VECTOR GROUP LTD
Form 10-Q
November 09, 2005

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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For The Quarterly Period Ended September 30, 2005

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

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

100 S.E. Second Street
Miami, Florida 33131
305/579-8000
(Address, including zip code and telephone number, including area code, of the principal executive offices)

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

Indicate by check mark whether the Registrant is an accelerated filer as defined in Rule 12b-2 of the Exchange Act. þ Yes o No

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

At November 8, 2005, Vector Group Ltd. had 44,592,890 shares of common stock outstanding.

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

	September 30, 2005	December 31, 2004
ASSETS:		
Current assets:		
Cash and cash equivalents	$ 158,964	$ 110,004
Investment securities available for sale	19,672	14,927
Accounts receivable trade	22,373	2,464
Other receivables	502	653
Inventories	76,602	78,941
Restricted assets		606
Deferred income taxes	3,486	22,695
Other current assets	9,140	11,834
Total current assets	290,739	242,124
Property, plant and equipment, net	62,615	65,357
Assets held for sale	2,212	54,077
Long-term investments, net	2,540	2,410
Investments in non-consolidated real estate businesses	33,441	27,160
Restricted assets	5,082	4,374
Deferred income taxes	17,937	18,119
Intangible asset	107,511	107,511
Other assets	14,330	14,763
Total assets	$ 536,407	$ 535,895
LIABILITIES AND STOCKHOLDERS EQUITY (DEFICIT):		
Current liabilities:		
Current portion of notes payable and long-term debt	$ 16,955	$ 6,043
Accounts payable	9,161	10,549
Accrued promotional expenses	15,442	17,579
Accrued taxes payable, net	31,084	28,859
Settlement accruals	14,130	28,200
Tobacco quota buyout	9,975	
Deferred income taxes	3,731	4,175
Accrued interest	3,643	4,931
Other accrued liabilities	18,555	19,499
Total current liabilities	122,676	119,835
Notes payable, long-term debt and other obligations, less current portion	237,772	254,603

Fair value of derivatives embedded within convertible debt		40,194		25,686
Noncurrent employee benefits		17,760		15,727
Deferred income taxes		150,332		146,284
Other liabilities		5,328		5,134
Minority interests		58,590		53,429
Commitments and contingencies				
Stockholders equity (deficit):				
Preferred stock, par value $1.00 per share, authorized 10,000,000 shares				
Common stock, par value $0.10 per share, authorized 100,000,000 shares, issued 48,160,679 and 45,163,386 shares and outstanding 44,592,890 and 41,773,591 shares		4,459		4,177
Additional paid-in capital		30,029		61,468
Unearned compensation		(10,100)		(656)
Deficit		(93,175)		(123,231)
Accumulated other comprehensive loss		(11,138)		(10,409)
Less: 3,567,789 and 3,389,795 shares of common stock in treasury, at cost		(16,320)		(16,152)
Total stockholders equity (deficit)		(96,245)		(84,803)
Total liabilities and stockholders equity (deficit)	$	536,407	$	535,895

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

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

	Three Months Ended		Nine Months Ended	
	Sept. 30, 2005	Sept. 30, 2004	Sept. 30, 2005	Sept. 30, 2004
Revenues*	$ 124,965	$ 124,251	$ 342,251	$ 370,869
Expenses:				
Cost of goods sold (including inventory impairment of $0, $0, $0 and $37,000)*	77,880	71,117	202,780	252,045
Operating, selling, administrative and general expenses	27,109	31,887	76,485	107,623
Restructuring and impairment charges		4,532		7,544
Operating income	19,976	16,715	62,986	3,657
Other income (expenses):				
Interest and dividend income	1,380	322	3,260	1,548
Interest expense	(8,266)	(6,378)	(24,155)	(18,650)
Gain on sale of investments, net	8	302	1,433	5,888
Gain from conversion of LTS notes			9,461	
Equity loss on operations of LTS			(299)	
Equity income from non-consolidated New Valley real estate businesses	4,184	4,539	6,202	9,827
Other, net	13	(1)	69	(10)
Income from operations before income taxes and minority interests	17,295	15,499	58,957	2,260
Income tax expense	7,541	6,708	29,322	3,562
Minority interests	(779)	(837)	(2,403)	(3,286)
Income (loss) from continuing operations	8,975	7,954	27,232	(4,588)
Discontinued operations:				
Income from discontinued operations, net of minority interests and taxes		112	82	379
Gain on disposal of discontinued operations, net of minority interests and taxes			2,952	
Gain from discontinued operations		112	3,034	379

Net income (loss)	$	8,975	$	8,066	$	30,266	$	(4,209)
Per basic common share:								
Income (loss) from continuing operations	$	0.20	$	0.18	$	0.62	$	(0.11)
Income from discontinued operations	$		$		$	0.07	$	0.01
Net income (loss) applicable to common shares	$	0.20	$	0.18	$	0.69	$	(0.10)
Per diluted common share:								
Income (loss) from continuing operations	$	0.19	$	0.17	$	0.59	$	(0.11)
Income from discontinued operations	$		$		$	0.07	$	0.01
Net income (loss) applicable to common shares	$	0.19	$	0.17	$	0.66	$	(0.10)
Cash distributions declared per share	$	0.38	$	0.36	$	1.14	$	1.08

* Revenues and Cost of goods sold include excise taxes of $42,413, $42,626, $112,856 and $132,729, respectively.

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

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

	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Unearned Compensation	Deficit	Treasury Stock	Accumulated Other Comprehensive Loss	Total
Balance, December 31, 2004	41,773,591	$ 4,177	$ 61,468	$ (656)	$ (123,231)	$ (16,152)	$ (10,409)	$ (84,803)
Net income					30,266			30,266
Foreign currency adjustments, net							(543)	(543)
Unrealized loss on investment securities, net							(186)	(186)
Total other comprehensive loss								(729)
Total comprehensive income								29,537
Distributions on common stock			(53,312)					(53,312)
Effect of stock dividend	2,099,452	210			(210)			
Impact of restricted stock grant	500,000	50	9,634	(9,634)				50
Exercise of options	219,847	22	2,924			(168)		2,778
Effect of New Valley restricted stock transactions, net			596					596
Amortization of deferred compensation, net				190				190
Tax benefit of options exercised			330					330
Beneficial conversion			8,450					8,450

feature of notes payable								
Other			(61)					(61)
Balance, September 30, 2005	44,592,890	$ 4,459	$ 30,029	$ (10,100)	$ (93,175)	$ (16,320)	$ (11,138)	$ (96,245)

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

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

	Nine Months Ended	
	Sept. 30, 2005	Sept. 30, 2004
Net cash provided by (used in) operating activities:	$ 27,401	$ (6,194)
Cash flows from investing activities:		
Proceeds from sales of assets, net		25,821
Sale or maturity of investment securities	3,268	65,454
Purchase of investment securities	(500)	(10,747)
Sale of long-term investments		243
Purchase of long-term investments	(128)	
Investments in non-consolidated real estate businesses	(6,250)	(2,500)
Distributions from non-consolidated real estate businesses	5,500	
(Increase) decrease in restricted assets	(842)	1,832
New Valley repurchase of common shares		(202)
Issuance of LTS common stock	(1,500)	
Issuance of LTS notes	(1,750)	
Capital expenditures	(5,164)	(3,005)
Net cash (used in) provided by investing activities	(7,366)	76,896
Cash flows from financing activities:		
Proceeds from debt	44,959	
Repayments of debt	(3,542)	(20,246)
Borrowings under revolver	328,086	411,150
Repayments on revolver	(319,359)	(395,660)
Distributions on common stock	(50,326)	(47,397)
Issuance of restricted stock	63	
Proceeds from exercise of options	2,778	2,868
Issuance of note receivable		(500)
Deferred financing charges	(2,168)	(208)
Net cash provided by (used in) financing activities	491	(49,993)
Net cash provided by discontinued operations	28,434	1,983
Net increase in cash and cash equivalents	48,960	22,692
Cash and cash equivalents, beginning of period	110,004	74,808
Cash and cash equivalents, end of period	$ 158,964	$ 97,500

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

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

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Basis of Presentation:

The consolidated financial statements of Vector Group Ltd. (the Company or Vector) include the accounts of VGR Holding Inc. (VGR Holding), Liggett Group Inc. (Liggett), Vector Tobacco Inc. (Vector Tobacco), Liggett Vector Brands Inc. (Liggett Vector Brands), New Valley Corporation (New Valley) and other less significant subsidiaries. The Company owned 57.7% of the common shares of New Valley at September 30, 2005. (See Note 11.) All significant intercompany balances and transactions have been eliminated.

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

The interim consolidated financial statements of the Company are unaudited and, in the opinion of management, reflect all adjustments necessary (which are normal and recurring) to state fairly the Company s consolidated financial position, results of operations and cash flows. These consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company s Annual Report on Form 10-K, as amended, for the year ended December 31, 2004, as filed with the Securities and Exchange Commission. The consolidated results of operations for interim periods should not be regarded as necessarily indicative of the results that may be expected for the entire year.

Certain amounts in the 2004 consolidated financial statements have been reclassified to conform to the current year s presentation, including reflecting stock dividends at par value when paid in a deficit position in common stock rather than at fair value in additional paid-in capital. Accordingly, the Company decreased its December 31, 2004 additional paid-in capital by $180,307 to $61,468 from $241,775 and decreased the deficit in like amount. The Company decreased its December 31, 2003 additional paid-in capital by $150,838 to $100,401 from $251,239 and decreased the deficit in like amount. The Company decreased its December 2002 additional paid-in capital by $122,753 from $279,305 to $156,552 and decreased the deficit in like amount. These changes in classification do not affect assets, liabilities or stockholders equity.

(b) Estimates and Assumptions:

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

(c) Earnings Per Share:

Information concerning the Company s common stock has been adjusted to give effect to the 5% stock dividends paid to Company stockholders on September 29, 2004 and September 29, 2005. In connection with the 5% stock dividends, the Company increased

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(Unaudited)

the number of outstanding stock options by 5% and reduced the exercise prices accordingly. All share amounts have been presented as if the stock dividends had occurred on January 1, 2004.

Basic net income per share is computed by dividing net income by the weighted-average number of shares outstanding. Diluted net income per share includes the dilutive effect of stock options and restricted stock grants. Basic and diluted EPS were calculated using the following shares for the three and nine months ended September 30, 2005 and 2004:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Weighted-average shares for basic EPS	44,095,747	43,752,583	43,989,435	43,352,166
Plus incremental shares related to stock options	2,429,573	1,720,179	2,118,392	
Weighted-average shares for diluted EPS	46,525,320	45,472,762	46,107,827	43,352,166

The Company had a net loss for the nine months ended September 30, 2004. Therefore, the effect of the common stock equivalents and convertible securities was excluded from the computation of diluted net loss per share since the effect is antidilutive. Potentially dilutive shares that were not included in the diluted loss per share calculations were 1,933,239 for the nine months ended September 30, 2004 which shares were issuable upon the exercise of stock options or conversion of debt, assuming the treasury stock method.

(d) Comprehensive Income (Loss):

Other comprehensive income (loss) is a component of stockholders equity (deficit) and includes such items as the unrealized gains and losses on investment securities available for sale, forward foreign contracts and minimum pension liability adjustments. Total comprehensive income was $29,426 for the nine months ended September 30, 2005 and total comprehensive loss was $5,665 for the nine months ended September 30, 2004.

(e) Financial Instruments:

The Company uses forward foreign exchange contracts to mitigate its exposure to changes in exchange rates relating to purchases of equipment from third parties. The primary currency to which the Company is exposed is the euro. A substantial portion of the Company s foreign exchange contracts is effective as hedges. The fair value of forward foreign exchange contracts designated as hedges is reported in other current assets or current liabilities and is recorded in other comprehensive income. The fair value of the hedge at September 30, 2005 was a liability of approximately $775. The Company did not have any open forward foreign exchange contracts at December 31, 2004.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in Thousands, Except Per Share Amounts) (Continued)
(Unaudited)

(f) Change in Stock Ownership of Subsidiary:

The Company recognizes changes in its ownership percentage in a subsidiary caused by issuances of a subsidiary s stock as an adjustment to additional paid-in capital and unearned compensation. During the nine month period ended September 30, 2005, the Company recorded a net decrease to its stockholders equity of $596, net of taxes, in connection with the decrease in the Company s ownership of New Valley from 58.2% to 57.7%.

(g) New Accounting Pronouncements:

In 2004, the Financial Accounting Standards Board (the FASB) issued SFAS No. 123 (revised 2004), Share-Based Payment (SFAS No. 123R). SFAS No. 123R requires companies to measure compensation cost for share-based payments at fair value. The Company will adopt this new standard prospectively, on January 1, 2006, and has not yet determined whether the adoption of SFAS No. 123R will have a material impact on its consolidated financial position, results of operations or cash flows.

In 2004, the FASB issued SFAS No. 151, Inventory Costs. SFAS No. 151 requires that abnormal idle facility expense and spoilage, freight and handling costs be recognized as current-period charges. In addition, SFAS No. 151 requires that allocation of fixed production overhead costs to inventories be based on the normal capacity of the production facility. The Company is required to adopt the provisions of SFAS No. 151 prospectively after January 1, 2006, but the effect of adoption is not expected to have a material impact on its consolidated financial position, results of operations or cash flows.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3 (SFAS No. 154). SFAS No. 154 changes the requirements for the accounting for and reporting of a change in accounting principle. The provisions of SFAS No. 154 require, unless impracticable, retrospective application to prior periods financial statements of (1) all voluntary changes in accounting principles and (2) changes required by a new accounting pronouncement, if a specific transition is not provided. SFAS No. 154 also requires that a change in depreciation, amortization, or depletion method for long-lived, non-financial assets be accounted for as a change in accounting estimate, which requires prospective application of the new method. SFAS No. 154 is effective for all accounting changes made in fiscal years beginning after December 15, 2005. The application of SFAS No. 154 is not expected to have a material impact on the Company s consolidated financial position, results of operations or cash flows.

In March 2005, the FASB issued Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations an Interpretation of SFAS Statement No. 143 (FIN 47). FIN 47 clarifies the timing of liability recognition for legal obligations associated with the retirement of a tangible long-lived asset when the timing and/or method of settlement are conditional on a future event. FIN 47 is effective for fiscal years ending after December 15, 2005. The application of FIN 47 is not expected to have a material impact on the Company s consolidated financial position, results of operations or cash flows.

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

In September 2005, the FASB s Emerging Issues Task Force (EITF) reached a consensus on Issue No. 04-13, Inventory Exchanges. EITF No. 04-13 required two or more inventory transactions with the same party to be considered a single nonmonetary transaction subject to APB Opinion No. 29, Accounting for Nonmonetary Transactions, if the transactions were entered into in contemplation of one another. EITF No. 04-13 is effective for the Company for new arrangements entered into after April 2, 2006. The Company does not expect the adoption of EITF No. 04-13 to have a material impact on its financial position, results of operations or cash flows.

In September 2005, the EITF reached a consensus on Issue 05-8, Income Tax Effects of Issuing Convertible Debt with a Beneficial Conversion Feature. The issuance of convertible debt with a beneficial conversion feature creates a temporary difference on which deferred taxes should be provided. The consensus is required to be applied in fiscal periods beginning after December 15, 2005, by retroactive restatement of prior financial statements back to the issuance of the convertible debt. The requirement to restate applies even if the convertible debt has been repaid or converted and no longer exists. The Company has not completed its assessment of the impact of this issue.

2. RESTRUCTURING

Liggett Vector Brands Restructurings. During April 2004, Liggett Vector Brands adopted a restructuring plan in its continuing effort to adjust the cost structure of the Company s tobacco business and improve operating efficiency. As part of the plan, Liggett Vector Brands eliminated 83 positions and consolidated operations, subletting its New York office space and relocating several employees. As a result of these actions, the Company recognized pre-tax restructuring charges of $2,791 in the first half of 2004, including $824 relating to employee severance and benefit costs and $1,967 for contract termination and other associated costs. Approximately $518 of these charges represent non-cash items. A reduction in contract termination and exit costs of $71 related to the above restructuring was recognized in the third quarter of 2004.

On October 6, 2004, the Company announced an additional plan to further restructure the operations of Liggett Vector Brands, its sales, marketing and distribution agent for its 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. Liggett Vector Brands is seeking to expand the portfolio of private and control label partner brands by utilizing a pricing strategy that offers long-term list price stability for customers. In connection with the restructuring, the Company eliminated approximately 330 full-time positions and 135 part-time positions as of December 15, 2004.

The Company recognized pre-tax restructuring charges of $10,583 in 2004, with approximately $5,659 of the charges related to employee severance and benefit costs and approximately $4,924 to contract termination and other associated costs. Approximately $2,503 of these charges represented non-cash items. Approximately $4,428 was recognized in the third quarter of 2004. Additionally, the Company incurred other charges in 2004 for various compensation and related payments to employees which are related to the restructuring. These charges of $1,670 were included in selling, general and administrative expenses.

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VECTOR GROUP LTD.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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(Unaudited)

The components of the combined pre-tax restructuring charges relating to the 2004 Liggett Vector Brands restructurings for the nine months ended September 30, 2005 are as follows:

	Employee Severance and Benefits	Non-Cash Asset Impairment	Contract Termination/ Exit Costs	Total
Balance, December 31, 2004	$ 3,614	$ 186	$ 3,285	$ 7,085
Utilized	(2,561)	(113)	(1,682)	(4,356)
Balance, September 30, 2005	$ 1,053	$ 73	$ 1,603	$ 2,729

Timberlake Restructuring. In October 2003, the Company announced that it would close Vector Tobacco s Timberlake, North Carolina cigarette manufacturing facility in order to reduce excess tobacco 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, the Company recognized restructuring and impairment charges of $21,696, of which $21,300 was recognized in 2003. Charges of $221 and $175 were taken in the first and third quarters of 2004, respectively.

The components of the pre-tax restructuring charge relating to the closing of Vector Tobacco s Timberlake, North Carolina cigarette manufacturing facility for the nine months ended September 30, 2005 are as follows:

	Employee Severance and Benefits	Contract Termination/ Exit Costs	Total
Balance, December 31, 2004	$ 467	$ 52	$ 519
Change in estimate	(22)	22	
Utilized	(227)	(74)	(301)
Balance, September 30, 2005	$ 218	$	$ 218

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

3. INVENTORIES

Inventories consist of:

	September 30, 2005	December 31, 2004
Leaf tobacco	$ 34,685	$ 35,416
Other raw materials	2,989	3,400
Work-in-process	1,976	1,610
Finished goods	40,995	42,003
Inventories at current cost	80,645	82,429
LIFO adjustments	(4,043)	(3,488)
	$ 76,602	$ 78,941

The Company has a leaf inventory management program whereby, among other things, it is committed to purchase certain quantities of leaf tobacco. The purchase commitments are for quantities not in excess of anticipated requirements and are at prices, including carrying costs, established at the date of the commitment. At September 30, 2005, Liggett had leaf tobacco purchase commitments of approximately $5,125. There were no leaf tobacco purchase commitments at Vector Tobacco at that date.

Included in the above table was approximately $1,309 at September 30, 2005 and $1,595 at December 31, 2004 of leaf inventory associated with Vector Tobacco s QUEST product. During the second quarter of 2004, based on an analysis of the market data obtained since the introduction of the QUEST product, the Company determined to postpone indefinitely the national launch of QUEST and, accordingly, the Company recognized a non-cash charge of $37,000 to adjust the carrying value of excess leaf tobacco inventory for the QUEST product, based on estimated future demand and market conditions.

LIFO inventories represent approximately 93% and 85% of total inventories at September 30, 2005 and December 31, 2004, respectively.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in Thousands, Except Per Share Amounts) (Continued)
(Unaudited)

4. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consist of:

	September 30, 2005	December 31, 2004
Land and improvements	$ 1,418	$ 1,418
Buildings	13,792	13,431
Machinery and equipment	97,343	93,700
Leasehold improvements	2,432	3,045
Construction-in-progress	2,607	3,240
	117,592	114,834
Less accumulated depreciation	(54,977)	(49,477)
	$ 62,615	$ 65,357

Depreciation and amortization expense for the three and nine months ended September 30, 2005 was $2,737 and $8,281, respectively. Depreciation and amortization expense for the three and nine months ended September 30, 2004 was $2,877 and $9,287, respectively. Future machinery and equipment purchase commitments at Liggett were $9,463 at September 30, 2005.

In February 2005, New Valley completed the sale of its two office buildings in Princeton, New Jersey for $71,500. (Refer to Notes 5 and 12). The buildings were classified as assets held for sale on the balance sheet at December 31, 2004.

In July 2003, Liggett granted an unaffiliated third party an option to purchase Liggett s former manufacturing facility and other excess real estate in Durham, North Carolina with a net book value at September 30, 2005 of approximately $2,212. The option agreement, as amended in October 2005, permits the purchaser to acquire the property during the period expiring December 15, 2005, at a purchase price of $15,450. At September 30, 2005, Liggett had received non-refundable option fees of $1,625 (increased to $1,775 after the October 2005 amendment to the agreement), creditable against the purchase price, which are recorded as deferred income in other accrued liabilities. The purchaser has the right on or prior to December 9, 2005 to further extend the closing date to January 31, 2006, in which event the purchase price will be increased to $15,700 and the purchaser s notice of extension must be accompanied by an additional option payment of $250. The purchaser is currently seeking to complete the financing for the transaction, and there can be no assurance the sale of the property will occur.

During the nine months ended September 30, 2005, the Company assumed $266 of equipment in connection with capital lease obligations.

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

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

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

	September 30, 2005	December 31, 2004
Vector:		
5% Variable Interest Senior Convertible Notes due 2011, net of unamortized discount and premium of $55,375 and $38,259*	$ 56,489	$ 28,646
6.25% Convertible Subordinated Notes due 2008	132,492	132,492
Liggett:		
Revolving credit facility	9,092	17
Term loan under credit facility	3,714	4,411
Equipment loans	4,111	6,341
Vector Tobacco:		
Notes payable Medallion acquisition	35,000	35,000
V.T. Aviation:		
Note payable	8,637	9,436
VGR Aviation:		
Note payable	4,926	5,090
New Valley:		
Note payable operating real estate		39,213
Other	266	
Total notes payable, long-term debt and other obligations	254,727	260,646
Less:		
Current maturities	(16,955)	(6,043)
Amount due after one year	$ 237,772	$ 254,603

* The fair value of the derivatives embedded within these notes ($40,194 at September 30, 2005 and

$25,686 at December 31, 2004) is separately classified as a derivatives liability in the consolidated balance sheet and the beneficial conversion feature ($22,075 at September 30, 2005 and $13,625 at December 31, 2004) is recorded as additional paid-in capital.

5% Variable Interest Senior Convertible Notes Due November 2011 — Vector:

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

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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 the Company per share on its common stock during the prior three-month period ending on the record date for such interest payment multiplied by the number of shares of its 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 will be the higher of (i) the Total Interest and (ii) 6 3/4% per year. The notes are convertible into the Company s common stock, at the holder s option. The conversion price, which was $18.48 at September 30, 2005, is subject to adjustment for various events, including the issuance of stock dividends.

The notes will mature on November 15, 2011. The Company must redeem 12.5% of the total aggregate principal amount of the notes outstanding on November 15, 2009. In addition to such redemption amount, the Company will also redeem on November 15, 2009 and 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 the Company to repurchase some or all of their remaining notes. The redemption price for such redemptions will equal 100% of the principal amount of the notes plus accrued interest. If a fundamental change occurs, the Company will be required to offer to repurchase the notes at 100% of their principal amount, plus accrued interest and, under certain circumstances, a make-whole premium .

In connection with the November 2004 placement, in order to facilitate hedging transactions by the purchasers of the notes, the purchasers required the principal stockholder and Chairman of the Company to enter into an agreement granting the placement agent for the offering the right, in its sole discretion, to borrow up to 3,646,518 shares of common stock from the principal stockholder or an entity affiliated with him during a 30-month period, subject to extension under various conditions, and that he agree not to dispose of such shares during this period, subject to limited exceptions. In consideration for the principal stockholder agreeing to lend his shares in order to facilitate the Company s offering and accepting the resulting liquidity risk, the Company agreed to pay him or an affiliate designated by him an annual fee, payable on a quarterly basis in cash or, by mutual agreement of the Company and the principal stockholder, shares of common stock, equal to 1% of the aggregate market value of 3,646,518 shares of common stock. In addition, the Company agreed to hold the principal stockholder harmless on an after-tax basis against any increase, if any, in the income tax rate applicable to dividends paid on the shares as a result of the share loan agreement. The principal stockholder has the right to assign to the President of the Company some or all of his obligation to lend the shares under such agreement. In connection with the April 2005 placement, the Company entered into a similar arrangement through May 2007 with one of the Company s principal stockholders, who is the President of the Company, with respect to 315,000 shares of common stock.

Embedded Derivatives. The portion of the Total Interest on the notes which is computed by reference to the cash dividends paid on the Company s common stock is considered an embedded derivative. Pursuant to SFAS No. 133, Accounting for Derivative Instruments and

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Hedging Activities , as amended by SFAS No. 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities , the Company has 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 issuance of the November 2004 notes, the estimated initial fair value 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, 2004, with the issuance of $1,405 of additional notes, the derivative liability was estimated at $25,686. At September 30, 2005, with the issuance of $14,959 of additional notes in connection with the November 2004 placement and the issuance of $30,000 of additional notes in April 2005, the derivative liability was estimated at $40,194. Changes to the fair value of this embedded derivative are reflected quarterly as an adjustment to interest expense. The Company recognized a gain of $1,131 in the third quarter of 2005 and a gain of $2,258 for the nine months ended September 30, 2005, due to changes in the fair value of the embedded derivative, which was reported as an adjustment to interest expense.

Beneficial Conversion Feature. After giving effect to the recording of the embedded derivative liability as a discount to the notes, the Company s 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 September 30, 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. The Company recognized non-cash interest expense of $731 in the third quarter of 2005 and $2,089 for the nine months ended September 30, 2005 due to the amortization of the debt discount attributable to the beneficial conversion feature.

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

In July 2001, Vector completed the sale of $172,500 (net proceeds of approximately $166,400) of its 6.25% convertible subordinated notes due July 15, 2008 through a private offering to qualified institutional investors in accordance with Rule 144A under the Securities Act of 1933. The notes pay interest at 6.25% per annum and are convertible into Vector s common stock, at the option of the holder. The conversion price, which was $22.12 per share at September 30, 2005, is subject to adjustment for various events, and any cash distribution on Vector s common stock will result in a corresponding decrease in the conversion price. In December 2001, $40,000 of the notes were converted into Vector s common stock and, in October 2004, an additional $8 of the notes were converted. A total $132,492 of the notes were outstanding at September 30, 2005.

Vector may redeem the notes, in whole or in part, at a price of 102.083% in the year beginning July 15, 2005, 101.042% in the year beginning July 15, 2006 and 100% in the year beginning July 15, 2007, together with accrued interest. If a change of control occurs, Vector will be required to offer to repurchase the notes at 101% of their principal amount, plus accrued interest and, under certain circumstances, a make whole payment.

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Revolving Credit Facility Liggett:

Liggett has a $50,000 credit facility with Wachovia Bank, N.A. (Wachovia). A total of $9,092 was outstanding under the facility at September 30, 2005. Availability as determined under the facility was approximately $21,864 based on eligible collateral at September 30, 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 capital (not to fall below a deficit of $17,000 as computed in accordance with the agreement). At September 30, 2005, Liggett was in compliance with all covenants under the credit facility; Liggett s adjusted net worth was $64,554 and net working capital was $43,771, 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 $3,714 outstanding under Liggett s credit facility at September 30, 2005. The remaining balance of the term loan is payable in monthly installments of $77 with a final payment on June 1, 2006 of $3,099. 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.

Equipment Loans Liggett:

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.

In October and December 2001, Liggett purchased equipment for $3,204 and $3,200, respectively, through the issuance of notes guaranteed by the Company, each payable in 60 monthly installments of $53 with interest calculated at the prime rate.

In March 2002, Liggett purchased equipment for $3,023 through the issuance of a note, payable in 30 monthly installments of $62 and then 30 monthly installments of $51. Interest is calculated at LIBOR plus 2.8%.

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

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

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

Notes for Medallion Acquisition Vector Tobacco:

The purchase price for the acquisition of Medallion included $60,000 in notes of Vector Tobacco, guaranteed by the Company and Liggett. Of the notes, $25,000 have been repaid with the final quarterly principal payment of $3,125 made on March 31, 2004. The remaining $35,000 of notes bear interest at 6.5% per year, payable semiannually, and mature on April 1, 2007.

Note Payable V.T. Aviation:

In February 2001, V.T. Aviation LLC, a subsidiary of Vector Research Ltd., purchased an airplane for $15,500 and borrowed $13,175 to fund the purchase. The loan, which is collateralized by the airplane and a letter of credit from the Company for $775, is guaranteed by Vector Research, VGR Holding and the Company. The loan is payable in 119 monthly installments of $125, including annual interest of 2.31% above the 30-day commercial paper rate, with a final payment of $2,206 based on current interest rates.

Note Payable 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 the Company. The loan is payable in 119 monthly installments of $40, including annual interest of 2.75% above the 30-day average commercial paper rate, with a final payment of $3,479 based on current interest rates. During the fourth quarter of 2003, this airplane was transferred to the Company s direct subsidiary, VGR Aviation LLC, which assumed the debt.

Note Payable 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. In February 2005, New Valley completed the sale of the buildings, and the loan was retired at closing with the proceeds of the sale.

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6. EMPLOYEE BENEFIT PLANS

Net periodic benefit cost for the Company s pension and other postretirement benefit plans for the three and nine months ended September 30, 2005 and 2004 consists of the following:

	Pension Benefits Three Months Ended		Pension Benefits Nine Months Ended	
	Sept. 30, 2005	Sept. 30, 2004	Sept. 30, 2005	Sept. 30, 2004
Service cost benefits earned during the period	$ 1,321	$ 1,248	$ 3,963	$ 3,744
Interest cost on projected benefit obligation	2,172	2,240	6,516	6,720
Expected return on plan assets	(3,069)	(3,027)	(9,207)	(9,081)
Amortization of net loss	468	506	1,404	1,518
Net expense	$ 892	$ 967	$ 2,676	$ 2,901

	Other Postretirement Benefits Three Months Ended		Other Postretirement Benefits Nine Months Ended	
	Sept. 30, 2005	Sept. 30, 2004	Sept. 30, 2005	Sept. 30, 2004
Service cost benefits earned during the period	$ 7	$ 8	$ 21	$ 24
Interest cost on projected benefit obligation	153	157	459	471
Expected return on plan assets				
Amortization of net loss	11	5	33	15
Net expense	$ 171	$ 170	$ 513	$ 510

The Company did not make contributions to its pension benefits plans for the three and nine months ended September 30, 2005 and does not anticipate making any contributions to such plans in the fourth quarter of 2005. The Company anticipates paying approximately $550 in other postretirement benefits in 2005.

7. CONTINGENCIES

Smoking-Related Litigation:

Overview. Since 1954, Liggett and other United States cigarette manufacturers have been named as defendants in numerous direct and third-party actions predicated on the theory that cigarette manufacturers should be liable for damages alleged to have been caused by cigarette smoking or by exposure to secondary smoke from cigarettes. New cases continue to be commenced against Liggett and the other cigarette manufacturers. The cases generally fall into the following categories: (i) smoking and health cases alleging injury brought on behalf of individual plaintiffs (Individual Actions); (ii) smoking and health cases alleging injury and purporting to be brought on behalf of a class of individual plaintiffs (Class Actions); (iii) health

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care cost recovery actions brought by various foreign and domestic governmental entities (Governmental Actions); and (iv) health care cost recovery actions brought by third-party payors including insurance companies, union health and welfare trust funds, asbestos manufacturers and others (Third-Party Payor Actions). As new cases are commenced, the costs associated with defending these cases and the risks relating to the inherent unpredictability of litigation continue to increase. The future financial impact of the risks and expenses of litigation and the effects of the tobacco litigation settlements discussed below are not quantifiable at this time. For the nine months ended September 30, 2005, Liggett incurred legal fees and other litigation costs totaling approximately $3,715 compared to $3,677 for the nine months ended September 30, 2004.

Individual Actions. As of September 30, 2005, there were approximately 278 cases pending against Liggett, and in most cases the other tobacco companies, where one or more individual plaintiffs allege injury resulting from cigarette smoking, addiction to cigarette smoking or exposure to secondary smoke and seek compensatory and, in some cases, punitive damages. Of these, 106 were pending in Florida, 44 in Mississippi, 23 in Missouri, 27 in Maryland and 17 in New York. The balance of the individual cases were pending in 16 states. In one of these cases, an action against cigarette manufacturers involving approximately 1,000 named individual plaintiffs has been consolidated 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 seven individual cases pending where Liggett is the only named defendant. In April 2004, in the *Beverly Davis v. Liggett Group Inc.* case, 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 February 2005, in the *Angel Martinez v. Liggett Group Inc.* case, a Florida state court jury returned a verdict in favor of Liggett. In July 2005, the court denied the plaintiff s post-trial motion seeking a new trial. The plaintiff may appeal. In March 2005, in the *Ferlanti v. Liggett Group Inc.* case, a Florida state court granted Liggett s motion for summary judgment disposing of the case in its entirety. The plaintiff has appealed.

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 RICO statutes and antitrust statutes. In many of these cases, in addition to compensatory damages, plaintiffs also seek other forms of relief including treble/multiple damages, medical monitoring, disgorgement of profits and punitive damages. Defenses raised by defendants in these cases include lack of proximate cause, assumption of the risk, comparative fault and/or contributory negligence, lack of design defect, statute of limitations, equitable defenses such as unclean hands and lack of benefit, failure to state a claim and federal preemption.

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Jury awards in various states have been entered against other cigarette manufacturers. The awards in these individual actions are for both compensatory and punitive damages and represent a material amount of damages. Liggett is not a party to these actions. The following is a brief description of various of these matters:

In February, 1999, in *Henley v. Philip Morris,* a California state court jury awarded $1,500 in compensatory damages and $50,000 in punitive damages. The trial court reduced the punitive damages award to $25,000. In September 2003, the California Court of Appeals reduced the punitive damages award to $9,000 based on the United States Supreme Court s 2003 opinion in *State Farm*, limiting punitive damages. In September 2004, the California Supreme Court upheld the $9,000 punitive damages award. In March 2005, the United States Supreme Court denied review and the defendant has paid the amount of the judgment plus accrued interest.

In March 1999, an Oregon state court jury found in favor of the plaintiff in *Williams-Branch v. Philip Morris*. The jury awarded $800 in compensatory damages and $79,500 in punitive damages. The trial court reduced the punitive damages award to $32,000. In June 2002, the Oregon Court of Appeals reinstated the $79,500 punitive damages award. In October 2003, the United States Supreme Court set aside the Oregon appellate court s ruling and directed the Oregon court to reconsider the case in light of the *State Farm* decision. In June 2004, the Oregon appellate court reinstated the original jury verdict. The Oregon Supreme Court agreed to review the case, and oral argument was held in May 2005.

In 2001, as a result of a Florida Supreme Court decision upholding the award, in *Carter v. Brown and Williamson Tobacco Corp.,* the defendant paid $1,100 in compensatory damages and interest to a former smoker and his spouse for injuries they allegedly incurred as a result of smoking.

In June 2001, a California state court jury found in favor of the plaintiff in *Boeken v. Philip Morris* and awarded $5,500 in compensatory damages and $3,000,000 in punitive damages. In August 2001, the trial court reduced the punitive damages award to $100,000. In September 2004, the California Court of Appeals affirmed the compensatory damages award, but reduced the punitive damages award to $50,000. In April 2005, the California Court of Appeals reaffirmed its decision. In August 2005, the California Supreme Court declined further review of the case. The defendant is seeking review by the United States Supreme Court.

In December 2001, in *Kenyon v. R.J. Reynolds Tobacco Co.*, a Florida state court jury awarded the plaintiff $165 in compensatory damages, but no punitive damages. In May 2003, the Florida Court of Appeals affirmed per curiam (that is, without an opinion) the trial court s final judgment in favor of the plaintiffs. The defendant paid the amount of the judgment plus accrued interest ($196) after exhausting all appeals.

In February 2002, in *Burton v. R.J. Reynolds Tobacco Co., et al*, a federal district court jury in Kansas awarded the plaintiff $198 in compensatory damages, and determined that the plaintiff was entitled to punitive damages. In June 2002, the trial court awarded the plaintiff $15,000 in punitive damages. In February 2005, the United States Court of Appeals for the Tenth Circuit overturned the punitive damages award,

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while upholding the compensatory damages award. The defendant paid the compensatory damages award in June 2005.

In March 2002, an Oregon state court jury found in favor of the plaintiff in *Schwarz v. Philip Morris* and awarded $169 in compensatory damages and $150,000 in punitive damages. In May 2002, the trial court reduced the punitive damages award to $100,000. The parties have appealed to the Oregon Court of Appeals.

In October 2002, a California state court jury found in favor of the plaintiff in *Bullock v. Philip Morris* and awarded $850 in compensatory damages and $28,000,000 in punitive damages. In December 2002, the trial court reduced the punitive damages award to $28,000. The parties have appealed to the California Court of Appeals.

In April 2003, in *Eastman v. Brown & Williamson Tobacco Corp., et al*, a Florida state court jury awarded $6,540 in compensatory damages. In May 2004, the Florida Court of Appeals affirmed the verdict in a per curiam opinion. The defendants motion for rehearing was denied, and the judgment was paid in October 2004.

In May 2003, in *Boerner v. Brown & Williamson Tobacco Corp.,* a federal district court jury in Arkansas awarded $4,000 in compensatory damages and $15,000 in punitive damages. In January 2005, the United States Court of Appeals for the Eighth Circuit affirmed the compensatory damages award, but reduced the punitive damages award to $5,000. The judgment was paid in February 2005.

In November 2003, in *Thompson v. Brown & Williamson Tobacco Corp., et al.*, a Missouri state court jury awarded $2,100 in compensatory damages. The defendants have appealed to the Missouri Court of Appeals.

In December 2003, in *Frankson v. Brown & Williamson Tobacco Corp., et al.*, a New York state court jury awarded $350 in compensatory damages. In January 2004, the jury awarded $20,000 in punitive damages. The deceased smoker was found to be 50% at fault. In June 2004, the court increased the compensatory damages to $500 and decreased the punitive damages to $5,000. The defendants have appealed to the New York Supreme Court, Appellate Division.

In October 2004, in *Arnitz v. Philip Morris*, a Florida state court jury awarded $600 in damages but found that the plaintiff was 60% at fault, thereby reducing the verdict against Philip Morris to $240. Philip Morris has appealed to the Florida Second District Court of Appeals.

In February 2005, in *Smith v. Brown & Williamson Tobacco Corp.*, a Missouri state court jury awarded $2,000 in compensatory damages and $20,000 in punitive damages. The defendants have appealed to the Missouri Court of Appeals.

In March 2005, in *Rose v. Philip Morris*, a New York state court jury awarded $3,400 in compensatory damages and $17,100 in punitive damages. The defendants have appealed to the New York Supreme Court, Appellate Division.

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In 2003, the Mississippi Supreme Court ruled that the Mississippi Product Liability Act precludes all tobacco cases that are based on product liability. In a 2005 decision, the Mississippi Supreme Court ruled that certain claims against cigarette manufacturers may remain available to plaintiffs.

Class Actions. As of September 30, 2005, there were approximately 11 actions pending, for which either a class has been certified or plaintiffs are seeking class certification, where Liggett, among others, was a named defendant. Many of these actions purport to constitute statewide class actions and were filed after May 1996 when the Fifth Circuit Court of Appeals, in the *Castano* case, reversed a Federal district court s certification of a purported nationwide class action on behalf of persons who were allegedly addicted to tobacco products.

The extent of the impact of the *Castano* decision on smoking-related class action litigation is still uncertain. The *Castano* decision has had a limited effect with respect to courts decisions regarding narrower smoking-related classes or class actions brought in state rather than federal court. For example, since the Fifth Circuit s ruling, a court in Louisiana (Liggett is not a defendant in this proceeding) certified an addiction-as-injury class action, in the *Scott v. American Tobacco Co., Inc.* case, that covered only citizens in the state. In May 2004, the *Scott* jury returned a verdict in the amount of $591,000, plus prejudgment interest, on the class claim for a smoking cessation program. The case is on appeal. Two other class actions, *Broin, et al., v. Philip Morris Companies Inc., et al.,* and *Engle, et al., v. R.J. Reynolds Tobacco Company, et al.,* were certified in state court in Florida prior to the Fifth Circuit s decision.

In May 1994, the *Engle* case was filed against Liggett and others in the Circuit Court, Eleventh Judicial Circuit, Miami-Dade County, Florida. 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 $12,704 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 $5,831, was not timely filed. In July 2000, the jury awarded approximately $145,000,000 in the punitive damages portion of Phase II against all

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defendants including $790,000 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 awards, 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 $145,000,000 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 October 2003, the Third District Court of Appeals denied class counsel s motions seeking, among other things, a rehearing by the court. Class counsel filed a motion with the Florida Supreme Court to invoke discretionary review on the basis that the Third District Court of Appeals decision construes the due process provisions of the state and federal constitutions and conflicts with other appellate and supreme court decisions. In May 2004, the Florida Supreme Court agreed to review the case, and oral argument was held in November 2004. If the Third District Court of Appeal s ruling is not upheld on appeal, it will have a material adverse effect on the Company.

In May 2000, legislation was enacted in Florida that limits the size of any bond required, pending appeal, to stay execution of a punitive damages verdict to the lesser of the punitive award plus twice the statutory rate of interest, $100,000 or 10% of the net worth of the defendant, but the limitation on the bond does not affect the amount of the underlying verdict. In November 2000, Liggett filed the $3,450 bond required by the Florida law in order to stay execution of the *Engle* judgment, pending appeal. Legislation limiting the amount of the bond required to file an appeal of an adverse judgment has been enacted in more than 30 states.

In May 2001, Liggett, Philip Morris and Lorillard Tobacco Company reached an agreement with the class in the *Engle* case, which provided assurance of Liggett s ability to appeal the jury s July 2000 verdict. 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. As a result, the Company recorded a $9,723 pre-tax charge to the consolidated statement of operations for the first quarter of 2001. The agreement, which was approved by the court, assured 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 an appeal to the United States Supreme Court. If Liggett s balance sheet net worth fell below $33,781 (as determined in accordance with generally accepted accounting principles in effect as of July 14, 2000), the agreement provided that the stay granted in favor of Liggett in the agreement would terminate and the *Engle* class would be free to challenge the Florida bonding statute.

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In June 2002, the jury in a Florida state court action entitled *Lukacs v. Philip Morris, et al.* awarded $37,500 in compensatory damages in a case involving Liggett and two other tobacco manufacturers. In March 2003, the court reduced the amount of the compensatory damages to $25,100. The jury found Liggett 50% responsible for the damages incurred by the plaintiff. The *Lukacs* case was the first individual case to be tried as part of Phase III of the *Engle* case; the claims of all other individuals who are members of the class were stayed pending resolution of the appeal of the *Engle* verdict. The *Lukacs* verdict, which was subject to the outcome of the *Engle* appeal, has been overturned as a result of the appellate court s ruling. As discussed above, class counsel in *Engle* is pursuing various appellate remedies seeking reversal of the appellate court s decision.

Class certification motions are pending in a number of putative class actions. Classes remain certified against Liggett in West Virginia *(Blankenship)*, Kansas (*Smith*) and New Mexico (*Romero*). A number of class certification denials are on appeal.

In August 2000, in *Blankenship v. Philip Morris,* a West Virginia state court conditionally certified (only to the extent of medical monitoring) a class of present or former West Virginia smokers who desire to participate in a medical monitoring plan. In January 2001, the judge declared a mistrial. In July 2001, the court issued an order severing Liggett from the retrial of the case which began in September 2001. In November 2001, the jury returned a verdict in favor of the other defendants. In May 2004, the West Virginia Supreme Court affirmed the defense jury verdict, and it denied plaintiffs petition for rehearing. Plaintiffs did not seek further appellate review of this matter and the case has been concluded in favor of the other defendants.

In April 2001, the California state court in *Brown, et al., v. The American Tobacco Co., Inc. et al.* granted in part plaintiffs motion for class certification and certified a class comprised of adult residents of California who smoked at least one of defendants cigarettes during the applicable time period and who were exposed to defendants marketing and advertising activities in California. Certification was granted as to plaintiffs claims that defendants violated California s unfair business practices statute. The court subsequently defined the applicable class period for plaintiffs claims, pursuant to a stipulation submitted by the parties, as June 10, 1993 through April 23, 2001. In March 2005, the court issued a ruling granting defendants motion to decertify the class based on a recent change in California law. In April 2005, the court denied plaintiffs motion for reconsideration of the order which decertified the case. The plaintiffs have appealed. Liggett is a defendant in the case.

In September 2002, in *In Re Simon II Litigation,* the federal district court for the Eastern District of New York granted plaintiffs motion for certification of a nationwide non-opt-out punitive damages class action against the major tobacco companies, including Liggett. The class is not seeking compensatory damages, but was created to determine whether smokers across the country may be entitled to punitive damages. In May 2005, the United States Court of Appeals for the Second Circuit vacated the trial court s class certification order and remanded the case to the trial court for further proceedings. The Second Circuit Court of Appeals denied plaintiffs motion for reconsideration of the decertification ruling.

Class action suits have been filed in a number of states against individual cigarette manufacturers, alleging that the use of the terms lights and ultralights constitutes unfair and

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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 March 2003, in a class action brought against Philip Morris on behalf of smokers of light cigarettes, a state court judge in Illinois in the *Price, et al., v. Philip* Morris case awarded $7,100,500 in actual damages to the class members, $3,000,000 in punitive damages to the State of Illinois (which was not a plaintiff in this matter), and approximately $1,800,000 in attorney s fees and costs. Entry of judgment has been stayed. Philip Morris has appealed the verdict.

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. A Kansas state court, in the case of *Smith v. Philip Morris, et al.,* granted class certification in November 2001. In April 2003, plaintiffs motion for class certification was granted in *Romero v. Philip Morris*, a case pending in New Mexico state court. In February 2005, the New Mexico Supreme Court affirmed the trial court s certification order. Liggett is one of the defendants in both the Kansas and New Mexico cases.

Governmental Actions. As of September 30, 2005, there were approximately five Governmental Actions pending against Liggett. In these proceedings, both foreign and domestic governmental entities seek reimbursement for Medicaid and other health care expenditures. The claims asserted in these 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. Trial in the health care recovery case brought by the City of St. Louis, Missouri, and approximately 50 area hospitals against the major cigarette manufacturers is scheduled for January 2006. As a result of a June 2005 ruling, the court has limited plaintiffs claims by barring those that occurred more than five years before the case was filed. The action is currently stayed pending a petition for writ of mandamus and prohibition.

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Third-Party Payor Actions. As of September 30, 2005, there were approximately three Third-Party Payor Actions pending against Liggett. The claims in Third-Party Payor Actions are similar to those in the Governmental Actions but have been commenced by insurance companies, union health and welfare trust funds, asbestos manufacturers and others. Nine United States Circuit Courts of Appeal have ruled that Third-Party Payors did not have standing to bring lawsuits against cigarette manufacturers. The United States Supreme Court has denied petitions for certiorari in the cases decided by five of the courts of appeal. However, a number of Third-Party Payor Actions remain pending.

In June 2001, a jury in a third party payor action brought by Empire Blue Cross and Blue Shield in the Eastern District of New York rendered a verdict awarding the plaintiff $17,800 in damages against the major cigarette manufacturers. As against Liggett, the jury awarded the plaintiff damages of $89. In February 2002, the court awarded plaintiff s counsel $37,800 in attorneys fees, without allocating the fee award among the several defendants. Liggett has appealed both the jury verdict and the attorneys fee award. In September 2003, the United States Court of Appeals for the Second Circuit reversed the portion of the judgment relating to subrogation, certified questions relating to plaintiff s direct claims of deceptive business practices to the New York Court of Appeals and deferred its ruling on the appeal of the attorneys fees award pending the ruling on the certified questions. In October 2004, the New York Court of Appeals ruled in defendants favor on the certified questions and found that plaintiff s direct claims are barred on grounds of remoteness. In December 2004, the Second Circuit issued a revised decision, vacating the award of compensatory damages and attorneys fees, and reversing the judgment. In February 2005, the parties stipulated to a dismissal with prejudice.

In other Third-Party Payor Actions claimants have set forth several additional theories of relief sought: funding of corrective public education campaigns relating to issues of smoking and health; funding for clinical smoking cessation programs; disgorgement of profits from sales of cigarettes; restitution; treble damages; and attorneys fees. Nevertheless, no specific amounts are provided. It is understood that requested damages against the tobacco company defendants in these cases might be in the billions of dollars.

In June 2005, the Jerusalem District Court in Israel added Liggett as a defendant in a Third-Party Payor Action brought by the largest private insurer in that country, Clalit Health Services. The court ruled that, although Liggett had not sold product in Israel since 1978, it may still have liability for damages resulting from smoking of its product when it did sell cigarettes there.

In August 2005, the United Seniors Association, Inc. filed a lawsuit in federal court in Massachusetts pursuant to the private cause of action provisions of the Medicare Secondary Payer Act seeking to recover for the Medicare program all expenditures since August 1999 on smoking-related diseases.

Federal Government Action. 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

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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 $20,000,000 annually. The action asserted claims under three federal statutes, the Medical Care Recovery Act (MCRA), the Medicare Secondary Payer provisions of the Social Security Act (MSP) and RICO. In September 2000, the court dismissed the government s claims based on MCRA and MSP, reaffirming its decision in July 2001. In the September 2000 decision, 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 $289,000,000 is an appropriate remedy in the case. In April 2004, the court denied Liggett s motion to be dismissed from 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) $14,000,000 for a cessation and counter marketing program; (2) so-called corrective statements; (3) disclosures; and (4) enjoined activities. The parties are expected to complete their post-trial submissions during November 2005.

Settlements. In March 1996, Liggett entered into an agreement, subject to court approval, to settle the *Castano* class action tobacco litigation. The *Castano* class was subsequently decertified by the court.

In March 1996, March 1997 and March 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, including claims for health care cost reimbursement and claims concerning sales of cigarettes to minors.

In November 1998, Philip Morris, Brown & Williamson, R.J. Reynolds and Lorillard (collectively, the Original Participating Manufacturers or OPMs) and Liggett (together with the OPMs and any other tobacco product manufacturer that becomes a signatory, the Participating Manufacturers) entered into the Master Settlement Agreement (the MSA) with 46 states, the District of Columbia, Puerto Rico, Guam, the United States Virgin Islands, American Samoa and the Northern Mariana Islands (collectively, the Settling States) to settle the asserted and unasserted health care cost recovery and certain other claims of those Settling States. The MSA received final judicial approval in each settling jurisdiction.

The MSA restricts tobacco product advertising and marketing within the Settling States and otherwise restricts the activities of Participating Manufacturers. Among other things, the MSA prohibits the targeting of youth in the advertising, promotion or marketing of tobacco products;

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bans the use of cartoon characters in all tobacco advertising and promotion; limits each Participating Manufacturer to one tobacco brand name sponsorship during any 12-month period; bans all outdoor advertising, with the exception of signs, 14 square feet or less, at retail establishments that sell tobacco products; prohibits payments for tobacco product placement in various media; bans gift offers based on the purchase of tobacco products without sufficient proof that the intended recipient is an adult; prohibits Participating Manufacturers from licensing third parties to advertise tobacco brand names in any manner prohibited under the MSA; prohibits Participating Manufacturers from using as a tobacco product brand name any nationally recognized non-tobacco brand or trade name or the names of sports teams, entertainment groups or individual celebrities; and prohibits Participating Manufacturers from selling packs containing fewer than 20 cigarettes.

The MSA also requires Participating Manufacturers to affirm corporate principles to comply with the MSA and to reduce underage usage of tobacco products and imposes requirements applicable to lobbying activities conducted on behalf of Participating Manufacturers.

Liggett has no payment obligations under the MSA except to the extent its market share exceeds a 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 MSA, 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 data from Management Science Associates, Inc., domestic shipments by Liggett and Vector Tobacco accounted for approximately 2.2% of the total cigarettes shipped in the United States during 2001, 2.4% during 2002, 2.5% during 2003 and 2.3% during 2004. On April 15 of any year following a year in which Liggett s and/or Vector Tobacco s market shares exceed their base shares, Liggett and/or Vector Tobacco will pay on each excess unit an amount equal (on a per-unit basis) to that due during the same following year by the OPMs under the annual and strategic contribution payment provisions of the MSA, subject to applicable adjustments, offsets and reductions. In March and April 2002, Liggett and Vector Tobacco paid a total of $31,130 for their 2001 MSA obligations. In March and April 2003, Liggett and Vector Tobacco paid a total of $37,541 for their 2002 MSA obligations. At that time, funds were held back based on Liggett s and Vector Tobacco s belief that their MSA payments for 2002 should be reduced as a result of market share loss to non-participating manufacturers. In June 2003, Liggett and Vector Tobacco entered into a settlement agreement with the Settling States whereby Liggett and Vector Tobacco agreed to pay $2,478 in April 2004 to resolve these claims. In April 2004, Liggett and Vector Tobacco paid a total of $50,322 for their 2003 MSA obligations. Liggett and Vector Tobacco have expensed $23,315 for their estimated MSA obligations for 2004 and $10,988 for the first nine months of 2005 as part of cost of goods sold. Under the annual and strategic contribution payment provisions of the MSA, the OPMs (and Liggett and Vector Tobacco to the extent their market shares exceed their base shares) are required to pay the following annual amounts (subject to certain adjustments):

Year	Amount
2005 - 2007	$ 8,000,000
2008 - 2017	$ 8,139,000
2018 and each year thereafter	$ 9,000,000

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

On March 30, 2005, the Independent Auditor under the MSA calculated $28,668 in MSA 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 MSA, disputed the balance of $16,990. Of the disputed amount, Liggett paid $9,304 into the disputed payments account under the MSA and withheld from payment $7,686. The $9,304 paid into the disputed payment accounts represents the amount claimed by Liggett as an adjustment to its 2003 payment obligation under the MSA for market share loss to non-participating manufacturers. At September 30, 2005, included in Other current assets on the Company s 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 MSA obligation for market share loss to non-participating manufacturers and $2,368 relating to the retroactive change, discussed below, to the method for computing payment obligations under the MSA which Liggett contends, among other things, is not in accordance with the MSA. 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 MSA 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 has recently been notified that all Participating Manufacturers payment obligations under the MSA, 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 MSA of approximately $2,300 per year for the period 2001 through 2004, or a total of approximately $9,200, and require Liggett to pay an additional amount of approximately $2,400 per year in 2005 and in future periods by lowering Liggett s market share exemption under the MSA.

Liggett has objected to this retroactive change, and intends to challenge 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:

- utilization of net unit amounts is not required by the MSA (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 MSA,

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

Liggett and others have relied upon the calculations based on gross unit amounts for the past six years.

The MSA replaces Liggett s prior settlements with all states and territories except for Florida, Mississippi, Texas and Minnesota. Each of these four states, prior to the effective date of the MSA, negotiated and executed settlement agreements with each of the other major tobacco companies, separate from those settlements reached previously with Liggett. Liggett s agreements with these states remain in 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 nations 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 have been eliminated, except for a $100 a year payment to Minnesota negotiated in 2003, to be paid any year cigarettes manufactured by Liggett are sold in that state. With respect to all non-economic obligations under the previous settlements, Liggett is entitled to the most favorable provisions as between the MSA and each state s respective settlement with the other major tobacco companies. Therefore, Liggett s non-economic obligations to all states and territories are now defined by the MSA.

In 2004, the Attorneys General for each of Florida, Mississippi and Texas advised Liggett that they believed that Liggett had failed to make all required payments under the settlement agreements with these three states for the period 1998 through 2003 and that additional payments might 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 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 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 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. Liggett has met with representatives of the three states to discuss the issues relating to the alleged defaults. No resolution has been reached.

No amounts have been accrued in the accompanying financial statements for any additional amounts that may be payable by Liggett under the MSA due to the recalculation of the Participating Manufacturers payment obligations or 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 the Company s consolidated financial position, results of operations or cash flows.

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In August 2004, the Company announced that Liggett and Vector Tobacco had notified the Attorneys General of 46 states that they intend to initiate proceedings against the Attorneys General for violating the terms of the MSA. The Company s subsidiaries allege that the Attorneys General violated their rights and the MSA by extending unauthorized favorable financial terms to Miami-based Vibo Corporation d/b/a/ General Tobacco when, on August 19, 2004, the Attorneys General entered into an agreement with General Tobacco allowing it to become a Subsequent Participating Manufacturer under the MSA. General Tobacco imports discount cigarettes manufactured in Colombia, South America.

In the notice sent to the Attorneys General, the Company s subsidiaries indicated that they will seek to enforce the terms of the MSA, void the General Tobacco agreement and enjoin the Settling States and National Association of Attorneys General from listing General Tobacco as a Participating Manufacturer on their websites.

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

Copies of the various settlement agreements are filed as exhibits to the Company s Annual Report on Form 10-K and the discussion herein is qualified in its entirety by reference thereto.

Trials. Trial in the United States government action concluded on June 15, 2005 in federal court in the District of Columbia. The parties are expected to complete their post-trial submissions during November 2005. Cases currently scheduled for trial during the next six months include an individual action in Missouri state court, where Liggett is the sole defendant, scheduled for November 2005 and the health care recovery case in Missouri state court brought by the City of St. Louis and area hospitals scheduled for January 2006. Trial dates, however, are subject to change.

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 $790,000 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 the Company. 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. As a result, the Company recorded a $9,723 pre-tax charge to the consolidated statement of operations for the first quarter of 2001. In June 2002, the jury in an individual

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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. In April 2004, a jury in a Florida state court action awarded compensatory damages of approximately $540 against Liggett in an individual action. In addition, plaintiff s counsel was awarded legal fees of $752. Liggett intends to appeal 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 the Company s consolidated financial position, results of operations or cash flows could be materially adversely affected by an unfavorable outcome in any such smoking-related litigation.

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

Liggett has been served in two reparations actions brought by descendants of slaves. Plaintiffs in these actions claim that defendants, including Liggett, profited from the use of slave labor. Seven additional cases have been filed in California, Illinois and New York. Liggett is a named defendant in only one of these additional cases, but has not been served. The nine cases were consolidated before the United States District Court for the Northern District of Illinois. In June 2005, the court granted defendants motion to dismiss the consolidated action. The plaintiffs intend to appeal.

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

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Legislation and Regulation:

Many cities and states have recently enacted legislation banning smoking in public places including offices, restaurants, public buildings and bars. Efforts to limit smoking in public places could have a material adverse effect on the Company.

In January 1993, the Environmental Protection Agency (EPA) released a report on the respiratory effect of secondary smoke which concludes that secondary smoke is a known human lung carcinogen in adults and in children, causes increased respiratory tract disease and middle ear disorders and increases the severity and frequency of asthma. In June 1993, the two largest of the major domestic cigarette manufacturers, together with other segments of the tobacco and distribution industries, commenced a lawsuit against the EPA seeking a determination that the EPA did not have the statutory authority to regulate secondary smoke, and that given the scientific evidence and the EPA s failure to follow its own guidelines in making the determination, the EPA s classification of secondary smoke was arbitrary and capricious. In July 1998, a federal district court vacated those sections of the report relating to lung cancer, finding that the EPA may have reached different conclusions had it complied with relevant statutory requirements. The federal government appealed the court s ruling. In December 2002, the United States Court of Appeals for the Fourth Circuit rejected the industry challenge to the EPA report ruling that it was not subject to court review. Issuance of the report may encourage efforts to limit smoking in public areas.

In February 1996, the United States trade representative issued an advance notice of proposed rule making concerning how tobacco is imported under a previously established tobacco tariff rate quota (TRQ). Currently, tobacco imported under the TRQ 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 based on domestic market share. Such an approach, if adopted, could have a material adverse effect on the Company.

In August 1996, the Food and Drug Administration (the FDA) 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 regulations 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 the Company.

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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, which was expensed as cost of goods sold in the third quarter of 2005. 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 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 the Company.

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.

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 sales taxes, local taxes and the current federal excise tax, may currently exceed $4.00 per pack. In 2004, 10 states enacted increases in excise taxes, and nine states have enacted increases in excise taxes in 2005. 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. Management believes increases in excise and similar taxes have had an adverse impact 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 fire-safe or self-extinguishing cigarettes. All cigarettes manufactured for sale in New York state must be manufactured to certain self-extinguishment standards set out in the regulations. Liggett and Vector Tobacco have not historically provided

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products that would be compliant under these new OFPC regulations, and certain design and manufacturing changes have been necessary for cigarettes manufactured for sale in New York to comply with the standards. Inventories of cigarettes existing in the wholesale and retail trade as of June 28, 2004 that do not comply with the standards, may continue to be sold provided New York tax stamps have been affixed and such inventories have been purchased in comparable quantities to the same period in the previous year. Liggett and Vector Tobacco have complied with these New York regulatory requirements. Effective May 1, 2006 and January 1, 2007, cigarettes sold in Vermont and California, respectively, must meet certain reduced ignition propensity standards. 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 reduced carcinogen and low nicotine and nicotine-free cigarette products 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 recently agreed to suspend all print advertising for its *Quest* brand while discussions are pending. 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 governmental 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 issues like the manufacture, sale, distribution, advertising and labeling of tobacco products as well as any express or implied health claims associated with reduced carcinogen and low nicotine and nicotine-free cigarette products and the use of genetically modified tobacco. A system of regulation by agencies like the FDA, the Federal Trade Commission or 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 also expressed interest in the regulation of tobacco products made by tobacco manufacturers, including Vector Tobacco, which bear reduced carcinogen claims. The ultimate outcome of any of the foregoing cannot be predicted, but any of the foregoing could have a material adverse impact on the Company.

In addition to the foregoing, there have been a number of other restrictive regulatory actions, adverse legislative and political decisions and other unfavorable developments concerning cigarette smoking and the tobacco industry. These developments may negatively affect the perception of potential triers of fact with respect to the tobacco industry, possibly to the detriment of certain pending litigation, and may prompt the commencement of additional similar litigation or legislation.

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Other Matters:

In March 1997, a stockholder derivative suit was filed in Delaware Chancery Court against New Valley, as a nominal defendant, its directors and Brooke Group Holding, Inc., the Company s predecessor, by a stockholder of New Valley. The suit alleged that New Valley s purchase of the BrookeMil Ltd. shares from Brooke (Overseas) Ltd., which was then an indirect subsidiary of Brooke Group Holding, in January 1997 constituted a self-dealing transaction which involved the payment of excessive consideration by New Valley. The plaintiff sought a declaration that New Valley s directors breached their fiduciary duties and Brooke Group Holding aided and abetted such breaches and that damages be awarded to New Valley. In December 1999, another stockholder of New Valley commenced an action in Delaware Chancery Court substantially similar to the March 1997 action. This stockholder alleged, among other things, that the consideration paid by New Valley for the BrookeMil shares was excessive, unfair and wasteful, that the special committee of New Valley s board lacked independence, and that the appraisal and fairness opinion were flawed. By order of the court, both actions were consolidated. In March 2005, New Valley, its directors and Brooke Group Holding settled the consolidated action. The defendants did not admit any wrongdoing as part of the settlement. At a hearing held on June 14, 2005, the court approved the settlement. No appeal was taken and, therefore, the settlement is final. Under the settlement, the Company paid New Valley $7,000 in July 2005, and New Valley paid legal fees and expenses of $2,150. The Company recorded a charge to operating, selling, administrative and general expense in 2004 of $4,177 (net of minority interests) related to the settlement.

In July 1999, a purported class action was commenced on behalf of New Valley s former Class B preferred shareholders against New Valley, Brooke Group Holding and certain directors and officers of New Valley in Delaware Chancery Court. The complaint alleges that the recapitalization, approved by a majority of each class of New Valley s stockholders in May 1999, was fundamentally unfair to the Class B preferred shareholders, the proxy statement relating to the recapitalization was materially deficient and the defendants breached their fiduciary duties to the Class B preferred shareholders in approving the transaction. The court dismissed six of plaintiff s nine claims alleging inadequate disclosure in the proxy statement. Brooke Group Holding and New Valley filed a motion for summary judgment on the remaining three claims which was granted by the court in May 2005. The plaintiffs did not appeal the decision.

See Note 11 for information concerning purported class action lawsuits commenced against the Company, New Valley and New Valley s directors in connection with the Company s exchange offer for New Valley.

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. The Company believes that the fair value of Eve s guarantee was negligible at September 30, 2005.

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In February 2004, Liggett Vector Brands and another cigarette manufacturer entered into a five year agreement with a subsidiary of the American Wholesale Marketers Association to support a program to permit tobacco distributors to secure, on reasonable terms, tax stamp bonds required by state and local governments for the distribution of cigarettes. Under the agreement, Liggett Vector Brands has agreed to pay a portion of losses, if any, incurred by the surety under the bond program, with a maximum loss exposure of $500 for Liggett Vector Brands. To secure its potential obligations under the agreement, Liggett Vector Brands has delivered to the subsidiary of the Association a $100 letter of credit and agreed to fund up to an additional $400. Liggett Vector Brands has incurred no losses to date under this agreement, and the Company believes the fair value of Liggett Vector Brands obligation under the agreement was immaterial at September 30, 2005.

As of September 30, 2005, New Valley had $300 of remaining prepetition bankruptcy-related claims. The remaining claims may be subject to future adjustments based on potential settlements or decisions of the court.

8. EQUITY

The Company accounts for employee stock compensation plans under APB Opinion No. 25, Accounting for Stock Issued to Employees , with the intrinsic value-based method permitted by SFAS No. 123, Accounting for Stock-Based Compensation as amended by SFAS No. 148. Accordingly, no compensation expense is recognized when the exercise price is equal to the market price of the underlying common stock on the date of grant.

Awards under the Company s stock compensation plans generally vest over periods ranging from four to five years from the date of grant. The expense related to stock option compensation included in the determination of net income for the three and nine month periods ended September 30, 2005 and September 30, 2004 is less than that which would have been recognized if the fair value method had been applied to all awards since the original effective date of SFAS No. 123. The following table illustrates the effect on net income (loss) and income (loss) per share if the Company had applied the fair value provisions of SFAS No. 123:

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	Three Months Ended		Nine Months Ended	
	Sept. 30, 2005	Sept. 30, 2004	Sept. 30, 2005	Sept. 30, 2004
Net income (loss)	$ 8,975	$ 8,066	$ 30,266	$ (4,209)
Add: employee stock compensation expense included in reported net income (loss), net of related tax effects	547	42	1,031	126
Deduct: total employee stock compensation expense determined under the fair value method for all awards, net of related tax effects	(904)	(432)	(1,938)	(1,388)
Pro forma net income (loss)	$ 8,618	$ 7,676	$ 29,359	$ (5,471)
Income (loss) per share:				
Basic as reported	$ 0.20	$ 0.18	$ 0.69	$ (0.10)
Diluted as reported	$ 0.19	$ 0.17	$ 0.66	$ (0.10)
Basic pro forma	$ 0.19	$ 0.18	$ 0.66	$ (0.13)
Diluted pro forma	$ 0.19	$ 0.17	$ 0.64	$ (0.13)

For purposes of this pro forma presentation, the fair value of each option grant was estimated at the date of the grant using the Black-Scholes option pricing model. The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including expected stock price characteristics which are significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, the existing models do not necessarily provide a reliable single measure of the fair value of stock-based compensation awards.

On September 27, 2005, the President of the Company was awarded a restricted stock grant of 500,000 shares of Vector s common stock pursuant to Vector s Amended and Restated 1999 Long-Term Incentive Plan. Under the terms of the award, one-fourth of the shares vest on September 15, 2006, with an additional one-fourth vesting on each of the three succeeding one-year anniversaries of the first vesting date through September 15, 2009. In the event the his employment with the Company is terminated for any reason other than his death, his disability or a change of control (as defined in this Restricted Share Agreement) of the Company, any remaining balance of the shares not previously vested will be forfeited by him. The Company recorded deferred compensation of $9,775 representing the fair market value of the restricted shares on the date of grant. The deferred compensation will be amortized over the vesting period as a charge to compensation expense.

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9. INCOME TAXES

Vector s income tax rate for the three and nine months ended September 30, 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, as applicable. Vector s tax rate for the three and nine months ended September 30, 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.

The consolidated balance sheets of the Company 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 September 30, 2005, the Company s deferred income tax liabilities exceeded its deferred income tax assets by $132,640. The largest component of the Company s deferred tax liabilities exists because of differences that resulted from a 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. 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 the Company has an option to require Philip Morris to purchase the remaining interest for a 90-day period commencing in March 2010. For additional information concerning the Philip Morris brand transaction, see Note 18 to the consolidated financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2004.

In connection with the transaction, the Company recognized in 1999 a pre-tax gain of $294,078 in its 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, the Company 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 the Company at that time. In connection with an examination of the Company s 1998 and 1999 federal income tax returns, the Internal Revenue Service issued to the Company 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 $126,000, including interest, net of tax benefits, through September 30, 2005. These amounts have been previously recognized in the Company s consolidated financial statements as tax liabilities. As of September 30, 2005, the Company believes amounts potentially due have been fully provided for in its consolidated statements of operations.

The Company believes the positions reflected on its income tax returns are correct and intends to vigorously oppose any proposed adjustments to its returns. The Company has 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

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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 the Company incurred a tax obligation prior to the exercise dates of these options and it was required to make such tax payments prior to 2009 or 2010, and if any necessary financing were not available to the Company, its liquidity could be materially adversely affected.

10. NEW VALLEY CORPORATION

Office Buildings. 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. (Refer to Notes 5 and 12.)

Real Estate Businesses. 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 a residential real estate brokerage company in the New York metropolitan area. Koa Investors 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. 16th & K Holdings acquired the St. Regis Hotel in Washington, D.C. in August 2005.

Residential Brokerage Business. New Valley recorded income of $4,229 and $4,602 for the three months ended September 30, 2005 and 2004, respectively, and income of $9,689 and $10,015 for the nine months ended September 30, 2005 and 2004, respectively, associated with Douglas Elliman Realty. Summarized financial information for Douglas Elliman Realty for the three and nine months ended September 30, 2005 and 2004 and as of September 30, 2005 and December 31, 2004 is presented below.

	September 30, 2005	December 31, 2004
Cash	$ 26,510	$ 21,375
Other current assets	6,538	4,726
Property, plant and equipment, net	16,546	15,520
Trademarks	21,663	21,663
Goodwill	37,589	36,676
Other intangible assets, net	2,241	2,748
Other noncurrent assets	1,100	1,112
Notes payable current	3,258	4,998
Other current liabilities	20,817	18,264
Notes payable long term	56,898	66,710
Other long-term liabilities	3,288	3,125
Members equity	27,926	10,723

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	Three Months Ended		Nine Months Ended	
	Sept. 30, 2005	Sept. 30, 2004	Sept. 30, 2005	Sept. 30, 2004
Revenues	$ 92,523	$ 78,379	$ 254,092	$ 211,779
Costs and expenses	81,498	67,265	227,260	185,565
Depreciation expense	1,259	1,102	3,587	3,251
Amortization expense	183	150	550	600
Interest expense, net	1,365	1,462	4,439	4,315
Income tax expense	276		650	
Net income	$ 7,942	$ 8,400	$ 17,606	$ 18,048

Hawaiian Hotel. New Valley recorded a loss of $58 and $63 for the three months ended September 30, 2005 and 2004, respectively, and a loss of $3,500 and $188 for the nine months ended September 30, 2005 and 2004, respectively, associated with Koa Investors. Summarized financial information for Koa Investors for the three and nine months ended September 30, 2005 and 2004 and as of September 30, 2005 and December 31, 2004 is presented below.

	September 30, 2005	December 31, 2004
Cash	$ 2,841	$ 2,062
Restricted assets	2,962	5,538
Other current assets	1,837	988
Property, plant and equipment, net	74,359	77,339
Deferred financing costs, net	2,408	1,724
Accounts payable and other current liabilities	8,719	11,064
Notes payable	82,000	60,356
Members (deficiency) equity	(6,312)	16,231

	Three Months Ended		Nine Months Ended	
	Sept. 30, 2005	Sept. 30, 2004	Sept. 30, 2005	Sept. 30, 2004
Revenues	$ 6,986	$	$ 17,739	$
Costs and operating expenses	7,776		18,991	
Management fees	200	125	534	375
Depreciation expense	1,347		3,999	
Amortization expense	1,452		1,870	
Interest expense, net	1,439		4,457	
Net loss	$ (5,228)	$ (125)	$ (12,112)	$ (375)

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

Investors anticipates that the hotel will continue to experience operating losses during its opening phase.

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In August 2005, a wholly-owned subsidiary of Koa Investors borrowed $82,000 at an interest rate of LIBOR plus 2.45%. Koa Investors used the proceeds of the loan to repay its $57,000 construction loan and distributed a portion of the proceeds to its members, including $5,500 to New Valley. As a result of the refinancing, New Valley suspended its recognition of equity losses in Koa Investors to the extent such losses exceed its basis plus any commitment to make additional investments, which totaled $600 at September 30, 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 $47,000 in August 2005. The Company, which holds a 50% interest in Hotel LLC, had invested $6,250 in the project and had committed to make additional investments of up to $3,750 at September 30, 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 $50,000 of senior and subordinated debt.

New Valley accounts for its interest in Hotel LLC under the equity method and recorded income of $13 for the three and nine months ended September 30, 2005. Hotel LLC will capitalize all costs related to the renovation of the property during the renovation phase.

LTS. In November 2004, New Valley and the other holder of the convertible notes of Ladenburg Thalmann Financial Services Inc. (LTS) entered into a debt conversion agreement with LTS. New Valley and the other holder agreed to convert their notes, with an aggregate principal amount of $18,010, 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 $5,000 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 $9,938 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. 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.

LTS borrowed $1,750 from New Valley in 2004 and an additional $1,750 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 distribution. On the same date, the Company distributed the 10,947,448 shares of LTS common stock that it received from New Valley to the holders of its common stock as a special distribution. New Valley stockholders of record on March 18, 2005 received 0.852 of a LTS share for each share of New Valley, and the Company s stockholders of record on that date received 0.24 ($2,968) of a LTS share for each share of the Company.

Following the distribution, New Valley continues to hold the 11,111,111 shares of LTS common stock (approximately 9% of the outstanding shares), the $5,000 of LTS s notes due

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December 31, 2006 and a warrant to purchase 100,000 shares of its common stock at $1.00 per share. The shares of LTS common stock held by New Valley have been accounted for as investment securities available for sale and are carried at $6,778 on the Company s condensed consolidated balance sheet at September 30, 2005.

Share Repurchase. In October 1999, New Valley s Board of Directors authorized the repurchase of up to 2,000,000 common shares from time to time on the open market or in privately negotiated transactions depending on market conditions. As of September 30, 2005, New Valley had repurchased 1,229,515 shares for approximately $4,895.

Restricted Share Award. On January 10, 2005, New Valley s President and Chief Operating Officer, who also serves in the same positions with the Company, was awarded a restricted stock grant of 1,250,000 New Valley common shares pursuant to New Valley s 2000 Long-Term Incentive Plan. Under the terms of the award, one-seventh of the shares vested on July 15, 2005, with an additional one-seventh vesting on each of the five succeeding one-year anniversaries of the first vesting date through July 15, 2010 and an additional one-seventh vesting on January 15, 2011. On September 27, 2005, the executive renounced and waived, as of that date, the unvested 1,071,429 common shares deliverable by New Valley to him in the future.

Vector initially recorded deferred compensation of $8,875 ($3,152 net of income taxes and minority interests), representing the fair market value of the restricted shares on the date of the grant which was anticipated to be amortized over the vesting period as a charge to compensation expense. In connection with the executive s renouncement of the unvested common shares, the Company reduced the deferred compensation associated with the award by $7,608 during the third quarter of 2005. The Company recorded expense associated with the grant of $102 and $1,267 for the three and nine months ended September 30, 2005, respectively.

11. NEW VALLEY EXCHANGE OFFER

On October 20, 2005, VGR Holding Inc., a direct wholly-owned subsidiary of Vector, made an offer to the holders of common shares of New Valley to exchange 0.461 shares of Vector s common stock (and cash instead of fractional shares) for each outstanding common share of New Valley validly tendered and not withdrawn in the exchange offer (the Offer). If New Valley s stockholders choose to tender their shares, Vector would issue approximately 4.4 million shares of its common stock to complete the transaction. Vector currently owns approximately 57.7% of all of the outstanding common shares of New Valley. The Offer is subject to the non-waivable condition that, after giving effect to the Offer, Vector owns at least 90% of the total number of outstanding common shares of New Valley. If this minimum tender condition is satisfied, more than a majority of the minority stockholders (*i.e.*, stockholders unaffiliated with Vector and its subsidiaries and stockholders who are not directors or officers of New Valley) will have also validly tendered and not properly withdrawn their common shares of New Valley in the Offer. The Offer is also subject to approval by the Company s stockholders of the issuance of certain shares of the Company s common stock to be issued in the Offer and to other customary conditions. The Offer will expire on December 9, 2005, unless it is extended by Vector. If Vector completes the Offer, it intends to effect a short form merger of New Valley with and into a wholly-owned subsidiary of Vector shortly thereafter. Each common share of New Valley not acquired in the Offer, other than the shares owned by

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Vector, would be converted in the short form merger into 0.461 shares of Vector s common stock and cash instead of fractional shares.

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 Vector, 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). On or about September 29, 2005, a separate action was filed in the Circuit Court of the Eleventh Judicial Circuit in and for Miami-Dade County, Florida styled as *Tombs v. New Valley Corporation, et al*. (Case No. 05-19623 CA 22). On or about October 28, 2005, an additional action was filed in the Delaware Court of Chancery styled as *Lindstrom v. LeBow, et al*. (C.A. No. 1745-N). In general, the complaints allege, among other things: (1) breaches of fiduciary duty by Vector, New Valley and the members of New Valley s board in connection with the Offer and the subsequent merger; (2) that the consideration Vector is offering is inadequate; and (3) that Vector is acting to further its own interests at the expense of the holders of New Valley s common shares. Among other remedies, the complaints seek to enjoin the Offer and the subsequent merger or, alternatively, damages in an unspecified amount and rescission in the event the merger occurs. Vector is not aware of any purported class action complaints other than those referenced above. In the *Tombs* matter, on or about November 3, 2005, the plaintiffs filed an amended complaint. On or about October 21, 2005, the plaintiffs moved to expedite discovery and that motion, which was opposed by the defendants, was heard on November 8, 2005. Further argument has been set for November 10, 2005. Plaintiffs have filed a motion to consolidate the *Pill* and *Lindstrom* cases, and the *Pill* plaintiff has filed a motion to certify the case, which motions defendants do not oppose. In the *Pill* matter, Vector filed an answer on or about October 25, 2005. On or about November 1, 2005, the plaintiffs moved (i) to amend their complaint to, among other things, add VGR Holding Inc. as a defendant, (ii) for a preliminary injunction, and (iii) for expedited discovery. Defendants have agreed that the amended complaint may be filed with the Delaware Court of Chancery and have agreed to a discovery schedule, as a result of which plaintiff is no longer proceeding with his motion to expedite discovery. Vector believes that each of these lawsuits is without merit and will defend against each lawsuit.

12. DISCONTINUED OPERATIONS

As discussed in Note 10, 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 and nine months ended September 30, 2005 and 2004. Accordingly, revenues, costs and expenses, and cash flows of the discontinued operations have been excluded from the respective captions in the consolidated statements of operations and consolidated statements of cash flows. The net operating results of the discontinued operations have been reported, net of applicable income taxes and minority interests, as Income from discontinued operations , and the net cash flows of these entities have been reported as Net cash provided by 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 and nine months ended September, 2005 and 2004 are as follows:

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(Unaudited)

	Three Months Ended		Nine Months Ended	
	Sept. 30, 2005	Sept. 30, 2004	Sept. 30, 2005	Sept. 30, 2004
Revenues	$	$ 1,809	$ 924	$ 5,401
Expenses		1,285	515	3,658
Income from discontinued operations before income taxes and minority interests		524	409	1,743
Income tax expense from discontinued operations		287	223	940
Minority interests		125	104	424
Income from discontinued operations	$	$ 112	$ 82	$ 379

The Company recorded a gain in connection with the sale of the office buildings of $2,952, net of minority interests ($3,725) and income taxes ($8,008), in the first quarter 2005.

13. SEGMENT INFORMATION

On April 12, 2012 Mr. Winoker s Employment Agreement was amended to provide that in the event that (i) the Company gives written notice to Mr. Winoker prior to the expiration of his term of employment of the Company s decision not to extend his employment thereunder, (ii) Mr. Winoker gives written notice to the Company prior to the expiration of his term of employment of his decision to terminate his employment with the Company for Good Reason or (iii) there is a Change of Control in which Mr. Winoker is terminated, all of Mr. Winoker s then-outstanding stock options shall immediately vest and become exercisable in their entirety and all restrictions on shares of restricted stock granted by the Company to Mr. Winoker on which any restrictions shall not have terminated shall immediately terminate. The Employment Agreement was also amended to provide that in the event that Mr. Winoker is terminated by the Company for Cause, then that portion of the then-outstanding stock options granted by the Company to Mr. Winoker that has not already vested shall be terminated and that portion of the then-outstanding shares of restricted stock granted by the Company to Mr. Winoker on which all restrictions have not already terminated shall be forfeited and cancelled.

The complete text of Mr. Winoker s Employment Agreement, before it was amended, was filed with the SEC as an exhibit to a Form 8-K dated July 3, 2007. The complete text of the March 8, 2010 Amendment to Mr. Winoker s Employment Agreement was filed with the SEC as an exhibit to a Form 8-K dated March 10, 2010. The complete text of the April 12, 2012 Amendment to Mr. Winoker s Employment Agreement was filed with the SEC as an exhibit to a Form 8-K dated April 16, 2012.

DIRECTOR COMPENSATION

The following table sets forth compensation paid to the Company s non-employee directors for 2011:

Name	Fees earned or paid in cash	Stock awards (1)	Total
Cherrie Nanninga	$ 70,500	$ 45,960	$ 116,460
William U. Westerfield	65,000	45,960	110,960
Michael Jeary	55,000	45,960	100,960
John Koegel	55,000	45,960	100,960
David E. R. Dangoor	50,500	45,960	96,460

Note:

(1) Consists of restricted stock awards valued at the closing market price of the Company s common stock on the date of grant.

The following table sets forth the aggregate number of restricted shares of the Company s common stock and shares of the Company s common stock issuable upon the exercise of stock options held by each non-employee director at December 31, 2011:

Name	Restricted Shares (1)	Stock Options	
		Vested (2)	Unvested
Cherrie Nanninga	4,280	31,000	
William U. Westerfield	4,280	30,000	
Michael Jeary	4,280	25,000	
John Koegel	4,280	25,000	
David E. R. Dangoor	4,280	25,000	

Note:

(1) 2,780 restricted shares of the Company s common stock were issued to each director on June 16, 2011 and vest 100% on June 16, 2012. 1,500 restricted shares of the Company s common stock were issued to each director on August 4, 2011 and vest 100% on August 4, 2012.

(2) Includes options to purchase 25,000 shares of the Company s common stock which were granted to each non-employee director on August 10, 2009 and vested 100% on August 9, 2010.

The table of *Security Ownership of Certain Beneficial Owners and Management* sets forth the beneficial ownership of each director of the Company s common stock at April 30, 2012.

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Fees paid to the non-employee directors of the Company are based on the following schedule:

Board of Directors Annual Retainer	
Cash	$ 25,000
Restricted common stock	45,000
Total	70,000
Annual Retainer for Committee Chairs:	
Audit and Compensation Committees	$ 20,000
All other committees of the Board	5,000
Annual Retainer for Committee members:	$ 2,000
Fees for each meeting attended:	
Board of Directors meetings	$ 2,000
Committee meetings	500

LIMITATION ON DIRECTORS AND OFFICERS LIABILITY

The Company s Second Restated Certificate of Incorporation contains a provision which eliminates the personal liability of a director for monetary damages other than for breaches of the director s duty of loyalty to the Company or its stockholders, acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law or violations under Section 174 of the Delaware General Corporation Law or for any transaction from which the director derived an improper personal benefit.

The Company has entered into indemnification agreements with each of its officers and directors which provide that the Company will indemnify the indemnitee against expenses, including reasonable attorney s fees, judgments, penalties, fines and amounts paid in settlement, actually and reasonably incurred by him or her in connection with any civil or criminal action or administrative proceeding arising out of the performance of his or her duties as a director, officer, employee or agent of the Company. Such indemnification is available if the acts of the indemnitee were in good faith, if the indemnitee acted in a manner he or she reasonably believed to be in or not opposed to the best interests of the Company and, with respect to any criminal proceeding, the indemnitee had no reasonable cause to believe his or her conduct was unlawful.

The Company maintains directors and officers liability insurance policies. The policies insure the directors and officers of the Company against loss arising from certain claims made against such directors or officers by reason of certain wrongful acts.

CERTAIN RELATIONSHIPS

Certain relatives of Jeffrey Siegel, the Chairman of the Board of Directors, Chief Executive Officer and President of the Company, are employed by the Company, as follows:

Daniel Siegel, a son of Jeffrey Siegel, is employed by the Company as its Executive Vice President. His compensation in 2011 included earned cash compensation of $774,600 and a grant of options to purchase 15,000 shares of the Company s common stock with an exercise price of 10.79.

James Wells, a son-in-law of Jeffrey Siegel, is employed by the Company as its President, Kitchenware. His compensation in 2011 included earned cash compensation of $470,835 and a grant of options to purchase 20,000 shares of the Company s common stock with a weighted-average exercise price of 11.44.

Clifford Siegel, a son of Jeffrey Siegel, is employed by the Company as its Executive Vice President Global Supply Chain. His compensation in 2011 included earned cash compensation of $385,642 and a grant of options to purchase 7,500 shares of the Company s common stock with an exercise price of 10.79.

RELATED-PARTY TRANSACTIONS

The Company s policies and procedures regarding transactions with related persons are set forth in writing in the Company s Code of Conduct, which states that the Audit Committee must review and approve any related party transaction as defined in Item 404(a) of Regulation S-K before it is consummated. The Audit Committee of the Board of Directors is responsible for applying such policies and procedures pursuant to its charter, which states that the Audit Committee of the Board of Directors will review and approve related-party transactions submitted by management after management s evaluation of the terms of such transaction.

SECTION 16(A) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Securities Exchange Act of 1934 requires the Company s directors and executive officers, and persons who own more than 10% of a registered class of the Company s equity securities, to file with the Company, the SEC, and the National Association of Securities Dealers initial reports of ownership and reports of changes in ownership of any equity securities of the Company. During Fiscal 2011, to the best of the Company s knowledge, with the exception of a Form 4 filing for Robert Reichenbach that was required to be filed on December 2, 2011, that was filed on December 5, 2011 and a Form 4 filing for Larry Sklute that was required to be filed on December 8, 2011 that was filed on December 9, 2011, all required reports were filed on a timely basis. In making this statement, the Company has relied on the written representations of its directors and officers and copies of Forms 3, 4 and 5 provided to the Company.

PROPOSAL NO. 2

RATIFICATION OF APPOINTMENT OF

INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Audit Committee appointed the firm of Ernst & Young LLP (Ernst & Young) as the independent registered public accounting firm to audit the Company s financial statements for the fiscal year ending December 31, 2011. Ernst & Young has audited the Company s financial statements since 1984.

The Audit Committee has adopted a policy that requires advance approval of all audit, audit-related and tax services and other services performed by the independent auditor. The policy provides for pre-approval by the Audit Committee of specifically defined audit and non-audit services. Unless the specific service has been previously pre-approved with respect to that year, the Audit Committee must approve the permitted service before the independent auditor is engaged to perform it. The Audit Committee has delegated to the Chair of the Audit Committee authority to approve permitted services costing up to $50,000 provided that the Chair reports any decisions to the Committee at its next scheduled meeting.

The following table sets forth fees paid or payable to Ernst & Young for services provided in each of the years ended December 31, 2011 and 2010:

	2011	2010
Audit fees	$ 1,029,500	$ 964,000
Audit-related fees	515,000	
Tax fees	192,201	212,650
All other fees	3,000	2,500
Total	$ 1,739,701	$ 1,179,150

Audit fees

Audit fees are fees paid to Ernst & Young for the annual audit of the Company s financial statements, the quarterly reviews of the Company s financial statements included in its Forms 10-Q, fees related to the Company s annual audit of internal controls over financial reporting, statutory audit fees and fees for regulatory filings.

Audit-related fees

Audit related fees are fees paid to Ernst & Young for assurance and related services that are related to the performance of the audit or review of the financial statements but not reported as audit fees.

Tax fees

Tax fees are billed for services rendered for tax compliance including the preparation of tax returns and tax advisory services.

All other fees

All other fees consist of fees paid to Ernst & Young for access to Ernst & Young s online accounting research tool.

In making its appointment of Ernst & Young to audit the Company s financial statements for the fiscal year ending December 31, 2012, the Audit Committee reviewed past audit, audit related and other non-audit services performed during 2011. In selecting Ernst & Young, the Audit Committee carefully considered their independence. The Audit Committee has determined that the performance of such non-audit services did not impair the independence of Ernst & Young.

Ernst & Young has confirmed to the Audit Committee that it is in compliance with all rules, standards and policies of the Public Company Accounting Oversight Board and the SEC governing auditor independence.

If the stockholders do not ratify this appointment, the Audit Committee will reconsider the appointment.

Representatives of Ernst & Young are expected to be present at the Meeting and will have the opportunity to make a statement if they desire and to respond to appropriate questions of stockholders.

The Audit Committee recommends that stockholders vote **FOR** the ratification of the appointment of Ernst & Young.

PROPOSAL NO. 3

AMENDMENT OF THE COMPANY S 2000 LONG-TERM INCENTIVE PLAN

Subject to stockholder approval, the Board of Directors has approved an amendment to the Company s 2000 Long-Term Incentive Plan (the 2000 Long-Term Plan) to provide an aggregate limit on the number of shares of the Company s Common Stock for which awards may be issued under the 2000 Long-Term Plan equal to 4,200,000 (disregarding forfeited or cancelled awards). In 2008, an amendment was made to the 2000 Long-Term Plan to provide an aggregate limit on the number of shares of the Company s Common Stock for which awards may be issued under the 2000 Long-Term Plan equal to 3,500,000. Prior to this amendment, the 2000 Long-Term Plan provided that no more than 2,500,000 shares of the Company s Common Stock could be subject to outstanding awards at any given time. As of December 31, 2011, awards for a total of 4,337,124 shares of the Company s Common Stock have been granted under the 2000 Long-Term Plan since its inception, of which 1,169,600 were cancelled or forfeited. As of December 31, 2011, the number of shares available for which awards may be issued under the 2000 Long-Term Plan was 332,476.

Approval of the amended plan would allow the Company to continue to use stock options (and other stock-based awards) as a means to attract, retain and motivate the Company s key personnel.

The 2000 Long-Term Plan, as proposed to be amended, is set forth as Appendix A to this Proxy Statement. The discussion of the 2000 Long-Term Plan which follows is intended to provide only a summary of the principal features of the plan and is in all respects qualified by, and subject to, the actual terms and provisions of the attached 2000 Long-Term Plan.

General

The purpose of the 2000 Long-Term Plan is to provide a means to attract, retain, motivate and reward selected directors, officers, employees and consultants of the Company and its parents and subsidiaries by increasing their ownership interests in the Company. Awards under the 2000 Long-Term Plan may take the form of: (i) options to purchase shares of Common Stock, including incentive stock options (ISOs), non-qualified stock options or both; (ii) stock appreciation rights (SARs), whether in conjunction with the grant of stock options or independent of such grant, or stock appreciation rights that are only exercisable in the event of a change in control of the Company or upon other events; (iii) restricted stock, consisting of shares that are subject to forfeiture based on the failure to satisfy employment-related restrictions; (iv) deferred stock, representing the right to receive shares of stock in the future; (v) bonus stock and awards in lieu of cash compensation; (vi) dividend equivalents, consisting of a right to receive cash, other awards, or other property equal in value to dividends paid with respect to a specified number of shares of Common Stock, or other periodic payments; or (vii) other awards not otherwise provided for, the value of which are based in whole or in part upon the value of Common Stock. Awards granted under the 2000 Long-Term Plan are generally not assignable or transferable except by the laws of descent and distribution.

As noted above, subject to stockholder approval, the 2000 Long-Term Plan will limit the aggregate number of shares of Stock for which awards may be granted to 4,200,000. Awards made under the 2000 Long-Term Plan which are forfeited, cancelled or have expired, will be disregarded for purposes of this limit.

The Compensation Committee, which administers the 2000 Long-Term Plan, will have the authority, among other things, to: (i) select the directors, officers and other employees and consultants entitled to receive awards under the 2000 Long-Term Plan; (ii) determine the form of awards, or combinations thereof, and whether such awards are to operate on a tandem basis or in conjunction with other awards; (iii) determine the number of shares of Common Stock or units or rights covered by an award, provided that no individual may receive awards under the 2000 Long-Term Plan in any one calendar year relating to more than 500,000 shares of Common Stock; and (iv) determine the terms and conditions of any awards granted under the 2000 Long-Term Plan, including any restrictions or limitations on transfer, any vesting schedules or the acceleration thereof and any forfeiture provision or waiver thereof.

The flexible terms of the 2000 Long-Term Plan are intended to, among other things, permit the Compensation Committee to impose performance conditions with respect to any award, thereby requiring forfeiture of all or part of any award if performance objectives are not met, or linking the time of exercisability or settlement of an award to the achievement of performance conditions. For awards intended to qualify as performance-based compensation within the meaning of Section 162(m) of the Code (see below), such performance objectives shall be based solely on (i) annual return on capital, (ii) annual earnings or earnings per share, (iii) annual cash flow provided by operations, (iv) changes in annual revenues, (v) stock price and/or (vi) strategic business criteria, consisting of one or more objectives based on meeting specified revenue, market penetration, geographic business expansion goals, cost targets, and goals relating to acquisitions or divestitures.

The 2000 Long-Term Plan may be amended, altered, suspended, discontinued, or terminated by the Board without stockholder approval unless such approval is required by law or regulation or under the rules of any stock exchange or automated quotation system on which Common Stock is then listed or quoted. Thus, stockholder approval will not necessarily be required for amendments which might increase the cost of the 2000 Long-Term Plan or broaden eligibility. Stockholder approval will not be deemed to be required under laws or regulations that condition favorable tax treatment on such approval, although the Board may, in its discretion, seek stockholder approval in any circumstances in which it deems such approval advisable.

Federal Tax Consequences

The following is a brief description of the federal income tax consequences generally arising with respect to awards that may be granted under the 2000 Long-Term Plan. This discussion is intended for the information of stockholders considering how to vote at the special meeting and not as tax guidance to individuals who participate in the 2000 Long-Term Plan.

The grant of an option or SAR (including a stock-based award in the nature of a purchase right) will create no tax consequences for the participant or the Company at the time of grant. A participant will not recognize taxable income upon exercising an ISO (except that the alternative minimum tax may apply) and the Company will receive no deduction at that time. Upon exercising an option other than an ISO (including a stock-based award in the nature of a purchase right), the participant must generally recognize ordinary income equal to the difference between the exercise price and fair market value of the freely transferable and nonforfeitable stock received. In each case, the Company will generally be entitled to a deduction equal to the amount recognized as ordinary income by the participant.

A participant s disposition of shares acquired upon the exercise of an option, SAR or other stock-based award in the nature of a purchase right generally will result in capital gain or loss measured by the difference between the sale price and the participant s tax basis in such shares (or the exercise price of the option in the case of shares acquired by exercise of an ISO and held for the applicable ISO holding periods). Generally, there will be no tax consequences to the Company in connection with a disposition of shares acquired upon exercise of an option or other award, except that the Company will generally be entitled to a deduction (and the participant will recognize ordinary income) if shares acquired upon exercise of an ISO are disposed of before the applicable ISO holding periods have been satisfied.

With respect to awards granted under the 2000 Long-Term Plan that may be settled either in cash or in stock or other property that is either not restricted as to transferability or not subject to a substantial risk of forfeiture, the participant must generally recognize ordinary income equal to the cash or the fair market value of stock or other property received. The Company will generally be entitled to a deduction for the same amount. With respect to awards involving stock or other property that is restricted as to transferability and subject to a substantial risk of forfeiture, the participant must generally recognize ordinary income equal to the fair market value of the shares or other property received at the first time the shares or other property become transferable or not subject to a substantial risk of forfeiture, whichever occurs earlier. The Company will generally be entitled to a deduction in an amount equal to the ordinary income recognized by the participant. A participant may elect to be taxed at the time of receipt of shares or other property rather than upon lapse of restrictions on transferability or substantial risk of forfeiture, but if the participant subsequently forfeits such shares or property he will not be entitled to any tax deduction, including a capital loss, for the value of the shares or property on which he previously paid tax. Such election must be made and filed with the Internal Revenue Service within thirty days of the receipt of the shares or other property.

Section 162(m) of the Code generally disallows a public company s tax deduction for compensation to the chief executive officer and the four other most highly compensated executive officers in excess of $1 million. Compensation that qualifies as performance-based compensation is excluded from the $1 million deductibility cap, and therefore remains fully deductible by the company that pays it. The Company believes that options granted with an exercise price at least equal to 100% of the fair market value of the underlying Common Stock at the date of grant will qualify as such performance-based compensation. Subject to the approval of this proposal, the Company believes that other awards under the 2000 Long-Term Plan, the settlement of which is conditioned upon achievement of performance goals (based on performance criteria described above), will also qualify as such performance-based compensation, although other awards under this plan may not so qualify.

The Company s Board of Directors recommends that stockholders vote **FOR** this proposal with respect to the 2000 Long-Term Plan.

PROPOSAL NO. 4

RE-APPROVAL OF PERFORMANCE CRITERIA UNDER THE COMPANY S 2000 LONG-TERM INCENTIVE PLAN

If stockholders approve this proposal there will be a continuation of the various performance criteria, described in Proposal No. 3, which may be utilized in establishing specific targets to be attained as a condition to the vesting of one or more stock-based awards under the 2000 Long-Term Plan so as to qualify the compensation attributable to those awards as performance-based compensation under Section 162(m) of the Code.

The 2000 Long-Term Plan, as proposed to be amended and summarized in Proposal No. 3, is set forth as Appendix A to this Proxy Statement. See Proposal No. 3 for a discussion of the 2000 Long-Term Plan.

The Company s Board of Directors recommends that stockholders vote **FOR** this proposal with respect to the 2000 Long-Term Plan.

PROPOSAL NO. 5

RE-APPROVAL OF PERFORMANCE CRITERIA UNDER THE COMPANY S 2000 INCENTIVE BONUS COMPENSATION PLAN

The Company s 2000 Incentive Bonus Compensation Plan (the 2000 Bonus Plan) was adopted by unanimous vote of the Board of Directors, effective for the performance periods commencing on or after January 1, 2000, and approved by the Company s stockholders on June 8, 2000. Section 162(m) of the Code generally disallows a public company s tax deduction in excess of $1 million for compensation paid to certain executive officers of the Company, subject to several exceptions, including an exception for compensation paid under a stockholder-approved plan that is performance-based within the meaning of Section 162(m). The 2000 Bonus Plan provides a means for the payment of performance-based cash bonuses to certain key executives of the company while preserving the Company s tax deduction with respect to the payment thereof. To continue to qualify under Section 162(m) of the Code, the Company must obtain stockholder approval of the performance criteria under this plan at least once every five years.

The Board believes that, as a matter of general policy, the Company s incentive compensation plans should be structured to facilitate compliance with Section 162(m), but that the Company should reserve the right to establish separate annual and other incentive compensation arrangements for certain executive officers that may not comply with Section 162(m) if it determines that to do so would be in the best interests of the Company and the stockholders.

At the Meeting the stockholders will be asked to re-approve the performance criteria, effective January 1, 2012 which has been and may continue to be utilized under the 2000 Bonus Plan so as to qualify the payment of certain cash bonuses as performance-based compensation under Section 162(m) of the Code.

The 2000 Bonus Plan is set forth as Appendix B to this Proxy Statement. The discussion of the 2000 Bonus Plan which follows is intended to provide only a summary of the principal features of the plan and is in all respects qualified by, and subject to, the actual terms and provisions of the attached 2000 Bonus Plan.

General

The purpose of the 2000 Bonus Plan is (i) to retain and motivate key executives of the Company who have been designated as participants in this plan for a given performance period (generally, any period used to determine whether the established goals have been attained, which may be one or more fiscal years or portions thereof), by providing them with the opportunity to earn bonus awards that are based on the extent to which specified performance goals for such performance period have been achieved or exceeded and (ii) to structure bonus opportunities in a way that will qualify the awards as performance-based for purposes of Section 162(m) so that the Company will be entitled to a tax deduction on the payment of such incentive awards to certain executive officers.

Administration

The 2000 Bonus Plan is administered by the Compensation Committee of the Board (the Compensation Committee), consisting of at least two non-employee directors, each of whom is intended to qualify as an outside director within the meaning of Section 162(m) of the Code. The Compensation Committee has broad administrative authority to, among other things, designate participants, establish performance goals and performance periods, determine the effect of termination of employment and change in control transactions (as defined in this plan) prior to the payment of an award, and interpret and administer this plan.

Eligibility of Awards

Participants in the 2000 Bonus Plan for any given performance period may include any key employee of the Company or a subsidiary who is an executive officer of the Company and who is designated as a participant for such period by the Compensation Committee. The participants in the 2000 Bonus Plan for any given period will be designated by the Compensation Committee, in its sole discretion, before the end of the 90th day of each performance period or the date on which 25% of such performance period has been completed (such period, the Applicable Period). This determination may vary from period to period, and will be based primarily on

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the Compensation Committee s judgment as to which executive officers are likely to be subject to the limitations of Section 162(m) as of the end of such performance period, and which are reasonably expected to have compensation in excess of $1 million.

General Performance Goals

Within the Applicable Period, the Compensation Committee will specify the applicable performance criteria and targets to be used under the Bonus Plan for such performance period. These performance criteria may vary from participant to participant and will be based on one or more of the following Company, subsidiary, operating unit, or division financial performance measures: pre-tax or after-tax net income; operating income; gross revenue; profit margin; stock price or cash flows; or strategic business criteria consisting of one or more objectives based upon meeting specified revenue market penetration, geographic business expansion goals, cost targets, and goals relating to acquisition or divestitures. These performance criteria or goals may be (i) expressed on an absolute or relative basis; (ii) based on internal targets; (iii) based on comparison(s) with prior performance; (iv) based on comparison(s) to capital, stockholders equity shares outstanding, assets or net assets; and/or (v) based on comparison(s) to the performance of other companies. For example, an income-based performance measure could be expressed in a number of ways, such as net earnings per share, or return on equity, and with reference to meeting or exceeding a specific target, or with reference to growth above a specified level, such as prior year s performance, or current or previous peer group performance. The 2000 Bonus provides that the achievement of such goals must be substantially uncertain at the time they are established, and awards are subject to the Compensation Committee s right to reduce the amount of any award payable as a result of such performance as discussed below.

The target bonus opportunity for each participant maybe be expressed as a dollar-denominated amount or by reference to a formula, such as a percentage share of a bonus pool to be created under the 2000 Bonus Plan, provided that, if a pool approach is used, the total bonus opportunities represented by the shares designated for the participants may not exceed 100% of the pool, and the Compensation Committee has the sole discretion to reduce (but not increase) the actual bonuses awarded under this plan. The actual bonus awarded to any given participant at the end of a performance period will be based on the extent to which the applicable financial performance goals for such performance period are achieved, as determined by the Compensation Committee. The maximum bonus payable under the 2000 Bonus Plan to any one individual in any one calendar year is $5 million.

Amendment/Termination

The Board may at any time amend or terminate the 2000 Bonus Plan, provided that (i) without the participant s written consent, no such amendment or termination will adversely affect the annual bonus rights (if any) of any already designated participant for a given performance period once the participant designations and performance goals for such performance period have been announced; and (ii) the Board is authorized to make any amendments necessary to comply with applicable regulatory requirements, including, without limitation, Section 162(m). Amendments to the 2000 Bonus Plan will require stockholder approval only if required under Section 162(m).

New Plan Benefits

The Compensation Committee will use its discretion in selecting the participants under the 2000 Bonus Plan and the particular performance goals applicable to those participants. Jeffrey Siegel and Ronald Shiftan have thus far been the only participants in the 2000 Bonus Plan, and the only awards currently outstanding under the 2000 Bonus Plan are the Annual Adjusted IBIT Performance Bonuses for 2012 required by Mr. Siegel s New Employment Agreement (as amended) and Mr. Shiftan s Amended and Restated Employment Agreement, as described above. If the stockholders do not vote for the approval of this proposal with respect to the 2000 Bonus Plan, these bonuses will not be paid pursuant to the 2000 Bonus Plan. However, as noted above, the Company has reserved the right to establish separate annual and other incentive compensation arrangements that may not comply with Section 162(m) if it determines that to do so would be in the best interests of the Company and the stockholders.

Federal Income Tax Consequences

The following is a brief description of the federal income tax consequences generally arising with respect to awards that may be granted under the 2000 Bonus Plan. The discussion is intended for the information of stockholders considering how to vote at the annual meeting and not as tax guidance to individuals who may participate in the 2000 Bonus Plan.

Under present federal income tax law, participants will generally realize ordinary income equal to the amount of the award received under the 2000 Bonus Plan in the year of such receipt. The Company will receive a deduction for the amount constituting ordinary income to the participant, provided that the participant s total compensation is below the Section 162(m) limit or the 2000 Bonus Plan award satisfies the requirements of the performance-based exception of Section 162(m) of the Code. It is the Company s intention that the 2000 Bonus Plan be administered in a manner that preserves the Company s deductibility of compensation under Section 162(m) of the Code.

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The Board recommends that stockholders vote **FOR** the approval of this proposal with respect to the 2000 Bonus Plan.

STOCKHOLDER PROPOSALS

A stockholder proposal intended to be presented at the Company s 2013 Annual Meeting of Stockholders must be received by the Company at its principal executive office on or before January 11, 2013, to be included in the Company s proxy statement and proxy relating to that meeting.

OTHER MATTERS

The management of the Company does not know of any matters other than those stated in this Proxy Statement which are to be presented for action at the Meeting. If any other matters should properly come before the Meeting, it is intended that proxies in the accompanying form will be voted on such other matters in accordance with the judgment of the persons voting such proxies. Discretionary authority to vote on such matters is conferred by such proxies upon the persons voting them.

Financial statements for the Company are included in the Annual Report of the Company for the fiscal year ended December 31, 2011, which accompanies this Proxy Statement.

Upon the written request of any person who on the record date was a record owner of common stock of the Company, or who represents in good faith that he or she was on such date a beneficial owner of common stock of the Company, the Company will send to such person, without charge, a copy of its Annual Report on Form 10-K for the fiscal year ended December 31, 2011, including financial statements and schedules, as filed with the SEC. Requests for this report should be directed to Laurence Winoker, Senior Vice-President Finance, Treasurer and Chief Financial Officer, Lifetime Brands, Inc., 1000 Stewart Avenue, Garden City, New York 11530.

By Order of the Board of Directors,

/s/ Sara Shindel
Secretary

Dated: April 30, 2012

APPENDIX A

2000 LONG-TERM INCENTIVE PLAN

(as proposed to be amended)

1. Purpose. The purpose of this 2000 Long-Term Incentive Plan (the Plan) of Lifetime Brands, Inc., a Delaware corporation (the Company), is to advance the interests of the Company and its stockholders by providing a means to attract, retain, motivate and reward directors, officers, employees and consultants of and service providers to the Company and its affiliates and to enable such persons to acquire or increase a proprietary interest in the Company, thereby promoting a closer identity of interests between such persons and the Company s stockholders.

2. Definitions. The definitions of awards under the Plan, including Options, SARs (including Limited SARs), Restricted Stock, Deferred Stock, Stock granted as a bonus or in lieu of other awards, Dividend Equivalents and Other Stock-Based Awards as are set forth in Section 6 of the Plan. Such awards, together with any other right or interest granted to a Participant under the Plan, are termed Awards. For purposes of the Plan, the following additional terms shall be defined as set forth below:

(a) Award Agreement means any written agreement, contract, notice or other instrument or document evidencing an Award.

(b) Beneficiary shall mean the person, persons, trust or trusts which have been designated by a Participant in his or her most recent written beneficiary designation filed with the Committee to receive the benefits specified under the Plan upon such Participant s death or, if there is no designated Beneficiary or surviving designated Beneficiary, then the person, persons, trust or trusts entitled by will or the laws of descent and distribution to receive such benefits.

(c) Board means the Board of Directors of the Company.

(d) Code means the Internal Revenue Code of 1986, as amended from time to time. References to any provision of the Code shall be deemed to include regulations thereunder and successor provisions and regulations thereto.

(e) Committee means the committee appointed by the Board to administer the Plan, or if no committee is appointed, the Board.

(f) Exchange Act means the Securities Exchange Act of 1934, as amended from time to time. References to any provision of the Exchange Act shall be deemed to include rules thereunder and successor provisions and rules thereto.

(g) Full-Value Award means any Award granted under the Plan other than (i) an Option that requires the Participant to pay (in cash, foregone cash compensation, or other consideration, other than the performance of services, designated as acceptable by the Committee) at least the Fair Market Value of the Stock subject thereto as determined on the date of grant of the Award or (ii) an SAR that is based solely on the appreciation of the Stock underlying the Award from the Fair Market Value of the Stock as determined on the date of grant of the Award.

(h) Fair Market Value means, with respect to Stock, Awards, or other property, the fair market value of such Stock, Awards, or other property determined by such methods or procedures as shall be established from time to time by the Committee, provided, however, that if the Stock is listed on a national securities exchange or quoted in an interdealer quotation system, the Fair Market Value of such Stock on a given date shall be based upon the last sales price at the end of regular trading or, if unavailable, the average of the closing bid and asked prices per share of the Stock at the end of regular trading on such date (or, if there was no trading or quotation in the Stock on such date, on the next preceding date on which there was trading or quotation) as provided by one of such organizations.

(i) ISO means any Option that is designated as an incentive stock option within the meaning of Section 422 of the Code, and qualifies as such.

(j) Parent means any person (within the meaning of Section 13(d)(3) or 14(d)(2) of the Exchange Act) that controls the Company, either directly or indirectly through one or more intermediaries.

(k) Participant means a person who, at a time when eligible under Section 5 hereof, has been granted an Award under the Plan.

(l) Rule 16b-3 means Rule 16b-3, as from time to time in effect and applicable to the Plan and Participants, promulgated by the Securities and Exchange Commission under Section 16 of the Exchange Act.

(m) Stock means the Company s common stock, and such other securities as may be substituted for Stock pursuant to Section 4.

(n) Subsidiary means each entity that is controlled by the Company or a Parent, either directly or indirectly through one or more intermediaries.

3. Administration.

(a) Authority of the Committee. Except as otherwise provided below, the Plan shall be administered by the Committee. The Committee shall have full and final authority to take the following actions, in each case subject to and consistent with the provisions of the Plan:

(i) to select persons to whom Awards may be granted;

(ii) to determine the type or types of Awards to be granted to each such person;

(iii) to determine the number of Awards to be granted, the number of shares of Stock to which an Award will relate, the terms and conditions of any Award granted under the Plan (including, but not limited to, any exercise price, grant price or purchase price, any restriction or condition, any schedule for lapse of restrictions or conditions relating to transferability or forfeiture, exercisability or settlement of an Award, and waivers or accelerations thereof, performance conditions relating to an Award (including performance conditions relating to Awards not intended to be governed by Section 7(f) and waivers and modifications thereof), based in each case on such considerations as the Committee shall determine), and all other matters to be determined in connection with an Award;

(iv) to determine whether, to what extent and under what circumstances an Award may be settled, or the exercise price of an Award may be paid, in cash, Stock, other Awards, or other property, or an Award may be canceled, forfeited, or surrendered;

(v) to determine whether, to what extent and under what circumstances cash, Stock, other Awards or other property payable with respect to an Award will be deferred either automatically, at the election of the Committee or at the election of the Participant;

(vi) to determine the restrictions, if any, to which Stock received upon exercise or settlement of an Award shall be subject (including lock-ups and other transfer restrictions), may condition the delivery of such Stock upon the execution by the Participant of any agreement providing for such restrictions;

(vii) to prescribe the form of each Award Agreement, which need not be identical for each Participant;

(viii) to adopt, amend, suspend, waive and rescind such rules and regulations and appoint such agents as the Committee may deem necessary or advisable to administer the Plan;

(ix) to correct any defect or supply any omission or reconcile any inconsistency in the Plan and to construe and interpret the Plan and any Award, rules and regulations, Award Agreement or other instrument hereunder; and

(x) to make all other decisions and determinations as may be required under the terms of the Plan or as the Committee may deem necessary or advisable for the administration of the Plan.

Other provisions of the Plan notwithstanding, (i) the Board shall perform the functions of the Committee for purposes of granting awards to directors who serve on the Committee, (ii) a subcommittee of the Committee or the Board composed solely of two or more directors who are (a) non-employee directors of the Company as defined in Rule 16b-3(b)(3) under the Exchange Act and (b) outside directors within the meaning of Treasury Regulation section 1.162-27 under Code section 162(m), shall perform the functions of the Committee for purposes of granting awards to directors who are not employed by the Company, Parent or any Subsidiary, and (iii) the Board may perform any function of the Committee under the Plan for any other purpose, including without limitation for the purpose of ensuring that transactions under the Plan by Participants who are then subject to Section 16 of the Exchange Act in respect of the Company are exempt under Rule 16b-3. In any case in which the Board is performing a function of the Committee under the Plan, each reference to the Committee herein shall be deemed to refer to the Board, except where the context otherwise requires.

(b) Manner of Exercise of Committee Authority. Any action of the Committee with respect to the Plan shall be final, conclusive and binding on all persons, including the Company, its Parent and Subsidiaries, Participants, any person claiming any rights under the Plan from or through any Participant and stockholders, except to the extent the Committee may subsequently modify, or take further action not consistent with, its prior action. If not specified in the Plan, the time at which the Committee must or may make any determination shall be determined by the Committee, and any such determination may thereafter be modified by the Committee (subject to Section 8(e)). The express grant of any specific power to the Committee, and the taking of any action by the Committee, shall not be construed as limiting any power or authority of the Committee. Except as provided under Section 7(f), the Committee may delegate to officers or managers of the Company, its Parent or Subsidiaries the authority, subject to such terms as the Committee shall determine, to perform such functions as the Committee may determine, to the extent permitted under applicable law.

(c) Limitation of Liability; Indemnification. Each member of the Committee shall be entitled to, in good faith, rely or act upon any report or other information furnished to him by any officer or other employee of the Company, its Parent or Subsidiaries, the Company s independent certified public accountants or any executive compensation consultant, legal counsel or other professional retained by the Company to assist in the administration of the Plan. No member of the Committee, or any officer or employee of the Company acting on behalf of the Committee, shall be personally liable for any action, determination or interpretation taken or made in good faith with respect to the Plan, and all members of the Committee and any officer or employee of the Company acting on its behalf shall, to the extent permitted by law, be fully indemnified and protected by the Company with respect to any such action, determination or interpretation.

4. Stock Subject to Plan.

(a) Amount of Stock Reserved. The aggregate number of shares of Stock for which Awards may be granted under this Plan shall not exceed 4,200,000; provided, however, that no more than 5% of such authorized shares may be issued pursuant to Full-Value Awards that do not satisfy the vesting requirements set forth in Section 7(g) of the Plan. Awards made under this Plan which are forfeited (including a repurchase or cancellation of shares of Stock subject thereto by the Company in exchange for the price, if any, paid to the Company for such shares, or for their par value or other nominal value), cancelled or have expired, shall be disregarded for purposes of the preceding sentence. Any shares of Stock delivered pursuant to an Award may consist, in whole or in part, of authorized and unissued shares, treasury shares or shares acquired in the market on a Participant s behalf.

(b) Annual Per-Participant Limitations. During any calendar year, no Participant may be granted Awards that may be settled by delivery of more than 500,000 shares of Stock, subject to adjustment as provided in Section 4(c). In addition, with respect to Awards that may be settled in cash (in whole or in part), no Participant may be paid during any calendar year cash amounts relating to such Awards that exceed the greater of the Fair Market Value of the number of shares of Stock set forth in the preceding sentence at the date of grant or the date of settlement of the Award. This provision sets forth two separate limitations, so that Awards that may be settled solely by delivery of Stock will not operate to reduce the amount of cash-only Awards, and vice versa; nevertheless, Awards that may be settled in Stock or cash must not exceed either limitation.

(c) Adjustments. In the event of any recapitalization, reclassification, forward or reverse split, reorganization, merger, consolidation, spinoff, combination, repurchase or exchange of Stock or other securities, Stock dividend or other special, large and non-recurring dividend or distribution (whether in the form of cash, securities or other property), liquidation, dissolution, or any other extraordinary or unusual event affecting the outstanding Stock as a class, then the Committee shall equitably adjust any or all of (i) the number and kind of shares of Stock reserved and available for Awards under Section 4(a) and 4(b), including shares reserved for ISOs, (ii) the number and kind of shares of outstanding Restricted Stock or other outstanding Awards in connection with which the shares have been issued, (iii) the number and kind of shares that may be issued in respect of other outstanding Awards and (iv) the exercise price, grant price or purchase price relating to any Award (or, if deemed appropriate, the Committee may make provision for a cash payment with respect to any outstanding Award), to preclude, to the extent practicable, the enlargement or dilution of rights and benefits under the Plan and such outstanding Awards; provided, however, that any fractional shares resulting from such adjustment shall be eliminated. In addition, the Committee is authorized to make adjustments in the terms and conditions of, and the criteria included in, Awards (including, without limitation, cancellation of unexercised or outstanding Awards, or substitution of Awards using stock of a successor or other entity) in recognition of unusual or nonrecurring events (including, without limitation, events described in the preceding sentence) affecting the Company, its Parent or any Subsidiary or the financial statements of the Company, its Parent or any Subsidiary, or in response to changes in applicable laws, regulations, or accounting principles.

Any adjustments to outstanding Awards shall be consistent with Section 409A or 424 of the Code, to the extent applicable. Any adjustments determined by the Committee shall be final, binding and conclusive.

5. Eligibility. Directors, officers and employees of the Company or its Parent or any Subsidiary, and persons who provide consulting or other services to the Company, its Parent or any Subsidiary deemed by the Committee to be of substantial value to the Company or its Parent and Subsidiaries, are eligible to be granted Awards under the Plan. In addition, persons who have been offered employment by, or agreed to become a director of, the Company, its Parent or any Subsidiary, and persons employed by an entity that the Committee reasonably expects to become a Subsidiary of the Company, are eligible to be granted an Award under the Plan.

6. Specific Terms of Awards.

(a) General. Awards may be granted on the terms and conditions set forth in this Section 6. In addition, the Committee may impose on any Award or the exercise thereof such additional terms and conditions, not inconsistent with the provisions of the Plan, as the Committee shall determine, including terms requiring forfeiture of Awards in the event of termination of employment or service of the Participant. Except as expressly provided by the Committee (including for purposes of complying with the requirements of the Delaware General Corporation Law relating to lawful consideration for the issuance of shares), no consideration other than services will be required as consideration for the grant (but not the exercise) of any Award.

(b) Options. The Committee is authorized to grant options to purchase Stock on the following terms and conditions (Options):

(i) Exercise Price. The exercise price per share of Stock purchasable under an Option shall be determined by the Committee; provided, however, such exercise price may not be less than one hundred percent (100%) of the Fair Market Value of such Stock on the date of grant of such Option.

(ii) Time and Method of Exercise. The Committee shall determine the time or times at which an Option may be exercised in whole or in part, the methods by which such exercise price may be paid or deemed to be paid, the form of such payment, including, without limitation, cash, Stock, other Awards or awards granted under other Company plans or other property (including notes or other contractual obligations of Participants to make payment on a deferred basis, such as through cashless exercise arrangements, to the extent permitted by applicable law), and the methods by which Stock will be delivered or deemed to be delivered to Participants.

(iii) Termination of Employment. The Committee shall determine the period, if any, during which Options shall be exercisable following a Participant s termination of his employment relationship with the Company, its Parent or any Subsidiary. For this purpose, unless otherwise determined by the Committee, any sale of a Subsidiary of the Company pursuant to which it ceases to be a Subsidiary of the Company shall be deemed to be a termination of employment by any Participant employed by such Subsidiary. Unless otherwise determined by the Committee, (x) during any period that an Option is exercisable following termination of employment, it shall be exercisable only to the extent it was exercisable upon such termination of employment, and (y) if such termination of employment is for cause, as determined in the discretion of the Committee, all Options held by the Participant shall immediately terminate.

(iv) Sale of the Company. Upon the consummation of any transaction whereby the Company (or any successor to the Company or substantially all of its business) becomes a wholly-owned Subsidiary of any corporation, all Options outstanding under the Plan shall terminate, unless such other corporation shall continue or assume the Plan as it relates to Options then outstanding (in which case such other corporation shall be treated as the Company for all purposes hereunder, and, pursuant to Section 4(c), the Committee of such other corporation shall make appropriate adjustment in the number and kind of shares of Stock subject thereto and the exercise price per share thereof to reflect consummation of such transaction). If the Plan is not to be so assumed, the Company shall notify the Participant of consummation of such transaction at least ten days in advance thereof.

(v) Options Providing Favorable Tax Treatment. The Committee may grant Options that may afford a Participant with favorable treatment under the tax laws applicable to such Participant, including, but not limited to ISOs. If Stock acquired by exercise of an ISO is sold or otherwise disposed of within two years after the date of grant of the ISO or within one year after the transfer of such Stock to the Participant, the holder of the Stock immediately prior to the disposition shall promptly notify the Company in writing of the date and terms of the disposition and shall provide such other information regarding the disposition as the Company may reasonably require in order to secure any deduction then available against the Company s or any other corporation s taxable income. The Company may impose such procedures as it determines may be necessary to ensure that such notification is made. Each Option granted as an ISO shall be designated as such in the Award Agreement relating to such Option.

(c) Stock Appreciation Rights. The Committee is authorized to grant stock appreciation rights on the following terms and conditions (SARs):

(i) Right to Payment. An SAR shall confer on the Participant to whom it is granted a right to receive, upon exercise thereof, the excess of (A) the Fair Market Value of one share of Stock on the date of exercise (or, if the Committee shall so determine in the case of any such right other than one related to an ISO, the Fair Market Value of one share at any time during a specified period before or after the date of exercise), over (B) the grant price of the SAR as determined by the Committee as of the date of grant of the SAR, which, except as provided in Section 7(a), shall be not less than the Fair Market Value of one share of Stock on the date of grant.

(ii) Other Terms. The Committee shall determine the time or times at which a SAR may be exercised in whole or in part, the method of exercise, method of settlement, form of consideration payable in settlement, method by which Stock will be delivered or deemed to be delivered to Participants, whether or not a SAR shall be in tandem with any other Award, and any other terms and conditions of any SAR. Limited SARs that may only be exercised upon the occurrence of a change in control of the Company may be granted on such terms, not inconsistent with this Section 6(c), as the Committee may determine. Limited SARs may be either freestanding or in tandem with other Awards.

(d) Restricted Stock. The Committee is authorized to grant Stock that is subject to restrictions based on continued employment on the following terms and conditions (Restricted Stock):

(i) Grant and Restrictions. Restricted Stock shall be subject to such restrictions on transferability and other restrictions, if any, as the Committee may impose, which restrictions may lapse separately or in combination at such times, under such circumstances, in such installments, or otherwise, as the Committee may determine. Except to the extent restricted under the terms of the Plan and any Award Agreement relating to the Restricted Stock, a Participant granted Restricted Stock shall have all of the rights of a stockholder including, without limitation, the right to vote Restricted Stock or the right to receive dividends thereon.

(ii) Forfeiture. Except as otherwise determined by the Committee, upon termination of employment or service (as determined under criteria established by the Committee) during the applicable restriction period, Restricted Stock that is at that time subject to restrictions shall be forfeited and reacquired by the Company; provided, however, that the Committee may provide, by rule or regulation or in any Award Agreement, or may determine in any individual case, that restrictions or forfeiture conditions relating to Restricted Stock will be waived in whole or in part in the event of termination resulting from specified causes.

(iii) Certificates for Stock. Restricted Stock granted under the Plan may be evidenced in such manner as the Committee shall determine. If certificates representing Restricted Stock are registered in the name of the Participant, such certificates may bear an appropriate legend referring to the terms, conditions, and restrictions applicable to such Restricted Stock, the Company may retain physical possession of the certificate, in which case the Participant shall be required to have delivered a stock power to the Company, endorsed in blank, relating to the Restricted Stock.

(iv) Dividends. Dividends paid on Restricted Stock shall be either paid at the dividend payment date in cash or in shares of unrestricted Stock having a Fair Market Value equal to the amount of such dividends, or the payment of such dividends shall be deferred and/or the amount or value thereof automatically reinvested in additional Restricted Stock, other Awards, or other investment vehicles, as the Committee shall determine or permit the Participant to elect. Stock distributed in connection with a Stock split or Stock dividend, and other property distributed as a dividend, shall be subject to restrictions and a risk of forfeiture to the same extent as the Restricted Stock with respect to which such Stock or other property has been distributed, unless otherwise determined by the Committee.

(e) Deferred Stock. The Committee is authorized to grant units representing the right to receive Stock at a future date subject to the following terms and conditions (Deferred Stock):

(i) Award and Restrictions. Delivery of Stock will occur upon expiration of the deferral period specified for an Award of Deferred Stock by the Committee (or, if permitted by the Committee, as elected by the Participant). In addition, Deferred Stock shall be subject to such restrictions as the Committee may impose, if any, which restrictions may lapse at the expiration of the deferral period or at earlier specified times, separately or in combination, in installments or otherwise, as the Committee may determine.

(ii) Forfeiture. Except as otherwise determined by the Committee, upon termination of employment or service (as determined under criteria established by the Committee) during the applicable deferral period or portion thereof to which forfeiture conditions apply (as provided in the Award Agreement evidencing the Deferred Stock), all Deferred Stock that is at that time subject to such forfeiture conditions shall be forfeited; provided, however, that the Committee may provide, by rule or regulation or in any Award Agreement, or may determine in any individual case, that restrictions or forfeiture conditions relating to Deferred Stock will be waived in whole or in part in the event of termination resulting from specified causes.

(f) Bonus Stock and Awards in Lieu of Cash Obligations. The Committee is authorized to grant Stock as a bonus, or to grant Stock or other Awards in lieu of Company obligations to pay cash under other plans or compensatory arrangements.

(g) Dividend Equivalents. The Committee is authorized to grant awards entitling the Participant to receive cash, Stock, other Awards or other property equal in value to dividends paid with respect to a specified number of shares of Stock (Dividend Equivalents). Dividend Equivalents may be awarded on a free-standing basis or in connection with another Award. The Committee may provide that Dividend Equivalents shall be paid or distributed when accrued or shall be deemed to have been reinvested in additional Stock, Awards or other investment vehicles, and subject to such restrictions on transferability and risks of forfeiture, as the Committee may specify.

(h) Other Stock-Based Awards. The Committee is authorized, subject to limitations under applicable law, to grant such other Awards that may be denominated or payable in, valued in whole or in part by reference to, or otherwise based on, or related to, Stock and factors that may influence the value of Stock, as deemed by the Committee to be consistent with the purposes of the Plan, including, without limitation, convertible or exchangeable debt securities, other rights convertible or exchangeable into Stock, purchase rights for Stock, Awards with value and payment contingent upon performance of the Company or any other factors designated by the Committee and Awards valued by reference to the book value of Stock or the value of securities of or the performance of specified Subsidiaries (Other Stock-Based Awards). The Committee shall determine the terms and conditions of such Awards. Stock issued pursuant to an Award in the nature of a purchase right granted under this Section 6(h) shall be purchased for such consideration, paid for at such times, by such methods, and in such forms, including, without limitation, cash, Stock, other Awards, or other property, as the Committee shall determine. Cash awards, as an element of or supplement to any other Award under the Plan, may be granted pursuant to this Section 6(h).

7. Certain Provisions Applicable to Awards.

(a) Stand-Alone, Additional, Tandem, and Substitute Awards. Awards granted under the Plan may, in the discretion of the Committee, be granted either alone or in addition to, in tandem with or in substitution for any other Award granted under the Plan or any award granted under any other plan of the Company, its Parent or Subsidiaries or any business entity to be acquired by the Company or a Subsidiary, or any other right of a Participant to receive payment from the Company its Parent or Subsidiaries. Awards granted in addition to or in tandem with other Awards or awards may be granted either as of the same time as or a different time from the grant of such other Awards or awards.

(b) Term of Awards. The term of each Award shall be for such period as may be determined by the Committee; provided, however, that in no event shall the term of any ISO or an SAR granted in tandem therewith exceed a period of ten years from the date of its grant (or such shorter period as may be applicable under Section 422 of the Code).

(c) Form of Payment Under Awards. Subject to the terms of the Plan and any applicable Award Agreement, payments to be made by the Company, its Parent or Subsidiaries upon the grant, exercise or settlement of an Award may be made in such forms as the Committee shall determine, including, without limitation, cash, Stock, other Awards or other property, and may be made in a single payment or transfer, in installments or on a deferred basis. Such payments may include, without limitation, provisions for the payment or crediting of reasonable interest on installment or deferred payments or the grant or crediting of Dividend Equivalents in respect of installment or deferred payments denominated in Stock.

(d) Rule 16b-3 Compliance.

(i) Six-Month Holding Period. Unless a Participant could otherwise dispose of equity securities, including derivative securities, acquired under the Plan without incurring liability under Section 16(b) of the Exchange Act, equity securities acquired under the Plan must be held for a period of six months following the date of such acquisition, provided that this condition shall be satisfied with respect to a derivative security if at least six months elapse from the date of acquisition of the derivative security to the date of disposition of the derivative security (other than upon exercise or conversion) or its underlying equity security.

(ii) Other Compliance Provisions. With respect to a Participant who is then subject to Section 16 of the Exchange Act in respect of the Company, the Committee shall implement transactions under the Plan and administer the Plan in a manner that will ensure that each transaction by such a Participant is exempt from liability under Rule 16b-3, except that such a Participant may be permitted to engage in a non-exempt transaction under the Plan if written notice has been given to the Participant regarding the non-exempt nature of such transaction. The Committee may authorize the Company to repurchase any Award or shares of Stock resulting from any Award in order to prevent a Participant who is subject to Section 16 of the Exchange Act from incurring liability under Section 16(b). Unless otherwise specified by the Participant, equity securities, including derivative securities, acquired under the Plan which are disposed of by a Participant shall be deemed to be disposed of in the order acquired by the Participant.

(e) Loan Provisions. With the consent of the Committee, and subject at all times to, and only to the extent, if any, permitted under and in accordance with, laws and regulations and other binding obligations or provisions applicable to the Company, the Company may make, guarantee or arrange for a loan or loans to a Participant with respect to the exercise of any Option or other payment in connection with any Award, including the payment by a Participant of any or all federal, state or local income or other taxes due in connection with any Award. Subject to such limitations, the Committee shall have full authority to decide whether to make a loan or loans hereunder and to determine the amount, terms and provisions of any such loan or loans, including the interest rate to be charged in respect of any such loan or loans, whether the loan or loans are to be with or without recourse against the borrower, the terms on which the loan is to be repaid and conditions, if any, under which the loan or loans may be forgiven.

(f) Performance-Based Awards. The Committee may, in its discretion, designate any Award the exercisability or settlement of which is subject to the achievement of performance conditions as a performance-based Award subject to this Section 7(f), in order to qualify such Award as qualified performance-based compensation within the meaning of Code Section 162(m) and regulations thereunder. The performance objectives for an Award subject to this Section 7(f) shall consist of one or more business criteria and a targeted level or levels of performance with respect to such criteria, as specified by the Committee but subject to this Section 7(f). Performance objectives shall be objective and shall otherwise meet the requirements of Section 162(m)(4)(C) of the Code. Business criteria used by the Committee in establishing performance objectives for Awards subject to this Section 7(f) shall be selected from among the following:

(1) Annual return on capital;

(2) Annual earnings or earnings per share;

(3) Annual cash flow provided by operations;

(4) Increase in stock price;

(5) Changes in annual revenues; and/or

(6) Strategic business criteria, consisting of one or more objectives based on meeting specified revenue, market penetration, geographic business expansion goals, cost targets, and goals relating to acquisitions or divestitures.

The levels of performance required with respect to such business criteria may be expressed in absolute or relative levels. Performance objectives may differ for such Awards to different Participants. The Committee shall specify the weighting to be given to each performance objective for purposes of determining the final amount payable with respect to any such Award. The Committee may, in its discretion, reduce the amount of a payout otherwise to be made in connection with an Award subject to this Section 7(f), but may not exercise discretion to increase such amount, and the Committee may consider other performance criteria in exercising such discretion. All determinations by the Committee as to the achievement of performance objectives shall be in writing. The Committee may not delegate any responsibility with respect to an Award subject to this Section 7(f).

Vesting for Full-Value Awards. Other provisions of the Plan notwithstanding, (i) no Full-Value Award issued under the Plan that is performance-based shall fully vest within one (1) year from the date of grant of such Full-Value Award, (ii) no Full-Value Award issued under the Plan that is service-based shall fully vest within three (3) years from the date of grant of such Full-Value Award, and (iii) the Committee may not waive such vesting periods except in the case of death, disability, retirement, change in control or termination without cause (the occurrence of any such event shall be determined by the Committee or the Board, as applicable); provided, however, the Committee or the Board may issue Full-Value Awards that are not subject to the restrictions set forth in this Section 7(g)(i) (iii) so long as the aggregate number of such Full-Value Awards does not exceed the limit for such Awards as set forth in Section 4(a) of the Plan.

8. General Provisions.

(a) Compliance With Laws and Obligations. The Company shall not be obligated to issue or deliver Stock in connection with any Award or take any other action under the Plan in a transaction subject to the requirements of any applicable securities law, any requirement under any listing agreement between the Company and any national securities exchange or automated quotation system or any other law, regulation or contractual obligation of the Company until the Company is satisfied that such laws, regulations, and other obligations of the Company have been complied with in full. Certificates representing shares of Stock issued under the Plan will be subject to such stop-transfer orders and other restrictions as may be applicable under such laws, regulations and other obligations of the Company, including any requirement that a legend or legends be placed thereon. In addition, the Company may adopt policies that impose restrictions on the timing of exercise of Options, SARs or other Awards (e.g., to enforce compliance with Company-imposed black-out periods).

(b) Limitations on Transferability. Awards and other rights under the Plan will not be transferable by a Participant except by will or the laws of descent and distribution or to a Beneficiary in the event of the Participant s death, shall not be pledged, mortgaged, hypothecated or otherwise encumbered, or otherwise subject to the claims of creditors, and, in the case of ISOs and SARs in tandem therewith, shall be exercisable during the lifetime of a Participant only by such Participant or his guardian or legal representative; provided, however, that such Awards and other rights (other than ISOs and SARs in tandem therewith) may be transferred to one or more transferees during the lifetime of the Participant to the extent and on such terms as then may be permitted by the Committee.

(c) No Right to Continued Employment or Service. Neither the Plan nor any action taken hereunder shall be construed as giving any employee, director or other person the right to be retained in the employ or service of the Company, its Parent or any Subsidiary, nor shall it interfere in any way with the right of the Company, its Parent or any Subsidiary to terminate any employee s employment or other person s service at any time or with the right of the Board or stockholders to remove any director.

(d) Taxes. The Company, its Parent and Subsidiaries are authorized to withhold from any Award granted or to be settled, any delivery of Stock in connection with an Award, any other payment relating to an Award or any payroll or other payment to a Participant amounts of withholding and other taxes due or potentially payable in connection with any transaction involving an Award, and to take such other action as the Committee may deem advisable to enable the Company, its Parent and Subsidiaries and Participants to satisfy obligations for the payment of withholding taxes and other tax obligations relating to any Award. This authority shall include authority to withhold or receive Stock or other property and to make cash payments in respect thereof in satisfaction of a Participant s tax obligations.

(e) Changes to the Plan and Awards.

(i) The Board may amend, alter, suspend, discontinue or terminate the Plan or the Committee s authority to grant Awards under the Plan without the consent of stockholders or Participants, except that any such action shall be subject to the approval of the Company s stockholders at or before the next annual meeting of stockholders for which the record date is after such Board action if such stockholder approval is required by any federal or state law or regulation or the rules of any stock exchange or automated quotation system on which the Stock may then be listed or quoted, and the Board may otherwise, in its discretion, determine to submit other such changes to the Plan to stockholders for approval; provided, however, that, without the consent of an affected Participant, no such action may materially impair the rights of such Participant under any Award theretofore granted to him (as such rights are set forth in the Plan and the Award Agreement). The Committee may waive any conditions or rights under, or amend, alter, suspend, discontinue, or terminate, any Award theretofore granted and any Award Agreement relating thereto; provided, however, that, (subject to Section 4(c)) without the consent of an affected Participant, no such action may materially impair the rights of such Participant under such Award (as such rights are set forth in the Plan and the Award Agreement). Notwithstanding the foregoing, the Board or the Committee may take any action (including actions affecting or terminating outstanding Awards) to the extent necessary for a business combination in which the Company is a party to be accounted for under the pooling-of-interests method of accounting under Accounting Principles Board Opinion No. 16 (or any successor thereto). The Board or the Committee shall also have the authority to establish separate sub-plans under the Plan with respect to Participants resident in a particular jurisdiction (the terms of which shall not be inconsistent with those of the Plan) if necessary or desirable to comply with the applicable laws of such jurisdiction.

(ii) Other provisions of the Plan notwithstanding, as to any Award granted as an Option to purchase shares of Stock or an appreciation right payable in Shares, the Committee is not authorized to subsequently reduce the applicable exercise price relating to such Award, or take such other action as may be considered a repricing of such Award under generally accepted accounting principles, without the prior approval of the Company s stockholders.

(f) No Rights to Awards; No Stockholder Rights. No person shall have any claim to be granted any Award under the Plan, and there is no obligation for uniformity of treatment of Participants and employees. No Award shall confer on any Participant any of the rights of a stockholder of the Company unless and until Stock is duly issued or transferred and delivered to the Participant in accordance with the terms of the Award or, in the case of an Option, the Option is duly exercised.

(g) Unfunded Status of Awards; Creation of Trusts. The Plan is intended to constitute an unfunded plan for incentive and deferred compensation. With respect to any payments not yet made to a Participant pursuant to an Award, nothing contained in the Plan or any Award shall give any such Participant any rights that are greater than those of a general creditor of the Company; provided, however, that the Committee may authorize the creation of trusts or make other arrangements to meet the Company s obligations under the Plan to deliver cash, Stock, other Awards, or other property pursuant to any Award, which trusts or other arrangements shall be consistent with the unfunded status of the Plan unless the Committee otherwise determines with the consent of each affected Participant.

(h) Nonexclusivity of the Plan. Neither the adoption of the Plan by the Board nor any submission of the Plan or amendments thereto to the stockholders of the Company for approval shall be construed as creating any limitations on the power of the Board to adopt such other compensatory arrangements as it may deem desirable, including, without limitation, the granting of stock options otherwise than under the Plan, and such arrangements may be either applicable generally or only in specific cases.

(i) No Fractional Shares. No fractional shares of Stock shall be issued or delivered pursuant to the Plan or any Award. The Committee shall determine whether cash, other Awards, or other property shall be issued or paid in lieu of such fractional shares or whether such fractional shares or any rights thereto shall be forfeited or otherwise eliminated.

(j) Governing Law. The validity, construction and effect of the Plan, any rules and regulations relating to the Plan and any Award Agreement shall be determined in accordance with the laws of the State of Delaware, without giving effect to principles of conflicts of laws, and applicable federal law.

(k) Effective Date; Plan Termination. The Plan shall become effective as of the date of its adoption by the Board, and shall continue in effect until terminated by the Board; provided, however, that if approval of such adoption by the Company s shareholders is not obtained within 12 months of the date of such adoption, the Plan shall terminate ab initio, and any Awards then outstanding shall be canceled.

APPENDIX B

2000 INCENTIVE BONUS COMPENSATION PLAN

1. Purpose. The purpose of this 2000 Incentive Bonus Compensation Plan (the Plan) of Lifetime Brands, Inc. (the Company) is (i) to retain and motivate key senior executives of the Company who have been designated as Participants in the Plan for a given Performance Period, by providing them with the opportunity to earn bonus awards that are based on the extent to which specified performance goals for such Performance Period have been achieved or exceeded; and (ii) to structure such bonus opportunities in a way that will qualify the awards made as performance-based for purposes of Section 162(m) of the Internal Revenue Code of 1986, as amended (or any successor section) so that the Company will be entitled to a tax deduction on the payment of such incentive awards to such employees.

2. Definitions. As used in the Plan, the following terms shall the meanings set forth below:

(a) Annual Base Salary shall mean the amount of base salary paid to a Participant for a given year, adjusted to include the amount of any base salary deferrals for such year, unless the Plan Committee otherwise specifies at the time that the Participant s award opportunity for a given Performance Period is established.

(b) Applicable Period shall mean, with respect to any Performance Period, a period commencing on or before the first day of such Performance Period and ending no later than the earlier of (i) the 90th day of such Performance Period, or (ii) the date on which 25% of such Performance Period has been completed. Any action required under the Plan to be taken with the period specified in the preceding sentence may be taken at a later date if, but only if, the regulations under Section 162(m) of the Code are hereafter amended, or interpreted by the Internal Revenue Service, to permit such later date, in which case the term Applicable Period shall be deemed amended accordingly.

(c) Board shall mean the Board of Directors of the Company as constituted from time to time.

(d) Cause shall mean cause as defined in any employment agreement then in effect between the Participant and the Company or if not defined therein or, if there shall be no such agreement, where the Participant: (i) commits any act of fraud, willful misconduct or dishonesty in connection with his employment or which injures the Company or its direct or indirect subsidiaries; (ii) breaches any other material provision of any agreement between the Participant and the Company or a subsidiary of the Company relating to the Participant s employment or breaches any fiduciary duty to the Company or its direct or indirect subsidiaries; (iii) fails, refuses or neglects to timely perform any material duty or obligation relating to his position; (iv) commits a material violation of any law, rule, regulation or by-law of any governmental authority (state, federal or foreign), any securities exchange or association or other regulatory or self-regulatory body or agency applicable to the Company or its direct or indirect subsidiaries or any general policy or directive of the Company or its direct or indirect subsidiaries communicated in writing to the Participant; or (v) is charged with a crime involving moral turpitude, dishonesty, fraud or unethical business conduct, or a felony.

(e) Change of Control shall mean:

(i) the date of the acquisition by any person (within the meaning of Section 13(d)(3) or 14(d)(2) of the Exchange Act), excluding the Company or any of its subsidiaries or affiliates or any employee benefit plan sponsored by any of the foregoing, of beneficial ownership (within the meaning of Rule 13d-3 under the Exchange Act) of 20% or more of either (x) the then outstanding shares of common stock of the Company or (y) the then outstanding voting securities entitled to vote generally in the election of directors; or

(ii) the date the individuals who constitute the Board as of the effective date of the Plan (the Incumbent Board) cease for any reason to constitute at least a majority of the members of the Board, provided that any individual becoming a director subsequent to the effective date of this Agreement whose election, or nomination for election by the Company s stockholders, was approved by a vote of at least a majority of the directors then comprising the Incumbent Board (other than any individual whose nomination for election to Board membership was not endorsed by the Company s management prior to, or at the time of, such individual s initial nomination for election) shall be, for purposes of this Agreement, considered as though such person were a member of the Incumbent Board; or

(iii) the consummation of a merger, consolidation, recapitalization, reorganization, sale or disposition of all or a substantial portion of the Company s assets, a reverse stock split of outstanding voting securities, the issuance of shares of stock of the Company in connection with the acquisition of the stock or assets of another entity, provided, however, that a Change of Control shall not occur under this clause (iii) if consummation of the transaction would result in at least 80% of the total voting power represented by the voting securities of the Company (or, if not the Company, the entity that succeeds to all or substantially all of the Company s business) outstanding immediately after such transaction being beneficially owned (within the meaning of Rule 13d-3 promulgated pursuant to the Exchange Act) by at least 75% of the holders of outstanding voting securities of the Company immediately prior to the transaction, with the voting power of each such continuing holder relative to other such continuing holders not substantially altered in the transaction.

(f) Code shall mean the Internal Revenue Code of 1986, as amended from time to time.

(g) Committee or Plan Committee shall mean the committee for the board consisting solely of two or more non-employee directors (each of whom is intended to qualify as an outside director within the meaning of Section 162(m) of the Code) designated by the Board as the committee responsible for administering and interpreting the Plan.

(h) Company shall mean Lifetime Brands, Inc., a corporation organized under the laws of the State of Delaware, and any successor thereto.

(i) Disability shall mean disability as defined in any employment agreement then in effect between the Participant and the Company or if not defined therein or if there shall be no such agreement, as defined in the Company s long-term disability plan as in effect from time to time, or if there shall be no plan or if not defined therein, the Participant s becoming physically or mentally incapacitated and consequent inability for a period of 120 days in any twelve consecutive month period to perform his duties to the Company.

(j) Exchange Act means the Securities Exchange Act of 1934, as amended.

(k) Executive Officer shall have the meaning set forth in Rule 3b-7 promulgated under the Securities Exchange Act of 1934, in each case as amended from time to time.

(l) Individual Award Opportunity shall mean the performance-based award opportunity for a given Participant for a given Performance Period as specified by the Plan Committee within the Applicable Period, which may be expressed in dollars or on a formula basis that is consistent with the provisions of the Plan.

(m) Negative Discretion shall mean the discretion authorized by the Plan to be applied by the Committee to eliminate, or reduce the size of, a bonus award otherwise payable to a Participant for a given Performance Period, provided that the exercise of such discretion would not cause the award to fail to qualify as performance-based compensation under Section 162(m) of the Code. By way of example and not by way of limitation, in no event shall any discretionary authority granted to the Committee by the Plan including, but not limited to, Negative Discretion, be used (i) to provide for an award under the Plan in excess of the amount payable based on actual performance versus the applicable performance goals for the Performance Period in question, or in excess of the maximum individual award limit specified in Section 6(b) below, or (ii) to increase the amount otherwise payable to any other Participant.

(n) Participant shall mean, for any given Performance Period with respect to which the Plan is in effect, each key employee of the Company (including any subsidiary, operating unit or division) who is an Executive Officer of the Company and who is designated as a Participant in the Plan for such Performance Period by the Committee pursuant to Section 4 below.

(o) Performance Period shall mean any period commencing on or after January 1, 2000 for which performance goals are set under Section 5 and during which performance shall be measured to determine whether such goals have been met for purposes of determining whether a Participant is entitled to payment of a bonus under the Plan. A Performance Period may be coincident with one or more fiscal years of the Company, or a portion thereof.

(p) Plan or Section 162(m) Plan shall mean the Lifetime Brands, Inc. Section 162(m) Bonus Plan as set forth in this document, and as amended from time to time.

(q) Retirement shall mean any termination of employment with the Company and its subsidiaries (other than a termination by the Company (or any of its subsidiaries) for Cause) that (i) qualifies as a retirement event under the terms of any tax-qualified retirement plan maintained by the Company in which the Participant participates, and (ii) is approved in writing as a Retirement event for purposes of this Plan by (or pursuant to procedures established by) the Plan Committee.

3. Administration.

(a) General. The Plan shall be administered by the Committee. Subject to the terms of the Plan and applicable law (including, but not limited to, Section 162(m) of the Code), and in addition to any other express powers and authorizations conferred on the Committee by the Plan, the Committee shall have the full power and authority, after taking into account, in its sole and absolute discretion, the recommendations of the Company s senior management:

(i) to designate (within the Applicable Period) the Participants in the Plan and the individual award opportunities and/or, if applicable, bonus pool award opportunities for such Performance Period;

(ii) to designate (within the Applicable Period) and thereafter administer the performance goals and other award terms and conditions that are to apply under the Plan for such Performance Period;

(iii) to determine and certify the bonus amounts earned for any given Performance Period, based on actual performance versus the performance goals for such Performance Period, after making any permitted Negative Discretion adjustments;

(iv) to decide (within the Applicable Period) any issues that are not resolved under the express terms of the Plan relating to the impact on the bonus awards for such Performance Period of (A) a termination of employment (due to death, Disability, Retirement, voluntary termination (other than Retirement), termination by the Company other than for Cause, or termination by the Company for Cause), provided, in each case, that no payment shall be made for any given Performance Period prior to the time that the Plan Committee certifies, pursuant to Section 6(c)(i) below, that the applicable performance goals for such Performance Period have been met or (B) a Change of Control;

(v) to decide whether, under what circumstances and subject to what terms bonus payouts are to be paid on a deferred basis, including automatic deferrals at the Committee s election as well as elective deferrals at the election of Participants;

(vi) to adopt, revise, suspend, waive or repeal, when and as appropriate, in its sole and absolute discretion, such administrative rules, guidelines and procedures for the Plan as it deems necessary or advisable to implement the terms and conditions of the Plan;

(vii) to interpret and administer the terms and provisions of the Plan and any award issued under the Plan (including reconciling any inconsistencies, correcting any defaults and addressing any omissions in the Plan or any related instrument or agreement); and

(viii) to otherwise supervise the administration of the Plan.

It is intended that all amounts payable to Participants under the Plan who are covered employees within the meaning of Treas. Reg. Sec. 1.162-27(c)(2) (as amended from time to time) shall constitute qualified performance-based compensation within the meaning of Section 162(m) of the Code and Treas. Reg. Sec. 1.162-27(e) (as amended from time to time), and, to the maximum extent possible, the Plan and the terms of any awards under the Plan shall be so interpreted and construed.

(b) <u>Binding Nature of Committee Decisions</u>. Unless otherwise expressly provided in the Plan, all designations, determinations, interpretations and other decisions made under or with respect to the Plan or any award under the Plan shall be within the sole and absolute discretion of the Committee, and shall be final, conclusive and binding on all persons, including the Company, any Participant, and any award beneficiary or other person having, or claiming, any rights under the Plan.

(c) <u>Other</u>. No member of the Committee shall be liable for any action or determination (including, but limited to, any decision not to act) made in good faith with respect to the Plan or any award under the Plan. If a Committee member intended to qualify as an outside director under Section 162(m) of the Code does not in fact so qualify, the mere fact of such non-qualification shall not invalidate any award or other action made by the Committee under the Plan which otherwise was validly made under the Plan.

4. Plan Participation.

(a) <u>Participant Designations By Plan Committee</u>. For any given Performance Period, the Plan Committee, in its sole and absolute discretion, shall, within the Applicable Period, designate those key employees of the Company (including its subsidiaries, operating units and divisions) who shall be Participants in the Plan for such Performance Period. Such Participant designations shall be made by the Plan Committee, in its sole and absolute discretion, based primarily on its determination as to which key employees:

(i) are likely to be Executive Officers of the Company as of the last day of the fiscal year for which the Company would be entitled to a Federal tax deduction for payment of the award in respect of such Performance Period;

(ii) are reasonably expected by the Plan Committee to have individual compensation for such fiscal year that may be in excess of $1 million, excluding any compensation that is grandfathered for Section 162(m) purposes or is otherwise excluded for Section 162(m) purposes based on an existing or other performance-based plan other than this Plan; and

(iii) are reasonably expected by the Plan Committee to be covered employees for such fiscal year for Section 162(m) purposes,

and such other consideration as the Committee deems appropriate, in its sole and absolute discretion.

(b) Impact Of Plan Participation. An individual who is a designated Participant in the Section 162(m) Plan for any given Performance Period shall not also participate in the Company s general bonus plans for such Performance Period, if such participation would cause any award hereunder to fail to qualify as performance-based under Section 162(m).

5. Performance Goals.

(a) Setting Of Performance Goals. For a given Performance Period, the Plan Committee shall, within the Applicable Period, set one or more objective performance goals for each Participant and/or each group of Participants and/or each bonus pool (if any). Such goals shall be based exclusively on one or more of the following corporate-wide or subsidiary, division or operating unit financial measures:

(1) pre-tax or after-tax net income,

(2) operating income,

(3) gross revenue,

(4) profit margin,

(5) stock price,

(6) cash flow(s),

(7) strategic business criteria, consisting of one or more objectives based on meeting specified revenue, market penetration, geographic business expansion goals, cost targets, and goals relating to acquisitions or divestitures,

or any combination thereof (in each case before or after such objective income and expense allocations or adjustments as the Committee may specify within the Applicable Period). Each such goal may be expressed on an absolute and/or relative basis, may be based on or otherwise employ comparisons based on current internal targets, the past performance of the Company (including the performance of one or more subsidiaries, divisions and/or operating units) and/or the past or current performance of other companies, and in the case of earnings-based measures, may use or employ comparisons relating to capital (including, but limited to, the cost of capital), shareholders equity and/or shares outstanding, or to assets or net assets. In all cases, the performance goals shall be such that they satisfy any applicable requirements under Treas. Reg. Sec. 1.162-27(e)(2) (as amended from time to time) that the achievement of such goals be substantially uncertain at the time that they are established, and that the award opportunity be defined in such a way that a third party with knowledge of the relevant facts could determine whether and to what extent the performance goal has been met, and, subject to the Plan Committee s right to apply Negative Discretion, the amount of the award payable as a result of such performance.

(b) Impact Of Extraordinary Items Or Changes In Accounting. The measures used in setting performance goals set under the Plan for any given Performance Period shall be determined in accordance with GAAP and a manner consistent with the methods used in the Company s audited financial statements, without regard to (i) extraordinary items as determined by the Company s independent public accountants in accordance with GAAP, (ii) changes in accounting, unless, in each case, the Plan Committee decides otherwise within the Applicable Period or (iii) non-recurring acquisition expenses and restructuring charges.

6. Bonus Pools, Award Opportunities And Awards.

(a) Setting Of Individual Award Opportunities. At the time that annual performance goals are set for Participants for a given Performance Period (within the Applicable Period), the Plan Committee shall also establish each Individual Award Opportunity for such Performance Period, which shall be based on the achievement of stated target performance goals, and may be stated in dollars or on a formula basis (including, but not limited to, a designated share of a bonus pool or a multiple of Annual Base Salary), provided:

(i) that the designated shares of any bonus pool shall not exceed 100% of such pool; and

(ii) that the Plan Committee, in all cases, shall have the sole and absolute discretion, based on such factors as it deems appropriate, to apply Negative Discretion to reduce (but not increase) the actual bonus awards that would otherwise actually be payable to any Participant on the basis of the achievement of the applicable performance goals.

(b) Maximum Individual Bonus Award. Notwithstanding any other provision of this Plan, the maximum bonus payable under the Plan to any one individual in any one calendar year shall be $5 million.

(c) Bonus Payments. Subject to the following, bonus awards determined under the Plan for given Performance Period shall be paid to Participants in cash, as soon as practicable following the end of the Performance Period to which they apply, provided:

(i) that no such payment shall be made unless and until the Plan Committee, based on the Company s audited financial results for such Performance Period (as prepared and reviewed by the Company s independent public accountants), has certified (in the manner prescribed under applicable regulations) the extent to which the applicable performance goals for such Performance Period have been satisfied, and has made its decisions regarding the extent of any Negative Discretion adjustment of awards (to the extent permitted under the Plan);

(ii) that the Plan Committee may specify that a portion of the actual bonus award for any given Performance Period shall be paid on a deferred basis, based on such award payment rules as the Plan Committee may establish and announce for such Performance Period;

(iii) that the Plan Committee may require (if established and announced within the Applicable Period), as a condition of bonus eligibility (and subject to such exceptions as the Committee may specify within the Applicable Period) that Participants for such Performance Period must still be employed as of end of such Performance Period and/or as of the later date that the actual bonus awards for such Performance Period are announced, in order to be eligible for an award for such Performance Period; and

(iv) that, within the Applicable Period and subject to Section 6(c)(i) above, the Committee may adopt such forfeiture, pro-ration or other rules as it deems appropriate, in its sole and absolute discretion, regarding the impact on bonus award rights of a Participant s death, Disability, Retirement, voluntary termination (other than Retirement), termination by the Company other than for Cause, or termination by the Company for Cause.

7. General Provisions.

(a) Plan Amendment Or Termination. The Board may at any time amend or terminate the Plan, provided that (i) without the Participant s written consent, no such amendment or termination shall adversely affect the bonus rights (if any) of any already designated Participant for a given Performance Period once the Participant designations and performance goals for such Performance Period have been announced, (ii) the Board shall be authorized to make any amendments necessary to comply with applicable regulatory requirements (including, without limitation, Section 162(m) of the Code), and (iii) the Board shall submit any Plan amendment to the Company s stockholders for their approval if and to the extent such approval is required under Section 162(m) of the Code.

(b) Applicable Law. All issues arising under the Plan shall be governed by, and construed in accordance with, the laws of the State of Delaware, applied without regard to conflict of law principles.

(c) Tax Withholding. The Company (and its subsidiaries) shall have right to make such provisions and take such action as it may deem necessary or appropriate for the withholding of any and all Federal, state and local taxes that the Company (or any of its subsidiaries) may be required to withhold.

(d) No Employment Right Conferred. Participation in the Plan shall not confer on any Participant the right to remain employed by the Company or any of its subsidiaries, and the Company and its subsidiaries specifically reserve the right to terminate any Participant s employment at any time with or without cause or notice.

(e) Impact of Plan Awards on Other Plans. Plan awards shall not be treated as compensation for purposes of any other compensation or benefit plan, program or arrangement of the Company or any subsidiary, unless and except to the extent that the Board or its Compensation Committee so determines in writing. Neither the adoption of the Plan nor the submission of the Plan to the Company s stockholders for their approval shall be construed as limiting the power of the Board or the Plan Committee to adopt such other incentive arrangements as it may otherwise deem appropriate.

(f) Beneficiary Designations. Each Participant shall designate in a written form filed with the Committee the beneficiary (or beneficiaries) to receive the amounts (if any) payable under the Plan in the event of the Participant s death prior to the bonus payment date for a given Performance Period. Any such beneficiary designation may be changed by the Participant at any time without the consent of the beneficiary (unless otherwise required by law) by filing a new written beneficiary designation with the Committee. A beneficiary designation shall be effective only if the Company is in receipt of the designation prior to the Participant s death. If no effective beneficiary designation is made, the beneficiary of any amounts die shall be the Participant s estate.

(g) Costs & Expenses. All award and administrative costs and expenses of the Plan shall be borne by the Company.

(h) Non-Transferability of Rights. Except as and to the extent required by law, a Participant s rights under the Plan may not be assigned or transferred in whole or in part either directly or by operation of law or otherwise (except, pursuant to Section 7(f) above, in the event of the Participant s death), including, but not limited to, by way of execution, levy, garnishment, attachment, pledge, bankruptcy or in any other manner, and no such right of the Participant shall be subject to any obligation or liability of the Participant other than any obligation or liability owed by the Participant to the Company (or any of its subsidiaries).

8. Effective Date; Prior Plan.

The Plan shall be effective for Performance Periods commencing on and after January 1, 2000 and shall remain effective until terminated by the Board; provided, however, that the continued effectiveness of the Plan shall be subject to the approval of the Company s stockholders at such times and in such manner as may be required pursuant to Section 162(m). The Plan shall replace the Company s 1996 Incentive Bonus Compensation Plan (the 1996 Plan) and no further awards shall be made thereunder.

APPENDIX C

LIFETIME BRANDS, INC.

CHARTER

OF THE

NOMINATING AND GOVERNANCE COMMITTEE

OF THE

BOARD OF DIRECTORS

This Charter governs the operations of the Nominating and Governance Committee (the Committee) of the Board of Directors (the Board) of Lifetime Brands, Inc. (the Company). The Committee shall review and reassess the adequacy of this Charter at least annually and recommend any proposed changes to the Board for approval. This Charter may be amended only by the affirmative vote of the Board.

PURPOSE

The Committee assists the Board by (i) evaluating the qualifications of candidates for Board membership; (ii) developing and recommending to the Board corporate governance principles applicable to the Company; and (iii) performing such other duties as the Board may assign to the Committee.

MEMBERSHIP

The Committee will be composed of all the Company s independent directors, meaning those directors who are independent of the management of the Company and free from any relationship that, in the opinion of the Board, would interfere with the exercise of independent judgment as Committee members. No person may be a member of the Committee if his or her service on the Committee would violate any restriction on service imposed by any rule of the United States Securities and Exchange Commission or any exchange on which shares of the common stock of the Company are traded.

MEETINGS

The Committee will meet at least once each year or as often as it deems necessary to fulfill its responsibilities. The Committee will ask the Chief Executive Officer to attend such meetings and to provide such relevant information as the Committee may request. The Committee will keep written minutes of its meetings, which minutes will be recorded or filed with the books and records of the Company. The Committee may delegate any of its responsibilities to one or more subcommittees, each of which shall be composed of two or more members, as the Committee may deem appropriate.

DUTIES, RESPONSIBILITIES AND PROCESSES

The Committee in carrying out its responsibilities believes its policies and procedures should remain flexible, in order to best react to changing conditions and circumstances. The following shall be the principal duties and responsibilities of the Committee and are set forth as a guide, with the understanding that the Committee may supplement them as appropriate:

NOMINATING DUTIES

The nominating duties and responsibilities of the Committee shall be as follows:

To evaluate the qualifications of candidates for Board membership and, following consultation with the Chief Executive Officer, recommend to the Board nominees for open or newly created director positions;

To consider nominees recommended by stockholders as long as such recommendations are received at least 120 days before the stockholders meet to elect directors;

To periodically review the composition of the Board to determine whether it may be appropriate to add individuals with different backgrounds or skill sets from those already on the Board, and submit to the Board on an annual basis a report summarizing its conclusions regarding these matters;

To provide an orientation and education program for Directors; and

To perform such other duties as the Board may assign to the Committee.

GOVERNANCE DUTIES

The governance duties and responsibilities of the Committee shall be as follows:

- To periodically assess the current structure and operations of the committees of the Board and recommend changes to the Board;

- To develop and recommend to the Board corporate governance guidelines and to review such guidelines at least annually and recommend to the Board changes as necessary;

- To develop and recommend to the Board procedures for the evaluation and self-evaluation of the Board and its committees and to oversee the evaluation process;

- To perform an evaluation of the Committee s performance at least annually to determine whether it is functioning effectively; and

- To periodically review the compensation of the Board and recommend changes to the Board.

This Charter was approved by the Board of Directors on March 6, 2012.

APPENDIX D

LIFETIME BRANDS, INC.

COMPENSATION COMMITTEE CHARTER

This Charter governs the operations of the Compensation Committee (the Committee) of the Board of Directors (the Board) of Lifetime Brands, Inc. (the Company). The Committee shall review and reassess the adequacy of this Charter annually and recommend any proposed changes to the Board for approval. This Charter may be amended only by the affirmative vote of the Board.

Organization

The Committee shall be appointed by the Board and shall comprise at least two directors, each of whom is independent, as defined by the United States Securities and Exchange Commission (the SEC) and The NASDAQ Stock Market, Inc. Members of the Committee may be removed at any time by the Board in its discretion. The Board shall also appoint one member of the Committee as the Committee s Chair.

Meetings

The Committee shall meet as often as it deems necessary to fulfill its responsibilities and shall report to the Board following each meeting. The Committee may delegate any of its responsibilities to one or more subcommittees, each of which shall be composed of two or more members, as the Committee may deem appropriate.

Purpose

The purpose of the Committee shall be to assist the Board in discharging its overall responsibilities relating to executive compensation.

Responsibilities and processes

The Committee in carrying out its responsibilities believes its policies and procedures should remain flexible, in order to best react to changing conditions and circumstances. The following shall be the principal duties and responsibilities of the Committee and are set forth as a guide, with the understanding that the Committee may supplement them as appropriate:

The Committee shall review and approve compensation principles that apply generally to the Company s executive and senior employees.

The Committee shall establish and review corporate goals and objectives relevant to the compensation of the Chief Executive Officer and the Chief Operating Officer of the Company, evaluate their performance in light of the established goals and objectives and approve their annual compensation.

The Committee shall review the corporate goals and objectives established by the Chief Executive Officer (CEO) and the Chief Operating Officer (COO) of the Company relevant to the compensation of the direct reports of the CEO and COO, of the Company and review and, based primarily on the evaluations and recommendations of the CEO and the COO of the Company of the performance of such executive officers in light of the established goals and objectives, approve their annual compensation.

The Committee shall review the evaluation process and compensation structure for the other members of the senior management of the Company and provide oversight regarding management s decisions concerning the performance and compensation of such senior management.

The Committee shall administer and shall oversee the Company s compliance with the requirements under the NASDAQ Marketplace Rules, with respect to the Company s long-term incentive compensation plans.

The Committee shall have the authority to retain and terminate at the Company s expense, an independent compensation-consulting firm(s) to assist the Committee in its evaluation of executive compensation, and any legal and other advisors that it deems necessary for the fulfillment of its responsibilities, including the sole authority to approve fees and other retention terms of such firm(s) and other advisors.

The Committee shall review and discuss the Compensation Discussion and Analysis (the CD&A) required to be included in the Company s proxy statement and annual report on Form 10-K by the rules and regulations of the SEC with management and, based on such review and discussion, determine whether or not to recommend to the Board that the CD&A be so included.

The Committee shall produce the annual Compensation Committee Report for inclusion in the Company s proxy statement in compliance with the rules and regulations promulgated by the SEC.

The Committee shall perform an evaluation of its performance annually to determine whether it is functioning effectively.

The Committee shall make regular reports to the Board.

The Committee shall review and discuss compensation programs that may create incentives that can affect the Company s risk and management of that risk. To the extent it is determined that such risks are reasonably likely to have a material adverse effect on the Company, the Committee will review and discuss with Company management and other relevant personnel how such disclosure will be made in the Company s CD&A.

This Charter was approved by the Board of Directors on March 6, 2012.