

REYNOLDS AMERICAN INC
Form 10-Q
April 23, 2013
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2013

OR

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

For the transition period from to

Commission file number: 1-32258

Reynolds American Inc.

(Exact name of registrant as specified in its charter)

North Carolina
(State or other jurisdiction of

20-0546644
(I.R.S. Employer

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

incorporation or organization)

Identification Number)

401 North Main Street

Winston-Salem, NC 27101

(Address of principal executive offices) (Zip Code)

(336) 741-2000

(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed from last report)

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 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company)

Smaller reporting company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date: 547,102,116 shares of common stock, par value \$.0001 per share, as of April 8, 2013.

Table of Contents

INDEX

	Page
<u>Part I Financial Information</u>	
Item 1. <u>Financial Statements</u>	
<u>Condensed Consolidated Statements of Income (Unaudited) Three Months Ended March 31, 2013 and 2012</u>	3
<u>Condensed Consolidated Statements of Comprehensive Income (Unaudited) Three Months Ended March 31, 2013 and 2012</u>	4
<u>Condensed Consolidated Statements of Cash Flows (Unaudited) Three Months Ended March 31, 2013 and 2012</u>	5
<u>Condensed Consolidated Balance Sheets March 31, 2013 (Unaudited) and December 31, 2012</u>	6
<u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u>	7
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	70
Item 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u>	90
Item 4. <u>Controls and Procedures</u>	91
<u>Part II Other Information</u>	
Item 1. <u>Legal Proceedings</u>	91
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	91
Item 6. <u>Exhibits</u>	92
<u>Signature</u>	93

Table of Contents**Part I Financial Information****Item 1. Financial Statements****REYNOLDS AMERICAN INC.****CONDENSED CONSOLIDATED STATEMENTS OF INCOME****(Dollars in Millions, Except Per Share Amounts)****(Unaudited)**

	For the Three Months Ended March 31, 2013 2012	
Net sales ⁽¹⁾	\$ 1,802	\$ 1,856
Net sales, related party	81	77
Net sales	1,883	1,933
Costs and expenses:		
Cost of products sold ⁽¹⁾	694	994
Selling, general and administrative expenses	301	298
Amortization expense	1	6
Restructuring charge		149
Operating income	887	486
Interest and debt expense	62	56
Interest income	(2)	(2)
Other (income) expense, net	(2)	3
Income before income taxes	829	429
Provision for income taxes	321	159
Net income	\$ 508	\$ 270
Basic income per share:		
Net income	\$ 0.92	\$ 0.47
Diluted income per share:		
Net income	\$ 0.92	\$ 0.47
Dividends declared per share	\$ 0.59	\$ 0.56

⁽¹⁾ Excludes excise taxes of \$855 million and \$923 million for the three months ended March 31, 2013 and 2012, respectively.
See Notes to Condensed Consolidated Financial Statements (Unaudited)

Table of Contents

REYNOLDS AMERICAN INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Dollars in Millions)

(Unaudited)

	For the Three Months Ended March 31,	
	2013	2012
Net income	\$ 508	\$ 270
Other comprehensive income (loss), net of tax:		
Retirement benefits, net of tax (benefit) expense (2013 \$ (3); 2012 \$ 49)	(5)	74
Unrealized gain on long-term investments, net of tax expense (2013 \$ 2; 2012 \$ 1)	2	2
Cumulative translation adjustment and other, net of tax expense (2013 \$ 5; 2012 \$ 2)	(15)	10
Comprehensive income	\$ 490	\$ 356

See Notes to Condensed Consolidated Financial Statements (Unaudited)

Table of Contents**REYNOLDS AMERICAN INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(Dollars in Millions)****(Unaudited)**

	For the Three Months Ended March 31,	
	2013	2012
Cash flows from (used in) operating activities:		
Net income	\$ 508	\$ 270
Adjustments to reconcile to net cash flows from (used in) operating activities:		
Depreciation and amortization	28	32
Restructuring charge, net of cash payments	(4)	133
Deferred income tax expense	90	28
Pension and postretirement	(30)	(16)
Tobacco settlement	268	563
Other, net	85	43
Net cash flows from operating activities	945	1,053
Cash flows from (used in) investing activities:		
Capital expenditures	(23)	(27)
Other, net	3	1
Net cash flows used in investing activities	(20)	(26)
Cash flows from (used in) financing activities:		
Dividends paid on common stock	(326)	(323)
Repurchase of common stock	(325)	(300)
Excess tax benefit on stock-based compensation plans	11	33
Other, net	(3)	(3)
Net cash flows used in financing activities	(643)	(593)
Effect of exchange rate changes on cash and cash equivalents		
	(6)	6
Net change in cash and cash equivalents	276	440
Cash and cash equivalents at beginning of period	2,502	1,956
Cash and cash equivalents at end of period	\$ 2,778	\$ 2,396
Income taxes paid, net of refunds	\$ 16	\$ 44
Interest paid	\$ 10	\$ 10

See Notes to Condensed Consolidated Financial Statements (Unaudited)

Table of Contents**REYNOLDS AMERICAN INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(Dollars in Millions)**

	March 31, 2013 (Unaudited)	December 31, 2012
Assets		
Current assets:		
Cash and cash equivalents	\$ 2,778	\$ 2,502
Accounts receivable	104	87
Accounts receivable, related party	52	61
Notes receivable	35	35
Other receivables	12	16
Inventories	1,046	984
Deferred income taxes, net	826	908
Prepaid expenses and other	176	219
Total current assets	5,029	4,812
Property, plant and equipment, net of accumulated depreciation (2013 \$1,637; 2012 \$1,618)	1,034	1,037
Trademarks and other intangible assets, net of accumulated amortization	2,454	2,455
Goodwill	8,011	8,011
Other assets and deferred charges	250	242
	\$ 16,778	\$ 16,557
Liabilities and shareholders equity		
Current liabilities:		
Accounts payable	\$ 137	\$ 187
Tobacco settlement accruals	2,757	2,489
Due to related party	1	1
Deferred revenue, related party	32	42
Current maturities of long-term debt	60	60
Other current liabilities	1,159	990
Total current liabilities	4,145	3,769
Long-term debt (less current maturities)	5,028	5,035
Deferred income taxes, net	482	461
Long-term retirement benefits (less current portion)	1,798	1,821
Other noncurrent liabilities	207	214
Commitments and contingencies:		
Shareholders equity:		
Common stock (shares issued: 2013 547,102,116; 2012 552,940,767)		
Paid-in capital	6,972	7,275
Accumulated deficit	(1,525)	(1,707)
Accumulated other comprehensive loss (defined benefit pension and postretirement plans: 2013 \$(270); 2012 \$(265), net of tax)	(329)	(311)
Total shareholders equity	5,118	5,257
	\$ 16,778	\$ 16,557

Table of Contents

Notes to Condensed Consolidated Financial Statements (Unaudited)

Note 1 Business and Summary of Significant Accounting Policies

Overview

The condensed consolidated financial statements (unaudited) include the accounts of Reynolds American Inc., referred to as RAI, and its wholly owned subsidiaries. RAI's wholly owned operating subsidiaries include R. J. Reynolds Tobacco Company; American Snuff Company, LLC, referred to as American Snuff Co.; Santa Fe Natural Tobacco Company, Inc., referred to as SFNTC; and Niconovum AB.

RAI was incorporated as a holding company in the state of North Carolina in 2004, and its common stock is listed on the NYSE under the symbol RAI. RAI was created to facilitate the business combination of the U.S. business of Brown & Williamson Holdings, Inc., referred to as B&W, an indirect wholly owned subsidiary of British American Tobacco p.l.c., referred to as BAT, with R. J. Reynolds Tobacco Company on July 30, 2004, with such combination referred to as the B&W business combination.

References to RJR Tobacco prior to July 30, 2004, relate to R. J. Reynolds Tobacco Company, a New Jersey corporation and a wholly owned subsidiary of R.J. Reynolds Tobacco Holdings, Inc., referred to as RJR. References to RJR Tobacco on and subsequent to July 30, 2004, relate to the combined U.S. assets, liabilities and operations of B&W and R. J. Reynolds Tobacco Company, a North Carolina corporation.

RAI's reportable operating segments are RJR Tobacco, American Snuff and Santa Fe. The RJR Tobacco segment consists of the primary operations of R. J. Reynolds Tobacco Company. The American Snuff segment consists of the primary operations of American Snuff Co. The Santa Fe segment consists of the primary operations of SFNTC. Niconovum AB and R.J. Reynolds Vapor Company, referred to as RJR Vapor, among other RAI subsidiaries, are included in All Other. The segments were identified based on how RAI's chief operating decision maker allocates resources and assesses performance. Certain of RAI's operating subsidiaries have entered into intercompany agreements for products or services with other subsidiaries. As a result, certain activities of an operating subsidiary may be included in a different segment of RAI.

RAI's operating subsidiaries primarily conduct their businesses in the United States.

Basis of Presentation

The accompanying interim condensed consolidated financial statements (unaudited) have been prepared in accordance with accounting principles generally accepted in the United States of America, referred to as GAAP, for interim financial information and, in management's opinion, contain all adjustments, consisting only of normal recurring items, necessary for a fair presentation of the results for the periods presented. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. All material intercompany balances have been eliminated. RAI has no investments that are accounted for under the equity or cost methods. For interim reporting purposes, certain costs and expenses are charged to operations in proportion to the estimated total annual amount expected to be incurred primarily based on sales volumes. The results for the interim period ended March 31, 2013, are not necessarily indicative of the results that may be expected for the year ending December 31, 2013.

The condensed consolidated financial statements (unaudited) should be read in conjunction with the consolidated financial statements and related footnotes, which appear in RAI's Annual Report on Form 10-K for the year ended December 31, 2012. Certain reclassifications were made to conform prior years' financial statements to the current presentation. All dollar amounts, other than per share amounts, are presented in millions, except for amounts set forth in note 9 and as otherwise noted.

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)***Cost of Products Sold*

Cost of products sold includes the expenses for the Master Settlement Agreement, referred to as the MSA, and other settlement agreements with the states of Mississippi, Florida, Texas and Minnesota, which together with the MSA are collectively referred to as the State Settlement Agreements; the federal tobacco quota buyout; and the user fees charged by the U.S. Food and Drug Administration, referred to as the FDA, which were as follows:

	For the Three Months Ended March 31,	
	2013	2012
State Settlement Agreements	\$ 268	\$ 557
Federal tobacco quota buyout	52	56
FDA user fees	32	30

On December 17, 2012, RJR Tobacco and certain other participating manufacturers, referred to as the PMs, including SFNTC, entered into a term sheet, referred to as the Term Sheet, with 17 states, the District of Columbia and Puerto Rico to settle certain claims related to the MSA non-participating manufacturer adjustment, referred to as the NPM Adjustment. The Term Sheet resolves claims related to volume years from 2003 through 2012 and puts in place a revised method to determine future adjustments from 2013 forward as to states that join the agreement. The Term Sheet was not binding on the parties at the time it was entered into. On March 12, 2013, a single, nationwide arbitration panel of three former federal judges, referred to as the Arbitration Panel, hearing the dispute related to the 2003 NPM Adjustment (and related matters) issued an order, referred to as the Order, authorizing the implementation of the Term Sheet. In addition, after the Order, one additional state signed the Term Sheet. As a result of the Order, the Term Sheet is now binding on all signatories.

Based on the jurisdictions bound by the Term Sheet, RJR Tobacco and SFNTC, collectively, will receive credits, currently estimated to total approximately \$1 billion, with respect to their NPM Adjustment claims for the period from 2003 through 2012. These credits will be applied against annual payments under the MSA over a five-year period, commencing with the MSA payment due in April 2013. As a result of this binding Order, expenses for the MSA were reduced by approximately \$204 million for the three months ended March 31, 2013, recognizing the credit that reduces the April 2013 MSA payment. In addition, RJR Tobacco and SFNTC will recognize additional credits in 2013 through 2016, subject to meeting the various performance obligations associated with the Term Sheet. The amount of these credits recognized for the three months ended March 31, 2013, was approximately \$57 million. For additional information related to the NPM Adjustment settlement, see

Litigation Affecting the Cigarette Industry Health-Care Cost Recovery Cases State Settlement Agreements Enforcement and Validity; Adjustments in note 9.

Pension and Postretirement

Pension and postretirement benefits require balance sheet recognition of the net asset or liability for the overfunded or underfunded status of defined benefit pension and other postretirement benefit plans, on a plan-by-plan basis, and recognition of changes in the funded status in the year in which the changes occur.

Actuarial gains or losses are annual changes in the amount of either the benefit obligation or the fair value of plan assets resulting from experience different from that assumed or from changes in assumptions. Differences between actual results and actuarial assumptions are accumulated and recognized in the year in which they occur as a mark-to-market adjustment, referred to as an MTM adjustment, to the extent such net gains and losses are in excess of 10% of the greater of the fair value of plan assets or the plan's benefit obligation, referred to as the corridor. Actuarial gains and losses outside the corridor are recognized annually as of December 31 or when the plans are remeasured during an interim period.

Prior service costs of pension expense, which are changes in benefit obligations due to plan amendments, are amortized on a straight-line basis over the average remaining service period for active employees, or average remaining life expectancies for inactive employees if most of the plan obligations are due to inactive employees. Prior service costs of postretirement benefits, which are changes in benefit obligations due to plan amendments, are amortized on a straight-line basis over the expected service period to full eligibility age for active employees, or average

remaining life expectancies for inactive employees if most of the plan obligations are due to inactive employees.

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

The components of the pension benefits and the postretirement benefits are set forth below:

	For the Three Months Ended March 31,			
	Pension Benefits		Postretirement Benefits	
	2013	2012	2013	2012
Service cost	\$ 5	\$ 6	\$ 1	\$ 1
Interest cost	62	69	12	17
Expected return on plan assets	(88)	(89)	(3)	(3)
Amortization of prior service cost (credit)	1	1	(10)	(5)
Curtailment		4		
Special termination benefits		34		
Total benefit cost (credit)	\$ (20)	\$ 25	\$	\$ 10

A workforce reduction in 2012, due to changes in the organizational structure of RJR Tobacco, RAI and RAI Services Company, met RAI's curtailment threshold as a major event for pension plans. As a result, curtailment charges and special termination benefits were recognized as restructuring expense. The workforce reduction did not exceed the minimum threshold for the postretirement plans, and no special postretirement termination benefits were offered. See note 4 for additional information regarding the restructuring.

As disclosed in its financial statements for the year ended December 31, 2012, RAI expects to contribute approximately \$110 million to its pension plans in 2013, of which \$2 million was contributed during the first three months of 2013.

Fair Value Measurement

RAI determines fair value of assets and liabilities, if any, using a fair value hierarchy that distinguishes between market participant assumptions based on market data obtained from sources independent of the reporting entity, and the reporting entity's own assumptions about market participant assumptions based on the best information available in the circumstances.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, essentially an exit price.

The levels of the fair value hierarchy are:

Level 1: inputs are quoted prices, unadjusted, in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

Level 2: inputs are other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. A Level 2 input must be observable for substantially the full term of the asset or liability.

Level 3: inputs are unobservable and reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability.

Recently Issued and Adopted Accounting Pronouncements

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

In February 2013, the Financial Accounting Standards Board issued amended guidance that requires an entity to present information about significant items reclassified out of accumulated other comprehensive income, referred to as AOCI, on the face of the statement where net income is presented or as a separate disclosure in the notes to the

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

financial statements. Additionally, the guidance expands the disclosure requirements for presentation of changes in AOCI by component. The guidance is effective for RAI for interim and annual reporting periods beginning January 1, 2013, and its adoption did not have an impact on RAI's results of operations, cash flows or financial position.

Note 2 Fair Value

Financial assets carried at fair value as of March 31, 2013, were as follows:

	Level 1	Level 2	Level 3	Total
Cash and cash equivalents:				
Cash equivalents	\$ 2,719	\$	\$	\$ 2,719
Other assets and deferred charges:				
Auction rate securities			74	74
Mortgage-backed security			13	13
Marketable equity security	4			4

Financial assets carried at fair value as of December 31, 2012, were as follows:

	Level 1	Level 2	Level 3	Total
Cash and cash equivalents:				
Cash equivalents	\$ 2,100	\$	\$	\$ 2,100
Other assets and deferred charges:				
Auction rate securities			70	70
Mortgage-backed security			13	13
Marketable equity security	4			4

There were no transfers between the levels in the three months ended March 31, 2013, or in the year ended December 31, 2012.

RAI reviews these investments on a quarterly basis to determine if it is probable that RAI will realize some portion of the unrealized loss and to determine the classification of the impairment as temporary or other-than-temporary. For those securities in which RAI does not intend to sell and it is more likely than not that RAI will not be required to sell the securities prior to recovery, RAI recognizes the credit loss component of an other-than-temporary impairment of its debt securities in earnings and the noncredit component in other comprehensive loss.

In determining if the difference between amortized cost and estimated fair value of the auction rate securities or the mortgage-backed security was deemed either temporary or other-than-temporary impairment, RAI evaluated each type of long-term investment using a set of criteria, including decline in value, duration of the decline, period until anticipated recovery, nature of investment, probability of recovery, financial condition and near-term prospects of the issuer, RAI's intent and ability to retain the investment, attributes of the decline in value, status with rating agencies, status of principal and interest payments and any other issues related to the underlying securities. To assess credit losses, RAI uses historical default rates, debt ratings, credit default swap spreads and recovery rates. RAI has the intent and ability to hold these investments for a period of time sufficient to allow for the recovery in market value.

Significantly all of the fair values of the auction rate securities, classified as Level 3, are linked to the longer-term credit risk of a diverse range of corporations, including, but not limited to, manufacturing, financial and insurance sectors. The fair value was determined by utilizing an income approach model, which was based upon the weighted average present value of future cash payments, given the probability of certain events occurring within the market. RAI considers the market for its auction rate securities to be inactive. The income approach model utilized observable inputs, including LIBOR-based interest rate curves, corporate credit spreads and corporate ratings/market valuations. Additionally, unobservable factors incorporated into the model included default probability assumptions based on historical migration tables, various default recovery rates and how these factors changed as ratings on the

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

underlying collateral migrated from one level to another. As related to the unobservable factors, substantial changes, relative to historical trends, of the levels of corporate defaults or default recovery rates would impact the fair value measurement of these securities. Maturity dates for the auction rate securities begin in 2017.

The fair value for the mortgage-backed security, classified as Level 3, utilized a market approach and was based upon the calculation of an overall weighted average valuation, derived from the actual, or modeled, market pricing of the specific collateral. The market approach utilized actual pricing inputs when observable and modeled pricing, based upon changes in observable market pricing, when unobservable. Substantial changes in the observable market pricing would directly impact the unobservable pricing and the fair value measurement of this security. RAI has deemed the market for its mortgage-backed security to be inactive. The maturity of the mortgage-backed security has been extended to March 2014, with the annual option to extend an additional year. Given the underlying collateral and RAI's intent to continue to extend this security, it is classified as a noncurrent asset.

RAI determined the change in the fair value of the investment in a marketable equity security using quoted market prices as of March 31, 2013.

Financial assets classified as Level 3 investments were as follows:

	March 31, 2013			December 31, 2012		
	Cost	Gross Unrealized Loss ⁽¹⁾	Estimated Fair Value	Cost	Gross Unrealized Loss ⁽¹⁾	Estimated Fair Value
Auction rate securities	\$ 99	\$ (25)	\$ 74	\$ 99	\$ (29)	\$ 70
Mortgage-backed security	22	(9)	13	22	(9)	13
	\$ 121	\$ (34)	\$ 87	\$ 121	\$ (38)	\$ 83

⁽¹⁾ Unrealized losses, net of tax, are reported in accumulated other comprehensive loss in RAI's condensed consolidated balance sheets as of March 31, 2013 (unaudited) and December 31, 2012.

The changes in the Level 3 investments during the three months ended March 31, 2013, were as follows:

	Auction Rate Securities		
	Cost	Gross Unrealized Gain (Loss)	Estimated Fair Value
Balance as of January 1, 2013	\$ 99	\$ (29)	\$ 70
Unrealized gain		4	4
Balance as of March 31, 2013	\$ 99	\$ (25)	\$ 74

	Mortgage-Backed Security		
	Cost	Gross Unrealized Loss	Estimated Fair Value

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

Balance as of January 1, 2013	\$ 22	\$ (9)	\$ 13
Balance as of March 31, 2013	\$ 22	\$ (9)	\$ 13

Fair Value of Debt

The estimated fair value of RAI's and RJR's outstanding debt, in the aggregate, was \$5.4 billion and \$5.5 billion with an effective average annual interest rate of approximately 4.7%, as of March 31, 2013, and December 31, 2012, respectively. The fair values are based on available market quotes, credit spreads and discounted cash flows, as appropriate.

Interest Rate Management

From time to time, RAI and RJR use interest rate swaps to manage interest rate risk on a portion of their respective debt obligations. In 2009, RAI and RJR entered into offsetting floating to fixed interest rate swap agreements, which, at March 31, 2013, had effectively decreased the fixed rate on \$1.1 billion of debt to a rate of

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

interest of approximately 4.1%. In September 2011, RAI and RJR terminated the original and offsetting interest rate swap agreements, and received a total of \$186 million cash in exchange for foregoing the future cash inflows associated with these swaps. These actions did not change the effective fixed rate of interest associated with the underlying debt.

In May 2012, RAI entered into forward starting interest rate contracts with an aggregate notional amount of \$1 billion. RAI designated those derivatives as cash flow hedges of a future debt issuance, and they were determined to be highly effective at inception. The forward starting interest rate contracts mitigated RAI's exposure to changes in the benchmark interest rate from the date of inception until the date of the forecasted transaction. On October 31, 2012, RAI completed the sale of \$2.55 billion in aggregate principal amount of senior notes, consisting of \$450 million of 1.05% senior notes due October 30, 2015, \$1.1 billion of 3.25% senior notes due November 1, 2022, and \$1 billion of 4.75% senior notes due November 1, 2042. The forward starting interest rate contracts were terminated, and \$23 million in associated losses were settled with cash payments to the counterparties. The effective portion of the losses are recorded in accumulated other comprehensive loss in RAI's condensed consolidated balance sheet (unaudited) as of March 31, 2013, and consolidated balance sheet as of December 31, 2012, and will be amortized over the life of the related debt.

The amortization of the net gain upon termination of derivative instruments impacted the condensed consolidated statements of income (unaudited) as follows:

	For the Three Months Ended March 31,	
	2013	2012
Interest and debt expense	\$ (6)	\$ (10)

Note 3 Intangible Assets

There was no significant change to the carrying amount of goodwill during the three months ended March 31, 2013.

The carrying amounts and changes therein of trademarks and other intangible assets by segment were as follows:

	RJR Tobacco		American Snuff		Santa Fe		All Other		Consolidated	
	Trademarks	Other	Trademarks	Trademarks	Other	Other	Trademarks	Other	Trademarks	Other
Finite-lived:										
Balance as of December 31, 2012	\$	\$ 24	\$ 9	\$	\$	\$	\$ 9	\$ 24	\$	\$ 24
Amortization		(1)						(1)		
Balance as of March 31, 2013	\$	\$ 23	\$ 9	\$	\$	\$	\$ 9	\$ 23	\$	\$ 23
Indefinite-lived:										
Balance as of December 31, 2012	\$ 1,027	\$ 99	\$ 1,136	\$ 155	\$ 5	\$ 5	\$ 2,318	\$ 104	\$ 2,318	\$ 104
Balance as of March 31, 2013	\$ 1,027	\$ 99	\$ 1,136	\$ 155	\$ 5	\$ 5	\$ 2,318	\$ 104	\$ 2,318	\$ 104

Details of finite-lived intangible assets as of March 31, 2013, were as follows:

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

	Gross	Accumulated Amortization	Net
Contract manufacturing agreements	\$ 151	\$ 128	\$ 23
Trademarks	96	87	9
	\$ 247	\$ 215	\$ 32

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

The estimated remaining amortization associated with finite-lived intangible assets is expected to be expensed as follows:

Year	Amount
Remainder of 2013	\$ 4
2014	5
2015	5
2016	5
2017	4
Thereafter	9
	\$ 32

Note 4 Restructuring

In 2012, RAI announced that it and its subsidiaries, RJR Tobacco and RAI Services Company, had completed a business analysis designed to identify resources to reinvest in their businesses. As a result of this initiative, the total U.S. workforce of RAI and its subsidiaries will decline by a net of approximately 10% upon the completion of the restructuring by the end of 2014.

Under existing severance plans, \$111 million of cash severance, benefits and related costs and \$38 million of non-cash pension-related benefits comprised a restructuring charge of \$149 million during the first quarter of 2012. Of this charge, \$138 million was recorded in the RJR Tobacco segment. Of the cash portion, \$44 million had been paid as of March 31, 2013. Accordingly, in the condensed consolidated balance sheet (unaudited) as of March 31, 2013, \$12 million was included in other current liabilities and \$55 million was included in other noncurrent liabilities.

The component of the restructuring charge accrued and utilized was as follows:

	Employee Severance and Benefits
Original accrual	\$ 149
Utilized in 2012	(78)
Balance as of December 31, 2012	71
Utilized in 2013	(4)
Balance as of March 31, 2013	\$ 67

Note 5 Income Per Share

The components of the calculation of income per share were as follows:

For the Three Months Ended March 31,	
2013	2012

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

Net income	\$ 508	\$ 270
Basic weighted average shares, in thousands	551,353	574,456
Effect of dilutive potential shares:		
Restricted stock units	2,097	3,083
Diluted weighted average shares, in thousands	553,450	577,539

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)****Note 6 Inventories**

The major components of inventories were as follows:

	March 31, 2013	December 31, 2012
Leaf tobacco	\$ 935	\$ 919
Other raw materials	49	51
Work in process	70	63
Finished products	154	125
Other	27	18
Total	1,235	1,176
Less LIFO allowance	189	192
	\$ 1,046	\$ 984

RJR Tobacco performs its annual LIFO inventory valuation at December 31. Interim periods represent an estimate of the expected annual valuation.

Note 7 Income Taxes

The provision for income taxes was as follows:

	For the Three Months Ended March 31,	
	2013	2012
Provision for income taxes	\$ 321	\$ 159
Effective tax rate	38.8%	37.0%

The effective tax rate for the three months ended March 31, 2013, as compared with the same prior-year period, was unfavorably impacted by a reduction in the domestic production activities deduction of the American Jobs Creation Act of 2004. The effective income tax rate for each period exceeded the federal statutory rate of 35% due to the impact of state taxes and certain nondeductible items, offset by the domestic production activities deduction.

Note 8 Borrowing Arrangements*Credit Agreement*

On July 29, 2011, RAI entered into a credit agreement, referred to as the Credit Agreement, with a syndicate of lenders, providing for a four-year \$750 million senior unsecured revolving credit facility, which may be increased to \$1 billion at the discretion of the lenders upon the request of RAI. This agreement replaced RAI's Fifth Amended and Restated Credit Agreement, dated as of June 28, 2007, as amended.

The Credit Agreement contains restrictive covenants that:

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

limit the ability of RAI and its subsidiaries to (1) pay dividends and repurchase stock, (2) engage in transactions with affiliates, (3) create liens, and (4) engage in sale-leaseback transactions involving a Principal Property, as defined in the Credit Agreement; and

limit the ability of RAI and its Material Subsidiaries, as defined in the Credit Agreement, to sell or dispose of all or substantially all of their assets and engage in specified mergers or consolidations.

The Credit Agreement also contains a restrictive covenant that limits the amount of debt that may be incurred by non-guarantor subsidiaries, together with certain financial covenants. The restrictive covenants in the Credit

Table of Contents

Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)

Agreement are subject to a number of qualifications and exceptions. The financial covenant levels in the Credit Agreement are a maximum of 3.00 to 1.00 for the consolidated leverage ratio and a minimum of 4.00 to 1.00 for the consolidated interest coverage ratio. In addition, the maturity date of the Credit Agreement is July 29, 2015, which date may be extended, with the agreement of the requisite lenders, to July 29, 2016. The Credit Agreement contains customary events of default, including upon a change in control, as defined therein, that could result in the acceleration of all amounts and cancellation of all commitments outstanding under the Credit Agreement.

RAI is able to use the revolving credit facility under the Credit Agreement for borrowings and issuances of letters of credit at its option, subject to a \$200 million sublimit on the aggregate amount of letters of credit. Issuances of letters of credit reduce availability under such revolving credit facility. As of March 31, 2013, there were no borrowings, and \$6 million of letters of credit outstanding, under the Credit Agreement.

Under the terms of the Credit Agreement, RAI is required to pay a facility fee of between 0.20% and 0.40% per annum, based on the facility's credit ratings, on the lender commitments with respect to the revolving credit facility thereunder.

Borrowings under the Credit Agreement bear interest, at the option of RAI, at a rate equal to an applicable margin, based upon the credit ratings assigned to the Credit Agreement, plus:

the alternate base rate, which is the higher of (1) the federal funds effective rate from time to time plus 0.5%, (2) the prime rate and (3) the reserve-adjusted eurodollar rate for a one-month interest period plus 1%; or

the eurodollar rate, which is the reserve-adjusted rate at which eurodollar deposits for one, two, three or six months (or shorter periods if agreed to by the administrative agent and the lenders) are offered in the interbank eurodollar market.

Overdue principal and, to the extent permitted by law, overdue interest, outstanding under the revolving credit facility under the Credit Agreement bear interest at a rate equal to the rate then in effect with respect to such borrowings, plus 2.0% per annum.

The obligations of RAI under the Credit Agreement are unsecured. Certain of RAI's subsidiaries, including its Material Subsidiaries, have guaranteed, on an unsecured basis, RAI's obligations under the Credit Agreement.

On March 27, 2012, RAI and the subsidiary guarantors entered into a First Amendment to the Credit Agreement and First Amendment to the Subsidiary Guarantee Agreement to provide for the further guarantee by the subsidiary guarantors of RAI's obligations to the lenders and affiliates thereof under certain designated swap, forward, future or derivative transactions or options or similar agreements from time to time entered into between RAI and such lenders or affiliates.

Term Loan

On March 15, 2013, RAI entered into a term loan, referred to as the Term Loan, with a syndicate of lenders, providing for an unsecured delayed draw term loan facility, with a maximum borrowing capacity of up to \$500 million. On April 10, 2013, RAI borrowed the entire \$500 million under the Term Loan. The Term Loan matures December 27, 2013.

The Term Loan contains restrictive covenants that are substantially the same as those in the Credit Agreement. The Term Loan contains customary events of default, including upon a change in control, as defined therein, that could result in the acceleration of all amounts outstanding under the Term Loan.

Borrowings under the Term Loan bear interest, at the option of RAI, at a rate equal to an applicable margin, which is based upon RAI's senior unsecured long-term debt credit rating, plus either the alternative base rate or eurodollar rate, as each such rate is defined above under the Credit Agreement.

Table of Contents

Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)

The amount borrowed on April 10, 2013, will initially bear interest at the annual rate of approximately 1.7%. Overdue principal and, to the extent permitted by law, overdue interest, outstanding under the Term Loan will bear interest at a rate equal to the rate then in effect with respect to such borrowings, plus 2.0% per annum.

The obligations of RAI under the Term Loan are unsecured. Certain of RAI's subsidiaries, including its Material Subsidiaries, have guaranteed, on an unsecured basis, RAI's obligations under the Term Loan.

Note 9 Commitments and Contingencies

Tobacco Litigation General

Introduction

Various legal proceedings or claims, including litigation claiming that cancer and other diseases, as well as addiction, have resulted from the use of, or exposure to, RAI's operating subsidiaries' products, are pending or may be instituted against RJR Tobacco, American Snuff Co. or their affiliates, including RAI and RJR, or indemnitees, including B&W. These pending legal proceedings include claims relating to cigarette products manufactured by RJR Tobacco or certain of its affiliates and indemnitees, as well as claims relating to smokeless tobacco products manufactured by American Snuff Co. A discussion of the legal proceedings relating to cigarette products is set forth below under the heading

Litigation Affecting the Cigarette Industry. All of the references under that heading to tobacco-related litigation, smoking and health litigation and other similar references are references to legal proceedings relating to cigarette products and are not references to legal proceedings involving smokeless tobacco products, and case numbers under that heading include only cases involving cigarette products. The legal proceedings relating to the smokeless tobacco products manufactured by American Snuff Co. are discussed separately under the heading Smokeless Tobacco Litigation below.

In connection with the B&W business combination, RJR Tobacco has agreed to indemnify B&W and its affiliates, including its indirect parent, BAT, against certain liabilities, costs and expenses incurred by B&W or its affiliates arising out of the U.S. cigarette and tobacco business of B&W. As a result of this indemnity, RJR Tobacco has assumed the defense of pending B&W-specific tobacco-related litigation, has paid the judgments and costs related to certain pre-business combination tobacco-related litigation of B&W, and has posted bonds on behalf of B&W, where necessary, in connection with cases decided since the B&W business combination.

Certain Terms and Phrases

Certain terms and phrases used in this disclosure may require some explanation. The term judgment or final judgment refers to the final decision of the court resolving the dispute and determining the rights and obligations of the parties. At the trial court level, for example, a final judgment generally is entered by the court after a jury verdict and after post-verdict motions have been decided. In most cases, the losing party can appeal a verdict only after a final judgment has been entered by the trial court.

The term damages refers to the amount of money sought by a plaintiff in a complaint, or awarded to a party by a jury or, in some cases, by a judge. Compensatory damages are awarded to compensate the prevailing party for actual losses suffered, if liability is proved. In cases in which there is a finding that a defendant has acted willfully, maliciously or fraudulently, generally based on a higher burden of proof than is required for a finding of liability for compensatory damages, a plaintiff also may be awarded punitive damages. Although damages may be awarded at the trial court stage, a losing party generally may be protected from paying any damages until all appellate avenues have been exhausted by posting a supersedeas bond. The amount of such a bond is governed by the law of the relevant jurisdiction and generally is set at the amount of damages plus some measure of statutory interest, modified at the discretion of the appropriate court or subject to limits set by court or statute.

The term per curiam refers to an opinion entered by a court. In most cases, it is used to indicate that the opinion entered is a brief announcement of the court's decision and is not accompanied by a written opinion.

The term settlement refers to certain types of cases in which cigarette manufacturers, including RJR Tobacco and B&W, have agreed to resolve disputes with certain plaintiffs without resolving the case through trial. The principal terms of certain settlements entered into by RJR Tobacco and B&W are explained below under Accounting for Tobacco-Related Litigation Contingencies.

Table of Contents

Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)

Theories of Recovery

The plaintiffs seek recovery on a variety of legal theories, including negligence, strict liability in tort, design defect, special duty, voluntary undertaking, breach of warranty, failure to warn, fraud, misrepresentation, unfair trade practices, conspiracy, unjust enrichment, medical monitoring, public nuisance and violations of state and federal antitrust laws. In certain of these cases, the plaintiffs claim that cigarette smoking exacerbated injuries caused by exposure to asbestos.

The plaintiffs seek various forms of relief, including compensatory and punitive damages, treble or multiple damages and statutory damages and penalties, creation of medical monitoring and smoking cessation funds, disgorgement of profits, and injunctive and other equitable relief. Although alleged damages often are not determinable from a complaint, and the law governing the pleading and calculation of damages varies from jurisdiction to jurisdiction, compensatory and punitive damages have been specifically pleaded in a number of cases, sometimes in amounts ranging into the hundreds of millions and even billions of dollars.

Defenses

The defenses raised by RJR Tobacco, American Snuff Co. and their affiliates and indemnitees include, where applicable and otherwise appropriate, preemption by the Federal Cigarette Labeling and Advertising Act of some or all claims arising after 1969, or by the Comprehensive Smokeless Tobacco Health Education Act for claims arising after 1986, the lack of any defect in the product, assumption of the risk, contributory or comparative fault, lack of proximate cause, remoteness, lack of standing and statutes of limitations or repose. RAI and RJR have asserted additional defenses, including jurisdictional defenses, in many of the cases in which they are named.

Accounting for Tobacco-Related Litigation Contingencies

In accordance with GAAP, RAI and its subsidiaries, including RJR Tobacco, American Snuff Co. and SFNTC, as applicable, record any loss concerning litigation at such time as an unfavorable outcome becomes probable and the amount can be reasonably estimated on an individual case-by-case basis. For the reasons set forth below, RAI's management continues to conclude that the loss of any particular pending smoking and health tobacco litigation claim against RJR Tobacco or its affiliates or indemnitees, or the loss of any particular claim concerning the use of smokeless tobacco against American Snuff Co., when viewed on an individual basis, is not probable.

RJR Tobacco and its affiliates believe that they have valid defenses to the smoking and health tobacco litigation claims against them, as well as valid bases for appeal of adverse verdicts against them. RAI, RJR Tobacco and their affiliates and indemnitees have, through their counsel, filed pleadings and memoranda in pending smoking and health tobacco litigation that set forth and discuss a number of grounds and defenses that they and their counsel believe have a valid basis in law and fact. With the exception of *Engle* Progeny cases, described below, RJR Tobacco and its affiliates and indemnitees continue to win the majority of smoking and health tobacco litigation claims that reach trial, and a very high percentage of the tobacco-related litigation claims brought against them continue to be dismissed at or before trial. Based on their experience in the smoking and health tobacco litigation against them and the strength of the defenses available to them in such litigation, RJR Tobacco and its affiliates believe that their successful defense of smoking and health tobacco litigation in the past will continue in the future.

An accrual of \$2.56 million has been recorded in RAI's condensed consolidated balance sheet (unaudited) as of March 31, 2013 for an *Engle* Progeny case, *Bowman*, described below. This amount includes \$450,000 for compensatory and punitive damages and \$2.11 million for attorneys' fees and statutory interest through March 31, 2013. Payment was made on April 17, 2013. As other cases proceed through the appellate process, RAI will consider making further accruals on an individual case-by-case basis if an unfavorable outcome becomes probable and the amount can be reasonably estimated.

It is the policy of RJR Tobacco and its affiliates to vigorously defend all tobacco-related litigation claims. Generally, RJR Tobacco and its affiliates and indemnitees have not settled any smoking and health tobacco litigation claims. Other than actions taken pursuant to offer of judgment statutes, as described below in *Litigation Affecting the Cigarette Industry*, RJR Tobacco and its affiliates do not intend to settle such claims.

Table of Contents

Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)

With respect to smoking and health tobacco litigation claims, the only significant settlements reached by RJR Tobacco and B&W involved:

the State Settlement Agreements and the funding by various tobacco companies of a \$5.2 billion trust fund contemplated by the MSA to benefit tobacco growers; and

the original *Broin* flight attendant case discussed below under *Litigation Affecting the Cigarette Industry - Broin II Cases*. The circumstances surrounding the State Settlement Agreements and the funding of a trust fund to benefit the tobacco growers are readily distinguishable from the current categories of smoking and health cases involving RJR Tobacco or its affiliates and indemnitees. The claims underlying the State Settlement Agreements were brought on behalf of the states to recover funds paid for health care and medical and other assistance to state citizens suffering from diseases and conditions allegedly related to tobacco use. The State Settlement Agreements settled all the health-care cost recovery actions brought by, or on behalf of, the settling jurisdictions and contain releases of various additional present and future claims. In accordance with the MSA, various tobacco companies agreed to fund a \$5.2 billion trust fund to be used to address the possible adverse economic impact of the MSA on tobacco growers. A discussion of the State Settlement Agreements, and a table depicting the related payment schedule, is set forth below under *Litigation Affecting the Cigarette Industry - Health-Care Cost Recovery Cases - State Settlement Agreements - Enforcement and Validity; Adjustments*.

The states were a unique set of plaintiffs and are not involved in any of the smoking and health cases remaining against RJR Tobacco or its affiliates and indemnitees. Although RJR Tobacco and certain of its affiliates and indemnitees continue to be defendants in health-care cost recovery cases similar in theory to the state cases but involving other plaintiffs, such as Native American tribes and foreign governments, the vast majority of such cases have been dismissed on legal grounds. RJR Tobacco and its affiliates, including RAI, believe that the same legal principles that have resulted in dismissal of health-care cost recovery cases either at the trial court level or on appeal should compel dismissal of the similar pending cases.

As with claims that were resolved by the State Settlement Agreements, the other cases settled by RJR Tobacco can be distinguished from existing cases pending against RJR Tobacco and its affiliates and indemnitees. The original *Broin* case, discussed below under *Litigation Affecting the Cigarette Industry - Broin II Cases*, was settled in the middle of trial during negotiations concerning a possible nation-wide settlement of claims similar to those underlying the State Settlement Agreements.

In 2010, RJR Tobacco entered into a comprehensive agreement with the Canadian federal, provincial and territorial governments, which resolved all civil claims related to the movement of contraband tobacco products in Canada during the period 1985 through 1999 that the Canadian governments could assert against RJR Tobacco and its affiliates. These claims were separate from any smoking and health tobacco litigation.

Likewise, in 2004, RJR Tobacco and B&W separately settled the antitrust case *DeLoach v. Philip Morris Cos., Inc.*, which was brought by a unique class of plaintiffs: a class of all tobacco growers and tobacco allotment holders. The plaintiffs asserted that the defendants conspired to fix the price of tobacco leaf and to destroy the federal government's tobacco quota and price support program. Despite legal defenses they believed to be valid, RJR Tobacco and B&W separately settled this case to avoid a long and contentious trial with the tobacco growers. The *DeLoach* case and the antitrust case currently pending against RJR Tobacco and B&W involve different types of plaintiffs and different theories of recovery under the antitrust laws than the smoking and health cases pending against RJR Tobacco and its affiliates and indemnitees.

Finally, as discussed under *Litigation Affecting the Cigarette Industry - State Settlement Agreements - Enforcement and Validity; Adjustments*, RJR Tobacco and B&W each has settled certain cases brought by states concerning the enforcement of State Settlement Agreements. Despite legal defenses believed to be valid, these cases were settled to avoid further contentious litigation with the states involved. These enforcement actions involve

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

alleged breaches of State Settlement Agreements based on specific actions taken by particular defendants. Accordingly, any future enforcement actions involving State Settlement Agreements will be reviewed by RJR Tobacco on the merits and should not be affected by the settlement of prior enforcement cases.

American Snuff Co. also believes that it has valid defenses to the smokeless tobacco litigation against it. American Snuff Co. asserted and will continue to assert some or all of these defenses in each case at the time and in the manner deemed appropriate by American Snuff Co. and its counsel. No verdict or judgment has been returned or entered against American Snuff Co. on any claim for personal injuries allegedly resulting from the use of smokeless tobacco. American Snuff Co. intends to defend vigorously all smokeless tobacco litigation claims asserted against it. No liability for pending smokeless tobacco litigation was recorded in RAI's condensed consolidated balance sheet (unaudited) as of March 31, 2013.

Cautionary Statement

Even though RAI's management continues to conclude that the loss of any particular pending smoking and health tobacco litigation claim (except for the *Bowman* case described below) against RJR Tobacco or its affiliates or indemnitees, or the loss of any particular case concerning the use of smokeless tobacco against American Snuff Co., when viewed on an individual case-by-case basis, is not probable, the possibility of material losses related to such litigation is more than remote. Litigation is subject to many uncertainties, and generally, it is not possible to predict the outcome of any particular litigation pending against RJR Tobacco, American Snuff Co. or their affiliates or indemnitees, or to reasonably estimate the amount or range of any possible loss.

Although RJR Tobacco believes that it has valid bases for appeals of adverse verdicts in its pending cases, and RJR Tobacco and RAI believe they have valid defenses to all actions, and intend to defend all actions vigorously, it is possible that there could be further adverse developments in pending cases, and that additional cases could be decided unfavorably against RAI, RJR Tobacco or their affiliates or indemnitees. Determinations of liability or adverse rulings in such cases or in similar cases involving other cigarette manufacturers as defendants, even if such judgments are not final, could have a material adverse effect on the litigation against RJR Tobacco or its affiliates or indemnitees and could encourage the commencement of additional tobacco-related litigation. In addition, a number of political, legislative, regulatory and other developments relating to the tobacco industry and cigarette smoking have received wide media attention. These developments may negatively affect the outcomes of tobacco-related legal actions and encourage the commencement of additional similar litigation.

Although it is impossible to predict the outcome of such events on pending litigation and the rate new lawsuits are filed against RJR Tobacco or its affiliates or indemnitees, a significant increase in litigation or in adverse outcomes for tobacco defendants, or difficulties in obtaining the bonding required to stay execution of judgments on appeal, could have a material adverse effect on any or all of these entities. Moreover, notwithstanding the quality of defenses available to RJR Tobacco and its affiliates and indemnitees in litigation matters, it is possible that RAI's results of operations, cash flows or financial position could be materially adversely affected by the ultimate outcome of certain pending litigation matters against RJR Tobacco or its affiliates or indemnitees.

Similarly, smokeless tobacco litigation is subject to many uncertainties. Notwithstanding the quality of defenses available to American Snuff Co., it is possible that RAI's results of operations, cash flows or financial position could be materially adversely affected by the ultimate outcome of certain pending litigation matters against American Snuff Co.

*Litigation Affecting the Cigarette Industry**Overview*

Introduction. In connection with the B&W business combination, RJR Tobacco agreed to indemnify B&W and its affiliates against, among other things, certain litigation liabilities, costs and expenses incurred by B&W or its affiliates arising out of the U.S. cigarette and tobacco business of B&W. Accordingly, the cases discussed below include cases brought solely against RJR Tobacco and its affiliates, including RAI and RJR; cases brought against both RJR Tobacco, its affiliates and B&W; and cases brought solely against B&W and assumed by RJR Tobacco in the B&W business combination.

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

During the first quarter of 2013, nine tobacco-related cases, including seven *Engle* Progeny cases, were served against RJR Tobacco or its affiliates or indemnitees. On March 31, 2013, there were 173 cases pending against RJR Tobacco or its affiliates or indemnitees: 157 in the United States and 16 in Canada, as compared with 169 total cases on March 31, 2012. The U.S. case number does not include the 564 individual smoker cases pending in West Virginia state court as a consolidated action, 5,690 *Engle* Progeny cases, involving approximately 6,868 individual plaintiffs, and 2,573 *Broin II* cases (as hereinafter defined), pending in the United States against RJR Tobacco or its affiliates or indemnitees. Of the U.S. cases pending on March 31, 2013, 19 are pending in federal court, and 137 in state court, primarily in the following states: Florida (28 cases); Maryland (23 cases); Missouri (20 cases); New York (17 cases); California (9 cases); and Louisiana (9 cases).

The following table lists the categories of the U.S. tobacco-related cases pending against RJR Tobacco or its affiliates or indemnitees as of March 31, 2013, compared with the number of cases pending against RJR Tobacco, its affiliates or indemnitees as of December 31, 2012, as reported in RAI's Annual Report on Form 10-K for the fiscal year ended December 31, 2012, filed with the SEC on February 12, 2013, and a cross-reference to the discussion of each case type.

Case Type	RJR Tobacco s	Change in	Page Reference
	Case Numbers as of March 31, 2013	Number of Cases Since December 31, 2012 Increase/(Decrease)	
Individual Smoking and Health	104	(1)	26
<i>West Virginia IPIC</i> (Number of Plaintiffs)*	1 (564)	No change	27
<i>Engle</i> Progeny (Number of Plaintiffs)**	5,690 (6,868)	(66) (69)	27
<i>Broin II</i>	2,573	(1)	38
Class-Action	8	No change	39
Health-Care Cost Recovery	2	No change	41
State Settlement Agreements-Enforcement and Validity; Adjustments	31	No change	47
Antitrust	1	No change	52
Other Litigation and Developments	10	No change	52

* Includes as one case the 564 cases pending as a consolidated action *In Re: Tobacco Litigation Individual Personal Injury Cases*, sometimes referred to as *West Virginia IPIC* cases, described below. The *West Virginia IPIC* cases have been separated from the Individual Smoking and Health cases for reporting purposes.

** The *Engle* Progeny cases have been separated from the Individual Smoking and Health cases for reporting purposes. The number of cases has decreased as the result of many of the multiple plaintiff federal court cases either being dismissed or consolidated.

The following cases against RJR Tobacco and B&W have attracted significant attention: the Florida state court class-action case, *Engle v. R. J. Reynolds Tobacco Co.* and the related *Engle* Progeny cases; and the case brought by the U.S. Department of Justice under the federal Racketeer Influenced and Corrupt Organizations Act, referred to as RICO.

In 2000, a jury in *Engle v. Liggett Group*, a class action brought against the major U.S. cigarette manufacturers by a class of Florida smokers allegedly harmed by their addiction to nicotine, rendered a \$145 billion punitive damages verdict in favor of the class. In 2006, the Florida Supreme Court set aside that award, prospectively decertified the class, and preserved several of the *Engle* jury findings for use in subsequent individual actions to be filed within one year of its decision. The preserved findings include jury determinations that smoking causes various diseases, that nicotine is addictive, and that each defendant sold cigarettes that were defective and unreasonably dangerous, committed unspecified acts of negligence and individually and jointly concealed unspecified information about the health risks of smoking. The *Engle* findings do not indicate that all cigarettes sold by each defendant were defective and unreasonably dangerous, nor do they specify what acts of negligence each defendant committed, or what information each defendant concealed.

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

In the wake of *Engle*, thousands of individual progeny actions were filed in federal and state courts in Florida. As of March 31, 2013, 2,396 cases were pending in federal court, and 3,294 cases were pending in state court. These cases include approximately 6,868 plaintiffs. In addition, as of March 31, 2013, RJR Tobacco was aware of 58 additional cases that had been filed but not served. Eighty-six cases have been tried in Florida state and federal courts since 2010, and numerous state court trials are scheduled for 2013. The number of pending cases fluctuates for a variety of reasons, including voluntary and involuntary dismissals. Voluntary dismissals include cases in which a plaintiff accepts an offer of judgment, referred to in Florida statutes as proposals for settlement, from RJR Tobacco and/or its affiliates. An offer of judgment, if rejected by the plaintiff, preserves RJR Tobacco's right to recover attorneys' fees under Florida law in the event of a favorable verdict and is sometimes made through court-ordered mediations.

In each *Engle* Progeny case, a central issue is the proper use of the preserved *Engle* findings. The federal and state courts that have addressed the question have adopted conflicting views. For example, in *Bernice Brown v. R. J. Reynolds Tobacco Co.*, the U.S. Court of Appeals for the Eleventh Circuit, referred to as the Eleventh Circuit, held that the preserved *Engle* findings establish only those issues actually adjudicated in the *Engle* class trial. In other words, those findings would not prevent RJR Tobacco and other defendants from raising issues and defenses that were not, or may not have been, resolved against them in *Engle*. The court further held that an *Engle* Progeny plaintiff bears the burden of showing, to a reasonable degree of certainty, that any issue the plaintiff seeks to treat as established in his favor was, in fact, actually decided in *Engle*. The court held that these standards were required by the Florida law of issue preclusion, and it reserved judgment on whether the same standards were also required by the Due Process Clause of the U.S. Constitution. Prior to the Eleventh Circuit decision in *Bernice Brown*, three federal district judges had concluded that any broader use of the preserved *Engle* findings would violate both the Florida law of issue preclusion and federal due process. However, following the *Bernice Brown* decision, a different federal district judge, in *Waggoner v. R. J. Reynolds Tobacco Co.*, concluded that it does not violate either Florida law or due process to use the *Engle* findings to establish individual elements of tort claims in progeny actions, even absent any determination that the *Engle* jury actually decided the relevant facts against the defendants. Under this view, for example, a progeny plaintiff could use the *Engle* findings to establish that the particular brands or types of cigarettes that he smoked were defective and unreasonably dangerous, even though the *Engle* jury may never have resolved that question.

On March 14, 2013, the Florida Supreme Court addressed the question in *Douglas v. Philip Morris USA, Inc.* Like the district court in *Waggoner*, the Florida Supreme Court held that the *Engle* findings automatically establish all of the conduct elements of every *Engle* Progeny claim, without any inquiry into whether the findings relate in any way to the specific claims of the individual plaintiff. However, the Florida Supreme Court disagreed with both the Eleventh Circuit in *Bernice Brown* and the district court in *Waggoner* in its characterization of the governing state law preclusion doctrine. Specifically, the Florida Supreme Court concluded that the question presented was one of claim preclusion rather than issue preclusion, and it stated that claim preclusion, unlike issue preclusion, has never been limited to facts shown to have been decided by a prior jury. The Florida Supreme Court then held that its selection of the claim preclusion label under state law removed any due process problem that otherwise might have been present. RJR Tobacco intends to file a petition for writ of certiorari with the U.S. Supreme Court to seek further review of the Florida Supreme Court's decision in *Douglas*, and that petition is presently due on June 12, 2013.

The same due process question is also now pending once again in the Eleventh Circuit. Several federal trials have gone forward under the *Waggoner* decision. The defendants have prevailed in most of them, but adverse verdicts were entered against RJR Tobacco in *Walker v. R. J. Reynolds Tobacco Co.* and *Duke v. R. J. Reynolds Tobacco Co.* RJR Tobacco has appealed *Walker* and *Duke* to the Eleventh Circuit. Both cases squarely present the question of whether use of the *Engle* findings to establish individual elements of progeny claims is consistent with federal due process. After RJR Tobacco filed its opening briefs in each case, the appeals were consolidated and further briefing was stayed pending the decision in *Douglas*. Briefing in *Duke* and *Walker* is expected to be complete in May 2013.

On January 30, 2013, the U.S. District Court for the Middle District of Florida ordered the parties to participate in mediation discussions concerning all of the cases pending in that court. The defendants' session with the mediators occurred on April 9, 2013. The discussions did not result in a resolution of all or any of the pending cases.

Nine cases have become final before the *Engle* defendants could obtain review of their due process argument. These cases resulted in an aggregate payment by RJR Tobacco of \$103.1 million (\$79.4 million for compensatory and punitive damages and \$23.7 million for attorneys' fees and statutory interest) in 2012. As of March 31, 2013,

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

an accrual of \$2.56 million (\$450,000 for compensatory and punitive damages and \$2.11 million for attorneys' fees and statutory interest) has been recorded in RAI's condensed consolidated balance sheet (unaudited) for an *Engle* Progeny case, *Bowman*, described below. Payment in the *Bowman* case was made on April 17, 2013.

The following chart reflects verdicts in individual *Engle* Progeny cases, pending as of March 31, 2013, in which a verdict has been returned against RJR Tobacco or B&W, or both. No liability for any of these cases has been recorded in RAI's condensed consolidated balance sheet (unaudited) as of March 31, 2013. This chart does not include the mistrials or verdicts returned in favor of RJR Tobacco or B&W, or both.

Plaintiff Case Name	RJR Tobacco Allocation of Fault	Compensatory Damages (as adjusted) ⁽¹⁾	Punitive Damages	Appeal Status
<i>Sherman</i>	50%	\$ 775,000	\$	Notice to invoke discretionary jurisdiction of Florida Supreme Court pending
<i>Jimmie Lee Brown</i>	50%	600,000		Notice to invoke discretionary jurisdiction of Florida Supreme Court pending
<i>Douglas</i>	5%	250,000		Preparing to seek review with U.S. Supreme Court
<i>Cohen</i>	33.3%	3,300,000	10,000,000	Notice to invoke jurisdiction of Florida Supreme Court pending
<i>Townsend</i>	51%	5,500,000	20,000,000	Remittitur entered; notice of appeal filed with First DCA
<i>Putney</i>	30%	4,500,000	2,500,000	Pending Fourth DCA
<i>Grossman</i>	25%	484,000		Notice to invoke jurisdiction of Florida Supreme Court pending
<i>Buonomo</i>	77.5%	4,060,000	15,700,000	Pending Fourth DCA
<i>Koballa</i>	30%	300,000 ⁽²⁾		Notice to invoke jurisdiction of Florida Supreme Court pending
<i>Webb</i>	90%	3,600,000	25,000,000	Remittitur entered; pending First DCA
<i>Kirkland</i>	10%	10,000	250,000	Pending Second DCA
<i>Mack</i>	65%	1,885,000		Pending First DCA
<i>Andy Allen</i>	45%	2,700,000	8,100,000	Pending First DCA
<i>Jewett</i>	20%	218,600		Notice to invoke jurisdiction of Florida Supreme Court pending
<i>Reese</i>	30%	1,070,000		Liability affirmed; preparing to seek review with the U.S. Supreme Court
<i>Soffer</i>	40%	2,000,000		Notice to invoke jurisdiction of Florida Supreme Court pending
<i>Cicccone</i>	30%	1,000,000	50,000	Pending Fourth DCA
<i>Weingart</i>	3%	4,500		Notice to invoke jurisdiction of Florida Supreme Court pending
<i>Sury</i>	20%	500,000 ⁽⁴⁾		Pending First DCA
<i>Hallgren</i>	25%	1,000,000 ⁽⁴⁾	750,000	Pending Second DCA
<i>Ward</i>	30%	487,000 ⁽⁵⁾	1,700,000	Pending First DCA
<i>Emmon Smith</i>	70%	7,000,000	20,000,000	Pending First DCA
<i>Duke</i>	25%	7,700		Pending Eleventh Circuit
<i>Calloway</i>	27%	16,100,000 ⁽⁶⁾	17,250,000	Pending Fourth DCA

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

<i>Walker</i>	10%	27,500		Pending	Eleventh Circuit
<i>Hiott</i>	40%	730,000		Pending	First DCA
<i>Hancock</i>	5%	700		Pending	Fourth DCA
<i>Sikes</i>	51%	2,100,000	2,000,000	Post-trial motions denied ⁽³⁾ ; final judgment not entered	
<i>James Smith</i>	55%	330,000	20,000	Post-trial motions pending ⁽³⁾	

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

<i>Schlenther</i>	50%	2,500,000	2,500,000	New trial on punitive damages only
<i>Ballard</i>	55%	4,702,500		Post-trial motions pending ⁽³⁾
<i>Lock</i>	9%	103,500		Pending Second DCA
<i>Williams</i>	85%	4,250,000		Post-trial motions pending ⁽³⁾
<i>Evers</i>				Directed verdict granted on concealment, conspiracy and punitive damages; reconsideration motion was denied on April 8, 2013
	60%	1,938,000	12,360,000	
<i>Schoeff</i>	75%	7,875,000	30,000,000	Post-trial motions pending ⁽³⁾
<i>Marotta</i>				Post-trial motions denied; appeal deadline May 6, 2013
	58%	3,480,000		
<i>Searcy</i>	30%	1,800,000	10,000,000	Post-trial motions pending ⁽³⁾
<i>Aycock</i>	72.5%	4,277,000		Final judgment has not been entered
Totals		\$ 91,466,000	\$ 178,180,000	

- (1) Unless otherwise noted, compensatory damages in these cases are adjusted to reflect the jury's allocation of comparative fault. Punitive damages are not so adjusted. The amounts listed above do not include attorneys' fees or statutory interest that may apply to the judgments.
- (2) The court in *Koballa* found RJR Tobacco not liable for the plaintiff's injuries, but awarded compensatory damages. For a detailed description of the case, see *Engle* and *Engle* Progeny Cases below.
- (3) Should the pending post-trial motions be denied, RJR Tobacco will file a notice of appeal with the appropriate appellate court.
- (4) The trial court held the defendants jointly and severally liable for the entire \$1 million, even though the jury had allocated 60% of fault to the plaintiff and 20% of fault to a co-defendant.
- (5) The trial court held the defendants jointly and severally liable, even though the jury allocated 50% of fault to the plaintiff and 20% to the co-defendants.
- (6) In its ruling on the post-trial motions, the court determined that the jury's apportionment of comparative fault did not apply to the compensatory damages award and found the defendants jointly and severally liable.

As of March 31, 2013, outstanding jury verdicts in favor of the *Engle* Progeny plaintiffs had been entered against RJR Tobacco in the amount of \$91,466,000 in compensatory damages (as adjusted) and in the amount of \$178,180,000 in punitive damages, for a total of \$269,646,000. All of these verdicts are at various stages in the appellate process. An accrual of \$2.56 million (\$450,000 for compensatory and punitive damages and \$2.11 million for attorneys' fees and statutory interest) was recorded in RAI's condensed consolidated balance sheet (unaudited) as of March 31, 2013, for *Bowman*, described below. Payment in the *Bowman* case was made on April 17, 2013. RJR Tobacco continues to believe that it has valid defenses in these cases, including the federal due process issues that impact all *Engle* Progeny cases. Should RJR Tobacco not prevail in any particular individual *Engle* Progeny case or determine that in any individual *Engle* Progeny case an unfavorable outcome has become probable and the amount can be reasonably estimated, a loss would be recognized, which could have a material adverse effect on earnings and cash flows of RAI in a particular fiscal quarter or fiscal year.

This recognition of *Engle* Progeny cases as of March 31, 2013, is consistent with RAI's and RJR Tobacco's historic recognition related to such smoking and health litigation claims. It is the policy of RJR Tobacco and its affiliates to vigorously defend all such claims, including *Engle* Progeny cases. It is also the policy of RJR Tobacco to record any loss concerning litigation at such time as an unfavorable outcome becomes probable and the amount can be reasonably estimated on an individual case-by-case basis.

In the *U.S. Department of Justice* case, brought in 1999 in the U.S. District Court for the District of Columbia, the government sought, among other forms of relief, the disgorgement of profits pursuant to the civil provisions of RICO. The U.S. Court of Appeals for the District of Columbia ruled in 2005 that disgorgement is not an available remedy in the case. The bench trial ended in June 2005, and the court, in August 2006, issued its ruling, among other things, finding certain defendants, including RJR Tobacco and B&W, liable for the RICO claims, imposing no direct financial penalties on the defendants, but ordering the defendants to make certain corrective communications in a variety of media and enjoining the defendants from using certain brand descriptors. Both sides appealed to the U.S. Court of Appeals for the District of Columbia. In May 2009, the U.S. Court of Appeals largely affirmed the findings against the tobacco company defendants and remanded to the trial court for further proceedings. The U.S. Supreme Court denied the parties' petitions for writ of certiorari in June 2010. Post-remand proceedings are

underway.

Table of Contents

Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)

For a detailed description of these cases, see *Engle* and *Engle* Progeny Cases and Health-Care Cost Recovery Cases Department of Justice Case below.

In November 1998, the major U.S. cigarette manufacturers, including RJR Tobacco and B&W, entered into the MSA with 46 U.S. states, Washington, D.C. and certain U.S. territories and possessions. These cigarette manufacturers previously settled four other cases, brought on behalf of Mississippi, Florida, Texas and Minnesota, by separate agreements with each state. These State Settlement Agreements:

settled all health-care cost recovery actions brought by, or on behalf of, the settling jurisdictions;

released the major U.S. cigarette manufacturers from various additional present and potential future claims;

imposed future payment obligations in perpetuity on RJR Tobacco, B&W and other major U.S. cigarette manufacturers; and

placed significant restrictions on their ability to market and sell cigarettes and smokeless tobacco products.

Payments under the State Settlement Agreements are subject to various adjustments for, among other things, the volume of cigarettes sold, relevant market share and inflation. See Health-Care Cost Recovery Cases State Settlement Agreements below for a detailed discussion of the State Settlement Agreements, including RAI s operating subsidiaries monetary obligations under these agreements. RJR Tobacco records the allocation of settlement charges as products are shipped.

Scheduled Trials. Trial schedules are subject to change, and many cases are dismissed before trial. It is likely that RJR Tobacco and other cigarette manufacturers will continue to have a similar number of tobacco-related trials in 2013 as it has had in recent years. There are nine cases, exclusive of *Engle* Progeny cases, scheduled for trial as of March 31, 2013 through March 31, 2014, for RJR Tobacco or its affiliates and indemnitees: two non-smoking and health cases, five individual smoking and health cases, one class action and the *West Virginia IPIC* case. There are 60 *Engle* Progeny cases against RJR Tobacco and/or B&W set for trial through March 31, 2014, but it is not known how many of these cases will actually be tried.

Trial Results. From January 1, 2010 through March 31, 2013, 92 smoking and health, *Engle* Progeny and health-care cost recovery cases in which RJR Tobacco or B&W were defendants were tried, including 8 trials for cases where mistrials were declared in the original proceedings. Verdicts in favor of RJR Tobacco, B&W and, in some cases, RJR Tobacco, B&W and other defendants, were returned in 47 cases, including 20 mistrials, tried in Florida (43), Missouri (1) and West Virginia (3). Verdicts in favor of the plaintiffs were returned in 41 cases tried in Florida, one in Connecticut, and one in New York. Two cases in Florida were dismissed during trial.

In the first quarter of 2013, six *Engle* Progeny cases in which RJR Tobacco was a defendant were tried:

In *Wilder v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of the defendants, including RJR Tobacco.

In *Evers v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of the plaintiff, found the decedent, Jacqueline Loyd, to be 31% at fault, RJR Tobacco to be 60% at fault, and the remaining defendant to be 9% at fault, and awarded \$3.23 million in compensatory damages and \$12.36 million in punitive damages against RJR Tobacco only.

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

In *Schoeff v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of the plaintiff, found the decedent, James Schoeff, to be 25% at fault and RJR Tobacco to be 75% at fault, and awarded \$10.5 million in compensatory damages and \$30 million in punitive damages.

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

In *Giddens v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of RJR Tobacco and the plaintiff and against the remaining defendants and awarded \$80,000 in compensatory damages.

In *Marotta v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of the plaintiff, found the decedent, Phil Marotta, to be 42% at fault and RJR Tobacco to be 58% at fault and awarded \$6 million in compensatory damages. Punitive damages were not awarded.

In *Fazekas v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of the defendants, including RJR Tobacco.

For a detailed description of the above-described cases, see *Engle* and *Engle Progeny Cases* below.

In addition, since the end of the first quarter of 2013, jurors returned a verdict in the following *Engle Progeny* case:

In *Searcy v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of the plaintiff, found the decedent, Carol LaSard, to be 40% at fault, RJR Tobacco to be 30% at fault and the remaining defendant to be 30% at fault, and awarded \$6 million in compensatory damages and \$10 million in punitive damages against each defendant.

In *Anderson v. R. J. Reynolds Tobacco Co.*, the court declared a mistrial due to the jury's inability to reach a decision.

In *Aycock v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of the plaintiff, found the decedent, Richard Aycock, to be 27.5% at fault and RJR Tobacco to be 72.5% at fault, and awarded \$5.9 million in compensatory damages. Punitive damages were not awarded.

In the first quarter of 2013, no non-*Engle Progeny* individual smoking and health cases in which RJR Tobacco was a defendant were tried.

The following chart reflects the verdicts in the smoking and health cases or health-care cost recovery cases that have been tried and remain pending as of March 31, 2013, in which verdicts have been returned against RJR Tobacco or B&W, or both. For information on the verdicts in the *Engle Progeny* cases that have been tried and remain pending as of March 31, 2013, in which verdicts have been returned against RJR Tobacco or B&W, or both, see the *Engle Progeny* cases chart above. For information on the post-trial status of individual smoking and health cases and the Governmental Health Care Cost Recovery Case, see *Individual Smoking and Health Cases*, and *Health Care Cost Recovery Cases Department of Justice Case*, respectively, below:

Date of Verdict	Case Name/Type	Jurisdiction	Verdict
December 18, 2003	<i>Frankson v. Brown & Williamson Tobacco Corp.</i>	Supreme Court, Kings County	\$350,000 in compensatory damages; 50% of fault assigned to B&W; \$20 million in punitive damages, of which \$6 million was assigned to B&W, and \$2 million to a predecessor company.
	[Individual]	(Brooklyn, NY)	
February 2, 2005	<i>Smith v. Brown & Williamson Tobacco Corp.</i>	Circuit Court, Jackson County	\$2 million in compensatory damages; 25% of fault assigned to B&W, which reduced the award to \$500,000; \$20 million in punitive damages. In August 2009, a new trial on punitive damages was conducted and the jury awarded \$1.5 million.

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

	[Individual]	(Independence, MO)	
August 17, 2006	<i>United States v. Philip Morris USA, Inc.</i>	U.S. District Court, District of Columbia	RJR Tobacco and B&W were found liable for civil RICO claims; were enjoined from using certain brand descriptors and from making certain misrepresentations; and were ordered to make corrective communications on five subjects, including smoking and health and addiction, to reimburse the U.S. Department of Justice appropriate costs associated with the lawsuit, and to maintain document web sites.
	[Governmental Health-Care Cost Recovery]	(Washington, DC)	

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

May 26, 2010	<i>Izzarelli v. R. J. Reynolds Tobacco Co.</i> [Individual]	U.S. District Court, District of Connecticut, (Bridgeport, CT)	\$13.9 million in compensatory damages; 58% of fault assigned to RJR Tobacco, which reduced the award to \$8.08 million against RJR Tobacco; \$3.97 million in punitive damages.
December 12, 2012	<i>Clinton v. Brown & Williamson Holdings, Inc.</i> [Individual]	Supreme Court, New York County, (New York, NY)	\$1.35 million in compensatory damages. Punitive damages were not at issue.

Individual Smoking and Health Cases

As of March 31, 2013, 104 individual cases were pending in the United States against RJR Tobacco, B&W, as its indemnitee, or both. This category of cases includes smoking and health cases alleging personal injury brought by or on behalf of individual plaintiffs, but does not include the *Broin II*, *Engle Progeny* or *West Virginia IPIC* cases discussed below. A total of 102 of the individual cases are brought by or on behalf of individual smokers or their survivors, while the remaining two cases are brought by or on behalf of individuals or their survivors alleging personal injury as a result of exposure to environmental tobacco smoke, referred to as ETS.

Below is a description of the individual smoking and health cases against RJR Tobacco or B&W, or both, which went to trial or were decided during the period from January 1, 2013 to March 31, 2013, or remained on appeal as of March 31, 2013.

On December 18, 2003, the jury returned a verdict in favor of the plaintiff in *Frankson v. Brown & Williamson Tobacco Corp.*, a case filed in August 2000 in Supreme Court, Kings County, New York, awarded \$350,000 in compensatory damages and eventually returned a verdict of \$20 million in punitive damages against the defendants in an action brought against the major U.S. cigarette manufacturers, including RJR Tobacco, who was dismissed prior to trial, and B&W. Other manufacturers were dismissed before trial. The plaintiff, Gladys Frankson, alleged that Mr. Frankson became addicted to nicotine, was unable to stop smoking, developed lung cancer and died as a result. The defendants as a group and the deceased smoker were each found to be 50% at fault. On January 9, 2004, the jury awarded \$20 million in punitive damages, assigning \$6 million to B&W and \$2 million to American Tobacco, a predecessor company to B&W. Pursuant to its agreement to indemnify B&W, RJR Tobacco posted a supersedeas bond in the amount of \$8.018 million. After various post-trial motions and appeals, the New York Supreme Court, Appellate Division, affirmed the compensatory damages award, set aside the punitive damages award and remanded the case to the Kings County Supreme Court for a new trial on punitive damages. No date has been set for the punitive damages retrial. In July 2012, the defendants filed a motion for summary judgment dismissing the plaintiff's claims for punitive damages. Argument on the motion occurred on August 28, 2012. A decision is pending. The plaintiff has told the court that she may renew her request for an additur as to the amount of compensatory damages, if the court grants the defendants' motion for summary judgment.

On February 1, 2005, the jury returned a split verdict in *Smith v. Brown & Williamson Tobacco Corp.*, a case filed in May 2003 in Circuit Court, Jackson County, Missouri, finding in favor of B&W on two counts, fraudulent concealment and conspiracy, and finding in favor of the plaintiffs on negligence, which incorporates failure to warn and product defect claims. The plaintiffs were awarded \$2 million in compensatory damages and \$20 million in punitive damages; however, the jury found the plaintiff to be 75% at fault and B&W 25% at fault, and thus the compensatory award was reduced to \$500,000. The Missouri Court of Appeals affirmed the compensatory damages award but reversed and ordered a new trial on punitive damages. On July 29, 2009, RJR Tobacco, on behalf of B&W, paid the compensatory damages verdict, plus interest, in the amount of approximately \$700,000. In August 2009, the jury in the punitive damages retrial returned a verdict for the plaintiffs and awarded the plaintiffs \$1.5 million in punitive damages. B&W and the plaintiffs filed notices of appeal in December 2009. In October 2012, the Missouri Court of Appeals reversed the punitive damages award entered in August 2009, and remanded the case for another new trial on punitive damages. In November 2012, B&W filed an application for transfer to the Missouri Supreme Court, which was granted in December 2012. Oral argument is scheduled for May 21, 2013.

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

On May 26, 2010, a jury returned a verdict in favor of the plaintiff in *Izzarelli v. R. J. Reynolds Tobacco Co.*, a case filed in December 1999 in the U.S. District Court for the District of Connecticut. The plaintiff sought to recover damages for personal injuries that the plaintiff alleges she sustained as a result of unsafe and unreasonably dangerous cigarette products and for economic losses she sustained as a result of unfair trade practices of the defendant. The jury found RJR Tobacco to be 58% at fault and the plaintiff to be 42% at fault, awarded \$13.9 million in compensatory damages and found the plaintiff to be entitled to punitive damages. In December 2010, the court awarded the plaintiff \$3.97 million in punitive damages. Final judgment was entered on December 30, 2010, in the amount of \$11.95 million. The court granted the plaintiff's motion for offer of judgment interest, and awarded the plaintiff \$15.8 million for the period of December 6, 1999 up to and including December 5, 2010, and approximately \$4,000 per day thereafter until an amended judgment was entered. The amended judgment was entered in the amount of approximately \$28.1 million on March 4, 2011. RJR Tobacco filed a notice of appeal in September 2011. Oral argument occurred on March 18, 2013. A decision is pending.

On May 19, 2011, a jury returned a verdict in favor of RJR Tobacco in *Hargroves v. R. J. Reynolds Tobacco Co.*, a case filed in December 2005 in the Circuit Court, Hillsborough County, Florida. The plaintiff alleged that as a result of using the defendant's products, the decedent, Debra Hargroves, suffered from lung cancer, emphysema, heart disease and other smoking-related diseases and/or conditions. Final judgment was entered in May 2011. The plaintiff filed a notice of appeal, and RJR Tobacco filed a notice of cross appeal in August 2011. On April 30, 2012, RJR Tobacco dismissed its cross appeal. In March 2013, the Second District affirmed the trial court's judgment, per curiam. The deadline to file a notice to invoke the discretionary jurisdiction of the Florida Supreme Court is April 22, 2013.

On December 12, 2012, in *Clinton v. Brown & Williamson Holdings, Inc.*, a jury returned a verdict in favor of the plaintiff and awarded \$1.35 million in compensatory damages. The case was filed in Supreme Court, New York County, New York. The plaintiff alleged that as a result of using the defendant's products, the decedent, William Champagne, suffered from lung cancer. The plaintiff sought \$100 million in compensatory damages. The defendants removed the case to the U.S. District Court for the Southern District of New York in 2005. Final judgment against B&W in the amount of approximately \$1.35 million was entered in December 2012. Post-trial motions are pending.

West Virginia IPIC

In West Virginia, as of March 31, 2013, 564 individual claims remain pending in a consolidated action, *In re: Tobacco Litigation Individual Personal Injury Cases*. The defendants are Philip Morris, Lorillard and RJR Tobacco (including claims concerning The American Tobacco Company and B&W). The Case Management Order currently calls for these cases to be resolved in a two phase procedure—a common issue trial in Phase I, and, if plaintiffs prevail on one or more issues, a Phase II, consisting of individual trials of liability, medical causation, compensatory damages, and punitive damages for each of the individual plaintiffs. The Phase I trial will focus on whether defendants manufactured defective products, whether their conduct was tortious and whether their conduct meets the standard for a potential award of punitive damages under West Virginia law. There will be no lump sum award of punitive damages and the Phase I jury will not be asked to set a punitive multiplier. Instead, if the jury finds that a defendant's conduct meets the punitive standard, then plaintiffs in their individual trials in Phase II will have the chance to ask Phase II juries to consider awarding punitive damages to each plaintiff on a case-by-case basis. Phase I trials have been initiated three times (twice in 2010 and once in 2011) resulting in mistrials. A new trial began on April 15, 2013.

Engle and Engle Progeny Cases

Trial began in July 1998 in *Engle v. R. J. Reynolds Tobacco Co.*, a case filed in May 1994, in Circuit Court, Miami-Dade County, Florida, in which a class consisting of Florida residents, or their survivors, alleged diseases or medical conditions caused by their alleged addiction to cigarettes. The action was brought against the major U.S. cigarette manufacturers, including RJR Tobacco and B&W, seeking actual damages and punitive damages in excess of \$100 billion each and the creation of a medical fund to compensate individuals for future health-care costs. In July 1999, the jury found against RJR Tobacco, B&W and the other cigarette-manufacturer defendants in the initial phase, which included alleged common issues related to certain elements of liability, general causation and a potential award of, or entitlement to, punitive damages.

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

On July 14, 2000, in the second phase of the trial, the jury returned a punitive damages verdict in favor of the Florida class of approximately \$145 billion against all the defendants, with approximately \$36.3 billion and \$17.6 billion being assigned to RJR Tobacco and B&W, respectively.

In November 2000, the trial judge denied all post-trial motions and entered judgment. The Third DCA reversed the trial court's final judgment and remanded the case to the Miami-Dade County Circuit Court with instructions to decertify the class. The class appealed, and the Florida Supreme Court accepted the case in May 2004.

In July 2006, the court affirmed the dismissal of the punitive damages award and decertified the class, on a going-forward basis. The court preserved a number of class-wide findings from Phase I of the trial, including that cigarettes can cause certain diseases, that nicotine is addictive and that defendants placed defective and unreasonably dangerous cigarettes on the market, and authorized former class members to avail themselves of those findings under certain conditions in individual lawsuits, provided they commence those lawsuits within one year of the date the court's decision became final. The court specified that the eligible plaintiffs are confined to those Florida citizen residents who suffered or died from smoking-related illnesses that manifested themselves on or before November 21, 1996, and that were caused by an addiction to cigarettes that contain nicotine.

In August 2006, RJR Tobacco and the other defendants filed a rehearing motion arguing, among other things, that the findings from the *Engle* trial were not sufficiently specific to serve as the basis for further proceedings and that the Florida Supreme Court's decision denied the defendants due process. The plaintiffs also filed a rehearing motion arguing that some smokers who became sick after November 21, 1996, and who were therefore not class members, should nevertheless have the statute of limitations tolled since they may have refrained from filing suit earlier in the mistaken belief that they were *Engle* class members. In December 2006, the Florida Supreme Court withdrew its July 2006 decision, and issued a revised opinion, in which it set aside the jury's findings of a conspiracy to misrepresent and clarified that the *Engle* jury's finding on express warranty were preserved for use by eligible plaintiffs. The court also denied the plaintiffs' motion and confirmed that the eligible plaintiffs were limited to those individuals who developed alleged smoking-related illnesses that manifested themselves on or before November 21, 1996.

In the fourth quarter of 2007, the defendants' petition for writ of certiorari and petition for rehearing with the U.S. Supreme Court were both denied.

Pursuant to the Florida Supreme Court's July 2006 ruling in *Engle*, which decertified the class, eligible plaintiffs had one year from January 11, 2007, in which to file individual lawsuits. In addition, some individuals who filed suit prior to January 11, 2007, and who claimed they meet the conditions in *Engle*, also attempted to avail themselves of the *Engle* ruling. Lawsuits by individuals requesting the benefit of the *Engle* ruling, whether filed before or after the January 11, 2007, mandate, are referred to as the *Engle* Progeny cases. As of March 31, 2013, RJR Tobacco was a defendant in 5,690 *Engle* Progeny cases in both state and federal courts in Florida. These cases include approximately 6,868 plaintiffs. Many of these cases are in active discovery or nearing trial.

Three federal district courts ruled that the findings in the first phase of the *Engle* proceedings cannot be used to satisfy elements of plaintiffs' claims, and two of those rulings, in *Bernice Brown v. R. J. Reynolds Tobacco Co.* and *Burr v. Philip Morris USA, Inc.*, were certified by the trial court for interlocutory review. In July 2010, the Eleventh Circuit held, as a matter of Florida law, that the findings from the first phase of the *Engle* proceedings cannot be given greater effect than what the *Engle* jury found. Because it rejected plaintiffs' approach on state-law grounds, the court did not find it necessary to consider whether that approach would violate the Due Process Clause of the U.S. Constitution.

On December 14, 2010, the First DCA rejected the Eleventh Circuit's holding and concluded, in the *Martin v. R. J. Reynolds Tobacco Co.* case, that the *Engle* findings establish the conduct of elements of plaintiffs' claims. On July 19, 2011, the Florida Supreme Court denied RJR Tobacco's request to review the decision of the intermediate state appellate court, and on March 26, 2012, the U.S. Supreme Court denied RJR Tobacco's petition for writ of certiorari. On September 21, 2011, the Fourth DCA in *Jimmie Lee Brown* disagreed on state-law grounds with the First DCA's decision in *Martin* as well as the Eleventh Circuit in *Bernice Brown*. On March 30, 2012, the Second DCA in *Douglas* also disagreed with the First DCA's decision in *Martin*, the Fourth DCA's decision in *Jimmie Lee*

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

Brown, and the Eleventh Circuit in *Bernice Brown*. On April 11, 2012, the Third DCA in *Frazier* approved the plaintiff's preferred use of the *Engle* findings without further explanation. RJR Tobacco has sought review of both *Jimmie Lee Brown* and *Douglas* with the Florida Supreme Court. In *Douglas*, the Florida Supreme Court affirmed the Second DCA's ruling for the plaintiff and found that accepting as res judicata the *Engle* findings does not violate the tobacco companies' due process rights. RJR Tobacco intends to file a petition for writ of certiorari with the U.S. Supreme Court to seek further review of the Florida Supreme Court's decision in *Douglas*. The defendants also asked the federal district court in Jacksonville to rule on their constitutional due process objection to the use of the *Engle* findings to satisfy elements of the plaintiffs' claims. The court ruled that application of the *Engle* findings would not violate the defendants' due process rights. RJR Tobacco sought interlocutory review of the decision in the Eleventh Circuit, but the district court declined to certify the order for review.

In June 2009, Florida amended its existing bond cap statute by adding a \$200 million bond cap that applied to all *Engle* Progeny cases in the aggregate. In May 2011, Florida removed the provision that allowed it to expire on December 31, 2012. The bond cap for any given individual *Engle* Progeny case varies depending on the number of judgments in effect at a given time, but never exceeds \$5 million per case. The legislation, which became effective in June 2009 and 2011, applies to judgments entered after the original 2009 effective date.

Below is a description of the *Engle* Progeny cases against RJR Tobacco or B&W, or both, which went to trial or were decided during the period from January 1, 2013 to March 31, 2013, or remained on appeal as of March 31, 2013.

On May 5, 2009, in *Sherman v. R. J. Reynolds Tobacco Co.*, a case filed in September 2007 in the Circuit Court, Broward County, Florida, a jury returned a verdict in favor of the plaintiff. The plaintiff, Melba Sherman, alleged that as a result of using the defendant's products, the decedent, John Sherman, developed lung cancer and died. The plaintiff sought compensatory damages and an unspecified amount of punitive damages. On May 8, 2009, the jury awarded compensatory damages of \$1.55 million and found the decedent to be 50% at fault. No punitive damages were awarded. The court entered final judgment in the amount of \$775,000 in June 2009. RJR Tobacco filed a notice of appeal to the Fourth DCA, and posted a supersedeas bond in the amount of approximately \$900,000. The plaintiff filed a notice of cross appeal of the final judgment in July 2009. In February 2012, the Fourth DCA affirmed the trial court's decision. In March 2012, RJR Tobacco filed a notice to invoke discretionary jurisdiction of the Florida Supreme Court. A decision is pending.

On May 20, 2009, in *Jimmie Lee Brown v. R. J. Reynolds Tobacco Co.*, a case filed in March 2007, in the Circuit Court, Broward County, Florida, a jury returned a verdict in favor of the plaintiff. The plaintiff alleged that the decedent, Roger Brown, developed smoking related diseases, which resulted in his death. The plaintiff sought compensatory damages and an unspecified amount of punitive damages. The jury later returned a verdict that the decedent was 50% at fault for his injuries and awarded compensatory damages of \$1.2 million. No punitive damages were awarded. RJR Tobacco's post-trial motions were denied, and the court entered final judgment in the amount of \$600,000. RJR Tobacco filed a notice of appeal to the Fourth DCA and posted a supersedeas bond in the amount of approximately \$700,000. The Fourth DCA affirmed the trial court's judgment in September 2011. In November 2011, RJR Tobacco filed a notice to invoke discretionary jurisdiction of the Florida Supreme Court. A decision is pending.

On February 25, 2010, in *Grossman v. R. J. Reynolds Tobacco Co.*, a case filed in December 2007 in the Circuit Court, Broward County, Florida, the court declared a mistrial due to the jury's inability to reach a decision. The plaintiff alleged that as a result of an addiction to cigarettes, the decedent, Laura Grossman, developed lung cancer and died. The plaintiff sought damages in excess of \$15,000 and all taxable costs and interest. Retrial began in March 2010. On April 21, 2010, the jury returned a verdict in favor of the plaintiff in Phase I. In April 2010, the jury awarded \$1.9 million in compensatory damages and no punitive damages. The jury also found RJR Tobacco to be 25% at fault, the decedent to be 70% at fault and the decedent's spouse to be 5% at fault. Final judgment was entered in June 2010, in the amount of \$483,682. In July 2011, RJR Tobacco filed a notice of appeal to the Fourth DCA and posted a supersedeas bond in the amount of approximately \$484,000. The plaintiff filed a notice of cross appeal. In June 2012, the Fourth DCA entered an opinion that affirmed the trial court's judgment on liability, but remanded the case for a new trial on all damages issues. In October 2012, RJR Tobacco filed a notice to invoke the discretionary jurisdiction of the Florida Supreme Court. A decision is pending. Retrial is scheduled for July 11, 2013.

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

On March 10, 2010, in *Douglas v. Philip Morris USA, Inc.*, a case filed in October 2007 in Circuit Court, Hillsborough County, Florida, a jury returned a verdict for the plaintiff, found the decedent, Charlotte Douglas, to be 50% at fault, RJR Tobacco to be 5% at fault and the remaining defendants to be 45% at fault, and awarded \$5 million in compensatory damages. No punitive damages were awarded. The plaintiff alleged that as a result of the decedent's addiction to smoking the defendants' cigarettes, she suffered bodily injury and died. In March 2010, the court entered final judgment against RJR Tobacco in the amount of \$250,000. RJR Tobacco filed a notice of appeal to the Second DCA, and posted a supersedeas bond in the amount of \$250,000. On March 30, 2012, the Second DCA affirmed the trial court's decision. However, the court agreed that the issue of due process is one that will be applicable to the many *Engle* Progeny cases being considered by the trial courts and certified the question regarding the due process issue to the Florida Supreme Court as being one of great importance. RJR Tobacco filed a notice to invoke the discretionary jurisdiction of the Florida Supreme Court. The Florida Supreme Court accepted jurisdiction in May 2012. In March 2013, the Florida Supreme Court affirmed the Second DCA's ruling for the plaintiff and found that accepting as res judicata the eight Phase I findings approved in *Engle* does not violate the tobacco companies' due process rights. The deadline to file a petition for writ of certiorari with the U.S. Supreme Court is June 12, 2013.

On March 10, 2010, in *Cohen v. R. J. Reynolds Tobacco Co.*, a case filed in May 2007 in the Circuit Court, Broward County, Florida, a jury returned a verdict in favor of the plaintiff. The plaintiff alleged that the decedent, Nathan Cohen, developed lung cancer as a result of using the defendants' products, and sought in excess of \$15,000 compensatory damages and unspecified punitive damages. On March 24, 2010, the jury awarded the plaintiff \$10 million in compensatory damages, and found the decedent to be 33.3% at fault, RJR Tobacco to be 33.3% at fault and the remaining defendant to be 33.3% at fault. The jury also awarded \$20 million in punitive damages, of which \$10 million was assigned to RJR Tobacco. In July 2010, the court entered final judgment against RJR Tobacco in the amount of \$3.33 million in compensatory damages and \$10 million in punitive damages and the plaintiff filed a motion to amend or alter the final judgment. The court entered an amended judgment in September 2010 to include interest from the date of the verdict. RJR Tobacco filed a notice of appeal to the Fourth DCA and posted a supersedeas bond in the amount of \$2.5 million. In September 2012, the Fourth DCA affirmed the liability finding and the compensatory damages award, but reversed the finding of entitlement to punitive damages, and remanded the case for a retrial limited to the issue of liability for concealment and conspiracy. The defendants and the plaintiff filed separate notices to invoke the discretionary jurisdiction of the Florida Supreme Court in January 2013. A decision is pending.

On April 21, 2010, in *Townsend v. R. J. Reynolds Tobacco Co.*, a case filed in December 2007 in the Circuit Court, Alachua County, Florida, a jury returned a verdict in favor of the plaintiff, found RJR Tobacco to be 51% at fault and the decedent, Frank Townsend, to be 49% at fault, and awarded \$10.8 million in compensatory damages and \$80 million in punitive damages. The plaintiff alleged that the decedent suffered from lung cancer and other conditions and diseases as a result of smoking the defendant's products. Final judgment was entered on April 29, 2010, in the amount of \$5.5 million in compensatory damages and \$40.8 million in punitive damages, which represents 51% of the original damages awards. RJR Tobacco filed a notice of appeal to the First DCA and posted a supersedeas bond in the amount of \$5 million. In February 2012, the First DCA affirmed the compensatory damages verdict, but remanded the case to the trial court for remittitur of the punitive damages or a potential new trial on punitive damages. In June 2012, the trial court entered an order that remitted the punitive damages award to \$20 million. The plaintiff consented, and an amended final judgment was entered against RJR Tobacco in the amount of \$5.5 million in compensatory damages and \$20 million in punitive damages. RJR Tobacco filed a notice of rejection of the remittitur and a demand for a new trial on the punitive damages issue. RJR Tobacco also filed a notice of appeal of the amended final judgment entered in June 2012. Oral argument occurred on March 12, 2013. A decision is pending. In February 2013, the Florida Supreme Court denied RJR Tobacco's and the plaintiff's petitions for review of the First DCA's decision. The deadline to file a petition for writ of certiorari with the U.S. Supreme Court is May 7, 2013. RJR Tobacco's appeal of the amended final judgment remains pending.

On April 26, 2010, in *Putney v. R. J. Reynolds Tobacco Co.*, a case filed in December 2007 in the Circuit Court, Broward County, Florida, a jury returned a verdict in favor of the plaintiff, finding the decedent, Margot Putney, to be 35% at fault, RJR Tobacco to be 30% at fault and the remaining defendants to be 35% at fault, and awarded \$15.1 million in compensatory damages and \$2.5 million in punitive damages each against RJR Tobacco and the remaining defendants. The plaintiff alleged that the decedent suffered from nicotine addiction and lung cancer as a

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

result of using the defendants' products. In August 2010, final judgment was entered against RJR Tobacco in the amount of \$4.5 million in compensatory damages, and \$2.5 million in punitive damages. RJR Tobacco filed a notice of appeal and the plaintiff filed a notice of cross appeal. In December 2010, the court entered an amended final judgment to provide that interest would run from April 26, 2010. The defendants filed a joint notice of appeal to the Fourth DCA of the amended final judgment, and RJR Tobacco posted a supersedeas bond in the amount of approximately \$2.4 million. Oral argument occurred on September 27, 2012. A decision is pending.

On May 20, 2010, in *Buonomo v. R. J. Reynolds Tobacco Co.*, a case filed in October 2007 in the Circuit Court, Broward County, Florida, a jury returned a verdict in favor of the plaintiff, found RJR Tobacco to be 77.5% at fault and the decedent, Matthew Buonomo, to be 22.5% at fault, and awarded \$5.2 million in compensatory damages and \$25 million in punitive damages. The plaintiff alleged that the decedent was addicted to cigarettes and, as a result, developed one or more smoking related medical conditions and/or diseases. Post-trial motions were denied, but the court, in accordance with the Florida statutory limitation on punitive damage awards, ordered the punitive damage award of \$25 million be reduced to \$15.7 million—three times the compensatory damages award of \$5.2 million. In August 2010, the court entered final judgment in the amount of \$4.06 million in compensatory damages and \$15.7 million in punitive damages. RJR Tobacco filed a notice of appeal to the Fourth DCA and posted a supersedeas bond in the amount of \$5 million. The plaintiff also filed a notice of appeal. Oral argument is scheduled for April 23, 2013.

On October 15, 2010, in *Frazier v. Philip Morris USA Inc.*, a case filed in December 2007 in the Circuit Court, Miami-Dade County, Florida, the jury returned a verdict in favor of the defendants. The plaintiff alleged that as a result of smoking defendants', including RJR Tobacco's, products she developed chronic obstructive pulmonary disease. Final judgment was entered in February 2011. The plaintiff filed a notice of appeal to the Third DCA, and the defendants filed a cross appeal. On April 11, 2012, the Third DCA reversed the trial court's judgment, directed entry of judgment in the plaintiff's favor and ordered a new trial. On July 9, 2012, the defendants filed a notice to invoke the discretionary jurisdiction of the Florida Supreme Court. A decision is pending.

On August 26, 2010, in *Budnick v. R. J. Reynolds Tobacco Co.*, a case filed in December 2007, in the Circuit Court, Broward County, Florida, a jury returned a verdict in favor of RJR Tobacco. The plaintiff alleged that the decedent, Leonard Budnick, was addicted to cigarettes manufactured by the defendant, and as a result, developed one or more smoking related medical conditions and/or diseases. The plaintiff filed a notice of appeal to the Fourth DCA. In December 2012, the Fourth DCA affirmed the final judgment entered in favor of RJR Tobacco. The deadline to seek review by the Florida Supreme Court and the U.S. Supreme Court has passed.

On October 29, 2010, in *Koballa v. Philip Morris USA Inc.*, a case filed in December 2007, in the Circuit Court, Volusia County, Florida against tobacco industry defendants, including RJR Tobacco, the court declared a mistrial after the jury informed the court that they were unable to reach a verdict. The plaintiff alleges that as a result of the use of the defendants' defective and unreasonably dangerous tobacco products, she suffers from, or has suffered from, nicotine addiction, lung cancer and other smoking related medical conditions and/or diseases. Retrial began on March 21, 2011, and on March 31, 2011, the jury returned an inconsistent verdict. The jury found that RJR Tobacco was not liable for the plaintiff's injuries, but found that her past injuries were worth \$1 million with the plaintiff being 70% at fault and RJR Tobacco 30% at fault. The court entered final judgment in August 2011. RJR Tobacco filed a notice of appeal to the Fifth DCA and posted a supersedeas bond in the amount of \$300,000. In September 2012, the Fifth DCA affirmed the trial court's judgment, per curiam. RJR Tobacco's motion for a written opinion was granted in October 2012. In November 2012, RJR Tobacco filed a notice to invoke the discretionary jurisdiction of the Florida Supreme Court. A decision is pending.

On November 4, 2010, in *Vasko v. R. J. Reynolds Tobacco Co.*, a case filed in January 2008, in the Circuit Court, Broward County, Florida, a jury returned a verdict in favor of RJR Tobacco. The jury found that the plaintiff's claim was barred by the statute of limitations. The plaintiff alleged that the decedent, John Vasko, was addicted to cigarettes manufactured by the defendants, and as a result, developed one or more smoking related medical conditions and/or diseases, including lung cancer. Final judgment was entered, and the plaintiff filed a notice of appeal to the Fourth DCA. The Fourth DCA affirmed the trial court's judgment, per curiam, on March 28, 2013. The deadline to file a notice to invoke the discretionary jurisdiction of the Florida Supreme Court is June 3, 2013.

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

On November 15, 2010, in *Webb v. R. J. Reynolds Tobacco Co.*, a case filed in December 2007, in the Circuit Court, Levy County, Florida, a jury returned a verdict in favor of the plaintiff, found RJR Tobacco to be 90% at fault and the decedent, James Horner, to be 10% at fault, and awarded \$8 million in compensatory damages and \$72 million in punitive damages. The plaintiff alleged that as a result of smoking the defendant's products, the decedent developed one or more smoking related medical conditions and/or diseases. The court entered final judgment in November 2010. RJR Tobacco filed a notice of appeal to the First DCA and posted a supersedeas bond in the amount of \$5 million. The plaintiff filed a notice of cross appeal. In April 2012, the First DCA affirmed the liability verdict, but ordered a remittitur or a new trial on damages. The trial court entered an order of remittitur or, alternatively, for a new trial. The court ordered that the compensatory damage award be reduced to \$4 million and the punitive damage award be reduced to \$25 million. The plaintiff consented to the remitted judgment, and RJR Tobacco filed a notice of rejection of the remittitur and demand for a new trial. The trial court entered an amended final judgment in September 2012. RJR Tobacco filed a notice of appeal to the First DCA of the amended final judgment in October 2012. Briefing is underway. In November 2012, the Florida Supreme Court denied RJR Tobacco's petition for review of the First DCA's decision. RJR Tobacco's appeal of the amended final judgment remains pending.

On February 10, 2011, in *Kirkland v. R. J. Reynolds Tobacco Co.*, a case filed in January 2008, in the Circuit Court, Hillsborough County, Florida, a jury returned a verdict in favor of the plaintiff, found RJR Tobacco to be 10% at fault and the plaintiff to be 90% at fault, and awarded \$100,000 in compensatory damages. The jury also awarded the plaintiff \$250,000 in punitive damages. The plaintiff alleged that he was addicted to cigarettes, and as a result, developed larynx cancer and other smoking related medical conditions and/or diseases. Final judgment was entered in March 2011. The plaintiff filed a notice of appeal to the Second DCA on April 12, 2011. RJR Tobacco filed a notice of cross appeal and posted a supersedeas bond in the amount of \$260,000. In January 2012, the plaintiff voluntarily dismissed his appeal. RJR Tobacco's appeal remains pending. Briefing is underway.

On March 18, 2011, in *Mack v. R. J. Reynolds Tobacco Co.*, a case filed in June 2008, in the Circuit Court, Alachua County, Florida, a jury returned a verdict in favor of the plaintiff, found RJR Tobacco to be 51% at fault and the decedent, Peter Mack, Sr., to be 49% at fault, and awarded \$1 million in compensatory damages. No punitive damages were awarded. The plaintiff alleged that due to the decedent's addiction to cigarettes, he developed bronchitis and lung cancer. In April 2011, final judgment was entered in favor of the plaintiff. RJR Tobacco appealed, and the First DCA reversed the trial court's judgment and remanded the case for a new trial. Retrial began on December 3, 2012. On December 14, 2012, the jury returned a verdict in favor of the plaintiff, found the decedent to be 35% at fault and RJR Tobacco to be 65% at fault and awarded \$2.9 million in compensatory damages. RJR Tobacco filed a notice of appeal to the First DCA and posted a supersedeas bond in the amount of \$1.9 million. Briefing is underway.

On March 28, 2011, in *Oliva v. R. J. Reynolds Tobacco Co.*, a case filed in November 2007, in the Circuit Court, Duval County, Florida, a jury returned a verdict in favor of the defendants, including RJR Tobacco. The plaintiff alleged that as a result of smoking the defendants' cigarettes, he developed chronic obstructive pulmonary disease and other smoking related diseases. Final judgment was entered in April 2011. The plaintiff filed a notice of appeal to the First DCA, and the defendants filed a notice of cross appeal in June 2011. In February 2013, the First DCA affirmed, per curiam, the trial court's judgment. The plaintiff's motion for rehearing en banc, motion for clarification and for issuance of written opinion was denied in March 2013. The deadline to file a notice to invoke the discretionary jurisdiction of the Florida Supreme Court is April 24, 2013.

On April 13, 2011, in *Tullo v. R. J. Reynolds Tobacco Co.*, a case filed in December 2007, in the Circuit Court, Palm Beach County, Florida, a jury returned a verdict in favor of RJR Tobacco and the plaintiff, but against the remaining defendants. The jury awarded \$4.5 million in compensatory damages and no punitive damages. The jury found the decedent, Dominick Tullo, to be 45% at fault and the remaining defendants cumulatively to be 55% at fault. The plaintiff alleged that the decedent was addicted to cigarettes manufactured by the defendants, and as a result, developed chronic obstructive pulmonary disease and other smoking related illnesses and/or diseases. The plaintiff sought in excess of \$15,000 against each defendant, taxable costs and interest. The court denied the plaintiff's motion for a new trial against RJR Tobacco and denied the remaining defendants' post-trial motions in June 2011. The remaining defendants have filed an appeal to the Fourth DCA, and the plaintiff filed a cross appeal. The plaintiff also filed a notice of appeal of the order denying the plaintiff's motion for new trial against RJR Tobacco. RJR Tobacco filed a cross appeal of the same order. Briefing is complete. Oral argument has not been scheduled.

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

On April 26, 2011, in *Andy Allen v. R. J. Reynolds Tobacco Co.*, a case filed in September 2007, in the Circuit Court, Duval County, Florida, a jury returned a verdict in favor of the plaintiff, found RJR Tobacco to be 45% at fault, the decedent, Patricia Allen, to be 40% at fault and the remaining defendant to be 15% at fault, and awarded \$6 million in compensatory damages and \$17 million in punitive damages against each defendant. The plaintiff alleged that as a result of smoking the defendants' products, the decedent developed chronic obstructive pulmonary disease. Final judgment was entered against RJR Tobacco in the amount of \$19.7 million in May 2011. In October 2011, the court entered a remittitur of the punitive damages to \$8.1 million and denied all other post-trial motions. The defendants filed a joint notice of appeal, RJR Tobacco posted a supersedeas bond in the amount of \$3.75 million, and the plaintiff filed a notice of cross appeal in November 2011. Oral argument occurred on January 16, 2013. A decision is pending.

On May 20, 2011, in *Reese v. R. J. Reynolds Tobacco Co.*, a case filed in September 2007, in the Circuit Court, Miami-Dade County, Florida, a jury returned a verdict in favor of the plaintiff, found the plaintiff to be 70% at fault and RJR Tobacco to be 30% at fault, and awarded \$3.6 million in compensatory damages and no punitive damages. The plaintiff alleged that as a result of smoking the defendant's products, she became addicted and developed laryngeal cancer, peripheral vascular disease and chronic obstructive pulmonary disease. The court entered final judgment on May 25, 2011. RJR Tobacco filed a notice of appeal to the Third DCA and posted a supersedeas bond in the amount of \$1.07 million. In February 2013, the Third DCA affirmed the judgment of the trial court. RJR Tobacco is preparing to seek review with the U.S. Supreme Court.

On May 20, 2011, in *Jewett v. R. J. Reynolds Tobacco Co.*, a case filed in December 2007, in the Circuit Court, Duval County, Florida, a jury returned a verdict in favor of the plaintiff, found RJR Tobacco to be 20% at fault, the decedent, Barbara Jewett, to be 70% at fault and the remaining defendant to be 10% at fault, and awarded \$1.1 million in compensatory damages and no punitive damages. The plaintiff alleged that the decedent, Barbara Jewett, was addicted to cigarettes and as a result of her addiction, developed chronic obstructive pulmonary disease, emphysema and respiratory failure. Final judgment was entered in June 2011. RJR Tobacco filed a notice of appeal to the First DCA and posted a supersedeas bond in the amount of \$218,600. In November 2012, the First DCA reversed the judgment and remanded the case for a new trial. The plaintiff and the defendants filed separate notices to invoke the discretionary jurisdiction of the Florida Supreme Court in March 2013. Decisions are pending.

On June 16, 2011, in *Soffer v. R. J. Reynolds Tobacco Co.*, a case filed in December 2007, in the Circuit Court, Alachua County, Florida, a jury returned a verdict in favor of the plaintiff, found RJR Tobacco to be 40% at fault, the decedent, Maurice Soffer, to be 60% at fault, and awarded \$5 million in compensatory damages and no punitive damages. The plaintiff alleged that the decedent was addicted to cigarettes and, as a result, developed lung cancer and other smoking related conditions and/or diseases. Final judgment was entered against RJR Tobacco in the amount of \$2 million. The plaintiff filed a notice of appeal to the First DCA in July 2011. RJR Tobacco filed a notice of cross appeal and posted a supersedeas bond in the amount of \$2 million. In October 2012, the First DCA affirmed the trial court's ruling in full. On the direct appeal, the court held that only intentional torts could support a punitive damages claim and held that *Engle* Progeny plaintiffs may not seek punitive damages for negligence or strict liability because the original *Engle* class did not seek punitive damages for those claims. The First DCA certified the question to the Florida Supreme Court as one of great public importance. On the cross appeal, the court rejected RJR Tobacco's arguments about the use of the *Engle* findings and the statute of limitations. RJR Tobacco filed a motion for rehearing or for certification to the Florida Supreme Court and the plaintiff filed a motion for rehearing or rehearing en banc. In January 2013, the First DCA granted rehearing on RJR Tobacco's cross appeal to clarify that the trial court's application of *Engle* findings did not violate RJR Tobacco's due process rights. Otherwise, rehearing, rehearing en banc and certification were denied. RJR Tobacco and the plaintiff have both filed notices to invoke the discretionary jurisdiction of the Florida Supreme Court. Decisions are pending.

On July 15, 2011, in *Ciccone v. R. J. Reynolds Tobacco Co.*, a case filed in August 2004, in the Circuit Court, Broward County, Florida, a jury returned a verdict finding the plaintiff is a member of the *Engle* class. The plaintiff alleged that as a result of the use of the defendant's tobacco products, the decedent, George Ciccone, suffered from nicotine addiction and one or more smoking related diseases and/or medical conditions. On July 21, 2011, the jury awarded approximately \$3.2 million in compensatory damages and \$50,000 in punitive damages. The jury found

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

the decedent to be 70% at fault and RJR Tobacco to be 30% at fault. Final judgment was entered in September 2011, and RJR Tobacco filed a notice of appeal to the Fourth DCA. RJR Tobacco posted a supersedeas bond in the amount of approximately \$1 million on October 17, 2011. Briefing is complete. Oral argument has not been scheduled.

On July 19, 2011, in *Weingart v. R. J. Reynolds Tobacco Co.*, a case filed in November 2007, in the Circuit Court, Palm Beach County, Florida, a jury returned a verdict in favor of the plaintiff; however, they refused to award compensatory or punitive damages and found the decedent, Claire Weingart, to be 91% at fault. The plaintiff alleged that as a result of using the defendants' tobacco products, the decedent developed lung cancer and other smoking related medical conditions and/or diseases. In September 2011, the court granted the plaintiff's motion for additur or new trial. The plaintiff was awarded \$150,000 as an additur for pain and suffering damages. Final judgment was entered in the amount of \$4,500, against each defendant and the defendants filed a joint notice of appeal to the Fourth DCA in November 2011. RJR Tobacco posted a supersedeas bond in the amount of \$4,500. In February 2013, the Fourth DCA affirmed the trial court's judgment, per curiam. The defendants filed a notice to invoke the discretionary jurisdiction of the Florida Supreme Court in March 2013. A decision is pending.

On September 15, 2011, in *Ojeda v. R. J. Reynolds Tobacco Co.*, a case filed in October 2007, in the Circuit Court, Miami-Dade County, Florida, a jury returned a verdict in favor of RJR Tobacco. The plaintiff alleged that as a result of the use of the defendant's products, the decedent, Juan Ojeda, suffered from one or more smoking related medical conditions and/or diseases. Final judgment was entered September 26, 2011. The plaintiff filed a notice of appeal to the Third DCA in October 2012. Briefing is underway.

On September 23, 2011, in *Bowman v. R. J. Reynolds Tobacco Co.*, a case filed in November 2007, in the Circuit Court, Duval County, Florida, a jury returned a verdict in favor of the plaintiff, found the decedent, Michael Bowman, to be 70% at fault and RJR Tobacco to be 30% at fault, and awarded \$1.5 million in compensatory damages and no punitive damages. The plaintiff alleged that as a result of the use of the defendant's products, the decedent suffered from esophageal cancer. The Court entered final judgment in October 2011. RJR Tobacco filed a notice of appeal and posted a supersedeas bond in the amount of \$450,000. In November 2012, the First DCA affirmed, per curiam, the judgment of the trial court. RJR Tobacco paid the judgment on April 17, 2013.

On November 28, 2011, in *Sury v. R. J. Reynolds Tobacco Co.*, a case filed in November 2007, in the Circuit Court, Duval County, Florida, a jury returned a verdict in favor of the plaintiff, found the decedent, William Sury, to be 60% at fault, RJR Tobacco to be 20% at fault, and the remaining defendant to be 20% at fault, and awarded \$1 million in compensatory damages and no punitive damages. The plaintiff alleged that as a result of the use of the defendants' products, the decedent suffered from lung cancer. Final judgment was entered in March 2012. The court entered an amended final judgment that held the defendants jointly and severally liable for the entire \$1 million, even though the jury had allocated 60% of fault to the plaintiff and 20% of fault to a co-defendant. The defendants filed a notice of appeal to the First DCA on April 20, 2012, and RJR Tobacco posted a supersedeas bond in the amount of \$500,000. Oral argument is scheduled for May 14, 2013.

On January 24, 2012, in *Hallgren v. R. J. Reynolds Tobacco Co.*, a case filed in April 2007, in the Circuit Court, Highlands County, Florida, a jury returned a verdict in favor of the plaintiff, found the decedent, Claire Hallgren, to be 50% at fault, RJR Tobacco to be 25% at fault, and the remaining defendant to be 25% at fault, and awarded \$2 million in compensatory damages and \$750,000 in punitive damages against each defendant. The plaintiff alleged that the decedent was addicted to the defendants' products, and as a result, suffered from lung cancer. In March 2012, the court entered final judgment in the amount of approximately \$1 million for which RJR Tobacco and the other defendant are jointly and severally liable; and \$750,000 in punitive damages against each defendant and reserved jurisdiction to rule on post-trial motions. The defendants filed a motion to alter or amend the final judgment to conform the judgment to Florida law. The defendants contend that the final judgment is erroneous because it purports to hold the defendants jointly and severally liable, and its award of damages to Mr. Hallgren individually contravenes Florida's wrongful death statute. The plaintiff filed a motion to amend the final judgment in accordance with the plaintiff's position that the comparative fault statute does not apply, and not reduce the plaintiff's compensatory award per the jury's allocation of fault. The defendants filed a joint notice of appeal to the Second DCA, and RJR Tobacco posted a supersedeas bond in the amount of approximately \$1.3 million in May 2012. The plaintiff filed a notice of cross appeal. Briefing is complete. Oral argument has not been scheduled.

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

On January 25, 2012, in *Ward v. R. J. Reynolds Tobacco Co.*, a case filed in December 2007, in the Circuit Court, Escambia County, Florida, a jury returned a verdict in favor of the plaintiff, found the decedent, Mattie Ward, to be 50% at fault, RJR Tobacco to be 30% at fault, and the remaining defendants, collectively, to be 20% at fault, and awarded \$1 million in compensatory damages and \$1.7 million in punitive damages. The plaintiff alleged that the decedent was addicted to the defendants' products, and as a result, suffered from chronic obstructive pulmonary disease and other smoking related conditions and/or diseases. In March 2012, the court entered final judgment in the amount of \$487,000 in compensatory damages, for which RJR Tobacco and the other defendants are jointly and severally liable; and \$1.7 million in punitive damages against RJR Tobacco. RJR Tobacco filed a notice of appeal to the First DCA and posted a supersedeas bond in the amount of \$2.19 million in June 2012. The plaintiff filed a notice of cross appeal. Briefing is underway.

On February 29, 2012, in *Marotta v. R. J. Reynolds Tobacco Co.*, a case filed in December 2007, in the Circuit Court, Broward County, Florida, the court declared a mistrial during jury prequalification. The plaintiff alleged that the decedent, Phil Marotta, was addicted to cigarettes and, as a result, suffered from lung cancer. The plaintiff seeks compensatory damages in excess of \$75,000, including compensatory and punitive damages, costs and pre-judgment interest. Retrial began on March 7, 2013. On March 20, 2013, a jury returned a verdict in favor of the plaintiff, found the decedent to be 42% at fault and RJR Tobacco to be 58% at fault and awarded \$6 million in compensatory damages and no punitive damages. Post-trial motions were denied and final judgment was entered in April 2013. The deadline to file a notice of appeal is May 6, 2013.

On March 19, 2012, in *McCray v. R. J. Reynolds Tobacco Co.*, a case filed in January 2008, in the U.S. District Court for the Middle District of Florida, a jury returned a verdict in favor of the defendants, including RJR Tobacco. The plaintiff alleged that the decedent, Mercedia Walker, was addicted to the defendants' tobacco products, and as a result, suffered from one or more smoking related diseases and/or medical conditions. The plaintiff sought compensatory damages for all injuries and losses, all recoverable costs of the case, and all legally recoverable interest. Final judgment was entered in March 2012. The plaintiff filed a notice of appeal in July 2012. Briefing is underway.

On March 27, 2012, in *Emmon Smith v. R. J. Reynolds Tobacco Co.*, a case filed in January 2008 in the Circuit Court, Jackson County, Florida, a jury returned a verdict in favor of the plaintiff, found Mr. Smith to be 30% at fault and RJR Tobacco to be 70% at fault, and awarded \$10 million in compensatory damages. The jury also awarded \$20 million in punitive damages. The plaintiff alleged that he was addicted to cigarettes manufactured by the defendants, and as a result, developed lung cancer. Final judgment was entered on April 2, 2012. RJR Tobacco filed a notice of appeal to the First DCA and posted a supersedeas bond in the amount of \$5 million. Oral argument occurred on January 15, 2013. A decision is pending.

On April 10, 2012, in *Duke v. R. J. Reynolds Tobacco Co.*, a case filed in December 2007, in the U.S. District Court for the Middle District of Florida, a jury returned a verdict in favor of the plaintiff, found the decedent, Sarah Duke, to be 75% at fault and RJR Tobacco to be 25% at fault, and awarded \$30,705 in compensatory damages and no entitlement to punitive damages. The plaintiff alleged that as a result of the use of the defendant's products, the decedent developed smoking related diseases. The plaintiff sought compensatory and punitive damages, including costs and interest. RJR Tobacco filed a notice of appeal to the Eleventh Circuit in September 2012. In November 2012, RJR Tobacco posted a supersedeas bond in the amount of approximately \$7,800. In February 2013, the Eleventh Circuit granted the joint motion to consolidate the appeal with the appeal in *Walker v. R. J. Reynolds Tobacco Co.*, discussed below. Briefing is underway.

On May 21, 2012, in *Walker v. R. J. Reynolds Tobacco Co.*, a case filed in August 2007, in the U.S. District Court for the Middle District of Florida, a jury returned a verdict in favor of the plaintiff, found the decedent, Albert Walker, to be 90% at fault and RJR Tobacco to be 10% at fault, and awarded \$275,000 in compensatory damages with no entitlement to punitive damages. The plaintiff alleged that as a result of the use of the defendant's products, the decedent suffered bodily injury. The plaintiff sought compensatory and punitive damages, including costs and interest. The court entered final judgment in May 2012. RJR Tobacco filed a notice of appeal to the Eleventh Circuit and posted a supersedeas bond in the amount of \$27,775. In February 2013, the Eleventh Circuit granted the joint motion to consolidate the appeal with the appeal in *Duke v. R. J. Reynolds Tobacco Co.*, discussed above. Briefing is underway.

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

On May 17, 2012, in *Calloway v. R. J. Reynolds Tobacco Co.*, a case filed in December 2007, in the Circuit Court, Broward County, Florida, a jury returned a verdict in favor of the plaintiff, found the decedent, Johnnie Calloway, to be 20.5% at fault, RJR Tobacco to be 27% at fault, and the remaining defendants collectively to be 52.5% at fault, and awarded \$20.5 million in compensatory damages and \$17.25 million in punitive damages against RJR Tobacco and \$37.6 million collectively against the remaining defendants. The plaintiff alleged that as a result of using the defendants' products, the decedent became addicted and developed smoking-related diseases and/or conditions. The plaintiff sought compensatory and punitive damages, including costs and interest. In its ruling on the post-trial motions, the court determined that the jury's apportionment of comparative fault did not apply to the compensatory damages award. Final judgment was entered in August 2012. In September 2012, the defendants filed a notice of appeal, and RJR Tobacco posted a supersedeas bond in the amount of \$1.5 million. The plaintiff filed a notice of cross-appeal. Briefing is underway.

On August 1, 2012, in *Hiott v. R. J. Reynolds Tobacco Co.*, a case filed in January 2008, in the Circuit Court, Duval County, Florida, a jury returned a verdict in favor of the plaintiff, found the decedent, Kenneth Hiott, to be 60% at fault and RJR Tobacco to be 40% at fault, and awarded \$1.83 million in compensatory damages and no punitive damages. The plaintiff alleged that as a result of using the defendant's product, the decedent suffered from addiction and smoking related diseases and/or conditions. The plaintiff sought an unspecified amount of compensatory and punitive damages. In November 2012, final judgment was entered against RJR Tobacco in the amount of \$730,000 in compensatory damages. RJR Tobacco filed a notice of appeal and posted a supersedeas bond in the amount of \$730,000 in December 2012. Briefing is underway.

On August 1, 2012, in *Denton v. R. J. Reynolds Tobacco Co.*, a case filed in August 2007, in the U.S. District Court for the Middle District of Florida, a jury found the defendants liable, but allocated 100% of fault to the decedent, Linda Denton. The plaintiff alleged that as a result of using the defendants' products, the decedent suffered from smoking related diseases and/or conditions. The plaintiff sought an unspecified amount of compensatory and punitive damages. Final judgment was entered on August 8, 2012. The plaintiff filed a motion for a new trial in September 2012. A decision is pending.

On August 10, 2012, in *Hancock v. Philip Morris USA, Inc.*, a case filed in January 2008, in the Circuit Court, Miami-Dade County, Florida, a jury returned a verdict in favor of the plaintiff, found the decedent, Edna Siwieck, to be 90% at fault, RJR Tobacco to be 5% at fault and the remaining defendant to be 5% at fault. However, the jury did not award compensatory damages and found that the plaintiff was not entitled to punitive damages. The court determined that the jury verdict was inconsistent due to the parties previously stipulating to \$110,200 in medical expenses, which is subject to the allocation of fault. The defendants agreed to an additur for that amount. The plaintiff alleged that as a result of using the defendants' products, the decedent suffered from chronic obstructive pulmonary disease. The plaintiff sought an unspecified amount of compensatory and punitive damages, costs and interest. Final judgment was entered against RJR Tobacco in the amount of \$705 in October 2012. The stipulated amount was reduced by the defendants' motion to reduce economic damages by collateral sources. The plaintiff filed a notice of appeal to the Fourth DCA and the defendants filed a notice of cross appeal, in November 2012. Briefing is underway.

On September 19, 2012, in *Baker v. R. J. Reynolds Tobacco Co.*, a case filed in November 2007, in the Circuit Court, Palm Beach County, Florida, a jury returned a verdict in favor of the defendant, RJR Tobacco. The plaintiff alleged that as a result of using the defendant's products, the decedent, Elmer Baker, suffered from lung cancer. The plaintiff sought compensatory damages in excess of \$15,000, costs and interest. Final judgment was entered in January 2013, in favor of RJR Tobacco. The plaintiff filed a notice of appeal to the Fourth DCA and RJR Tobacco filed a notice of cross appeal in February 2013. Briefing is underway.

On September 20, 2012, in *Sikes v. R. J. Reynolds Tobacco Co.*, a case filed in December 2007, in the Circuit Court, Duval County, Florida, a jury returned a verdict in favor of the plaintiff, found the decedent, Jimmie Sikes, to be 49% at fault and RJR Tobacco to be 51% at fault, and awarded \$4.1 million in compensatory damages and \$2 million in punitive damages. The plaintiff alleged that as a result of using the defendant's product, the decedent suffered from chronic obstructive pulmonary disease. Post-trial motions were denied in January 2013. Final judgment has not been entered.

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

On October 17, 2012, in *James Smith v. R. J. Reynolds Tobacco Co.*, a case filed in August 2007, in the U.S. District Court for the Middle District of Florida, a jury returned a verdict in favor of the plaintiff, found the decedent, Wanette Smith, to be 45% at fault and RJR Tobacco to be 55% at fault, and awarded \$600,000 in compensatory damages and \$20,000 in punitive damages. The plaintiff alleged that as a result of using the defendant's products, the decedent suffered from lung cancer and chronic obstructive pulmonary disease. The plaintiff sought compensatory and punitive damages, costs and interest. Final judgment has not been entered, and post-trial motions are pending.

On October 18, 2012, in *Schlechter v. R. J. Reynolds Tobacco Co.*, a case filed in January 2008, in the Circuit Court, Hillsborough County, Florida, a jury returned a verdict in favor of the plaintiff, found the decedent, Beverly Schlechter, to be 50% at fault and RJR Tobacco to be 50% at fault, and awarded \$5 million in compensatory damages and \$2.5 million in punitive damages. The plaintiff alleged that as a result of using the defendant's products, the decedent suffered from chronic obstructive pulmonary disease and heart disease. The plaintiff sought compensatory and punitive damages, costs and interest. In April 2013, the court vacated the punitive damage award, granted a new trial on entitlement to punitive damages and the amount of any such damages and abated the new trial pending the Florida Supreme Court decision in *Soffer v. R. J. Reynolds Tobacco Co.*, described above. The plaintiff filed a motion to reconsider on April 11, 2013. A decision is pending.

On October 19, 2012, in *Ballard v. R. J. Reynolds Tobacco Co.*, a case filed in September 2007 in the Circuit Court, Miami-Dade County, Florida, a jury returned a verdict in favor of the plaintiff, found the plaintiff to be 45% at fault and RJR Tobacco to be 55% at fault, and awarded \$8.55 million in compensatory damages. Punitive damages were not at issue. The plaintiff alleged that as a result of using the defendant's products, he suffers from bladder cancer and emphysema. Post-trial motions are pending.

On October 25, 2012, in *Lock v. Philip Morris USA, Inc.*, a case filed in November 2007, in the Circuit Court, Pinellas County, Florida, a jury returned a verdict in favor of the plaintiff, found the plaintiff to be 82% at fault, RJR Tobacco to be 9% at fault and the remaining defendant to be 9% at fault, and awarded \$1.15 million in compensatory damages. Punitive damages were not at issue. The plaintiff alleged that as a result of using the defendant's products, he suffers from lung cancer. Final judgment was entered against RJR Tobacco and the remaining defendants in the amount of \$103,500 each. The defendants filed a joint notice of appeal and RJR Tobacco posted a supersedeas bond in the amount of \$103,500 in March 2013. Briefing is underway.

On December 12, 2012, in *Virginia Williams v. R. J. Reynolds Tobacco Co.*, a case filed in December 2007, in the Circuit Court, Miami-Dade County, Florida, a jury returned a verdict in favor of the plaintiff, found the decedent, Milton Williams, to be 15% at fault and RJR Tobacco to be 85% at fault, and awarded \$5 million in compensatory damages. Punitive damages were not sought. The plaintiff alleged that as a result of using the defendant's products, the decedent suffered from pharyngeal cancer. Final judgment was entered against RJR Tobacco in the amount of \$4.25 million in compensatory damages in January 2013. Post-trial motions are pending.

On February 5, 2013, in *Wilder v. R. J. Reynolds Tobacco Co.*, a case filed in August 2007, in the U.S. District Court for the Middle District of Florida, a jury returned a verdict in favor of the defendants. The plaintiff alleged that as a result of using the defendant's products, the decedent, Jane Hewett, became addicted and suffered from smoking-related diseases and/or conditions. Final judgment was entered in February 2013.

On February 11, 2013, in *Evers v. R. J. Reynolds Tobacco Co.*, a case filed in November 2007, in the Circuit Court, Hillsborough County, Florida, a jury returned a verdict in favor of the plaintiff, found the decedent, Jacqueline Loyd, to be 31% at fault, RJR Tobacco to be 60% at fault, and the remaining defendant to be 9% at fault, and awarded \$3.23 million in compensatory damages and \$12.36 million in punitive damages against RJR Tobacco only. The plaintiff alleged that as a result of using the defendant's products, the decedent became addicted and suffered from smoking-related diseases and/or conditions. In March 2013, the court granted the defendant's post-trial motions for directed verdict on fraudulent concealment, conspiracy and punitive damages. As a result, the \$12.36 million punitive damages award was set aside. The plaintiff's motion to reconsider directed verdict as to concealment, conspiracy and punitive damages was denied on April 8, 2013. The deadline to file a notice of appeal is May 8, 2013.

On February 13, 2013, in *Schoeff v. R. J. Reynolds Tobacco Co.*, a case filed in November 2007, in the Circuit Court, Broward County, Florida, a jury returned a verdict in favor of the plaintiff, found the decedent, James

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

Schoeff, to be 25% at fault, RJR Tobacco to be 75% at fault, and awarded \$10.5 million in compensatory damages and \$30 million in punitive damages. The plaintiff alleged that as a result of using the defendant's products, the decedent suffered from addiction and one or more smoking-related diseases and/or conditions, including lung cancer. In April 2013, final judgment was entered against RJR Tobacco in the amount of \$7.875 million in compensatory damages and \$30 million in punitive damages. RJR Tobacco expects to appeal and the deadline to file a notice of appeal is May 8, 2013.

On March 20, 2013, in *Giddens v. R. J. Reynolds Tobacco Co.*, a case filed in January 2008, in the U.S. District Court for the Middle District of Florida, a jury returned a verdict in favor of RJR Tobacco and the plaintiff and against the remaining defendant, found the decedent, Roger Giddens, to be 93% at fault and the remaining defendant to be 7% at fault and awarded \$80,000 in compensatory damages and no punitive damages. The plaintiff alleged that the decedent was addicted to cigarettes manufactured by the defendants which resulted in the decedent's death. In March 2013, final judgment was entered in favor of the plaintiff and RJR Tobacco, and against a co-defendant in the amount of \$5,600. In April 2013, the parties filed a joint stipulation of dismissal with prejudice. The parties agreed that the case is voluntarily dismissed with prejudice and that the judgment in the case is released and should be vacated.

On March 29, 2013, in *Fazekas v. R. J. Reynolds Tobacco Co.*, a case filed in January 2008, in the U.S. District Court for the Middle District of Florida, a jury returned a verdict in favor of the defendants, including RJR Tobacco. The plaintiff alleged that as a result of using the defendants' products, the decedent, Kenneth Kauffman, suffered from lung cancer. Final judgment was entered on April 11, 2013. The deadline to file a notice of appeal is May 13, 2013.

On April 1, 2013, in *Searcy v. R. J. Reynolds Tobacco Co.*, a case filed in January 2008, in the U.S. District Court for the Middle District of Florida, a jury returned a verdict in favor of the plaintiff, found the decedent, Carol LaSard, to be 40% at fault, RJR Tobacco to be 30% at fault and the remaining defendant to be 30% at fault, and awarded \$6 million in compensatory damages and \$10 million in punitive damages against each defendant. The plaintiff alleged that as a result of using the defendants' products, the decedent suffered from lung cancer. Final judgment has not been entered, and post-trial motions are pending.

On April 18, 2013, in *Anderson v. R. J. Reynolds Tobacco Co.*, a case pending in Hillsborough County, Florida, the court declared a mistrial due to the jury's inability to reach a decision. The plaintiff alleged that as a result of using the defendants' products, the decedent, Daniel Begley, suffered from esophageal cancer.

On April 18, 2013, in *Aycock v. R. J. Reynolds Tobacco Co.*, a case filed in January 2008, in the U.S. District Court for the Middle District of Florida, the jury returned a verdict in favor of the plaintiff, found the decedent, Richard Aycock, to be 27.5% at fault and RJR Tobacco to be 72.5% at fault, and awarded \$5.9 million in compensatory damages. Punitive damages were not awarded. The plaintiff alleged that the decedent was addicted to cigarettes manufactured by the defendant and, as a result, suffered from lung cancer. Final judgment has not been entered.

Broin II Cases

RJR Tobacco, B&W and other cigarette manufacturer defendants settled *Broin v. Philip Morris, Inc.* in October 1997. This case had been brought in Florida state court on behalf of flight attendants alleged to have suffered from diseases or ailments caused by exposure to ETS in airplane cabins. The settlement agreement required the participating tobacco companies to pay a total of \$300 million in three annual \$100 million installments, allocated among the companies by market share, to fund research on the early detection and cure of diseases associated with tobacco smoke. It also required those companies to pay a total of \$49 million for the plaintiffs' counsel's fees and expenses. RJR Tobacco's portion of these payments was approximately \$86 million; B&W's portion of these payments was approximately \$57 million. The settlement agreement bars class members from bringing aggregate claims or obtaining punitive damages and also bars individual claims to the extent that they are based on fraud, misrepresentation, conspiracy to commit fraud or misrepresentation, RICO, suppression, concealment or any other alleged intentional or willful conduct. The defendants agreed that, in any individual case brought by a class member, the defendant will bear the burden of proof with respect to whether ETS can cause certain specifically enumerated diseases, referred to as general causation. With respect to all other issues relating to liability, including whether an individual plaintiff's disease was caused by his or her exposure to ETS in airplane cabins, referred to as specific causation, the individual plaintiff will have the burden of proof. On September 7, 1999, the Florida Supreme Court approved the settlement. The *Broin II* cases arose out of the settlement of this case.

On October 5, 2000, the *Broin* court entered an order applicable to all *Broin II* cases that the terms of the *Broin* settlement agreement do not require the individual *Broin II* plaintiffs to prove the elements of strict liability, breach of warranty or negligence. Under this order, there is a

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

rebuttable presumption in the plaintiffs favor on those elements, and the plaintiffs bear the burden of proving that their alleged adverse health effects actually were caused by exposure to ETS in airplane cabins, that is, specific causation.

As of March 31, 2013, there were 2,573 *Broin II* lawsuits pending in Florida. There have been no *Broin II* trials since 2007.

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)***Class-Action Suits*

Overview. As of March 31, 2013, eight class-action cases were pending in the United States against RJR Tobacco or its affiliates or indemnitees. In 1996, the Fifth Circuit Court of Appeals in *Castano v. American Tobacco Co.* overturned the certification of a nation-wide class of persons whose claims related to alleged addiction to tobacco products. Since this ruling by the Fifth Circuit, most class-action suits have sought certification of state-wide, rather than nation-wide, classes. Class-action suits based on claims similar to those asserted in *Castano* or claims that class members are at a greater risk of injury or injured by the use of tobacco or exposure to ETS are pending against RJR Tobacco and its affiliates and indemnitees in state or federal courts in California, Illinois, Louisiana, Missouri, and West Virginia. All pending class-action cases are discussed below.

The pending class actions against RJR Tobacco or its affiliates or indemnitees include four cases alleging that the use of the term "lights" constitutes unfair and deceptive trade practices under state law or violates the federal RICO statute. Such suits are pending in state or federal courts in Illinois and Missouri and are discussed below under "Lights" Cases.

Finally, certain third-party payers have filed health-care cost recovery actions in the form of class actions. These cases are discussed below under "Health-Care Cost Recovery Cases."

Few smoker class-action complaints have been certified or, if certified, have survived on appeal. Eighteen federal courts, including two courts of appeals, and most state courts that have considered the issue have rejected class certification in such cases. Apart from the *Castano* case discussed above, only two smoker class actions have been certified by a federal court — *In re Simon (II) Litigation*, and *Schwab [McLaughlin] v. Philip Morris USA, Inc.*, both of which were filed in the U.S. District Court for the Eastern District of New York and ultimately decertified.

California Business and Professions Code Case. In *Sateriale v. R. J. Reynolds Tobacco Co.*, a class action filed in November 2009 in the U.S. District Court for the Central District of California, the plaintiffs brought the case on behalf of all persons who tried unsuccessfully to redeem Camel Cash certificates from 1991 through March 31, 2007, or who held Camel Cash certificates as of March 31, 2007. The plaintiffs allege that in response to the defendants' action to discontinue redemption of Camel Cash as of March 31, 2007, customers, like the plaintiffs, attempted to exchange their Camel Cash for merchandise and that the defendants, however, did not have any merchandise to exchange for Camel Cash. The plaintiffs allege unfair business practices, deceptive practices, breach of contract and promissory estoppel. The plaintiffs seek injunctive relief, actual damages, costs and expenses. In January 2010, the defendants filed a motion to dismiss, which prompted the plaintiffs to file an amended complaint in February 2010. The class definition changed to a class consisting of all persons who reside in the U.S. and tried unsuccessfully to redeem Camel Cash certificates, from October 1, 2006 (six months before the defendant ended the Camel Cash program) or who held Camel Cash certificates as of March 31, 2007. The plaintiffs also brought the class on behalf of a proposed California subclass, consisting of all California residents meeting the same criteria. In May 2010, RJR Tobacco's motion to dismiss the amended complaint for lack of jurisdiction over subject matter and, alternatively, for failure to state a claim was granted with leave to amend. The plaintiffs filed a second amended complaint. In July 2010, RJR Tobacco's motion to dismiss the second amended complaint was granted with leave to amend. The plaintiffs filed a third amended complaint, and RJR Tobacco filed a motion to dismiss in September 2010. In December 2010, the court granted RJR Tobacco's motion to dismiss with prejudice. Final judgment was entered by the court and the plaintiffs filed a notice of appeal in January 2011. In July 2012, the appellate court affirmed the dismissal of the plaintiffs' claims under the Unfair Competition Law and the Consumer Legal Remedies Acts and reversed the dismissal of the plaintiffs' claims for promissory estoppel and breach of contract. RJR Tobacco's motion for rehearing or rehearing en banc was denied in October 2012. RJR Tobacco filed its answer to the plaintiffs' third amended complaint in December 2012. Trial is scheduled for March 4, 2014.

Lights Cases. As noted above, "lights" class-action cases are pending against RJR Tobacco or B&W in Illinois (2) and Missouri (2). The classes in these cases generally seek to recover \$50,000 to \$75,000 per class member for compensatory and punitive damages, injunctive and other forms of relief, and attorneys' fees and costs from RJR Tobacco and/or B&W. In general, the plaintiffs allege that RJR Tobacco or B&W made false and misleading claims that "lights" cigarettes were lower in tar and nicotine and/or were less hazardous or less mutagenic than other cigarettes. The cases typically are filed pursuant to state consumer protection and related statutes.

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

Many of these lights cases were stayed pending review of the *Good v. Altria Group, Inc.* case by the U.S. Supreme Court. In that lights class-action case against Altria Group, Inc. and Philip Morris USA, the U.S. Supreme Court decided that these claims are not preempted by the Federal Cigarette Labeling and Advertising Act or by the Federal Trade Commission's, referred to as FTC, historic regulation of the industry. Since this decision in December 2008, a number of the stayed cases have become active again.

The seminal lights class-action case involves RJR Tobacco's competitor, Philip Morris, Inc. Trial began in *Price v. Philip Morris, Inc.* in January 2003. In March 2003, the trial judge entered judgment against Philip Morris in the amount of \$7.1 billion in compensatory damages and \$3 billion in punitive damages. Based on Illinois law, the bond required to stay execution of the judgment was set initially at \$12 billion. Philip Morris pursued various avenues of relief from the \$12 billion bond requirement. On December 15, 2005, the Illinois Supreme Court reversed the lower court's decision and sent the case back to the trial court with instructions to dismiss the case. On December 5, 2006, the trial court granted the defendant's motion to dismiss and for entry of final judgment. The case was dismissed with prejudice the same day. In December 2008, the plaintiffs filed a petition for relief from judgment, stating that the U.S. Supreme Court's decision in *Good v. Altria Group, Inc.* rejected the basis for the reversal. The trial court granted the defendant's motion to dismiss the plaintiffs' petition for relief from judgment in February 2009. In March 2009, the plaintiffs filed a notice of appeal to the Illinois Appellate Court, Fifth Judicial District, requesting a reversal of the February 2009 order and remand to the circuit court. On February 24, 2011, the appellate court entered an order, concluding that the two-year time limit for filing a petition for relief from a final judgment began to run when the trial court dismissed the plaintiffs' lawsuit on December 18, 2006. The appellate court therefore found that the petition was timely, reversed the order of the trial court, and remanded the case for further proceedings. Philip Morris filed a petition for leave to appeal to the Illinois Supreme Court. On September 28, 2011, the Illinois Supreme Court denied Philip Morris's petition for leave to appeal and returned the case to the trial court for further proceedings. In December 2012, the trial court denied the plaintiffs' petition for relief from the judgment. The plaintiffs filed a notice of appeal to the Illinois Appellate Court, Fifth Judicial District. Briefing is underway. Philip Morris filed a motion to transfer the plaintiff's appeal directly to the Illinois Supreme Court.

In *Turner v. R. J. Reynolds Tobacco Co.*, a case filed in February 2000 in Circuit Court, Madison County, Illinois, a judge certified a class in November 2001. In June 2003, RJR Tobacco filed a motion to stay the case pending Philip Morris's appeal of the *Price v. Philip Morris Inc.* case mentioned above, which the judge denied in July 2003. In October 2003, the Illinois Fifth District Court of Appeals denied RJR Tobacco's emergency stay/supremacy order request. In November 2003, the Illinois Supreme Court granted RJR Tobacco's motion for a stay pending the court's final appeal decision in *Price*. On October 11, 2007, the Illinois Fifth District Court of Appeals dismissed RJR Tobacco's appeal of the court's denial of its emergency stay/supremacy order request and remanded the case to the Circuit Court. A status conference is scheduled for May 29, 2013.

In *Howard v. Brown & Williamson Tobacco Corp.*, another case filed in February 2000 in Circuit Court, Madison County, Illinois, a judge certified a class in December 2001. In June 2003, the trial judge issued an order staying all proceedings pending resolution of the *Price v. Philip Morris, Inc.* case mentioned above. The plaintiffs appealed this stay order to the Illinois Fifth District Court of Appeals, which affirmed the Circuit Court's stay order in August 2005. There is currently no activity in the case.

A lights class-action case is pending against each of RJR Tobacco and B&W in Missouri. In *Collora v. R. J. Reynolds Tobacco Co.*, a case filed in May 2000 in Circuit Court, St. Louis County, Missouri, a judge in St. Louis certified a class in December 2003. In April 2007, the court granted the plaintiffs' motion to reassign *Collora* and the following cases to a single general division: *Craft v. Philip Morris Companies, Inc.* and *Black v. Brown & Williamson Tobacco Corp.*, discussed below. In April 2008, the court stayed the case pending U.S. Supreme Court review in *Good v. Altria Group, Inc.* A nominal trial date of January 10, 2011 was scheduled, but it did not proceed at that time. A status conference is scheduled for February 3, 2014.

Finally, in *Black v. Brown & Williamson Tobacco Corp.*, a case filed in November 2000 in Circuit Court, City of St. Louis, Missouri, B&W removed the case to the U.S. District Court for the Eastern District of Missouri. The plaintiffs filed a motion to remand, which was granted in March 2006. In April 2008, the court stayed the case pending U.S. Supreme Court review in *Good v. Altria Group, Inc.* A nominal trial date of January 10, 2011, was scheduled, but it did not proceed at that time. A status conference is scheduled for February 3, 2014.

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

In the event RJR Tobacco and its affiliates or indemnitees lose one or more of the pending lights class-action suits, RJR Tobacco could face bonding difficulties depending upon the amount of damages ordered, if any, which could have a material adverse effect on RJR Tobacco's, and consequently RAI's, results of operations, cash flows or financial position.

Other Class Actions. In *Young v. American Tobacco Co., Inc.*, a case filed in November 1997 in Circuit Court, Orleans Parish, Louisiana, the plaintiffs brought an ETS class action against U.S. cigarette manufacturers, including RJR Tobacco and B&W, and parent companies of U.S. cigarette manufacturers, including RJR, on behalf of all residents of Louisiana who, though not themselves cigarette smokers, have been exposed to secondhand smoke from cigarettes which were manufactured by the defendants, and who allegedly suffered injury as a result of that exposure. The plaintiffs seek to recover an unspecified amount of compensatory and punitive damages. In March 2013, the court entered an order staying the case, including all discovery, pending the implementation of the smoking cessation program ordered by the court in *Scott v. The American Tobacco Co.*

In *Parsons v. A C & S, Inc.*, a case filed in February 1998 in Circuit Court, Ohio County, West Virginia, the plaintiff sued asbestos manufacturers, U.S. cigarette manufacturers, including RJR Tobacco and B&W, and parent companies of U.S. cigarette manufacturers, including RJR, seeking to recover \$1 million in compensatory and punitive damages individually and an unspecified amount for the class in both compensatory and punitive damages. The class was brought on behalf of persons who allegedly have personal injury claims arising from their exposure to respirable asbestos fibers and cigarette smoke. The plaintiffs allege that Mrs. Parsons' use of tobacco products and exposure to asbestos products caused her to develop lung cancer and to become addicted to tobacco. In December 2000, three defendants, Nitral Liquidators, Inc., Desseaux Corporation of North American and Armstrong World Industries, filed bankruptcy petitions in the U.S. Bankruptcy Court for the District of Delaware, *In re Armstrong World Industries, Inc.* Pursuant to section 362(a) of the Bankruptcy Code, *Parsons* is automatically stayed with respect to all defendants.

Finally, in *Jones v. American Tobacco Co., Inc.*, a case filed in December 1998 in Circuit Court, Jackson County, Missouri, the defendants removed the case to the U.S. District Court for the Western District of Missouri in February 1999. The action was brought against the major U.S. cigarette manufacturers, including RJR Tobacco and B&W, and parent companies of U.S. cigarette manufacturers, including RJR, by tobacco product users and purchasers on behalf of all similarly situated Missouri consumers. The plaintiffs allege that their use of the defendants' tobacco products has caused them to become addicted to nicotine. The plaintiffs seek to recover an unspecified amount of compensatory and punitive damages. The case was remanded to the Circuit Court in February 1999. There is currently no activity in this case.

Health-Care Cost Recovery Cases

Health-care cost recovery cases have been brought by a variety of plaintiffs. Other than certain governmental actions, these cases largely have been unsuccessful on remoteness grounds, which means that one who pays an injured person's medical expenses is legally too remote to maintain an action against the person allegedly responsible for the injury.

As of March 31, 2013, two health-care cost recovery cases were pending in the United States against RJR Tobacco, B&W, as its indemnitee, or both, as discussed below after the discussion of the State Settlement Agreements. A limited number of claimants have filed suit against RJR Tobacco, its current or former affiliates, B&W and other tobacco industry defendants to recover funds for health care, medical and other assistance paid by foreign provincial governments in treating their citizens. For additional information on these cases, see International Cases below.

State Settlement Agreements. In June 1994, the Mississippi Attorney General brought an action, *Moore v. American Tobacco Co.*, against various industry members, including RJR Tobacco and B&W. This case was brought on behalf of the state to recover state funds paid for health care and other assistance to state citizens suffering from diseases and conditions allegedly related to tobacco use. Most other states, through their attorneys general or other state agencies, sued RJR Tobacco, B&W and other U.S. cigarette manufacturers based on similar theories. The cigarette manufacturer defendants, including RJR Tobacco and B&W, settled the first four of these cases scheduled for trial in Mississippi, Florida, Texas and Minnesota by separate agreements with each such state.

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

On November 23, 1998, the major U.S. cigarette manufacturers, including RJR Tobacco and B&W, entered into the Master Settlement Agreement with attorneys general representing the remaining 46 states, the District of Columbia, Puerto Rico, Guam, the Virgin Islands, American Samoa and the Northern Marianas. Effective on November 12, 1999, the MSA settled all the health-care cost recovery actions brought by, or on behalf of, the settling jurisdictions and released various additional present and future claims.

In the settling jurisdictions, the MSA released RJR Tobacco, B&W, and their affiliates and indemnitees, including RAI, from:

all claims of the settling states and their respective political subdivisions and other recipients of state health-care funds, relating to past conduct arising out of the use, sale, distribution, manufacture, development, advertising, marketing or health effects of, the exposure to, or research, statements or warnings about, tobacco products; and

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

Set forth below are tables depicting the unadjusted tobacco industry settlement payment schedule and the settlement payment schedule for RAI's operating subsidiaries under the State Settlement Agreements, and related information for 2011 and beyond:

Unadjusted Original Participating Manufacturers Settlement Payment Schedule

	2011	2012	2013	2014 - 2016	2017	Thereafter
First Four States Settlement ⁽¹⁾						
Mississippi Annual Payment	\$ 136	\$ 136	\$ 136	\$ 136	\$ 136	\$ 136
Florida Annual Payment	440	440	440	440	440	440
Texas Annual Payment	580	580	580	580	580	580
Minnesota Annual Payment	204	204	204	204	204	204
Remaining States Settlement: Annual Payments ⁽¹⁾	8,004	8,004	8,004	8,004	8,004	8,004
Total	\$ 9,364	\$ 9,364	\$ 9,364	\$ 9,364	\$ 9,364	\$ 9,364

RAI's Operating Subsidiaries Settlement Expenses and Payment Schedule

Settlement expenses	\$ 2,435	\$ 2,370				
Settlement cash payments	\$ 2,492	\$ 2,414				
Projected settlement expenses			\$ >1,800	\$ >2,000	\$ >2,300	\$ >2,300
Projected settlement cash payments			\$ >2,500	\$ >2,000	\$ >2,000	\$ >2,300

⁽¹⁾ Subject to adjustments for changes in sales volume, inflation and other factors. All payments are to be allocated among the companies on the basis of relative market share. For further information, see State Settlement Agreements-Enforcement and Validity; Adjustments below.

The State Settlement Agreements also contain provisions restricting the marketing of tobacco products. Among these provisions are restrictions or prohibitions on the use of cartoon characters, brand-name sponsorships, apparel and other merchandise, outdoor and transit advertising, payments for product placement, free sampling and lobbying. Furthermore, the State Settlement Agreements required the dissolution of three

industry-sponsored research and trade organizations.

The State Settlement Agreements have materially adversely affected RJR Tobacco's shipment volumes. RAI believes that these settlement obligations may materially adversely affect the results of operations, cash flows or financial position of RAI and RJR Tobacco in future periods. The degree of the adverse impact will depend, among other things, on the rate of decline in U.S. cigarette sales in the premium and value categories, RJR Tobacco's share of the domestic premium and value cigarette categories, and the effect of any resulting cost advantage of manufacturers not subject to the State Settlement Agreements.

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

U.S. Department of Justice Case. On September 22, 1999, in *United States v. Philip Morris USA Inc.*, the U.S. Department of Justice brought an action against RJR Tobacco, B&W and other tobacco companies in the U.S. District Court for the District of Columbia. The government initially sought to recover federal funds expended by the federal government in providing health care to smokers who developed diseases and injuries alleged to be smoking-related, based on several federal statutes. In addition, the government sought, pursuant to the civil provisions of RICO, disgorgement of profits the government contends were earned as a consequence of a RICO racketeering enterprise. In September 2000, the court dismissed the government's claims asserted under the Medical Care Recovery Act as well as those under the Medicare Secondary Payer provisions of the Social Security Act, but did not dismiss the RICO claims. In February 2005, the U.S. Court of Appeals for the District of Columbia ruled that disgorgement is not an available remedy in this case. The government's petition for writ of certiorari with the U.S. Supreme Court was denied in October 2005. The non-jury, bench trial began in September 2004, and closing arguments concluded in June 2005.

On August 17, 2006, the court found certain defendants, including RJR Tobacco and B&W, liable for the RICO claims, but did not impose any direct financial penalties. The court instead enjoined the defendants from committing future racketeering acts, participating in certain trade organizations, making misrepresentations concerning smoking and health and youth marketing, and using certain brand descriptors such as low tar, light, ultra light, mild and natural. The court also ordered defendants to issue corrective communications on five subjects, including smoking and health and addiction, and to comply with further undertakings, including maintaining web sites of historical corporate documents and disseminating certain marketing information on a confidential basis to the government. In addition, the court placed restrictions on the ability of the defendants to dispose of certain assets for use in the United States, unless the transferee agrees to abide by the terms of the court's order, and ordered the defendants to reimburse the U.S. Department of Justice its taxable costs incurred in connection with the case.

Certain defendants, including RJR Tobacco, filed notices of appeal to the U.S. Court of Appeals for the District of Columbia in September 2006. The government filed its notice of appeal in October 2006. In addition, the defendants, including RJR Tobacco, filed joint motions asking the district court to clarify and to stay its order pending the defendants' appeal. On September 28, 2006, the district court denied the defendants' motion to stay. On September 29, 2006, the defendants, including RJR Tobacco, filed a motion asking the court of appeals to stay the district court's order pending the defendants' appeal. The court granted the motion in October 2006.

In November 2006, the court of appeals stayed the appeals pending the trial court's ruling on the defendants' motion for clarification. The defendants' motion was granted in part and denied in part. The defendants' motion as to the meaning and applicability of the general injunctive relief of the August 2006 order was denied. The request for clarification as to the scope of the provisions in the order prohibiting the use of descriptors and requiring corrective statements at retail point of sale was granted. The court also ruled that the provisions prohibiting the use of express or implied health messages or descriptors do apply to the actions of the defendants taken outside of the United States.

In May 2009, the U.S. Court of Appeals largely affirmed the finding of liability against the tobacco defendants and remanded to the trial court for dismissal of the trade organizations. The court also largely affirmed the remedial order, including the denial of additional remedies, but vacated the order and remanded for further proceedings as to the following four discrete issues:

the issue of the extent of Brown & Williamson Holdings' control over tobacco operations was remanded for further fact finding and clarification;

the remedial order was vacated to the extent that it binds all defendants' subsidiaries and was remanded to the lower court for determination as to whether inclusion of the subsidiaries and which of the subsidiaries satisfy Rule 65(d) of the Federal Rules of Civil Procedure;

the court held that the provision found in paragraph four of the injunction, concerning the use of any express or implied health message or health descriptor for any cigarette brand, should not be read to govern overseas sales. The issue was remanded to the lower court with instructions to reformulate it so as to exempt foreign activities that have no substantial, direct and foreseeable domestic effects; and

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

the remedial order was vacated regarding point of sale displays and remanded for the district court to evaluate and make due provisions for the rights of innocent persons, either by abandoning this part of the remedial order or re-crafting a new version reflecting the rights of third parties.

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

RJR Tobacco and the other defendants, as well as the Department of Justice, filed petitions for writ of certiorari to the U.S. Supreme Court in February 2010. In June 2010, the U.S. Supreme Court denied the parties' petitions for writ of certiorari. Post-remand proceedings are underway to determine the extent to which the original order will be implemented. The defendants filed a motion for vacatur, in which they moved to vacate the trial court's injunctions and factual findings and dismiss the case in its entirety, on March 3, 2011. The court denied the motion on June 1, 2011. The defendants filed a notice of appeal. In addition, the parties to the lawsuit entered into an agreement concerning certain technical obligations regarding their public websites. Pursuant to this agreement, RJR Tobacco agreed to deposit \$3.125 million over the next three years into the registry of the district court. In July 2012, the Court of Appeals for the D.C. Circuit affirmed the trial court's denial of the defendants' motion to vacate the injunctions. In November 2012, the trial court entered an order wherein the court determined the language to be included in the text of the corrective statements and directed the parties to engage in discussions with the Special Master to implement them. The defendants filed a notice of appeal on January 25, 2013. In February 2013, the court granted the defendants' motion to hold the case in abeyance pending the District Court's resolution of corrective statement implementation issues.

Native American Tribe Case. As of March 31, 2013, one Native American tribe case was pending before a tribal court against RJR Tobacco and B&W, *Crow Creek Sioux Tribe v. American Tobacco Co.*, a case filed in September 1997 in Tribal Court, Crow Creek Sioux, South Dakota. The plaintiffs seek to recover actual and punitive damages, restitution, funding of a clinical cessation program, funding of a corrective public education program, and disgorgement of unjust profits from sales to minors. The plaintiffs claim that the defendants are liable under the following theories: unlawful marketing and targeting of minors, contributing to the delinquency of minors, unfair and deceptive acts or practices, unreasonable restraint of trade and unfair method of competition, negligence, negligence per se, conspiracy and restitution of unjust enrichment. The case is dormant.

International Cases. Nine health-care reimbursement cases have been filed against RJR Tobacco, its current or former affiliates, or B&W outside the United States, by nine Canadian provinces. The remaining Canadian province, the Province of Nova Scotia, has indicated an intention to file a similar case. In these actions, foreign governments are seeking to recover for health care, medical and other assistance paid and to be paid in treating their citizens for tobacco-related disease. No such actions are pending in the United States. Pursuant to the terms of the 1999 sale of RJR Tobacco's international tobacco business, RJR Tobacco has tendered the defense of these actions to JTI. Subject to a reservation of rights, JTI has assumed the defense of RJR Tobacco and its current or former affiliates.

British Columbia In 1997, British Columbia enacted a statute, subsequently amended, which created a civil cause of action for the government to recover the costs of health-care benefits incurred for insured populations of British Columbia residents resulting from tobacco-related disease. An action brought on behalf of the Province of British Columbia pursuant to the statute against Canadian and non-Canadian tobacco-related entities, including RJR Tobacco and certain of its affiliates, was dismissed in February 2000 when the British Columbia Supreme Court ruled that the legislation was unconstitutional and set aside service ex juris against the foreign defendants for that reason. British Columbia then enacted a revised statute, pursuant to which an action was filed in January 2001 against many of the same defendants, including RJR Tobacco and one of its affiliates, in Supreme Court, British Columbia. In that action, the British Columbia government seeks to recover the present value of its total expenditures for health-care benefits provided for insured persons resulting from tobacco-related disease or the risk of tobacco-related disease caused by alleged breaches of duty by the manufacturers, the present value of its estimated total expenditures for health-care benefits that reasonably could be expected to be provided for those insured persons resulting from tobacco-related disease or the risk of tobacco-related disease in the future, court ordered interest, and costs, or in the alternative, special or increased costs. The government alleges that the defendants are liable under the British Columbia statute by reason of their tobacco related wrongs, which are alleged to include: selling defective products, failure to warn, sale of cigarettes to children and adolescents, illegal importation, strict liability, deceit and misrepresentation, violation of trade practice and competition acts, concerted action, and joint liability. RJR Tobacco and its affiliate filed statements of defense in January 2007. In February 2010, the trial date was adjourned, and no new date has been set.

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

New Brunswick In March 2008, a case was filed on behalf of Her Majesty the Queen in Right of the Province of New Brunswick, Canada, against Canadian and non-Canadian tobacco-related entities, including RJR Tobacco's predecessor and one of RJR Tobacco's affiliates, in the Trial Division in the Court of Queen's Bench of New Brunswick. The claim is brought pursuant to New Brunswick legislation enacted in 2008, which legislation is substantially similar to the revised British Columbia statute described above. In this action, the New Brunswick government seeks to recover essentially the same types of damages that are being sought in the British Columbia action described above based on analogous theories of liability. RJR Tobacco and its affiliate filed statements of defense in March 2010.

Ontario In September 2009, a case was filed on behalf of the Province of Ontario, Canada, against Canadian and non-Canadian tobacco-related entities, including RJR Tobacco and one of its affiliates, in the Ontario Superior Court of Justice. The claim is brought pursuant to Ontario legislation enacted in 2009, which legislation is substantially similar to the revised British Columbia statute described above. In this action, the Ontario government seeks to recover essentially the same types of damages that are being sought in the British Columbia and New Brunswick actions described above based on analogous theories of liability, although the government also asserted claims based on the illegal importation of cigarettes, which claims were deleted in an amended statement of claim filed in August 2010. The jurisdictional challenge brought by RJR Tobacco and its affiliate was denied by the motions court on January 4, 2012, and RJR Tobacco and its affiliate have filed an appeal.

Newfoundland and Labrador In February 2011, a case was filed on behalf of the Province of Newfoundland and Labrador, Canada against Canadian and non-Canadian tobacco-related entities, including RJR Tobacco and one of its affiliates, in the General Trial Division of the Supreme Court of Newfoundland and Labrador. The claim is brought pursuant to legislation passed in Newfoundland in 2001 and proclaimed in February 2011, which legislation is substantially similar to the revised British Columbia statute described above. In this action, the Newfoundland government seeks to recover essentially the same types of damages that are being sought in the British Columbia and other provincial actions described above based on analogous theories of liability. RJR Tobacco and its affiliate have brought a motion challenging the jurisdiction of the Newfoundland court. A decision is pending.

Quebec In June 2012, a case was filed on behalf of the Province of Quebec, Canada, against Canadian and non-Canadian tobacco-related entities, including RJR Tobacco and one of its affiliates, in the Superior Court of the Province of Quebec, District of Montreal. The claim is brought pursuant to legislation enacted in Quebec in 2009, which legislation is substantially similar to the revised British Columbia statute described above. In this action, the Quebec government seeks to recover essentially the same types of damages that are being sought in the British Columbia and other provincial actions described above based on analogous theories of liability. RJR Tobacco and its affiliate have brought a motion challenging the jurisdiction of the Quebec court. Separately, in August 2009, certain Canadian manufacturers filed a constitutional challenge to the Quebec statute, and that challenge is pending.

Manitoba In May 2012, a case was filed on behalf of the Province of Manitoba, Canada, against Canadian and non-Canadian tobacco-related entities, including RJR Tobacco and one of its affiliates, in the Court of Queen's Bench, Winnipeg Judicial Centre, Manitoba. The claim is brought pursuant to legislation assented to in 2006 and proclaimed in 2012, which legislation is substantially similar to the revised British Columbia statute described above. In this action, the Manitoba government seeks to recover essentially the same types of damages that are being sought in the British Columbia and other provincial actions described above based on analogous theories of liability. RJR Tobacco and its affiliate have brought a motion challenging the jurisdiction of the Manitoba court.

Saskatchewan In June 2012, a case was filed on behalf of the Province of Saskatchewan, Canada, against Canadian and non-Canadian tobacco-related entities, including RJR Tobacco and one of its affiliates, in the Court of Queen's Bench, Judicial Centre of Saskatoon, Saskatchewan. The claim is brought pursuant to legislation assented to in 2007 and proclaimed in 2012,

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

which legislation is substantially similar to the revised British Columbia statute described above. In this action, the Saskatchewan government seeks to

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

recover essentially the same types of damages that are being sought in the British Columbia and other provincial actions described above based on analogous theories of liability. RJR Tobacco and its affiliate have brought a motion challenging the jurisdiction of the Saskatchewan court.

Alberta In June 2012, a case was filed on behalf of the Province of Alberta, Canada, against Canadian and non-Canadian tobacco-related entities, including RJR Tobacco and one of its affiliates, in the Court of Queen's Bench of Alberta Judicial Centre, Calgary, Alberta. The claim is brought pursuant to legislation assented to in 2009 and proclaimed in 2012, which legislation is substantially similar to the revised British Columbia statute described above. In this action, the Alberta government seeks to recover essentially the same types of damages that are being sought in the British Columbia and other provincial actions described above based on analogous theories of liability.

Prince Edward Island In September 2012, a case was filed on behalf of the Province of Prince Edward Island, Canada, against Canadian and non-Canadian tobacco-related entities, including RJR Tobacco and one of its affiliates, in the Supreme Court of Prince Edward Island (General Section), Charlottetown, Prince Edward Island. The claim is brought pursuant to legislation assented to in 2009 and proclaimed in 2012, which legislation is substantially similar to the revised British Columbia statute described above. In this action, the Prince Edward Island government seeks to recover essentially the same types of damages that are being sought in the British Columbia and other provincial actions described above based on analogous theories of liability. RJR Tobacco and its affiliate have brought a motion challenging the jurisdiction of the Prince Edward Island court.

The following seven putative Canadian class actions were filed against various Canadian and non-Canadian tobacco-related entities, including RJR Tobacco and one of its affiliates, in courts in the Provinces of Alberta, British Columbia, Manitoba, Nova Scotia, Ontario and Saskatchewan, although the plaintiffs' counsel have been actively pursuing only the action pending in Saskatchewan at this time:

In Adams v. Canadian Tobacco Manufacturers' Council, a case filed in July 2009 in the Court of Queen's Bench for Saskatchewan against Canadian and non-Canadian tobacco-related entities, including RJR Tobacco and one of its affiliates, the plaintiffs brought the case on behalf of all individuals who were alive on July 10, 2009, and who have suffered, or who currently suffer, from chronic obstructive pulmonary disease, emphysema, heart disease or cancer, after having smoked a minimum of 25,000 cigarettes designed, manufactured, imported, marketed or distributed by the defendants.

In Dorion v. Canadian Tobacco Manufacturers' Council, a case filed in June 2009, in the Court of Queen's Bench of Alberta against Canadian and non-Canadian tobacco-related entities, including RJR Tobacco and one of its affiliates, the plaintiffs brought the case on behalf of all individuals, including their estates, dependents and family members, who purchased or smoked cigarettes designed, manufactured, marketed or distributed by the defendants.

In Kunka v. Canadian Tobacco Manufacturers' Council, a case filed in 2009 in the Court of Queen's Bench of Manitoba against Canadian and non-Canadian tobacco-related entities, including RJR Tobacco and one of its affiliates, the plaintiffs brought the case on behalf of all individuals, including their estates, and their dependents and family members, who purchased or smoked cigarettes manufactured by the defendants.

In Semple v. Canadian Tobacco Manufacturers' Council, a case filed in June 2009 in the Supreme Court of Nova Scotia against Canadian and non-Canadian tobacco-related entities, including RJR Tobacco and one of its affiliates, the plaintiffs brought the case on behalf of all individuals, including their estates, dependents and family members, who purchased or smoked cigarettes designed, manufactured, marketed or distributed by the defendants for the period of January 1, 1954, to the expiry of the opt out period as set by the court.

In *Bourassa v. Imperial Tobacco Canada Limited*, a case filed in June 2010 in the Supreme Court of British Columbia against Canadian and non-Canadian tobacco-related entities, including RJR Tobacco and one of its affiliates, the plaintiffs brought the case on behalf of all individuals, including their estates, who were alive on June 12, 2007, and who have suffered, or who currently suffer from chronic respiratory diseases, after having smoked a minimum of 25,000 cigarettes designed, manufactured, imported, marketed, or distributed by the defendants.

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

In *McDermid v. Imperial Tobacco Canada Limited*, a case filed in June 2010 in the Supreme Court of British Columbia against Canadian and non-Canadian tobacco-related entities, including RJR Tobacco and one of its affiliates, the plaintiffs brought the case on behalf of all individuals, including their estates, who were alive on June 12, 2007, and who have suffered, or who currently suffer from heart disease, after having smoked a minimum of 25,000 cigarettes designed, manufactured, imported, marketed, or distributed by the defendants.

In *Jacklin v. Canadian Tobacco Manufacturers Council*, a case filed in June 2012 in the Ontario Superior Court of Justice against Canadian and non-Canadian tobacco-related entities, including RJR Tobacco and one of its affiliates, the plaintiffs brought the case on behalf of all individuals, including their estates, who were alive on June 12, 2007, and who have suffered, or who currently suffer from chronic obstructive pulmonary disease, heart disease, or cancer, after having smoked a minimum of 25,000 cigarettes designed, manufactured, imported, marketed, or distributed by the defendants.

In each of these seven cases, the plaintiffs allege fraud, fraudulent concealment, breach of warranty, breach of warranty of merchantability and of fitness for a particular purpose, failure to warn, design defects, negligence, breach of a special duty to children and adolescents, conspiracy, concert of action, unjust enrichment, market share liability, joint liability, and violations of various trade practices and competition statutes. The plaintiffs seek compensatory and aggravated damages; punitive or exemplary damages; the right to waive the torts described above and claim disgorgement of the amount of revenues or profits the defendants received from the sale of tobacco products to putative class members; interest pursuant to the Pre-judgment Interest Act and other similar legislation; and other relief the court deems just. Pursuant to the terms of the 1999 sale of RJR Tobacco's international tobacco business, RJR Tobacco has tendered the defense of these seven actions to JTI. Subject to a reservation of rights, JTI has assumed the defense of RJR Tobacco and its current or former affiliates in these actions.

State Settlement Agreements-Enforcement and Validity; Adjustments

As of March 31, 2013, there were 31 cases concerning the enforcement, validity or interpretation of the State Settlement Agreements in which RJR Tobacco or B&W is a party. This number includes those cases, discussed below, relating to disputed payments under the State Settlement Agreements.

The Vermont Attorney General filed suit in July 2005, in the Vermont Superior Court, Chittenden County, alleging that certain advertising for the Eclipse cigarette brand violated both the MSA and the Vermont Consumer Fraud Statute. The State of Vermont is seeking declaratory, injunctive, and monetary relief. The bench trial in this action began on October 6, 2008, and lasted a total of five weeks. Closing arguments occurred on March 11, 2009. On March 10, 2010, the court issued its opinion, finding that three of the advertising claims made by RJR Tobacco were not supported by the appropriate degree of scientific evidence. The court did, however, rule that the remaining six advertising claims challenged by the State of Vermont were not actionable. The court indicated that remedies and any damages to be awarded, as well as the issue of attorney's fees and litigation expenses, will be addressed in additional proceedings. On March 22, 2010, RJR Tobacco filed a motion to amend findings of fact that it believes are demonstrably contrary to, or unsupported by, the record. On December 14, 2010, the court issued an order granting in part and denying in part RJR Tobacco's motion. The parties conducted a mediation on the remaining issues on February 14, 2012, but failed to reach an agreement. On April 6, 2012, the court entered a stipulated scheduling order outlining a schedule for pre-trial briefs on the relief/remedies sought by the State. That briefing was completed on September 26, 2012. A hearing on the remedies sought by the State occurred on March 4, 2013. A decision is pending.

In April 2005, the Mississippi Attorney General notified B&W of its intent to seek approximately \$3.9 million in additional payments under the Mississippi Settlement Agreement. The Mississippi Attorney General asserts that B&W failed to report in its net operating profit or its shipments, cigarettes manufactured by B&W under contract for Star Tobacco or its parent, Star Scientific, Inc. B&W advised the State that it did not owe the state any money. In August 2005, the Mississippi Attorney General filed in the Chancery Court of Jackson County, Mississippi, a Notice of Violation, Motion to Enforce Settlement Agreement, and Request for an Accounting by Defendant Brown & Williamson Holdings, Inc., formerly known as Brown & Williamson Tobacco Corporation. In this filing,

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

Mississippi estimated that its damages exceeded \$5.0 million. On August 24, 2011, the court entered an order finding in favor of the State on the Star contract manufacturing issue, that the total amount of the underpayment from B&W was approximately \$3.8 million and that interest on the underpayment was approximately \$4.3 million. The court also appointed a special master to undertake an accounting of the benefit received by B&W for failure to include its profits from Star contract manufacturing in its net operating profits reported to the State. Finally, the court awarded the State attorneys' fees and costs in an amount to be determined. B&W filed a motion to certify the Star contract issue for interlocutory appeal, pursuant to Rule 54 (b) of the Mississippi Rules of Civil Procedure. On January 9, 2012, that motion was denied.

In addition, in February 2010, the Mississippi Attorney General filed a motion alleging that RJR Tobacco had improperly failed to report shipments of certain categories of cigarette volumes, and for certain years had improperly reported its net operating profit. As a result, the State alleges that settlement payments to it were improperly reduced. RJR Tobacco disputes these allegations and is vigorously defending against them. Hearings on these issues were held on January 24-25, 2012, and May 9, 2012. On May 15, 2012, the court entered an order finding in favor of RJR Tobacco on the claim related to RJR Tobacco's reported net operating profits in the year used as a baseline for future calculations of the State's net operating profits payment. The State had sought \$3.8 million in damages for this issue, with an additional \$2.7 million in interest. On June 19, 2012, the court entered an order finding in favor of the State on the remaining issues, holding that the total amount of the underpayment was approximately \$3.3 million and that interest on the underpayment was also approximately \$3.3 million, though the court also held that this amount should be offset by additional payments previously made by Lorillard Tobacco Company on some of these issues. The court further ordered RJR Tobacco to perform an accounting of its profits and shipments from 1999-2011. Finally, the court awarded the State attorneys' fees and costs in an amount to be determined. On July 10, 2012, RJR Tobacco filed a petition with the Mississippi Supreme Court requesting leave to immediately appeal the court's ordered accounting and its entry of judgment for the State without first conducting an evidentiary hearing. On August 15, 2012, the request was denied. An accountant acceptable to both the State and RJR Tobacco has been identified and retained, and the accounting process is now underway.

In May 2006, the State of Florida filed a motion, in the Circuit Court of the Fifteenth Judicial Circuit, in and for Palm Beach County, Florida, to enforce the Settlement Agreement, for an Accounting by Brown & Williamson Holdings, Inc., and for an Order of Contempt, raising substantially the same issues as raised by the Mississippi Attorney General and seeking approximately \$12.4 million in additional payments under the Florida Settlement Agreement, as well as \$17.0 million in interest payments. This matter is currently in the discovery phase.

In December 2007, nine states sued RJR Tobacco claiming that an advertisement published in Rolling Stone magazine the prior month violated the MSA's ban on the use of cartoons. The states asserted that the magazine's content adjacent to a Camel gatefold advertisement included cartoon images prohibited by the MSA and that certain images used in the Camel advertisement itself were prohibited cartoons. Each state sought injunctive relief and punitive monetary sanctions. Eight of the nine courts have since ruled that the states are not entitled to the punitive sanctions being sought. There has been resolution of all of the cases except for California.

The court in California ruled that the company was not liable for preventing the use of cartoons in magazine-created content next to the RJR Tobacco advertisement, but that a few of the images in the RJR Tobacco advertisement itself were technical and unintentional cartoons. No monetary sanctions were awarded by the California court. The California Court of Appeals affirmed the judgment on the merits. In April 2011, the California Court of Appeals reversed the trial court's award of attorneys' fees to the State and remanded the case to the trial court with instructions to use the correct legal standard and prevailing market rates in determining the award of fees to either party. A final order was issued on October 6, 2011, finding the State to be the prevailing party for purposes of entitlement to attorneys' fees. On March 22, 2012, the court entered an order granting the State's request for approximately \$3 million in attorneys' fees. RJR Tobacco filed a notice of appeal in April 2012. Oral argument occurred on April 11, 2013. A decision is pending.

Table of Contents

Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)

NPM Adjustment. The MSA includes an adjustment that potentially reduces the annual payment obligations of RJR Tobacco and the other PMs. Certain requirements, collectively referred to as the Adjustment Requirements, must be satisfied before the NPM Adjustment for a given year is available:

an independent auditor designated under the MSA must determine that the PMs have experienced a market share loss beyond a triggering threshold to those manufacturers that do not participate in the MSA, such non-participating manufacturers referred to as NPMs; and

in a binding arbitration proceeding, a firm of independent economic consultants must find that the disadvantages of the MSA were a significant factor contributing to the loss.

When the Adjustment Requirements are satisfied, the MSA provides that the NPM Adjustment applies to reduce the annual payment obligation of the PMs. However, an individual settling state may avoid its share of the NPM Adjustment if it had in place and diligently enforced during the entirety of the relevant year a Qualifying Statute that imposes escrow obligations on NPMs that are comparable to what the NPMs would have owed if they had joined the MSA. In such event, the state's share of the NPM Adjustment is reallocated to other settling states, if any, that did not have in place and diligently enforce a Qualifying Statute.

NPM Adjustment Claim for 2003. For 2003, the Adjustment Requirements were satisfied. As a result, in April 2006, RJR Tobacco placed approximately \$647 million of its MSA payment into a disputed payments account, in accordance with a procedure established by the MSA. That amount represented RJR Tobacco's share of the 2003 NPM Adjustment as calculated by the MSA independent auditor. In March 2007, the independent auditor issued revised calculations that reduced RJR Tobacco's share of the NPM Adjustment for 2003 to approximately \$615 million. As a result, in April 2007, RJR Tobacco instructed the independent auditor to release to the settling states approximately \$32 million from the disputed payments account.

Following RJR Tobacco's payment of a portion of its 2006 MSA payment into the disputed payments account, 37 of the settling states filed legal proceedings in their respective MSA courts seeking declaratory orders that they diligently enforced their Qualifying Statutes during 2003 and/or orders compelling RJR Tobacco and the other PMs that placed money in the disputed payments account to pay the disputed amounts to the settling states. In response, RJR Tobacco and other PMs, pursuant to the MSA's arbitration provisions, moved to compel arbitration of the parties dispute concerning the 2003 NPM Adjustment, including the States' diligent enforcement claims, before the Arbitration Panel. The settling states opposed these motions, arguing, among other things, that the issue of diligent enforcement must be resolved by MSA courts in each of the 52 settling states and territories.

As of March 31, 2013, 47 of the 48 courts that had addressed the question whether the dispute concerning the 2003 NPM Adjustment is arbitrable had ruled that arbitration is required under the MSA. The orders compelling arbitration in these states are now final and/or non-appealable. The Montana Supreme Court ruled that the state of Montana did not agree to arbitrate the question of whether it diligently enforced a qualifying statute. Trial on Montana's assertion of its diligent enforcement defense to the 2003 NPM Adjustment was set for trial on September 10, 2012. On June 22, 2012, Montana and the PMs reached an agreement that the PMs do not contest Montana's claim that it diligently enforced the Qualifying Statute during 2003.

As of January 2009, RJR Tobacco and certain other PMs entered into an Agreement Regarding Arbitration, referred to as the Arbitration Agreement, with 45 of the settling states, representing approximately 90% of the allocable share of the settling states. Pursuant to the Arbitration Agreement, signing states will have their ultimate liability (if any) with respect to the 2003 NPM Adjustment reduced by 20%, and RJR Tobacco and the other PMs that placed their share of the disputed 2005 NPM Adjustment (discussed below) into the disputed payments account have, without releasing or waiving any claims, authorized the release of those funds to the settling states.

The Arbitration Panel contemplated by the MSA and the Arbitration Agreement has been selected, and proceedings before the panel with respect to the 2003 NPM Adjustment Claim have begun. An initial administrative conference was held in July 2010, and subsequent proceedings have been held since then. Document and deposition discovery has been conducted pursuant to various orders of the Arbitration Panel. On November 3, 2011,

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

RJR Tobacco and the other PMs advised the Arbitration Panel that they were not contesting the diligent enforcement of 12 states and the four Pacific territories with a combined allocable share of less than 14%. The diligent enforcement of the remaining 33 settling states, DC and Puerto Rico was contested and will be the subject of further proceedings. A common issues hearing was held in April 2012 and state specific evidentiary hearings began in May 2012. To date, evidentiary hearings for 16 states have been held.

Other NPM Adjustment Claims. From 2006 to 2008, proceedings were initiated with respect to an NPM Adjustment for 2004, 2005 and 2006. The Adjustment Requirements were satisfied with respect to the NPM Adjustment for each of 2004, 2005 and 2006. As a result:

in April 2007, RJR Tobacco placed approximately \$561 million of its 2007 MSA payment (representing its share of the 2004 NPM Adjustment as calculated by the MSA independent auditor), and in April 2008, placed approximately \$431 million of its 2008 MSA payment (representing its share of the 2005 NPM Adjustment as calculated by the independent auditor, net of certain slight adjustments to reflect revised independent auditor calculations of RJR Tobacco's share of the 2003 and 2004 NPM Adjustments) into the disputed payments account. In 2009 and 2010, revised independent auditor calculations resulted in increases in RJR Tobacco's 2005 NPM Adjustment, bringing the total amount of the adjustment to approximately \$445 million; and

in April 2009, RJR Tobacco retained approximately \$406.5 million of its 2009 MSA payment to reflect its share of the 2006 NPM Adjustment as calculated by the independent auditor. Based on revised calculations by the MSA independent auditor, in April 2010, RJR Tobacco withheld an additional amount, bringing the total amount withheld with respect to the 2006 NPM Adjustment to approximately \$420 million. Again based on revised calculations by the MSA independent auditor, in April 2011, RJR Tobacco paid approximately \$1 million extra to account for a downward adjustment in its share of the 2006 NPM Adjustment.

The MSA permits PMs to retain disputed payment amounts pending resolution of the dispute. If the resolution of the dispute ultimately requires a PM to pay some or all of the disputed amount, then the amount deemed to be due includes interest calculated from the date the payment was originally due at the prime rate plus three percent.

In June 2009, RJR Tobacco, certain other PMs and the settling states entered into an agreement with respect to the 2007, 2008 and 2009 significant factor determinations. This agreement provides that the settling states will not contest that the disadvantages of the MSA were a significant factor contributing to the market share loss experienced by the PMs in those years. The stipulation pertaining to each of the three years became effective in February of the year a final determination by the firm of independent economic consultants would otherwise have been expected (2010, 2011 and 2012, respectively), if the issue had been arbitrated on the merits. RJR Tobacco and the PMs will pay a total amount of \$5 million into the States Antitrust/Consumer Protection Tobacco Enforcement Fund established under Section VIII(c) of the MSA for each year covered by that agreement, with RJR Tobacco paying approximately 47% of such amounts. On January 9, 2012, a new agreement with respect to significant factor determinations was entered into on terms essentially identical to the earlier agreement, but pertaining to 2010, 2011 and 2012.

Based on the payment calculations of the MSA independent auditor and the agreement described above regarding the 2007, 2008 and 2009 significant factor determinations, the Adjustment Requirements were satisfied with respect to the NPM Adjustments for 2007, 2008 and 2009. As a result, in April 2010, RJR Tobacco placed approximately \$448 million of its 2010 MSA payment (representing its share of the 2007 NPM Adjustment as calculated by the MSA independent auditor) into the disputed payments account; in April 2011, it placed approximately \$477 million of its 2011 MSA payment (representing its share of the 2008 NPM Adjustment as calculated by the MSA independent auditor) into the disputed payments account; and in April 2012, it placed approximately \$469 million of its 2012 MSA payment (representing its share of the 2009 NPM Adjustment as calculated by the MSA independent auditor) into the disputed payments account. RJR Tobacco's 2011 payment into the disputed payments account was reduced by approximately \$1.1 million to adjust for a downward revision by the independent auditor to RJR Tobacco's share of the 2007 NPM Adjustment. RJR Tobacco's 2012 payment into the disputed payments account was reduced by approximately \$12.4 million to adjust for a downward revision by the independent auditor to RJR Tobacco's share of the 2007 NPM Adjustment, and by approximately \$7.7 million to adjust for a downward revision to RJR Tobacco's share of the 2008 NPM Adjustment.

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

Based on the payment calculations of the MSA independent auditor and the agreement described above regarding the 2010, 2011 and 2012 significant factor determinations, the Adjustment Requirements were satisfied with respect to the NPM Adjustment for 2010. As a result, in April 2013, RJR Tobacco placed approximately \$460 million of its 2013 MSA payment (representing its share of the 2010 NPM Adjustment as calculated by the MSA independent auditor, net of certain small adjustments to reflect revised independent auditor calculations of RJR Tobacco's share of the 2008 and 2009 NPM Adjustments) into the disputed payments account. RJR Tobacco's 2013 payment into the disputed payments account was reduced by approximately \$1.2 million to adjust for a downward revision by the independent auditor to RJR Tobacco's share of the 2008 NPM Adjustment, and by approximately \$319,000 to adjust for a downward revision to RJR Tobacco's share of the 2009 NPM Adjustment. In addition, RJR Tobacco placed approximately \$419 million into the disputed payments account in April 2013 to reflect its share of the 2006 NPM Adjustment that it previously retained.

The table below summarizes the information discussed above with respect to the disputed portions of RJR Tobacco's MSA payment obligations from 2003 through 2010—the years as to which the NPM Adjustment Requirements have been met. These amounts are prior to the impact of the partial settlement of certain NPM Adjustment claims, as described below, in which states with approximately 43% allocable share have entered into a Stipulated Partial Settlement and Award:

Year for which NPM Adjustment calculated	2003	2004	2005	2006	2007	2008	2009	2010
Year in which deduction from NPM Adjustment was taken	2006	2007	2008	2009	2010	2011	2012	2013
RJR Tobacco's approximate share of disputed NPM Adjustment (millions)	\$ 615	\$ 562	\$ 445	\$ 419	\$ 435	\$ 468	\$ 469	\$ 461

In addition to the NPM Adjustment claims described above, RJR Tobacco has filed dispute notices with respect to its 2011 and 2012 annual MSA payments relating to the NPM Adjustments potentially applicable to those years. The amount at issue for those two years is approximately \$841 million.

Due to the uncertainty over the final resolution of the NPM Adjustment claims asserted by RJR Tobacco, no assurances can be made related to the amounts, if any, that will be realized or any amounts (including interest) that will be owed, except as described below related to the partial settlement of certain NPM Adjustment claims.

Partial Settlement of Certain NPM Adjustment Claims. On November 14, 2012, RJR Tobacco, certain other PMs and certain settling states entered into a Term Sheet that sets forth terms on which accrued and potential NPM Adjustment claims for 2003 through 2014 could be resolved. The Term Sheet also set forth a restructured NPM Adjustment process to be applied on a going-forward basis, starting with the 2013 volume year. The Term Sheet was provided to all of the MSA settling states for their review and consideration. The Term Sheet established December 14, 2012, as the deadline by which settling states had to indicate whether they wished to join the proposed settlement. December 17, 2012, was set as the date the PMs and the joining settling states would determine whether to proceed with the settlement. A total of 17 states, the District of Columbia and Puerto Rico, together representing just under 42% Allocable Share, determined to join the proposed settlement. RJR Tobacco and the other PMs indicated that they were prepared to go forward with the proposed settlement with that level of state participation.

The Term Sheet provided that the Arbitration Panel currently in place to deal with the 2003 NPM Adjustment (and other NPM Adjustment-related matters) must review the proposed settlement and enter an appropriate order to confirm for the independent auditor that it should implement as necessary the terms of the settlement agreement. An initial hearing on the proposed settlement was held on January 22-23, 2013. Another hearing on the proposed settlement was held on March 7-8, 2013.

On March 12, 2013, the Arbitration Panel entered a Stipulated Partial Settlement and Award, referred to as the Award, reflecting the financial terms of the Term Sheet. On March 29, 2013, the independent auditor issued a notice indicating that it intended to implement the financial provisions of the Term Sheet and also issued various revised payment calculations pertaining to payment years 2009 through 2012 and final calculations pertaining to payment year 2013 that reflected implementation of the financial provisions of the Term Sheet.

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

On April 12, 2013, the State of Oklahoma joined the Term Sheet, bringing to 20 the total number of jurisdictions that have joined the settlement, representing approximately 43% Allocable Share, and the independent auditor issued revised payment calculations reflecting the financial impact of Oklahoma's decision to join the settlement.

As of April 15, 2013, eight non-settling states had filed motions, in their respective MSA courts, to vacate and/or modify the Award. The arbitration with respect to the 2003 NPM Adjustment will continue to its conclusion as to the contested states that have not yet joined the settlement. Decisions in that proceeding are expected by the end of June 2013.

For additional information related to the Term Sheet and the Award, see *Cost of Products Sold* in note 1.

Other NPM Matters. Separately, on August 19, 2011, Idaho sent a letter on behalf of itself and 31 other states, stating their intent to initiate arbitration with respect to whether amounts used to measure the domestic cigarette market and to calculate PM payment obligations under the MSA should be the adjusted gross or the net number of cigarettes on which federal excise tax (including arbitrios de cigarillos) is paid. The parties also agreed to arbitrate the independent auditor's calculation of the volume adjustment with respect to the treatment of roll your own, referred to as RYO, tobacco. On December 15, 2011, the parties entered into an agreement regarding procedures for formation of an Arbitration Panel with respect to this arbitration. Selection of arbitrators was completed, an initial hearing was held, discovery was undertaken and completed, and briefing on the issues was completed. Merits hearings on the issues raised in the arbitration were held December 11-13, 2012. On January 21, 2013, the panel ruled that adjusted gross figures should be used in payment calculations and that, in the calculation of the volume adjustment, the independent auditor should use 0.0325 ounces of RYO tobacco to be the equivalent of one cigarette.

Antitrust Case

A number of tobacco wholesalers and consumers have sued U.S. cigarette manufacturers, including RJR Tobacco and B&W, in federal and state courts, alleging that cigarette manufacturers combined and conspired to set the price of cigarettes in violation of antitrust statutes and various state unfair business practices statutes. In these cases, the plaintiffs asked the court to certify the lawsuits as class actions on behalf of other persons who purchased cigarettes directly or indirectly from one or more of the defendants. As of March 31, 2013, all of the federal and state court cases on behalf of indirect purchasers had been dismissed.

In *Smith v. Philip Morris Cos., Inc.*, a case filed in February 2000, and pending in District Court, Seward County, Kansas, the court granted class certification in November 2001, in an action brought against the major U.S. cigarette manufacturers, including RJR Tobacco and B&W, and the parent companies of the major U.S. cigarette manufacturers, including RJR, seeking to recover an unspecified amount in actual and punitive damages. The plaintiffs allege that the defendants participated in a conspiracy to fix or maintain the price of cigarettes sold in the United States. In an opinion dated March 23, 2012, the court granted summary judgment in favor of RJR Tobacco and B&W on the plaintiffs' claims. On July 18, 2012, the plaintiffs filed a notice of appeal.

Other Litigation and Developments

JTI Claims for Indemnification. By purchase agreement dated March 9, 1999, amended and restated as of May 11, 1999, referred to as the 1999 Purchase Agreement, RJR and RJR Tobacco sold the international tobacco business to JTI. Under the 1999 Purchase Agreement, RJR and RJR Tobacco retained certain liabilities relating to the international tobacco business sold to JTI. Under its reading of the indemnification provisions of the 1999 Purchase Agreement, JTI has requested indemnification for damages allegedly arising out of these retained liabilities. As previously reported, a number of the indemnification claims between the parties relating to the activities of Northern Brands in Canada have been resolved. The other matters for which JTI has requested indemnification for damages under the indemnification provisions of the 1999 Purchase Agreement are described below:

In a letter dated March 31, 2006, counsel for JTI stated that JTI would be seeking indemnification under the 1999 Purchase Agreement for any damages it may incur or may have incurred arising out of a Southern District of New York grand jury investigation, a now-terminated Eastern District of North Carolina grand jury investigation, and various actions filed by the European Community and others in the U.S. District Court for the Eastern District of New York, referred to as the EDNY, against RJR Tobacco and certain of its affiliates on November 3, 2000, August 6, 2001, and (as discussed in greater detail below)

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

October 30, 2002, and against JTI on January 11, 2002.

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

JTI also has sought indemnification relating to a Statement of Claim filed on April 23, 2010, against JTI Macdonald Corp., referred to as JTI-MC, by the Ontario Flue-Cured Tobacco Growers Marketing Board, referred to as the Board, Andy J. Jacko, Brian Baswick, Ron Kichler, and Aprad Dobrenty, proceeding on their own behalf and on behalf of a putative class of Ontario tobacco producers that sold tobacco to JTI-MC during the period between January 1, 1986 and December 31, 1996, referred to as the Class Period, through the Board pursuant to certain agreements. The Statement of Claim seeks recovery for damages allegedly incurred by the class representatives and the putative class for tobacco sales during the Class Period made at the contract price for duty free or export cigarettes with respect to cigarettes that, rather than being sold duty free or for export, purportedly were sold in Canada, which allegedly breached one or more of a series of contracts dated between June 4, 1986, and July 3, 1996. A motion to dismiss has been filed.

Finally, JTI has advised RJR and RJR Tobacco of its view that, under the terms of the 1999 Purchase Agreement, RJR and RJR Tobacco are liable for a roughly \$1.7 million judgment entered in 1998, plus interest and costs, in an action filed in Brazil by Lutz Hanneman, a former employee of a former RJR Tobacco subsidiary. RJR and RJR Tobacco deny that they are liable for this judgment under the terms of the 1999 Purchase Agreement.

Although RJR and RJR Tobacco recognize that, under certain circumstances, they may have these and other unresolved indemnification obligations to JTI under the 1999 Purchase Agreement, RJR and RJR Tobacco disagree with JTI as to (1) what circumstances relating to any such matters may give rise to indemnification obligations by RJR and RJR Tobacco, and (2) the nature and extent of any such obligation. RJR and RJR Tobacco have conveyed their position to JTI, and the parties have agreed to resolve their differences at a later time.

European Community. On October 30, 2002, the European Community and ten of its member states filed a complaint in the EDNY against RJR, RJR Tobacco and several currently and formerly related companies. The complaint contains many of the same or similar allegations found in an earlier complaint, now dismissed, filed in August 2001 and also alleges that the defendants, together with certain identified and unidentified persons, engaged in money laundering and other conduct violating civil RICO and a variety of common laws. The complaint also alleges that the defendants manufactured cigarettes that were eventually sold in Iraq in violation of U.S. sanctions. The plaintiffs seek compensatory, punitive and treble damages among other types of relief. This matter had been stayed and largely inactive until November 24, 2009 when, with the court's permission, the European Community and member states filed and served a second amended complaint. The second amended complaint added 16 member states as plaintiffs and RAI, RJR Tobacco and R. J. Reynolds Global Products Inc., referred to as GPI, as defendants. The allegations contained in the second amended complaint are in most respects either identical or similar to those found in the prior complaint, but now add new allegations primarily regarding the activities of RAI, RJR Tobacco and GPI following the B&W business combination. Pursuant to a stipulation and order, the defendants filed a motion to dismiss the plaintiffs' second amended complaint on February 15, 2010. Ruling on part of the defendants' motion to dismiss, on March 8, 2011, the court dismissed the plaintiffs' RICO claims, and reserved decision as to dismissal of the plaintiffs' state-law claims. Thereafter, on May 13, 2011, the court granted the remaining portion of the defendants' motion and dismissed the plaintiffs' state-law claims based on the court's lack of subject matter jurisdiction. On May 16, 2011, the clerk of court entered a judgment dismissing the action in its entirety. On June 10, 2011, the plaintiffs filed a notice of appeal with the U.S. Court of Appeals for the Second Circuit, appealing from the May 16, 2011 judgment, as well as the March 8, 2011 and May 13, 2011 orders that respectively resulted in the dismissal of their RICO and state-law claims. Oral argument occurred on February 24, 2012. A decision is pending.

FDA Litigation. In August 2009, RJR Tobacco and American Snuff Co. joined other tobacco manufacturers and a tobacco retailer in filing a lawsuit, *Commonwealth Brands, Inc. v. United States of America*, in the U.S. District Court for the Western District of Kentucky, challenging certain provisions of the Family Smoking Prevention and Tobacco Control Act, referred to as the FDA Tobacco Act, that severely restricts the few remaining channels available to communicate with adult tobacco consumers. RAI believes these provisions cannot be justified on any basis consistent with the demands of the First Amendment. The suit does not challenge the U.S. Congress's decision

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

to give the FDA regulatory authority over tobacco products, nor does it challenge the vast majority of the provisions of the new law. In November 2009, the court denied certain plaintiffs' motion for preliminary injunction as to the modified risk tobacco products provision of the FDA Tobacco Act. In January 2010, the court granted summary judgment for the plaintiffs so as to allow the continued use of color and imagery in labeling and advertising and the right to make statements that their products conform to FDA regulatory requirements. The court granted summary judgment to the U.S. Government as to all other challenged provisions. In March 2010, each side filed a notice of appeal with the Sixth Circuit Court of Appeals. On March 29, 2012, the Sixth Circuit issued its opinion affirming the district court's decision in all respects but two: (1) holding as constitutional the ban on manufacturers making statements that their products conform to FDA regulatory requirements; and (2) holding as unconstitutional the ban on continuity programs. On May 31, 2012, the Sixth Circuit denied the plaintiffs' motion for rehearing en banc. The plaintiffs filed a petition for writ of certiorari with the U.S. Supreme Court on October 26, 2012. Briefing on the petition was completed on April 2, 2013. A decision is pending.

On February 25, 2011, RJR Tobacco, Lorillard, Inc., and Lorillard Tobacco Company jointly filed a lawsuit, *Lorillard, Inc. v. U.S. Food and Drug Administration*, in the U.S. District Court for the District of Columbia, challenging the composition of the Tobacco Products Scientific Advisory Committee, referred to as the TPSAC, which had been established by the FDA. The complaint alleges that certain members of the TPSAC and certain members of its Constituents Subcommittee have financial and appearance conflicts of interest that are disqualifying under federal ethics law and regulations, and that the TPSAC is not fairly balanced, as required by the Federal Advisory Committee Act, referred to as FACA. In March 2011, the plaintiffs filed an amended complaint, which added an additional claim, based on a nonpublic meeting of members of the TPSAC, in violation of the FACA. The court granted the plaintiffs' unopposed motion to file a second amended complaint adding a count addressing the FDA's refusal to produce all documents generated by the TPSAC and its subcommittee in preparation of the menthol report. The FDA filed a motion to dismiss the second amended complaint. On August 1, 2012, the court denied the FDA's motion to dismiss. The FDA filed its answer to the complaint on October 12, 2012. The parties are to submit an agreed upon summary judgment briefing schedule or, if not, participate in a status conference scheduled for April 22, 2013.

On August 16, 2011, RJR Tobacco and SFNTC joined other tobacco manufacturers in a lawsuit, *R. J. Reynolds Tobacco Co. v. U.S. Food and Drug Administration*, in the U.S. District Court for the District of Columbia, challenging the final regulation specifying nine new graphic warnings pursuant to the FDA Tobacco Act violates the plaintiffs' rights under the First Amendment to the U.S. Constitution and the Administrative Procedure Act, referred to as the APA. On November 7, 2011, the court granted the plaintiffs' motion for preliminary injunction, which stays the imposition of the graphic warning rule for 15 months following a final ruling from the district court as to the merits of the parties' claims. On December 1, 2011, the government appealed the district court's preliminary injunction ruling to the Court of Appeals for the D.C. Circuit. On February 29, 2012, the district court granted the plaintiffs' motion for summary judgment, finding that these mandatory graphic warnings violated the First Amendment by unconstitutionally compelling speech. In so finding, the court issued a permanent injunction preventing the FDA from requiring the companies to implement new textual and graphic warnings until 15 months after the issuance of new regulations that are constitutionally permissible. The government filed a notice of appeal of this order with the Court of Appeals for the D. C. Circuit on March 4, 2012, and moved the appellate court to consolidate this appeal with the government's appeal of the preliminary injunction decision. The Court of Appeals granted the government's motion and heard argument on both appeals on April 10, 2012. On August 24, 2012, the Court of Appeals for the D. C. Circuit affirmed the District Court's decision invalidating graphic warning regulation. The Court of Appeals denied the Government's motion for rehearing en banc on December 5, 2012. On March 19, 2013, the Government announced its decision to forego an appeal to the U.S. Supreme Court and instead work toward reissuing a graphic warning regulation in the future.

For a detailed description of the FDA Tobacco Act, see Governmental Activity in Management's Discussion and Analysis of Financial Condition and Results of Operations, in Part I, Item 2.

Other Matters. RJR Tobacco and others brought suit against the City of Providence, Rhode Island challenging ordinances that prohibit the acceptance of tobacco product coupons, offering of certain pricing discounts for tobacco products, and certain flavored tobacco products in Providence, Rhode Island. The case, *National Association of Tobacco Outlets, Inc. v. City of Providence*, was filed in the U.S. District Court for the District of Rhode Island on February 13, 2012. The parties filed cross motions for summary judgment, and on December 11, 2012, the court

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

granted judgment in favor of the defendants, except that the court modified the definition of a flavored tobacco product consistent with plaintiffs argument. On January 8, 2013, the plaintiffs filed a notice of appeal. Briefing is underway.

In *Richard Villarreal v. R. J. Reynolds Tobacco Co.*, a case filed June 6, 2012, the plaintiff filed a collective action complaint against R. J. Reynolds Tobacco Co., Pinstripe, Inc., and CareerBuilder, LLC, in the U.S. District Court, Northern District of Georgia. The complaint alleges unlawful discrimination with respect to the hiring of individuals to fill entry-level regional sales positions in violation of the Age Discrimination in Employment Act (29 U.S.C. §621, et seq.). The defendants' motion for partial dismissal was granted on March 6, 2013, thereby eliminating the plaintiff's disparate impact claim and limiting the relevant time period for both the plaintiff's claims and potential class claims. The defendants filed answers to the remaining disparate treatment claim on March 20, 2013.

Smokeless Tobacco Litigation

As of March 31, 2013, American Snuff Co. was a defendant in six actions brought by individual plaintiffs in West Virginia state court seeking damages in connection with personal injuries allegedly sustained as a result of the usage of American Snuff Co.'s smokeless tobacco products. These actions are pending before the same West Virginia court as the 564 consolidated individual smoker cases against RJR Tobacco, B&W, as RJR Tobacco's indemnitee, or both. Pursuant to the court's December 3, 2001, order, the smokeless tobacco claims and defendants remain severed.

Pursuant to a second amended complaint filed in September 2006, American Snuff Co. is a defendant in *Vassallo v. United States Tobacco Company*, pending in the Eleventh Circuit Court in Miami-Dade County, Florida. The individual plaintiff alleges that he sustained personal injuries, including addiction and cancer, as a result of his use of smokeless tobacco products, allegedly including products manufactured by American Snuff Co. The plaintiff seeks unspecified compensatory and consequential damages in an amount greater than \$15,000. There is no punitive damages demand in this case, though the plaintiff retains the right to seek leave of court to add such a demand later. Discovery is underway.

American Snuff Co. was served with a complaint that was filed in October 2011 in the U.S. District Court for the Northern District of Mississippi, *Vertison v. American Snuff Co., LLC*. The plaintiff alleges that as a result of her use of the defendants' smokeless tobacco products, she developed oral cancer. The plaintiff seeks unspecified compensatory and punitive damages. On January 13, 2012, American Snuff Co. filed its answer to the complaint. Discovery is underway. The defendants filed a motion for summary judgment on all of the plaintiff's claims on September 10, 2012. A decision is pending. Trial is scheduled for August 5, 2013.

Tobacco Buyout Legislation

In 2004, legislation was passed eliminating the U.S. government's tobacco production controls and price support program. The buyout of tobacco quota holders provided for in the Fair and Equitable Tobacco Reform Act, referred to as FETRA, is funded by a direct quarterly assessment on every tobacco product manufacturer and importer, on a market-share basis measured on volume to which federal excise tax is applied. The aggregate cost of the buyout to the industry is approximately \$9.9 billion, including approximately \$9.6 billion payable to quota tobacco holders and growers through industry assessments over ten years and approximately \$290 million for the liquidation of quota tobacco stock. As a result of the tobacco buyout legislation, the MSA Phase II obligations established in 1999 continued as scheduled through the end of 2010, but were offset against the tobacco quota buyout obligations. RAI's operating subsidiaries' annual expense under FETRA for 2013 and 2014 is estimated to be approximately \$220 million and \$170 million, respectively.

RAI's operating subsidiaries recorded the FETRA assessment on a quarterly basis as cost of goods sold. RAI's operating subsidiaries estimate that their overall share of the buyout will approximate \$2.5 billion prior to the deduction of permitted offsets under the MSA.

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)*****ERISA Litigation***

In May 2002, in *Tatum v. The R.J.R. Pension Investment Committee of the R. J. Reynolds Tobacco Company Capital Investment Plan*, an employee of RJR Tobacco filed a class-action suit in the U.S. District Court for the Middle District of North Carolina, alleging that the defendants, RJR, RJR Tobacco, the RJR Employee Benefits Committee and the RJR Pension Investment Committee, violated the Employee Retirement Income Security Act of 1974, referred to as ERISA. The actions about which the plaintiff complains stem from a decision made in 1999 by RJR Nabisco Holdings Corp., subsequently renamed Nabisco Group Holdings Corp., referred to as NGH, to spin off RJR, thereby separating NGH's tobacco business and food business. As part of the spin-off, the 401(k) plan for the previously related entities had to be divided into two separate plans for the now separate tobacco and food businesses. The plaintiff contends that the defendants breached their fiduciary duties to participants of the RJR 401(k) plan when the defendants removed the stock funds of the companies involved in the food business, NGH and Nabisco Holdings Corp., referred to as Nabisco, as investment options from the RJR 401(k) plan approximately six months after the spin-off. The plaintiff asserts that a November 1999 amendment (the 1999 Amendment) that eliminated the NGH and Nabisco funds from the RJR 401(k) plan on January 31, 2000, contained sufficient discretion for the defendants to have retained the NGH and Nabisco funds after January 31, 2000, and that the failure to exercise such discretion was a breach of fiduciary duty. In his complaint, the plaintiff requests, among other things, that the court require the defendants to pay as damages to the RJR 401(k) plan an amount equal to the subsequent appreciation that was purportedly lost as a result of the liquidation of the NGH and Nabisco funds.

In July 2002, the defendants filed a motion to dismiss, which the court granted in December 2003. In December 2004, the U.S. Court of Appeals for the Fourth Circuit reversed the dismissal of the complaint, holding that the 1999 Amendment did contain sufficient discretion for the defendants to have retained the NGH and Nabisco funds as of February 1, 2000, and remanded the case for further proceedings. The court granted the plaintiff leave to file an amended complaint and denied all pending motions as moot. In April 2007, the defendants moved to dismiss the amended complaint. The court granted the motion in part and denied it in part, dismissing all claims against the RJR Employee Benefits Committee and the RJR Pension Investment Committee. The remaining defendants, RJR and RJR Tobacco, filed their answer and affirmative defenses in June 2007. The plaintiff filed a motion for class certification, which the court granted in September 2008. The district court ordered mediation, but no resolution of the case was reached. In September 2008, each of the plaintiffs and the defendants filed motions for summary judgment, and in January 2009, the defendants filed a motion to decertify the class. A second mediation occurred in June 2009, but again no resolution of the case was reached. The district court overruled the motions for summary judgment and the motion to decertify the class.

A non-jury trial was held in January and February 2010. During closing arguments, the plaintiff argued for the first time that certain facts arising at trial showed that the 1999 Amendment was not validly adopted, and then moved to amend his complaint to conform to this evidence at trial. On June 1, 2011, the court granted the plaintiff's motion to amend his complaint and found that the 1999 Amendment was invalid.

The parties filed their findings of fact and conclusions of law on February 4, 2011. On February 25, 2013, the district court dismissed the case with prejudice. On March 8, 2013, the plaintiffs filed a notice of appeal.

Environmental Matters

RAI and its subsidiaries are subject to federal, state and local environmental laws and regulations concerning the discharge, storage, handling and disposal of hazardous or toxic substances. Such laws and regulations provide for significant fines, penalties and liabilities, sometimes without regard to whether the owner or operator of the property knew of, or was responsible for, the release or presence of hazardous or toxic substances. In addition, third parties may make claims against owners or operators of properties for personal injuries and property damage associated with releases of hazardous or toxic substances. In the past, RJR Tobacco has been named a potentially responsible party with third parties under the Comprehensive Environmental Response, Compensation and Liability Act with respect to several superfund sites. RAI and its subsidiaries are not aware of any current environmental matters that are expected to have a material adverse effect on the business, results of operations or financial position of RAI or its subsidiaries.

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

RAI and its operating subsidiaries believe that climate change is an environmental issue primarily driven by carbon dioxide emissions from the use of energy. RAI's operating subsidiaries are working to reduce carbon dioxide emissions by minimizing the use of energy where cost effective, minimizing waste to landfills and increasing recycling. Climate change is not viewed by RAI's operating subsidiaries as a significant direct economic risk to their businesses, but rather an indirect risk involving the potential for a longer term general increase in the cost of doing business. Regulatory changes are difficult to predict, but the current regulatory risks to the business of RAI's operating subsidiaries with respect to climate change are relatively low. Financial impacts will be driven more by the cost of natural gas and electricity. Efforts are made to mitigate the effect of increases in fuel costs directly impacting RAI's operating subsidiaries by evaluating natural gas usage and market conditions, and occasionally purchasing forward contracts, limited to a three-year period, for natural gas. In addition, RAI's operating subsidiaries are constantly evaluating electrical energy conservation measures and energy efficient equipment to mitigate impacts of increases in electrical energy costs.

Regulations promulgated by the EPA and other governmental agencies under various statutes have resulted in, and likely will continue to result in, substantial expenditures for pollution control, waste treatment, facility modification and similar activities. RAI and its subsidiaries are engaged in a continuing program to comply with federal, state and local environmental laws and regulations, and dependent upon the probability of occurrence and reasonable estimation of cost, accrue or disclose any material liability. Although it is difficult to reasonably estimate the portion of capital expenditures or other costs attributable to compliance with environmental laws and regulations, RAI does not expect such expenditures or other costs to have a material adverse effect on the business, results of operations, cash flows or financial position of RAI or its subsidiaries.

Other Contingencies

In connection with the sale of the international tobacco business to JTI, pursuant to the 1999 Purchase Agreement, RJR and RJR Tobacco agreed to indemnify JTI against:

any liabilities, costs and expenses arising out of the imposition or assessment of any tax with respect to the international tobacco business arising prior to the sale, other than as reflected on the closing balance sheet;

any liabilities, costs and expenses that JTI or any of its affiliates, including the acquired entities, may incur after the sale with respect to any of RJR's or RJR Tobacco's employee benefit and welfare plans; and

any liabilities, costs and expenses incurred by JTI or any of its affiliates arising out of certain activities of Northern Brands.

As described above in *Litigation Affecting the Cigarette Industry* *Other Litigation and Developments* *JTI Claims for Indemnification*, RJR Tobacco has received claims for indemnification from JTI, and several of these have been resolved. Although RJR and RJR Tobacco recognize that, under certain circumstances, they may have other unresolved indemnification obligations to JTI under the 1999 Purchase Agreement, RJR and RJR Tobacco disagree what circumstances described in such claims give rise to any indemnification obligations by RJR and RJR Tobacco and the nature and extent of any such obligation. RJR and RJR Tobacco have conveyed their position to JTI, and the parties have agreed to resolve their differences at a later date.

RJR Tobacco, SFNTC and American Snuff Co. have entered into agreements to indemnify certain distributors and retailers from liability and related defense costs arising out of the sale or distribution of their products. Additionally, SFNTC has entered into an agreement to indemnify a supplier from liability and related defense costs arising out of the sale or use of SFNTC's products. The cost has been, and is expected to be, insignificant. RJR Tobacco, SFNTC and American Snuff Co. believe that the indemnified claims are substantially similar in nature and extent to the claims that they are already exposed to by virtue of their having manufactured those products.

Except as otherwise noted above, RAI is not able to estimate the maximum potential amount of future payments, if any, related to these indemnification obligations.

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)****Note 10 Shareholders Equity**

	Common Stock	Paid-In Capital	Accumulated Deficit	Accumulated Other Comprehensive Loss	Total Shareholders Equity
Balance as of December 31, 2011	\$	\$ 8,293	\$ (1,660)	\$ (382)	\$ 6,251
Net income			270		270
Retirement benefits, net of \$49 million tax expense				74	74
Unrealized gain on long-term investments, net of \$1 million tax expense				2	2
Cumulative translation adjustment and other, net of \$2 million tax expense				10	10
Dividends - \$0.56 per share			(323)		(323)
Common stock repurchased		(300)			(300)
Equity incentive award plan and stock-based compensation		11			11
Excess tax benefit on stock-based compensation plans		33			33
Balance as of March 31, 2012	\$	\$ 8,037	\$ (1,713)	\$ (296)	\$ 6,028
	Common Stock	Paid-In Capital	Accumulated Deficit	Accumulated Other Comprehensive Loss	Total Shareholders Equity
Balance as of December 31, 2012	\$	\$ 7,275	\$ (1,707)	\$ (311)	\$ 5,257
Net income			508		508
Retirement benefits, net of \$3 million tax benefit				(5)	(5)
Unrealized gain on long-term investments, net of \$2 million tax expense				2	2
Cumulative translation adjustment and other, net of \$5 million tax expense				(15)	(15)
Dividends - \$0.59 per share			(326)		(326)
Common stock repurchased		(325)			(325)
Equity incentive award plan and stock-based compensation		11			11
Excess tax benefit on stock-based compensation plans		11			11
Balance as of March 31, 2013	\$	\$ 6,972	\$ (1,525)	\$ (329)	\$ 5,118

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)***Accumulated Other Comprehensive Income (Loss)*

The components of accumulated other comprehensive loss, net of tax, for the three months ended March 31, 2013, were as follows:

	Retirement Benefits	Unrealized Gain (Loss) on Long- Term Investments	Realized Loss on Hedging Instruments	Cumulative Translation Adjustment and Other	Total
Balance at December 31, 2012	\$ (265)	\$ (21)	\$ (14)	\$ (11)	\$ (311)
Other comprehensive income (loss) before reclassifications	1	2		(15)	(12)
Amounts reclassified from accumulated other comprehensive income (loss)	(6)				(6)
Net current-period other comprehensive income (loss)	(5)	2		(15)	(18)
Balance at March 31, 2013	\$ (270)	\$ (19)	\$ (14)	\$ (26)	\$ (329)

Details about the reclassifications out of accumulated other comprehensive loss and the affected line items in the condensed consolidated statement of income (unaudited) for the three months ended March 31, 2013, were as follows:

Components	Amounts Reclassified	Affected Line Item
Defined benefit pension and postretirement plan:		
Amortization of prior service costs	\$ (5)	Cost of products sold
Amortization of prior service costs	(4)	Selling, general and administrative expenses
	(9)	
Deferred taxes	3	Provision for income taxes
Total reclassifications	\$ (6)	Net income

Share Repurchases and Other

On November 14, 2011, the board of directors of RAI authorized the repurchase, from time to time on or before mid-2014, of up to \$2.5 billion of outstanding shares of RAI common stock in open-market or privately negotiated transactions. The repurchases are subject to prevailing market and business conditions, and the program may be terminated or suspended at any time. In connection with the share repurchase program, RAI and B&W entered into an agreement, pursuant to which B&W has agreed to participate in the repurchase program on a basis approximately proportionate with B&W's 42% ownership of RAI's common stock. RAI, B&W and BAT also entered into Amendment No. 3 to the governance agreement, pursuant to which RAI has agreed that, so long as B&W's ownership interest has not dropped below 25%, if RAI issues shares of its common stock or any other RAI equity security to certain designated persons, including its directors, officers or employees, then RAI will repurchase a number of shares of outstanding RAI common stock so that the number of outstanding shares of RAI common stock are not increased, and B&W's ownership interest is not decreased, by such issuance after taking into account such repurchase.

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

Due to RAI's incorporation in North Carolina, which does not recognize treasury shares, the shares repurchased are cancelled at the time of repurchase. During the first three months of 2013, RAI repurchased and cancelled 6,844,082 shares of RAI common stock for \$300 million under the above share repurchase program. As of March 31, 2013, RAI had repurchased and cancelled 38,564,952 shares of RAI common stock for \$1.6 billion under the above-described share repurchase program.

Restricted stock units granted in March 2010 under the 2009 Omnibus Incentive Compensation Plan, referred to as the Omnibus Plan, vested in March 2013 and were settled with the issuance of 1,572,389 shares of RAI common stock. In addition, during the first three months of 2013, at a cost of \$25 million, RAI purchased 574,383 shares of RAI common stock that were cancelled with respect to tax liabilities associated with restricted stock unit vesting under the Omnibus Plan.

On February 7, 2013, RAI's board of directors declared a quarterly cash dividend of \$0.59 per common share, or \$2.36 on an annualized basis, to shareholders of record as of March 8, 2013.

Note 11 Stock Plans

In February 2013, the board of directors of RAI approved a grant to key employees of RAI and its subsidiaries, effective March 1, 2013, of 1,112,436 nonvested restricted stock units under the Omnibus Plan. The restricted stock units generally will vest on March 1, 2016. Upon settlement, each grantee will receive a number of shares of RAI's common stock equal to the product of the number of vested units and a percentage up to 150% based on the average RAI annual incentive award plan score over the three-year period ending December 31, 2015.

Table of Contents

Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)

As an equity-based grant, compensation expense relating to the 2013 grant under the Omnibus Plan will take into account the vesting period lapsed and will be calculated based on the per share closing price of RAI common stock on the date of grant, or \$43.36. Dividends paid on shares of RAI common stock will accumulate on the restricted stock units and will be paid to the grantee on the vesting date. If RAI fails to pay its shareholders cumulative dividends of at least \$7.08 per share for the three-year performance period ending December 31, 2015, then each award will be reduced by an amount equal to three times the percentage of the dividend underpayment, up to a maximum reduction of 50%.

Note 12 Segment Information

RAI's reportable operating segments are RJR Tobacco, American Snuff and Santa Fe. The RJR Tobacco segment consists of the primary operations of R. J. Reynolds Tobacco Company. The American Snuff segment consists of the primary operations of American Snuff Co. The Santa Fe segment consists of the primary operations of SFNTC. Nicovum AB, among other RAI subsidiaries, is included in All Other. The segments were identified based on how RAI's chief operating decision maker allocates resources and assesses performance. Certain of RAI's operating subsidiaries have entered into intercompany agreements for products or services with other subsidiaries. As a result, certain activities of an operating subsidiary may be included in a different segment of RAI.

RAI's largest reportable operating segment, RJR Tobacco, is the second largest tobacco company in the United States. RJR Tobacco's brands include many of the best-selling cigarettes in the United States: CAMEL, PALL MALL, WINSTON, KOOL, DORAL and SALEM. Those brands, and its other brands, including MISTY and CAPRI, are manufactured in a variety of styles and marketed in the United States. As part of its total tobacco strategy, RJR Tobacco also offers a smoke-free tobacco product, CAMEL Snus. RJR Tobacco also manages contract manufacturing of cigarette and tobacco products through arrangements with BAT affiliates, and manages the export of tobacco products to certain U.S. territories, U.S. duty-free shops and U.S. overseas military bases. RJR Tobacco manages the super-premium cigarette brands, DUNHILL and STATE EXPRESS 555, which are licensed from BAT.

American Snuff is the second largest smokeless tobacco products manufacturer in the United States. American Snuff's primary brands include its largest selling moist snuff brands, GRIZZLY and KODIAK.

Santa Fe manufactures and markets cigarettes and other tobacco products under the NATURAL AMERICAN SPIRIT brand.

Nicovum AB, a marketer of nicotine replacement therapy products in Sweden under the ZONNIC brand name, and RJR Vapor, among other RAI subsidiaries, are included in All Other.

Intersegment revenues and items below the operating income line of the condensed consolidated statements of income (unaudited) are not presented by segment, since they are excluded from the measure of segment profitability reviewed by RAI's chief operating decision maker. Additionally, information about total assets by segment is not reviewed by RAI's chief operating decision maker and therefore is not disclosed.

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**

Segment Data:

	For the Three Months Ended March 31,	
	2013	2012
Net sales:		
RJR Tobacco	\$ 1,558	\$ 1,631
American Snuff	167	158
Santa Fe	115	100
All Other	43	44
Consolidated net sales	\$ 1,883	\$ 1,933
Operating income (loss):		
RJR Tobacco ⁽¹⁾	\$ 758	\$ 377
American Snuff	93	84
Santa Fe ⁽¹⁾	54	45
All Other	(4)	8
Corporate expense	(14)	(28)
Consolidated operating income	\$ 887	\$ 486
Reconciliation to income before income taxes:		
Operating income ⁽¹⁾⁽²⁾	\$ 887	\$ 486
Interest and debt expense	62	56
Interest income	(2)	(2)
Other (income) expense, net	(2)	3
Income before income taxes	\$ 829	\$ 429

⁽¹⁾ For information related to NPM Adjustments, see Cost of Products Sold in note 1.

⁽²⁾ For information related to restructuring charges, see note 4.

Note 13 Related Party Transactions

RAI and RAI's operating subsidiaries engage in transactions with affiliates of BAT, which owns approximately 42% of RAI's outstanding common stock. A summary of balances and transactions with such BAT affiliates was as follows:

Balances:

	March 31, 2013	December 31, 2012
Accounts receivable, related party	\$ 52	\$ 61
Due to related party		1
Deferred revenue, related party	32	42

Transactions:

	For the Three Months	
	Ended March 31,	
	2013	2012
Net sales	\$ 81	\$ 77
Purchases	3	1
RAI common stock purchases from B&W	108	79
Capsule royalty income	3	1

RAI's operating subsidiaries sell contract-manufactured cigarettes, tobacco leaf and processed tobacco to BAT affiliates. In December 2012, RJR Tobacco entered into an amendment to its contract manufacturing agreement with a BAT affiliate, which amendment, among other things, requires either party to provide three years' notice to the other party to terminate the agreement without cause, with any such notice to be given no earlier than January 1, 2016. Net sales to BAT affiliates, primarily cigarettes, represented approximately 4.3% and 4.0% of RAI's total net sales during the three months ended March 31, 2013 and 2012, respectively.

RJR Tobacco recorded deferred sales revenue relating to leaf sold to BAT affiliates that had not been delivered as of the end of the respective quarter, given that RJR Tobacco has a legal right to bill the BAT affiliates. Leaf sales revenue to BAT affiliates is recognized when the product is shipped to the customer. RJR Tobacco recorded royalty income from the license of capsule technology to BAT affiliates.

Table of Contents

Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)

RAI's operating subsidiaries also purchase unprocessed leaf at market prices, and import cigarettes at prices not to exceed manufacturing costs plus 10%, from BAT affiliates.

In connection with RAI's share repurchase program, RAI and B&W entered into an agreement on November 14, 2011, pursuant to which B&W agreed to participate in the repurchase program on a basis approximately proportionate with B&W's 42% ownership of RAI common stock. Under this agreement, RAI repurchased 2,454,376 shares of RAI common stock from B&W during the three months ended March 31, 2013 and 15,011,185 shares as of March 31, 2013.

Table of Contents

Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)

Note 14 RAI Guaranteed, Unsecured Notes Condensed Consolidating Financial Statements

The following condensed consolidating financial statements relate to the guaranties of RAI's \$5.0 billion unsecured notes. Certain of RAI's direct, wholly owned subsidiaries and certain of its indirectly owned subsidiaries have fully and unconditionally, and jointly and severally, guaranteed these notes. The following condensed consolidating financial statements (unaudited) include: the accounts and activities of RAI, the parent issuer; RJR, RJR Tobacco, American Snuff Co., SFNTC, and certain of RAI's other subsidiaries, the Guarantors; other direct and indirect subsidiaries of RAI that are not Guarantors; and elimination adjustments.

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)****Condensed Consolidating Statements of Income****(Dollars in Millions)**

	Parent Issuer	Guarantors	Non- Guarantors	Eliminations	Consolidated
For the Three Months Ended March 31, 2013					
Net sales	\$	\$ 1,777	\$ 34	\$ (9)	\$ 1,802
Net sales, related party		81			81
Net sales		1,858	34	(9)	1,883
Cost of products sold		691	12	(9)	694
Selling, general and administrative expenses	3	268	30		301
Amortization expense		1			1
Operating income (loss)	(3)	898	(8)		887
Interest and debt expense	61	30		(29)	62
Interest income	(29)	(1)	(1)	29	(2)
Other expense (income), net	1	(12)	(2)	11	(2)
Income (loss) before income taxes	(36)	881	(5)	(11)	829
Provision for (benefit from) income taxes	(13)	337	(3)		321
Equity income from subsidiaries	531	5		(536)	
Net income (loss)	\$ 508	\$ 549	\$ (2)	\$ (547)	\$ 508
For the Three Months Ended March 31, 2012					
Net sales	\$	\$ 1,831	\$ 32	\$ (7)	\$ 1,856
Net sales, related party		77			77
Net sales		1,908	32	(7)	1,933
Cost of products sold		993	8	(7)	994
Selling, general and administrative expenses	2	275	21		298
Amortization expense		6			6
Restructuring charge	4	145			149
Operating income (loss)	(6)	489	3		486
Interest and debt expense	54	30		(28)	56
Interest income	(28)	(1)	(1)	28	(2)
Other expense (income), net	1	(11)	2	11	3
Income (loss) before income taxes	(33)	471	2	(11)	429
Provision for (benefit from) income taxes	(11)	171	(1)		159
Equity income from subsidiaries	292	6		(298)	
Net income	\$ 270	\$ 306	\$ 3	\$ (309)	\$ 270

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)****Condensed Consolidating Statements of Comprehensive Income****(Dollars in Millions)**

	Parent Issuer	Guarantors	Non- Guarantors	Eliminations	Consolidated
For the Three Months Ended March 31, 2013					
Net income (loss)	\$ 508	\$ 549	\$ (2)	\$ (547)	\$ 508
Other comprehensive income (loss), net of tax:					
Retirement benefits	(5)	(5)		5	(5)
Unrealized gain on long-term investments	2	2		(2)	2
Cumulative translation adjustment and other	(15)	(15)	(10)	25	(15)
Comprehensive income (loss)	\$ 490	\$ 531	\$ (12)	\$ (519)	\$ 490
For the Three Months Ended March 31, 2012					
Net income	\$ 270	\$ 306	\$ 3	\$ (309)	\$ 270
Other comprehensive income, net of tax:					
Retirement benefits	74	74		(74)	74
Unrealized gain on long-term investments	2	2		(2)	2
Cumulative translation adjustment and other	10	10	12	(22)	10
Comprehensive income	\$ 356	\$ 392	\$ 15	\$ (407)	\$ 356

Details about the reclassifications out of accumulated other comprehensive loss and the affected line items in the condensed consolidating statements of income (unaudited) for the three months ended March 31, 2013, were as follows:

Components	Amount Reclassified					Affected Line Item
	Parent Issuer	Guarantors	Non- Guarantors	Eliminations	Consolidated	
Defined benefit pension and postretirement plan:						
Amortization of prior service costs	\$ (5)	\$ (5)	\$	\$ 5	\$ (5)	Cost of products sold
Amortization of prior service costs	(4)	(4)		4	(4)	Selling, general and administrative expenses
	\$ (9)	\$ (9)	\$	\$ 9	\$ (9)	
Deferred taxes	3	3		(3)	3	Provision for income taxes
Total reclassifications	\$ (6)	\$ (6)	\$	\$ 6	\$ (6)	Net income

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)****Condensed Consolidating Statements of Cash Flows****(Dollars in Millions)**

	Parent Issuer	Guarantors	Non- Guarantors	Eliminations	Consolidated
For the Three Months Ended March 31, 2013					
Cash flows from operating activities	\$ 282	\$ 663	\$ 2	\$ (2)	\$ 945
Cash flows from (used in) investing activities:					
Capital expenditures		(13)	(1)	(9)	(23)
Other, net	(33)	15		21	3
Net cash flows from (used in) investing activities	(33)	2	(1)	12	(20)
Cash flows from (used in) financing activities:					
Dividends paid on common stock	(326)				(326)
Repurchase of common stock	(325)				(325)
Excess tax benefit on stock-based compensation plans	11				11
Dividends paid on preferred stock	(11)			11	
Other, net	(14)		32	(21)	(3)
Net cash flows from (used in) financing activities	(665)		32	(10)	(643)
Effect of exchange rate changes on cash and cash equivalents			(6)		(6)
Net change in cash and cash equivalents	(416)	665	27		276
Cash and cash equivalents at beginning of period	755	1,420	327		2,502
Cash and cash equivalents at end of period	\$ 339	\$ 2,085	\$ 354	\$	\$ 2,778

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)****Condensed Consolidating Statements of Cash Flows****(Dollars in Millions)**

	Parent Issuer	Guarantors	Non- Guarantors	Eliminations	Consolidated
For the Three Months Ended March 31, 2012					
Cash flows from operating activities	\$ 89	\$ 1,042	\$ 8	\$ (86)	\$ 1,053
Cash flows from (used in) investing activities:					
Capital expenditures		(27)			(27)
Return of intercompany investments	432			(432)	
Other, net	20	12		(31)	1
Net cash flows from (used in) investing activities	452	(15)		(463)	(26)
Cash flows from (used in) financing activities:					
Dividends paid on common stock	(323)	(75)		75	(323)
Repurchase of common stock	(300)				(300)
Excess tax benefit on stock-based compensation plans	33				33
Dividends paid on preferred stock	(11)			11	
Distribution of equity		(432)		432	
Other, net	(14)	(20)		31	(3)
Net cash flows used in financing activities	(615)	(527)		549	(593)
Effect of exchange rate changes on cash and cash equivalents			6		6
Net change in cash and cash equivalents	(74)	500	14		440
Cash and cash equivalents at beginning of period	328	1,361	267		1,956
Cash and cash equivalents at end of period	\$ 254	\$ 1,861	\$ 281	\$	\$ 2,396

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)****Condensed Consolidating Balance Sheets****(Dollars in Millions)**

	Parent Issuer	Guarantors	Non- Guarantors	Eliminations	Consolidated
March 31, 2013					
Assets					
Cash and cash equivalents	\$ 339	\$ 2,085	\$ 354	\$	\$ 2,778
Accounts receivable		71	33		104
Accounts receivable, related party		52			52
Notes receivable		1	34		35
Other receivables	299	43	3	(333)	12
Inventories		993	53		1,046
Deferred income taxes, net		838	1	(13)	826
Prepaid expenses and other	9	163	4		176
Total current assets	647	4,246	482	(346)	5,029
Property, plant and equipment, net	5	1,005	24		1,034
Trademarks and other intangible assets, net		2,449	5		2,454
Goodwill		7,999	12		8,011
Long-term intercompany notes receivable	1,936	1,305		(3,241)	
Investment in subsidiaries	9,487	450		(9,937)	
Other assets and deferred charges	96	169	50	(65)	250
Total assets	\$ 12,171	\$ 17,623	\$ 573	\$ (13,589)	\$ 16,778
Liabilities and shareholders equity					
Accounts payable	\$ 2	\$ 120	\$ 15	\$	\$ 137
Tobacco settlement accruals		2,757			2,757
Deferred revenue, related party		32			32
Current maturities of long-term debt		60			60
Other current liabilities	639	783	83	(346)	1,159
Total current liabilities	641	3,752	98	(346)	4,145
Long-term intercompany notes payable	1,305	1,900	36	(3,241)	
Long-term debt (less current maturities)	5,028				5,028
Deferred income taxes, net		547		(65)	482
Long-term retirement benefits (less current portion)	58	1,729	11		1,798
Other noncurrent liabilities	21	186			207
Shareholders equity	5,118	9,509	428	(9,937)	5,118
Total liabilities and shareholders equity	\$ 12,171	\$ 17,623	\$ 573	\$ (13,589)	\$ 16,778

Table of Contents**Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)****Condensed Consolidating Balance Sheets****(Dollars in Millions)**

	Parent Issuer	Guarantors	Non- Guarantors	Eliminations	Consolidated
December 31, 2012					
Assets					
Cash and cash equivalents	\$ 755	\$ 1,420	\$ 327	\$	\$ 2,502
Accounts receivable		63	24		87
Accounts receivable, related party		61			61
Notes receivable		1	34		35
Other receivables	369	48	4	(405)	16
Inventories		944	41	(1)	984
Deferred income taxes, net		909	1	(2)	908
Prepaid expenses and other	25	188	8	(2)	219
Total current assets	1,149	3,634	439	(410)	4,812
Property, plant and equipment, net	5	1,019	12	1	1,037
Trademarks and other intangible assets, net		2,450	5		2,455
Goodwill		7,999	12		8,011
Long-term intercompany notes receivable	1,920	1,316		(3,236)	
Investment in subsidiaries	8,956	456		(9,412)	
Other assets and deferred charges	88	165	51	(62)	242
Total assets	\$ 12,118	\$ 17,039	\$ 519	\$ (13,119)	\$ 16,557
Liabilities and shareholders equity					
Accounts payable	\$ 1	\$ 183	\$ 3	\$	\$ 187
Tobacco settlement accruals		2,489			2,489
Due to related party		1			1
Deferred revenue, related party		42			42
Current maturities of long-term debt		60			60
Other current liabilities	425	910	64	(409)	990
Total current liabilities	426	3,685	67	(409)	3,769
Long-term intercompany notes payable	1,316	1,920		(3,236)	
Long-term debt (less current maturities)	5,035				5,035
Deferred income taxes, net		523		(62)	461
Long-term retirement benefits (less current portion)	58	1,752	11		1,821
Other noncurrent liabilities	26	188			214
Shareholders equity	5,257	8,971	441	(9,412)	5,257
Total liabilities and shareholders equity	\$ 12,118	\$ 17,039	\$ 519	\$ (13,119)	\$ 16,557

Table of Contents**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following is a discussion and analysis of RAI's business, initiatives, critical accounting estimates and its consolidated results of operations and financial position. Following the overview and discussion of business initiatives, the critical accounting estimates disclose certain accounting estimates that are material to RAI's results of operations and financial position for the periods presented in this report. The discussion and analysis of RAI's results of operations compares the first quarter of 2013 with the first quarter of 2012. Disclosures related to liquidity and financial position complete management's discussion and analysis. You should read this discussion and analysis of RAI's consolidated financial position and results of operations in conjunction with the financial information included in the condensed consolidated financial statements (unaudited).

Overview and Business Initiatives

RAI's reportable operating segments are RJR Tobacco, American Snuff and Santa Fe. The RJR Tobacco segment consists of the primary operations of R. J. Reynolds Tobacco Company. The American Snuff segment consists of the primary operations of American Snuff Co. The Santa Fe segment consists of the primary operations of SFNTC. Niconovum AB and RJR Vapor, among other RAI subsidiaries, are included in All Other. The segments were identified based on how RAI's chief operating decision maker allocates resources and assesses performance. Certain of RAI's operating subsidiaries have entered into intercompany agreements for products or services with other subsidiaries. As a result, certain activities of an operating subsidiary may be included in a different segment of RAI.

RAI's strategy encourages the migration of adult smokers to smoke-free tobacco products, which it believes aligns consumer preferences for new alternatives to traditional tobacco products in view of societal pressure to reduce public smoking. RAI's operating companies facilitate this migration through innovation, including the development of CAMEL Snus, tobacco extract products, heat-not-burn cigarettes, tobacco vapor products and nicotine replacement therapy technologies.

RAI's largest reportable operating segment, RJR Tobacco, is the second largest tobacco company in the United States. RJR Tobacco's brands include many of the best-selling cigarettes in the United States: CAMEL, PALL MALL, WINSTON, KOOL, DORAL and SALEM. Those brands, and its other brands, including MISTY and CAPRI, are manufactured in a variety of styles and marketed in the United States. RJR Tobacco also manages contract manufacturing of cigarettes and tobacco products through arrangements with BAT affiliates, and manages the export of tobacco products to certain U.S. territories, U.S. duty-free shops and U.S. overseas military bases. RJR Tobacco manages the super-premium cigarette brands, DUNHILL and STATE EXPRESS 555, which are licensed from BAT.

American Snuff is the second largest smokeless tobacco products manufacturer in the United States. American Snuff's primary brands include its largest selling moist snuff brands, GRIZZLY and KODIAK.

Santa Fe manufactures and markets super-premium cigarettes and other tobacco products under the NATURAL AMERICAN SPIRIT brand.

RJR Tobacco

RJR Tobacco primarily conducts business in the highly competitive U.S. cigarette market, which has a few large manufacturers and many smaller participants. The U.S. cigarette market is a mature market in which overall consumer demand has declined since 1981 and is expected to continue to decline. Profitability of the U.S. cigarette industry and RJR Tobacco continues to be adversely impacted by decreases in consumption, increases in state excise taxes and governmental regulations and restrictions, such as marketing limitations, product standards and ingredients legislation.

The international rights to substantially all of RJR Tobacco's brands were sold in 1999 to JTI, and no international rights were acquired in connection with the B&W business combination.

RJR Tobacco's cigarette brand portfolio strategy is based upon three brand categories: growth, support and non-support. The growth brands consist of a premium brand, CAMEL, and a value brand, PALL MALL. Although both

Table of Contents

of these brands are managed for long-term market share and profit growth. CAMEL will continue to receive the most significant equity support. The support brands include four premium brands, WINSTON, KOOL, SALEM and CAPRI, and two value brands, DORAL and MISTY, all of which receive limited marketing support. The non-support brands, consisting of all other brands, are managed to maximize near-term profitability. The key objectives of the portfolio strategy are designed to focus on the long-term market share growth of the growth brands while managing the support brands for long-term sustainability and profitability.

RJR Tobacco's portfolio also includes CAMEL Snus, a modern smoke-free tobacco that focuses on long-term growth. CAMEL Snus is heat-treated tobacco in individual pouches that provides convenient tobacco consumption.

Competition is based primarily on brand positioning, including price, product attributes and packaging, consumer loyalty, promotions, advertising and retail presence. Cigarette brands produced by the major manufacturers generally require competitive pricing, substantial marketing support, retail programs and other incentives to maintain or improve market position or to introduce a new brand or brand style. Competition among the major cigarette manufacturers has begun shifting to product innovation and expansion into smoke-free tobacco categories, such as snus, as well as finding efficient and effective means of balancing market share and profit growth.

RJR Tobacco is committed to building and maintaining a portfolio of profitable brands. RJR Tobacco's marketing programs are designed to strengthen brand image, build brand awareness and loyalty, and switch adult smokers of competing brands to RJR Tobacco brands. In addition to building strong brand equity, RJR Tobacco's marketing approach utilizes a retail pricing strategy, including discounting at retail, to defend certain brands' shares of market against competitive pricing pressure. RJR Tobacco's competitive pricing methods may include list price changes, discounting programs, such as retail and wholesale buydowns, periodic price reductions, off-invoice price reductions, dollar-off promotions and consumer coupons. Retail buydowns refer to payments made to the retailer to reduce the price that consumers pay at retail. Consumer coupons generally are distributed by a variety of methods, including in, or on, the cigarette pack and by direct mail.

American Snuff

American Snuff offers a range of differentiated smokeless and other tobacco products to adult consumers. The moist snuff category is divided into premium and price-value brands. The moist snuff category has developed many of the characteristics of the larger cigarette market, including multiple pricing tiers with intense competition, focused marketing programs and significant product innovation.

In contrast to the declining U.S. cigarette market, U.S. moist snuff retail volumes grew approximately 5% in the first three months of 2013. Profit margins on moist snuff products are generally higher than on cigarette products. Moist snuff's growth is partially attributable to cigarette smokers switching from cigarettes to smokeless tobacco products or using both.

American Snuff faces significant competition in the smokeless tobacco categories. Similar to the cigarette market, competition is based primarily on brand positioning and price, as well as product attributes and packaging, consumer loyalty, promotions, advertising and retail presence.

Santa Fe

Santa Fe competes in the U.S. cigarette market. Santa Fe's cigarette brand, NATURAL AMERICAN SPIRIT, is priced at a premium compared with most other competitive brands, and is differentiated from key competitors through its use of all natural, additive-free tobacco. Competition in the cigarette category is based primarily on brand positioning, including price, product attributes and packaging, consumer loyalty, promotions, advertising and retail presence.

Other

RAI's subsidiary, Niconovum AB, is a marketer of nicotine replacement therapy products in Sweden under the ZONNIC brand name. RAI's subsidiary, Niconovum USA, Inc., has entered into its first lead market in the United States with ZONNIC, a nicotine replacement therapy gum, while another subsidiary, RJR Vapor, has introduced an electronic cigarette, VUSE, in limited distribution in the United States.

Table of Contents

Critical Accounting Estimates

GAAP requires estimates and assumptions to be made that affect the reported amounts in RAI's condensed consolidated financial statements (unaudited) and accompanying notes. Some of these estimates require difficult, subjective and/or complex judgments about matters that are inherently uncertain, and as a result, actual results could differ from those estimates. Due to the estimation processes involved, the following summarized accounting policies and their application are considered to be critical to understanding the business operations, financial position and results of operations of RAI and its subsidiaries.

Litigation

RAI discloses information concerning litigation for which an unfavorable outcome is more than remote. RAI and its subsidiaries record their legal expenses and other litigation costs and related administrative costs as selling, general and administrative expenses as those costs are incurred. RAI and its subsidiaries will record any loss related to litigation at such time as an unfavorable outcome becomes probable and the amount can be reasonably estimated on an individual case-by-case basis. When the reasonable estimate is a range, the recorded loss will be the best estimate within the range. If no amount in the range is a better estimate than any other amount, the minimum amount of the range will be recorded.

As discussed in note 9 to condensed consolidated financial statements (unaudited), RJR Tobacco, American Snuff Co. and their affiliates, including RAI, and indemnitees, have been named in a number of tobacco-related legal actions, proceedings or claims seeking damages in amounts ranging into the hundreds of millions or even billions of dollars. Unfavorable judgments have been returned in a number of tobacco-related cases and state enforcement actions.

RAI and its subsidiaries believe that they have valid bases for appeal of adverse verdicts against them and believe they have valid defenses to all actions, and they intend to defend all actions vigorously. RAI's management continues to conclude that the loss of any particular smoking and health tobacco litigation claim against RJR Tobacco or its affiliates or indemnitees, including B&W, or the loss of any particular claim concerning the use of smokeless tobacco against American Snuff Co., when viewed on an individual basis, is not probable or estimable, except for the *Bowman* case accrued as of March 31, 2013, as described in Tobacco Litigation General Accounting for Tobacco-Related Contingencies in note 9 to condensed consolidated financial statements (unaudited).

Litigation is subject to many uncertainties, and it is possible that some of the tobacco-related legal actions, proceedings or claims could ultimately be decided against RJR Tobacco, American Snuff Co. or their affiliates, including RAI, and indemnitees. Any unfavorable outcome of such actions could have a material adverse effect on the consolidated results of operations, cash flows or financial position of RAI or its subsidiaries. For further discussion of the litigation and legal proceedings pending against RAI or its affiliates or indemnitees, see note 9 to condensed consolidated financial statements (unaudited).

State Settlement Agreements

RJR Tobacco and SFNTC are participants in the MSA, and RJR Tobacco is a participant in the other State Settlement Agreements. Their obligations and the related expense charges under the State Settlement Agreements are subject to adjustments based upon, among other things, the volume of cigarettes sold by the operating subsidiaries, their relative market share and inflation. Since relative market share is based on cigarette shipments, the best estimate of the allocation of charges to RJR Tobacco and SFNTC under these agreements is recorded in cost of products sold as the products are shipped. Included in these adjustments is an NPM Adjustment that potentially reduces the annual payment obligation of RJR Tobacco, SFNTC and the other PMs. Adjustments to these estimates are recorded in the period that the change becomes probable and the amount can be reasonably estimated. American Snuff Co. is not a participant in the State Settlement Agreements. For additional information related to historical and expected settlement expenses and payments under the State Settlement Agreements, see

Litigation Affecting the

Table of Contents

Cigarette Industry Health-Care Cost Recovery Cases State Settlement Agreements and State Settlement Agreements Enforcement and Validity; Adjustments in note 9 to condensed consolidated financial statements (unaudited).

Pension and Postretirement Benefits

RAI sponsors a number of non-contributory defined benefit pension plans covering most of the employees of RAI and certain of its subsidiaries, and also provides certain health and life insurance benefits for most of their retired employees and their dependents. These benefits are generally no longer provided to employees hired on or after January 1, 2004.

Because pension and other postretirement obligations ultimately will be settled in future periods, the determination of annual expense and liabilities is subject to estimates and assumptions. RAI reviews these assumptions annually based on historic experience and expected future trends or coincidental with a major event and modifies them as needed. Demographic assumptions such as termination of employment, mortality or retirement are reviewed periodically as expectations change.

Actuarial gains or losses are annual changes in the amount of either the benefit obligation or the fair value of plan assets resulting from experience different from that assumed or from changes in assumptions. RAI immediately recognizes actuarial gains and losses in its operating results in the year in which they occur, to the extent such gains and losses are in excess of 10% of the greater of the fair value of the plan assets or the plan's benefit obligation, referred to as the corridor. Actuarial gains and losses outside the corridor are generally recognized annually as of December 31, or when the plans are remeasured during an interim period. Additionally, for the purposes of calculating the expected return on plan assets, RAI uses the actual fair value of plan assets.

Prior service costs of pension expense, which are changes in benefit obligations due to plan amendments, are amortized on a straight-line basis over the average remaining service period for active employees, or average remaining life expectancies for inactive employees if most of the plan obligations are due to inactive employees. Prior service costs of postretirement benefits, which are changes in benefit obligations due to plan amendments, are amortized on a straight-line basis over the expected service period to full eligibility age for active employees, or average remaining life expectancies for inactive employees if most of the plan obligations are due to inactive employees.

In recent years, actual results have varied significantly from actuarial assumptions. In particular, pension and postretirement obligations have increased due to significant decreases in discount rates. These changes have resulted in an increase in charges to other comprehensive loss and increased pension and postretirement expense. The Pension Protection Act of 2006 may require additional cash funding of the increased pension obligations in the future.

Intangible Assets

Intangible assets include goodwill, trademarks and other intangible assets. Goodwill, trademarks and other intangible assets with indefinite lives are tested for impairment annually in the fourth quarter. Goodwill, trademarks and other intangible assets are tested more frequently if events and circumstances indicate that the asset might be impaired. The determination of fair value involves considerable estimates and judgment. For goodwill, the determination of the fair value of a reporting unit involves, among other things, RAI's market capitalization, and application of the income approach, which includes developing forecasts of future cash flows and determining an appropriate discount rate. If goodwill impairment is implied, the fair values of individual assets and liabilities, including unrecorded intangibles, must be determined. Although RAI believes it has based impairment testing and impairment charges of its intangibles on reasonable estimates and assumptions, the use of different estimates and assumptions could result in materially different results. If the current competitive or regulatory environment worsens or RAI's operating companies' strategic initiatives adversely affect their financial performance, the fair value of goodwill, trademarks and other intangible assets could be impaired in future periods.

Table of Contents*Fair Value Measurement*

RAI determines fair value of assets and liabilities using a fair value hierarchy that distinguishes between market participant assumptions based on market data obtained from sources independent of the reporting entity, and the reporting entity's own assumptions about market participant assumptions based on the best information available in the circumstances.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, essentially an exit price. The levels of the fair value hierarchy are:

Level 1: inputs are quoted prices, unadjusted, in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

Level 2: inputs are other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. A Level 2 input must be observable for substantially the full term of the asset or liability.

Level 3: inputs are unobservable and reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability.

Income Taxes

Tax law requires certain items to be excluded or included in taxable income at different times than is required for book reporting purposes. These differences may be permanent or temporary in nature.

RAI determines its annual effective income tax rate based on forecasted pre-tax book income and forecasted permanent book and tax differences. The rate is established at the beginning of the year and is evaluated on a quarterly basis. Any changes to the forecasted information may cause the effective rate to be adjusted. Additional tax, interest and penalties associated with uncertain tax positions are recognized in tax expense on a quarterly basis.

To the extent that any book and tax differences are temporary in nature, that is, the book realization will occur in a different period than the tax realization, a deferred tax asset or liability is established. To the extent that a deferred tax asset is created, management evaluates RAI's ability to realize this asset. RAI maintains a valuation allowance to reduce certain deferred tax assets to amounts that are more likely than not to be realized. This allowance is attributable to deferred tax assets established for capital loss carryforwards.

The financial statements reflect management's best estimate of RAI's current and deferred tax liabilities and assets. Future events, including, but not limited to, additional resolutions with taxing authorities could have an impact on RAI's current estimate of tax liabilities, realization of tax assets and effective income tax rate.

Recently Issued and Adopted Accounting Pronouncements

For information relating to recently issued and adopted accounting pronouncements, see note 1 to condensed consolidated financial statements (unaudited).

Results of Operations

	For the Three Months Ended March 31,		
	2013	2012	% Change
Net sales ⁽¹⁾ :			
RJR Tobacco	\$ 1,558	\$ 1,631	(4.5)%
American Snuff	167	158	5.7%
Santa Fe	115	100	15.0%
All Other	43	44	(2.3)%
Net sales	1,883	1,933	(2.6)%

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

Cost of products sold ⁽¹⁾⁽²⁾	694	994	(30.2)%
Selling, general and administrative expenses	301	298	1.0%
Amortization expense	1	6	(83.3)%
Restructuring charge		149	NM ⁽³⁾
Operating income (loss):			
RJR Tobacco	758	377	101.1%
American Snuff	93	84	10.7%
Santa Fe	54	45	20%
All Other	(4)	8	NM ⁽³⁾
Corporate expense	(14)	(28)	(50.0)%
Operating income	\$ 887	\$ 486	82.5%

Table of Contents

(1) Excludes excise taxes of:

	For the Three Months Ended March 31,	
	2013	2012
RJR Tobacco	\$ 748	\$ 818
American Snuff	12	12
Santa Fe	40	35
All Other	55	58
	\$ 855	\$ 923

(2) See below for further information related to the State Settlement Agreements, federal tobacco buyout expense and FDA expense included in cost of products sold.

(3) Percentage of change not meaningful.

In the following discussion, the amounts presented in the operating companies shipment volume and share tables are rounded on an individual basis and, accordingly, may not sum in the aggregate. Percentages are calculated on unrounded numbers.

RJR Tobacco*Net Sales*

Domestic cigarette shipment volume, in billions of units for RJR Tobacco and the industry, were as follows:

	For the Three Months Ended March 31,		
	2013	2012	% Change
RJR Tobacco⁽¹⁾:			
Growth brands:			
CAMEL	4.8	5.1	(5.5)%
PALL MALL	4.8	4.9	(2.0)%
	9.6	10.0	(3.8)%
Other	5.3	6.3	(16.4)%
Total RJR Tobacco domestic cigarette shipment volume	14.9	16.3	(8.7)%
Total premium	8.7	9.5	(9.1)%
Total value	6.2	6.7	(8.1)%
Premium/total mix	58.3%	58.5%	
Industry⁽¹⁾:			
Premium	44.7	47.4	(5.8)%
Value	18.1	19.4	(7.0)%
Total industry domestic cigarette shipment volume	62.7	66.8	(6.2)%
Premium/total mix	71.2%	70.9%	

⁽¹⁾ Based on information from Management Science Associates, Inc.

Table of Contents

RJR Tobacco's net sales are dependent upon its cigarette shipment volume in a declining market, premium versus value-brand mix and list pricing, offset by promotional spending, trade incentives and federal excise taxes.

RJR Tobacco's net sales for the quarter ended March 31, 2013, decreased compared with the prior-year quarter, due to \$158 million attributable to lower cigarette volume partially offset by higher pricing of \$73 million.

The shares of RJR Tobacco's cigarette brands as a percentage of total share of U.S. retail cigarette sales based on data collected by SymphonyIRI Group, Inc. and Capstone Research Inc., collectively referred to as IRI/Capstone⁽¹⁾, were as follows:

	For the Three Months Ended				
	March 31, 2013	December 31, 2012	Share Point Change	March 31, 2012	Share Point Change
Growth brands:					
CAMEL	8.5%	8.6%	(0.1)	8.4%	0.1
PALL MALL	9.0%	8.9%	0.1	8.4%	0.5
Total growth brands	17.5%	17.5%		16.9%	0.6
Other	8.6%	8.9%	(0.3)	9.9%	(1.3)
Total RJR Tobacco domestic cigarette retail share of market	26.1%	26.4%	(0.3)	26.7%	(0.6)

⁽¹⁾ Retail share of U.S. cigarette sales data is included in this document because it is used by RJR Tobacco primarily as an indicator of the relative performance of industry participants, and brands and market trends. You should not rely on the market share data reported by IRI/Capstone as being a precise measurement of actual market share because IRI/Capstone is not able to effectively track all volume. Moreover, you should be aware that in a product market experiencing overall declining consumption, a particular product can experience increasing market share relative to competing products, yet still be subject to declining consumption volumes.

The retail share of market of CAMEL, at 8.5 share points, was up slightly compared with the prior-year quarter, in spite of significant competitive activity and promotional support.

CAMEL's cigarette market share continued to be favorably impacted by its innovative capsule technology offered in CAMEL Crush and CAMEL menthol styles. CAMEL Crush styles provide adult smokers the choice of switching from non-menthol to menthol; CAMEL menthol styles allow adult smokers to choose the level of menthol flavor on demand. CAMEL's first quarter of 2013 menthol market share, including CAMEL Crush styles, increased 0.5 percentage points from the first quarter of 2012 to 3.3 percent.

CAMEL Snus, a smoke-free tobacco product, continues to lead the growing U.S. snus category. CAMEL Snus continued to show steady growth in 2013 as interest builds in this convenient option for adult tobacco customers. CAMEL Snus introduced Fresh Seal packaging in February 2013, which eliminates the need for refrigeration, while continuing to ensure that adult tobacco consumers benefit from the freshness and flavor of this product.

Table of Contents

PALL MALL, a product that offers a high quality, longer-lasting cigarette at a value price, continues to attract interest from adult tobacco consumers. PALL MALL's first-quarter market share of 9.0% was up significantly compared with the prior-year period despite continued competitive pressure. The recent expansion of PALL MALL's menthol portfolio is providing the brand incremental growth.

The combined share of market of RJR Tobacco's growth brands during the first quarter of 2013 increased by 0.6 share points over the same period in 2012. RJR Tobacco's total cigarette market share declined from the prior year, mainly driven by losses on the company's support and non-support brands, consistent with its strategy of focusing on growth brands.

Operating Income

RJR Tobacco's operating income for the three-month period ended March 31, 2013, was favorably impacted by the partial settlement of certain NPM Adjustment claims of \$259 million, higher cigarette pricing and productivity improvements, partially offset by lower cigarette volume and increased promotional spending. In addition, RJR Tobacco incurred a restructuring charge of \$138 million in the first quarter of 2012.

RJR Tobacco's expense under the State Settlement Agreements, federal tobacco quota buyout and FDA user fees, included in cost of products sold, are detailed in the schedule below:

	For the Three Months Ended	
	March 31,	
	2013	2012
State Settlement Agreements	\$ 250	\$ 540
Federal tobacco quota buyout	49	53
FDA user fees	30	29

Expenses under the State Settlement Agreements are expected to be approximately \$1.8 billion in 2013, subject to adjustment for changes in volume and other factors. Pursuant to the Term Sheet, RJR Tobacco will receive credits with respect to its NPM Adjustment claims for the period from 2003 through 2012. These credits will be applied against annual payments under the MSA over a five-year period, commencing with the MSA payment due in April 2013. As a result of the binding Order, RJR Tobacco's MSA expenses were reduced by \$202 million for the three months ended March 31, 2013, recognizing the credit that reduced its April 2013 MSA payment. In addition, RJR Tobacco will recognize additional credits in 2013 through 2016, subject to meeting the various performance obligations associated with the Term Sheet. The amount of these credits recognized for the three months ended March 31, 2013 was approximately \$57 million. Expense for the federal tobacco quota buyout is expected to be approximately \$195 million to \$205 million in 2013. For additional information, see *Litigation Affecting the Cigarette Industry Health-Care Cost Recovery Cases State Settlement Agreements and Tobacco Buyout Legislation* in note 9 and *Cost of Products Sold* in note 1 to condensed consolidated financial statements (unaudited). Expenses for FDA user fees are expected to be approximately \$115 million to \$125 million in 2013. For additional information, see *Governmental Activity* below.

Selling, general and administrative expenses include the costs of litigating and administering product liability claims, as well as other legal expenses. RJR Tobacco's product liability defense costs were \$42 million for the three months ended March 31, 2013 and 2012.

Product liability cases generally include the following types of smoking and health related cases:

Individual Smoking and Health;

West Virginia IPIC;

Engle Progeny;

Broin II;

Table of Contents

Class Actions; and

Health-Care Cost Recovery Claims.

Product liability defense costs include the following items:

direct and indirect compensation, fees and related costs, and expenses for internal legal and related administrative staff administering product liability claims;

fees and cost reimbursements paid to outside attorneys;

direct and indirect payments to third party vendors for litigation support activities;

expert witness costs and fees; and

payments to fund legal defense costs for the now dissolved Council for Tobacco Research U.S.A.

Numerous factors affect product liability defense costs. The most important factors are the number of cases pending and the number of cases in trial or in preparation for trial, that is, with active discovery and motions practice. See *Litigation Affecting the Cigarette Industry Overview* in note 9 to condensed consolidated financial statements (unaudited) for detailed information regarding the number and type of cases pending, and

Litigation Affecting the Cigarette Industry Scheduled Trials in note 9 to condensed consolidated financial statements (unaudited) for detailed information regarding the number and nature of cases in trial and scheduled for trial through March 31, 2014.

RJR Tobacco expects that the factors described above will continue to have the primary impact on its product liability defense costs in the future. Given the level of activity in RJR Tobacco's pending cases, including the number of cases in trial and scheduled for trial, particularly with respect to *Engle Progeny* cases, RJR Tobacco's product liability defense costs continue to remain at a high level. In addition, it is possible that other adverse developments in the factors discussed above, as well as other circumstances beyond the control of RJR Tobacco, could have a material adverse effect on the consolidated results of operations, cash flows or financial position of RAI or its subsidiaries. Those other circumstances beyond the control of RJR Tobacco include the results of present and future trials and appeals, and the development of possible new theories of liability by plaintiffs and their counsel.

American Snuff***Net Sales***

The moist snuff shipment volume to wholesale, in millions of cans, for American Snuff was as follows:

	For the Three Months Ended		
	2013	March 31, 2012	% Change
GRIZZLY	94.9	93.0	2.1%
Other	10.7	11.5	(6.9)%
Total American Snuff moist snuff shipment volume	105.6	104.4	1.1%

American Snuff's net sales for the three-month period ended March 31, 2013, were favorably impacted by higher moist snuff volume and pricing.

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

Moist snuff has been the key driver to American Snuff's overall growth and profitability within the U.S. smokeless tobacco market. Moist snuff accounted for approximately 87% of American Snuff's revenue in the first quarter of 2013 compared with approximately 85% of American Snuff's revenue in the first quarter of 2012. U.S. moist snuff industry retail shipment volume grew by approximately 5.0% in the first quarter of 2013 compared with the same period in 2012.

Table of Contents

The shares of American Snuff's moist snuff brands as a percentage of total share of U.S. retail moist snuff sales according to IRI/Capstone⁽¹⁾, were as follows:

	For the Three Months Ended				
	March 31, 2013	December 31, 2012	Share Point Change	March 31, 2012	Share Point Change
GRIZZLY	29.8%	29.2%	0.6	28.7%	1.1
Other	3.2%	3.4%	(0.2)	3.5%	(0.3)
Total American Snuff moist snuff retail share of market	33.0%	32.6%	0.4	32.2%	0.8

⁽¹⁾ Retail share of U.S. moist snuff sales data is included in this document because it is used by American Snuff primarily as an indicator of the relative performance of industry participants, and brands and market trends. You should not rely on the market share data reported by IRI/Capstone as being a precise measurement of actual market share because IRI/Capstone is not able to effectively track all volume. GRIZZLY, the leading U.S. moist snuff brand, grew 1.1 share points in the first quarter of 2013, compared with the first quarter of 2012. GRIZZLY's increase in first quarter shipment volume was negatively impacted by two fewer shipping days in the quarter and the timing of promotional shipments in the prior-year quarter. GRIZZLY's pouch sales continued their strong performance, with shipments increasing by more than 30%.

Operating Income

American Snuff's operating income for the three months ended March 31, 2013, increased as compared with the three months ended March 31, 2012, due to higher moist snuff pricing and sales volume.

*Santa Fe**Net Sales*

Domestic cigarette shipment volume, in billions of units for Santa Fe, was as follows:

	For the Three Months Ended		
	2013	2012	% Change
NATURAL AMERICAN SPIRIT	0.7	0.6	14.7%

Santa Fe's net sales for the three-month period ended March 31, 2013, were favorably impacted by higher pricing and volume. The cigarette shipment volume in the first quarter of 2012 was negatively impacted by Santa Fe's shift to a more efficient integrated supply chain. This shift resulted in a one-time reduction of wholesale inventory levels.

The shares of Santa Fe's NATURAL AMERICAN SPIRIT as a percentage of total share of U.S. retail cigarette sales according to data from IRI/Capstone⁽¹⁾, were as follows:

	For the Three Months Ended				
	March 31, 2013	December 31, 2012	Share Point Change	March 31, 2012	Share Point Change
NATURAL AMERICAN SPIRIT	1.3%	1.3%		1.1%	0.2

Table of Contents

- (1) Retail share of U.S. cigarette sales data is included in this document because it is used by Santa Fe primarily as an indicator of the relative performance of industry participants, and brands and market trends. You should not rely on the market share data reported by IRI/Capstone as being a precise measurement of actual market share because IRI/Capstone is not able to effectively track all volume. Moreover, you should be aware that in a product market experiencing overall declining consumption, a particular product can experience increasing market share relative to competing products, yet still be subject to declining consumption volumes.

Operating Income

Santa Fe's operating income for the three months ended March 31, 2013, increased as compared with the three months ended March 31, 2012, as a result of higher cigarette pricing and volume.

Santa Fe's expense under the MSA, federal tobacco quota buyout and FDA user fees, included in cost of products sold, are detailed in the schedule below:

	For the Three Months Ended	
	March 31,	
	2013	2012
MSA	\$ 17	\$ 16
Federal tobacco quota buyout	2	2
FDA user fees	1	1

Expenses under the MSA are expected to be approximately \$90 million to \$100 million in 2013, subject to adjustment for changes in volume and other factors. Pursuant to the Term Sheet, SFNTC will receive credits with respect to its NPM Adjustment claims for the period from 2003 to 2012. Santa Fe's expenses for the MSA were reduced by approximately \$2 million for the three months ended March 31, 2013, for the credit that reduced its April 2013 MSA payment. For additional information, see *Litigation Affecting the Cigarette Industry Health-Care Cost Recovery Cases State Settlement Agreements* in note 9 and *Cost of Products Sold* in note 1 to condensed consolidated financial statements (unaudited).

Other

In 2012, RAI's subsidiary, Nicovum USA, Inc. entered its first lead market in the United States with ZONNIC, a nicotine replacement therapy product and continues to generate marketing feedback. Another subsidiary, RJR Vapor, introduced an electronic cigarette, VUSE, in limited distribution in the United States.

RAI Consolidated

Interest and debt expense was \$62 million for the quarter ended March 31, 2013, compared with \$56 million for the quarter ended March 31, 2012, due to higher average debt balances in the 2013 period partially offset by lower interest rates.

Restructuring costs of \$149 million were recorded during the first quarter of 2012. RAI and its subsidiaries, RJR Tobacco and RAI Services Company, completed a business analysis designed to identify resources to reinvest in their businesses. As a result of this initiative, the total U.S. workforce of RAI and its subsidiaries will decline by a net of approximately 10% upon the completion of the restructuring by the end of 2014. Job eliminations, a majority of which were voluntary, during that period will be partially offset by the hiring of new employees as and where needed.

Provision for income taxes was \$321 million, for an effective rate of 38.8%, for the three months ended March 31, 2013, compared with \$159 million, for an effective rate of 37.0%, for the three months ended March 31, 2012. The effective tax rate for the three months ended March 31, 2013, as compared with the same prior-year period, was unfavorably impacted by a reduction in the domestic production activities deduction of the American Jobs Creation Act of 2004. The effective income tax rate for each period exceeded the federal statutory rate of 35% due to the impact of state taxes and certain nondeductible items, offset by the domestic production activities deduction.

Table of Contents**Liquidity and Financial Condition*****Liquidity***

At present, the principal sources of liquidity for RAI's operating subsidiaries' businesses and operating needs are internally generated funds from their operations and intercompany loans and advances. The principal sources of liquidity for RAI, in turn, are proceeds from issuances of debt securities, the Credit Agreement and the Term Loan described below under Borrowing Arrangements. Cash flows from operating activities are believed to be sufficient for the foreseeable future to enable the operating subsidiaries to meet their obligations under the State Settlement Agreements, to fund their capital expenditures and to make payments to RAI that, when combined with RAI's cash balances and proceeds from any financings, will enable RAI to make its required debt-service payments, to pay dividends to its shareholders and purchase shares under its share repurchase program.

The negative impact, if any, on the sources of liquidity that could result from a decrease in demand for products due to short-term inventory adjustments by wholesale and retail distributors, changes in competitive pricing, accelerated declines in consumption, particularly from increases in regulation or excise taxes, or adverse impacts from financial markets, cannot be predicted. RAI cannot predict its cash requirements or those of its subsidiaries related to any future settlements or judgments, including cash required to be held in escrow or to bond any appeals, if necessary, and RAI makes no assurance that it or its subsidiaries will be able to meet all of those requirements.

RAI's operating companies monitor the liquidity of key suppliers and customers, and where liquidity concerns are identified, appropriate contingency or response plans are developed. During the quarter ended March 31, 2013, no business interruptions occurred due to key supplier liquidity, and no liquidity issues were identified involving significant suppliers or customers.

RAI's excess cash may be invested in money market funds, commercial paper, U.S. treasuries, U.S. government agencies and time deposits in major institutions to minimize investment risk. At present, RAI primarily invests cash in U.S. treasuries.

As of March 31, 2013, R.J. Reynolds Tobacco C.V., an indirect wholly owned subsidiary of RAI, held approximately 72 million euros in a euro government liquidity fund, included in cash and cash equivalents in RAI's condensed consolidated balance sheet (unaudited). Nearly two-thirds of the fund is comprised of repurchase agreements with financial institutions that are collateralized by sovereign debt of approved countries. The fund has investments in sovereign debt of France, Belgium, Germany and the Netherlands. The average maturity of the fund was 28 days as of March 31, 2013. RAI's management believes that this cash equivalent is not reasonably likely to have a material impact on RAI's liquidity or results of operations. RAI has no hedge in place with respect to this exposure.

As of March 31, 2013, RAI held investments in auction rate securities, a mortgage-backed security and a marketable equity security totaling \$91 million. Adverse changes in financial markets had caused the auction rate securities and the mortgage-backed security to revalue lower than carrying value and become less liquid. The auction rate securities and mortgage-backed security will not become liquid until a successful auction occurs or a buyer is found. RAI intends, and has the ability, to hold these auction rate securities and mortgage-backed security for a period of time sufficient to allow for sale, redemption or anticipated recovery in fair value. For additional information on these investments, see note 2 to condensed consolidated financial statements (unaudited).

Cash Flows

Net cash flows from operating activities were \$945 million in the first three months of 2013, compared with \$1,053 million in the first three months of 2012. This change was driven primarily by higher net income in the first three months of 2013 that is more than offset by the impact of restructuring and tobacco settlements.

Net cash flows used in investing activities were \$20 million in the first three months of 2013, compared with \$26 million in the first three months of 2012, primarily due to lower capital expenditures in the first three months of 2013.

Table of Contents

Net cash flows used in financing activities were \$643 million in the first three months of 2013, compared with \$593 million in the prior-year period. This increase in usage was primarily the result of an increase in the repurchase of common stock in 2013 and a lower income tax benefit on stock-based compensation in the first quarter of 2013.

Borrowing Arrangements

RAI and RJR Notes

As of March 31, 2013, the principal amount of RAI's and RJR's outstanding notes was \$5.0 billion, with maturity dates ranging from 2013 to 2042. RAI, at its option, may redeem any or all of its outstanding notes, in whole or in part at any time, subject to the payment of a make-whole premium. RJR's 9.25% notes due in 2013, \$60 million in principal amount of which was outstanding as of March 31, 2013, are not redeemable.

Credit Agreement

On July 29, 2011, RAI entered into a Credit Agreement with a syndicate of lenders, providing for a four-year \$750 million senior unsecured revolving credit facility, which may be increased to \$1 billion at the discretion of the lenders upon the request of RAI. This agreement replaced RAI's Fifth Amended and Restated Credit Agreement, dated as of June 28, 2007, as amended. The obligations of RAI under the Credit Agreement are unsecured. Certain of RAI's subsidiaries, including its Material Subsidiaries, have guaranteed, on an unsecured basis, RAI's obligations under the Credit Agreement.

On March 27, 2012, RAI and the subsidiary guarantors entered into a First Amendment to the Credit Agreement and First Amendment to the Subsidiary Guarantee Agreement to provide for the further guarantee by the subsidiary guarantors of RAI's obligations to the lenders and affiliates thereof under certain designated swap, forward, future or derivative transactions or options or similar agreements from time to time entered into between RAI and such lenders or affiliates.

For additional information on the Credit Agreement, see note 8 to condensed consolidated financial statements (unaudited).

Term Loan

On March 15, 2013, RAI entered into a Term Loan with a syndicate of lenders, providing for an unsecured delayed draw term loan facility, with a maximum borrowing capacity of up to \$500 million. On April 10, 2013, RAI borrowed the entire \$500 million under the Term Loan, with such borrowing initially bearing interest at the annual rate of approximately 1.7%. The Term Loan matures December 27, 2013. RAI used the proceeds for general corporate purposes of RAI and its subsidiaries, including to make payments under the MSA and to purchase shares under RAI's share repurchase program.

Concerns about, or lowering of, RAI's ratings by S&P or Moody's could have an adverse impact on RAI's ability to access the debt markets and could increase borrowing costs. However, given the cash balances and operating performance of RAI and its subsidiaries, RAI's management believes that such concerns about, or lowering of, such ratings would not have a material adverse impact on RAI's cash flows.

RAI, RJR and their affiliates were in compliance with all covenants and restrictions imposed by their indebtedness at March 31, 2013.

For additional information on the Term Loan, see note 8 to condensed consolidated financial statements (unaudited).

Dividends

On February 7, 2013, RAI's board of directors declared a quarterly cash dividend of \$0.59 per common share. The dividends were paid on April 1, 2013, to shareholders of record as of March 8, 2013.

Table of Contents

On an annualized basis, the dividend rate is \$2.36 per common share. The current dividend reflects RAI's policy of paying dividends to the holders of RAI's common stock in an aggregate amount that is approximately 80% of RAI's annual consolidated net income.

Stock Repurchases

On November 14, 2011, the board of directors of RAI authorized the repurchase, from time to time on or before mid-2014, of up to \$2.5 billion of outstanding shares of RAI common stock in open-market or privately negotiated transactions.

During the first three months of 2013, RAI repurchased and cancelled 6,844,082 shares of RAI common stock for \$300 million under the above share repurchase program. As of March 31, 2013, RAI had repurchased and cancelled 38,564,952 shares of RAI common stock for \$1.6 billion under the above share repurchase program.

Additionally, during 2013, at a cost of \$25 million, RAI purchased 574,383 shares of RAI common stock that were cancelled with respect to tax liabilities associated with restricted stock units vesting under its Omnibus Plan.

For additional information, see note 10 to condensed consolidated financial statements (unaudited).

Capital Expenditures

RAI's operating subsidiaries recorded cash capital expenditures of \$23 million and \$27 million for the first three months of 2013 and 2012, respectively. The decrease was primarily the result of American Snuff facility expansion projects finalized in the first quarter of 2012. RAI's operating subsidiaries plan to spend an additional \$110 million to \$120 million for capital expenditures during the remainder of 2013. Capital expenditures are funded primarily by cash flows from operations. RAI's operating subsidiaries' capital expenditure programs are expected to continue at a level sufficient to support their strategic and operating needs. There were no material long-term commitments for capital expenditures as of March 31, 2013.

Retirement Benefits

As disclosed in its financial statements for the year ended December 31, 2012, RAI expects to contribute approximately \$110 million to its pension plans in 2013, of which \$2 million was contributed during the first three months of 2013.

Income Taxes

At March 31, 2013, RAI had a net deferred asset of \$350 million. RAI has determined that a valuation of \$33 million is required to fully offset a deferred tax asset related to the federal capital loss carryforward resulting from the sale of Lane, Limited. RAI believes it is unlikely that this deferred tax asset will be realized through the expected generation of future net capital gains. No valuation allowance has been provided on other deferred tax assets as RAI believes it is more likely than not that all of such deferred tax assets will be realized through the expected generation of future taxable income.

Litigation and Settlements

RJR Tobacco, American Snuff Co., and their affiliates, including RAI, and indemnitees, including B&W, have been named in a number of tobacco-related legal actions, proceedings or claims seeking damages in amounts ranging into the hundreds of millions or even billions of dollars. For further discussion of specific cases, see note 9 to condensed consolidated financial statements (unaudited). Unfavorable judgments have been returned in a number of tobacco-related cases and state enforcement actions. As of March 31, 2013, RJR Tobacco had paid approximately \$101 million since January 1, 2011, related to unfavorable smoking and health litigation judgments and \$139 million related to an unfavorable medical monitoring and smoking cessation case.

Table of Contents

As of March 31, 2013, an accrual of \$2.56 million was recorded for the *Bowman* case. See, *Litigation Affecting the Cigarette Industry Engle and Engle Progeny Cases* in note 9 to condensed consolidated financial statements (unaudited). This amount included \$450,000 for compensatory and punitive damages and \$2.11 million for attorneys' fees and statutory interest through March 31, 2013. RJR Tobacco paid this judgment in the second quarter of 2013.

Litigation is subject to many uncertainties, and generally it is not possible to predict the outcome of the litigation pending against RJR Tobacco, American Snuff Co., or their affiliates or indemnitees, or to reasonably estimate the amount or range of any possible loss. Moreover, notwithstanding the quality of defenses available to it and its affiliates in tobacco-related litigation matters, it is possible that RAI's consolidated results of operations, cash flows or financial position could be materially adversely affected by the ultimate outcome of certain pending or future litigation matters or difficulties in obtaining the bonds required to stay execution of judgments on appeal.

In November 1998, RJR Tobacco, B&W and the other major U.S. cigarette manufacturers entered into the MSA with attorneys general representing most U.S. states, territories and possessions. The State Settlement Agreements impose a perpetual stream of future payment obligations on RJR Tobacco and the other major U.S. cigarette manufacturers, and place significant restrictions on their ability to market and sell cigarettes in the future. For more information related to historical and expected settlement expenses and payments under the State Settlement Agreements, see *Litigation Affecting the Cigarette Industry Health-Care Cost Recovery Cases State Settlement Agreements* in note 9 to condensed consolidated financial statements (unaudited). The State Settlement Agreements have materially adversely affected RJR Tobacco's shipment volumes. RAI believes that these settlement obligations may materially adversely affect the results of operations, cash flows or financial position of RAI and RJR Tobacco in future periods.

RJR Tobacco and certain of the other PMs under the MSA are currently involved in an arbitration with the settling states with respect to the availability of an NPM Adjustment for the 2003 payment year. RJR Tobacco has disputed a total of approximately \$4.7 billion in potential NPM Adjustment claims for the payment years 2003 through 2012.

In 2012, RJR Tobacco, certain other PMs and certain settling states entered into a Term Sheet that set forth the terms on which accrued and potential NPM Adjustment claims for 2003 through 2014 could be resolved. The Term Sheet also set forth a restructured NPM Adjustment process to be applied on a going-forward basis, starting with the 2013 volume year. The Term Sheet was provided to all of the settling states for their review and consideration. Based on the jurisdictions that signed the Term Sheet and are bound by its terms, RJR Tobacco and SFNTC will receive credits, collectively, currently estimated to total approximately \$1 billion, with respect to their NPM Adjustment claims for the period from 2003 to 2012. The expenses for the MSA were reduced by \$204 million for the three months ended March 31, 2013.

For additional information related to this litigation and its potential resolution, see *Litigation Affecting the Cigarette Industry Health-Care Cost Recovery Cases State Settlement Agreements Enforcement and Validity*, in note 9 and *Cost of Products Sold* in note 1 to condensed consolidated financial statements (unaudited).

Governmental Activity

The marketing, sale, taxation and use of tobacco products have been subject to substantial regulation by government and health officials for many years. Various state governments have adopted or are considering, among other things, legislation and regulations that would:

significantly increase their taxes on tobacco products;

restrict displays, advertising and sampling of tobacco products;

raise the minimum age to possess or purchase tobacco products;

Table of Contents

restrict or ban the use of menthol in cigarettes or prohibit mint or wintergreen as a flavor in smokeless tobacco products;

require the disclosure of ingredients used in the manufacture of tobacco products;

require the disclosure of nicotine yield information for cigarettes;

impose restrictions on smoking in public and private areas; and

restrict the sale of tobacco products directly to consumers or other unlicensed recipients, including over the Internet.

Together with manufacturers' price increases in recent years and substantial increases in state and federal taxes on tobacco products, these developments have had and will likely continue to have an adverse effect on the sale of tobacco products.

Cigarettes and other tobacco products are subject to substantial taxes in the United States. On February 4, 2009, President Obama signed into law, effective April 1, 2009, an increase of \$0.62 in the excise tax per pack of cigarettes, and significant tax increases on other tobacco products, to fund expansion of the State Children's Health Insurance Program. Under these federal tax increases:

the federal excise tax per pack of 20 cigarettes increased to \$1.01; and

the federal excise tax rate for chewing tobacco increased \$0.3083 per pound to \$0.5033 per pound, and for snuff increased \$0.925 per pound to \$1.51 per pound.

On April 10, 2013, President Obama released a proposed budget which, if approved by the U.S. Congress, would increase the federal excise tax: on a pack of cigarettes from \$1.01 to \$1.95; for snuff from \$1.51 per pound to \$2.93 per pound; and for chewing tobacco from \$0.5033 per pound to \$0.98 per pound. These proposed tax increases would fund a new initiative for pre-kindergarten education for lower-income children. Although the likelihood of the foregoing federal tax increases becoming law is uncertain, RAI's management believes that such tax increases, if approved by the U.S. Congress, would have an adverse impact on the sale of tobacco products by RAI's operating companies and could have a materially adverse effect on the results of operations, cash flows or financial position of RAI, including impairment of the value of its operating subsidiaries' trademarks.

The 2009 federal excise tax increase on tobacco products increased taxes on cigarettes at a much higher rate than taxes on loose tobacco. As a result of that tax disparity, the number of retailers selling loose tobacco and operating RYO machines, allowing consumers to convert the loose tobacco into finished cigarettes, greatly increased following the 2009 federal tax hike on tobacco products. On July 6, 2012, President Obama signed into law a provision classifying retailers which operate RYO machines as cigarette manufacturers, and thus requiring those retailers to pay the same tax rate as other cigarette manufacturers.

All states and the District of Columbia currently impose cigarette excise taxes at levels ranging from \$0.17 per pack in Missouri to \$4.35 per pack in New York. As of March 31, 2013, and December 31, 2012, the weighted average state cigarette excise tax per pack, calculated on a 12-month rolling average basis, was approximately \$1.28. Certain city and county governments, such as New York and Chicago, also impose substantial excise taxes on cigarettes sold in those jurisdictions.

Forty-nine states and the District of Columbia also subject smokeless tobacco to excise taxes, and the Commonwealth of Pennsylvania, the singular exception, is considering such a tax during its 2013 legislative session. As of March 31, 2013,

28 states taxed moist snuff on an ad valorem basis, at rates ranging from 5% in South Carolina to 100% in Wisconsin;

Table of Contents

19 states and the District of Columbia had weight-based taxes on moist snuff, ranging from \$0.02 for cans weighing between $\frac{5}{8}$ of an ounce and $1\frac{5}{8}$ ounces in Alabama to \$2.02 per ounce in Maine; and

two states imposed a unit tax on moist snuff: Kentucky with a tax of \$0.19 per unit, and Washington, with a tax of \$2.526 per unit for units weighing 1.2 ounces or less and a proportionate amount above that weight.

During the first three months of 2013, legislation to convert from an ad valorem to a weight-based tax on moist snuff was introduced in two states, Minnesota and Mississippi. In 2012, Illinois adopted such a change effective January 1, 2013.

On June 22, 2009, President Obama signed into law the Family Smoking Prevention and Tobacco Control Act, referred to as the FDA Tobacco Act, which grants the FDA broad authority over the manufacture, sale, marketing and packaging of tobacco products.

The following provisions of the FDA Tobacco Act took effect upon passage:

no charitable distribution of tobacco products;

prohibitions on statements that would lead consumers to believe that a tobacco product is approved, endorsed, or deemed safe by the FDA;

pre-market approval by the FDA for claims made with respect to reduced risk or reduced exposure products; and

prohibition on the marketing of tobacco products in conjunction with any other class of product regulated by the FDA.

In addition, pursuant to the FDA Tobacco Act:

as of September 20, 2009, tobacco manufacturers were banned from selling cigarettes with characterizing flavors (other than menthol, which under the FDA Tobacco Act is specifically exempt as a characterizing flavor, but the impact of which on public health will be studied as discussed below);

on February 28, 2010, all manufacturers registered with the FDA their domestic manufacturing facilities as well as all cigarette and smokeless tobacco products sold in the United States;

on March 18, 2010, the FDA reissued regulations addressing advertising and marketing restrictions that were originally promulgated in 1996;

as of April 30, 2010, manufacturers were required to produce health-related documents generated from and after June 22, 2009 through December 31, 2009 (the FDA has interpreted the FDA Tobacco Act as establishing an ongoing requirement to submit health-related documents; however, the FDA has not yet established a timetable for further production);

as of June 22, 2010, manufacturers were required to make by-brand ingredient submissions, place different and larger warnings on packaging and advertising for smokeless tobacco products and eliminate the use of descriptors on tobacco products, such as low-tar and lights ;

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

as of March 22, 2011, manufacturers were required to submit documentation to obtain FDA clearance for cigarettes and smokeless tobacco products commercially launched after February 15, 2007;

on June 22, 2011, the FDA issued a final regulation for the imposition of larger, graphic health warnings on cigarette packaging and advertising, which was scheduled to take effect September 22, 2012, but the FDA is currently enjoined from enforcing such regulation. For additional information concerning this matter, see [Litigation Affecting the Cigarette Industry](#) Other Litigation and Developments - FDA Litigation in note 9 to condensed consolidated financial statements (unaudited);

Table of Contents

on July 5, 2011, the FDA issued a final regulation setting forth a process by which manufacturers may seek an exemption to the substantial equivalence review process for tobacco additive changes;

on August 16, 2011, the FDA announced that it would inspect every domestic establishment that manufactured cigarettes, cigarette tobacco, roll-your-own tobacco or smokeless tobacco products once in a two-year cycle beginning on October 1, 2011; and

on March 30, 2012, the FDA issued draft guidance on: (1) the reporting of harmful and potentially harmful constituents in tobacco products and tobacco smoke pursuant to Section 904(a)(3) of the FDA Tobacco Act, and (2) preparing and submitting applications for modified risk tobacco products pursuant to Section 911 of the FDA Tobacco Act.

On a going forward basis, various provisions under the FDA Tobacco Act and regulations to be issued under the FDA Tobacco Act will become effective and will:

require manufacturers to test ingredients and constituents identified by the FDA and disclose this information to the public;

prohibit use of tobacco containing a pesticide chemical residue at a level greater than allowed under Federal law;

establish good manufacturing practices to be followed at tobacco manufacturing facilities;

authorize the FDA to place more severe restrictions on the advertising, marketing and sale of tobacco products;

permit inconsistent state regulation of labeling and advertising and eliminate the existing federal preemption of such regulation;

authorize the FDA to require the reduction of nicotine and the reduction or elimination of other constituents; and

grant the FDA the regulatory authority to impose broad additional restrictions.

The U.S. Congress did limit the FDA's authority in two areas, prohibiting it from:

banning all tobacco products; and

requiring the reduction of nicotine yields of a tobacco product to zero.

A Center for Tobacco Products has been established within the FDA, funded through quarterly user fees that will be assessed against tobacco product manufacturers and importers based on market share. The total amount of user fees to be collected over the first ten years will be approximately \$5.4 billion. The expense related to the FDA user fees of RAI's operating companies for 2013 will be approximately \$130 million.

Within the Center, a Tobacco Products Scientific Advisory Committee, referred to as the TPSAC, was established on March 22, 2010, to provide advice, information and recommendations with respect to the safety, dependence or health issues related to tobacco products. The TPSAC is scheduled to meet quarterly to address matters brought to it by the Center as well as those required of it by the Act, including:

a recommendation on modified risk applications;

a recommendation as to whether there is a threshold level below which nicotine yields do not produce dependence;

Table of Contents

a report on the impact of the use of menthol in cigarettes on the public health; and

a report on the impact of dissolvable tobacco products on the public health.

At a meeting held on March 18, 2011, the TPSAC presented its final report on the use of menthol, which concluded that removal of menthol cigarettes from the marketplace would benefit public health in the United States. At a meeting on July 21, 2011, the TPSAC met to discuss and formally adopt editorial changes to the menthol report proposed by the committee members. The FDA is not required to follow the TPSAC's recommendations, and the agency has not yet taken any action with respect to menthol use. The FDA issued a status report on the issue on June 27, 2011, indicating that the agency will prepare an independent, peer-reviewed analysis of the available science on menthol and make a report available for public comment in the *Federal Register*.

At a meeting on March 1, 2012, the TPSAC presented to the FDA its final report and recommendations with respect to dissolvable tobacco products. The FDA will consider the report and recommendations and determine what future action, if any, is warranted with respect to dissolvable tobacco products. There is no timeline or statutory requirement for the FDA to act on the TPSAC's recommendations.

On February 25, 2011, RJR Tobacco, Lorillard, Inc. and Lorillard Tobacco Company jointly filed in the U.S. District Court for the District of Columbia a lawsuit, *Lorillard, Inc. v. U.S. Food and Drug Administration*, challenging the composition of the TPSAC.

On August 31, 2009, RJR Tobacco and American Snuff Co. joined other tobacco manufacturers and a tobacco retailer in filing a lawsuit, *Commonwealth Brands, Inc. v. United States of America*, in the U.S. District Court for the Western District of Kentucky, challenging certain provisions of the FDA Tobacco Act that severely restrict the few remaining channels available to communicate with adult tobacco consumers. RAI believes these provisions cannot be justified on any basis consistent with the demands of the First Amendment. The suit does not challenge the U.S. Congress's decision to give the FDA regulatory authority over tobacco products, nor does it challenge the vast majority of the provisions of the new law.

On August 16, 2011, RJR Tobacco and SFNTC joined other tobacco manufacturers in filing a lawsuit, *R.J. Reynolds Tobacco Company v. U.S. Food and Drug Administration*, in the U.S. District Court for the District of Columbia, challenging the final regulation specifying nine new graphic warnings pursuant to the FDA Tobacco Act that violates the plaintiffs' rights under the First Amendment to the U.S. Constitution and the Administrative Procedure Act, referred to as the APA. For additional information concerning FDA-related cases, see *Litigation Affecting the Cigarette Industry - Other Litigation and Developments - FDA Litigation* in note 9 to condensed consolidated financial statements (unaudited).

It is likely that the FDA Tobacco Act could result in a decrease in cigarette and smokeless tobacco sales in the United States, including sales of RJR Tobacco's, American Snuff Co.'s and SFNTC's brands, and an increase in costs to RJR Tobacco, American Snuff Co. and SFNTC that could have a material adverse effect on RAI's financial condition, results of operations and cash flows. RAI believes that such regulation may adversely affect the ability of its operating subsidiaries to compete against their larger competitor, which may be able to more quickly and cost-effectively comply with these new rules and regulations. The FDA has yet to issue guidance with respect to many provisions of the FDA Tobacco Act, which may result in less efficient compliance efforts. Finally, the ability of RAI's operating companies to gain efficient market clearance for new tobacco products could be affected by FDA rules and regulations.

It is not possible to determine what additional federal, state or local legislation or regulations relating to smoking or cigarettes will be enacted or to predict the effect of new legislation or regulations on RJR Tobacco or the cigarette industry in general, but any new legislation or regulations could have an adverse effect on RJR Tobacco or the cigarette industry in general. Similarly, it is not possible to determine what additional federal, state or local legislation or regulations relating to smokeless tobacco products will be enacted or to predict the effect of new regulation on American Snuff Co. or smokeless tobacco products in general, but any new legislation or regulations could have an adverse effect on American Snuff Co. or smokeless tobacco products in general.

Table of Contents

Tobacco Buyout Legislation

For information relating to tobacco buyout legislation, see **Tobacco Buyout Legislation** in note 9 to condensed consolidated financial statements (unaudited).

Other Contingencies

For information relating to other contingencies of RAI, RJR, RJR Tobacco, American Snuff Co. and SFNTC, see **Other Contingencies** in note 9 to condensed consolidated financial statements (unaudited).

Off-Balance Sheet Arrangements

RAI has no off-balance sheet arrangements that have or are reasonably likely to have a current or future material effect on its financial position, results of operations, liquidity, capital expenditures or capital resources.

Cautionary Information Regarding Forward-Looking Statements

Statements included in this report that are not historical in nature are forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These statements regarding future events or the future performance or results of RAI and its subsidiaries inherently are subject to a variety of risks and uncertainties that could cause actual results to differ materially from those described in the forward-looking statements. These risks and uncertainties include:

the substantial and increasing taxation and regulation of tobacco products, including the regulation of tobacco products by the FDA;

the possibility that the FDA will issue a regulation prohibiting menthol as a flavor in cigarettes or prohibit mint or wintergreen as a flavor in smokeless tobacco products;

decreased sales resulting from the future issuance of corrective communications, required by the order in the *U.S. Department of Justice* case on five subjects, including smoking and health, and addiction;

various legal actions, proceedings and claims relating to the sale, distribution, manufacture, development, advertising, marketing and claimed health effects of tobacco products that are pending or may be instituted against RAI or its subsidiaries;

the possibility of being required to pay various adverse judgments in the *Engle Progeny* and/or other litigation;

the substantial payment obligations with respect to cigarette sales, and the substantial limitations on the advertising and marketing of cigarettes (and of RJR Tobacco's smoke-free tobacco products) under the State Settlement Agreements;

the possibility that the Arbitration Panel's Award reflecting the partial resolution of the NPM disputes will be vacated or otherwise modified;

the continuing decline in volume in the U.S. cigarette industry and RAI's dependence on the U.S. cigarette industry;

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

concentration of a material amount of sales with a single customer or distributor;

competition from other manufacturers, including industry consolidations or any new entrants in the marketplace;

increased promotional activities by competitors, including manufacturers of deep-discount cigarette brands;

the success or failure of new product innovations and acquisitions;

Table of Contents

the responsiveness of both the trade and consumers to new products, marketing strategies and promotional programs;

the ability to achieve efficiencies in the businesses of RAI's operating companies without negatively affecting financial or operating results;

the reliance on a limited number of suppliers for certain raw materials;

the cost of tobacco leaf, and other raw materials and other commodities used in products;

the effect of market conditions on interest rate risk, foreign currency exchange rate risk and the return on corporate cash;

changes in the financial position or strength of lenders participating in RAI's credit facility;

the impairment of goodwill and other intangible assets, including trademarks;

the effect of market conditions on the performance of pension assets or any adverse effects of any new legislation or regulations changing pension expense accounting or required pension funding levels;

the substantial amount of RAI debt;

the credit ratings assigned to RAI, and to the senior unsecured long-term debt and the revolving credit facility of RAI;

any restrictive covenants imposed under RAI's debt agreements;

the possibility of natural or man-made disasters or other disruptions that may adversely affect manufacturing or other operations and other facilities;

the significant ownership interest of B&W, RAI's largest shareholder, in RAI and the rights of B&W under the governance agreement between the companies;

the expiration of the standstill provisions of the governance agreement on July 30, 2014;

a termination of the governance agreement or certain provisions of it in accordance with its terms, including the limitations on B&W's representation on RAI's Board and its board committees;

RAI's shareholder rights plan (which, generally, will expire on July 30, 2014) not applying to BAT except in limited circumstances; and,

the expiration of the non-competition agreement between RAI and BAT on July 30, 2014.

Due to these uncertainties and risks, you are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date of this report. Except as provided by federal securities laws, RAI is not required to publicly update or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Market risk represents the risk of loss that may impact the consolidated results of operations, cash flows and financial position due to adverse changes in financial market prices and rates. RAI and its subsidiaries are exposed to interest rate risk directly related to their normal investing and funding activities. In addition, RAI and its subsidiaries have immaterial exposure to foreign currency exchange rate risk related primarily to purchases or foreign operations denominated in euros, British pounds, Swiss francs, Swedish krona, Chinese renminbi and Japanese yen. RAI and its subsidiaries have established policies and procedures to manage their exposure to market risks.

Table of Contents

The table below provides information, as of March 31, 2013, about RAI's financial instruments that are sensitive to changes in interest rates. The table presents notional amounts and weighted average interest rates by contractual maturity dates for the years ending December 31:

	2013	2014	2015	2016	2017	Thereafter	Total	Fair Value ⁽¹⁾
Investments:								
Variable rate	\$ 2,719	\$ 13	\$	\$	\$ 67	\$	\$ 2,799	\$ 2,799
Average interest rate	0.1%	0.6%			2.4%		0.1%	
Fixed-rate	\$	\$	\$	\$	\$	\$ 7	\$ 7	\$ 7
Average interest rate ⁽²⁾						4.7%	4.7%	
Debt:								
Fixed-rate	\$ 60	\$	\$ 650	\$ 775	\$ 700	\$ 2,800	\$ 4,985	\$ 5,447
Average interest rate ⁽²⁾	9.3%		3.0%	7.6%	6.8%	4.8%	5.3%	

(1) Fair values are based on current market rates available or on rates available for instruments with similar terms and maturities and quoted fair values.

(2) Based upon coupon interest rates for fixed-rate instruments.

RAI's exposure to foreign currency transactions was not material to results of operations for the three months ended March 31, 2013, but may become material in future periods in relation to activity associated with RAI's international operations. RAI currently has no hedges for its exposure to foreign currency.

Item 4. Controls and Procedures

(a) RAI's chief executive officer and chief financial officer have concluded that RAI's disclosure controls and procedures were effective as of the end of the period covered by this report, based on their evaluation of these controls and procedures.

(b) There have been no changes in RAI's internal controls over financial reporting that occurred during the first quarter of 2013 that have materially affected, or are reasonably likely to materially affect, RAI's internal controls over financial reporting.

PART II-Other Information**Item 1. Legal Proceedings**

For a discussion of the litigation and legal proceedings pending against RJR Tobacco, American Snuff Co. or their affiliates, including RAI and RJR, or indemnitees, including B&W, see note 9 to condensed consolidated financial statements (unaudited) and Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Estimates Litigation included in Part I, Item 2.

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

RAI conducts its business through its subsidiaries and is dependent on the earnings and cash flows of its subsidiaries to satisfy its obligations and other cash needs. For additional information, see Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Financial Condition in Part I, Item 2. RAI believes that the provisions of its Term Loan, Credit Agreement and notes (and the associated guarantees of the foregoing) will not impair its payment of quarterly dividends.

Table of Contents

The following table summarizes RAI's purchases of its common stock during the first quarter of 2013:

	Total Number of Shares Purchased ⁽¹⁾	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs ⁽²⁾
February 1, 2013 to February 28, 2013	2,461,811	\$ 44.34	2,461,811	\$ 1,053
March 1, 2013 to March 31, 2013	4,956,654	43.52	4,382,271	862
First Quarter Total	7,418,465	43.79	6,844,082	862

⁽¹⁾ During March 2013, RAI repurchased and cancelled 574,383 shares of its common stock with respect to the tax liability associated with vesting of restricted stock units under the Omnibus Plan.

⁽²⁾ On November 14, 2011, the board of directors of RAI authorized the repurchase, from time to time on or before mid-2014, of up to \$2.5 billion of outstanding shares of RAI common stock.

Item 6. Exhibits

(a) Exhibits

Exhibit**Number****Description**

- 10.1 Form of Performance Share Agreement (three-year vesting), dated March 1, 2013, between Reynolds American Inc. and the grantee named therein.
- 10.2 Term Loan Agreement, dated as of March 15, 2013, among Reynolds American Inc., the agents and other parties named therein, and the lending institutions listed on schedule 2.01 thereto (incorporated by reference to Exhibit 10.1 to Reynolds American Inc.'s Form 8-K, dated March 15, 2013).
- 10.3 Subsidiary Guarantee Agreement, dated as of March 15, 2013, among certain of the subsidiaries of Reynolds American Inc. as guarantors and JPMorgan Chase Bank, N.A. as administrative agent (incorporated by reference to Exhibit 10.2 to Reynolds American Inc.'s Form 8-K, dated March 15, 2013).
- 10.4 Term Sheet agreed to by R. J. Reynolds Tobacco Company, an indirect subsidiary of Reynolds American Inc., certain other Participating Manufacturers, 17 states, the District of Columbia and Puerto Rico (incorporated by reference to Exhibit 10.1 to Reynolds American Inc.'s Form 8-K, dated March 12, 2013).
- 10.5 Reynolds American Inc. 2013 Independent Directors' Compensation Summary.
- 31.1 Certification of Chief Executive Officer relating to RAI's Quarterly Report on Form 10-Q for the quarter ended March 31, 2013.
- 31.2 Certification of Chief Financial Officer relating to RAI's Quarterly Report on Form 10-Q for the quarter ended March 31, 2013.
- 32.1* Certification of Chief Executive Officer and Chief Financial Officer relating to RAI's Quarterly Report on Form 10-Q for the quarter ended March 31, 2013, pursuant to Section 18 U.S.C. §1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 99.1 Arbitration Panel's Entry of Stipulated Partial Settlement and Award, dated March 12, 2013 (incorporated by reference to Exhibit 99.2 to Reynolds American Inc.'s Form 8-K, dated March 12, 2013).

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

101.INS	XBRL instance document
101.SCH	XBRL taxonomy extension schema
101.CAL	XBRL taxonomy extension calculation linkbase
101.LAB	XBRL taxonomy extension label linkbase
101.PRE	XBRL taxonomy extension presentation linkbase

* Exhibit is being furnished and shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subjected to the liabilities of that Section. This exhibit shall not be incorporated by reference into any registration statement or other document pursuant to the Securities Act of 1933, as amended, except as shall be expressly set forth by specific reference in such a filing.

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Dated: April 23, 2013

REYNOLDS AMERICAN INC.
(Registrant)

/s/ Thomas R. Adams
Thomas R. Adams
Executive Vice President and Chief Financial Officer
(principal financial officer)