advertising contain misleading or unsubstantiated health claims or product comparisons, may result in litigation or governmental proceedings.

In recent years, there have been a number of proposed restrictive regulatory actions from various Federal administrative bodies, including the United States Environmental Protection Agency and the Food and Drug Administration. There have also been adverse political decisions and other unfavorable developments concerning cigarette smoking and the tobacco industry, including the commencement and certification of class actions and the commencement of third-party payor actions. These developments generally receive widespread media attention. We are not able to evaluate the effect of these developing matters on pending litigation or the possible commencement of additional litigation, but our consolidated financial position, results of operations or cash flows could be materially adversely affected by an unfavorable outcome in any smoking-related litigation. See Note 13 to our consolidated financial statements for a description of legislation, regulation and litigation.

Critical Accounting Policies

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

Revenue Recognition. Revenues from sales of cigarettes 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. We provide an allowance for expected sales returns, net of any related inventory cost recoveries. Since our primary line of business is tobacco, our financial position and our results of operations and cash flows have been and could continue to be materially adversely effected by significant unit sales volume declines, litigation and defense costs, increased tobacco costs or reductions in the selling price of cigarettes in the near term.

Marketing Costs. We record marketing costs as an expense in the period to which such costs relate. We do not defer the recognition of any amounts on our consolidated balance sheets with respect to marketing costs. We expense advertising costs as incurred, which is the period in which the related advertisement initially appears. We record consumer incentive and trade promotion costs as a reduction in revenue in the period in which these programs are offered, based on estimates of utilization and redemption rates that are developed from historical information.

Restructuring and Asset Impairment Charges. We have recorded charges related to employee severance and benefits, asset impairments, contract termination and other associated exit costs during 2003 and 2004. The calculation of severance pay requires management to identify employees to be terminated and the timing of their severance from employment. The calculation of benefits charges requires actuarial assumptions including determination of discount rates. As discussed further below, the asset impairments were recorded in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, which requires management to estimate the fair value of assets to be disposed of. On January 1, 2003, we adopted SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. Charges related to restructuring activities initiated after this date were recorded when incurred. Prior to this date, charges were recorded at the date of an entity's commitment to an exit plan in accordance with EITF 94-3, *Liability*

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Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring) . These restructuring charges are based on management's best estimate at the time of restructuring. The status of the restructuring activities is reviewed on a quarterly basis and any adjustments to the reserve, which could differ materially from previous estimates, are recorded as an adjustment to operating income.

Purchase Accounting. We account for business combination transactions, including the exchange offer and merger with New Valley, in accordance with SFAS No. 141, Business Combinations . SFAS No. 141 requires that we allocate the cost of the acquisition to assets acquired and liabilities assumed, based on their fair values as of the acquisition date. Estimates of fair values for the non-consolidated real estate businesses of New Valley are generally based on independent appraisals and other accounts are based on management's best estimates using assumptions that are believed to be reasonable. The determination of fair values involves considerable estimation and judgment, including developing forecasts of cash flows and discount rates for the non-consolidated real estate businesses.

Impairment of Long-Lived Assets. We evaluate our long-lived assets for possible impairment annually or whenever events or changes in circumstances indicate that the carrying value of the asset, or related group of assets, may not be fully recoverable. Examples of such events or changes in circumstances include a significant adverse charge in the manner in which a long-lived asset, or group of assets, is being used or a current expectation that, more likely than not, a long-lived asset, or group of assets, will be disposed of before the end of its estimated useful life. The estimate of fair value of our long-lived assets is based on the best information available, including prices for similar assets and the results of using other valuation techniques. Since judgment is involved in determining the fair value of long-lived assets, there is a risk that the carrying value of our long-lived assets may be overstated or understated.

In October 2003, we announced that we would close Vector Tobacco's Timberlake, North Carolina cigarette manufacturing facility and produce its cigarette products at Liggett's Mebane, North Carolina facility. We evaluated the net realizable value of the long-lived assets located at the Timberlake facility which has been sold. Based on management's estimates of the values, we initially recognized non-cash asset impairment charges of \$18,752 in the third quarter of 2003 on machinery and equipment. As of June 30, 2004, we decreased the asset impairment accrual to reflect the actual amounts realized from the Timberlake sale and to reduce values of other excess machinery and equipment in accordance with SFAS No. 144.

Contingencies. We record Liggett's product liability legal expenses and other litigation costs as operating, selling, general and administrative expenses as those costs are incurred. As discussed in Note 13 to our consolidated financial statements and above under the heading Recent Developments in Legislation, Regulation and Litigation , legal proceedings covering a wide range of matters are pending or threatened in various jurisdictions against Liggett. Management is unable to make a reasonable estimate with respect to the amount or range of loss that could result from an unfavorable outcome of pending smoking-related litigation or the costs of defending such cases, and we have not provided any amounts in our consolidated financial statements for unfavorable outcomes, if any. You should not infer from the absence of any such reserve in our financial statements that Liggett will not be subject to significant tobacco-related liabilities in the future. Litigation is subject to many uncertainties, and it is possible that our consolidated financial position, results of operations or cash flows could be materially adversely affected by an unfavorable outcome in any such smoking-related litigation.

Settlement Agreements. As discussed in Note 13 to our consolidated financial statements, Liggett and Vector Tobacco are participants in the Master Settlement Agreement, the 1998 agreement to settle governmental healthcare cost recovery actions brought by various states. Liggett and Vector Tobacco have no payment obligations under the Master Settlement Agreement except to the extent their market shares exceed approximately 1.65% and 0.28%, respectively, of total cigarettes sold in the United States. Their obligations, and the related expense charges under the Master Settlement Agreement, are subject to adjustments based upon, among other things, the volume of cigarettes sold by Liggett and Vector Tobacco, their relative market shares and inflation. Since relative market shares are based on cigarette shipments, the best estimate of the allocation of charges under the Master Settlement Agreement is recorded in cost of goods sold as the products

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are shipped. Settlement expenses under the Master Settlement Agreement recorded in the accompanying consolidated statements of operations were \$14,924 for 2005, \$23,315 for 2004 and \$35,854 for 2003. Adjustments to these estimates are recorded in the period that the change becomes probable and the amount can be reasonably estimated.

Derivatives; Beneficial Conversion Feature. We measure all derivatives, including certain derivatives embedded in other contracts, at fair value and recognize them in the consolidated balance sheet as an asset or a liability, depending on our rights and obligations under the applicable derivative contract. In November 2004, we issued in a private placement 5% variable interest senior convertible notes due 2011 where a portion of the total interest payable on the notes is computed by reference to the cash dividends paid on our common stock. (In December 2004 and during the first half of 2005, we issued additional notes on the same terms.) This portion of the interest payment is considered an embedded derivative. Pursuant to SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by SFAS No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, we have bifurcated this dividend portion of the interest on the notes and, based on a valuation by an independent third party, estimated the fair value of the embedded derivative liability. At the initial issuance of the notes in November 2004, the estimated initial fair value of the embedded derivative liability was \$24,738, which was recorded as a discount to the notes and classified as a derivative liability on the consolidated balance sheet. At December 31, 2005, with the issuance of \$46,364 of additional notes, the derivative liability was estimated at \$39,371. Changes to the fair value of this embedded derivative are reflected quarterly as an adjustment to interest expense. We recognized a gain of \$3,082 in 2005 and a loss of \$412 in 2004, due to changes in the fair value of the embedded derivative, which were reported as adjustments to interest expense.

After giving effect to the recording of the embedded derivative liability as a discount to the notes, our common stock had a fair value at the issuance date of the notes in excess of the conversion price resulting in a beneficial conversion feature. Emerging Issues Task Force (EITF) No. 98-5, *Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Convertible Ratios*, requires that the intrinsic value of the beneficial conversion feature (\$22,075 at December 31, 2005) be recorded to additional paid-in capital and as a discount on the notes. The discount is then amortized to interest expense over the term of the notes using the effective interest rate method. We recognized non-cash interest expense of \$2,824 in 2005 and \$247 in 2004, due to the amortization of the debt discount attributable to the beneficial conversion feature.

Inventories. Tobacco inventories are stated at lower of cost or market and are determined primarily by the last-in, first-out (LIFO) method at Liggett and the first-in, first-out (FIFO) method at Vector Tobacco. Although portions of leaf tobacco inventories may not be used or sold within one year because of time required for aging, they are included in current assets, which is common practice in the industry. We estimate an inventory reserve for excess quantities and obsolete items based on specific identification and historical write-offs, taking into account future demand and market conditions. At December 31, 2005, approximately \$1,208 of our leaf inventory was associated with Vector Tobacco's QUEST product. During the second quarter of 2004, we recognized a non-cash charge of \$37,000 to adjust the carrying value of excess leaf tobacco inventory for the QUEST product, based on estimates of future demand and market conditions. If actual demand for the product or market conditions are less favorable than those estimated, additional inventory write-downs may be required.

Employee Benefit Plans. The determination of our net pension and other postretirement benefit income or expense is dependent on our selection of certain assumptions used by actuaries in calculating such amounts. Those assumptions include, among others, the discount rate, expected long-term rate of return on plan assets and rates of increase in compensation and healthcare costs. In accordance with accounting principles generally accepted in the United States of America, actual results that differ from our assumptions are accumulated and amortized over future periods and therefore, generally affect our recognized income or expense in such future periods. While we believe that our assumptions are appropriate, significant differences in our actual experience or significant changes in our assumptions may materially affect our future net pension and other postretirement benefit income or expense.

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Net pension expense for defined benefit pension plans and other postretirement benefit expense aggregated approximately \$4,250 for 2005, and we currently anticipate such expense will be approximately \$4,650 for 2006. In contrast, our funding obligations under the pension plans are governed by ERISA. To comply with ERISA's minimum funding requirements, we do not currently anticipate that we will be required to make any funding to the pension plans for the pension plan year beginning on January 1, 2006 and ending on December 31, 2006. Any additional funding obligation that we may have for subsequent years is contingent on several factors and is not reasonably estimable at this time.

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 consolidated financial statements and related notes included elsewhere in this report. The 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 years ended December 31, 2005 were Liggett and Vector Tobacco. The Liggett segment consists of the manufacture and sale of conventional cigarettes and, for segment reporting purposes, includes the operations of Medallion acquired on April 1, 2002 (which operations are held for legal purposes as part of Vector Tobacco). The Vector Tobacco segment includes the development and marketing of the low nicotine and nicotine-free cigarette products as well as the development of reduced risk cigarette products and, for segment reporting purposes, excludes the operations of Medallion.

	For the Year Ended December 31,		
	2005	2004	2003
	(Dollars in Thousands)		
Revenues:			
Liggett	\$ 468,652	\$ 484,898	\$ 503,231
Vector Tobacco	9,775	13,962	26,154
Total revenues	\$ 478,427	\$ 498,860	\$ 529,385
Operating income:			
Liggett	\$ 143,361(1)	\$ 110,675(2)	\$ 119,749
Vector Tobacco	(14,992)(1)	(64,942)(2)	(92,825)(3)
Total tobacco	128,369	45,733	26,924
Corporate and other	(39,258)	(30,286)	(26,434)
Total operating income	\$ 89,111(1)	\$ 15,447(2)	\$ 490(3)

(1) Includes a special federal quota stock liquidation assessment under the federal tobacco buyout legislation of \$5,219 in 2005 (\$5,150 at Liggett and \$69 at Vector Tobacco), gain on sale of assets at Liggett of \$12,748 in 2005 and a reversal of restructuring charges of \$114 at Liggett and \$13 at Vector Tobacco in 2005.

(2) Includes restructuring and impairment charges of \$11,075 at Liggett and \$2,624 at Vector Tobacco and a \$37,000 inventory impairment charge at Vector Tobacco in 2004.

(3) Includes restructuring and impairment charges of \$21,300 in 2003.

2005 Compared to 2004

Revenues. Total revenues were \$478,427 for the year ended December 31, 2005 compared to \$498,860 for the year ended December 31, 2004. This \$20,433 (4.1%) decrease in revenues was due to a \$16,246 (3.4%) decrease in revenues at Liggett and a \$4,187 (30.0%) decrease in revenues at Vector Tobacco.

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Tobacco Revenues. Effective February 1, 2004, Liggett reduced the list prices for EVE from the premium price level to the branded discount level. In August 2004, Liggett increased its list price on LIGGETT SELECT by \$1.00 per carton. In October 2004, Liggett increased the list price of all its brands by \$.65 per carton.

All of Liggett's sales in 2004 and 2005 were in the discount category. In 2005, net sales at Liggett totaled \$468,652, compared to \$484,898 in 2004. Revenues decreased by 3.4% (\$16,246) due to a 7.9% decrease in unit sales volume (approximately 700 million units) accounting for \$38,391 in unfavorable volume variance and \$13,721 in unfavorable sales mix, partially offset by a combination of list price increases and reduced promotional spending of \$35,866. Net revenues of the LIGGETT SELECT brand decreased \$47,262 in 2005 compared to 2004, and its unit volume decreased 26.5% in 2005 compared to 2004. Unit sales volume for Liggett has been affected by the strategic changes in distribution associated with the restructuring at Liggett Vector Brands in the fourth quarter of 2004.

Revenues at Vector Tobacco were \$9,775 in 2005 compared to \$13,962 in 2004 due to decreased sales volume. Vector Tobacco's revenues in 2005 and 2004 related primarily to sales of QUEST.

Tobacco Gross Profit. Tobacco gross profit was \$193,034 in 2005 compared to \$210,197 in 2004, excluding the inventory write-off of \$37,000 taken by Vector Tobacco in the second quarter of 2004 to adjust the carrying value of excess leaf tobacco inventory for the QUEST product. This represented a decrease of \$17,170 (8.2%) when compared to 2004, due primarily to the reduced sales volume net of related reduced promotional spending as well as tobacco quota buyout costs which included a special federal quota stock liquidation assessment of \$5,219. Liggett's brands contributed 98.4% to our gross profit and Vector Tobacco contributed 1.6% in 2005. In 2004, Liggett's brands contributed 97.9% to tobacco gross profit and Vector Tobacco contributed 2.1%.

Liggett's gross profit of \$189,961 in 2005 decreased \$15,853 from gross profit of \$205,814 in 2004. As a percent of revenues (excluding federal excise taxes), gross profit at Liggett decreased to 61.5% in 2005 compared to gross profit of 66.2% in 2004. This decrease in Liggett's gross profit in 2005 was attributable to higher than anticipated tobacco quota buyout costs discussed above, partially offset by lower Master Settlement Agreement costs and increased prices.

Vector Tobacco's gross profit was \$3,073 in 2005 compared to gross profit, excluding the inventory write-down, of \$4,383 for the same period in 2004. The decrease was due primarily to the reduced sales volume.

Expenses. Operating, selling, general and administrative expenses were \$114,048 in 2005 compared to \$144,051 in 2004, a decrease of \$30,003 (20.8%). Expenses for 2004 included a charge of \$4,177 (net of minority interests) in connection with the settlement of the shareholder derivative lawsuit. Expenses at Liggett were \$59,463 in 2005 compared to \$84,064 in 2004, a decrease of \$24,601 (29.3%). The decrease in expense in 2005 was due primarily to the lower expenses of a reduced sales force resulting from the 2004 restructuring. Liggett's product liability legal expenses and other litigation costs of \$8,048 in 2005 compared to \$5,110 in 2004. Expenses at Vector Tobacco in 2005 were \$18,070 compared to expenses of \$29,702 in 2004 due to the sale of the Timberlake facility in 2004 and the reduction in headcount in the fourth quarter of 2004.

Restructuring and impairment charges in 2004 were \$11,075 at Liggett and \$2,624 at Vector Tobacco, a total of \$13,699, and relate to the closing of the Timberlake facility, sales force reductions and the loss on the sublease of Liggett Vector Brands' New York office space.

In 2005, Liggett's operating income increased to \$143,361 compared to \$110,675 for the prior year. In 2005, Vector Tobacco's operating loss was \$14,992 compared to a loss of \$64,942 in 2004. Liggett's operating income for 2005 included a gain on sale of assets of \$12,748. Liggett's operating income for 2004 included restructuring charges of \$11,075, and Vector Tobacco's operating loss for 2004 included the non-cash inventory charge of \$37,000 and restructuring charges of \$2,624.

Other Income (Expenses). In 2005, other income (expenses) was a loss of \$8,592 compared to a loss of \$9,341 in 2004. In 2005, interest expense of \$31,980 and equity loss in operations of LTS of \$299 were partially offset by a gain from conversion of the LTS notes of \$9,461, equity income from non-consolidated

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real estate businesses of \$7,543, interest and dividend income of \$5,610 and a net gain on sale of investments of \$1,426. The equity income resulted primarily from \$11,217 related to New Valley's investment in Douglas Elliman Realty offset by losses of \$3,501 related to its investment in Koa Investors and \$173 related to its investment in 16th & K Holdings. In 2004, interest expense of \$25,077 and loss on extinguishment of debt of \$5,333 were offset by interest and dividend income of \$2,563, a gain on sale of investments of \$8,664 and equity income from non-consolidated New Valley real estate businesses of \$9,782.

Income from Continuing Operations. The income from continuing operations before income taxes and minority interests in 2005 was \$80,519 compared to income of \$6,106 in 2004. The income tax provision was \$40,352 and minority interests in income of subsidiaries was \$1,969 in 2005. This compared to a tax benefit of \$6,960 and minority interests in income of subsidiaries of \$9,027 in 2004. Our income tax rate for 2005 does not bear a customary relationship to statutory income tax rates as a result of the impact of nondeductible expenses, state income taxes, the receipt of the LTS distribution, the intraperiod allocation at New Valley between income from continuing and discontinued operations and the utilization of deferred tax assets at New Valley. Our tax rate for 2004 does not bear a customary relationship to statutory income tax rates as a result of the impact of nondeductible expenses, state income taxes and the intraperiod allocation at New Valley between income from continuing and discontinued operations.

Significant Fourth Quarter 2005 Adjustments. Fourth quarter 2005 income from continuing operations included a \$12,748 gain on the sale of Liggett's excess Durham real estate, an \$860 charge in connection with the settlement of shareholder litigation relating to the New Valley acquisition, reserves for uncollectibility of \$2,750 established against advances by New Valley, a \$2,000 charge related to Liggett's state settlement agreements and a \$127 gain from the reversal of amounts previously accrued as restructuring charges. In the fourth quarter 2005, we recognized extraordinary income of \$7,850 in connection with unallocated goodwill associated with the New Valley acquisition.

2004 Compared to 2003

Revenues. Total revenues were \$498,860 for the year ended December 31, 2004 compared to \$529,385 for the year ended December 31, 2003. This 5.8% (\$30,525) decrease in revenues was due to an \$18,333 or 3.6% decrease in revenues at Liggett and a \$12,192 (46.6%) decrease in revenues at Vector Tobacco.

Tobacco Revenues. In February 2003, Liggett increased its net sales price for selected discount brands by \$.80 per carton. In May 2003, Liggett increased its list price on USA by \$.50 per carton. In June 2003, Liggett increased its net sales price for LIGGETT SELECT by \$1.10 per carton. In September 2003, Liggett increased its net sales price for PYRAMID by \$.95 per carton. In December 2003, Liggett increased the list price on a leading private label brand by \$.85 per carton. In August 2004, Liggett increased its net sales price of LIGGETT SELECT by \$1.00 per carton. In October 2004, Liggett increased the list price of all its brands by \$.65 per carton.

Effective February 1, 2004, Liggett reduced the list price for EVE from the premium price level to the branded discount level. During 2003, EVE product had been subject to promotional buy-downs at the retail level and was effectively promoted to consumers at a level that was fully reflected in the new reduced list price.

All of Liggett's sales in 2004 were in the discount category. In 2004, net sales at Liggett totaled \$484,898, compared to \$503,231 in 2003. Revenues decreased by 3.6% (\$18,333) due to an 8.6% decrease in unit sales volume (approximately 833 million units) accounting for \$43,288 in unfavorable volume variance and \$1,018 in unfavorable sales mix partially offset by a combination of list price increases and reduced promotional spending of \$25,973. The favorable price variance of \$25,973 in 2004 gives effect to approximately \$1,400 of costs associated with the buy down of unpromoted EVE inventory at retail due to the price reduction discussed above. Net revenues of the LIGGETT SELECT brand increased \$17,513 in 2004 compared to in 2003, and its unit volume increased 0.2% in 2004 compared to 2003.

Revenues at Vector Tobacco were \$13,962 in 2004 compared to \$26,154 in 2003, a 46.6% decline, due to decreased sales volume. Vector Tobacco's revenues in both years related primarily to sales of QUEST. Given

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market place conditions, and the results we have seen to date with QUEST, we have taken a measured approach to expanding the market presence of the brand.

Tobacco Gross Profit. Tobacco gross profit excluding the inventory write-down at Vector Tobacco of \$37,000 in the second quarter was \$210,197 in 2004 compared to \$189,768 in 2003, an increase of \$20,429 or 10.8% when compared to last year, due primarily to the reduction in promotional spending, price increases discussed above at Liggett and lower estimated Master Settlement Agreement expense at Liggett and Vector Tobacco. Liggett's brands contributed 97.9% to our tobacco gross profit and Vector Tobacco contributed 2.1% in 2004. In 2003, Liggett brands contributed 104.7% to our gross profit and Vector Tobacco's brands cost 4.7%.

Liggett's gross profit of \$205,814 in 2004 increased \$7,585 from gross profit of \$198,229 in 2003. As a percent of revenues (excluding federal excise taxes), gross profit at Liggett increased to 66.2% in 2004 compared to 63.1% in 2003. This increase in Liggett's gross profit in 2004 was attributable to the items discussed above.

Vector Tobacco's gross profit, excluding the inventory write-down, was \$4,383 in 2004 compared to negative gross profit of \$8,879 in 2003. The increase was due to the cost savings realized with the closing of Vector Tobacco's Timberlake facility and the transfer of production, commencing January 1, 2004, to Liggett's facility in Mebane, as well as decreased promotional expense.

Expenses. Operating, selling, general and administrative expenses, net of restructuring charges, were \$144,051 in 2004 compared to \$167,978, a decrease of \$23,927. The effects of the restructurings were offset by a charge in 2004 of \$4,177 (net of minority interests) in connection with the settlement of the shareholder derivative lawsuit. Expenses at Liggett were \$84,064 in 2004 compared to \$78,480, an increase of \$5,584 in 2004. The increase in 2004 was due primarily to increased selling, marketing and administrative expenses allocated from Liggett Vector Brands of \$12,388 and \$1,670 of various additional compensation payments made to retained employees which were related to the Liggett Vector Brands restructuring, offset by a decrease in sales and marketing research costs and point of sales material and distribution costs of \$6,040 and a decrease in product liability legal expenses and other litigation costs of \$1,012. Liggett's product liability legal expenses and other litigation costs were \$5,110 in 2004 compared to \$6,122 in 2003. Expenses at Vector Tobacco in 2004 were \$29,702 compared to expenses of \$83,946 in 2003, a decrease of \$54,244, due to the closing and sale of the Timberlake facility, related reduction in headcount and reduced expense allocation from Liggett Vector Brands. Effective January 1, 2004, we modified the allocations of the selling, marketing and administrative expenses of Liggett Vector Brands to Liggett and Vector Tobacco based on a review of relative business activities. Accordingly, in 2004, the increased selling, marketing and administrative expenses allocated to Liggett of \$12,388 had a corresponding decrease in such expenses at Vector Tobacco compared to the allocation of these expenses between the segments during 2003. These modifications did not affect the consolidated financial statements.

The operating, selling, general and administrative expenses above are net of restructuring charges of \$13,699 and an inventory impairment charge of \$37,000 in 2004. The restructuring charges relate to the closing of the Timberlake facility, the loss on the sublease of Liggett Vector Brands' New York office space and the Liggett Vector Brands restructurings. Liggett recognized \$11,075 in restructuring charges and Vector Tobacco recognized \$2,624 in addition to the inventory impairment. Restructuring and impairment charges in 2003 were \$21,300 and related to the closing of Vector Tobacco's Timberlake facility.

In 2004, Liggett's operating income decreased to \$110,675 compared to \$119,749 for the prior year due primarily to lower sales volume and the restructuring charges of \$11,075. Vector Tobacco's operating loss which included the second quarter inventory impairment charge of \$37,000 and restructuring charges of \$2,624 was \$64,942 in 2004 compared to a loss of \$92,825 in 2003, which included the restructuring charge of \$21,300 for the closing of the Timberlake facility.

Other Income (Expenses). In 2004, other income (expenses) was a loss of \$9,341 compared to a loss of \$20,264 in 2003. In 2004, interest expense of \$25,077 and loss on extinguishment of debt of \$5,333 were offset by equity income from non-consolidated New Valley real estate businesses of \$9,782, a gain on sale of

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investments of \$8,664 and interest and dividend income of \$2,563. The equity income resulted from income at New Valley of \$11,612 from Douglas Elliman Realty, LLC offset by a loss of \$1,830 related to New Valley's investment in Koa Investors, LLC, which owns the Sheraton Keauhou Bay Resort and Spa in Kailua-Kona, Hawaii. In 2003, interest expense of \$26,592 and a loss on extinguishment of debt of \$1,721 were offset by interest and dividend income of \$4,696, a gain on sale of investments of \$1,955, equity income from non-consolidated real estate businesses of \$901 and a gain on sale of assets of \$478.

Income (Loss) from Continuing Operations. The income from continuing operations before income taxes and minority interests in 2004 was \$6,106 compared to a loss of \$19,774 for 2003. Income tax benefit was \$6,960 and minority interests in income of subsidiaries was \$9,027 in 2004. This compared to a tax benefit of \$666 and minority interests in losses of subsidiaries of \$2,976 in 2003. The effective tax rates for the years ended December 31, 2004 and 2003 do not bear a customary relationship to pre-tax accounting income principally as a consequence of changes in New Valley's valuation allowance, which resulted in the recognition of \$9,000 of deferred tax assets at December 31, 2004, the intraperiod tax allocation between income from continuing operations and discontinued operations, non-deductible expenses and state income taxes.

Significant Fourth Quarter 2004 Adjustments. Fourth quarter 2004 income from continuing operations included \$6,155 restructuring charge related to Liggett Vector Brands, \$4,177 charge (net of minority interests) for settlement of shareholder derivative suit and \$4,694 loss on extinguishment of debt related to retirement of VGR Holding's senior secured notes. Fourth quarter 2004 income from discontinued operations included a \$2,231 gain (net of minority interests of \$2,478 and income taxes of \$5,272) from the reversal of tax and bankruptcy accruals previously established by New Valley following resolution of these matters.

Discontinued Operations

Real Estate Leasing. In February 2005, New Valley completed the sale for \$71,500 of its two office buildings in Princeton, N.J. As a result of the sale, the consolidated financial statements of the Company reflect New Valley's real estate leasing operations as discontinued operations for the three years ended December 31, 2005. Accordingly, revenues, costs and expenses of the discontinued operations have been excluded from the respective captions in the consolidated statements of operations. The net operating results of the discontinued operations have been reported, net of applicable income taxes and minority interests, as *Income from discontinued operations*. The assets of the discontinued operations were recorded as *Assets held for sale* in the consolidated balance sheet at December 31, 2004.

Summarized operating results of the discontinued real estate leasing operations for the three years ended December 31, 2005 are as follows:

	2005	2004	2003
Revenues	\$ 924	\$ 7,333	\$ 7,298
Expenses	515	5,240	4,952
Income from operations before income taxes and minority interests	409	2,093	2,346
Provision for income taxes	223	1,125	1,240
Minority interests	104	510	584
Income from discontinued operations	\$ 82	\$ 458	\$ 522

Gain on Disposal of Discontinued Operations. New Valley recorded a gain on disposal of discontinued operations of \$2,952 (net of minority interests and taxes) for the year ended December 31, 2005 in connection with the sale of the office buildings. New Valley recorded a gain on disposal of discontinued operations of \$2,231 (net of minority interests and taxes) for the year ended December 31, 2004 related to the adjustment of accruals established during New Valley's bankruptcy proceedings in 1993 and 1994. The reversal of these accruals reduced various tax accruals previously established and were made due to the completion of settlements related to these matters. The adjustment of

these accruals is classified as gain on disposal of discontinued operations since the original establishment of such accruals was similarly classified as a reduction of gain on disposal of discontinued operations.

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Net cash and cash equivalents increased \$71,055 in 2005 and \$35,196 in 2004 and decreased \$25,219 in 2003.

Net cash provided by operations was \$68,189 in 2005, \$44,622 in 2004 and \$17,191 in 2003. Cash provided by operations in 2005 resulted primarily from the net income of \$49,082, depreciation and amortization of \$11,220, deferred income taxes of \$20,310 and non-cash interest expense of \$6,317, partially offset by a gain on sale of assets of \$12,432, a gain from conversion of LTS notes of \$9,461, a decrease in current liabilities and an increase in receivables. Cash provided by operations in 2004 resulted primarily from non-cash charges for depreciation and amortization expense, restructuring and impairment charges, loss on retirement of debt and effect of minority interests, offset by the payment of the Master Settlement Agreement expense for 2003 in April of 2004, a decrease in current liabilities, the non-cash gain on investment securities and equity income from non-consolidated real estate businesses. Net cash provided in 2003 resulted from non-cash charges for depreciation and amortization expense, restructuring, stock-based expense and non-cash interest expense, a decrease in receivables and an increase in accounts payable and accrued liabilities and other assets and liabilities. These were offset primarily by an increase in inventories as well as deferred income taxes and the effect from minority interests.

Cash provided by investing activities was \$64,177 in 2005, \$72,693 in 2004 and \$48,838 in 2003. In 2005, cash was provided by cash flows from discontinued operations of \$66,912, the sale or maturity of investment securities of \$7,490, distributions from non-consolidated real estate businesses at New Valley of \$5,500 and proceeds from the sale of assets of \$14,118. This was offset in part by capital expenditures of \$10,295, purchase of investment securities of \$4,713, investment in non-consolidated real estate businesses at New Valley of \$6,250, purchase of LTS common stock for \$3,250, issuance of note receivable for \$2,750 and costs associated with New Valley acquisition of \$2,422. In 2004, cash was provided primarily through the sale or maturity of investment securities for \$68,357, the sale of assets for \$25,713 and the decrease in restricted cash of \$1,157. This was partially offset primarily by the purchase of investment securities for \$12,197, investment in non-consolidated real estate businesses at New Valley of \$4,500 and capital expenditures of \$4,294. In 2003, cash was provided principally through the sale or maturity of investment securities for \$135,737 offset primarily by the purchase of investment securities of \$68,978, the investment by new Valley of \$9,500 in Douglas Elliman Realty and \$1,500 in KOA Investors and capital expenditures principally at Liggett of \$8,894.

Cash used by financing activities was \$61,311 in 2005, \$82,119 in 2004 and \$91,248 in 2003. In 2005, cash was used for distributions on common stock of \$70,252, discontinued operations of \$39,213, repayments on debt of \$4,305 and deferred financing charges of \$2,068, offset by proceeds from debt of \$50,841, and proceeds from the exercise of options of \$3,626. In 2004, cash was used for distributions on common stock of \$64,106 and repayments on debt of \$84,425, including \$70,000 of VGR Holding's 10% senior secured notes. These were offset by the proceeds from the sale of convertible notes of \$66,905 and proceeds from the exercise of options of \$3,233. In 2003, cash was used principally for distributions on common stock of \$59,997 and repayments of debt of \$31,064, including \$12,000 of VGR Holding's 10% senior secured notes, \$12,500 of the Medallion notes and \$6,564 in various other notes.

Liggett. Liggett has a \$50,000 credit facility with Wachovia Bank, N.A. No amount was outstanding under the facility at December 31, 2005. Availability as determined under the facility was approximately \$33,606 based on eligible collateral at December 31, 2005. The facility is collateralized by all inventories and receivables of Liggett and a mortgage on its manufacturing facility. Borrowings under the facility bear interest at a rate equal to 1.0% above the prime rate of Wachovia. The facility requires Liggett's compliance with certain financial and other covenants including a restriction on Liggett's ability to pay cash dividends unless Liggett's borrowing availability under the facility for the 30-day period prior to the payment of the dividend, and after giving effect to the dividend, is at least \$5,000 and no event of default has occurred under the agreement, including Liggett's compliance with the covenants in the credit facility, including an adjusted net worth and working capital requirement. In addition, the facility imposes requirements with respect to Liggett's adjusted net worth (not to fall below \$8,000 as computed in accordance with the agreement) and working

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capital (not to fall below a deficit of \$17,000 as computed in accordance with the agreement). At December 31, 2005, Liggett was in compliance with all covenants under the credit facility; Liggett's adjusted net worth was \$54,462 and net working capital was \$29,858, as computed in accordance with the agreement.

100 Maple LLC, a company formed by Liggett in 1999 to purchase its Mebane, North Carolina manufacturing plant, has a term loan of \$3,482 outstanding as of December 31, 2005 under Liggett's credit facility. The remaining balance of the term loan is payable in monthly installments of \$77 with a final payment on June 1, 2006 of \$3,095. Interest is charged at the same rate as applicable to Liggett's credit facility, and the outstanding balance of the term loan reduces the maximum availability under the credit facility. Liggett has guaranteed the term loan, and a first mortgage on the Mebane property and manufacturing equipment collateralizes the term loan and Liggett's credit facility.

In March 2000, Liggett purchased equipment for \$1,000 through the issuance of a note, payable in 60 monthly installments of \$21 with an effective annual interest rate of 10.14%. In April 2000, Liggett purchased equipment for \$1,071 through the issuance of notes, payable in 60 monthly installments through April 2005 of \$22 with an effective interest rate of 10.20%. The notes were paid in full during the first half of 2005.

Beginning in October 2001, Liggett upgraded the efficiency of its manufacturing operation at Mebane with the addition of four new state-of-the-art cigarette makers and packers, as well as related equipment. The total cost of these upgrades was approximately \$20,000. Liggett took delivery of the first two of the new lines in the fourth quarter of 2001 and financed the purchase price of \$6,404 through the issuance of notes, guaranteed by us and payable in 60 monthly installments of \$106 with interest calculated at the prime rate. In March 2002, the third line was delivered, and the purchase price of \$3,023 was financed through the issuance of a note, payable in 30 monthly installments of \$62 and then 30 monthly installments of \$51 with an interest rate of LIBOR plus 2.8%. In May 2002, the fourth line was delivered, and Liggett financed the purchase price of \$2,871 through the issuance of a note, payable in 30 monthly installments of \$59 and then 30 monthly installments of \$48 with an interest rate of LIBOR plus 2.8%. In September 2002, Liggett purchased additional equipment for \$1,573 through the issuance of a note guaranteed by us, payable in 60 monthly installments of \$26 plus interest rate calculated at LIBOR plus 4.31%. Each of these equipment loans is collateralized by the purchased equipment.

During 2003, Liggett leased three 100 millimeter box packers, which will allow Liggett to meet the growing demand for this cigarette style, and a new filter maker to improve product quality and capacity. These operating lease agreements provide for payments totaling approximately \$4,500. In October 2005, Liggett purchased the three box packers for \$2,351.

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

In December 2005, Liggett purchased equipment for \$2,272 through a financing agreement payable in 24 installments of \$58 and then 24 installments of \$46. Interest is calculated at 5.03%. Liggett was required to provide a security deposit equal to 25% of the funded amount or \$568.

In December 2005, Liggett completed the sale for \$15,450 of its former manufacturing plant, research facility and offices located in Durham, North Carolina. We recorded a gain of \$7,706, net of income taxes of \$5,042, in 2005 in connection with the sale.

Liggett and other United States cigarette manufacturers have been named as defendants in a number of direct and third-party actions (and purported class actions) predicated on the theory that they should be liable for damages from cancer and other adverse health effects alleged to have been caused by cigarette smoking or by exposure to so-called secondary smoke from cigarettes. We believe, and have been so advised by counsel handling the respective cases, that Liggett has a number of valid defenses to claims asserted against it. Litigation is subject to many uncertainties. In May 2003, a Florida intermediate appellate court overturned a \$790,000 punitive damages award against Liggett and decertified the *Engle* smoking and health class action. In May 2004, the Florida Supreme Court agreed to review the case, and oral argument was held in November

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2004. If the intermediate appellate court's ruling is not upheld on appeal, it will have a material adverse effect on us. In November 2000, Liggett filed the \$3,450 bond required under the bonding statute enacted in 2000 by the Florida legislature which limits the size of any bond required, pending appeal, to stay execution of a punitive damages verdict. In May 2001, Liggett reached an agreement with the class in the *Engle* case, which provided assurance to Liggett that the stay of execution, in effect pursuant to the Florida bonding statute, would not be lifted or limited at any point until completion of all appeals, including to the United States Supreme Court. As required by the agreement, Liggett paid \$6,273 into an escrow account to be held for the benefit of the *Engle* class, and released, along with Liggett's existing \$3,450 statutory bond, to the court for the benefit of the class upon completion of the appeals process, regardless of the outcome of the appeal. In June 2002, the jury in an individual case brought under the third phase of the *Engle* case awarded \$37,500 (subsequently reduced by the court to \$25,100) of compensatory damages against Liggett and two other defendants and found Liggett 50% responsible for the damages. The verdict, which was subject to the outcome of the *Engle* appeal, has been overturned as a result of the appellate court's ruling discussed above. In April 2004, a Florida state court jury awarded compensatory damages of \$540 against Liggett in an individual action. In addition, plaintiff's counsel was awarded legal fees of \$752. Liggett has appealed the verdict. It is possible that additional cases could be decided unfavorably and that there could be further adverse developments in the *Engle* case. Liggett may enter into discussions in an attempt to settle particular cases if it believes it is appropriate to do so. Management cannot predict the cash requirements related to any future settlements and judgments, including cash required to bond any appeals, and there is a risk that those requirements will not be able to be met. An unfavorable outcome of a pending smoking and health case could encourage the commencement of additional similar litigation. In recent years, there have been a number of adverse regulatory, political and other developments concerning cigarette smoking and the tobacco industry. These developments generally receive widespread media attention. Neither we nor Liggett are able to evaluate the effect of these developing matters on pending litigation or the possible commencement of additional litigation or regulation. See Note 13 to our consolidated financial statements.

Management is unable to make a reasonable estimate of the amount or range of loss that could result from an unfavorable outcome of the cases pending against Liggett or the costs of defending such cases. It is possible that our consolidated financial position, results of operations or cash flows could be materially adversely affected by an unfavorable outcome in any such tobacco-related litigation.

V.T. Aviation. In February 2001, V.T. Aviation LLC, a subsidiary of Vector Research Ltd., purchased an airplane for \$15,500 and borrowed \$13,175 to fund the purchase. The loan, which is collateralized by the airplane and a letter of credit from us for \$775, is guaranteed by Vector Research, VGR Holding and us. The loan is payable in 119 monthly installments of \$125 including annual interest of 2.31% above the 30-day commercial paper rate, with a final payment of \$2,404, based on current interest rates.

VGR Aviation. In February 2002, V.T. Aviation purchased an airplane for \$6,575 and borrowed \$5,800 to fund the purchase. The loan is guaranteed by us. The loan is payable in 119 monthly installments of \$40, including annual interest at 2.75% above the 30-day commercial paper rate, with a final payment of \$3,666 based on current interest rates. During the fourth quarter of 2003, this airplane was transferred to our direct subsidiary, VGR Aviation LLC, which has assumed the debt.

Vector Tobacco. On April 1, 2002, a subsidiary of ours acquired the stock of The Medallion Company, Inc., a discount cigarette manufacturer, and related assets from Medallion's principal stockholder. Following the purchase of the Medallion stock, Vector Tobacco merged into Medallion and Medallion changed its name to Vector Tobacco Inc. The total purchase price for the Medallion shares and the related assets consisted of \$50,000 in cash and \$60,000 in notes, with the notes guaranteed by us and by Liggett. Of the notes, \$25,000 have been repaid with the final quarterly principal payment of \$3,125 made on March 31, 2004. The remaining \$35,000 of notes bear interest at 6.5% per year, payable semiannually, and mature on April 1, 2007.

New Valley. In December 2002, New Valley financed a portion of its purchase of two office buildings in Princeton, New Jersey with a \$40,500 mortgage loan from HSBC Realty Credit Corporation (USA). In February 2005, New Valley completed the sale of the office buildings. The mortgage loan on the properties was retired at closing with the proceeds of the sale.

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Vector. We believe that we will continue to meet our liquidity requirements through 2006. Corporate expenditures (exclusive of Liggett, Vector Research, Vector Tobacco and New Valley) over the next twelve months for current operations include cash interest expense of approximately \$23,600, dividends on our outstanding shares (currently at an annual rate of approximately \$81,000 and corporate expenses. We anticipate funding our expenditures for current operations with available cash resources, proceeds from public and/or private debt and equity financing, management fees and other payments from subsidiaries. New Valley 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 its ability to make such distributions.

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

The notes pay interest on a quarterly basis at a rate of 5% per year with an additional amount of interest payable on the notes on each interest payment date. This additional amount is based on the amount of cash dividends actually paid by us per share on our common stock during the prior three-month period ending on the record date for such interest payment multiplied by the number of shares of our common stock into which the notes are convertible on such record date (together, the Total Interest). Notwithstanding the foregoing, however, during the period prior to November 15, 2006, the interest payable on each interest payment date is the higher of (i) the Total Interest and (ii) 6³/₄% per year. The notes are convertible into our common stock, at the holder's option. The conversion price, which was of \$18.48 at December 31, 2005, is subject to adjustment for various events, including the issuance of stock dividends.

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

In July 2001, we completed the sale of \$172,500 (net proceeds of approximately \$166,400) of our 6.25% convertible subordinated notes due July 15, 2008 through a private offering to qualified institutional investors in accordance with Rule 144A under the Securities Act of 1933. The notes pay interest at 6.25% per annum and are convertible into our common stock, at the option of the holder. The conversion price, which was \$21.72 at December 31, 2005, is subject to adjustment for various events, and any cash distribution on our common stock results in a corresponding decrease in the conversion price. In December 2001, \$40,000 of the notes were converted into our common stock, and in October 2004, \$8 of the notes were converted. A total of \$132,492 principal amount of the notes were outstanding at December 31, 2005.

Our consolidated balance sheets include deferred income tax assets and liabilities, which represent temporary differences in the application of accounting rules established by generally accepted accounting principles and income tax laws. As of December 31, 2005, our deferred income tax liabilities exceeded our deferred income tax assets by \$43,509. The largest component of our deferred tax liabilities exists because of

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differences that resulted from a 1998 and 1999 transaction with Philip Morris Incorporated in which a subsidiary of Liggett contributed three of its premium brands to Trademarks LLC, a newly-formed limited liability company. In such transaction, Philip Morris acquired an option to purchase the remaining interest in Trademarks for a 90-day period commencing in December 2008, and we have an option to require Philip Morris to purchase the remaining interest commencing in March 2010. For additional information concerning the Philip Morris brand transaction, see Note 16 to our consolidated financial statements.

In connection with the transaction, we recognized in 1999 a pre-tax gain of \$294,078 in our consolidated financial statements and established a deferred tax liability of \$103,100 relating to the gain. Upon exercise of the options during the 90-day periods commencing in December 2008 or in March 2010, we will be required to pay tax in the amount of the deferred tax liability, which will be offset by the benefit of any deferred tax assets, including any net operating losses, available to us at that time. In connection with an examination of our 1998 and 1999 federal income tax returns, the Internal Revenue Service issued to us in September 2003 a notice of proposed adjustment. The notice asserts that, for tax reporting purposes, the entire gain should have been recognized in 1998 and in 1999 in the additional amounts of \$150,000 and \$129,900, respectively, rather than upon the exercise of the options during the 90-day periods commencing in December 2008 or in March 2010. If the Internal Revenue Service were to ultimately prevail with the proposed adjustment, it would result in the potential acceleration of tax payments of approximately \$127,000, including interest, net of tax benefits, through December 31, 2005. These amounts have been previously recognized in our consolidated financial statements as tax liabilities. As of December 31, 2005, we believe amounts potentially due have been fully provided for in our consolidated statements of operations.

We believe the positions reflected on our income tax returns are correct and intend to vigorously oppose any proposed adjustments to our returns. We have filed a protest with the Appeals Division of the Internal Revenue Service. No payment is due with respect to these matters during the appeal process. Interest currently is accruing on the disputed amounts at a rate of 9%, with the rate adjust quarterly based on rates published by the U.S. Treasury Department. If taxing authorities were to ultimately prevail in their assertion that we incurred a tax obligation prior to the exercise dates of these options and we were required to make such tax payments prior to 2009 or 2010, and if any necessary financing were not available to us, our liquidity could be materially adversely affected.

Long-Term Financial Obligations and Other Commercial Commitments

Our significant long-term contractual obligations as of December 31, 2005 were as follows:

Contractual Obligations	Fiscal Year						Total
	2006	2007	2008	2009	2010	Thereafter	
Long-term debt(1)	\$ 9,313	\$ 38,866	\$ 135,455	\$ 16,744	\$ 1,519	\$ 104,313	\$ 306,210
Operating leases(2)	4,423	2,729	2,027	1,640	1,188	2,810	14,817
Inventory purchase commitments(3)	5,577						5,577
Capital expenditure purchase commitments(4)	5,748	1,474					7,222
New Valley obligations under limited partnership agreements	4,905						4,905
Interest payments(5)	27,624	20,373	16,304	11,883	10,713	8,961	95,858
Total	\$ 57,590	\$ 63,442	\$ 153,786	\$ 30,267	\$ 13,420	\$ 116,084	\$ 434,589

(1)

Long-term debt is shown before discount. For more information concerning our long-term debt, see [Liquidity and Capital Resources](#) above and Note 7 to our consolidated financial statements.

- (2) Operating lease obligations represent estimated lease payments for facilities and equipment. See Note 8 to our consolidated financial statements.
- (3) Inventory purchase commitments represent purchase commitments under our leaf inventory management program. See Note 4 to our consolidated financial statements.

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(4) Capital expenditure purchase commitments represent purchase commitments for machinery and equipment at Liggett and Vector Tobacco. See Note 5 to our consolidated financial statements.

(5) Interest payments are based on the assumption our current dividend policy will continue.

Payments under the Master Settlement Agreement and the federal tobacco quota legislation discussed in Note 13 to our consolidated financial statements are excluded from the table above, as the payments are subject to adjustment for several factors, including inflation, overall industry volume, our market share and the market share of non-participating manufacturers.

Off-Balance Sheet Arrangements

We have various agreements in which we may be obligated to indemnify the other party with respect to certain matters. Generally, these indemnification clauses are included in contracts arising in the normal course of business under which we customarily agree to hold the other party harmless against losses arising from a breach of representations related to such matters as title to assets sold and licensed or certain intellectual property rights. Payment by us under such indemnification clauses is generally conditioned on the other party making a claim that is subject to challenge by us and dispute resolution procedures specified in the particular contract. Further, our obligations under these arrangements may be limited in terms of time and/or amount, and in some instances, we may have recourse against third parties for certain payments made by us. It is not possible to predict the maximum potential amount of future payments under these indemnification agreements due to the conditional nature of our obligations and the unique facts of each particular agreement. Historically, payments made by us under these agreements have not been material. As of December 31, 2005, we were not aware of any indemnification agreements that would or are reasonably expected to have a current or future material adverse impact on our financial position, results of operations or cash flows.

In May 1999, in connection with the Philip Morris brand transaction, Eve Holdings Inc., a subsidiary of Liggett, guaranteed a \$134,900 bank loan to Trademarks LLC. The loan is secured by Trademarks' three premium cigarette brands and Trademarks' interest in the exclusive license of the three brands by Philip Morris. The license provides for a minimum annual royalty payment equal to the annual debt service on the loan plus \$1,000. We believe that the fair value of Eve's guarantee was negligible at December 31, 2005.

In December 2001, New Valley's subsidiary, Western Realty Development LLC, sold all the membership interests in Western Realty Investments LLC to Andante Limited. In August 2003, Andante submitted an indemnification claim to Western Realty Development alleging losses of \$1,225 from breaches of various representations made in the purchase agreement. Under the terms of the purchase agreement, Western Realty Development has no obligation to indemnify Andante unless the aggregate amount of all claims for indemnification made by Andante exceeds \$750, and Andante is required to bear the first \$200 of any proven loss. New Valley would be responsible for 70% of any damages payable by Western Realty Development. New Valley has contested the indemnification claim.

In February 2004, Liggett Vector Brands and another cigarette manufacturer entered into a five year agreement with a subsidiary of the American Wholesale Marketers Association to support