

VECTOR GROUP LTD

Form S-3/A

December 15, 2006

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As filed with the Securities and Exchange Commission on December 15, 2006

Registration No. 333-137093

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

**Amendment No. 2 to
FORM S-3
REGISTRATION STATEMENT
*Under
The Securities Act of 1933***

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

Delaware
(State or other jurisdiction of
incorporation or organization)

65-0949535
(I.R.S. Employer
Identification Number)

**100 S.E. Second Street
Miami, Florida 33131
(305) 579-8000**

(Address, including zip code, and telephone number, including area code, of Registrant's principal executive offices)

**Richard J. Lampen
Executive Vice President
Vector Group Ltd.
100 S.E. Second Street
Miami, Florida 33131
(305) 579-8000**

(Name, address, including zip code, and telephone number, including area code, of agent for service)

Copies to:
**Mark J. Mihanovic, Esq.
McDermott Will & Emery LLP
2049 Century Park East, 34th Floor
Los Angeles, California 90067
(310) 277-4110**

Approximate date of commencement of proposed sale to the public: From time to time after the effective date of this Registration Statement.

If the only securities being registered on this Form are being offered pursuant to dividend or interest reinvestment plans, please check the following box. ☐

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, other than securities offered only in connection with dividend or interest reinvestment plans, check the following box. ☐

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If this Form is a registration statement pursuant to General Instruction I.D. or a post-effective amendment thereto that shall become effective upon filing with the Commission pursuant to Rule 462(e) under the Securities Act, check the following box. o

If this Form is a post-effective amendment to a registration statement filed pursuant to General Instruction I.D. filed to register additional securities or additional classes of securities pursuant to Rule 413(b) under the Securities Act, check the following box. o

CALCULATION OF REGISTRATION FEE

Title of Each Class of Securities to be Registered	Amount to be Registered	Proposed Maximum Offering Price Per Security	Aggregate Offering Price	Amount of Registration Fee
\$110,000,000 3 7/8% Variable Interest Senior Convertible Debentures due June 15, 2026 Common Stock, \$.10 par value	\$110,000,000 ⁽¹⁾ 5,371,094 ⁽³⁾	100% ⁽²⁾	\$110,000,000 ⁽¹⁾	\$11,770 ⁽⁵⁾ (4)

(1) Represents the aggregate principal amount of the debentures issued by the Registrant.

(2) Estimated solely for the purpose of calculating the registration fee pursuant to Rule 457(c) under the Securities Act of 1933 and exclusive of accrued interest and distributions, if any.

(3) Represents 5,371,094 shares of

common stock issuable upon conversion of the debentures at the conversion price of \$20.48 per share of common stock. Pursuant to Rule 416 under the Securities Act, such number of shares of common stock registered hereby shall include an indeterminate number of shares of common stock that may be issued in connection with a stock split, stock dividend, recapitalization or similar event.

- (4) Pursuant to Rule 457(i), no additional filing fee is payable with respect to the shares of common stock issuable upon conversion of the debentures because no additional consideration will be received in connection with the exercise of the conversion privilege.

- (5) Previously paid
on September 1,
2006.

The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until the Registration Statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.

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The information in this prospectus is not complete and may be changed. The holders may not sell these securities until the registration statement relating to these securities that has been filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and it is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

Subject to Completion, Dated December 15, 2006
\$110,000,000
3 7/8% Variable Interest Senior Convertible Debentures due June 15, 2026
and the common stock issuable upon conversion of the Debentures

This prospectus relates to the resale of up to 5,371,094 of our shares of common stock by certain selling securityholders. The shares that may be resold pursuant to this prospectus include 5,371,094 shares of common stock issuable upon conversion of \$110,000,000 aggregate principal amount of our convertible debentures (the "debentures").

We issued the debentures offered by this prospectus in a private placement in June 2006. This prospectus will be used by selling securityholders to resell their debentures and the common stock issuable upon conversion of their debentures. We will not receive any proceeds from this offering.

The debentures are convertible by securityholders prior to maturity (unless previously redeemed or repurchased pursuant to their terms) into common stock at a conversion rate of 48.828 shares per each \$1,000 principal amount of debentures, subject to adjustment if certain events occur. This is equivalent to a conversion price of \$20.48 per share. We will pay interest on the debentures on each March 15, June 15, September 15, and December 15 of each year the debentures are outstanding, beginning on September 15, 2006. The debentures accrue interest at a rate of 3 7/8% per year, with an additional amount of interest payable on the debentures on each interest payment date 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 debentures are convertible on such record date (together, the "Total Interest"). Notwithstanding the foregoing, however, the interest payable on each interest payment date shall be the higher of (i) the Total Interest and (ii) 5 3/4% per year.

The debentures will mature on June 15, 2026, unless earlier converted, redeemed or repurchased. We may not redeem any debentures before June 15, 2012. Beginning on June 15, 2012, we may redeem the debentures at any time or from time to time, in whole or in part. We will give not less than 30 nor more than 60 days notice to the debenture holders of any redemption. Upon any redemption, we will pay a redemption price equal to 100% of the principal amount of the debentures to be redeemed, plus accrued and unpaid interest, and registration default payments, if any, up to, but excluding, the redemption date.

We must redeem 10% of the total aggregate principal amount of the debentures outstanding on June 15, 2011. In addition to such redemption amount, we will also redeem on June 15, 2011 and at the end of each interest accrual period thereafter, such amounts on a pro-rata basis, if any, of the debentures necessary to prevent the debentures from being treated as an "Applicable High Yield Discount Obligation" under the Internal Revenue Code.

The holders of the debentures may require us to repurchase all or any portion of their debentures for cash on June 15, 2012, June 15, 2016 and June 15, 2021, at a repurchase price equal to 100% of their principal amount plus accrued and unpaid interest, and registration default payments, if any, up to but excluding the repurchase date. See

Description of Debentures Mandatory Redemption and Repurchase at the Option of the Holders.

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In the event of a fundamental change, as described in this prospectus, the holders of the debentures may require us to repurchase any debentures held by them. In addition to the repurchase price, we will pay the make-whole premium described in this prospectus in cash and/or common stock to holders of debentures who require us to repurchase their debentures in connection with such repurchase event.

Our common stock is traded on the New York Stock Exchange under the symbol VGR . On December , 2006, the closing price of our common stock on the New York Stock Exchange was \$ ___ per share.

The securities offered by this prospectus involve a high degree of risk. See Risk Factors beginning on page 13.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

This prospectus is dated December __, 2006

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ABOUT THIS PROSPECTUS

This prospectus is part of a registration statement that we filed with the Securities and Exchange Commission (SEC) using a shelf registration process. Under this shelf process, the selling stockholders may from time to time sell the shares of Vector Group Ltd. common stock described in this prospectus.

You should rely only on the information contained or incorporated by reference in this prospectus. We have not, and the selling stockholders have not, authorized anyone to provide you with information different from that contained in this prospectus. The selling stockholders are offering to sell, and seeking offers to buy, shares of our common stock only in jurisdictions where it is lawful to do so. The information in this prospectus is accurate only as of the date of this prospectus, regardless of the time of delivery of this prospectus or any sale of our common stock. Neither the delivery of this prospectus nor any sale made hereunder shall, under any circumstances, create any implication that there has been no change in our affairs since the date of this prospectus or that the information contained or incorporated by reference in this prospectus or any accompanying prospectus supplement is correct as of any time subsequent to the date of such information.

WHERE YOU CAN FIND MORE INFORMATION

We are subject to the informational reporting requirements of the Securities Exchange Act of 1934, as amended (the Exchange Act), and file reports, proxy statements and other information with the SEC. You can read and copy all of this information at the Public Reference Room maintained by the SEC at its principal office at 100 F Street, NE, Washington, D.C. 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. In addition, the SEC maintains a web site that contains reports, proxy statements and other information regarding issuers, like us, that file such material electronically with the SEC. The address of this web site is: <http://www.sec.gov>. You also can inspect such reports, proxy statements and other information about us at the offices of the New York Stock Exchange, 20 Broad Street, New York, New York 10005. Our common stock is listed on the New York Stock Exchange.

We have filed with the SEC a registration statement on Form S-3 under the Securities Act of 1933, as amended (the Securities Act), with respect to the common stock offered by this prospectus. This prospectus does not contain all of the information set forth in the registration statement. We have omitted parts of the registration statement as permitted by the rules and regulations of the SEC. Statements contained in or incorporated by reference into this prospectus as to the contents of any contract or other document are not necessarily complete. You should refer to a copy of each contract or document filed as an exhibit to the registration statement or incorporated by reference into this prospectus for complete information. Copies of the registration statement, including exhibits and information incorporated by reference into this prospectus, may be inspected without charge at the SEC's Public Reference Room or website.

INCORPORATED DOCUMENTS

The SEC allows us to incorporate by reference into this prospectus. This means that we can disclose important information to you by referring you to another document filed separately with the SEC.

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The information incorporated is considered part of this prospectus, except for any information that is superseded by information that is included in this document or in a later filed document.

This prospectus incorporates by reference the documents listed below and any filings made by us with the SEC pursuant to Sections 13(a), 13(c), 14 and 15(d) of the Securities Exchange Act of 1934 between the date of this prospectus and the termination of this offering. Any report, document or portion thereof that is furnished to, but not filed with, the SEC is not incorporated by reference.

Our Annual Report on Form 10-K for the fiscal year ended December 31, 2005, filed with the SEC on March 17, 2006 (as amended by Form 10-K/A, filed with the SEC on November 24, 2006);

Our Quarterly Reports on Form 10-Q for the quarter ended September 30, 2006, filed with the SEC on November 14, 2006; for the quarter ended March 31, 2006, filed with the SEC on May 10, 2006 (as amended by Form 10-Q/A, filed with the SEC on November 22, 2006); and for the quarter ended June 30, 2006, filed with the SEC on August 9, 2006 (as amended by Form 10-Q/A, filed with the SEC on November 22, 2006);

Our Current Reports on Form 8-K, filed with the SEC on January 3, 2006, January 27, 2006, February 6, 2006, March 6, 2006, April 3, 2006, June 8, 2006, June 27, 2006, June 30, 2006, July 13, 2006 (as amended by Form 8-K/A, filed with the SEC on November 27, 2006), July 17, 2006, July 24, 2006, October 19, 2006 (as amended by Form 8-K/A, filed with the SEC on November 27, 2006), November 13, 2006, and November 22, 2006, (On June 27, 2006, we filed with the SEC a Current Report on Form 8-K, which contained revised items 6, 7 and 8 of our amended Annual Report on Form 10-K, where appropriate, to reflect the retrospective application of a new accounting standard that we were required to adopt as of January 1, 2006. All of the preceding references in this paragraph to our amended Annual Report on Form 10-K are intended to refer to such amended Form 10-K, as so revised by the Form 8-K. Please see the Form 8-K for a detailed discussion of the policy change. The Form 8-K filed on June 27, 2006 was amended by Form 8-K/A, filed with the SEC on November 28, 2006.); and

The description of our common stock set forth in our prospectus dated June 3, 2005 filed on Form 424B3 on June 3, 2005.

Any statement contained in a document incorporated or deemed to be incorporated by reference herein shall be deemed to be modified or superceded for purposes of this prospectus to the extent that a statement contained herein or in any other document subsequently filed which is also incorporated by reference herein modifies or supercedes such statement. Any such statement so modified or superceded shall not be deemed, except as so modified, to constitute a part of this prospectus.

You can obtain any of the documents incorporated by reference in this prospectus from us without charge, excluding any exhibits to those documents unless the exhibit is specifically incorporated by reference in the document. You can obtain documents incorporated by reference by requesting them from us, either orally or in writing. Requests for such documents should be directed to:

Vector Group Ltd.
Attention: Investor Relations
100 S.E. Second Street
32nd Floor
Miami, Florida 33131
(305) 579-8000

You should rely only on the information provided or incorporated by reference in this prospectus or a prospectus supplement or amendment. We have not authorized anyone else to provide you with different information. We are not making an offer of these securities in any jurisdiction where the offer is not permitted. You should not assume the information in this prospectus or a prospectus supplement or amendment is accurate as of any date other than the date on the front of the documents.

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

capital expenditures;

cost reduction;

new legislation;

cash flows:

operating performance;

litigation;

impairment charges and cost savings associated with restructurings of our tobacco operations; and

related industry developments (including trends affecting our business, financial condition and results of operations).

We identify forward-looking statements in this prospectus by using words or phrases such as anticipate , believe , estimate , expect , intend , may be , objective , plan , seek , predict , project ,and will be and similar words and phrases, including their negative forms. Forward-looking statements are statements that are based on expectations, forecasts or projections regarding future events or financial performance. Forward-looking statements are not guarantees of future performance and are subject to risks and uncertainties. Forward-looking statements may be identified by the presence of certain words or phrases, such as those listed above, but not limited to, and the absence of such words or phrases does not necessarily mean that a statement is not forward-looking. Forward-looking statements may be identified by the presence of certain words or phrases, such as those listed above, but not limited to, and the absence of such words or phrases does not necessarily mean that a statement is not forward-looking.

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

general economic and market conditions and any changes therein, due to acts of war and terrorism or otherwise;

governmental regulation and policies;

effects of industry competition;

impact of business combinations, including acquisitions and divestitures, both internally for us and externally in the tobacco industry;

impact of restructurings on our tobacco business and our ability to achieve any increases in profitability estimated to occur as a result of these restructurings;

impact of new legislation on our competitors payment obligations, results of operations and product costs, i.e., the impact of recent federal legislation eliminating the federal tobacco quota system;

uncertainty related to litigation and potential additional payment obligations for us under the Master Settlement Agreement and other settlement agreements with the states; and

risks inherent in our new product development initiatives.

Further information on risks and uncertainties specific to our business include the risk factors discussed in Risk Factors and in Management's Discussion and Analysis of Financial Condition and

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Results of Operations incorporated by reference into this prospectus.

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

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THE OFFERING

The following is a brief summary of some of the terms of the debentures offered for resale in this prospectus. For a more complete description of the terms of the debentures, see the "Description of Debentures" section in this prospectus.

Issuer	Vector Group Ltd.
Securities Offered	\$110,000,000 in aggregate principal amount of 3 7/8% Variable Interest Senior Convertible Debentures due 2026. This prospectus also relates to shares of our common stock issuable upon conversion of the debentures.
Maturity	June 15, 2026.
Interest	Annual Rate: 3 7/8%, with an additional amount of interest payable on each interest payment date based on the amount of cash dividends per share paid by us on our common stock during the prior three-month period ending on the record date for such interest payment multiplied by the total number of shares of our common stock into which the debentures are convertible on such record date (together, the "Total Interest"). Notwithstanding the foregoing, however, the interest payable on each interest payment date shall be the higher of (i) the Total Interest and (ii) 5 3/4% per year. Payment Frequency: Every quarter on March 15, June 15, September 15 and December 15. First Payment: September 15, 2006.
Optional Redemption	We may not redeem any debentures before June 15, 2012. Beginning on June 15, 2012, we may redeem some or all of the debentures at any time or from time to time. We will give not less than 30 nor more than 60 days notice of any redemption. Upon any redemption, we will pay a redemption price equal to 100% of the principal amount of the debentures to be redeemed, plus accrued and unpaid interest, and registration default payments, if any, up to, but excluding, the redemption date.
Conversion Rights	The debentures are convertible at the holders' option at any time following the date of issuance until the maturity date, unless previously redeemed or repurchased pursuant to their terms, into our common stock at a conversion price of \$20.48 per share of common stock, subject to adjustment for various events. The conversion ratio is 48.828 shares of common stock per \$1,000 principal amount of debentures.
Mandatory Redemption	We must redeem 10.0% of the total aggregate principal amount of the debentures outstanding on June 15, 2011. We will also redeem on June 15, 2011 and at the end of

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each interest accrual period thereafter, such amounts on a pro-rata basis, if any, of the debentures necessary to prevent the debentures from being treated as an Applicable High Yield Discount Obligation within the meaning of section 163(i)(1) of the Internal Revenue Code of 1986, as amended. You may require us to repurchase all or any portion of your debentures for cash on June 15, 2012, June 15, 2016 and June 15, 2021, at a repurchase price equal to 100% of their principal amount plus accrued and unpaid interest, and registration default payments, if any, up to but excluding the repurchase date. See Description of Debentures Mandatory Redemption and Repurchase at the Option of the Holders.

Repurchase at Option of the Holders Upon a Fundamental Change	If a fundamental change (as defined in Description of Debentures Repurchase of Debentures at the Option of the Holders Upon a Fundamental Change) occurs, subject to certain conditions and restrictions, we will be required to repurchase the debentures, at the option of the holders thereof, at 100% of their principal amount, plus accrued and unpaid interest, if any, plus, under certain circumstances, the make-whole premium described in this prospectus in cash and/or common stock to holders of debentures who require us to repurchase their debentures in connection with such repurchase event.
Ranking	The debentures are our senior unsecured obligations and rank on a parity in right of payment with all of our existing and future senior unsecured indebtedness. The debentures will effectively rank junior to any future secured indebtedness we may incur and junior to liabilities of our subsidiaries. As of September 30, 2006, these debentures would have been effectively junior to approximately \$75.6 million of indebtedness of our subsidiaries.
Use of Proceeds	We will not receive any of the proceeds from the resale by the selling securityholders of the debentures or the common stock issuable upon conversion of the debentures.
Events of Default	<p>The following will be events of default under the indenture governing the debentures:</p> <ul style="list-style-type: none"> we fail to deliver within 30 business days the required number of shares of common stock issuable upon conversion, we fail for 30 business days to reserve shares of common stock issuable upon conversion, we fail to pay interest or registration default payments when due and that failure continues for five days, we fail to pay the principal and any premium on the debentures when due,

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we fail to perform any other covenant in the indenture or the debentures and that failure continues for 60 days after notice to us by the trustee or the holders of a least 25% in aggregate principal amount of the outstanding debentures,

subject to certain exceptions, we fail to pay when due the principal of, or interest on, any indebtedness for money borrowed by us or any of our subsidiaries in excess of \$10.0 million if such indebtedness has been accelerated and such acceleration is not annulled within 30 days after written notice to us by the trustee or the holders of at least 25% in the aggregate principal amount of the outstanding debentures,

final unsatisfied judgments not covered by insurance aggregating in excess of \$10.0 million, at any one time, are rendered against us or any significant subsidiary and are not stayed, bonded or discharged within 60 days, and

certain events of bankruptcy, insolvency or reorganization with respect to us or any of our significant subsidiaries specified in the indenture.

See Description of Debentures Events of Default and Remedies.

Registration Rights

Pursuant to a registration rights agreement, we have filed with the SEC a shelf registration statement, of which this prospectus is a part, with respect to the debentures and the common stock issuable upon conversion of the debentures. See Description of Debentures Registration Rights.

Trading Market

The debentures are a new issue of securities with no established trading market. We do not intend to list the debentures on any securities exchange or automated quotation system. We expect the debentures to be eligible for trading in the PORTAL Market of the NASD, Inc. Our common stock trades on the New York Stock Exchange under the symbol VGR .

**Certain United States Federal
Income Tax Consequences**

We and each holder of the debentures agree in the indenture, for United States federal income tax purposes, to treat the debentures as contingent payment debt instruments and to be bound by our application of the

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U.S. Treasury regulations that govern contingent payment debt instruments, including our determination that the rate at which interest will be deemed to accrue for United States federal income tax purposes will be 10.75% compounded quarter-annually, which is the rate comparable to the rate at which we would borrow on a non-contingent, non-convertible borrowing with terms and conditions otherwise comparable to the debentures. Accordingly, each holder will be required to accrue interest on a constant yield to maturity basis at that rate (subject to certain adjustments), with the result that a U.S. holder (as defined below under **Certain United States Federal Income Tax Consequences**) may recognize taxable income significantly in excess of cash received while the debentures are outstanding. In addition, a U.S. holder will recognize ordinary income upon a sale, exchange, conversion, redemption or repurchase of the debenture at a gain. In computing such gain, the amount realized by a U.S. holder will include, in the case of a conversion, the amount of cash and the fair market value of shares received. However, the proper United States federal income tax treatment of a holder of a debenture is uncertain in various respects. If the agreed upon treatment was successfully challenged by the Internal Revenue Service, it might be determined that, among other differences, a holder should have accrued interest income at a lower rate, should not have recognized income or gain upon the conversion, and should not have recognized ordinary income upon a taxable disposition of its debentures. See **Certain United States Federal Income Tax Consequences**.

We intend to take the position that payments of contingent interest to non-U.S. holders will not be exempt from the 30% U.S. withholding tax and, therefore, we intend to withhold on such payments of contingent interest at a rate of 30% unless such holder is eligible for a reduced rate or an exemption under an applicable U.S. income tax treaty or such interest is effectively connected with the holder's conduct of a U.S. trade or business. Payments of noncontingent interest and cash or common stock delivered upon the conversion, redemption, or retirement of a debenture will generally not be subject to such withholding if certain conditions are satisfied by the holder, as explained in detail below under **Certain United States Federal Income Tax Consequences**.

HOLDERS ARE URGED TO CONSULT THEIR TAX ADVISORS REGARDING THE TAX TREATMENT OF THE DEBENTURES AND WHETHER A PURCHASE OF THE DEBENTURES IS ADVISABLE IN LIGHT OF THE TAX TREATMENT OF THE DEBENTURES AND THE INVESTOR'S PARTICULAR TAX SITUATION.

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Risk Factors

Investment in the debentures and the underlying common stock involves a high degree of risk. Therefore, you should carefully consider all information in this prospectus and in particular the matters set forth in the Risk Factors section beginning on page 13.

The Common Stock

This prospectus covers, and the registration statement of which it is a part registers, 5,371,094 shares of our common stock, par value \$0.10. As of December 14, 2006, we had approximately 56,891,600 shares of our common stock outstanding. Holders of our common stock are entitled to one vote per share on all matters submitted to a vote of stockholders.

Our common stock is listed on the NYSE under the symbol VGR .

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RISK FACTORS

Before you invest in the debentures, you should be aware that we are subject to various risks, including the ones listed below, the occurrence of any of which could materially adversely affect our business, financial condition and results of operations. You should carefully consider these risk factors, as well as the other information included or incorporated by reference in this Offering Circular, in evaluating an investment in our securities. Although the risks identified below represent those we believe are the most significant risks at the present time, additional risks of which we are currently unaware or that we currently deem immaterial could also materially impair our business operations.

Risks Relating to Our Business

We and our subsidiaries have a substantial amount of indebtedness.

We and our subsidiaries have significant indebtedness and debt service obligations. At September 30, 2006, we and our subsidiaries had total outstanding indebtedness (including embedded derivative liability and beneficial conversion feature related to convertible notes) of \$255.2 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 debentures 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 \$5.0 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.

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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 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 was 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 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

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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. We believe 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 September 30, 2006, there were approximately 142 individual suits, 11 purported class actions and nine 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 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. Trial of the case concluded in June 2005. In June 2005, the government sought to restructure its potential remedies and filed a proposed Final Judgment and Order requesting: (1) \$14 billion for a cessation and counter marketing program; (2) so-called "corrective statements"; (3) disclosures; and (4) enjoined activities. In August 2006, the trial court entered a Final Judgment and Remedial Order against each of the cigarette manufacturing defendants, except Liggett. The Final Judgment, among other things, ordered the following relief against the non-Liggett defendants:

the defendants are enjoined from committing any act of racketeering concerning the manufacturing, marketing, promotion, health consequences or sale of cigarettes in the United States;

the defendants are enjoined from making any material false, misleading, or deceptive statement or representation concerning cigarettes that persuades people to purchase cigarettes;

the defendants are permanently enjoined from utilizing "lights", "low tar", "ultra lights", "mild", or "natural" descriptors or conveying any other express or implied health messages in connection with the marketing or sale of cigarettes as of January 1, 2007;

the defendants must make corrective statements on their websites, and in television and print media advertisements, and certain defendants must affix corrective statements as inserts to cigarette packaging and point of sale materials, concerning:

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- (i) the adverse health effects of smoking;
- (ii) the addictiveness of smoking and nicotine;
- (iii) the lack of any significant health benefit from smoking lights , low tar , ultra l lights , mild or natural cigarettes;
- (iv) the manipulation of cigarette design and composition to ensure optimum nicotine delivery; and
- (v) the adverse health effects of exposure to secondhand smoke;
the defendants must maintain internet document websites until 2016 with access to smoking and health related documents;

the defendants must disclose all disaggregated marketing data to the government in the same form and on the same schedule as they provide such information to the Federal Trade Commission (FTC);

the defendants are not permitted to sell or otherwise transfer any of their cigarette brands, product formulas or businesses to any person or entity for domestic use without a court order, and unless the acquiring person or entity will be bound by the terms of the Final Judgment; and

the defendants must pay the appropriate costs of the government in prosecuting the action, in an amount to be determined by the trial court.

No monetary damages were awarded other than the government's costs. The U.S. Court of Appeals for the District of Columbia has stayed the Final Judgement pending appeal. It is unclear what impact, if any, the Final Judgment will have on the cigarette industry as a whole. While Liggett was excluded from the Final Judgment, to the extent that it leads to a decline in industry-wide shipments of cigarettes in the United States, Liggett's sales volume, operating income and cash flows could be materially adversely affected, which in turn could negatively affect the value of our common stock.

In one of the other cases pending against Liggett, in 2000, an action against cigarette manufacturers involving approximately 975 named individual plaintiffs was consolidated for trial on some common 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.

Class action suits have been filed in a number of states against individual cigarette manufacturers, alleging, among other things, that the use of the terms light and ultralight 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. The action asserts claims under the Racketeer Influenced and Corrupt Organizations Act (RICO). The proposed class is seeking as much as \$200 billion in damages, which could be trebled under RICO. In November 2005, the court ruled that if the class is certified, the plaintiffs would be permitted to calculate damages on an aggregate basis and use fluid recovery theories to allocate them among class members. Fluid recovery would permit potential damages to be paid out in ways other than merely giving cash directly to plaintiffs, such as establishing a pool of money that could be used for public purposes.

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On September 25, 2006, the court granted plaintiffs' motion for class certification. On November 20, 2006, the United States Court of Appeals for the Second Circuit issued a formal stay of the case, pending appeal.

There are currently four individual smoking-related actions pending 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 \$0.54 million against Liggett. In addition, plaintiff's counsel was awarded legal fees of \$0.75 million. Liggett has appealed both the verdict and the award of legal fees. 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. In June 2006, a Florida intermediate appellate court reversed the trial court's decision and remanded the case for further proceedings. Trial has been scheduled in Missouri state court for May 2007 in another case.

In May 2003, a Florida intermediate appellate court overturned a \$790.0 million punitive damages award against Liggett and decertified the *Engle* smoking and health class action. In July 2006, the Florida Supreme Court affirmed in part and reversed in part the May 2003 intermediate appellate court decision. Although the Florida Supreme Court affirmed the decision to decertify the class and the order vacating the punitive damages award, the court upheld certain of the trial court's Phase I determinations (including that: (i) smoking causes lung cancer, among other diseases; (ii) nicotine in cigarettes is addictive; (iii) defendants placed cigarettes on the market that were defective and unreasonably dangerous; (iv) the defendants concealed material information; (v) the defendants agreed to misrepresent information relating to the health effects of cigarettes with the intention that the public would rely on this information to its detriment; (vi) all defendants sold or supplied cigarettes that were defective; and (vii) all defendants were negligent) and allowed plaintiffs to proceed to trial on individual liability issues and compensatory and punitive damage issues, provided they commence their individual lawsuits within one year from the court's mandate. The defendant tobacco companies have moved for reconsideration and/or clarification of the decision. If the Florida Supreme Court's decision is allowed to stand, it could result in the filing of a large number of individual personal injury cases in Florida which could 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 *Engle* class, 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 light of the Florida Supreme Court's July 2006 decision decertifying the *Engle* class, entitlement to the escrowed monies will have to be determined by the court. In June 2002, the jury in *Lukacs v. RJ Reynolds Tobacco Company*, an individual case brought under the third phase of the *Engle* case, awarded \$37.5 million (subsequently reduced by the court to \$24.86 million) of compensatory damages against Liggett and two other defendants and found Liggett 50% responsible for the damages. Entry of the final judgment in *Lukacs*, along with the plaintiff's motion to tax costs and attorneys' fees, was stayed pending appellate review of the *Engle* final judgment. Liggett may be required to bond the amount of the judgment against it to perfect its appeal. 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

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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 (the FDA). 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, were 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 \$12.3 million for the periods 2001 through 2005, and require Liggett to pay an additional amount of approximately \$2.8 million in 2006 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. No amounts have been accrued in our 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, which has since been released to the settling states although Liggett continues to dispute that this money is owed, 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, which is known as the NPM Adjustment. The \$7.7 million withheld from payment represents \$5.3 million claimed as an adjustment to Liggett's 2004 Master Settlement Agreement obligation for the NPM Adjustment 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. Liggett withheld approximately \$1.6 million from its payment due under the Master Settlement Agreement on April 15, 2006 which Liggett claims as the NPM Adjustment to its 2005 payment obligation and \$2.6 million relating to the gross vs. net dispute discussed above. The following amounts have not been accrued in our consolidated financial statements as they relate to Liggett's and Vector Tobacco's claim for an NPM Adjustment: \$6.5 million for 2003, \$3.8 million for 2004 and approximately \$0.8 million for 2005.

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

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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. Liggett has recently offered Florida \$2.5 million in a lump sum to settle all alleged obligations through December 31, 2006 and \$100,000 per year thereafter, to resolve all alleged future obligations under the settlement agreement. 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 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 and an additional \$500,000 accrued during the third quarter of 2006, 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 eliminated the federal tobacco quota system and price support system through an industry funded buyout of tobacco growers and quota holders. 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. Management currently estimates that Liggett's and Vector Tobacco's assessment will be approximately \$22.0 million for the second year of the program which began January 1, 2006. 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

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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, and five states, in 2006, have 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.

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, 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 other product modifications.

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Recoverability of costs of inventory. At September 30, 2006, approximately \$1.0 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 \$37.0 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 previously 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.

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 FDA, the FTC 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.

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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 abroad, 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, or issued to third parties, if infringement would otherwise occur, both in the United States and abroad.

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, 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

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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