REYNOLDS AMERICAN INC
Form 10-K
February 19, 2010

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

FORM 10-K

(Mark One)

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2009
OR
o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission file number: 1-32258
Reynolds American Inc.
(Exact name of registrant as specified in its charter)

North Carolina	**20-0546644**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer 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)

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

Title of each class	Name of each exchange on which registered	Title of each class	Name of each exchange on which registered
Common stock, par value $.0001 per share	New York	Rights to Purchase Series A Junior Participating Preferred Stock	New York

Securities registered pursuant to Section 12(g) of the Act: None

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

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

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 þ No o

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

Indicate by check mark whether the registrant 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 þ No o

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

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

The aggregate market value of common stock held by non-affiliates of Reynolds American Inc. on June 30, 2009, was approximately $6.5 billion, based on the closing price of $38.62. Directors, executive officers and a significant shareholder of Reynolds American Inc. are considered affiliates for purposes of this calculation, but should not necessarily be deemed affiliates for any other purpose.

Indicate the number of shares outstanding of each of the registrant s classes of common stock, as of the latest practicable date: January 29, 2010: 291,441,336 shares of common stock, par value $.0001 per share.

Documents Incorporated by Reference:

Portions of the Definitive Proxy Statement of Reynolds American Inc. to be filed with the Securities and Exchange Commission pursuant to Regulation 14A of the Securities Exchange Act of 1934 on or about March 22, 2010, are incorporated by reference into Part III of this report.

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PART I

Item 1. Business

Reynolds American Inc., referred to as RAI, is a holding company whose operating subsidiaries include the second largest cigarette manufacturer in the United States, R. J. Reynolds Tobacco Company, and the second largest smokeless tobacco products manufacturer in the United States, American Snuff Company, LLC, which prior to January 1, 2010, was known as Conwood Company, LLC. RAI was incorporated in the state of North Carolina on January 5, 2004, and its common stock is listed on the NYSE under the symbol RAI. RAI s headquarters are located in Winston-Salem, North Carolina. On July 30, 2004, RAI combined the U.S. assets, liabilities and operations 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, a wholly owned operating subsidiary of R.J. Reynolds Tobacco Holdings, Inc., a wholly owned subsidiary of RAI, referred to as RJR. These July 30, 2004, transactions generally are referred to as the B&W business combination. As a result of the B&W business combination, B&W owns approximately 42% of RAI s outstanding common stock. Also, as a result of the B&W business combination, Lane, Limited, referred to as Lane, became a direct, wholly owned subsidiary of RAI.

References to RJR Tobacco prior to July 30, 2004, relate to R. J. Reynolds Tobacco Company, a New Jersey corporation. 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. Concurrent with the completion of the B&W business combination, RJR Tobacco became a North Carolina corporation.

In 2006, RAI, through Conwood Holdings, Inc., completed its acquisition of a group of smokeless tobacco companies collectively referred to as the Conwood companies, currently only including American Snuff Company, LLC and Rosswil, LLC.

RAI s Internet Web site address is www.reynoldsamerican.com. RAI s annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, insider trading reports on Forms 3, 4 and 5 and all amendments to those reports are available free of charge through RAI s Web site, as soon as reasonably practicable after such material is electronically filed with, or furnished to, the SEC. RAI s Internet Web site and the information contained therein or connected thereto are not intended to be incorporated into this Annual Report on Form 10-K. Effective January 1, 2010, RAI s Web site is the primary source of publicly disclosed news about RAI and its operating companies.

RAI s reportable operating segments are RJR Tobacco and Conwood. The RJR Tobacco segment consists of the primary operations of R. J. Reynolds Tobacco Company. The Conwood segment consists of Conwood Holdings, Inc., the primary operations of the Conwood companies and Lane. Two of RAI s wholly owned subsidiaries, Santa Fe Natural Tobacco Company, Inc., referred to as Santa Fe, and Niconovum AB, among others, are included in All Other. The segments were identified based on how RAI s chief operating decision maker allocates resources and assesses performance. RAI s wholly owned operating subsidiaries have entered into intercompany agreements for products or services with other RAI operating subsidiaries. As a result, certain activities of an operating subsidiary may be included in a different segment of RAI. For net sales, operating income and total assets attributable to each segment, see Item 8, note 18 to consolidated financial statements.

Changes Impacting the Tobacco Industry

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, referred to as the SCHIP. As a result, the federal excise tax rate for snuff increased $0.925 per pound to $1.51 per pound. The federal excise tax on small cigars, defined as those weighing three pounds or less per thousand, increased $48.502 per thousand to $50.33 per thousand. In addition, the federal excise tax rate for roll-your-own tobacco increased from $1.097 per pound to $24.78 per pound. RAI s operating subsidiaries believe that these federal excise tax increases have had, and will continue to have, a significant and adverse impact on sales volume.

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On June 22, 2009, President Obama signed into law the Family Smoking Prevention and Tobacco Control Act, referred to as the FDA Tobacco Act. Under the FDA Tobacco Act, the U.S. Food and Drug Administration, referred to as the FDA, has been granted broad authority over the manufacture, sale, marketing and packaging of tobacco products. 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 and Conwood s brands, and an increase in costs to RJR Tobacco and Conwood that could have a material adverse effect on RAI s financial condition, results of operations and cash flows. 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 Item 7.

RAI Strategy

RAI s strategy is focused on anticipating shifts in consumer preferences by becoming an innovative total tobacco company. RAI also is focused on delivering sustainable earnings growth, strong cash flow and enhanced long-term shareholder value through growth strategies for its operating companies. These strategies include growth in base brands of RJR Tobacco s cigarette business, growth and innovation in smokeless tobacco products, super-premium cigarette brand growth, opportunistic international expansion and selective portfolio enhancements. RAI remains committed to maintaining high standards of corporate governance and business conduct in a high performing culture.

RJR Tobacco

Overview

RAI s largest reportable operating segment, RJR Tobacco, is the second largest cigarette manufacturer in the United States. RJR Tobacco s largest selling cigarette brands, CAMEL, PALL MALL, WINSTON, KOOL and DORAL, were five of the ten best-selling brands of cigarettes in the United States as of December 31, 2009. Those brands, and its other brands, including SALEM, MISTY and CAPRI, are manufactured in a variety of styles and marketed in the United States. RJR Tobacco also manages contract manufacturing of cigarette and tobacco products through arrangements with BAT affiliates. On January 1, 2009, the management of tobacco products sold to certain U.S. territories, U.S. duty-free shops and U.S. overseas military bases was transferred to RJR Tobacco from R. J. Reynolds Global Products, Inc., referred to as GPI.

RJR Tobacco primarily conducts its business in the highly competitive U.S. cigarette market. The international rights to substantially all of RJR Tobacco s brands were sold in 1999 to Japan Tobacco Inc., referred to as JTI and no international rights were acquired in connection with the B&W business combination. The U.S. cigarette market, which has a few large manufacturers and many smaller participants, is a mature market in which overall consumer demand has declined since 1981 and is expected to continue to decline. Management Science Associates, Inc., referred to as MSAi, reported that U.S. cigarette shipments declined 8.6% in 2009, to 315.7 billion cigarettes, 3.3% in 2008 and 5.0% in 2007. From year to year, shipments are impacted by various factors including price increases, excise tax increases and wholesale inventory adjustments.

Profitability of the U.S. cigarette industry and RJR Tobacco continues to be adversely impacted by the decreases in consumption, increases in federal and state excise taxes and governmental regulations and restrictions, such as marketing limitations, product standards and smoking bans.

Expanding beyond the cigarette market as an innovative tobacco company, RJR Tobacco offers two types of smoke-free tobacco, CAMEL Snus and CAMEL Dissolvables. CAMEL Snus, launched nationally in 2009, is pasteurized tobacco in a small pouch that provides convenient tobacco consumption. CAMEL Dissolvables include CAMEL Orbs, Sticks and Strips, all of which are made of finely milled tobacco and dissolve completely in the mouth. CAMEL Orbs were launched in three lead markets during the first quarter of 2009, and CAMEL Sticks and Strips were launched in those lead markets during the third quarter of 2009.

Competition

RJR Tobacco s primary competitors include Philip Morris USA Inc., Lorillard Tobacco Company, Liggett Group and Commonwealth Brands, Inc., as well as manufacturers of deep-discount brands. Deep-discount brands are brands manufactured by companies that are not original participants in the Master Settlement Agreement,

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referred to as MSA, and other state settlement agreements with the states of Mississippi, Florida, Texas and Minnesota, together with the MSA collectively referred to as the State Settlement Agreements, and accordingly, do not have cost structures burdened with State Settlement Agreements-related payments to the same extent as the original participating manufacturers. For further discussion of the State Settlement Agreements, see Litigation Affecting the Cigarette Industry Health-Care Cost Recovery Cases State Settlement Agreements in Item 8, note 14 to consolidated financial statements.

Based on data collected by Information Resources Inc., referred to as IRI/Capstone, using a revised sampling model implemented in 2009 to better reflect the current retail environment, during 2009 and 2008, RJR Tobacco had an overall retail share of the U.S. cigarette market of 28.3% and 28.4%, respectively. During these same years, Philip Morris USA Inc. had an overall retail share of the U.S. cigarette market of 49.7% and 50.9%, respectively.

Domestic shipment volume and retail share of market data that appear in this document have been obtained from MSAi and IRI/Capstone, respectively. These two organizations are the primary sources of volume and market share data relating to the cigarette and tobacco industry. This information is included in this document because it is used by RJR Tobacco primarily as an indicator of the relative performance of industry participants. However, you should not rely on the market share data reported by IRI/Capstone as being precise measurements of actual market share because IRI/Capstone uses a sample and projection methodology that 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. RJR Tobacco believes that deep-discount brands made by small manufacturers have combined shipments of approximately 16% of total U.S. industry shipments. Accordingly, the retail share of market of RJR Tobacco and its brands as reported by IRI/Capstone may overstate their actual market share.

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 moist snuff and snus, as well as finding efficient and effective means of balancing market share and profit growth.

Marketing

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, free product 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.

RJR Tobacco provides trade incentives through trade terms, wholesale partner programs and retail incentives. Trade discounts are provided to wholesalers based on compliance with certain terms. The wholesale partner programs provide incentives to RJR Tobacco s direct buying customers based on performance levels. Retail incentives are paid to the retailer based on compliance with RJR Tobacco s contract terms.

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 of these brands are managed for long-term market share and profit growth, CAMEL will continue to receive the most significant investment 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. At present, RJR Tobacco s smoke-free products are marketed under the CAMEL brand and focus on long-term growth.

Anti-tobacco groups have attempted to restrict cigarette sales, cigarette advertising, and the testing and introduction of new tobacco products as well as encourage smoking bans. The MSA and federal, state and local laws and regulations restrict or prohibit utilization of television, radio or billboard advertising or certain other marketing and promotional tools for cigarettes and smoke-free tobacco products. RJR Tobacco continues to use direct mailings and other means to market its brands and enhance their appeal among age-verified adults who use tobacco products. RJR Tobacco continues to advertise and promote at retail locations and in adult venues where permitted and also uses print advertising in newspapers and consumer magazines in the U.S.

Manufacturing and Distribution

RJR Tobacco owns its cigarette manufacturing facilities, located in the Winston-Salem, North Carolina area, known as the Tobaccoville manufacturing facility and the Whitaker Park complex. The Whitaker Park complex includes a manufacturing facility, a research and development facility, RJR Tobacco s Central Distribution Center and a pilot plant for trial manufacturing of new products. RJR Tobacco has a total production capacity of approximately 160 billion cigarettes per year. RJR Tobacco continues to evaluate capacity rationalization, which may result in the consolidation or closure of some facilities.

RJR Tobacco sells its cigarettes primarily through distributors, wholesalers and other direct customers, some of which are retail chains. RJR Tobacco distributes its cigarettes primarily to public warehouses located throughout the United States that serve as local distribution centers to its customers. No significant backlog of orders existed at December 31, 2009 or 2008.

RJR Tobacco has entered into various transactions with affiliates of BAT. RJR Tobacco sells contract-manufactured cigarettes and processed strip leaf to BAT affiliates. Net sales, primarily of cigarettes, to BAT affiliates represented approximately 5.0% of RAI s total net sales in each of 2009 and 2008 and approximately 6.0% in 2007.

Raw Materials

In its production of tobacco products, RJR Tobacco uses U.S. and foreign, grown primarily in Brazil and Malawi, burley and flue-cured leaf tobaccos, as well as Oriental tobaccos grown primarily in Turkey, Macedonia and Bulgaria. RJR Tobacco believes there is a sufficient supply of leaf in the worldwide tobacco market to satisfy its current and anticipated production requirements.

RJR Tobacco purchases the majority of its U.S. flue-cured and burley leaf directly through contracts with tobacco growers. These short-term contracts are frequently renegotiated. RJR Tobacco believes the relationship with its leaf suppliers is good.

Under the modified terms of settlement agreements with flue-cured and burley tobacco growers, and quota holders, RJR Tobacco is required, among other things, to purchase a minimum amount, in pounds and subject to adjustment based on its annual total requirements, annually of U.S. green leaf flue-cured and burley tobacco combined, through the 2015 crop year.

RJR Tobacco also uses other raw materials such as filter tow, filter rods and fire standards compliant paper, which are sourced from either one supplier or a few suppliers. RJR Tobacco believes it has reasonable measures in place designed to mitigate the risk posed by the limited number of suppliers of certain raw materials.

Conwood

Overview

RAI s other reportable operating segment, Conwood, is the second largest smokeless tobacco products manufacturer in the United States. Conwood s primary products include its largest selling moist snuff brands, GRIZZLY, the best-selling brand of moist snuff in the United States as of December 31, 2009, and KODIAK. The moist snuff category is divided into premium and price-value brands. Conwood offers KODIAK in the premium brand category and GRIZZLY in the price-value brand category.

In contrast to the declining U.S. cigarette market, MSAi reported U.S. moist snuff volumes grew over 4% in 2009, driven by the accelerated growth of price-value brands. 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. Within the moist snuff category, premium brands have lost market share to price-value brands, led by the growth of GRIZZLY, in recent years. However, during 2009, heavy promotion and competitive pricing of premium brands has slowed the growth of the price-value brands.

Leveraging RAI s total tobacco business model, Conwood launched CAMEL Dip, a premium moist snuff, in lead markets during the second quarter of 2009. CAMEL Dip will be launched in additional markets in 2010.

Moist snuff has been the key driver of Conwood s overall growth and profitability within the U.S. smokeless tobacco market. Moist snuff accounted for approximately 71%, 66% and 60% of Conwood s revenue in 2009, 2008 and 2007, respectively. Conwood s U.S. moist snuff market share was 29.4%, 27.6% and 26.0% in 2009, 2008 and 2007, respectively, based on distributor-reported data processed by MSAi for distributor shipments to retail. Although moist snuff volume grew over 4% in 2009, Conwood s moist snuff volume grew over 6% in 2009, attributable to its innovation, product development and brand building. GRIZZLY brand moist snuff had a market share of 25.3%, 23.2% and 21.1% in 2009, 2008 and 2007, respectively.

Conwood also distributes a variety of other tobacco products, including WINCHESTER and CAPTAIN BLACK little cigars, and BUGLER roll-your-own tobacco. The operations of Lane are included in the Conwood segment.

Competition

Conwood is dependent on the U.S. smokeless tobacco market, where competition is significant. 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. Moist snuff has developed many of the characteristics of the larger, cigarette market, including multiple pricing tiers with intense competition, focused marketing programs and product innovation.

Conwood s largest competitor is U.S. Smokeless Tobacco Company LLC, referred to as USSTC, which had approximately 55.1%, 58.1% and 60.6% of the U.S. moist snuff market share in 2009, 2008 and 2007, respectively. The parent company of RJR Tobacco s largest competitor in the cigarette market, Philip Morris USA Inc., completed its acquisition of USSTC in January 2009. Conwood also competes in the U.S. smokeless tobacco market with other domestic and international companies.

Marketing

Conwood s brand portfolio strategy consists of investment brands, KODIAK and GRIZZLY, and selective and non-support brands that include all other brands. Among Conwood s newest offerings are GRIZZLY mint, straight and snuff pouches. GRIZZLY pouches provide pre-measured portions that are more convenient than traditional, loose moist snuff. Pouches represented approximately 8% of the total U.S. moist snuff market as of December 31, 2009, and demand continues to grow. Conwood also launched CAMEL Dip in Wintergreen Wide Cut and Dark Milled styles in lead markets during 2009. GRIZZLY 1900 Long Cut, a natural product with a traditional long cut, was introduced in the first quarter of 2010. Continuing with innovation and brand building, Conwood will feature embossed metal lids on KODIAK and GRIZZLY brands in 2010.

Conwood is committed to being an innovative industry leader and in the servicing of its customers needs, evidenced by the creative packaging of smokeless products, including the development of a plastic can.

Manufacturing and Distribution

Conwood s primary manufacturing facilities are located in Memphis, Tennessee; Clarksville, Tennessee; and Winston-Salem, North Carolina. Other facilities are located in Tucker, Georgia; Bowling Green, Kentucky; and

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Springfield, Tennessee. Conwood owns all of its facilities. During 2009, Conwood began capacity upgrade and expansion projects at newly acquired sites in Memphis, Tennessee and Clarksville, Tennessee. The new Memphis facility will replace the current Memphis facility with production expected to begin in 2012, while the new Clarksville facility will provide for capacity expansion with initial production beginning in 2010. Both facilities will be FDA compliant. Conwood sells its products primarily to distributors, wholesalers and other direct customers, some of which are retail chains.

Raw Materials

In its production of moist snuff, Conwood uses U.S. fire-cured and air-cured tobaccos as well as foreign, primarily Brazilian, burley and air-cured leaf tobaccos. Conwood purchases the majority of its U.S. fire-cured and air-cured leaf directly through contracts with tobacco growers. These short-term contracts are frequently renegotiated. Conwood believes the relationship with its leaf suppliers is good.

Conwood believes there is a sufficient supply of leaf in the worldwide tobacco market to satisfy its current and anticipated production requirements.

Consolidated RAI

Santa Fe manufactures and markets cigarettes and other tobacco products under the NATURAL AMERICAN SPIRIT brand, as well as manages super premium brands licensed from BAT, including DUNHILL and STATE EXPRESS 555.

In January 2009, the activities of GPI were transitioned to other operating subsidiaries of RAI. The management and export of tobacco products to certain U.S. territories, U.S. duty-free shops and U.S. overseas military bases was transferred to RJR Tobacco, and sales of NATURAL AMERICAN SPIRIT in Europe and Japan were transferred to other indirect subsidiaries of RAI.

Customers

The largest customer of RAI s operating companies is McLane Company Inc. Sales to McLane, a distributor, comprised 27%, 29% and 28% of RAI s consolidated revenue in 2009, 2008 and 2007, respectively. No other customer accounted for 10% or more of RAI s consolidated revenue during those periods. RJR Tobacco and Conwood each believe that its relationship with McLane is good. Sales of RJR Tobacco and Conwood to McLane are not governed by any written supply contract. No significant backlog of orders existed at RJR Tobacco or Conwood as of December 31, 2009 or 2008.

Sales to Foreign Countries

RAI s operating subsidiaries sales to foreign countries, primarily to BAT affiliates, for the years ended December 31, 2009, 2008 and 2007 were $547 million, $611 million and $616 million, respectively.

Raw Materials

In 2004, legislation was passed eliminating the U.S. government s tobacco production controls and price support program. The buyout 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 tobacco 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. RAI s operating subsidiaries estimate that their overall share will approximate $2.3 billion to $2.8 billion prior to the deduction of permitted offsets under the MSA.

Research and Development

The primary research and development activities of RAI s operating subsidiaries are conducted at RJR Tobacco s Whitaker Park complex. Scientists and engineers at this facility continue to explore and develop innovative products, packaging and processes, as well as harm reduction technologies, potential reduced exposure products and analytical methodologies. A focus activity for research and development going forward is to prepare for the FDA regulatory compliance and adhere to future FDA guidelines and approval processes.

RAI s operating subsidiaries research and development expense for the years ended December 31, 2009, 2008 and 2007, was $68 million, $59 million and $57 million, respectively. The increase in research and development expense in 2009 compared with 2008 and 2007 was attributable primarily to the development of harm reduction and smoke-free products at RJR Tobacco.

Intellectual Property

RAI s operating subsidiaries own or have the right to use numerous trademarks, including the brand names of their tobacco products and the distinctive elements of their packaging and displays. RAI s operating subsidiaries material trademarks are registered with the U.S. Patent and Trademark Office. Rights in these trademarks in the United States will last as long as RAI s subsidiaries continue to use the trademarks. The operating subsidiaries consider the distinctive blends and recipes used to make each of their brands to be trade secrets. These trade secrets are not patented, but RAI s operating subsidiaries take appropriate measures to protect the unauthorized disclosure of such information.

In 1999, RJR Tobacco sold most of its trademarks and patents outside the United States in connection with the sale of the international tobacco business to JTI. The sale agreement granted JTI the right to use certain of RJR Tobacco s trade secrets outside the United States, but details of the ingredients or formulas for flavors and the blends of tobacco may not be provided to any sub-licensees or sub-contractors. The agreement also generally prohibits JTI and its licensees and sub-licensees from the sale or distribution of tobacco products of any description employing the purchased trademarks and other intellectual property rights in the United States. In 2005, the U.S. duty-free and U.S. overseas military businesses relating to certain brands were acquired from JTI. These rights had been sold to JTI in 1999 as a part of the sale of RJR Tobacco s international tobacco business.

In addition to intellectual property rights it directly owns, RJR Tobacco has certain rights with respect to BAT intellectual property that were available for use by B&W prior to the completion of the B&W business combination.

On December 9, 2009, through an indirect subsidiary, RAI acquired Niconovum AB. Substantially all of the value of the acquired assets was determined to be a technology-based, indefinite-lived other intangible asset. For additional information on the acquisition of Niconovum AB, see Item 8, note 3 to consolidated financial statements.

Legislation and Other Matters Affecting the Tobacco Industry

The tobacco industry is subject to a wide range of laws and regulations regarding the marketing, sale, taxation and use of tobacco products imposed by local, state, federal and foreign governments. 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;
- establish fire standards compliance for cigarettes;
- raise the minimum age to possess or purchase tobacco products;

restrict or ban the use of certain flavorings, including menthol, in tobacco products, or the use of certain flavor descriptors in marketing of 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.

In addition, during 2009, the U.S. Congress adopted legislation increasing the federal excise tax on cigarettes and other tobacco products, and granting the FDA broad authority over the manufacture, sale, marketing and packaging of tobacco products. During 2010, the U.S. Congress also may consider legislation regarding:

- regulation of environmental tobacco smoke;
- implementation of a national fire standards compliance for cigarettes;
- regulation of the retail sale of tobacco products over the Internet and in other non-face-to-face retail transactions, such as by mail order and telephone; and
- banning the delivery of tobacco products by the U.S. Postal Service.

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. For further discussion of the regulatory and legislative environment applicable to the tobacco industry, see Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations Governmental Activity.

Litigation and Settlements

Various legal proceedings or claims, including litigation claiming that lung cancer and other diseases, as well as addiction, have resulted from the use of, or exposure to, RAI s operating subsidiaries products, and seeking damages in amounts ranging into the hundreds of millions or even billions of dollars, are pending or may be instituted against RJR Tobacco, the Conwood companies or their affiliates, including RAI or RJR, or indemnitees, including B&W. In particular, in *Engle v. R. J. Reynolds Tobacco Co., et al.*, the Florida Supreme Court issued a ruling that, among other things, determined that the case could not proceed further as a class action. The ruling also permitted members of the *Engle* class to file individual claims, including claims for punitive damages, through January 11, 2008. RJR Tobacco refers to these cases as the *Engle* Progeny Cases. RJR Tobacco has been served as of January 29, 2010 in 7,711 cases on behalf of approximately 9,246 plaintiffs. The *Engle* Progeny Cases have resulted and will continue to result in increased litigation and trial activity and increased expenses. For a more complete description of the *Engle* Progeny cases, see Engle Progeny Cases in Item 8, note 14 to consolidated financial statements. Also, the consolidated action, *In re: Tobacco Litigation Individual Personal Injury Cases,* is pending in West Virginia, against both RJR Tobacco and B&W. The case consists of over 600 plaintiffs and will be tried in a single proceeding. Trial began February 1, 2010, but a mistrial was declared February 3, 2010. A new trial is scheduled to begin June 1, 2010. For a more complete description of this case, see West Virginia IPIC in Item 8, note 14 to consolidated financial statements.

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, or the loss of any particular claim concerning the use of smokeless tobacco against the Conwood companies, when viewed on an individual basis, is not probable. RAI and its subsidiaries believe that they have valid basis for appeal of adverse verdicts against them and have valid defenses to all actions and intend to defend all actions vigorously. Nonetheless, the possibility of material losses related to tobacco litigation is more than remote. Litigation is subject to many uncertainties, and generally it is not possible to predict the outcome of the litigation pending against RJR Tobacco, the Conwood companies 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. For further discussion of the litigation and legal proceedings pending against RAI or its affiliates or indemnitees, see Item 8, note 14 to consolidated financial statements.

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. As described in Item 8, note 14 to consolidated financial statements, 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 tobacco products 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 Item 8, note 14 to consolidated financial statements. 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 participating manufacturers under the MSA are currently involved in litigation with the settling states with respect to the availability for certain market years of a downward adjustment to the annual MSA settlement payment obligation, known as the Non-Participating Manufacturer Adjustment. RJR Tobacco has disputed a total of $2.9 billion for the years 2003 through 2008. For more information related to this litigation, see Litigation Affecting the Cigarette Industry Health-Care Cost Recovery Cases State Settlement Agreements Enforcement and Validity in Item 8, note 14 to consolidated financial statements.

Employees

At December 31, 2009, RAI and its subsidiaries had approximately 6,400 full-time employees and approximately 150 part-time employees. The 6,400 full-time employees include approximately 4,500 RJR Tobacco employees and 1,000 Conwood employees. No employees of RAI or its subsidiaries are unionized.

Item 1A. Risk Factors

RAI and its subsidiaries operate with certain known risks and uncertainties that could have a material adverse effect on their results of operations, cash flows and financial position. The risks below are not the only ones RAI and its subsidiaries face. Additional risks not currently known or currently considered immaterial also could affect RAI s business. You should carefully consider the following risk factors in connection with other information included in this Annual Report on Form 10-K.

RAI s operating subsidiaries could be subject to substantial liabilities and bonding difficulties from litigation related to cigarette products or smokeless tobacco products, thereby reducing operating margins and cash flows from operations. Adverse litigation outcomes could have a negative impact on RAI s ability to continue to operate due to their impact on cash flows.

RJR Tobacco, the Conwood companies and their affiliates, including RAI, and indemnitees, including B&W, have been named in a large number of tobacco-related legal actions, proceedings or claims. The claimants seek recovery on a variety of legal theories, including negligence, strict liability in tort, design defect, fraud, misrepresentation, unfair trade practices and violations of state and federal antitrust laws. Various forms of relief are sought, including compensatory and, where available, punitive damages in amounts ranging in some cases into the hundreds of millions or even billions of dollars.

The tobacco-related legal actions range from individual lawsuits to class-actions and other aggregate claim lawsuits. In particular, class-action suits have been filed in a number of states against individual cigarette manufacturers, including RJR Tobacco, and their parents, including RAI, alleging that the use of the terms lights and ultra lights constitutes unfair and deceptive trade practices. In December 2008, the U.S. Supreme Court ruled that neither the Federal Cigarette Labeling and Advertising Act nor the Federal Trade Commission s regulation of tar and nicotine disclosures preempts (or bars) such claims. This ruling limits certain defenses available to RJR Tobacco and other cigarette manufacturers and has led to the filing of additional lawsuits. In the event RJR Tobacco and its affiliates and indemnitees lose one or more of the pending lights class-action suits, RJR Tobacco, depending upon the amount of any damages ordered, could face difficulties in obtaining the bond required to stay execution of the judgment. For a more complete description of these cases, see Class-Action Suits Lights Cases in Item 8, note 14 to consolidated financial statements.

In *Engle v. R. J. Reynolds Tobacco Co., et al.*, the Florida Supreme Court issued a ruling that, among other things, determined that the case could not proceed further as a class action. The ruling also permitted members of the *Engle* class to file individual claims, including claims for punitive damages, through January 11, 2008. RJR Tobacco has been served as of January 29, 2010 in 7,711 cases on behalf of approximately 9,246 plaintiffs. The *Engle* Progeny Cases have resulted in increased litigation and trial activity, including an increased number of adverse verdicts, and increased expenses. For a more complete description of the *Engle* Progeny cases, see Engle Progeny Cases in Item 8, note 14 to consolidated financial statements.

Also, the consolidated action, *In re: Tobacco Litigation Individual Personal Injury Cases,* is pending in West Virginia, against both RJR Tobacco and B&W. The case consists of over 600 plaintiffs and will be tried in a single proceeding. Trial began February 1, 2010, but a mistrial was declared February 3, 2010. A new trial is scheduled to begin June 1, 2010. For a more complete description of this case, see West Virginia IPIC in Item 8, note 14 to consolidated financial statements.

It is likely that similar legal actions, proceedings and claims arising out of the sale, distribution, manufacture, development, advertising, marketing and claimed health effects of cigarettes and smokeless tobacco products will continue to be filed against RJR Tobacco, the Conwood companies, or their affiliates and indemnitees and other tobacco companies for the foreseeable future.

Victories by plaintiffs in highly publicized cases against RJR Tobacco and other tobacco companies regarding the health effects of smoking may stimulate further claims. A material increase in the number of pending claims could significantly increase defense costs. In addition, adverse outcomes in pending cases could have adverse effects on the ability of RJR Tobacco and its indemnitees, including B&W, to prevail in other smoking and health litigation.

For a more complete description of the litigation involving RAI and its operating subsidiaries, including RJR Tobacco and the Conwood companies, see Litigation Affecting the Cigarette Industry and Smokeless Tobacco Litigation in Item 8, note 14 to consolidated financial statements.

The verdict and order in the case brought by the U.S. Department of Justice, while not final, could subject RJR Tobacco to additional, substantial marketing restrictions as well as significant financial burdens, which would negatively impact the results of operations, cash flows and the financial position of RJR Tobacco and, consequently, of RAI.

In September 1999, the U.S. Department of Justice brought an action against RJR Tobacco, B&W and other tobacco companies. The government sought, in addition to other remedies, pursuant to the civil provisions of RICO, disgorgement of profits in an amount of approximately $280 billion, the government contends have been earned as a consequence of a RICO racketeering enterprise. In August 2006, the court found certain defendants, including RJR Tobacco, liable for the RICO claims, but did not impose any direct financial penalties. Instead, the court, among other things, 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, and ordered the defendants to issue corrective communicati
five subjects, including smoking and health, and addiction.

Both sides have appealed. In October 2006, the U.S. Court of Appeals granted the defendants motion to stay pending the outcome of the defendants appeal. On May 22, 2009, the Court of Appeals affirmed in part the trial court s order and remanded for further proceedings. The parties petitions for writ of certiorari from the U.S. Supreme Court are due February 19, 2010. If the order is affirmed without modification, then RJR Tobacco believes that certain provisions of the order would have adverse business effects on the marketing of RJR Tobacco s current product portfolio and that such effects could be material. Also, if the order is affirmed, then RJR Tobacco would incur costs in connection with complying with the order, such as the costs of corrective communications. In addition, the DOJ has preserved its right to seek review of the district court s denial of the government s request for disgorgement of profits and other remedies, which could have a material adverse impact on the results of operations, cash flows and financial position of RJR Tobacco and, consequently, of RAI.

For a more complete description of this case, see Health-Care Cost Recovery Cases Department of Justice Case in Item 8, note 14 to consolidated financial statements.

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RJR Tobacco s overall retail market share of cigarettes has declined in recent years and may continue to decline; if RJR Tobacco is not able to continue to grow market share of its growth brands, or develop, produce or market new alternative tobacco products profitably, results of operations, cash flows and financial position of RJR Tobacco and, consequently, of RAI could be adversely impacted.

RJR Tobacco s U.S. retail market share of cigarettes has been declining for a number of years, and may continue to decline. According to data from IRI/Capstone, RJR Tobacco s share of the U.S. cigarette retail market declined slightly to 28.3% in 2009 from 28.4% in 2008, continuing a trend in effect for several years. If RJR Tobacco s growth brands do not continue to grow combined market share, results of operations, cash flows and financial position will be adversely affected. In addition, consumer health concerns, changes in adult consumer preferences and changes in regulations have prompted RJR Tobacco to introduce new alternative tobacco products. Consumer acceptance of these new products, such as CAMEL Snus or CAMEL Dissolvables, may fall below expectations. Furthermore, RJR Tobacco may not find vendors willing to produce alternative tobacco products resulting in additional capital expenditures for RJR Tobacco.

RJR Tobacco is dependent on the U.S. cigarette market, which it expects to continue to decline, negatively impacting revenue.

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. Therefore, RJR Tobacco is dependent on the U.S. cigarette market. Price increases, restrictions on advertising and promotions, funding of smoking prevention campaigns, increases in regulation and excise taxes, health concerns, a decline in the social acceptability of smoking, increased pressure from anti-tobacco groups and other factors have reduced U.S. cigarette consumption. U.S. cigarette consumption is expected to continue to decline. In addition, RJR Tobacco believes its consumers are more price-sensitive than consumers of competing brands, which may result in some consumers switching to a lower priced brand.

RJR Tobacco is RAI s largest operating segment. As such, it is the primary source of RAI s revenue, operating income and cash flows.

RJR Tobacco s contract manufacturing agreements with BAT may end in 2014.

RJR Tobacco s contract manufacturing for BAT accounted for 5% of total RAI sales and approximately 22% of total RJR Tobacco cigarette production in 2009. These contract manufacturing agreements may expire at the end of 2014. If BAT s contracts are not renewed or extended or if sales under these contracts decline, RJR Tobacco s revenue, operating income and cash flows will be unfavorably impacted.

In the U.S., tobacco products are subject to substantial and increasing regulation and taxation, which has a negative effect on revenue and profitability.

Tobacco products are subject to substantial federal and state excise 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 federal excise tax per pack of cigarettes, and significant increases on other tobacco products, to fund expansion of the SCHIP.

As a result, the federal excise tax rate for snuff increased $0.925 per pound to $1.51 per pound. The federal excise tax on small cigars, defined as those weighing three pounds or less per thousand, increased $48.502 per thousand to $50.33 per thousand. In addition, the federal excise tax rate for roll-your-own tobacco increased from $1.097 per pound to $24.78 per pound.

In addition to federal and state excise taxes, certain city and county governments also impose substantial excise taxes on tobacco products sold. Increased excise taxes are likely to result in declines in overall sales volume and shifts by consumers to less expensive brands.

A wide variety of federal, state and local laws limit the advertising, sale and use of cigarettes, and these laws have proliferated in recent years. For example, many local laws prohibit smoking in restaurants and other public places. Private businesses also have adopted regulations that prohibit or restrict, or are intended to discourage, smoking. Such laws and regulations also are likely to result in a decline in the overall sales volume of cigarettes. For additional information on the issues described above, see Governmental Activity in Management s Discussion and Analysis of Financial Condition and Results of Operations in Item 7.

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RAI s operating subsidiaries are subject to significant limitations on advertising and marketing of tobacco products, which could harm the value of their existing brands or their ability to launch new brands, thus negatively impacting revenue.

In the United States, television and radio advertisements of cigarettes have been prohibited since 1971, and television and radio advertisements of smokeless tobacco products have been prohibited since 1986. Under the MSA, certain of RAI s operating subsidiaries, including RJR Tobacco, cannot use billboard advertising, cartoon characters, sponsorship of certain events, non-tobacco merchandise bearing their brand names and various other advertising and marketing techniques. In addition, the MSA prohibits targeting of youth in advertising, promotion or marketing of tobacco products, including the smokeless tobacco products of RJR Tobacco. The Conwood companies are not participants in the MSA. Although these restrictions were intended to ensure that tobacco advertising was not aimed at young people, some of the restrictions also may limit the ability of RAI s operating subsidiaries to communicate with adult tobacco users. Additional restrictions, such as the FDA regulations discussed below, may be imposed legislatively or agreed to in the future.

The regulation of tobacco products by the Food and Drug Administration may adversely affect RAI s sales and operating profit.

On June 22, 2009, President Obama signed into law the FDA Tobacco Act, which granted the FDA broad authority over the manufacture, sale, marketing and packaging of tobacco products. 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 and Conwood s brands, and an increase in costs to RJR Tobacco and Conwood, resulting in 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, Altria Group Inc., 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.

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 Item 7.

RJR Tobacco s and Conwood s volumes, market share and profitability may be adversely affected by competitive actions and pricing pressures in the marketplace.

The tobacco industry is highly competitive. Among the major manufacturers, brands primarily compete on product quality, price, brand recognition, brand imagery and packaging. Substantial marketing support, merchandising display, discounting, promotions and other financial incentives generally are required to maintain or improve a brand s market position or introduce a new brand.

In addition, substantial payment obligations under the State Settlement Agreements adversely affect RJR Tobacco s ability to compete with manufacturers of deep-discount cigarettes that are not subject to such substantial obligations. For a more complete description of the State Settlement Agreements, see Health-Care Cost Recovery Cases State Settlement Agreements in Item 8, note 14 to consolidated financial statements.

Conwood s largest competitor, USSTC, was acquired by the parent company of Philip Morris USA, Inc. in January 2009. This acquisition of USSTC has changed the competitive dynamics with heavy promotions and competitive pricing. In addition, the possibility of combining pricing and merchandising display for cigarettes and smokeless tobacco products could adversely affect Conwood s and RJR Tobacco s market share, which would adversely affect

RAI s profitability and revenues.

Increases in commodity prices will increase costs and may reduce profitability.

Increases in the cost of tobacco leaf, other raw materials and other commodities used in RAI s operating subsidiaries products could cause profits to decline.

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Certain of RAI s operating subsidiaries may be required to write-down intangible assets, including goodwill, due to impairment, thus reducing operating profit.

Intangible assets include goodwill, trademarks and other intangibles. The determination of fair value involves considerable estimates and judgment. For goodwill, the determination of 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. RAI believes it has based its goodwill impairment testing on reasonable estimates and assumptions, and during the annual testing in the fourth quarter of 2009, the estimated fair value of each of RAI s reporting units was substantially in excess of its respective carrying value.

Trademarks and other intangible assets with indefinite lives also are tested for impairment annually, in the fourth quarter. The aggregate fair value of RAI s operating units trademarks and other intangible assets was substantially in excess of their aggregate carrying value. However, the individual fair value of six indefinite-lived trademarks was less than 15% in excess of their respective carrying values. The aggregate carrying value of these six trademarks was $561 million at December 31, 2009.

The methodology used to determine the fair value of trademarks includes assumptions with inherent uncertainty, including projected sales volumes and related projected revenues, long-term growth rates, royalty rates that a market participant might assume and judgments regarding the factors to develop an applied discount rate.

The carrying value of these six trademarks are at risk of impairment if future projected revenues or long-term growth rates are lower than those currently projected, or if factors used in the development of a discount rate result in the application of a higher discount rate.

Goodwill, all trademarks and other intangible assets are tested more frequently if events and circumstances indicate that the asset might be impaired. The carrying value of these intangible assets could be impaired if a significant adverse change in the use, life, or brand strategy of the asset is determined, or if a significant adverse change in the legal and regulatory environment, business or competitive climate occurs that would adversely impact the asset. See Item 8, note 3 to consolidated financial statements for a discussion of the impairment charges.

Changes in financial market conditions could result in higher costs and decreased profitability.

Changes in financial market conditions could negatively impact RAI s interest rate risk, foreign currency exchange rate risk and the return on corporate cash, thus increasing costs and reducing profitability. Due to the adverse conditions in the financial markets during 2009, RAI invested excess cash in either low interest funds or near zero interest funds, thereby lowering interest income.

Adverse changes in liquidity in the financial markets could result in additional realized or unrealized losses on investments.

Adverse changes in the liquidity in the financial markets could result in additional realized or unrealized losses associated with the value of RAI s investments, which would negatively impact RAI s consolidated results of operations, cash flows and financial position. As of December 31, 2009, $80 million of unrealized losses remain in other comprehensive loss. For more information on investment losses, see Item 8, note 7 to consolidated financial statements.

RAI s access to cash could be impacted by adverse changes in the financial markets and bankruptcy of financial institutions.

Effective July 3, 2009, the revolving loan commitment of Lehman Commercial Paper Inc., which filed for protection under Chapter 11 of the federal Bankruptcy Code in 2008, was terminated, thereby reducing the total revolving loan commitments under RAI s credit facility from $550 million to $498 million. For more information on participants in RAI s credit facility, see Liquidity and Financial Condition in Management s Discussion and Analysis of Financial Condition and Results of Operations in Item 7.

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Increases in pension expense or pension funding may reduce RAI s profitability and cash flow.

RAI s profitability is affected by the costs of pension benefits available to employees generally hired prior to January 1, 2004. Adverse changes in investment returns earned on pension assets and discount rates used to calculate pension and related liabilities or changes in required pension funding levels may have an unfavorable impact on pension expense and cash flows. During 2009, RAI contributed $295 million to its pension plans and expects to contribute $309 million to its pension plans in 2010. RAI actively seeks to control increases in pension expense, but there can be no assurance that profitability will not be adversely affected. In addition, changes to pension legislation or changes in pension accounting may adversely affect profitability and cash flow.

RJR Tobacco relies on outside suppliers to manage certain non-core business processes. Any interruption in these services could negatively affect the operations of RJR Tobacco and harm its reputation and consequently the operations and reputation of RAI.

In an effort to gain cost efficiencies, RJR Tobacco has substantially completed the outsourcing of many of its non-core business processes. Non-core business processes include, but are not limited to, certain processes relating to information technology, human resources, trucking and facilities. If any of the suppliers fail to perform their obligations in a timely manner or at a satisfactory quality level, RJR Tobacco may fail to operate effectively and fail to meet shipment demand.

RAI s operating subsidiaries rely on a limited number of suppliers for direct materials. An interruption in service from any of these suppliers could adversely affect the results of operations, cash flows and financial position of RAI.

RAI s operating subsidiaries rely on a limited number of suppliers for direct materials. If a supplier fails to meet any of RAI s operating subsidiary s demand for direct materials, the operating subsidiary may fail to operate effectively and may fail to meet shipment demand, adversely impacting RAI s results of operations.

Certain of RAI s operating subsidiaries face a customer concentration risk. The loss of this customer would result in a decline in revenue and have an adverse effect on cash flows.

Revenues from McLane Company, Inc., a distributor, comprised 27% of RAI s consolidated revenues in 2009. The loss of this customer, or a significant decline in its purchases, could have a material adverse effect on revenue of RAI.

Fire, violent weather conditions and other disasters may adversely affect the operations of RAI s operating subsidiaries.

A major fire, violent weather conditions or other disasters that affect manufacturing and other facilities of RAI s operating subsidiaries, or of their suppliers and vendors, could have a material adverse effect on the operations of RAI s operating subsidiaries. Despite RAI s insurance coverage for some of these events, a prolonged interruption in the manufacturing operations of RAI s operating subsidiaries could have a material adverse effect on the ability of its operating subsidiaries to effectively operate their businesses.

The agreement relating to RAI s credit facility contains restrictive covenants that limit the flexibility of RAI and its subsidiaries. Breach of those covenants will result in a default under the agreement relating to the facility.

Restrictions in the agreement relating to RAI s credit facility limit the ability of RAI and its subsidiaries to obtain future financing, and could impact the ability to withstand a future downturn in their businesses or the economy in general, conduct operations or otherwise take advantage of business opportunities that may arise. In addition, if RAI does not comply with these covenants, any indebtedness outstanding under the credit facility could become immediately due and payable. The lenders under RAI s credit facility could refuse to lend funds if RAI is not in compliance with the covenants or could terminate the credit facility. If RAI were unable to repay accelerated amounts, the lenders under RAI s credit facility could initiate a bankruptcy proceeding or liquidation proceeding.

For more information on the restrictive covenants in RAI s credit facility, see Item 8, note 11 to consolidated financial statements.

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RAI has substantial long-term debt, which could adversely affect its financial position and its ability to obtain financing in the future and react to changes in its business.

Because RAI and RJR have principal outstanding long-term notes of $4.2 billion:

RAI s ability to obtain additional financing for working capital, capital expenditures, acquisitions, debt service requirements or general corporate purposes, and its ability to satisfy its obligations with respect to its indebtedness, may be impaired in the future;

a substantial portion of RAI s cash flow from operations must be dedicated to the payment of principal and interest on its indebtedness, thereby reducing the funds available to it for other purposes;

RAI may be at a disadvantage compared to its competitors with less debt or comparable debt at more favorable interest rates; and

RAI s flexibility to adjust to changing market conditions and ability to withstand competitive pressures could be limited, and it may be more vulnerable to a downturn in general economic conditions or its business, or be unable to carry out capital spending that is necessary or important to its growth strategy and its efforts to improve operating margins.

It is likely that RAI will refinance, or attempt to refinance, a significant portion of its indebtedness prior to maturity through the incurrence of new indebtedness. There can be no assurance that RAI s available cash or access to financing on acceptable terms will be sufficient to satisfy such indebtedness.

The ability of RAI to access the debt capital markets could be impaired if the credit rating of its debt securities falls below investment grade.

The outstanding notes issued by RAI and RJR are rated investment grade. In certain cases, if RAI s credit rating falls below investment grade, RAI and certain of RAI s subsidiaries, including its material domestic subsidiaries, referred to as the Guarantors, will be required to provide collateral to secure RAI s credit facility and senior notes. In such event, RAI may not be able to sell additional debt securities or borrow money in such amounts, at the times, at the lower interest rates or upon the more favorable terms and conditions that might be available if its debt was rated investment grade. In addition, future debt security issuances or other borrowings may be subject to further negative terms, including limitations on indebtedness or similar restrictive covenants.

RAI s credit ratings are influenced by some important factors not entirely within the control of RAI or its affiliates, such as tobacco litigation, the regulatory environment and the performance of suppliers and vendors to RAI s operating subsidiaries. Moreover, because the kinds of events and contingencies that may impair RAI s credit ratings and the ability of RAI and its affiliates to access the debt capital markets are often the same kinds of events and contingencies that could cause RAI and its affiliates to seek to raise additional capital on an urgent basis, RAI and its affiliates may not be able to issue debt securities or borrow money upon acceptable terms, or at all, at the times at which they may most need additional capital.

For more complete information on RAI s borrowing arrangements, see Item 8, note 11 to consolidated financial statements.

B&W s significant equity interest in RAI could be determinative in matters submitted to a vote by RAI shareholders, resulting in RAI taking actions that RAI s other shareholders do not support. B&W also has influence over RAI by virtue of the governance agreement, which requires B&W s approval before RAI takes

certain actions.

B&W owns approximately 42% of the outstanding shares of RAI common stock. Only one other stockholder owns more than 10% of the outstanding shares of RAI common stock. Unless substantially all of RAI s public shareholders vote together on matters presented to RAI shareholders, B&W would have the power to determine the outcome of matters submitted to a shareholder vote.

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Moreover, in connection with the B&W business combination, RAI, B&W and BAT entered into an agreement, referred to as the governance agreement, relating to various aspects of RAI s corporate governance. Under the governance agreement, the approval of B&W, as a RAI shareholder, is required in connection with, among other things, the following matters:

- the sale or transfer of certain RAI intellectual property associated with B&W brands having an international presence, other than in connection with a sale of RAI; and
- RAI s adoption of any takeover defense measures that would apply to the acquisition of equity securities of RAI by B&W or its affiliates, other than the adoption of the RAI rights plan.

Such influence could result in RAI taking actions that RAI s other shareholders do not support.

Under the governance agreement, B&W is entitled to nominate certain persons to RAI s Board, and the approvals of the majority of such persons is required before certain actions may be taken, even though such persons represent less than a majority of the entire Board. In addition, certain provisions of RAI s articles of incorporation may create conflicts of interest between RAI and certain of these persons.

Under the governance agreement, B&W, based upon its current equity stake in RAI, is entitled to nominate five directors to RAI s Board, at least three of whom are required to be independent directors and two of whom may be executive officers of BAT or any of its subsidiaries. RAI s Board currently is comprised of 12 persons, including B&W s five designees. Matters requiring the approval of RAI s Board generally require the affirmative vote of a majority of the directors present at a meeting. Under the governance agreement, however, the approval of a majority of B&W s designees on RAI s Board is required in connection with the following matters:

- any issuance of RAI securities in excess of 5% of its outstanding voting stock, unless at such time B&W s ownership interest in RAI is less than 32%; and
- any repurchase of RAI common stock, subject to a number of exceptions, unless at such time B&W s ownership interest in RAI is less than 25%.

As a result, B&W s designees on RAI s Board may prevent the foregoing transactions from being effected, notwithstanding a majority of the entire Board may have voted to approve such transactions.

Under RAI s articles of incorporation, a B&W designated director who is affiliated with, or employed by, BAT or its subsidiaries and affiliates is not required to present a transaction, relationship, arrangement or other opportunity, all of which are collectively referred to as a business opportunity, to RAI if that business opportunity does not relate primarily to the United States.

B&W s significant ownership interest in RAI, and RAI s shareholder rights plan, classified board of directors and other anti-takeover defenses could deter acquisition proposals and make it difficult for a third party to acquire control of RAI without the cooperation of B&W. This could have a negative effect on the price of RAI common stock.

As RAI s largest shareholder, B&W could vote its shares of RAI common stock against any takeover proposal submitted for shareholder approval or refuse to accept any tender offer for shares of RAI common stock. This right would make it very difficult for a third party to acquire RAI without B&W consent. In addition, RAI has a shareholder rights plan, a classified board of directors and other takeover defenses in its articles of incorporation and bylaws. B&W s ownership interest in RAI and these defenses could discourage potential acquisition proposals and could delay or prevent a change in control of RAI. These deterrents could adversely affect the price of RAI common stock and make it very difficult to remove or replace members of the board of directors or management of RAI without cooperation of B&W.

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RAI shareholders may be adversely affected by the expiration of the standstill and transfer restrictions in the governance agreement, which would enable B&W to, among other things, transfer all or a significant percentage of its RAI shares to a third party, seek additional representation on the RAI board of directors, replace existing RAI directors, solicit proxies or otherwise acquire effective control of RAI.

The standstill provisions contained in the governance agreement generally restrict B&W from acquiring additional shares of RAI common stock and taking other specified actions as a shareholder of RAI. These restrictions generally will expire upon the earlier of ten years from the date of the B&W business combination and the date on which a significant transaction, as defined in the governance agreement, is consummated or occurs.

Subject to the terms of the RAI shareholder rights plan, B&W will be free after expiration of the standstill period to increase its ownership interest in RAI to more than 50% and may use this controlling vote to elect any number of or all the members of RAI s board of directors.

In addition, if the transfer restrictions in the governance agreement are terminated, subject to the terms of the RAI shareholder rights plan, there will be no contractual restrictions on B&W s ability to sell or transfer its shares of RAI common stock on the open market, in privately negotiated transactions or otherwise. These sales or transfers could create a substantial decline in the price of shares of RAI common stock or, if these sales or transfers were made to a single buyer or group of buyers that own RAI shares, could result in a third party acquiring effective control of RAI.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

The executive offices of RAI and RJR Tobacco are located in Winston-Salem, North Carolina, and the executive offices of the Conwood companies are located in Memphis, Tennessee. RJR Tobacco s manufacturing facilities are located in the Winston-Salem, North Carolina area, and Conwood s primary manufacturing facilities are located in Memphis, Tennessee; Clarksville, Tennessee and Winston-Salem, North Carolina. Other Conwood facilities are located in Bowling Green, Kentucky and Springfield, Tennessee. During 2009, Conwood began capacity upgrade and expansion projects at newly acquired sites in Memphis, Tennessee and Clarksville, Tennessee. The new Memphis facility will replace the current Memphis facility with production expected to begin in 2012, while the new Clarksville facility will provide for capacity expansion with initial production beginning in 2010. Both facilities will be FDA compliant. Included in the Conwood segment is Lane s manufacturing facility, which is located in Tucker, Georgia. Santa Fe s primary manufacturing facility is located in Oxford, North Carolina. An indirect subsidiary of RAI has a manufacturing facility located in Puerto Rico. All of RAI s operating subsidiaries executive offices and manufacturing facilities are owned. RAI s operating subsidiaries continue to evaluate capacity rationalization, which may result in the consolidation or closure of some facilities.

Item 3. Legal Proceedings

See Item 8, note 14 to consolidated financial statements for disclosure of legal proceedings involving RAI and its operating subsidiaries.

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

None.

Executive Officers and Certain Significant Employees of the Registrant

The executive officers of RAI are set forth below:

Susan M. Ivey. Ms. Ivey, 51, has been President and Chief Executive Officer of RAI since January 2004, and was elected the Chairman of the Board of RAI effective January 1, 2006. Ms. Ivey also became President of RAI Services Company in January 2010. She served as Chairman of the Board of RJR Tobacco from July 2004 to May

2008. From July 2004 to December 2006, she also served as Chief Executive Officer of RJR Tobacco. She served as President and Chief Executive Officer of B&W from 2001 to 2004. Ms. Ivey also served as a director of B&W from 2000 to 2004 and Chairman of the Board of B&W from January 2003 to 2004. Ms. Ivey commenced serving on the Board of RAI as of January 2004. She also is a member of the board of directors of R. R. Donnelley & Sons Company. In addition, Ms. Ivey is a member of the boards of directors of the United Way of Forsyth County, the Winston-Salem YWCA and the University of Florida Foundation; and she serves on the boards of trustees of Wake Forest University, Senior Services, Inc. and Salem College.

Thomas R. Adams. Mr. Adams, 59, has been Executive Vice President and Chief Financial Officer of RAI since January 2008 and Executive Vice President and Chief Financial Officer of RAI Services Company since January 2010. In addition, he has served on the board of directors for RAI Services Company since January 2010. Mr. Adams previously served as Senior Vice President and Chief Accounting Officer of RAI from March 2007 to December 2007. He served as Senior Vice President-Business Processes of RAI from September 2006 to March 2007 and of RJR Tobacco from May 2005 to November 2006. Mr. Adams also served as Senior Vice President and Chief Accounting Officer of both RAI and RJR Tobacco from July 2004 to April 2005. From June 1999 to July 2004, he served as Senior Vice President and Controller of both RJR Tobacco and RJR. Mr. Adams is a member of the boards of directors of Allegacy Federal Credit Union and the Old Hickory Council of the Boy Scouts of America and the board of commissioners of the Housing Authority of Winston-Salem.

Lisa J. Caldwell. Ms. Caldwell, 49, has been Executive Vice President and Chief Human Resources Officer of RAI since May 2009 and RAI Services Company since January 2010. Ms. Caldwell has served on the board of directors of RAI Services Company since January 2010. She was previously Executive Vice President and Chief Human Resources Officer for RJR Tobacco from May 2009 to January 2010. Ms. Caldwell served as Executive Vice President Human Resources of RAI and RJR Tobacco since June 2008. She served as Senior Vice President Human Resources of RAI from November 2006 to June 2008, after having served as Vice President Human Resources of RAI from September 2004 to November 2006. She also served as Senior Vice President Human Resources of RJR Tobacco from July 2007 to June 2008, after having served as Vice President Human Resources of RJR Tobacco from January 2002 to November 2006. Prior to 2002, Ms. Caldwell held numerous human resources positions with RJR Tobacco since joining RJR Tobacco in 1991. Ms. Caldwell serves on the University of North Carolina Board of Visitors.

Daniel (Daan) M. Delen. Mr. Delen, 44, joined RJR Tobacco as President and Chief Executive Officer in January 2007, and was elected Chairman of the Board of RJR Tobacco in May 2008. Prior to joining RJR Tobacco, Mr. Delen was President of BAT Ltd. Japan from August 2004 to December 2006 and Senior Vice President of Marketing and Sales for B&W from 2001 to July 2004. He held various other positions with BAT after joining BAT in 1989. Mr. Delen is a member of the board of directors of Winston-Salem Alliance.

Daniel A. Fawley. Mr. Fawley, 52, has served as Senior Vice President and Treasurer of RAI, RJR Tobacco and RJR since September 2004 and Senior Vice President and Treasurer of RAI Services Company since January 2010. He was previously Vice President and Assistant Treasurer of RJR from 1999 until July 2004 and of RAI from July 2004 until September 2004. Mr. Fawley is a member of the board of directors of the Reynolds American Foundation, the Board of Trustees of the Arts Council Endowment Fund, Inc. and the Finance Advisory Board for the Finance Academy.

McDara P. Folan, III. Mr. Folan, 51, has been Senior Vice President, Deputy General Counsel and Secretary of RAI since July 2004 and Senior Vice President, Deputy General Counsel and Secretary of RAI Services Company since January 2010. Mr. Folan served as Vice President, Deputy General Counsel and Secretary of RJR from June 1999 to July 2004, and has been Senior Vice President and Secretary and Director of RJR since July 2004. He also was Vice President, Deputy General Counsel and Secretary of RJR Tobacco from June 1999 to March 2000, and currently serves as Assistant Secretary of RJR Tobacco. Mr. Folan serves on the advisory board for Brenner Children s Hospital, the National Advisory Council of Reynolda House Museum of American Art and the board of advisors of Salem College and Academy and is a member of the board of trustees of the Arts Council of Winston-Salem and Forsyth County and the Arts Council Endowment Fund, Inc.

Jeffery S. Gentry, PhD. Dr. Gentry, 52, became Executive Vice President Operations and Chief Scientific Officer of RJR Tobacco on January 1, 2010, after having served as RAI Group Executive Vice President since April 1, 2008. Dr. Gentry has served on the board of directors of RJR Tobacco since January 2010. He was previously Executive Vice President Research and Development of RJR Tobacco from December 2004, after serving as Vice President Product Development since 2000. Dr. Gentry joined RJR Tobacco in 1986 as a research and development chemist. He is the co-founder of No Limits II, a non-profit organization providing social opportunities for disabled adults in the Winston-Salem area.

Andrew D. Gilchrist. Mr. Gilchrist, 37, became Executive Vice President and Chief Financial Officer of RJR Tobacco and Executive Vice President and Chief Information Officer of RAI Services Company on January 1, 2010, after having served as Executive Vice President, Chief Financial Officer and Chief Information Officer of RJR Tobacco from July 2008 until January 2010. Mr. Gilchrist has served on the board of directors of RJR Tobacco since May 2008. He also served as Senior Vice President and Chief Financial Officer of RJR Tobacco from November 2006 to July 2008, after having served as Vice President Integrated Business Management of RJR Tobacco from January 2006 to November 2006. Prior to 2006, Mr. Gilchrist served as Senior Director Business Development since joining RAI in 2004. Prior to July 2004, Mr. Gilchrist held various positions with B&W and its parent company, BAT. Mr. Gilchrist is a member of the board of trustees of the Arts Council of Winston-Salem and Forsyth County.

E. Julia (Judy) Lambeth. Ms. Lambeth, 58, joined RAI as Executive Vice President Corporate Affairs, General Counsel and Assistant Secretary in September 2006 and also became Executive Vice President Corporate Affairs, General Counsel and Assistant Secretary of RAI Services Company in January 2010. She has served on the board of directors of RAI Services Company since January 2010. Prior to joining RAI, Ms. Lambeth served as Corporate Secretary and Deputy General Counsel, Corporate Services for ConocoPhillips from 2002 to 2006. Ms. Lambeth is a member of the Wake Forest Law School Board of Visitors and serves on the board of directors of Reynolds American Foundation, the Winston-Salem Symphony and Southeastern Center for Contemporary Art.

J. Brice O Brien. Mr. O Brien, 41, was named Executive Vice President Consumer Marketing of RJR Tobacco on January 1, 2010, after having served as President of Reynolds Innovations Inc. since January 2009. He served as Senior Vice President Consumer Marketing of RJR Tobacco from January 2006 until January 2009, after serving as Vice President Marketing since October 2004. Prior to 2004, he held various positions with RJR Tobacco after joining RJR Tobacco in 1995.

Tommy J. Payne. Mr. Payne, 52, was named President of Niconovum USA, Inc. on January 1, 2010, after having served as Executive Vice President Public Affairs of RAI from November 2006 to January 2010 and RJR Tobacco from May 2008 to January 2010. Mr. Payne previously served as Executive Vice President External Relations of RAI from July 2004 to November 2006, and RJR Tobacco from September 1999 to November 2006. Mr. Payne served as Executive Vice President External Relations at RJR from July 1999 to July 2004. Prior to that time, he held various positions after joining RJR in 1988. Mr. Payne serves on the board of directors and executive committee of the North Carolina Chamber and the board of directors of the Tobacco Manufacturers Association.

Frederick W. Smothers. Mr. Smothers, 46, has served as Senior Vice President and Chief Accounting Officer of RAI since January 2008 and RAI Services Company since January 2010. Mr. Smothers served as Vice President and Corporate Controller of RAI from October 2007 to December 2007. Prior to joining RAI, Mr. Smothers was an independent management consultant from 2002 until 2007, serving as Chief Executive Officer of ATRS Consulting from 2005 until October 2007, providing general management consulting to consumer products and manufacturing clients, including RAI. From 1986 until 2002, Mr. Smothers was employed by the accounting firm of Deloitte & Touche LLP, including four years as partner.

Robert D. Stowe. Mr. Stowe, 52, was named Executive Vice President Trade Marketing of RJR Tobacco on January 1, 2010, after having served as Senior Vice President Trade Marketing of RJR Tobacco from January 2006 to January 2010. He also served as an Area Vice President of RJR Tobacco from July 2004 to January 2006. Prior to July 2004, Mr. Stowe held various positions with B&W.

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E. Kenan Whitehurst. Mr. Whitehurst, 53, has been Senior Vice President Strategy and Business Development of RAI since November 2006. He was previously Vice President Investor Relations of RAI from July 2004 until November 2006. From January 2001 to July 2004, Mr. Whitehurst served as Vice President Corporate Business Development for RJR Tobacco, after serving as its Vice President Marketing from 2000 to 2001. Prior to 2000, he held various positions with RJR Tobacco after joining RJR Tobacco in 1988.

The chief executive officers of RAI s other principal operating subsidiaries are set forth below:

Nicholas Bumbacco. Mr. Bumbacco, 45, was named President and Chief Executive Officer of Santa Fe on March 1, 2009. Previously he served as President of GPI from September 2007 until February 2009. Mr. Bumbacco served as Vice President Strategy Development for RJR Tobacco from January 2007 until September 2007. He served as President and Chief Executive Officer of Lane from October 2005 until January 2007 after being promoted from Vice President Trade Marketing of Lane. Prior to October 2005, he held various positions with B&W since joining B&W in 1999.

Bryan K. Stockdale. Mr. Stockdale, 51, was named President and Chief Executive Officer of American Snuff Company, LLC on February 1, 2009. He previously served as Senior Vice President Marketing Operations for RJR Tobacco from January 2006 until February 2009 and Vice President Trade Marketing from September 1996 through December 2005.

PART II

Item 5. Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

RAI common stock, par value $.0001 per share, is listed on the NYSE under the trading symbol RAI. On January 29, 2010, there were approximately 17,100 holders of record of RAI common stock. Shareholders whose shares are held of record by a broker or clearing agency are not included in this amount; however, each of those brokers or clearing agencies is included as one holder of record. The closing price of RAI common stock on January 29, 2010, was $53.20 per share.

The cash dividends declared, and high and low sales prices per share for RAI common stock on the NYSE Composite Tape, as reported by the NYSE, were as follows:

	Price Per Share		Cash Dividends Declared per
	High	Low	Share
2009:			
First Quarter	$ 41.16	$ 31.55	$ 0.85
Second Quarter	42.06	35.97	0.85
Third Quarter	46.95	37.91	0.85
Fourth Quarter	54.26	43.82	0.90
2008:			
First Quarter	$ 72.00	$ 58.86	$ 0.85
Second Quarter	60.80	46.40	0.85
Third Quarter	57.73	45.61	0.85
Fourth Quarter	50.00	37.21	0.85

On October 6, 2009, RAI s board of directors raised the quarterly cash dividend to $0.90 per common share. On February 2, 2010, the board of directors of RAI declared a quarterly cash dividend of $0.90, or $3.60 on an annualized basis, per common share. The dividends will be paid on April 1, 2010, to shareholders of record as of March 10, 2010. The current dividend reflects RAI s policy of paying dividends to the holders of RAI common stock in an aggregate amount that is approximately 75% of RAI s annual consolidated net income.

RAI repurchases and cancels shares of its common stock forfeited with respect to the tax liability associated with vesting of restricted stock grants under the RAI Long-Term Incentive Plan, referred to as the LTIP. During 2009, at a cost of $5 million, RAI purchased 154,441 shares that were forfeited with respect to tax liabilities associated with restricted stock vesting under its LTIP.

On April 29, 2008, RAI s board of directors authorized RAI s repurchase, from time to time on or before April 30, 2009, of up to $350 million of outstanding shares of RAI common stock in open-market or privately negotiated transactions. RAI and B&W entered into an agreement, 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. RAI repurchased and cancelled 3,817,095 shares of RAI common stock for $207 million under the above share repurchase programs in 2008. RAI did not repurchase any RAI common stock under this program in 2009.

For equity-based benefit plan information, see Item 8, note 16 to consolidated financial statements.

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Performance Graph

Set forth below is a line graph comparing, for the period which commenced on December 31, 2004, and ended on December 31, 2009, the cumulative shareholder return of $100 invested in RAI common stock with the cumulative return of $100 invested in the Standard & Poor s 500 Index and the Standard & Poor s Tobacco Index.

COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN[(1)]
Among Reynolds American Inc., The S&P 500 Index
and The S&P Tobacco Index

	12/31/04	12/31/05	12/31/06	12/31/07	12/31/08	12/31/09
Reynolds American Inc.	$ 100.00	$ 127.36	$ 183.24	$ 194.05	$ 126.72	$ 181.01
S&P 500	100.00	104.91	121.48	128.16	80.74	102.11
S&P Tobacco[(2)]	100.00	125.19	152.93	183.29	149.84	188.21

(1) Assumes that $100 was invested in RAI common stock on December 31, 2004, and that in each case all dividends were reinvested.

(2) The S&P Tobacco Index includes as of December 31, 2009, the following companies: Altria Group Inc.; Lorillard Inc.; Philip Morris International; and Reynolds American Inc.

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Item 6. Selected Financial Data

The selected historical consolidated financial data as of December 31, 2009 and 2008, and for each of the years in the three-year period ended December 31, 2009, are derived from the consolidated financial statements and accompanying notes, which have been audited by RAI s independent registered public accounting firm. The selected historical consolidated financial data as of December 31, 2007, 2006 and 2005, and for the years ended December 31, 2006 and 2005, are derived from audited consolidated financial statements not presented or incorporated by reference. The consolidated financial statements of RAI include the results of the Conwood companies subsequent to May 31, 2006. For further information, including the impact of new accounting developments, restructuring and impairment charges, you should read this table in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations in Item 7 and the consolidated financial statements.

	For the Years Ended December 31,				
	2009	2008	2007	2006	2005
	(Dollars in Millions, Except Per Share Amounts)				
Results of Operations:					
Net sales[1]	$ 8,419	$ 8,845	$ 9,023	$ 8,510	$ 8,256
Income from continuing operations before extraordinary item[1][2][3][4]	962	1,338	1,307	1,136	985
Income from discontinued operations					2
Extraordinary item gain on acquisition			1	74	55
Net income	962	1,338	1,308	1,210	1,042
Per Share Data[5]:					
Basic income from continuing operations	3.30	4.56	4.43	3.85	3.34
Diluted income from continuing operations	3.30	4.56	4.43	3.84	3.34
Basic income from discontinued operations					0.01
Diluted income from discontinued operations					0.01
Basic income from extraordinary item				0.25	0.18
Diluted income from extraordinary item				0.25	0.18
Basic net income	3.30	4.56	4.43	4.10	3.53
Diluted net income	3.30	4.56	4.43	4.09	3.53
Basic weighted average shares, in thousands	291,381	293,401	295,163	295,449	294,790
Diluted average shares, in thousands	291,826	293,600	295,409	295,742	295,172
Cash dividends declared per share of common stock	$ 3.45	$ 3.40	$ 3.20	$ 2.75	$ 2.10
Balance Sheet Data (at end of periods):					
Total assets	18,009	18,154	18,629	18,178	14,519
Long-term debt (less current maturities)	4,136	4,486	4,515	4,389	1,558
Shareholders equity	6,498	6,237	7,466	7,043	6,553
Cash Flow Data:					
Net cash from operating activities	1,454	1,315	1,331	1,457	1,273
Net cash from (used in) investing activities	(123)	278	763	(3,531)	(989)
Net cash (used in) from financing activities	(1,192)	(1,206)	(1,312)	2,174	(450)
Other Data:					
Ratio of earnings to fixed charges[6]	6.9	8.5	7.0	7.4	12.2

(1) Net sales and cost of products sold exclude excise taxes of $3,927 million, $1,890 million, $2,026 million, $2,124 million and $2,175 million for the years ended December 31, 2009, 2008, 2007, 2006 and 2005, respectively.

(2) Includes gain on termination of joint venture of $328 million in 2008.

(3) Includes restructuring and/or asset impairment charges of $56 million, $90 million, $1 million and $2 million for the years ended December 31, 2009, 2008, 2006 and 2005, respectively.

(4) Includes trademark and/or goodwill impairment charges of $567 million, $318 million, $65 million, $90 million and $200 million for the years ended December 31, 2009, 2008, 2007, 2006 and 2005, respectively.

(5) All share and per share amounts have been retroactively adjusted to reflect the August 14, 2006, two-for-one stock split. Certain per share amounts have been retroactively adjusted for restated share amounts resulting from the adoption of revised GAAP effective January 1, 2009.

(6) Earnings consist of income from continuing operations before equity earnings, income taxes and fixed charges. Fixed charges consist of interest on indebtedness, amortization of debt issuance costs and one-third of operating rental expense, representative of the interest factor.

Item 7. 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 policies and its consolidated results of operations and financial position. Following the overview and discussion of business initiatives, the critical accounting policies disclose certain accounting policies 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 is presented in two comparative sections, 2009 compared with 2008, and 2008 compared with 2007. 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 consolidated financial statements and the related notes as of December 31, 2009 and 2008, and for each of the years in the three-year period ended December 31, 2009.

Overview and Business Initiatives

RAI s reportable operating segments are RJR Tobacco and Conwood. The RJR Tobacco segment consists of the primary operations of R. J. Reynolds Tobacco Company. The Conwood segment consists of Conwood Holdings, Inc., the primary operations of the Conwood companies and Lane. Two of RAI s wholly owned subsidiaries, Santa Fe and Niconovum AB, among others, are included in All Other. RAI s wholly owned operating subsidiaries have entered into intercompany agreements for products or services with other RAI operating 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 cigarette manufacturer in the United States. RJR Tobacco s largest selling cigarette brands, CAMEL, PALL MALL, WINSTON, KOOL and DORAL, were five of the ten best-selling brands of cigarettes in the United States as of December 31, 2009. Those brands, and its other brands, including SALEM, 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.

RAI s other reportable operating segment, Conwood, is the second largest smokeless tobacco products manufacturer in the United States. Conwood s primary brands include its largest selling moist snuff brands, GRIZZLY, the best-selling brand of moist snuff in the United States as of December 31, 2009, and KODIAK. Conwood also distributes a variety of other tobacco products, including WINCHESTER and CAPTAIN BLACK little cigars, and BUGLER roll-your-own tobacco.

Santa Fe manufactures and markets cigarettes and other tobacco products under the NATURAL AMERICAN SPIRIT brand, as well as manages super premium brands licensed from BAT, including DUNHILL and STATE EXPRESS 555. In January 2009, the activities of GPI were transitioned to other operating subsidiaries of RAI. The management and export of tobacco products sold to certain U.S. territories, U.S. duty-free shops and U.S. overseas military bases was transferred to RJR Tobacco and sales of NATURAL AMERICAN SPIRIT in Europe and Japan were transferred to other indirect subsidiaries of RAI.

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. In addition, in connection with the B&W business combination in 2004, RAI entered into a non-competition agreement with BAT under which RAI s operating subsidiaries generally were prohibited, subject to certain exceptions, from manufacturing and marketing certain tobacco products outside the United States from the date of the B&W business combination until July 2009.

Expanding beyond the cigarette market as an innovative tobacco company, RJR Tobacco offers two types of smoke-free tobacco, CAMEL Snus and CAMEL Dissolvables. CAMEL Snus, launched nationally in 2009, is pasteurized tobacco in a small pouch that provides convenient tobacco consumption. CAMEL Dissolvables include CAMEL Orbs, Sticks and Strips, all of which are made of finely milled tobacco and dissolve completely in the mouth. CAMEL Orbs were launched in three lead markets during the first quarter of 2009, and CAMEL Sticks and Strips were launched in those lead markets during the third quarter of 2009.

RJR Tobacco s 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 of these brands are managed for long-term market share and profit growth, CAMEL will continue to receive the most significant investment 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 to ensure the long-term market share growth of the growth brands while managing the support brands for long-term sustainability and profitability. At present, RJR Tobacco s smoke-free products are marketed under the CAMEL brand and focus on long-term growth.

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 style.

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, free product 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.

Conwood

Conwood 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 volumes grew over 4% in 2009, driven by the accelerated growth of price-value brands. 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. Within the moist snuff category, premium brands have lost market share to price-value brands, led by the growth of GRIZZLY, in recent years. However, during 2009, heavy promotion and competitive pricing of premium brands have slowed the growth of the price-value brands.

Conwood 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. The parent company of RJR Tobacco s largest competitor in the cigarette market, Philip Morris USA, Inc., completed its acquisition of Conwood s largest competitor, USSTC, in January 2009.

Critical Accounting Policies and Estimates

Accounting principles generally accepted in the United States, referred to as GAAP, require estimates and assumptions to be made that affect the reported amounts in RAI s consolidated financial statements 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. For information related to these and other significant accounting policies, see Item 8, note 1 to consolidated financial statements.

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. 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 Item 8, note 14 to consolidated financial statements, RJR Tobacco, the Conwood companies 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. As of January 29, 2010, RJR Tobacco had paid approximately $12 million since January 1, 2007, related to unfavorable judgments.

RAI and its subsidiaries believe that they have valid bases for appeal of adverse verdicts against them and 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 the Conwood companies, when viewed on an individual basis, is not probable or estimable. As of December 31, 2009, RJR Tobacco had $2 million accrued for an unfavorable judgment in the *Whiteley v R. J. Reynolds Tobacco Co*. case and $2 million accrued for non-smoking and health litigation. In addition, as of December 31, 2009, RJR, including its subsidiary RJR Tobacco, had liabilities totaling $94 million that were recorded in connection with certain non-smoking and health indemnification claims asserted by JTI relating to certain activities of Northern Brands and related litigation.

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, the Conwood companies 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 Item 8, note 14 to consolidated financial statements.

Settlement Agreements

RJR Tobacco, Santa Fe and Lane are participants in the MSA, and RJR Tobacco is a participant in other state settlement agreements related to governmental health-care cost recovery actions. 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 under these agreements is recorded in cost of products sold as the products are shipped. Adjustments to these estimates are recorded in the period that the change becomes probable and the amount can be reasonably estimated. The

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Conwood companies are not participants in the State Settlement Agreements. 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 and State Settlement Agreements Enforcement and Validity in Item 8, note 14 to consolidated financial statements.

Intangible Assets

Intangible assets include goodwill, trademarks and other intangibles. The determination of fair value involves considerable estimates and judgment. For goodwill, the determination of 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. RAI believes it has based its goodwill impairment testing on reasonable estimates and assumptions, and during the annual testing in the fourth quarter of 2009, the estimated fair value of each of RAI s reporting units was substantially in excess of its respective carrying value.

Trademarks and other intangible assets with indefinite lives also are tested for impairment annually, in the fourth quarter. The aggregate fair value of RAI s operating units trademarks and other intangible assets was substantially in excess of their aggregate carrying value. However, the individual fair value of six indefinite-lived trademarks was less than 15% in excess of their respective carrying values. The aggregate carrying value of these six trademarks was $561 million at December 31, 2009.

The methodology used to determine the fair value of trademarks includes assumptions with inherent uncertainty, including projected sales volumes and related projected revenues, long-term growth rates, royalty rates that a market participant might assume and judgments regarding the factors to develop an applied discount rate.

The carrying value of these six trademarks are at risk of impairment if future projected revenues or long-term growth rates are lower than those currently projected, or if factors used in the development of a discount rate result in the application of a higher discount rate.

Goodwill, all trademarks and other intangible assets are tested more frequently if events and circumstances indicate that the asset might be impaired. The carrying value of these intangible assets could be impaired if a significant adverse change in the use, life, or brand strategy of the asset is determined, or if a significant adverse change in the legal and regulatory environment, business or competitive climate occurs that would adversely impact the asset. See Item 8, note 3 to consolidated financial statements for a discussion of the impairment charges.

Fair Value Measurement

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

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Investments

Marketable securities are classified as available-for-sale and are carried at fair value, with related unrealized gains and losses deemed temporarily impaired reported, net of tax, as accumulated other comprehensive loss. All losses deemed to be other than temporarily impaired are recorded in earnings. As of December 31, 2009, RAI held investments primarily in money market funds, auction rate securities, a mortgage-backed security and a marketable equity security. Certain money market funds are classified as short-term investments due to the liquidity restrictions by the fund managers preventing immediate withdrawal.

Adverse changes in financial markets caused the auction rate securities and the mortgage-backed security to revalue lower than carrying value and become less liquid. The funds associated with the auction rate securities and the mortgage-backed security will not be accessible until a successful auction occurs or a buyer is found. These investments are evaluated on a quarterly basis to determine if a credit loss has been incurred and the investment is other than temporarily impaired. For these investments, RAI uses assumptions about future cash flows and risk-adjusted discount rates to determine fair value. To assess credit losses, RAI uses historical default rates, debt ratings, credit default swap spreads and recovery rates to determine if credit losses have been incurred. RAI has the intent and ability to hold these investments for a period of time sufficient to allow for the recovery in market value.

Pension and Postretirement Benefits

RAI and certain of its subsidiaries sponsor a number of non-contributory defined benefit pension plans covering most of their employees, and also provide 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. For additional information relating to pension and postretirement benefits, see Item 8, note 17 to consolidated financial statements.

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.

Gains or losses are annual changes in the amount of either the benefit obligation or the market-related value of plan assets resulting from experience different from that assumed or from changes in assumptions. The minimum amortization of unrecognized gains or losses, is included in pension expense. Prior service costs, 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.

The minimum amortization of unrecognized gains or losses is also included in the postretirement benefit expense. Prior service costs, which are changes in benefit obligations due to plan amendments, are amortized on a straight-line basis over the service to expected 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.

Differences between actual results and actuarial assumptions are accumulated and amortized over future periods. In recent years, actual results have varied significantly from actuarial assumptions. In particular, pension and postretirement assets have decreased due to significant decreases in fair value. These changes, especially during 2008, have resulted in an increase in charges to other comprehensive loss and increased pension expense. These changes are expected to result in an increase in pension and postretirement expense in future years. The Pension Protection Act may require additional cash funding of the pension obligations in the future.

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The most critical assumptions and their sensitivity to change are presented below:

Assumed asset return and discount rates have a significant effect on the amounts reported for the benefit plans. A one-percentage-point change in assumed discount rate for the pension plans and other postretirement plans would have had the following effects:

	1-Percentage Point Increase		1-Percentage Point Decrease	
	Pension Plans	Postretirement Plans	Pension Plans	Postretirement Plans
Effect on 2009 net periodic benefit cost	$ (15)	$ (6)	$ 32	$ 6
Effect on December 31, 2009, projected benefit obligation and accumulated postretirement benefit obligation	(489)	(115)	586	136

A one-percentage point change in assumed asset return would have had the following effects:

	1-Percentage Point Increase		1-Percentage Point Decrease	
	Pension Plans	Postretirement Plans	Pension Plans	Postretirement Plans
Effect on 2009 net periodic benefit cost	$ (41)	$ (3)	$ 41	$ 3

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. Management currently believes it is more likely than not that the deferred tax assets recorded in RAI s consolidated balance sheet will be realized. To the extent a deferred tax liability is established, it is recorded, tracked and, once it becomes currently due and payable, paid to the taxing authorities.

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 upon RAI s effective income tax rate.

Recently Adopted Accounting Pronouncements

For information relating to recently adopted accounting guidance, see Item 8, note 1 to consolidated financial statements.

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Results of Operations

2009 Compared with 2008

	For the Twelve Months Ended December 31,		
	2009	**2008**	**% Change**
Net sales:(1)			
RJR Tobacco	$ 7,334	$ 7,755	(5.4)%
Conwood	673	723	(6.9)%
All other	412	367	12.3%
Net sales	8,419	8,845	(4.8)%
Cost of products sold(1)(2)	4,485	4,863	(7.8)%
Selling, general and administrative expenses	1,508	1,500	0.5%
Amortization expense	28	22	27.3%
Restructuring charge	56	90	(37.8)%
Trademark impairment charges	567	318	78.3%
Operating income:			
RJR Tobacco	1,487	1,805	(17.6)%
Conwood	276	232	19.0%
All other	112	104	7.7%
Corporate expense	(100)	(89)	12.4%
	$ 1,775	$ 2,052	(13.5)%

(1) Excludes excise taxes of:

	2009	**2008**
RJR Tobacco	$ 3,532	$ 1,689
Conwood	124	20
All other	271	181
	$ 3,927	$ 1,890

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

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RJR Tobacco

Net Sales

Domestic cigarette shipment volume, in billions of units for RJR Tobacco and the industry, were as follows[1]:

	For the Twelve Months Ended December 31, 2009	2008	% Change
Growth brands:			
CAMEL excluding non-filter	21.2	23.3	(9.2)%
PALL MALL	14.6	8.6	70.9%
	35.8	31.8	12.3%
Support brands	37.9	46.6	(18.7)%
Non-support brands	8.0	11.0	(27.2)%
Total domestic	81.7	89.5	(8.7)%
Total premium	48.1	55.9	(13.9)%
Total value	33.5	33.5	(0.1)%
Premium/Total mix	59.0%	62.5%	
Industry[2]:			
Premium	222.6	251.1	(11.3)%
Value	93.1	94.2	(1.2)%
Total domestic	315.7	345.3	(8.6)%
Premium/Total mix	70.5%	72.7%	

(1) Amounts presented in this table are rounded on an individual basis and, accordingly, may not sum on an aggregate basis. Percentages are calculated on unrounded numbers.

(2) Based on information from MSAi. All amounts reflect the current methodology.

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 believes the federal excise tax increase, effective April 1, 2009, has had, and will continue to have, a significant and adverse impact on cigarette sales volume. RJR Tobacco also believes its consumers are more price-sensitive than consumers of competing brands and, therefore, are more negatively affected by an increase in the federal excise tax and by the current adverse economic environment.

RJR Tobacco s net sales for the year ended December 31, 2009, decreased $421 million, or 5.4%, from the year ended December 31, 2008, driven by $566 million attributable to lower cigarette volume. RJR Tobacco s decreases in net sales and cigarette shipment volume primarily reflect a continued decline in consumption, partially offset by the recent price increase resulting from the increase in federal excise tax. RJR Tobacco s total domestic cigarette shipment volume decreased 8.7% in 2009 compared with 2008. Industry cigarette shipment volume for 2009 was down 8.6% compared with 2008. RJR Tobacco s and industry cigarette shipment volume declines for 2009 are higher than prior years as a result of the increase in the federal excise tax.

The shares of RJR Tobacco s brands as a percentage of total share of U.S. retail cigarette sales according to data[1] from IRI/Capstone, were as follows[2][3]:

	For the Twelve Months Ended December 31,		
	2009	**2008**	**Share Point Change**
Growth brands:			
CAMEL excluding non-filter	7.5%	7.7%	(0.1)
PALL MALL	4.8%	2.7%	2.1
Total growth brands	12.3%	10.4%	1.9
Support brands	13.1%	14.6%	(1.5)
Non-support brands	2.9%	3.5%	(0.6)
Total domestic	28.3%	28.4%	(0.1)

(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.

(2) Amounts presented in this table are rounded on an individual basis and, accordingly, may not sum on an aggregate basis.

(3) In 2009, at the request of RJR Tobacco, the IRI/Capstone model was revised to better reflect actual retail sales. All data reflects the new methodology.

The retail share of market of CAMEL s filtered styles decreased 0.1 share points in 2009 compared with 2008. CAMEL Crush has captured 0.7 share points as of December 31, 2009, as the success of this style continues to be a key driver in the growing menthol category. RJR Tobacco expanded the use of the capsule technology found in CAMEL Crush to CAMEL s core menthol styles beginning in third quarter of 2009, giving adult smokers the choice between two levels of menthol. In the first quarter of 2010, RJR Tobacco will introduce new packaging for these styles to raise consumer awareness and trial and to strengthen growth in the menthol category.

CAMEL Snus was expanded nationally in the first quarter of 2009, and as of December 31, 2009, gained market share of 0.3 percent on a cigarette equivalent basis that assumes a can of snus is equal to a pack of cigarettes. Two new styles of CAMEL Snus were launched in limited markets in the third quarter of 2009.

CAMEL Orbs were launched in three lead markets during the first quarter of 2009, and CAMEL Sticks and Strips were launched in those lead markets in the third quarter of 2009. RJR Tobacco continues to gain insight on ways to improve the products and the packaging of the products.

PALL MALL s market share increased 2.1 share points in 2009 compared with 2008. PALL MALL s growth is believed to be the result of adult consumers switching brands seeking greater value. PALL MALL, positioned as a product that offers a longer-lasting cigarette at a value price, has retained a high percentage of adult smokers who try the brand.

The combined share of market of RJR Tobacco s growth brands during 2009 showed improvement over 2008.

Operating Income

RJR Tobacco s operating income for the year ended December 31, 2009, decreased $318 million to $1,487 million from $1,805 million for the year ended December 31, 2008. A trademark impairment charge of $377 million was recorded in the first quarter of 2009 as the result of impairment testing to reflect the forecasted sales impact due to the increase in the federal excise tax. An additional trademark impairment charge of $114 million was recorded in the fourth quarter of 2009 as the result of annual impairment testing of brand

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trademarks. During 2008, RJR Tobacco recorded trademark impairment charges of $176 million. The impairment charges were based on the excess of each brand s carrying value over its fair value using the present value of estimated future cash flows assuming a discount rate of 10.5%.

RJR Tobacco s operating income was unfavorably impacted by lower cigarette volume, higher pension expense and higher legal expense. Higher pricing, lower promotional spending and productivity gains resulting from the 2008 restructuring partially offset the unfavorability.

In December 2009, RJR Tobacco announced the elimination of approximately 400 full-time production positions. These positions were selected from employees who volunteered to be considered for job elimination. The job eliminations are expected to be substantially completed by December 31, 2010.

Under existing benefit plans, $48 million of severance-related cash benefits and $8 million of non-cash pension-related benefits comprised a restructuring charge of $56 million. None of the cash portion of the charge was paid during 2009. The cash benefits are expected to be substantially paid by December 31, 2011. Cost savings related to the restructuring are expected to be $17 million in 2010 and increasing to approximately $30 million in 2011 and each year thereafter.

RJR Tobacco s State Settlement Agreements and federal tobacco buyout expenses, included in cost of products sold, are detailed in the schedule below:

	For the Twelve Months Ended December 31,	
	2009	**2008**
Settlements	$ 2,490	$ 2,664
Federal tobacco quota buyout	$ 231	$ 240

Expenses under the State Settlement Agreements are expected to be approximately $2.5 billion in 2010, subject to adjustment for changes in volume and other factors, and expense for the federal tobacco quota buyout is expected to be approximately $230 million to $260 million in 2010. For additional information, see Litigation Affecting the Cigarette Industry Health-Care Cost Recovery Cases State Settlement Agreements in Item 8, note 14 to consolidated financial statements.

Selling, general and administrative expenses include the costs of litigating and administering product liability claims, as well as other legal expenses. For the years ended December 31, 2009 and 2008, RJR Tobacco s product liability defense costs were $123 million and $96 million, respectively. The increase in product liability defense costs in 2009 compared with 2008 is due primarily to the increase in *Engle* Progeny cases. For more information, see Individual Smoking and Health Cases *Engle* Progeny Cases in Item 8, note 14 to consolidated financial statements.

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;

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 Item 8, note 14 to consolidated financial statements for detailed information regarding the number and type of cases pending, and Litigation Affecting the Cigarette Industry Scheduled Trials in Item 8, note 14 to consolidated financial statements for detailed information regarding the number and nature of cases in trial and scheduled for trial through December 31, 2010.

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 increased level of activity in RJR Tobacco s pending cases and possible new cases, including the increased number of cases in trial and scheduled for trial, particularly with respect to the *Engle* Progeny cases, RJR Tobacco s product liability defense costs have increased in 2009 compared with the most recent years. See Litigation Affecting the Cigarette Industry *Engle* Progeny Cases and Litigation Affecting the Cigarette Industry Class Action Suits *Engle* Case in Item 8, note 14 to consolidated financial statements for additional information. In addition, it is possible that 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.

Conwood

Net Sales

The moist snuff shipment volume, in millions of cans, for Conwood was as follows[(1)]:

	For the Twelve Months Ended December 31,		
	2009	**2008**	**% Change**
KODIAK	47.8	51.0	(6.3)%
GRIZZLY	304.6	279.6	8.9%
Other	4.1	4.5	(9.9)%
Total moist snuff	356.5	335.2	6.4%

(1) Amounts presented in this table are rounded on an individual basis and, accordingly, may not sum on an aggregate basis. Percentages are calculated on unrounded numbers.

Conwood s net sales for the year ended December 31, 2009, were $673 million compared with $723 million for the year ended December 31, 2008. GRIZZLY, Conwood s leading price-value moist snuff brand, continues to grow moist snuff sales and was the leading moist snuff brand in the United States as of December 31, 2009. KODIAK, Conwood s leading premium moist snuff brand, reduced pricing at the end of the first quarter of 2009 to remain competitive. This price reduction and volume decline on KODIAK, and a delay in the price increase on GRIZZLY to cover the additional federal excise tax, were the primary drivers of the decrease in sales during 2009 compared with 2008. During 2009, in addition to aggressive promotional spending, pricing was significantly reduced by a competitor on its premium and certain price-value brands.

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The Conwood shares of the moist snuff category as a percentage of total share of U.S. shipments of moist snuff, according to distributor reported data[1] processed by MSAi, were as follows[2]:

	For the Twelve Months Ended December 31,		
	2009	2008	Share Point Change
KODIAK	3.8%	4.0%	(0.2)
GRIZZLY	25.3%	23.2%	2.0
Other	0.3%	0.4%	(0.1)
Total moist snuff	29.4%	27.6%	1.8

(1) Distributor shipments-to-retail share of U.S. moist snuff is included in this document because it is used by Conwood 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 distributors and processed by MSAi as being a precise measurement of actual market share because this distributor data set is not able to effectively track all volume.

(2) Amounts presented in this table are rounded on an individual basis and, accordingly, may not sum on an aggregate basis.

Moist snuff has been the key driver to Conwood s overall growth and profitability within the U.S. smokeless tobacco market. Moist snuff accounted for approximately 71% of Conwood s revenue in 2009 and approximately 66% in 2008. While industry moist snuff volume grew over 4% in 2009, Conwood s moist snuff volume grew over 6% in 2009, attributable to its innovation, product development and brand building. Continuing with innovation and brand building, Conwood will feature embossed metal lids on KODIAK and GRIZZLY brands in 2010.

GRIZZLY had a 25.3% share of moist snuff shipments in 2009, an increase of 2.0 share points from 2008, due in part to the success of new GRIZZLY styles. GRIZZLY launched mint and straight pouch styles in the first quarter of 2009 and GRIZZLY snuff pouches in the fourth quarter of 2009. Pouches, in the industry, have grown over 25% in 2009 and now account for nearly 8% of moist snuff sales. GRIZZLY s pouch styles generated approximately 60% of the pouch growth in the industry during 2009. Also being launched in the first quarter of 2010 is GRIZZLY 1900 Long Cut, a natural product with a traditional long cut.

The shipment share of KODIAK declined 0.2 share points in 2009 compared with 2008 due to competitive promotional activity and the brand s core markets being burdened by high tobacco taxes and the current economic recession. KODIAK s price reduction during the first quarter of 2009 aligned KODIAK with other premium brands, making it more competitive.

Conwood launched CAMEL Dip, a premium moist snuff, in two styles, Wintergreen Wide Cut and Dark Milled, in lead markets during the second quarter of 2009. CAMEL Dip will be launched in ten additional markets in the first quarter of 2010. CAMEL Wintergreen pouches will be launched in the first quarter of 2010.

Operating Income

Conwood s operating income for the year ended December 31, 2009, increased to $276 million from $232 million, primarily impacted by a trademark impairment charge of $76 million in 2009 compared with a trademark impairment charge of $142 million in 2008. Additionally, lower margins on KODIAK and higher promotional spending due to product introductions, tax increases and competitive activity were partially offset by increases in volume and pricing by GRIZZLY.

The 2009 impairment charge was the result of impairment testing triggered by certain price reductions and the anticipated sales impact due to the increase in the federal excise tax effective April 1, 2009. This impairment occurred on several of Conwood s brands, including KODIAK, driven by the decrease in its list price to meet competition, as well as the federal excise tax impact on other brands. The impairment charge was based on the excess of each brand s carrying value over its fair value using the present value of estimated future cash flows assuming a discount rate of 10.5%.

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All Other

All Other sales for the year ended December 31, 2009, were favorably impacted by the growth of Santa Fe s NATURAL AMERICAN SPIRIT brand. Operating income for the 2009 year increased as a result of higher sales in 2009 as compared with 2008.

RAI Consolidated

Interest and debt expense was $251 million for the year ended December 31, 2009, a decrease of $24 million over the comparable prior year. This decrease was primarily due to lower effective interest rates in 2009 as compared with 2008 coupled with lower debt balances during 2009.

Interest income was $19 million for the year ended December 31, 2009, a decrease of $41 million compared with the year ended December 31, 2008. This decrease was the result of investing at lower interest rates in 2009.

Gain on termination of joint venture of $328 million in 2008 resulted from the termination of the Reynolds-Gallaher International Sarl joint venture. See Item 8, note 5 to consolidated financial statements for additional information related to the joint venture termination.

Other expense net was $9 million for the year ended December 31, 2009, a decrease of $28 million compared with the year ended December 31, 2008. Impairments on investments deemed other-than-temporary of $35 million were expensed in 2008.

Provision for income taxes was $572 million, or an effective rate of 37.3%, for the year ended December 31, 2009, compared with $790 million, or an effective rate of 37.1%, for the year ended December 31, 2008. The effective tax rate for 2009 was unfavorably impacted by the increases in unrecognized income tax benefits and increases in tax attributable to accumulated and undistributed foreign earnings. The 2008 effective rate was favorably impacted by a lower tax rate related to the gain on the termination of the Reynolds-Gallaher International Sarl joint venture, but was offset by unfavorability related to tax reserves and U.S. taxes recorded on foreign earnings. The effective tax rates exceeded the federal statutory rate of 35% primarily due to the impact of state taxes and certain non-deductible items, offset by the domestic production activities deduction of the American Jobs Creation Act, enacted on October 22, 2004.

RAI expects its effective tax rate to be approximately 38% in 2010.

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2008 Compared with 2007

	For the Twelve Months Ended December 31,		
	2008	2007	% Change
Net sales:[1]			
RJR Tobacco	$ 7,755	$ 8,022	(3.3)%
Conwood	723	670	7.9%
All other	367	331	10.9%
Net sales	8,845	9,023	(2.0)%
Cost of products sold[1][2]	4,863	4,960	(2.0)%
Selling, general and administrative expenses	1,500	1,687	(11.1)%
Amortization expense	22	23	(4.3)%
Restructuring charge	90		NM[3]
Trademark impairment charges	318	65	NM[3]
Operating income:			
RJR Tobacco	1,805	1,988	(9.2)%
Conwood	232	312	(25.6)%
All other	104	94	10.6%
Corporate expense	(89)	(106)	(16.0)%
	$ 2,052	$ 2,288	(10.3)%

(1) Excludes excise taxes of:

	2008	2007
RJR Tobacco	$ 1,689	$ 1,847
Conwood	20	18
All other	181	161
	$ 1,890	$ 2,026

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

(3) Percentage change not meaningful.

In 2008, RAI and RJR Tobacco announced changes in their organizational structures to streamline non-core business processes and programs in order to allocate additional resources to strategic growth initiatives. The reorganizations resulted in the elimination of approximately 600 full-time jobs, which were substantially completed by December 31, 2009.

Under existing benefit plans, \$83 million of severance-related cash benefits and \$7 million of non-cash pension-related benefits comprised a restructuring charge of \$90 million. Of this charge, \$81 million was recorded in the RJR Tobacco segment. Of the cash portion of the charge, \$5 million was paid as of December 31, 2008. The cash benefits are expected to be substantially paid by December 31, 2010.

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RJR Tobacco

Net Sales

Domestic cigarette shipment volume, in billions of units for RJR Tobacco and the industry, were as follows[1]:

	For the Twelve Months Ended December 31,		
	2008	**2007**	**% Change**
Growth brands:			
CAMEL excluding non-filter	23.3	24.2	(3.8)%
PALL MALL	8.6	7.1	20.8%
	31.8	31.3	1.7%
Support brands	46.6	52.0	(10.3)%
Non-support brands	11.0	14.3	(23.3)%
Total domestic	89.5	97.6	(8.4)%
Total premium	55.9	60.9	(8.2)%
Total value	33.5	36.7	(8.7)%
Premium/Total mix	62.5%	62.4%	
Industry[2]:			
Premium	251.1	259.9	(3.4)%
Value	94.2	97.3	(3.1)%
Total domestic	345.3	357.2	(3.3)%
Premium/Total mix	72.7%	72.8%	

(1) Amounts presented in this table are rounded on an individual basis and, accordingly, may not sum on an aggregate basis. Percentages are calculated on unrounded numbers.

(2) Based on information from MSAi.

During 2008, RJR Tobacco selectively reduced the number of products sold by discontinuing a number of low-margin and non-core brands and styles to reduce complexity and improve efficiency.

RJR Tobacco s net sales for the year ended December 31, 2008, decreased $267 million, or 3.3%, from the year ended December 31, 2007, driven by $339 million attributable to lower volume, partially offset by improved pricing, net of promotional spending. RJR Tobacco s decreases in net sales and shipment volume reflect intensified competitive activity in the first half of 2008, a decrease in consumption, wholesale inventory reductions, and the impact of RJR Tobacco s selective brand and style reduction. In addition, RJR Tobacco s consumers are believed to be more price-sensitive than consumers of competing brands and, therefore, are more negatively affected by the current adverse economic pressures. RJR Tobacco s total domestic shipment volume decreased 8.4% in 2008 compared with 2007. Industry shipment volume for 2008 was down 3.3% compared with 2007.

The shares of RJR Tobacco s brands as a percentage of total share of U.S. retail cigarette sales according to data[1] from IRI/Capstone, were as follows[2][3]:

	For the Twelve Months Ended December 31,		
	2008	2007	Share Point Change
Growth brands:			
CAMEL excluding non-filter	8.0%	7.8%	0.3
PALL MALL	2.6%	2.1%	0.5
Total growth brands	10.7%	9.9%	0.8
Support brands	13.8%	14.7%	(0.9)
Non-support brands	3.6%	4.4%	(0.8)
Total domestic	28.1%	29.0%	(1.0)

(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.

(2) Amounts presented in this table are rounded on an individual basis and, accordingly, may not sum on an aggregate basis.

(3) In 2009, at the request of RJR Tobacco, IRI/Capstone revised its sampling model to better reflect the current retail environment. Data provided herein reflects previously published data using IRI/Capstone s historical methodology.

The retail share of market of CAMEL s filtered styles increased 0.3 share points in 2008 compared with 2007. During the first half of 2008, CAMEL launched updated packaging and smoother blends for its core styles. CAMEL also introduced CAMEL Crush in lead markets during the first quarter of 2008. CAMEL Crush was expanded nationally during the third quarter of 2008 and had a market share of 0.7 share points in the fourth quarter of 2008.

CAMEL Snus expanded into a total of 17 markets in 2008. Additionally, in October 2008, RJR Tobacco introduced CAMEL Dissolvables that include CAMEL Orbs, Sticks and Strips.

PALL MALL s market share increased 0.5 share points in 2008 compared with 2007. PALL MALL s growth is believed to be the result of the brand s position as a product that offers a longer-lasting cigarette at a value price. PALL MALL introduced more stylish, round-corner packs in the second quarter of 2008.

The combined share of market of RJR Tobacco s growth brands during 2008 showed improvement over 2007. However, the decline in share of support and non-support brands more than offset the gains on the growth brands.

Operating Income

RJR Tobacco s operating income for the year ended December 31, 2008, decreased $183 million to $1,805 million from $1,988 million for the year ended December 31, 2007. In addition to a restructuring charge of $81 million in the second half of 2008, the reclassification of KOOL to a support brand from a growth brand in the third quarter of 2008 triggered a non-cash trademark impairment of $173 million. An additional impairment charge of $3 million was recorded in the fourth quarter of 2008 as the result of annual impairment testing of brand trademarks. In 2007, RJR Tobacco recorded a trademark impairment charge of $33 million.

The trademark impairment charge and restructuring charge were partially offset by higher pricing and improvements in productivity. RJR Tobacco s operating income was also negatively impacted by decreases in shipment volume due to intensified competitive activity in the first half of 2008, a decrease in consumption, wholesale inventory reductions, as well as RJR Tobacco s selective style and brand reduction.

RJR Tobacco s State Settlement Agreements and federal tobacco buyout expenses, included in cost of products sold, are detailed in the schedule below:

	For the Twelve Months Ended December 31,	
	2008	**2007**
Settlements	$ 2,664	$ 2,791
Federal tobacco quota buyout	$ 240	$ 247

Selling, general and administrative expenses include the costs of litigating and administering product liability claims, as well as other legal expenses. For the years ended December 31, 2008 and 2007, RJR Tobacco s product liability defense costs were $96 million and $88 million, respectively.

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Conwood

Net Sales

The moist snuff shipment volume, in millions of cans, for Conwood was as follows[1]:

	For the Twelve Months Ended December 31,		
	2008	2007	% Change
KODIAK	51.0	53.2	(4.2)%
GRIZZLY	279.6	237.0	18.0%
Other	4.5	5.4	(16.1)%
Total moist snuff	335.2	295.6	13.4%

(1) Amounts presented in this table are rounded on an individual basis and, accordingly, may not sum on an aggregate basis. Percentages are calculated on unrounded numbers.

Conwood s net sales for the year ended December 31, 2008, were $723 million compared with $670 million for the year ended December 31, 2007. Moist snuff sales generated the increase over the prior-year period, led by GRIZZLY.

The Conwood shares of the moist snuff category as a percentage of total share of U.S. shipments of moist snuff, according to distributor reported data[1] processed by MSAi, were as follows[2]:

	For the Twelve Months Ended December 31,		
	2008	2007	Share Point Change
KODIAK	4.0%	4.4%	(0.4)
GRIZZLY	23.2%	21.1%	2.2
Other	0.4%	0.5%	(0.1)
Total moist snuff	27.6%	26.0%	1.7

(1) Distributor shipments-to-retail share of U.S. moist snuff is included in this document because it is used by Conwood 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 distributors and processed by MSAi as being a precise measurement of actual market share because this distributor data set is not able to effectively track all volume.

(2)

Amounts presented in this table are rounded on an individual basis and, accordingly, may not sum on an aggregate basis.

Moist snuff accounted for approximately 66% of Conwood s revenue in 2008 and approximately 60% in 2007. Conwood s key brands include KODIAK in the premium brand category and GRIZZLY in the price-value brand category. Conwood s U.S. moist snuff market share was 27.6% in 2008 and 26.0% in 2007 based on distributor-reported data processed by MSAi, for distributor shipments to retail. Although moist snuff volume grew over 7% in 2008, Conwood s moist snuff volume grew over 13% in 2008, attributable to its innovation, product development and brand building.

GRIZZLY had a 23.2% share of moist snuff shipments in 2008, an increase of 2.2 share points from 2007, despite further narrowing of the price gap between premium brands and value brands, such as GRIZZLY. In 2008, Conwood expanded nationally the launch of two new GRIZZLY styles, GRIZZLY Wintergreen Pouches and GRIZZLY Snuff, to build on the brand s momentum and aid in its share growth.

The shipment share of KODIAK declined 0.4 share points in 2008 compared with 2007 due to competitive promotional activity and the brand s core markets being burdened by high tobacco taxes and the current economic recession.

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Operating Income

Conwood s operating income for the year ended December 31, 2008, decreased to $232 million from $312 million for 2007. This change is due to increased price-value volume and higher pricing offset primarily by trademark impairment. The annual impairment testing of trademarks in the fourth quarter of 2008 resulted in a charge of $142 million compared with $32 million in 2007. The 2008 impairment occurred primarily on KODIAK, which reflected the demand shift from premium to price-value brands.

All Other

All Other sales for the year ended December 31, 2008, were favorably impacted by the growth of Santa Fe s NATURAL AMERICAN SPIRIT brand. Operating income for the 2008 year increased as a result of lower marketing expenses in 2008 as compared with 2007.

RAI Consolidated

Gain on termination of joint venture of $328 million in 2008 resulted from the termination of the Reynolds-Gallaher International Sarl joint venture. See Item 8, note 5 to consolidated financial statements for additional information related to the joint venture termination.

Interest and debt expense was $275 million for the year ended December 31, 2008, a decrease of $63 million over the comparable prior year. This decrease was primarily due to lower effective interest rates and lower outstanding debt in 2008 as compared with 2007.

Interest income was $60 million for the year ended December 31, 2008, a decrease of $74 million compared with the year ended December 31, 2007. This decrease was the result of investing available cash at lower interest rates in 2008.

Other expense net was expense of $37 million for the year ended December 31, 2008, an increase of $26 million compared with the year ended December 31, 2007. Impairments on investments deemed other-than-temporary of $35 million were expensed in 2008.

Provision for income taxes was $790 million, or an effective rate of 37.1%, for the year ended December 31, 2008, compared with $766 million, or an effective rate of 37.0%, for the year ended December 31, 2007. The 2008 provision was favorably impacted by a lower tax rate related to the gain on the termination of the Reynolds-Gallaher International Sarl joint venture, but was offset by unfavorability related to tax reserves and U.S. taxes recorded on foreign earnings. The effective tax rates exceeded the federal statutory rate of 35% primarily due to the impact of state taxes and certain non-deductible items, offset by the domestic production activities deduction of the American Jobs Creation Act, enacted on October 22, 2004.

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, mainly from RAI and RJR. The principal capital resources and sources of liquidity for RAI and RJR, in turn, are proceeds from issuances of debt securities by RAI and RJR and the RAI credit facility 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 and RJR that, when combined with RAI s and RJR s cash balances, will enable RAI and RJR to make their required debt-service payments, and enable RAI to pay dividends to its shareholders.

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

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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 evaluated the liquidity of key suppliers and significant customers throughout 2009. Where there were liquidity concerns identified with key suppliers, contingency plans were developed. To date, no business interruptions have occurred caused by key supplier liquidity. No liquidity issues were identified regarding significant customers.

As of December 31, 2009, RAI held investments primarily in money market funds, auction rate securities, a mortgage-backed security and a marketable equity security. Certain money market funds are classified as short-term investments due to liquidity restrictions by the fund managers preventing immediate withdrawal. Given such restrictions, these funds will not be available until the underlying investments mature or are sold. Adverse changes in financial markets 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 the 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 money market funds, auction rate securities and the mortgage-backed security for a period of time sufficient to allow for sale, redemption or anticipated recovery in fair value. At December 31, 2009, RAI considered the mortgage-backed security and the auction rate securities to be temporarily impaired.

Contractual obligations as of December 31, 2009 were as follows:

		Payments Due by Period			
	Total	**Less than 1 Year-2010**	**1-3 Years 2011-2012**	**4-5 Years 2013-2014**	**Thereafter**
Long-term notes, exclusive of interest[(1)]	$ 4,210	$ 300	$ 850	$ 685	$ 2,375
Interest payments related to long-term notes[(1)]	1,902	233	412	306	951
Operating leases[(2)]	69	17	29	20	3
Non-qualified pension obligations[(3)]	88	9	18	17	44
Postretirement benefit obligations[(3)]	718	68	144	147	359
Qualified pension funding[(3)]	300	300			
Purchase obligations[(4)]	779	339	178	189	73
Other noncurrent liabilities[(5)]	95	N/A	64	10	21
State Settlement Agreements obligations[(6)]	13,300	2,500	5,400	5,400	
Gross unrecognized tax benefit[(7)]	94				
Federal tobacco buyout obligations[(8)]	1,360	260	550	550	
Total cash obligations	$ 22,915	$ 4,026	$ 7,645	$ 7,324	$ 3,826

(1) For more information about RAI s and RJR s long-term notes, see Item 8, note 12 to consolidated financial statements.

(2) Operating lease obligations represent estimated lease payments primarily related to office space, automobiles, warehouse space and computer equipment. See Item 8, note 14 to consolidated financial statements for additional information.

(3) For more information about RAI s pension plans and postretirement benefits, see Item 8, note 17 to consolidated financial statements. Non-qualified pension and postretirement benefit obligations captioned under Thereafter include obligations during the next five years only. These obligations are not reasonably estimable beyond ten years. Qualified pension plan funding is based on the Pension Protection Act and tax deductibility and is not reasonably estimable beyond one year.

(4) Purchase obligations primarily include commitments to acquire tobacco leaf. Purchase orders for the purchase of other raw materials and other goods and services are not included in the table. RAI s operating subsidiaries are not able to determine the aggregate amount of such purchase orders that represent contractual obligations, as purchase orders typically represent authorizations to purchase rather than binding agreements. For purposes

of this table, contractual obligations for the purchase of goods or services are defined by RAI s operating subsidiaries as agreements that are enforceable and legally binding that specify all significant terms, including fixed or minimum quantities to be purchased; fixed, minimum or variable price provisions; and the approximate timing of the transaction. Purchase orders of RAI s operating subsidiaries are based on current demand expectations and are fulfilled by vendors within short time horizons. RAI s operating subsidiaries do not have significant non-cancelable agreements for the purchase of raw materials or other goods or services specifying minimum quantities or set prices that exceed our expected requirements. RAI s operating subsidiaries also enter into contracts for outsourced services; however, the obligations under these contracts were generally not significant and the contracts generally contain clauses allowing for the cancellation without significant penalty.

(5) Other noncurrent liabilities include primarily restructuring and bonus compensation. Certain other noncurrent liabilities are excluded from the table above, including RJR s liabilities recorded in 1999 related to certain indemnification claims, for which timing of payments are not estimable. For more information about RJR s indemnification obligations, see Item 8, note 14 to consolidated financial statements.

(6) State Settlement Agreements obligation amounts in the aggregate beyond five years are not meaningful as these are obligations into perpetuity. For more information about the State Settlement Agreements, see Item 8, note 14 to consolidated financial statements.

(7) For more information on gross unrecognized tax benefits, see Item 8, note 10 to consolidated financial statements. Due to inherent uncertainties regarding the timing of payment of these amounts, RAI cannot reasonably estimate the payment period.

(8) For more information about the tobacco buyout legislation, see Governmental Activity below and Item 8, note 14 to consolidated financial statements.

Commitments as of December 31, 2009 were as follows:

	Commitment Expiration Period	
	Total	**Less than 1 Year**
Standby letters of credit backed by revolving credit facility	$ 15	$ 15
Total commitments	$ 15	$ 15

Cash Flows

2009 Compared with 2008

Net cash flows from operating activities were $1,454 million in 2009, compared with $1,315 million in 2008. This change was driven by the partial retention of the 2009 MSA payment and lower taxes paid, partially offset by higher pension payments, higher bonds posted and lower interest received in 2009.

Net cash flows used in investing activities was $123 million in 2009, compared with net cash flows from investing activities of $278 million for the prior year. This change was primarily driven by lower proceeds from short-term investments as well as higher capital expenditures and an acquisition in 2009 compared with the 2008 proceeds from the termination of the joint venture.

Net cash flows used in financing activities were $1,192 million in 2009, compared with $1,206 million in 2008. Lower common stock purchases in 2009 were nearly offset by long-term debt repaid in 2009.

2008 Compared with 2007

Net cash flows from operating activities were $1,315 million in 2008, compared with $1,331 million in 2007. This change was driven primarily by higher State Settlement Agreement and tax payments, partially offset by lower pension funding in 2008.

Net cash flows from investing activities were $278 million in 2008, compared with $763 million for the prior year. This change was primarily driven by higher short-term investing net proceeds in 2007 that more than offset the proceeds received in 2008 as a result of the termination of the joint venture.

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Net cash flows used in financing activities were $1,206 million in 2008, compared with $1,312 million in 2007. This change was due to prior-year repayment of long-term debt, offset by higher stock repurchases and higher dividends per share in 2008.

Borrowing Arrangements

As of December 31, 2009, RAI s total consolidated debt consisted of RAI notes in the aggregate principal amount of $4.1 billion, with maturity dates ranging from 2010 to 2037, and RJR notes in the aggregate principal amount of $118 million, with maturity dates ranging from 2012 to 2015. See Item 8, note 12 to consolidated financial statements for more information on these notes.

RAI and RJR use interest rate swaps to manage interest rate risk on a portion of their debt obligations. On December 31, 2008, interest rate swaps existed on $1.6 billion of fixed-rate notes. When entered into, these swaps were designated as hedges of underlying exposures. On January 6, 2009, RAI and RJR entered into offsetting interest rate swap agreements in the notional amount of $1.5 billion with maturity dates ranging from June 1, 2012 to June 15, 2017. These swaps were entered into with the same financial institution that holds a notional amount of $1.5 billion of current swaps and have a technical right of offset. The future cash flows, established as a result of entering into the January 6, 2009, swaps, total $321 million, and will be amortized and effectively reduce net interest costs over the remaining life of the notes. Concurrent with entering the swap agreements on January 6, 2009, RAI de-designated the current swaps as fair value hedges.

On January 7, 2009, RAI and RJR terminated an interest rate swap agreement in the notional amount of $100 million with a maturity date of June 1, 2012. The resulting gain of approximately $12 million will be amortized to effectively reduce interest expense over the remaining life of the notes.

As a result of these actions, RAI and RJR have effectively converted $1.6 billion of fixed-rate notes swapped to a variable rate of interest, to a fixed rate of interest of approximately 4.0%.

At their option, RAI and RJR, as applicable, may redeem any or all of their outstanding fixed-rate notes, in whole or in part at any time, subject to the payment of a make-whole premium. RAI s floating rate notes are redeemable at par on any interest payment date after December 15, 2008.

Effective July 3, 2009, RAI entered into a Second Amendment to Credit Agreement, referred to as the Second Amendment, amending RAI s credit facility. The Second Amendment amends the credit facility by, among other things:

- terminating the revolving loan commitment of Lehman Commercial Paper Inc., referred to as LCPI, which filed for protection under Chapter 11 of the federal Bankruptcy Code on October 5, 2008, and thereby reducing the total revolving loan commitment under the credit facility from $550 million to $498 million;
- amending the definition of Lender Default and certain related definitions;
- granting RAI the right under certain circumstances to terminate the revolving loan commitment of a Defaulting Lender, as defined in the credit facility, if RAI is unable to replace such Defaulting Lender; and
- otherwise clarifying the rights and responsibilities of the parties to the credit facility upon the occurrence of a Lender Default.

Effective with the Second Amendment, RAI s credit facility of $498 million may be increased up to $848 million at the discretion of the lenders upon the request of RAI.

Lenders and their respective commitments in the credit facility, which are several, not joint, commitments, are listed below:

Lender	Commitment	
JP Morgan Chase Bank, N.A.	$	52.89
Citibank N.A.		52.89
Morgan Stanley Bank		52.00
Mizuho Corporate Bank, Ltd.		52.00
General Electric Capital Corporation		52.00
AG First Farm Credit Bank		52.00
Goldman Sachs Bank USA		35.00
Wachovia Bank, National Association		35.00
The Bank of Nova Scotia		35.00
The Bank of New York		35.00
Farm Credit Services of Minnesota Valley, PCA DBA FCS Commercial Finance Group		20.00
City National Bank of New Jersey		14.22
Farm Credit Bank of Texas		10.00
	$	498.00

At December 31, 2009, RAI had $15 million in letters of credit outstanding under the credit facility. At such date, no borrowings were outstanding, and the remaining $483 million of the credit facility was available for borrowing.

Certain of RAI s subsidiaries, including the Guarantors, have guaranteed RAI s obligations under the credit facility and under RAI s outstanding senior notes, referred to as the Notes. The collateral for the credit facility, Notes and related guarantees (which was released during 2008) will be reinstated if RAI s corporate credit rating issued by each of S&P and Moody s is lowered to at least one level below the lowest rating level established as investment grade, or if RAI s corporate credit rating issued by either S&P or Moody s is lowered to at least two levels below the lowest rating level established as investment grade.

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 December 31, 2009.

Dividends

On February 2, 2010, RAI s board of directors declared a quarterly cash dividend of $0.90 per common share. The dividend will be paid on April 1, 2010, to shareholders of record as of March 10, 2010. On an annualized basis, the dividend rate is $3.60 per common share. The current dividend reflects RAI s policy of paying dividends to the holders of RAI common stock in an aggregate amount that is approximately 75% of RAI s annual consolidated net income.

Stock Repurchases

On April 29, 2008, RAI s board of directors authorized RAI s repurchase, prior to April 30, 2009, of up to $350 million of outstanding shares of RAI common stock in open market or privately negotiated transactions. Due to RAI s incorporation in North Carolina, which does not recognize treasury shares, the shares repurchased are cancelled at the time of repurchase. RAI had repurchased and cancelled 3,817,095 shares of RAI common stock for

$207 million under the above share repurchase program during 2008. RAI did not repurchase any shares of RAI common stock under this program in 2009.

Additionally during 2009, at a cost of $5 million, RAI purchased 154,441 shares that were forfeited with respect to tax liabilities associated with restricted stock vesting under its LTIP.

Capital Expenditures

RAI s operating subsidiaries recorded cash capital expenditures of $141 million, $113 million and $142 million in 2009, 2008 and 2007, respectively. Of the 2009 amount, $55 million related to RJR Tobacco and $75 million related to Conwood. RJR Tobacco plans to spend $50 million to $60 million for capital expenditures during 2010, primarily on non-discretionary business requirements, and Conwood plans to spend $165 million to $175 million in 2010, primarily on non-discretionary capacity projects for the Memphis, Tennessee and Clarksville, Tennessee facilities. 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 December 31, 2009.

Retirement Benefits

Due primarily to the adverse changes in the financial markets, RAI s pension assets have been negatively impacted. In 2008, the overall rate of return on the investments for the pension assets was negative approximately 30.1%. RAI assessed the asset allocation and investment strategy and will phase in appropriate changes to balance funded status, interest rate risk and asset returns. Once fully implemented, these changes will reduce the pension fund s exposure to equities and increase exposure to fixed income and alternatives. As a result of changes to the asset allocation and investment strategy, RAI lowered the expected long-term return on pension assets, referred to as the ELTRA, to 8.25%, in 2009, from 8.74%. The ELTRA, asset allocation, current asset performance and the discount rate may impact the funded status of RAI s pension plans. As a result, to improve the funded status, RAI contributed $295 million to the pension assets in 2009 and pension expense increased approximately $187 million in 2009 to $125 million.

In 2009, the overall rate of return on the investments for the pension assets was approximately 24.8%. In 2010, RAI plans to contribute $309 million to the pension assets, of which $300 million was contributed in January 2010, and the pension expense is expected to be $115 million.

Income Taxes

At December 31, 2009, RAI had a net deferred tax asset of $515 million. RAI has determined that no valuation allowance is required to be recorded against this deferred tax asset as RAI believes it is more likely than not that all of the deferred tax asset will be realized. This determination is due largely to RAI s historical and projected reporting pretax earnings and taxable income.

Litigation and Settlements

As discussed in Item 8, note 14 to consolidated financial statements, RJR Tobacco, the Conwood companies 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. Unfavorable judgments have been returned in a number of tobacco-related cases and state enforcement actions. As of January 29, 2010, RJR Tobacco has paid approximately $12 million since January 1, 2007, related to unfavorable judgments. RJR, including its subsidiary RJR Tobacco, have liabilities totaling $94 million that were recorded in connection with certain indemnification claims, not related to smoking and health, asserted by JTI against RJR and RJR Tobacco, relating to the activities of Northern Brands and related litigation.

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, or the loss of any particular claim concerning the use of smokeless tobacco against the Conwood companies, when viewed on an individual basis, is not probable. RAI and its subsidiaries believe that they have valid bases for appeal of adverse verdicts against them and have valid defenses to all actions and intend to defend all actions vigorously. Nonetheless, the possibility of material losses related to

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tobacco litigation is more than remote. Litigation is subject to many uncertainties, and generally it is not possible to predict the outcome of the litigation pending against RJR Tobacco, the Conwood companies 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.

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. As described in Item 8, note 14 to consolidated financial statements, 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 Item 8, note 14 to consolidated financial statements. 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.

RJR Tobacco and certain of the other participating manufacturers under the State Settlement Agreements are currently involved in litigation with the settling states with respect to the availability for certain market years of a downward adjustment to the annual State Settlement Agreements payment obligation, known as the Non-Participating Manufacturer Adjustment. Pending the resolution of these disputes, RJR Tobacco and certain of the other participating manufacturers have placed the disputed portions of their 2006, 2007 and 2008 annual payments into the MSA disputed funds account. In February 2009, approximately $431 million was released, without waiving claim, to the settling states. Accordingly, RJR Tobacco had approximately $1.2 billion deposited in the MSA disputed funds account as of December 31, 2009. 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. For more information related to this litigation, see Litigation Affecting the Cigarette Industry State Settlement Agreements Enforcement and Validity and Other NPM Adjustment Claims in Item 8, note 14 to consolidated financial statements.

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;
- establish fire standards compliance for cigarettes;
- raise the minimum age to possess or purchase tobacco products;
- restrict or ban the use of certain flavorings, including menthol, in tobacco products, or the use of certain flavor descriptors in the marketing of 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.

In addition, as discussed in greater detail below, during 2009, the U.S. Congress adopted legislation increasing the federal excise tax on cigarettes and other tobacco products, and granting the FDA broad authority over the manufacture, sale, marketing and packaging of tobacco products. During 2010, the U.S. Congress also may consider legislation regarding:

- regulation of environmental tobacco smoke;
- implementation of a national fire standards compliance for cigarettes;
- regulation of the retail sale of tobacco products over the Internet and in other non-face-to-face retail transactions, such as by mail order and telephone; and
- banning of the delivery of tobacco products by the U.S. Postal Service.

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 SCHIP.

Under these federal tax increases:

- the federal excise tax per pack of 20 cigarettes increased to $1.01;
- 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;
- the federal excise tax on small cigars, defined as those weighing three pounds or less per thousand, increased $48.502 per thousand to $50.33 per thousand; and
- the federal excise tax rate for roll-your-own tobacco increased from $1.097 per pound to $24.78 per pound.

All states and the District of Columbia currently impose cigarette excise taxes at levels ranging from $0.07 per pack in South Carolina to $3.46 per pack in Rhode Island. As of December 31, 2009, the weighted average state cigarette excise tax per pack, calculated on a 12-month rolling average basis, was approximately $1.16, compared with the 12-month rolling average of $1.00 as of December 31, 2008. During 2009, 14 states and the District of Columbia passed cigarette excise tax increases, and a number of other states are considering an increase in their cigarette excise taxes for 2010. Certain city and county governments, such as New York and Chicago, also impose substantial excise taxes on cigarettes sold in those jurisdictions.

Cigars generally are taxed by states on an ad valorem basis, ranging from 5% in South Carolina to 80% in Rhode Island. Other states have unit-based tax schemes for cigars or tax little cigars the same as cigarettes.

Forty-nine states and the District of Columbia also subject smokeless tobacco to excise taxes, and the Commonwealth of Pennsylvania, the singular exception, may enact such a tax during its 2010 legislative session. As of December 31, 2009, 32 states taxed moist snuff, and 44 states taxed chewing tobacco, on an ad valorem basis at rates that range from

5% in South Carolina to 100% in Wisconsin. Other states have a unit tax or a weight-based tax. During 2009, four states and the District of Columbia enacted legislation changing from an ad valorem to a weight-based taxation system on moist snuff. In addition, Oregon also passed a weight-based tax on moist snuff, which took effect on January 1, 2010, and Wisconsin switched the method of taxing moist snuff from a weight-based tax back to an ad valorem tax. Legislation to convert from an ad valorem to a weight-based tax is expected to be introduced in several states in 2010. In total, during 2009, 17 states passed tax increases on other tobacco products, and a number of other states are considering an increase in their taxes on other tobacco products for 2010.

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On July 16, 2009, Oregon enacted a statute including a requirement that smokeless tobacco manufacturers who are not signatories to the Smokeless Tobacco Master Settlement Agreement, referred to as the STMSA, either certify compliance with certain requirements imposed by the STMSA or place into escrow $0.40 for every unit of smokeless tobacco sold in the state as security against certain types of claims that might be brought by Oregon or other Releasing Parties under the STMSA. On September 4, 2009, Conwood Company, LLC, among others, brought suit in Circuit Court, Madison County, Oregon (*Conwood Company, LLC v. Kroger*) to enjoin the enforcement of this Oregon statute contending the statute violates the constitutions of Oregon and the United States. For further information regarding this case, see Item 8, note 14, to consolidated financial statements.

Oregon also is considering legislation that would require smokeless tobacco manufacturers to join the STMSA and make payments thereunder or place into escrow an amount equivalent to what a manufacturer would have paid had it joined the STMSA. The legislation also would change the tax on chewing tobacco from ad valorem to a weight-based tax of $1.78 per ounce.

In 1964, the Report of the Advisory Committee to the Surgeon General of the U.S. Public Health Service concluded that cigarette smoking was a health hazard of sufficient importance to warrant appropriate remedial action. Since 1966, federal law has required a warning statement on cigarette packaging, and cigarette advertising in other media also is required to contain a warning statement. Since 1971, television and radio advertising of cigarettes has been prohibited in the United States.

During the past four decades, various laws affecting the cigarette industry have been enacted. In 1984, Congress enacted the Comprehensive Smoking Education Act. Among other things, this act:

- established an interagency committee on smoking and health that is charged with carrying out a program to inform the public of any dangers to human health presented by cigarette smoking;
- required a series of four health warnings to be printed on cigarette packages and advertising on a rotating basis;
- increased type size and area of the warning required in cigarette advertisements; and
- required that cigarette manufacturers provide annually, on a confidential basis, a list of ingredients added to tobacco in the manufacture of cigarettes to the Secretary of Health and Human Services.

The warnings currently required on cigarette packages and advertisements are:

- SURGEON GENERAL S WARNING: Smoking Causes Lung Cancer, Heart Disease, Emphysema, And May Complicate Pregnancy;
- SURGEON GENERAL S WARNING: Quitting Smoking Now Greatly Reduces Serious Risks to Your Health;
- SURGEON GENERAL S WARNING: Smoking By Pregnant Women May Result in Fetal Injury, Premature Birth, And Low Birth Weight; and
- SURGEON GENERAL S WARNING: Cigarette Smoke Contains Carbon Monoxide.

Since the initial report in 1964, the Secretary of Health, Education and Welfare, now the Secretary of Health and Human Services, and the Surgeon General have issued a number of other reports which purport to find the nicotine in cigarettes addictive and to link cigarette smoking and exposure to cigarette smoke with certain health hazards, including various types of cancer, coronary heart disease and chronic obstructive lung disease. These reports have recommended various governmental measures to reduce the incidence of smoking. In 1992, the federal Alcohol, Drug Abuse and Mental Health Act was signed into law. This act required states to adopt a minimum age of 18 for purchase of tobacco products and to establish a system to monitor, report and reduce the illegal sale of tobacco products to minors in order to continue receiving federal funding for mental health and drug abuse programs. In 1996, the U.S. Department of Health and Human Services announced regulations implementing this legislation. And in 2006, the Surgeon General released a report entitled The Health Consequences of Involuntary Exposure to Tobacco Smoke. Among its conclusions, the report found the following: exposure of adults to secondhand smoke causes coronary heart disease and lung cancer, exposure of children to secondhand smoke results in an increased risk of sudden infant death syndrome, acute respiratory infections, ear problems and more severe asthma; and that there is no risk-free level of exposure to secondhand smoke.

In 1986, Congress enacted the Comprehensive Smokeless Tobacco Health Education Act of 1986, which, among other things, required health warning notices on smokeless tobacco packages and advertising and prohibited the advertising of smokeless tobacco products on any medium of electronic communications subject to the jurisdiction of the Federal Communications Commission. The warnings currently required on smokeless tobacco packages and advertising, which appear on a rotating basis, are:

WARNING: THIS PRODUCT MAY CAUSE MOUTH CANCER;

WARNING: THIS PRODUCT MAY CAUSE GUM DISEASE AND TOOTH LOSS; and

WARNING: THIS PRODUCT IS NOT A SAFE ALTERNATIVE TO CIGARETTES.

In 2000, the seven largest U.S. cigar companies, including Lane, entered into agreements with the FTC, to clearly and conspicuously display on virtually every cigar package and advertisement one of the following warnings, which appear on a rotating basis:

SURGEON GENERAL WARNING: Cigar Smoking Can Cause Cancers Of The Mouth And Throat, Even If You Do Not Inhale;

SURGEON GENERAL WARNING: Cigar Smoking Can Cause Lung Cancer And Heart Disease;

SURGEON GENERAL WARNING: Tobacco Use Increases The Risk Of Infertility, Stillbirth And Low Birth Weight;

SURGEON GENERAL WARNING: Cigars Are Not A Safe Alternative To Cigarettes; and

SURGEON GENERAL WARNING: Tobacco Smoke Increases The Risk Of Lung Cancer And Heart Disease, Even In Nonsmokers.

On June 22, 2009, President Obama signed into law 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, as of September 20, 2009, tobacco manufacturers are 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).

Over the course of the next three years, various provisions under the FDA Tobacco Act and regulations to be issued under the FDA Tobacco Act will become effective and will:

- require tobacco manufacturers to register their manufacturing facilities and list of tobacco products;
- require manufacturers to produce health-related documents generated from and after June 22, 2009;
- require manufacturers to report ingredients and harmful constituents;

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- require different and larger warnings on packaging and advertising for cigarettes and smokeless tobacco products;
- ban the use of descriptors on tobacco products, such as low-tar and light ;
- require manufacturers to obtain FDA clearance for cigarette and smokeless tobacco products commercially launched or to be launched after February 15, 2007;
- require manufacturers to test ingredients and constituents identified by 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 was $22 million in 2009, and the expense for 2010 will be approximately $75 million to $85 million.

Within the Center, a Tobacco Products Scientific Advisory Committee will provide advice, information and recommendations with respect to the safety, dependence or health issues related to tobacco products, 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;
- 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.

In February 2010, RJR Tobacco received a letter from the Center for Tobacco Products (which letter is available on the FDA s web site) requesting, in connection with the Tobacco Products Scientific Advisory Committee s study of dissolvable tobacco products, certain information regarding the perception and use of CAMEL Dissolvables. RJR Tobacco, which markets its tobacco products only to adult tobacco users, intends to respond to FDA s information request.

On August 31, 2009, RJR Tobacco and Conwood joined other tobacco manufacturers and a tobacco retailer in filing a lawsuit in the U.S. District Court for the Western District of Kentucky (*Commonwealth Brands, Inc. v. United States of America*), 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. For further information regarding this case, see Item 8, note 14 to consolidated financial statements.

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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 and Conwood s brands, and an increase in costs to RJR Tobacco and Conwood 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.

Legislation imposing various restrictions on public smoking also has been enacted by 49 states and many local jurisdictions, and many employers have initiated programs restricting or eliminating smoking in the workplace. A number of states have enacted legislation designating a portion of increased cigarette excise taxes to fund either anti-smoking programs, health-care programs or cancer research. In addition, educational and research programs addressing health-care issues related to smoking are being funded from industry payments made or to be made under settlements with state attorneys general. Federal law prohibits smoking in scheduled passenger aircraft, and the U.S. Interstate Commerce Commission has banned smoking on buses transporting passengers interstate. Certain common carriers have imposed additional restrictions on passenger smoking.

In 2003, the California Environmental Protection Agency Air Resources Board issued a Proposed Identification of Environmental Tobacco Smoke as a Toxic Air Contaminant for public review. In 2006, the Air Resources Board identified environmental tobacco smoke as a Toxic Air Contaminant, following a three-year administrative process. The Air Resources Board is now required to prepare a report assessing the need and appropriate degree of control of environmental tobacco smoke. RJR Tobacco cannot predict the form any future California regulation may take.

In 2003, the New York Office of Fire Prevention and Control issued a final standard with accompanying regulations that requires all cigarettes offered for sale in New York State after June 28, 2004, to achieve specified test results when placed on ten layers of filter paper in controlled laboratory conditions. As of December 31, 2009, 48 states in addition to New York, as well as Washington, D.C., had enacted fire standards compliance legislation of their own, adopting the same testing standard set forth in the OFPC regulations described above. The cigarettes that RAI s operating companies sell in these jurisdictions comply with this standard. Wyoming remains the only state to not have enacted this type of legislation. Recognizing these legislative trends in conjunction with its effort to increase productivity and reduce complexity, RJR Tobacco voluntarily converted all of its brands to fire standard compliance paper by the end of 2009.

In July 2007, the State of Maine became the first state to enact a statute that prohibits the sale of cigarettes and cigars that have a characterizing flavor. The legislation defines characterizing flavor as a distinguishable taste or aroma that is imparted to tobacco or tobacco smoke either prior to or during consumption, other than a taste or aroma from tobacco, menthol, clove, coffee, nuts or peppers. In October 2008, the State of New Jersey passed a similar ban on flavored cigarettes with a similar definition of characterizing flavor but excluding only tobacco, menthol or clove. Additionally, New Jersey extended the ban not only to whether the product itself has a characterizing flavor as part of the aroma of the product or smoke, but also if the product was marketed or advertised as producing such a flavor, taste or aroma. During 2009, New York City passed legislation that would ban characterizing flavors in tobacco products other than cigarettes beginning on February 25, 2010. An exemption applies if the characterizing flavor is tobacco, menthol, mint or wintergreen. U.S. Smokeless Tobacco Manufacturing Co. LLC and U.S. Smokeless Tobacco Brands, Inc. filed suit in federal court on January 7, 2010, claiming that the local law is preempted by the FDA Tobacco Act and violates the Commerce Clause of the U.S. Constitution. Similar bills banning characterizing flavors in tobacco products are pending in other states.

Effective October 1, 2008, the San Francisco Board of Supervisors adopted a ban on the sale of tobacco products in some pharmacies. During 2009, the Boston Public Health Commission and the Massachusetts communities of Uxbridge and Needham instituted similar bans.

A price differential exists between cigarettes manufactured for sale abroad and cigarettes manufactured for sale in the United States. Consequently, a domestic gray market has developed in cigarettes manufactured for sale abroad, but instead diverted for domestic sales that compete with cigarettes that RJR Tobacco manufactures for domestic sale. The U.S. federal government and all states, except Massachusetts, have enacted legislation prohibiting the sale and distribution of gray market cigarettes. In addition, RJR Tobacco has taken legal action against distributors and retailers who engage in such practices.

RJR Tobacco expects to benefit from certain state legislative activity aimed at leveling the playing field between original participating manufacturers under the MSA and nonparticipating manufacturers under the MSA, referred to as NPMs. Forty-six states have passed legislation to ensure NPMs are making required escrow payments. Under this legislation, a state would only permit distribution of brands by manufacturers who are deemed by the states to be MSA-compliant. Failure to make escrow payments could result in the loss of an NPM s ability to sell tobacco products in a respective state.

Additionally, 44 states have enacted legislation that closes a loophole in the MSA. The loophole allows NPMs that concentrate their sales in a single state, or a limited number of states, to recover most of the funds from their escrow accounts. To obtain the refunds, the manufacturers must establish that their escrow deposit was greater than the amount the state would have received had the manufacturer been a subsequent participating manufacturer under the MSA, that is, the state s allocable share. The National Association of Attorneys General, referred to as NAAG, has endorsed adoption of the allocable share legislation needed to eliminate this loophole. Following a challenge by NPMs, the U.S. District Court for the Southern District of New York has issued an order enjoining New York from enforcing allocable share legislation. It is possible that NPMs will challenge allocable share legislation passed in other states.

Finally, four states, Alaska, Michigan, Minnesota and Utah, have enacted equity assessments on NPMs products. This legislative initiative has not been endorsed by NAAG, and one NPM has filed a challenge to the equity assessment in Michigan.

Forty-two states by statute or court rule have limited, and several additional states are considering limiting, the amount of the bonds required to file an appeal of an adverse judgment in state court. The limitation on the amount of such bonds generally ranges from $1 million to $150 million. Bonding statutes in 37 states allow defendants that are subject to large adverse judgments, such as cigarette manufacturers, to reasonably bond such judgments and pursue the appellate process. In five other states and Puerto Rico, the filing of a notice of appeal automatically stays the judgment of the trial court.

In 2003, the World Health Organization adopted a broad tobacco-control treaty. The treaty recommends and requires enactment of legislation establishing specific actions to prevent youth smoking, restrict and gradually eliminate tobacco products marketing, provide greater regulation and disclosure of ingredients, increase the size and scope of package warning labels to cover at least 30% of each package and include graphic pictures on packages. The treaty entered into force on February 27, 2005 90 days after ratification by the 40th country. In February 2006, the first session of the Conference of the Parties, referred to as the COP, occurred in Geneva, Switzerland. The COP, among other actions taken, established a permanent secretariat, adopted a budget, and created working groups to begin to develop protocols on cross-border advertising and illegal trade and guidelines on establishing smoke-free places and regulating tobacco products. Among the decisions taken at the COP s second session, in July 2007, the COP adopted guidelines from the working group on the protection from exposure to tobacco smoke and called for an intergovernmental negotiating body to negotiate a protocol on illicit trade. At the COP s third conference, in November 2008, the parties adopted guidelines with respect to various provisions of the tobacco control treaty, including the packaging and labeling of tobacco products. The fourth COP session is scheduled to be held in Uruguay in late 2010. Although the U.S. delegate to the World Health Organization voted for the treaty in May 2003, and the Secretary for

Health and Human Services signed the document in May 2004, the Bush Administration did not send the treaty to the U.S. Senate for ratification. Ratification by the United States could lead to broader regulation of the industry.

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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 Conwood or smokeless tobacco products in general, but any new legislation or regulations could have an adverse effect on Conwood or smokeless tobacco products in general.

Tobacco Buyout Legislation

For information relating to tobacco buyout legislation, see Tobacco Buyout Legislation and Related Litigation in Item 8, note 14 to consolidated financial statements.

Other Contingencies

For information relating to other contingencies of RAI, RJR, RJR Tobacco and Conwood, see Other Contingencies in Item 8, note 14 to consolidated financial statements.

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 recent federal excise tax increases, and 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 that the FDA will extend the ban on characterizing flavors to smokeless tobacco products;

- 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 potential difficulty of obtaining bonds as a result of litigation outcomes;

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

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

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;

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- increased promotional activities by competitors, including deep-discount cigarette brands;
- the success or failure of new product innovations and acquisitions;
- 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, including outsourcing functions, without negatively affecting sales;
- 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;
- declining liquidity in the financial markets, including bankruptcy of lenders participating in the 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 rating of RAI and its securities;
- any restrictive covenants imposed under RAI s debt agreements;
- the possibility of fire, violent weather and other disasters that may adversely affect manufacturing 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; and
- the potential existence of significant deficiencies or material weaknesses in internal control over financial reporting that may be identified during the performance of testing required under Section 404 of the Sarbanes-Oxley Act of 2002.

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 7A. ***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 concerning investments in, or obligations for, and service agreements related to, 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 and use major institutions as counterparties to minimize their investment and credit risk. Frequently, these institutions are also members of the bank group that provide RAI credit, and management believes this further minimizes the risk of nonperformance. Derivative financial instruments are not used for trading or speculative purposes.

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The table below provides information about RAI s financial instruments, as of December 31, 2009, 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:

	2010	2011	2012	2013	2014	Thereafter	Total	Fair Value(1)
Investments:								
Variable Rate	$ 2,707					$ 34	$ 2,741	$ 2,741
Average Interest Rate	0.1%					2.0%	0.1%	
Fixed-Rate						$ 5	$ 5	$ 5
Average Interest Rate(2)						4.7%	4.7%	
Debt:								
Fixed-Rate	$ 300		$ 450	$ 685		$ 2,375	$ 3,810	$ 4,050
Average Interest Rate(2)	6.5%		7.3%	7.4%		7.3%	7.2%	
Variable Rate		$ 400					$ 400	$ 396
Average Interest Rate(2)		1.0%					1.0%	
Swaps Fixed to Floating:								
Notional Amount(3)			$ 350			$ 1,150	$ 1,500	$ 182
Average Variable Interest Pay Rate(2)			1.9%			1.7%	1.7%	
Average Fixed Interest Receive Rate(2)			7.3%			7.1%	7.1%	
Swaps Floating to Fixed:								
Notional Amount(3)			$ 350			$ 1,150	$ 1,500	$ 55
Average Variable Interest Pay Rate(2)			1.9%			1.7%	1.7%	
Average Fixed Interest Receive Rate(2)			3.8%			4.1%	4.0%	

(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 contractual interest rates for fixed-rate indebtedness or current market rates for LIBOR plus negotiated spreads until maturity for variable rate indebtedness.

(3) As of December 31, 2009, RAI had swapped $1.5 billion of debt using both fixed-rate to floating-rate interest rate swaps and floating-rate to fixed-rate interest rate swaps to variable rate debt. See Item 8, note 13 to consolidated financial statements for additional information.

RAI s exposure to foreign currency transactions was not material to results of operations for the year ended December 31, 2009, 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. See Liquidity and Financial Condition in Item 7 for additional information.

Item 8. Financial Statements and Supplementary Data

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders
Reynolds American Inc.:

We have audited the accompanying consolidated balance sheets of Reynolds American Inc. and subsidiaries as of December 31, 2009 and 2008, and the related consolidated statements of income, shareholders equity and comprehensive income (loss), and cash flows for each of the years in the three-year period ended December 31, 2009. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Reynolds American Inc. and subsidiaries as of December 31, 2009 and 2008, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2009, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 1 to the consolidated financial statements, the Company has changed its methods of accounting for determining whether certain securities should be included in the basic earnings per share calculation as of January 1, 2009, due to the adoption of Financial Accounting Standards Board Staff Position No. EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities* (codified in Financial Accounting Standards Board Accounting Standards Codification (FASB ASC) Topic 260, *Earnings Per Share*) and for measuring and disclosing the fair value of assets and liabilities as of January 1, 2008, due to the adoption of Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (codified in FASB ASC Topic No. 820, *Fair Value Measurements and Disclosures*).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Reynolds American Inc. s internal control over financial reporting as of December 31, 2009, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated February 19, 2010, expressed an unqualified opinion on the effectiveness of the Company s internal control over financial reporting.

/s/ KPMG LLP

Greensboro, North Carolina
February 19, 2010

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Management s Report on Internal Control over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rule 13a-15(f) of the Securities Exchange Act of 1934. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with generally accepted accounting principles and includes those policies and procedures that:

(i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of RAI,

(ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of RAI are being made only in accordance with authorizations of management and directors of RAI, and

(iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of RAI s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements and even when determined to be effective, can only provide reasonable assurance with respect to financial statement preparation and presentation. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies and procedures may deteriorate.

Management conducted an evaluation of the effectiveness of RAI s internal control over financial reporting based on the framework in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, management concluded that RAI s system of internal control over financial reporting was effective as of December 31, 2009.

KPMG LLP, independent registered public accounting firm, has audited RAI s consolidated financial statements and issued an attestation report on RAI s internal control over financial reporting as of December 31, 2009.

Dated: February 19, 2010

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders
Reynolds American Inc.:

We have audited Reynolds American Inc. and subsidiaries internal control over financial reporting as of December 31, 2009, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Reynolds American Inc. s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Reynolds American Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2009, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Reynolds American Inc. and subsidiaries as of December 31, 2009 and 2008, and the related consolidated statements of income, shareholders equity and comprehensive income (loss), and cash flows for each of the years in the three-year period ended December 31, 2009, and our report dated February 19, 2010, expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Greensboro, North Carolina
February 19, 2010

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REYNOLDS AMERICAN INC.

CONSOLIDATED STATEMENTS OF INCOME
(Dollars in Millions, Except Per Share Amounts)

	For the Years Ended December 31, 2009	2008	2007
Net sales[1]	$ 8,015	$ 8,377	$ 8,516
Net sales, related party	404	468	507
Net sales	8,419	8,845	9,023
Costs and expenses:			
Cost of products sold[1][2][3]	4,485	4,863	4,960
Selling, general and administrative expenses	1,508	1,500	1,687
Amortization expense	28	22	23
Restructuring charge	56	90	
Trademark impairment charges	567	318	65
Operating income	1,775	2,052	2,288
Interest and debt expense	251	275	338
Interest income	(19)	(60)	(134)
Gain on termination of joint venture		(328)	
Other expense, net	9	37	11
Income before income taxes and extraordinary item	1,534	2,128	2,073
Provision for income taxes	572	790	766
Income before extraordinary item	962	1,338	1,307
Extraordinary item gain on acquisition			1
Net income	$ 962	$ 1,338	$ 1,308
Basic income per share:			
Income before extraordinary item	$ 3.30	$ 4.56	$ 4.43
Extraordinary item			
Net income	$ 3.30	$ 4.56	$ 4.43
Diluted income per share:			
Income before extraordinary item	$ 3.30	$ 4.56	$ 4.43
Extraordinary item			
Net income	$ 3.30	$ 4.56	$ 4.43
Dividends declared per share	$ 3.45	$ 3.40	$ 3.20

(1) Excludes excise taxes of $3,927 million, $1,890 million and $2,026 million for the years ended December 31, 2009, 2008 and 2007, respectively.

(2) Includes Master Settlement Agreement, referred to as MSA, and other state settlement agreements with the states of Mississippi, Florida, Texas and Minnesota, together with the MSA collectively referred to as the State Settlement Agreements, expense of $2,540 million, $2,703 million and $2,821 million for the years ended December 31, 2009, 2008 and 2007, respectively.

(3) Includes federal tobacco quota buyout expenses of $240 million, $249 million and $255 million for the years ended December 31, 2009, 2008 and 2007, respectively.

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REYNOLDS AMERICAN INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in Millions)

	For the Years Ended December 31, 2009	2008	2007
Cash flows from (used in) operating activities:			
Net income	$ 962	$ 1,338	$ 1,308
Adjustments to reconcile to net cash flows from (used in) continuing operating activities:			
Depreciation and amortization	144	142	143
Gain on termination of joint venture		(328)	
Restructuring charge, net of cash payments	7	75	(12)
Trademark impairment charges	567	318	65
Deferred income tax expense	(154)	16	69
Other changes that provided (used) cash:			
Accounts and other receivables		(27)	8
Inventories	(49)	26	(41)
Related party, net	2		(47)
Accounts payable	(10)	(12)	(57)
Accrued liabilities including income taxes and other working capital	(191)	(67)	(72)
Litigation bonds	(23)	5	94
Tobacco settlement	291	(125)	205
Pension and postretirement	(181)	(88)	(328)
Other, net	89	42	(4)
Net cash flows from operating activities	1,454	1,315	1,331
Cash flows from (used in) investing activities:			
Purchases of short-term investments		(56)	(3,764)
Proceeds from settlement of short-term investments	19	238	4,655
Proceeds from settlement of long-term investments	6	8	
Capital expenditures	(141)	(113)	(142)
Acquisition, net of cash acquired	(43)		(3)
Distributions from equity investees		27	15
Net proceeds from sale of fixed assets	11	8	3
Proceeds from termination of joint venture	24	164	
Other, net	1	2	(1)
Net cash flows from (used in) investing activities	(123)	278	763
Cash flows from (used in) financing activities:			
Dividends paid on common stock	(991)	(999)	(916)
Repurchase of common stock	(5)	(210)	(60)
Repayments of long-term debt	(200)		(329)

Repayment of term loan			(1,542)
Proceeds from issuance of long-term debt			1,547
Deferred debt issuance costs			(15)
Other, net	4	3	3
Net cash flows used in financing activities	(1,192)	(1,206)	(1,312)
Effect of exchange rate changes on cash and cash equivalents	6	(24)	
Net change in cash and cash equivalents	145	363	782
Cash and cash equivalents at beginning of year	2,578	2,215	1,433
Cash and cash equivalents at end of year	$ 2,723	$ 2,578	$ 2,215
Income taxes paid, net of refunds	$ 709	$ 846	$ 655
Interest paid	$ 245	$ 268	$ 334

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REYNOLDS AMERICAN INC.

CONSOLIDATED BALANCE SHEETS
(Dollars in Millions)

	December 31, 2009	December 31, 2008
Assets		
Current assets:		
Cash and cash equivalents	$ 2,723	$ 2,578
Short-term investments	4	23
Accounts receivable	109	84
Accounts receivable, related party	96	91
Notes receivable	36	35
Other receivables	15	37
Inventories	1,219	1,170
Deferred income taxes, net	956	838
Prepaid expenses and other	337	163
Total current assets	5,495	5,019
Property, plant and equipment, at cost:		
Land and land improvements	88	95
Buildings and leasehold improvements	661	692
Machinery and equipment	1,759	1,756
Construction-in-process	87	37
Total property, plant and equipment	2,595	2,580
Less accumulated depreciation	1,570	1,549
Property, plant and equipment, net	1,025	1,031
Trademarks and other intangible assets, net of accumulated amortization (2009 $647; 2008 $619)	2,718	3,270
Goodwill	8,185	8,174
Other assets and deferred charges	586	660
	$ 18,009	$ 18,154
Liabilities and shareholders equity		
Current liabilities:		
Accounts payable	$ 196	$ 206
Tobacco settlement accruals	2,611	2,321
Due to related party	3	3
Deferred revenue, related party	57	50
Current maturities of long-term debt	300	200
Other current liabilities	1,173	1,143
Total current liabilities	4,340	3,923

Long-term debt (less current maturities)	4,136	4,486
Deferred income taxes, net	441	282
Long-term retirement benefits (less current portion)	2,218	2,836
Other noncurrent liabilities	376	390
Commitments and contingencies:		
Shareholders equity:		
Common stock (shares issued: 2009 291,424,051; 2008 291,450,762)		
Paid-in capital	8,498	8,463
Accumulated deficit	(579)	(531)
Accumulated other comprehensive loss (Defined benefit pension and post-retirement plans: 2009 $(1,376) and 2008 $(1,643), net of tax)	(1,421)	(1,695)
Total shareholders equity	6,498	6,237
	$ 18,009	$ 18,154

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REYNOLDS AMERICAN INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY AND COMPREHENSIVE INCOME (LOSS)
(Dollars in Millions, Except Per Share Amounts)

	Common Stock	Paid-In Capital	Accumulated Deficit	Accumulated Other Comprehensive Loss	Total Shareholders Equity	Comprehensive Income (Loss)
Balance at December 31, 2006	$	$ 8,702	$ (1,241)	$ (418)	$ 7,043	
Cumulative effect of change in accounting principle			5		5	
Adjusted balance as of January 1, 2007		8,702	(1,236)	(418)	7,048	
Net income			1,308		1,308	$ 1,308
Retirement benefits, net of $72 tax expense				112	112	112
Unrealized loss on investments, net of $8 tax benefit				(11)	(11)	(11)
Cumulative translation adjustment and other				3	3	3
Total comprehensive income						$ 1,412
Dividends $3.20 per share			(945)		(945)	
Equity incentive award plan and stock-based compensation		9			9	
Common stock repurchased		(60)			(60)	
Excess tax benefit on stock-based compensation plans		2			2	
Balance at December 31, 2007		8,653	(873)	(314)	7,466	
Net income			1,338		1,338	$ 1,338
Retirement benefits, net of $884 tax benefit				(1,337)	(1,337)	(1,337)
Unrealized loss on investments, net of $20 tax benefit				(30)	(30)	(30)
Cumulative translation adjustment and other, net of $6 tax benefit				(14)	(14)	(14)
Total comprehensive loss						$ (43)
Dividends $3.40 per share			(996)		(996)	
		18			18	

Equity incentive award plan and stock-based compensation						
Common stock repurchased		(210)			(210)	
Excess tax benefit on stock-based compensation plans		2			2	
Balance at December 31, 2008		8,463	(531)	(1,695)	6,237	
Net income			962		962	$ 962
Retirement benefits, net of $177 tax expense				267	267	267
Unrealized gain on investments, net of $2 tax expense				4	4	4
Cumulative translation adjustment and other, net of $7 tax expense				3	3	3
Total comprehensive income						$ 1,236
Dividends $3.45 per share			(1,010)		(1,010)	
Equity incentive award plan and stock-based compensation		38			38	
Common stock repurchased		(5)			(5)	
Excess tax benefit on stock-based compensation plans		2			2	
Balance at December 31, 2009	$	$ 8,498	$ (579)	$ (1,421)	$ 6,498	

See Notes to Consolidated Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Business and Summary of Significant Accounting Policies

Overview

The consolidated financial statements include the accounts of Reynolds American Inc., referred to as RAI, and its wholly owned subsidiaries. RAI s wholly owned subsidiaries include R. J. Reynolds Tobacco Company; Santa Fe Natural Tobacco Company, Inc., referred to as Santa Fe; Lane, Limited, referred to as Lane; Conwood Holdings Inc.; and American Snuff Company, LLC, formerly known as Conwood Company, LLC, and Rosswil LLC, collectively referred to as the Conwood companies.

RAI was incorporated as a holding company in the state of North Carolina on January 5, 2004, and its common stock is listed on the NYSE under the symbol RAI. RAI was created to facilitate the transactions on July 30, 2004, to combine the U.S. assets, liabilities and operations 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, a wholly owned operating subsidiary of R.J. Reynolds Tobacco Holdings, Inc., referred to as RJR. These July 30, 2004, transactions generally are 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 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 and Conwood. The RJR Tobacco segment consists of the primary operations of R. J. Reynolds Tobacco Company. The Conwood segment consists of Conwood Holdings, Inc., the primary operations of the Conwood companies and Lane. Santa Fe and Niconovum AB, 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. RAI s wholly owned operating subsidiaries have entered into intercompany agreements for products or services with other RAI operating 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 business in the United States.

Basis of Presentation

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, referred to as GAAP, requires estimates and assumptions to be made that affect the reported amounts in the consolidated financial statements and accompanying notes. Volatile credit and equity markets, changes to regulatory and legal environments, and consumer spending may affect the uncertainty inherent in such estimates and assumptions. Actual results could differ from those estimates. Certain reclassifications were made to conform prior years financial statements to the current presentation.

The equity method is used to account for investments in businesses that RAI does not control, but has the ability to significantly influence operating and financial policies. The cost method is used to account for investments in which RAI does not have the ability to significantly influence operating and financial policies. RAI has no investments in entities greater than 20% for which it accounts by the cost method, and has no investments in entities greater than 50% for which it accounts by the equity method. All material intercompany balances have been eliminated.

All dollar amounts, other than per share amounts, are presented in millions, except for amounts set forth in note 14 and as otherwise noted.

Cash and Cash Equivalents

Cash balances are recorded net of book overdrafts when a bank right-of-offset exists. All other book overdrafts are recorded in accounts payable. Cash equivalents may include money market funds, commercial paper and time deposits in major institutions to minimize investment risk. As short-term, highly liquid investments readily

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

convertible to known amounts of cash, with remaining maturities of three months or less at the time of purchase, cash equivalents have carrying values that approximate fair values. Debt securities included in cash equivalents are classified and accounted for as held-to-maturity. The appropriate classification of cash equivalents is determined at the time of purchase and the classification is reassessed at each reporting date.

Fair Value Measurement

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

Investments

Marketable securities are classified as available-for-sale and are carried at fair value, with related unrealized gains and losses deemed temporarily impaired reported, net of tax, as accumulated other comprehensive loss. All losses deemed to be other than temporarily impaired are recorded in earnings. As of December 31, 2009, RAI held investments primarily in money market funds, auction rate securities, a mortgage-backed security and a marketable equity security. Certain money market funds are classified as short-term investments due to the liquidity restrictions by the fund managers preventing immediate withdrawal.

Adverse changes in financial markets caused the auction rate securities and the mortgage-backed security to revalue lower than carrying value and become less liquid. The funds associated with the auction rate securities and the mortgage-backed security will not be accessible until a successful auction occurs or a buyer is found. These investments are evaluated on a quarterly basis to determine if a credit loss has been incurred and the investment is other than temporarily impaired. For these investments, RAI uses assumptions about future cash flows and risk-adjusted discount rates to determine fair value. To assess credit losses, RAI uses historical default rates, debt ratings, credit default swap spreads and recovery rates to determine if credit losses have been incurred. RAI has the intent and ability to hold these investments for a period of time sufficient to allow for the recovery in market value.

Inventories

Inventories are stated at the lower of cost or market. The cost of tobacco inventories is determined principally under the last-in, first-out, or LIFO, method and is calculated at the end of each year. The cost of work in process and finished goods includes materials, direct labor, variable costs and overhead, and full absorption of fixed manufacturing overhead. Stocks of tobacco, which have an operating cycle that exceeds 12 months due to aging requirements, are classified as current assets, consistent with recognized industry practice.

Long-lived Assets

Long-lived assets, such as property, plant and equipment, trademarks and other intangible assets with finite lives, are reviewed for impairment whenever events or changes in circumstances indicate that the book value of the

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

asset may not be recoverable. Impairment of the carrying value of long-lived assets would be indicated if the best estimate of future undiscounted cash flows expected to be generated by the asset grouping is less than its carrying value. If an impairment is indicated, any loss is measured as the difference between estimated fair value and carrying value and is recognized in operating income.

Property, Plant and Equipment

Property, plant and equipment are recorded at cost and depreciated using the straight-line method over the estimated useful lives of the assets. Useful lives range from 20 to 50 years for buildings and improvements, and from 3 to 30 years for machinery and equipment. The cost and related accumulated depreciation of assets sold or retired are removed from the accounts and the gain or loss on disposition is recognized in operating income.

Intangible Assets

Intangible assets include goodwill, trademarks and other intangible assets and are capitalized when acquired. The determination of fair value involves considerable estimates and judgment. In particular, the fair value of a reporting unit involves, among other things, developing forecasts of future cash flows, determining an appropriate discount rate, and when goodwill impairment is implied, determining the fair value of individual assets and liabilities, including unrecorded intangibles. Although RAI believes it has based its impairment testing and impairment charges on reasonable estimates and assumptions, the use of different estimates and assumptions could result in materially different results. Generally, 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. Trademarks and other intangible assets with indefinite lives are not amortized, but are tested for impairment annually, in the fourth quarter, and more frequently if events and circumstances indicate that the asset might be impaired.

Accounting for Derivative Instruments and Hedging Activities

RAI measures derivative instruments, including certain derivative instruments embedded in other contracts, at fair value and records them in the balance sheet as either an asset or liability. Changes in fair value of derivatives are recorded in earnings unless hedge accounting criteria are met. For derivatives designated as fair value hedges, the changes in fair value of both the derivative instrument and the hedged item are recorded in earnings. For derivatives designated as cash flow hedges, the effective portions of changes in the fair value of the derivative are reported in accumulated other comprehensive loss. The ineffective portions of hedges are recognized in earnings in the current period. At December 31, 2009, RAI had no derivative instruments classified as hedges.

RAI formally assesses at inception of the hedge and on an ongoing basis, whether each derivative is highly effective in offsetting changes in fair values or cash flows of the hedged item, and formally designates as a hedge those derivatives that qualify for hedge accounting. If it is determined that a derivative is not highly effective as a hedge or if a derivative ceases to be a highly effective hedge, RAI will discontinue hedge accounting prospectively. Any unrecognized gain or loss will be deferred and recognized into income as the formerly hedged item is recognized in earnings.

Software Costs

Computer software and software development costs incurred in connection with developing or obtaining computer software for internal use that has an extended useful life are capitalized. These costs are amortized over their estimated useful life, which is typically five years or less. During 2009 and 2008, costs of $21 million and $25 million, respectively, were capitalized or included in construction in process. At December 31, 2009, and December 31, 2008, the unamortized balance was $73 million and $81 million, respectively. Software amortization expense was $26 million, $24 million and $16 million for the years ended December 31, 2009, 2008 and 2007, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Revenue Recognition

Revenue from product sales is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the seller s price to the buyer is fixed or determinable, and collectibility is reasonably assured. These criteria are generally met when title and risk of loss pass to the customer. Payments received in advance of shipments are deferred and recorded in other accrued liabilities until shipment occurs. Certain sales of leaf to a related party, considered as bill-and-hold for accounting purposes, are recorded as deferred revenue when all of the above revenue recognition criteria are met except delivery, postponed at the customer s request. Revenue is subsequently recognized upon delivery.

Shipping and handling costs are classified as cost of products sold. Net sales include certain sales incentives, including coupons and buydowns.

Advertising and Research and Development

Advertising costs, which are expensed as incurred, were $103 million, $127 million and $165 million for the years ended December 31, 2009, 2008 and 2007, respectively. Research and development costs, which are expensed as incurred, were $68 million, $59 million and $57 million for the years ended December 31, 2009, 2008 and 2007, respectively.

Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Interest and penalties related to uncertain tax positions are accounted for as tax expense. Federal income taxes for RAI and its subsidiaries are calculated on a consolidated basis. State income taxes for RAI and its subsidiaries are primarily calculated on a separate return basis.

RAI accounts for uncertain tax positions which require that a position taken or expected to be taken in a tax return be recognized in the financial statements when it is more likely than not (a likelihood of more than 50 percent) that the position would be sustained upon examination by tax authorities. A recognized tax position is then measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement.

Stock-Based Compensation

Stock-based compensation recognizes all forms of share-based payment awards, including shares issued to employees under stock options, restricted stock, restricted stock units and stock appreciation rights.

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. These changes are reported in accumulated other comprehensive loss, as a separate component of shareholders equity.

Recognized gains or losses are annual changes in the amount of either the benefit obligation or the market-related value of plan assets resulting from experience different from that assumed or from changes in assumptions. The minimum amortization of unrecognized gains or losses was included in either pension expense or in the postretirement benefit cost. Prior service costs, 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. The market-related value of plan assets recognizes changes in fair value in a systematic and rational manner over five years.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Litigation Contingencies

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. 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.

Recently Adopted Accounting Pronouncements

The adoption of the following accounting guidance had no material impact on RAI s consolidated results of operations, cash flows or financial position:

Effective January 1, 2009, guidance for the measurements and disclosure of fair value for nonfinancial assets and nonfinancial liabilities. This new guidance does not require any new fair value measurements but provides a definition of fair value, establishes a framework for measuring fair value and expands disclosure about fair value measurements. It also establishes a fair value hierarchy that distinguishes between independent and observable inputs and unobservable inputs based on the best information available.

Effective January 1, 2009, authoritative GAAP that addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and, therefore, need to be included in the earnings allocation in computing earnings per share. As a result, unvested restricted shares outstanding under the Reynolds American Inc. Long-Term Incentive Plan, referred to as the LTIP, are included in basic EPS calculations. Comparative earnings per share have been adjusted retrospectively to conform to the provisions of this authoritative GAAP, which reduced basic and diluted net income per share by $0.02 and $0.01, respectively for 2008, and reduced basic income per share by $0.01 for 2007.

Effective January 1, 2009, guidance for the qualitative disclosures about the objectives and strategies for using derivatives; quantitative data about the fair value of, and gains and losses on, derivative contracts; and details of credit-risk-related contingent features in hedged positions. This guidance also seeks enhanced disclosure around derivative instruments in financial statements and how hedges affect an entity s financial position, financial performance and cash flows.

Effective June 30, 2009, additional clarification for estimating fair value when the volume and level of activity for the asset and liability have significantly decreased, as well as clarification on identifying circumstances that indicate a transaction is not orderly.

Effective June 30, 2009, additional clarification to make other-than-temporary impairment guidance more operational and to improve the financial statement presentation of such impairments.

Effective June 30, 2009, guidance requiring disclosures about fair value of financial instruments in interim financial statements as well as in annual financial statements.

Effective June 30, 2009, authoritative GAAP that establishes general standards of accounting for and disclosure of events that occur after the balance sheet date, but before financial statements are issued or are available to be issued.

Effective September 30, 2009, additional clarification on the measurement of liabilities at fair value when no observable data is available.

In June 2009, the Financial Accounting Standards Board, referred to as FASB, issued its Accounting Standards Codification, referred to as ASC. The ASC became the source of authoritative GAAP recognized by the FASB to be applied by nongovernmental entities, effective for financial statements issued for interim and annual periods ending after September 15, 2009.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Subsequent Events

RAI has evaluated events that occurred subsequent to December 31, 2009, through the financial statement issue date of February 19, 2010, and determined there were no material recordable or reportable subsequent events, except as disclosed in note 14.

Note 2 Fair Value Measurement

Financial assets (liabilities) carried at fair value as of December 31, 2009, were as follows:

	Level 1	Level 2	Level 3	Total
Money market funds	$ 2,662	$	$ 4	$ 2,666
Auction rate securities corporate credit risk			30	30
Auction rate securities financial insurance companies			17	17
Mortgage-backed security			16	16
Marketable equity security	19			19
Assets held in grantor trusts	12			12
Interest rate swaps fixed to floating rate		182		182
Interest rate swaps floating to fixed rate		57		57
Interest rate swaps floating to fixed rate		(2)		(2)

Financial assets carried at fair value as of December 31, 2008, were as follows:

	Level 1	Level 2	Level 3	Total
Money market funds	$ 2,269	$	$ 23	$ 2,292
Auction rate securities corporate credit risk			44	44
Auction rate securities financial insurance companies			15	15
Mortgage-backed security			21	21
Assets held in grantor trusts	16			16
Interest rate swaps fixed to floating rate		287		287

The fair value of the interest rate swaps, classified as Level 2, utilized a market approach model using the notional amount of the interest rate swap multiplied by the observable inputs of time to maturity, interest rates and credit spreads. See note 13 for additional information on interest rate swaps.

The fair value of the money market funds, classified as Level 3, utilized an income approach model and was based upon expected future cash flows from accumulated cash in the fund and future maturities of the remaining securities held in the fund. During 2009, redemptions of $5 million were received from the Reserve Fund-Primary Fund and redemptions of $14 million were received from the Reserve Fund-International Liquidity Fund. No current valuations had been issued by either fund, and RAI was unable to identify a similar fund that carried identical holdings. As a result, the observable transactions and pricing were not current. The funds did issue a detailed listing of the securities that were held and not matured, as well as their face value and maturity date. This observable data, along with unobservable factors, such as assumptions about fund liquidation of accumulated cash and the collectability of the outstanding underlying securities, were used to determine the fair value of the funds as of December 31, 2009.

The fair value of the auction rate securities, either related to certain financial insurance companies or linked to the credit risk of a diverse range of corporations, including, but not limited to, manufacturing, financial and insurance sectors, classified as Level 3, utilized an income approach model and 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 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,

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

recovery potential and how these factors changed as ratings on the underlying collateral migrated from one level to another.

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, depending on availability. The market approach utilized actual pricing inputs when observable and modeled pricing when unobservable. RAI has deemed the market for this security to be inactive.

The changes in the Level 3 investments as of December 31, 2009, were as follows:

	Money Market Funds		Mortgage-Backed Security		
	Cost	Estimated Fair Value	Cost	Gross Unrealized (Loss) Gain	Estimated Fair Value
Balance as of January 1, 2009	$ 23	$ 23	$ 37	$ (16)	$ 21
Unrealized gains				1	1
Settlements	(19)	(19)	(6)		(6)
Balance as of December 31, 2009	$ 4	$ 4	$ 31	$ (15)	$ 16

	Auction Rate Securities Corporate Credit Risk			Auction Rate Securities Financial Insurance Companies		
	Cost	Gross Unrealized Loss	Estimated Fair Value	Cost	Gross Unrealized (Loss) Gain	Estimated Fair Value
Balance as of January 1, 2009	$ 95	$ (51)	$ 44	$ 17	$ (2)	$ 15
Unrealized (losses) gains		(14)	(14)		2	2
Balance as of December 31, 2009	$ 95	$ (65)	$ 30	$ 17	$	$ 17

The fair value of the trademarks measured on a nonrecurring basis, classified as Level 3, represent certain trademarks, for which impairment during the first and fourth quarters of 2009 reduced their book value to fair value. The fair value determinations utilized an income approach model and were based on a discounted cash flow valuation model under a relief from royalty methodology. This approach utilized unobservable factors, such as royalty rate, projected revenues and a discount rate, applied to the estimated cash flows. The determination of the discount rate was based on a cost of equity model, using a risk-free rate, adjusted by a stock beta-adjusted risk premium and a size premium. See note 3 for additional information with respect to the event during the first quarter of 2009 that required impairment testing in addition to the annual testing of trademarks and the assumptions used therefor, as well as the consolidated amount of trademarks as of December 31, 2009.

The fair value of nonfinancial assets was not measured as of December 31, 2009. Nonfinancial assets measured at fair value on a nonrecurring basis were as follows:

	Level 1	Level 2	Level 3	Total	Total Loss
Trademarks, March 31, 2009	$	$	$ 875	$ 875	$ (453)
Trademarks, November 30, 2009	$	$	$ 80	$ 80	$ (114)

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3 Intangible Assets

There were no changes in goodwill in 2008. The changes in the carrying amounts of goodwill by segment as of December 31, 2009, were as follows:

	RJR Tobacco	Conwood	All Other	Consolidated
Balance as of December 31, 2008				
Goodwill	$ 9,065	$ 2,650	$ 224	$ 11,939
Less: Accumulated impairment losses	(3,763)	(2)		(3,765)
Net goodwill balance as of December 31, 2008	5,302	2,648	224	8,174
Balance as of December 31, 2009				
Acquisition of Niconovum AB			11	11
Goodwill	9,065	2,650	235	11,950
Less: Accumulated impairment losses	(3,763)	(2)		(3,765)
Net goodwill balance as December 31, 2009	$ 5,302	$ 2,648	$ 235	$ 8,185

The changes in the carrying amounts of indefinite-lived intangible assets by segment not subject to amortization during the years ended December 31, 2009 and 2008, were as follows:

	RJR Tobacco		Conwood	All Other		Consolidated	
	Trademarks	Other	Trademarks	Trademarks	Other	Trademarks	Other
Balance as of December 31, 2007	$ 1,826	$ 55	$ 1,374	$ 155	$ 47	$ 3,355	$ 102
Impairment	(173)		(130)			(303)	
Acquisition					1		1
Transfer to finite-lived			(22)			(22)	
Balance as of December 31, 2008	1,653	55	1,222	155	48	3,030	103
Impairment	(490)		(70)			(560)	
Intersegment transfer		44			(44)		
Acquisition of Niconovum AB					43		43
Balance as of December 31, 2009	$ 1,163	$ 99	$ 1,152	$ 155	$ 47	$ 2,470	$ 146

The changes in the carrying amounts of finite-lived intangible assets by segment subject to amortization during the years ended December 31, 2009 and 2008, were as follows:

	RJR Tobacco		Conwood	Consolidated	
	Trademarks	Other	Trademarks	Trademarks	Other
Balance as of December 31, 2007	$ 41	$ 100	$ 11	$ 52	$ 100
Amortization	(5)	(16)	(1)	(6)	(16)
Impairment	(3)		(12)	(15)	
Transferred from indefinite-lived			22	22	
Balance as of December 31, 2008	33	84	20	53	84
Amortization	(12)	(15)	(1)	(13)	(15)
Impairment	(1)		(6)	(7)	
Balance as of December 31, 2009	$ 20	$ 69	$ 13	$ 33	$ 69

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Details of finite-lived intangible assets subject to amortization as of December 31, 2009, were as follows:

	Gross	Accumulated Amortization	Net
Contract manufacturing agreements	$ 151	$ 82	$ 69
Trademarks	95	62	33
	$ 246	$ 144	$ 102

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

Year	Amount
2010	$ 26
2011	23
2012	20
2013	16
2014	10
Thereafter	7
	$ 102

During the first quarter of 2009, President Obama signed into law an increase of $0.62 in the federal excise tax per pack of cigarettes, as well as significant tax increases on other tobacco products, to fund expansion of the State Children s Health Insurance Program, referred to as the SCHIP. The tax increases were effective April 1, 2009.

The increase in federal excise tax was expected to adversely impact the net sales of RAI s operating subsidiaries. This event was considered a triggering event and required the testing for impairment of the carrying value of trademarks and goodwill during the first quarter of 2009. As a result of this testing, RJR Tobacco and Conwood recorded trademark impairment charges in the first quarter of 2009. These charges were based on the excess of certain brands carrying values over their estimated fair values. The analysis of the fair value of trademarks was based on estimates of fair value on an income approach using a discounted cash flow valuation model under a relief from royalty methodology. The relief from royalty model includes the estimates of the royalty rate that a market participant might assume, projected revenues and judgment regarding the 10.50% discount rate applied to those estimated cash flows. The determination of the discount rate was based on a cost of equity model, using a risk-free rate, adjusted by a stock beta-adjusted risk premium and a size premium.

The impairment testing of trademarks in the fourth quarters of 2009, 2008 and 2007, included modification to the previously anticipated level of support among certain brands, and an increased rate of decline in projected net sales of certain brands, compared with that assumed in the prior year strategic plan.

As a result of annual impairment testing, RJR Tobacco and Conwood recorded trademark impairment charges during 2009, 2008 and 2007. Also, triggered by the reclassification of KOOL from a growth brand to a support brand during the third quarter of 2008, RJR Tobacco completed impairment testing, and as a result, recorded an impairment charge. These charges were based on the excess of certain brands carrying values over their estimated fair values using the present value of estimated future cash flows assuming a discount rate of 10.50% in 2009, 2008 and 2007. The discount rate was determined by adjusting the enterprise discount rate by an appropriate risk premium to reflect a market rate risk.

These trademark impairment charges are reflected as decreases in the carrying value of the trademarks in the consolidated balance sheets as of December 31, 2009 and 2008, as trademark impairment charges in the consolidated statements of income for the years ended December 31, 2009, 2008 and 2007, and had no impact on cash flows. In addition, certain brands that would no longer receive marketing support indicated that a finite life was probable. As a result, these brands are being amortized over their remaining lives, which range from 3 to 19 years, consistent with the pattern of economic benefits estimated to be received.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the impairment testing of the goodwill of RAI s reporting units, each reporting unit s estimated fair value was compared with its carrying value. A reporting unit is an operating segment or one level below an operating segment. The determination of estimated fair value of each reporting unit was calculated primarily utilizing an income approach model, based on the present value of the estimated future cash flows of the reporting unit assuming a discount rate. The determination of the discount rate was based on a weighted average cost of capital and cost of equity, described above as utilized in the trademark valuation. Additionally, the aggregate estimated fair value of the reporting units, determined with the use of the income approach model, was compared with RAI s market capitalization. In considering RAI s market capitalization, an estimated premium to reflect the fair value on a control basis was applied. The estimated fair value of each reporting unit, determined utilizing the income approach and RAI s market capitalization, was substantially greater than its respective carrying value.

Concurrent with the transfer of the management of tobacco products sold to certain U.S. territories, U.S. duty-free shops and U.S. overseas military bases, from R. J. Reynolds Global Products Inc., referred to as GPI, to RJR Tobacco on January 1, 2009, an indefinite-lived intangible asset was transferred from All Other to RJR Tobacco.

On December 9, 2009, through an indirect subsidiary, RAI completed its acquisition of all of the outstanding shares of Niconovum AB, a Swedish-based nicotine replacement therapy company, for approximately $43 million in cash. The acquisition was treated as a purchase of the Niconovum AB net assets for financial accounting purposes. The estimated fair value of assets acquired, primarily indefinite-lived other intangible assets, and liabilities assumed was determined and recognized. The difference between the consideration paid and the acquisition-date value of the identifiable assets acquired and liabilities assumed was recognized as goodwill, as disclosed in the table above. The financial condition and results of operations of Niconovum AB do not meet the materiality criteria to be reportable and are therefore included in the operating segment All Other.

Note 4 Restructuring Charges

2009 Restructuring Charge

In December 2009, RJR Tobacco announced the elimination of approximately 400 full-time production positions. These positions were selected from employees who volunteered to be considered for job elimination. The job eliminations are expected to be substantially completed by December 31, 2010.

Under existing benefit plans, $48 million of severance-related cash benefits and $8 million of non-cash pension-related benefits comprised a restructuring charge of $56 million. None of the cash portion of the charge was paid during 2009. Accordingly, in the consolidated balance sheet as of December 31, 2009, $21 million was included in other current liabilities, and $27 million was included in other noncurrent liabilities. The cash benefits are expected to be substantially paid by December 31, 2011.

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

	Employee Severance and Benefits
Original accrual	$ 56

Utilized in 2009		(8)
Balance as of December 31, 2009	$	48

2008 Restructuring Charge

In 2008, RAI and RJR Tobacco announced changes in their organizational structures to streamline non-core business processes and programs in order to allocate additional resources to strategic growth initiatives. The reorganizations resulted in the elimination of approximately 600 full-time jobs, substantially completed by December 31, 2009.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Under existing benefit plans, $83 million of severance-related cash benefits and $7 million of non-cash pension-related benefits comprised a restructuring charge of $90 million. Of this charge, $81 million was recorded in the RJR Tobacco segment. Of the cash portion of the charge, $43 million was paid as of December 31, 2009. Accordingly, in the consolidated balance sheet as of December 31, 2009, $29 million was included in other current liabilities, and $11 million was included in other noncurrent liabilities. The cash benefits are expected to be substantially paid by December 31, 2011.

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

	Employee Severance and Benefits
Original accrual	$ 91
Utilized in 2008	(12)
Adjusted in 2008	(1)
Balance as of December 31, 2008	78
Utilized in 2009	(38)
Balance as of December 31, 2009	$ 40

2004 B&W Business Combination Restructuring Costs

In connection with the allocation of the cost of the B&W business combination to assets acquired and liabilities assumed, RJR Tobacco accrued restructuring costs of $272 million in 2004, related to severance, and other relocation, contract terminations and facility closure costs. As of December 31, 2009, $248 million of the accrual had been paid, and a net cost reduction of $17 million had been recorded for lower-than-expected costs. In the consolidated balance sheet as of December 31, 2009, $1 million is included in other current liabilities and $6 million is included in other noncurrent liabilities.

Note 5 Termination of Joint Venture

In 2002, R.J. Reynolds Tobacco C.V., an indirect wholly owned subsidiary of RAI and referred to as RJRTCV, and an affiliate of Gallaher Group Plc, referred to as Gallaher, formed a joint venture, with each party owning a 50% membership interest. The joint venture, R. J. Reynolds-Gallaher International Sarl, marketed American-blend cigarettes primarily in Italy, France and Spain.

In 2007, an affiliate of Japan Tobacco Inc., referred to as JTI, acquired Gallaher, and Gallaher subsequently notified RJRTCV that the acquisition constituted a change of control of Gallaher within the meaning of the joint venture agreement. Pursuant to the terms of the joint venture agreement, RJRTCV elected to terminate the joint venture prior to its expiration date. The joint venture was terminated on December 31, 2007.

The joint venture agreement provided that upon a termination of the joint venture, the value of all the trademarks each joint venture member or its affiliate licensed to the joint venture, other than NATURAL AMERICAN SPIRIT, would be calculated and that the party whose licensed trademarks were determined to be of greater value would be required to pay the other party an amount, referred to as the Termination Amount, equal to one-half of the difference between the values of the parties respective trademarks. In 2008, RJRTCV and Gallaher Limited, an affiliate of Gallaher, entered into a valuation payment settlement agreement, pursuant to which Gallaher Limited agreed to pay RJRTCV a Termination Amount equal to euros 265 million, or approximately $388 million. Of this amount, euros 132.50 million, or 50%, was paid as of December 31, 2009, and the remaining 50% is to be paid in five equal annual installments starting in April 2010. Of this receivable, $35 million, including imputed interest, was included in current notes receivable, and $134 million was included in other assets and deferred charges, in RAI s consolidated balance sheet as of December 31, 2009. Related to the gain on termination of the joint venture of $328 million, approximately $118 million of deferred tax was recognized and included in deferred income taxes, net in the noncurrent liability section of the consolidated balance sheet as of December 31, 2009.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 6 Income Per Share

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

	For the Years Ended December 31, 2009	2008	2007
Income from continuing operations before extraordinary item	$ 962	$ 1,338	$ 1,307
Extraordinary item gain on acquisition			1
Net income	$ 962	$ 1,338	$ 1,308
Basic weighted average shares, in thousands	291,381	293,401	295,163
Effect of dilutive potential shares:			
Options	135	199	246
Stock units	310		
Diluted weighted average shares, in thousands	291,826	293,600	295,409

Effective January 1, 2009, RAI adopted revised GAAP that had the effect of including unvested restricted shares outstanding in basic and diluted weighted average share calculations. Retrospective application reduced basic and diluted income per share by $0.02 and $0.01, respectively, for 2008, and reduced basic income per share by $0.01 for 2007.

Note 7 Investments

Short-term investments classified as available-for-sale were as follows:

	December 31, 2009			December 31, 2008			
	Cost	Redemptions	Estimated Fair Value	Cost	Gross Realized Loss	Redemptions	Estimated Fair Value
Reserve Fund Primary Fund	$ 7	$ (5)	$ 2	$ 37	$ (1)	$ (29)	$ 7
Reserve Fund International Liquidity Fund	16	(14)	2	17	(1)		16
	$ 23	$ (19)	$ 4	$ 54	$ (2)	$ (29)	$ 23

RAI has the intent and the ability to hold the investments in the Reserve Funds until the remaining holdings are distributed.

Long-term investments classified as available-for-sale were as follows:

	December 31, 2009			December 31, 2008			
	Cost	Gross Unrealized Gain/(Loss)	Estimated Fair Value	Cost	Gross Realized Loss	Gross Unrealized Loss	Estimated Fair Value
Auction rate securities corporate credit risk	$ 95	$ (65)	$ 30	$ 95	$	$ (51)	$ 44
Auction rate securities financial insurance companies	17		17	50	(33)	(2)	15
Mortgage-backed security	31	(15)	16	37		(16)	21
Marketable equity security	2	17	19	2			2
	$ 145	$ (63)	$ 82	$ 184	$ (33)	$ (69)	$ 82

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

RAI has five investments in auction rate securities linked to corporate credit risk, four investments in auction rate securities related to financial insurance companies, one investment in a mortgage-backed security and one investment in a marketable equity security. These securities were carried at fair value and included in other assets and deferred charges, and unrealized gains and losses, net of tax, were included in other comprehensive loss in RAI s consolidated balance sheets as of December 31, 2009 and 2008. The realized losses were recorded in other expense, net in RAI s consolidated statement of income for the years ended December 31, 2009, 2008 and 2007. The funds associated with the auction rate securities will not be accessible until a successful auction occurs or a buyer is found. The mortgage-backed security matures in March 2010. RAI is in the process of evaluating its alternatives for restructuring the terms of this investment and will make a determination by the maturity date.

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. Since the adoption of authoritative GAAP in June 2009, 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 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.

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. Additionally, RAI evaluated any credit loss within the fair market valuation by comparing the net amortized cost of the securities to the discounted present value of anticipated future cash flows.

RAI determined the change in the fair value of the investments in the auction rate securities linked to corporate credit risk was temporary as of December 31, 2009, primarily based on estimated cash flows of the investments, present and expected defaults of the underlying collateral and RAI s ability and intent to hold such investments. RAI also determined the present value of anticipated future cash flows exceeded the net amortized cost of the investment and therefore did not have any credit loss to recognize. RAI believes the decline in the fair value of the securities is related to present market conditions and that the investments will continue to be carried at less than cost until economic conditions improve. RAI believes it is probable these securities will eventually recover, and RAI has no intention of, and does not believe there will be a requirement for, selling these securities in the foreseeable future.

In 2008, three of the four investments in auction rate securities related to financial insurance companies were other-than-temporarily impaired. As of December 31, 2009, the fair value of those three investments increased above their amortized cost, generating unrealized gains. The decline in the fair value of the remaining investment has been determined by RAI to be temporary, primarily based on estimated cash flows of the security, near-term prospects and financial condition of the issuer and RAI s ability and intent to hold such investment. RAI also determined the present value of anticipated future cash flows exceeded the net amortized cost of the investment and therefore did not have any credit loss to recognize. RAI believes the decline in the fair value of this security is related to present market conditions and that this investment will continue to be carried at less than cost until economic conditions improve. RAI believes it is probable this security will eventually recover, and RAI has no intention of, and does not believe there will be a requirement for, selling any of these securities in the foreseeable future.

RAI determined the change in the fair value of the investment of the mortgage-backed security, classified above sub-prime at inception, was also temporary as of December 31, 2009, primarily based on estimated cash flows of the security, as well as the underlying collateral. RAI also determined the present value of anticipated future cash flows exceeded the net amortized cost of the investment and therefore did not have any credit loss to recognize. RAI believes the decline in the fair value of the mortgage-backed security is related to present market conditions and that this investment will continue to be carried at less than cost until economic conditions surrounding the housing markets improve. RAI believes it is probable this security will recover as the lowering

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

of interest rates and the assistance of government-related funds will result in refinancing opportunities. In addition, during 2009, RAI received $6 million in principal payments on the mortgage-backed security. RAI has no intention of, and does not believe there will be a requirement for, selling this security in the foreseeable future and has the ability to allow financial markets to recover and ultimately realize the value of this investment.

RAI determined the change in the fair value of the investment in a marketable equity security using quoted market prices as of December 31, 2009.

Note 8 Inventories

The major components of inventories at December 31 were as follows:

	2009	2008
Leaf tobacco	$ 1,052	$ 993
Other raw materials	65	60
Work in process	80	58
Finished products	180	145
Other	32	26
Total	1,409	1,282
Less LIFO allowance	190	112
	$ 1,219	$ 1,170

Inventories valued under the LIFO method were $743 million and $765 million at December 31, 2009 and 2008, respectively, net of the LIFO allowance. The LIFO allowance reflects the excess of the current cost of LIFO inventories at December 31, 2009 and 2008, over the amount at which these inventories were carried on the consolidated balance sheets. RAI recorded expense of $78 million, $61 million and income of $12 million from LIFO inventory changes during 2009, 2008 and 2007, respectively.

Note 9 Other Current Liabilities

Other current liabilities at December 31 included the following:

	2009	2008
Payroll and employee benefits	$ 228	$ 222
Pension and other post-retirement benefits	79	85
Marketing and advertising	142	137
Declared dividends	262	248
Excise, franchise and property tax	166	66
Restructuring	52	43

Other	244	342
	$ 1,173	$ 1,143

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 10 Income Taxes

The components of the provision for income taxes from continuing operations for the years ended December 31 were as follows:

	2009	2008	2007
Current:			
Federal	$ 592	$ 632	$ 588
State and other	134	142	109
	726	774	697
Deferred:			
Federal	(150)	27	42
State and other	(4)	(11)	27
	(154)	16	69
	$ 572	$ 790	$ 766

The net current deferred income tax asset shown on the consolidated balance sheets at December 31 included the following:

	2009	2008
Deferred tax assets (liabilities):		
LIFO inventories	$ (206)	$ (203)
Pension and other postretirement liabilities	36	48
Tobacco settlement accruals	1,040	925
Other accrued liabilities	86	68
	$ 956	$ 838

The composition of the net current deferred income tax asset by jurisdiction at December 31 was as follows:

	2009	2008
Federal	$ 778	$ 683
State and other	178	155

	$ 956	$ 838

The net noncurrent deferred income tax liability shown on the consolidated balance sheets at December 31 included the following:

	2009	**2008**
Deferred tax assets:		
Pension and other postretirement liabilities	$ 766	$ 1,134
Other noncurrent liabilities	141	139
	907	1,273
Deferred tax liabilities:		
Property and equipment	(231)	(236)
Trademarks and other intangibles	(985)	(1,200)
Other	(132)	(119)
	(1,348)	(1,555)
	$ (441)	$ (282)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The composition of net noncurrent deferred income tax liability by jurisdiction at December 31 was as follows:

	2009	2008
Federal	$ (414)	$ (319)
State and other	(27)	37
	$ (441)	$ (282)

No valuation allowance has been provided on the deferred tax assets as of December 31, 2009 or 2008, as RAI believes it is more likely than not that all of the deferred tax assets will be realized through the expected generation of future taxable income.

Pre-tax income for domestic and foreign operations for the years ended December 31 consisted of the following:

	2009	2008	2007
Domestic (includes U.S. exports)	$ 1,508	$ 1,774	$ 2,043
Foreign	26	354	30
	$ 1,534	$ 2,128	$ 2,073

A gain of $328 million from the termination of the R. J. Reynolds-Gallaher International Sarl joint venture was included in foreign income during 2008.

The differences between the provision for income taxes from continuing operations and income taxes computed at statutory U.S. federal income tax rates for the years ended December 31 were as follows:

	2009	2008	2007
Income taxes computed at statutory U.S. federal income tax rates	$ 537	$ 745	$ 725
State and local income taxes, net of federal tax benefits	81	73	86
Favorable resolution of federal tax matters		(2)	(1)
Other items, net	(46)	(26)	(44)
Provision for income taxes from continuing operations	$ 572	$ 790	$ 766
Effective tax rate	37.3%	37.1%	37.0%

As of December 31, 2009, there were $462 million of accumulated and undistributed foreign earnings. Of this amount, RAI has invested $88 million and has plans to invest $27 million overseas. RAI has recorded deferred income taxes of $120 million on the $347 million of accumulated earnings in excess of its historical and planned overseas investments.

The deferred tax benefits included in accumulated other comprehensive loss were $900 million for retirement benefits and $26 million for unrealized losses on long-term investments as of December 31, 2009, and were $1,076 million for retirement benefits and $28 million for unrealized losses on long-term investments as of December 31, 2008.

The gross accruals for unrecognized income tax benefits, including interest and penalties, reflected in other noncurrent liabilities were $159 million at December 31, 2009 and 2008. RAI accrues interest and penalties related to accruals for income taxes and reflects these amounts in income tax expense. The gross amount of interest accrued at December 31, 2009 and 2008, was $53 million and $50 million, respectively. The gross amount of penalties accrued was $12 million at December 31, 2009 and 2008.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

A reconciliation of the unrecognized gross tax benefits is as follows:

	2009	2008	2007
Balance at beginning of year	$ 97	$ 111	$ 115
Gross increases related to current period tax positions	6	10	15
Gross increases related to tax positions in prior periods	3	3	3
Gross decreases related to tax positions in prior periods	(4)	(3)	(9)
Gross decreases related to audit settlements paid	(3)	(16)	(9)
Gross decreases related to lapse of applicable statute of limitations	(5)	(8)	(4)
Balance at end of year	$ 94	$ 97	$ 111

As of December 31, 2009, $54 million of unrecognized tax benefits and $45 million of interest and penalties, if recognized, would decrease RAI s effective tax rate.

RAI and its subsidiaries may be subject to income taxes in the United States, certain foreign jurisdictions and multiple state jurisdictions. A number of years may elapse before a particular matter, for which RAI has established an accrual, is audited and finally resolved. The number of years with open tax audits varies depending on the tax jurisdiction. RAI s major taxing jurisdictions and related open tax audits are discussed below.

RAI filed a federal consolidated income tax return for the years through 2008. The statute of limitations remains open for the years 2006 through 2008. There are no IRS examinations scheduled at this time for these open years.

In 2007, the State of North Carolina completed its examination of RJR Tobacco for years 2000 through 2002 and issued a total assessment of $37 million: $21 million related to tax, $8 million related to interest and $8 million related to penalties. RJR Tobacco filed a protest in January 2008. RJR Tobacco will continue to work with North Carolina to resolve issues identified and assessed for years 2000 through 2002. A complete resolution is not anticipated within the next 12 months. However, in the event a complete resolution of this audit is reached during the next 12 months, RJR Tobacco could recognize additional expense up to $13 million, inclusive of tax, interest, net of federal benefit, and penalties.

It is expected that the amount of unrecognized tax benefits will change in the next 12 months. Excluding the impact of North Carolina s assessment for years 2000 through 2002, RAI does not expect the change to have a significant impact on its consolidated results of operations, cash flows or financial position.

Note 11 Borrowing Arrangements

On June 28, 2007, RAI entered into a Fifth Amended and Restated Credit Agreement, which, as subsequently amended, is referred to as the Credit Facility and provides for a five-year, $498 million revolving credit facility, which may be increased up to $848 million at the discretion of the lenders upon the request of RAI.

Effective July 3, 2009, RAI entered into a Second Amendment to Credit Agreement, referred to as the Second Amendment, amending the Credit Facility by, among other things:

terminating the revolving loan commitment of Lehman Commercial Paper Inc., which filed for protection under Chapter 11 of the federal Bankruptcy Code on October 5, 2008, and thereby reducing the total revolving loan commitment under the Credit Facility from $550 million to $498 million;

amending the definition of Lender Default and certain related definitions;

granting RAI the right under certain circumstances to terminate the revolving loan commitment of a Defaulting Lender, as defined in the Credit Facility, if RAI is unable to replace such Defaulting Lender; and

otherwise clarifying the rights and responsibilities of the parties to the Credit Facility upon the occurrence of a Lender Default.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Credit Facility contains, among others, the following restrictive covenants that limit, and in some circumstances prohibit, the ability of RAI and its subsidiaries to:

- incur or guarantee additional debt;
- pay dividends;
- make capital expenditures, investments or other restricted payments;
- engage in transactions with shareholders and affiliates;
- create, incur or assume liens;
- engage in mergers, acquisitions and consolidations; and
- sell assets.

These covenants are subject to a number of qualifications and exceptions.

RAI s results on certain covenants under the Credit Facility were as follows:

	Actual	Credit Facility Requirement
Consolidated total leverage ratio as of December 31, 2009	1.67	Less than or equal to 3.25
Consolidated interest coverage ratio as of December 31, 2009	11.12	Greater than or equal to 3.00
Capital expenditures in 2009	$141 million	Less than or equal to $450 million

The Credit Facility contains customary events of default, including upon a change in control, that could result in the acceleration of the repayment of all amounts and cancellation of all commitments outstanding thereunder.

RAI is able to use the Credit Facility for borrowings and issuances of letters of credit at its option. Issuances of letters of credit reduce availability under the facility. As of December 31, 2009, there were no borrowings, and $15 million of letters of credit outstanding, under the Credit Facility.

Under the terms of the Credit Facility, RAI is not required to maintain compensating balances; however, RAI is required to pay a commitment fee of between 0.25% and 1.0% per annum on the unused portion of the Credit Facility. During 2009, RAI incurred $3 million in commitment fees.

Borrowings under the Credit Facility bear interest, at the option of RAI, at a rate equal to an applicable margin plus:

- the reference rate, which is the higher of (1) the federal funds effective rate from time to time plus 0.5% and (2) the prime rate; or the eurodollar rate, which is the rate at which eurodollar deposits for one, two, three or six months are offered in the interbank eurodollar market.

Certain of RAI s subsidiaries, including its material domestic subsidiaries, referred to as the Guarantors, have guaranteed RAI s obligations under the Credit Facility and under RAI s outstanding senior notes, referred to as the Notes.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 12 Long-Term Debt

Long-term debt, net of discount and including fair value adjustments associated with interest rate swaps, as of December 31 consisted of the following:

	2009	2008
RJR debt:		
9.25%, notes due 2013	$ 60	$ 60
7.25% guaranteed, notes due 2012	61	64
7.3% guaranteed, notes due 2015	1	1
Total RJR debt	122	125
RAI debt:		
6.5% guaranteed, notes due 2010		299
6.75% guaranteed, notes due 2017	824	846
7.25% guaranteed, notes due 2012	424	439
7.25% guaranteed, notes due 2013	623	622
7.25% guaranteed, notes due 2037	448	447
7.3% guaranteed, notes due 2015	199	199
7.625% guaranteed, notes due 2016	847	860
7.75% guaranteed, notes due 2018	249	249
Floating rate, guaranteed, notes due 2011	400	400
Total RAI debt	4,014	4,361
Total long-term debt (less current maturities)	4,136	4,486
Current maturities of long-term debt	300	200
	$ 4,436	$ 4,686

As of December 31, 2009, the maturities of RAI s and RJR s notes, net of discount and excluding fair value adjustments associated with interest rate swaps, were as follows:

Year	RAI	RJR	Total
2010	$ 300	$	$ 300
2011	400		400
2012	392	57	449
2013	623	60	683
2015 and thereafter	2,368	1	2,369

	$ 4,083	$ 118	$ 4,201

In conjunction with their obligations under the Credit Facility, RAI s material domestic subsidiaries, including RJR, RJR Tobacco, Santa Fe, Lane, GPI and the Conwood companies guarantee the Notes.

The estimated fair value of RAI s and RJR s outstanding long-term notes was $4.4 billion and $3.5 billion with an effective average annual interest rate of 5.46% and 5.67%, as of December 31, 2009 and 2008, respectively. The fair values were based on available market quotes, credit spreads and discounted cash flows, as appropriate.

At its option, RAI and RJR, as applicable, may redeem any or all of their outstanding fixed-rate notes, in whole or in part, at any time, subject to the payment of a make-whole premium. The floating rate notes, with the variable component of interest based on three-month LIBOR, are redeemable at par on any interest payment date after December 15, 2008.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 13 Financial Instruments

Interest Rate Management

RAI and RJR use interest rate swaps to manage interest rate risk on a portion of their respective debt obligations.

Swaps existed on the following principal amount of debt:

	Fixed to Floating Rate December 31, 2009		Floating to Fixed Rate December 31, 2009		Fixed to Floating Rate December 31, 2008 and 2007	
RJR 7.25% notes, due 2012	$	44	$	44	$	57
Total swapped RJR debt		44		44		57
RAI 7.25% notes, due 2012		306		306		393
RAI 7.625% notes, due 2016		450		450		450
RAI 6.75% notes, due 2017		700		700		700
Total swapped RAI debt		1,456		1,456		1,543
Total swapped debt	$	1,500	$	1,500	$	1,600

Historically, the interest rate swap agreements were derivative instruments that qualified for hedge accounting. RAI and RJR assess at the inception of the hedge whether the hedging derivatives are highly effective in offsetting changes in fair value of the hedged item. Ineffectiveness results when changes in the market value of the hedged debt are not completely offset by changes in the market value of the interest rate swap. There was no ineffectiveness recognized related to derivative instruments during 2009, 2008 or 2007. As detailed below, at December 31, 2009, RAI and RJR had no derivative instruments designated as hedges.

On January 6, 2009, the fair value of RAI s and RJR s fixed to floating interest rate swaps, designated as hedges, was $258 million. RAI and RJR locked in the value of these swaps by entering into offsetting floating to fixed interest rate swap agreements in the notional amount of $1.5 billion with maturity dates ranging from June 1, 2012 to June 15, 2017. The floating to fixed interest rate swaps were entered into with the same financial institution that holds a notional amount of $1.5 billion of fixed to floating interest rate swaps and have a legal right of offset. The future cash flows, established as a result of entering into the January 6, 2009, floating to fixed interest rate swaps, total $321 million, and will be amortized and effectively reduce net interest costs over the remaining life of the notes. Concurrent with entering the floating to fixed interest rate swap agreements on January 6, 2009, which were not designated as hedging instruments, RAI and RJR removed the designation of fair value hedge from the fixed to floating interest rate swaps.

On January 7, 2009, RAI and RJR terminated an interest rate swap agreement in the notional amount of $100 million with a maturity date of June 1, 2012. The resulting gain of approximately $12 million will be amortized to effectively reduce interest expense over the remaining life of the notes.

As a result of these actions, RAI and RJR have economically decreased the fixed rate on $1.6 billion of debt to a fixed rate of interest of approximately 4.0%.

As of December 31, 2009, a summary of interest rate swaps outstanding was as follows:

	Fixed to Floating	**Floating to Fixed**
Pay	Floating based on one and six month LIBOR	4.0% fixed
Receive	7.1% fixed	Floating based on one and six month LIBOR
Weighted average maturity	5.97 years	5.97 years

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Interest rate swaps are presented in the consolidated balance sheets at December 31 at fair value as follows:

	2009	2008
Designated as hedging instrument:		
Other assets and deferred charges	$	$ 287
Long-term debt (less current maturities)		(287)
Not designated as hedging instrument:		
Other assets and deferred charges	239	
Long-term debt (less current maturities)	(235)	
Other noncurrent liabilities	(2)	

Interest rate swaps impacted the consolidated statements of income as of December 31 as follows:

	2009	2008	2007
Interest and debt expense	$ (47)	$ (43)	$ (4)
Other (income) expense, net	(9)		

Credit Risk

RAI and its subsidiaries minimize counterparty credit risk related to their financial instruments by using major institutions.

See note 12 for additional disclosures regarding long-term debt.

Note 14 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, the Conwood companies 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 the Conwood companies. 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 the Conwood companies 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, British American Tobacco p.l.c., referred to as 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. In addition, pursuant to this indemnity, RJR Tobacco expensed less than $1 million during each of 2009 and 2008 and $1 million in 2007 for funds to be reimbursed to BAT for costs and expenses incurred arising out of certain tobacco-related litigation.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 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.

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 state to state and jurisdiction to jurisdiction, compensatory and punitive damages have been specifically pleaded in a number of cases, sometimes in amounts ranging into the hundreds of millions and even billions of dollars.

Defenses

The defenses raised by RJR Tobacco, the Conwood companies 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 and the Conwood companies, as applicable, record any loss concerning litigation at such time as an unfavorable outcome becomes probable and the amount can be reasonably estimated. 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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

or indemnitees, or the loss of any particular claim concerning the use of smokeless tobacco against the Conwood companies, 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. 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.

Except for a $2 million accrual related to an unfavorable judgment in the *Whiteley v R. J. Reynolds Tobacco Co.* case, no other liability for pending smoking and health tobacco litigation was recorded in RAI s consolidated balance sheet as of December 31, 2009. However, as of December 31, 2009, RJR Tobacco had $2 million related to non-smoking and health litigation, and RJR, and its subsidiary RJR Tobacco, had liabilities totaling $94 million that were recorded in 1999 in connection with certain non-smoking and health indemnification claims asserted by JTI relating to certain activities of Northern Brands International, Inc., a now inactive, indirect subsidiary of RAI formerly involved in the international tobacco business, referred to as Northern Brands. For further information on Northern Brands and related litigation and the indemnification claims of JTI, see Litigation Affecting the Cigarette Industry Other Litigation and Developments and Other Contingencies below.

Generally, RJR Tobacco and its affiliates and indemnitees have not settled, and currently RJR Tobacco and its affiliates do not intend to settle, any smoking and health tobacco litigation claims. It is the policy of RJR Tobacco and its affiliates to vigorously defend all tobacco-related litigation claims.

The only smoking and health tobacco litigation claims settled 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 Class-Action Suits.

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.

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 hospitals, 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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The pending U.S. Department of Justice case brought against various industry members, including RJR Tobacco and B&W, discussed below under Litigation Affecting the Cigarette Industry Health-Care Cost Recovery Cases, also can be distinguished from the circumstances surrounding the State Settlement Agreements. Under its Medical Care Recovery Act and Medicare Secondary Payer Act claims, the federal government made arguments similar to the states and sought to recover federal funds expended in providing health care to smokers who have developed diseases and injuries alleged to be smoking-related. These claims were dismissed, and the only claim remaining in the case involves alleged violations of civil provisions of the federal Racketeer Influenced and Corrupt Organizations Act, referred to as RICO. A comprehensive discussion of this case is set forth below under Litigation Affecting the Cigarette Industry Health-Care Cost Recovery 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 Class-Action Suits, 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.

Likewise, 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. Despite valid legal defenses, 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 cases currently pending against RJR Tobacco and B&W involve different types of plaintiffs and different theories of recovery under the antitrust laws than other 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, RJR Tobacco and B&W each has settled certain cases brought by states concerning the enforcement of State Settlement Agreements. Despite valid legal defenses, these cases were settled to avoid further contentious litigation with the states involved. These enforcement actions involve 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.

The Conwood companies also believe that they have valid defenses to the smokeless tobacco litigation against them. The Conwood companies have 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 the Conwood companies and their counsel. No verdict or judgment has been returned or entered against the Conwood companies on any claim for personal injuries allegedly resulting from the use of smokeless tobacco. The Conwood companies intend to defend vigorously all smokeless tobacco litigation claims asserted against them. No liability for pending smokeless tobacco litigation was recorded in RAI s consolidated balance sheet as of December 31, 2009.

Cautionary Statement

Even though 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 case concerning the use of smokeless tobacco against the Conwood companies, when viewed on an individual 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, the Conwood companies 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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

judgments are not final, could materially adversely affect 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 it 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 the Conwood companies, 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 the Conwood companies.

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.

During the fourth quarter of 2009, 10 tobacco-related cases were served against RJR Tobacco or its affiliates or indemnitees. On December 31, 2009, there were 11,165 cases, including 671 individual smoker cases pending in West Virginia state court as a consolidated action and 7,709 *Engle* Progeny Cases, involving approximately 9,243 individual plaintiffs, pending in the United States against RJR Tobacco or its affiliates or indemnitees, as compared with 3,953 total cases on December 31, 2008, and 1,399 total cases on December 31, 2007, pending in the United States against RJR Tobacco or its affiliates or indemnitees.

As of January 29, 2010, 215 tobacco-related cases were pending against RJR Tobacco or its affiliates or indemnitees: 205 in the United States; one in Puerto Rico; eight in Canada; and one in Israel. Of the 205 total U.S. cases, 24 cases are pending against B&W that are not also pending against RJR Tobacco. The U.S. case number does not include the 2,595 *Broin II* or the 7,711 *Engle* Progeny Cases, as discussed below, pending as of January 29, 2010.

The following table lists the number of U.S. tobacco-related cases by state that were pending against RJR Tobacco or its affiliates or indemnitees as of January 29, 2010, exclusive of the *Broin II* and *Engle* Progeny Cases:

State	Number of U.S. Cases
Florida	24
New York	21
Missouri	21
Maryland	18
Louisiana	16
California	13
Illinois	7
West Virginia	6*
Pennsylvania	5
Mississippi	4
Georgia	4
Connecticut	4
Alabama	4
Kentucky	4

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State	Number of U.S. Cases
Ohio	3
District of Columbia	3
New Mexico	3
North Carolina	3
Washington	2
Kansas	2
Minnesota	2
South Dakota	2
Tennessee	2
Vermont	2
Wisconsin	2
New Jersey	2
Arizona	2
Delaware	1
Arkansas	1
Maine	1
Michigan	1
Oregon	1
South Carolina	1
Alaska	1
Colorado	1
Hawaii	1
Idaho	1
Indiana	1
Iowa	1
Mariana Islands	1
Massachusetts	1
Montana	1
Nebraska	1
Nevada	1
New Hampshire	1
North Dakota	1
Oklahoma	1
Rhode Island	1
Utah	1
Virginia	1
Wyoming	1
Total	205**

* Includes as one case the 672 cases pending as a consolidated action *In Re: Tobacco Litigation Individual Personal Injury Cases*, sometimes referred to as *West Virginia IPIC* cases, described below.

** Of the pending U.S. cases, 31 are pending in federal court, 173 in state court and 1 in tribal court.

The following table lists the categories of the U.S. tobacco-related cases pending against RJR Tobacco or its affiliates or indemnitees as of January 29, 2010, compared with the number of cases pending against RJR Tobacco, its affiliates or indemnitees as of October 9, 2009, as reported in RAI s Quarterly Report on Form 10-Q for the fiscal quarter ended September 30, 2009, filed with the SEC on October 27, 2009, and a cross-reference to the discussion of each case type.

Case Type	RJR Tobacco s Case Numbers as of January 29, 2010	Change in Number of Cases Since October 9, 2009 Increase/(Decrease)	Page Reference
Individual Smoking and Health	106	No Change	96
West Virginia IPIC (Number of Plaintiffs)*	1(672)	18	97
Engle Progeny (Number of Plaintiffs)**	7,711 (9,246)	4,385 (+505)	97
Broin II	2,595	(1)	99
Class-Action	17	2	99
Health-Care Cost Recovery	4	No Change	106
State Settlement Agreements-Enforcement and Validity	58	(1)	112
Antitrust	2	No Change	115
Other Litigation and Developments	17	3	116

* The West Virginia Individual Personal Injury Cases have been separated from the Individual Smoking and Health cases for reporting purposes.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

** The *Engle* Progeny Cases have been separated from the Individual Smoking and Health cases for reporting purposes. Plaintiffs counsel are attempting to include multiple plaintiffs in most of the cases filed. The increase in the number of cases includes new cases served and new cases filed by severed plaintiffs.

Three 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*., the Louisiana state court class-action case, *Scott v. American Tobacco Co.,* and the federal RICO case brought by the U.S. Department of Justice.

In 2000, a jury in *Engle* rendered a punitive damages verdict in favor of the Florida class of approximately $145 billion against all defendants. On July 6, 2006, the Florida Supreme Court, among other things, affirmed an appellate court s reversal of the punitive damages award, decertified the class going forward, preserved several class-wide findings from the trial, including that nicotine is addictive and cigarettes are defectively designed, and authorized class members to avail themselves of these findings in individual lawsuits under certain conditions. After subsequent motions were resolved, the Florida Supreme Court issued its mandate on January 11, 2007, thus beginning a one-year period in which former class members were permitted to file individual lawsuits. On October 1, 2007, the U.S. Supreme Court denied the defendants petition for writ of certiorari. As of January 29, 2010, RJR Tobacco had been served in 7,711 *Engle* Progeny Cases in both state and federal courts in Florida. These cases include approximately 9,246 plaintiffs. The number of cases will likely change due to individual plaintiffs being severed from multi-plaintiff cases. In addition, as of January 29, 2010, RJR Tobacco was aware of 28 additional cases that had been filed but not served (with 302 plaintiffs).

In 2004, a jury in *Scott* returned a verdict in favor of the Louisiana class for $591 million to establish a state-wide smoking cessation program. In 2007, the Louisiana Court of Appeals upheld class certification, significantly reduced the scope of recovery, and remanded the case for further proceedings. The Louisiana and U.S. Supreme Courts denied the defendants applications for writ of certiorari. In July 2008, the trial court entered an amended judgment in favor of the class for approximately $263 million plus interest from June 30, 2004. On December 15, 2008, the trial court signed the order for appeal of the amended judgment. Oral argument on the defendants appeal occurred on September 1, 2009. A decision is pending.

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. On May 22, 2009, the U.S. Court of Appeals largely affirmed the finding of liability against the tobacco company defendants and remanded to the trial court for further proceedings. The defendants sought rehearing and/or rehearing *en banc*, but that motion was denied by the appellate court on September 22, 2009. On October 21, 2009, the defendants motion to stay issuance of the mandate pending the filing and disposition of petitions for writ of certiorari to the U.S Supreme Court was granted. Petitions for writ of certiorari from the U.S. Supreme Court are due on February 19, 2010. In addition, the Department of Justice may include in its writ petition a request for reinstatement of its claims for remedies, including disgorgement of profits.

For a detailed description of these cases, see Class-Action Suits *Engle* Case, Class-Action Suits Medical Monitoring and Smoking Cessation 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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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, however, that RJR Tobacco and other cigarette manufacturers will face an increased number of tobacco-related trials in 2010 compared to recent years. The following table lists the non-*Engle* Progeny tobacco-related trials scheduled, as of January 29, 2010, for RJR Tobacco or its affiliates and indemnitees through December 31, 2010. There are 68 *Engle* Progeny cases against RJR Tobacco and/or B&W set for trial through December 31, 2010, but it is not known how many of these cases will actually be tried.

Trial Date	Case Name/Type	Defendant(s)	Jurisdiction
April 27, 2010	*Izzarelli v. R. J. Reynolds Tobacco Co.* [Individual]	RJR Tobacco	U.S. District Court District of Connecticut (Bridgeport, CT)
May 18, 2010	*Power v. John Crane-Houdaille, Inc.* [Individual]	RJR Tobacco, B&W	Circuit Court Baltimore City (Baltimore, MD)
May 25, 2010	*Grisham v. Philip Morris, Inc.* [Individual]	B&W	U.S. District Court Central District (Los Angeles, CA)
July 19, 2010	*Bell v. Brown & Williamson Tobacco Corp.* [Individual]	RJR Tobacco, B&W	Circuit Court Jackson County (Kansas City, MO)

Trial Results. From January 1, 1999 through January 29, 2010, 61 smoking and health and health-care cost recovery cases in which RJR Tobacco or B&W were defendants were tried. Verdicts in favor of RJR Tobacco, B&W and, in some cases, RJR Tobacco, B&W and other defendants, were returned in 40 cases, including six mistrials, tried in Florida (13), New York (4), Missouri (5), Tennessee (3), Mississippi (2), California (2), West Virginia (2), Ohio (2), Connecticut (1), Louisiana (1), New Jersey (1), Pennsylvania (1), South Carolina (1), Texas (1) and Washington (1).

Additionally, from January 1, 1999 through January 29, 2010, 27 smoking and health cases in which RJR Tobacco, B&W, or their respective affiliates were not defendants were tried. Verdicts were returned in favor of the defendants in 15 cases, including two mistrials, tried in Florida (7), California (3), New Hampshire (1), New York (1), Pennsylvania (1), Rhode Island (1) and Tennessee (1). Verdicts in favor of the plaintiffs were returned in 13 cases tried in Florida (6), California (4), Oregon (2) and Illinois (1).

One smoking and health case (and no health-care cost recovery case) in which RJR Tobacco was a defendant was tried in the fourth quarter of 2009. *In Williams v. Brown & Williamson Tobacco Corp.,* on December 2, 2009, the court declared a mistrial due to an insufficiency in the remaining number of jury panelists. The court further

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ordered the parties to notify the court by February 26, 2010, of an agreed upon trial date. For a detailed description of the case, see Individual Smoking and Health Cases below.

In addition, in *West Virginia IPIC*, trial began on February 1, 2010. However, on February 3, 2010, a mistrial was granted due to the inability to seat a jury. Trial has been continued until June 1, 2010. For a detailed description of the case, see *West Virginia IPIC* below.

In *Gray v. R. J. Reynolds Tobacco Co.,* on February 5, 2010 a jury returned a verdict in favor of the plaintiff, Carolyn Gray. The jury found the decedent, Charles Gray, to be 40% at fault, RJR Tobacco to be 60% at fault and awarded $7 million in compensatory damages and $2 million in punitive damages. For a detailed description of the case, see *Engle* Progeny Cases below.

The following chart reflects the verdicts in the smoking and health cases that have been tried and remain pending as of January 29, 2010, in which verdicts have been returned in favor of the plaintiffs and against RJR Tobacco or B&W, or both.

Date of Verdict	Case Name/Type	Jurisdiction	Verdict	Cross-Reference to Post-Trial Status
June 11, 2002	*Lukacs v. R. J. Reynolds Tobacco Co.* [*Engle* Progeny]	Circuit Court, Miami-Dade County (Miami, FL)	$500,000 economic damages, $24.5 million non-economic damages and $12.5 million loss of consortium damages against Philip Morris, B&W and Liggett, of which B&W was assigned 22.5% of liability. Final judgment was entered in the amount of $24.8 million plus interest applicable at the yearly statutory rates from July 11, 2002. RJR Tobacco was dismissed from the case in May 2002, prior to trial.	See *Engle* Progeny Cases below.
December 18, 2003	*Frankson v. Brown & Williamson Tobacco Corp.* [Individual]	Supreme Court, Kings County (Brooklyn, NY)	$350,000 compensatory damages; 50% fault assigned to B&W and two industry	See Individual Smoking and Health Cases below.

			organizations; $20 million in punitive damages, of which $6 million was assigned to B&W, $2 million to a predecessor company and $12 million to two industry organizations.	
May 21, 2004	*Scott v. American Tobacco Co.* [Class Action]	District Court, Orleans Parish (New Orleans, LA)	$591 million against RJR Tobacco, B&W, Philip Morris, Lorillard, and the Tobacco Institute, jointly and severally, for a smoking cessation program.	See Class-Action Suits - Medical Monitoring and Smoking Cessation Case below.
February 2, 2005	*Smith v. Brown & Williamson Tobacco Corp.* [Individual]	Circuit Court, Jackson County (Independence, MO)	$2 million in compensatory damages, which was reduced to $500,000 because of jury s findings that the plaintiff was 75% at fault; $20 million in punitive damages.	See Individual Smoking and Health Cases below.

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Date of Verdict	Case Name/Type	Jurisdiction	Verdict	Cross-Reference to Post-Trial Status
August 17, 2006	*United States v. Philip Morris USA, Inc.* [Governmental Health-Care Cost Recovery]	U.S. District Court, District of Columbia (Washington, DC)	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.	See Health-Care Cost Recovery Cases - Department of Justice Case below.
May 2, 2007	*Whiteley v. R. J. Reynolds Tobacco Co.* [Individual]	Superior Court, San Francisco County, (San Francisco, CA)	$2.46 million in compensatory damages jointly against RJR Tobacco and Philip Morris; $250,000 punitive damages against RJR Tobacco only.	See Individual Smoking and Health Cases below.
May 5, 2009	*Sherman v. R. J. Reynolds Tobacco Co.* [*Engle* Progeny]	Circuit Court, Broward County, (Ft. Lauderdale, FL)	$1.5 million in actual damages; 50% of fault assigned to RJR Tobacco, which reduced the award to $775,000. No punitive damages awarded.	See *Engle* Progeny Cases below.
May 20, 2009	*Brown v. R. J. Reynolds Tobacco Co.* [*Engle* Progeny]	Circuit Court, Broward County, (Ft. Lauderdale, FL)	$1.2 million in actual damages; 50% of fault assigned to RJR Tobacco, which	See *Engle* Progeny Cases below.

			reduced the award to $600,000. No punitive damages awarded.	
May 29, 2009	*Martin v. R. J. Reynolds Tobacco Co.* [*Engle* Progeny]	Circuit Court, Escambia County, (Pensacola, FL)	$5 million in actual damages; 66% of fault assigned to RJR Tobacco, which reduced the award to $3.3 million; $25 million in punitive damages.	See *Engle* Progeny Cases below.
August 19, 2009	*Campbell v. R. J. Reynolds Tobacco Co.* [*Engle* Progeny]	Circuit Court, Escambia County, (Pensacola, FL)	$7.8 million in compensatory damages; 39% of fault assigned to RJR Tobacco, which reduced the award to $3.04 million.	See *Engle* Progeny Cases below.
February 8, 2010	*Gray v. R. J. Reynolds Tobacco Co.* [*Engle* Progeny]	Circuit Court, Escambia County, (Pensacola, FL)	$7 million in compensatory damages; 60% of fault assigned to RJR Tobacco which reduced the award to $4.2 million; $2 million in punitive damages.	See *Engle* Progeny cases below.

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Individual Smoking and Health Cases

As of January 29, 2010, 106 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 103 of the individual cases are brought by or on behalf of individual smokers or their survivors, while the remaining three cases are brought by or on behalf of individuals or their survivors alleging personal injury as a result of exposure to 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, 2009 to December 31, 2009, or remained on appeal as of December 31, 2009.

In Williams v. Brown & Williamson Tobacco Corp., jury selection began on November 30, 2009. The plaintiff alleges that his use of the defendants tobacco products caused him to develop peripheral vascular disease. The plaintiff seeks in excess of $25,000 in actual damages and an unspecified amount of punitive damages. On December 2, 2009, the court declared a mistrial due to an insufficiency in the remaining number of jury panelists. The court further ordered the parties to notify the court by February 26, 2010, of an agreed upon trial date.

In Whiteley v. R. J. Reynolds Tobacco Co., the retrial of *Whiteley v. Raybestos-Manhattan,* a case filed in April 1999 in Superior Court, San Francisco County, California and originally tried in 2000, the jury awarded the plaintiff $2.46 million in compensatory damages jointly against RJR Tobacco and Philip Morris, in May 2007, and returned a punitive damages verdict award of $250,000 against RJR Tobacco. RJR Tobacco s motion for judgment notwithstanding the verdict or, in the alternative, for a new trial was denied on September 5, 2007. RJR Tobacco appealed. RJR Tobacco deposited with the court approximately $2.6 million in U.S. Treasury bills in lieu of a supersedeas bond to stay enforcement of the judgment pending appeal. On October 14, 2009, the California Court of Appeal affirmed the final judgment against RJR Tobacco. The defendants petition for rehearing was denied on November 4, 2009. On January 13, 2010, the California Supreme Court denied the defendants petition for review. RJR Tobacco paid approximately $2.2 million on February 5, 2010.

On August 15, 2003, a jury returned a verdict in favor of B&W in *Eiser v. Brown & Williamson Tobacco Corp.*, a case filed in March 1999 in the Court of Common Pleas, Philadelphia County, Pennsylvania. The plaintiff, Lois Eiser, sought compensatory and punitive damages in an amount in excess of $50,000, together with interest, costs and attorneys fees in this wrongful death action against B&W. On January 19, 2006, the Superior Court of Pennsylvania affirmed the verdict. On September 22, 2006, the Pennsylvania Supreme Court granted the plaintiff s petition to appeal, and on December 28, 2007, remanded the case to the Superior Court for further review of certain issues. Briefing to the Superior Court is complete. A decision is pending.

On December 18, 2003, in *Frankson v. Brown & Williamson Tobacco Corp.,* a case filed in August 2000 in Supreme Court, Kings County, New York, a jury awarded $350,000 in compensatory damages against B&W and two former tobacco industry organizations, the Tobacco Institute and the Council for Tobacco Research, in an action brought against the major U.S. cigarette manufacturers, including RJR Tobacco, who was dismissed prior to trial, and B&W, seeking $270 million in compensatory damages, unspecified punitive damages, attorneys fees, costs and disbursements. Other manufacturers were dismissed before trial. The plaintiff, Gladys Frankson, alleged that Mr. Frankson became addicted to nicotine, was unable to cease 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 8, 2004, the jury awarded $20 million in punitive damages, assigning $6 million to B&W, $2 million to American Tobacco, a predecessor company to B&W, and $6 million to each of the Council for Tobacco Research and the Tobacco Institute. On June 22, 2004, the trial judge granted a new trial unless the parties consented to an increase in compensatory damages to $500,000 and a decrease in punitive damages to $5 million, of which $4 million would be assigned to B&W. On January 21, 2005, the plaintiff stipulated to the reduction in punitive damages.

Judgment was entered in favor of the plaintiffs for $175,000 in compensatory damages, the original jury award reduced by 50%, and $5 million in punitive damages, the amount to which the plaintiff stipulated. On June 26, 2007,

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final judgment was entered against the defendants in the amount of approximately $6.8 million, including interest and costs. The defendants filed a notice of appeal to the Appellate Division, New York Supreme Court, Second Department on July 3, 2007. Pursuant to its agreement to indemnify B&W, RJR Tobacco posted a supersedeas bond in the amount of $8.018 million on July 5, 2007. On September 29, 2009, the New York Supreme Court, Appellate Division, affirmed the compensatory damages award, set aside the punitive damages verdict and remanded the case to the Kings County Supreme Court for a new trial on punitive damages. No trial date has yet been set.

On February 1, 2005, a 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 plaintiff, Lincoln Smith, claimed that the defendant s tobacco products caused Mrs. Smith s death from lung cancer and sought an unspecified amount of compensatory and punitive damages. 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. B&W appealed to the Missouri Court of Appeals and on July 31, 2007, the court affirmed the compensatory damages and ordered a new trial on punitive damages. On December 16, 2008, the Missouri Court of Appeals issued an opinion that affirmed in part, reversed in part, and remanded the case for further proceedings on the issue of punitive damages. Trial on the issue of punitive damages began July 27, 2009. 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. On August 11, 2009, the jury returned a verdict for the plaintiffs finding B&W liable for damages for aggravating circumstances, and on August 20, 2009, returned a verdict for the plaintiffs and awarded the plaintiffs $1.5 million in punitive damages. On December 21, 2009, the court denied the plaintiffs and the defendant s post-trial motions. B&W filed a notice of appeal on December 30, 2009. The plaintiffs filed a notice of appeal on December 31, 2009.

West Virginia IPIC

In West Virginia, as of January 29, 2010, there were 712 cases (of which 672 are actions against RJR Tobacco and/or B&W) pending as a consolidated action, *In re: Tobacco Litigation Individual Personal Injury Cases.* These cases are proposed to be tried in Kanawha County Circuit Court in a single proceeding. The West Virginia Supreme Court of Appeals ruled that the U.S. Constitution does not preclude a trial in multiple phases in this case, and the U.S. Supreme Court declined to review the issue. The current trial plan provides for a three-phase proceeding, with certain elements of liability and entitlement to punitive damages being tried in Phase I. Phase II would address the ratio between any compensatory and punitive damages awarded. Phase III would address all remaining individual issues including medical and legal causation and compensatory damages. Trial began on February 1, 2010. On February 3, 2010, a mistrial was granted due to the inability to seat a jury. Trial has been continued until June 1, 2010.

Engle Progeny Cases

Pursuant to the Florida Supreme Court s July 6, 2006, ruling in *Engle v. R. J. Reynolds Tobacco Co.,* which decertified the class, former class members 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 claim they meet the conditions in *Engle,* also are attempting 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 January 29, 2010, RJR Tobacco had been served in 7,711 *Engle* Progeny Cases in both state and federal courts in Florida. These cases include approximately 9,246 plaintiffs. The number of cases will likely change due to individual plaintiffs being severed from multi-plaintiff cases. Many of these cases are in active discovery, and several are expected to be tried in 2010. For further information on the *Engle* case, see Class-Action Suits *Engle* Case, below.

Prior to the Florida Supreme Court ruling on July 6, 2006, RJR Tobacco and/or B&W were named as a defendant(s) in several individual cases filed by members of the *Engle* class. One such case, *Lukacs v. Philip Morris,*

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Inc., was filed in February 2001, and is pending in Circuit Court, Miami-Dade County, Florida, against the major U.S. cigarette manufacturers seeking to recover an unspecified amount in compensatory and punitive damages. The plaintiff, John Lukacs, alleged that his use of the defendants brands caused his development of bladder, throat, oral cavity and tongue cancer. RJR Tobacco was voluntarily dismissed on May 1, 2002. The case was tried against Philip Morris, Liggett and B&W, and resulted in a verdict for the plaintiffs on June 11, 2002. The Florida state court jury awarded the plaintiffs a total of $37.5 million in compensatory damages. The jury assigned 22.5% fault to B&W, 72.5% fault to the other defendants and 5% fault to plaintiff John Lukacs. On April 1, 2003, the Miami-Dade County Circuit Court granted in part the defendants motion for remittitur and reduced the jury s award to plaintiff Yolanda Lukacs on the loss of consortium claim from $12.5 million to $0.125 million, decreasing the total award to $25.125 million. On August 2, 2006, the plaintiff filed a motion for entry of partial judgment and notice of jury trial on punitive damages. On January 2, 2007, the defendants asked the court to set aside the jury s verdict for the plaintiff and to dismiss the plaintiff s punitive damages claim. On January 3, 2007, the plaintiff filed a motion for entry of judgment, which the court deferred until the U.S. Supreme Court completed its review of *Engle* and after further submissions by the parties. The court granted the plaintiff s motion for entry of judgment on August 14, 2008 awarding the plaintiff, Robin Lukacs, as personal representative of the estate of John and Yolanda Lukacs, the sum of $24.8 million plus interest applicable at the yearly statutory rates from June 11, 2002. On October 17, 2008, the plaintiff withdrew her request for punitive damages. On November 12, 2008, the court entered final judgment. On December 1, 2008, the defendants filed a notice of appeal. Pursuant to its agreement to indemnify B&W, RJR Tobacco posted a supersedeas bond in the amount of approximately $15.2 million on March 19, 2009. Oral argument is scheduled for March 1, 2010.

On May 5, 2009, a jury returned a verdict in favor of the plaintiff in *Sherman v. R. J. Reynolds Tobacco Co.,* a case filed in September 2007 in the Circuit Court, Broward County, Florida. The plaintiff, Melba Sherman, alleged that as a result of using the defendants products, the decedent, John Sherman, developed lung cancer and died. The plaintiff sought actual damages and an unspecified amount of punitive damages. On May 8, 2009, the jury awarded actual damages of $1.5 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 on June 8, 2009, which represents 50% of the actual damages award. In June 2009, RJR Tobacco filed a notice of appeal to the Fourth District Court of Appeal, and posted a supersedeas bond in the amount of approximately $900,000. On July 1, 2009, the plaintiff filed a notice of cross appeal of the final judgment. Briefing is underway.

On May 20, 2009, a jury returned a verdict in favor of the plaintiff in *Brown v. R. J. Reynolds Tobacco Co.,* a case filed in March 2007, in the Circuit Court, Broward County, Florida. The plaintiff alleged that the decedent, Roger Brown, developed smoking related diseases, which resulted in his death. The plaintiff sought actual damages and an unspecified amount of punitive damages. On May 22, 2009, the jury returned a verdict that the decedent was 50% at fault for his injuries and awarded actual damages of $1.2 million. No punitive damages were awarded. RJR Tobacco s post-trial motions were denied on June 12, 2009. The same day, the court entered final judgment in the amount of $600,000, which represents 50% of the actual damages award. On July 2, 2009, RJR Tobacco filed a notice of appeal to the Fourth District Court of Appeal and posted a supersedeas bond in the amount of approximately $700,000. Briefing is underway.

On May 29, 2009, in *Martin v. R. J. Reynolds Tobacco Co.,* a case filed in October 2007 in the Circuit Court, Escambia County, Florida, a jury returned a verdict in favor of the plaintiff, found RJR Tobacco to be 66% at fault for the decedent s injuries, and awarded $5 million in actual damages. The plaintiff alleged that as a result of Benny Martin s use of the defendant s tobacco products, he developed lung cancer and other medical conditions and died. The plaintiff, Mathilda Martin, sought an unspecified amount of actual and punitive damages. On June 1, 2009, the jury returned a punitive damages award of $25 million. The trial court denied RJR Tobacco s various post-trial motions, including a motion for a new trial based on defects in the punitive damages phase, and alternatively, for remittitur of the punitive damages award. The court entered final judgment on September 13, 2009, awarding the plaintiff the sum of $3.3 million in compensatory damages and $25 million in punitive damages. RJR Tobacco filed a notice of appeal to the First District Court of Appeal on September 18, 2009. On October 6, 2009, RJR Tobacco

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posted a supersedeas bond in the amount of approximately $5 million. On October 8, 2009, the plaintiff filed a notice of cross-appeal of the final judgment. Briefing is underway.

In *Kaplan v. R. J. Reynolds Tobacco Co.,* a case filed in October 2007 in the Circuit Court, Broward County, Florida, jury prequalification began on May 27, 2009. The plaintiff alleged that as a result of her addiction to the defendants cigarettes, she suffers from chronic obstructive pulmonary disease and other alleged smoking-related medical conditions and diseases. The plaintiff is seeking an unspecified amount of actual and punitive damages. On June 1, 2009, the judge declared a mistrial. The trial has not yet been rescheduled.

On August 19, 2009, in *Campbell 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, Betty Campbell, to be 57% at fault, RJR Tobacco to be 39% at fault, and PM USA and Liggett Group each to be 2% at fault for the decedent s injuries, and awarded $7.8 million in compensatory damages. No punitive damages were awarded. The plaintiff alleged that as a result of Mrs. Campbell s addiction to cigarettes, she suffered and died from various smoking related diseases, including chronic obstructive pulmonary disease. On September 13, 2009, the court entered final judgment against RJR Tobacco in the amount of $3.04 million. The defendants have filed various post-trial motions and are awaiting a decision. RJR Tobacco filed a notice of appeal on January 14, 2010. On January 19, 2010, RJR Tobacco posted a supersedeas bond in the amount of approximately $3 million.

On February 5, 2010, in *Gray v. R. J. Reynolds Tobacco Co*., a case filed in November 2007 in the Circuit Court, Escambia County, Florida, a jury returned a verdict in favor of the plaintiff, Carolyn Gray. The jury found the decedent, Charles Gray, to be 40% at fault, RJR Tobacco to be 60% at fault for Mr. Gray s injuries and awarded $7 million in compensatory damages. On February 8, 2010, the jury awarded $2 million in punitive damages. Mrs. Gray alleged that as a result of her husband s addiction and use of RJR Tobacco s products, he died from lung cancer. Mrs. Gray sought an unspecified amount of actual and punitive damages.

Broin II Cases

As of January 29, 2010, there were 2,595 lawsuits pending in Florida brought by individual flight attendants for personal injury as a result of illness allegedly caused by exposure to ETS in airplane cabins, referred to as the *Broin II* cases. In these lawsuits, filed pursuant to the terms of the settlement of the *Broin v. Philip Morris, Inc.* class action, discussed below under Class-Action Suits, each individual flight attendant will be required to prove that he or she has a disease and that the individual s exposure to ETS in airplane cabins caused the disease. Punitive damages are not available in these cases.

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 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.

Class-Action Suits

Overview. As of January 29, 2010, 17 class-action cases, exclusive of antitrust class actions, were pending in the United States against RJR Tobacco or its affiliates or indemnitees. In May 1996, in *Castano v. American Tobacco Co.*, the Fifth Circuit Court of Appeals 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, Minnesota, Missouri, West Virginia, Georgia, New Mexico and Arizona. All pending class-action cases are discussed below.

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The pending class-actions against RJR Tobacco or its affiliates or indemnitees include nine 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, Minnesota, Missouri, New Mexico and Arizona 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.*, discussed below under Lights Cases*,* both of which were filed in the U.S. District Court for the Eastern District of New York and ultimately decertified.

Medical Monitoring and Smoking Cessation Case. On November 5, 1998, in *Scott v. American Tobacco Co.,* a case filed in May 1996 in District Court, Orleans Parish, Louisiana, the trial court certified a medical monitoring or smoking cessation class of Louisiana residents who were smokers on or before May 24, 1996, in an action brought against the major U.S. cigarette manufacturers, including RJR Tobacco and B&W, seeking to recover an unspecified amount of compensatory and punitive damages. On July 28, 2003, the jury returned a verdict in favor of the defendants on the plaintiffs claim for medical monitoring and found that cigarettes were not defectively designed. However, the jury also made certain findings against the defendants on claims relating to fraud, conspiracy, marketing to minors and smoking cessation. Notwithstanding these findings, this portion of the trial did not determine liability as to any class member or class representative. What primarily remained in the case was a class-wide claim that the defendants pay for a program to help people stop smoking.

On May 21, 2004, the jury returned a verdict in the amount of $591 million on the class s claim for a smoking cessation program. On September 29, 2004, the defendants posted a $50 million bond, pursuant to legislation that limits the amount of the bond to $50 million collectively for MSA signatories, and noticed their appeal. RJR Tobacco posted $25 million (the portions for RJR Tobacco and B&W) towards the bond. On February 7, 2007, the Louisiana Court of Appeals upheld the class certification and found the defendants responsible for funding smoking cessation for eligible class members. The appellate court also ruled, however, that the defendants were not liable for any post-1988 claims, rejected the award of prejudgment interest and struck eight of the 12 components of the smoking cessation program. In particular, the appellate court ruled that no class member, who began smoking after September 1, 1988, could receive any relief, and that only those smokers, whose claims accrued on or before September 1, 1988, would be eligible for the smoking cessation program. The plaintiffs have expressly represented to the trial court that none of their claims accrued before 1988 and that the class claims did not accrue until around 1996, when the case was filed. On March 2, 2007, the defendants application for rehearing and clarification was denied. The defendants application for writ of certiorari with the Louisiana Supreme Court was denied on January 7, 2008. The defendants petition for writ of certiorari with the U.S. Supreme Court was denied on June 10, 2008. On July 21, 2008, the trial court entered an amended judgment in the case. The court found that the defendants are jointly and severally liable for funding the cost of a court-supervised smoking cessation program and ordered the defendants to deposit approximately $263 million together with interest from June 30, 2004, into a trust for the funding of the program. The court also stated that it would favorably consider a motion to return to defendants a portion of unused funds at the close of each program year in the event the monies allocated for the preceding program year were not fully expended because of a reduction in class size or underutilization by the remaining plaintiffs.

On December 15, 2008, the trial court judge signed an order granting the defendants an appeal from the amended judgment. Oral argument in the Louisiana Court of Appeals occurred on September 1, 2009. A decision is pending.

Jackson v. R. J. Reynolds Tobacco Co., filed in May 2009, in the U.S. District Court for the Northern District of Georgia, is another purported RICO class action on behalf of Georgia smokers claiming that the major U.S. cigarette

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manufacturers, including RJR Tobacco, influenced the National Cancer Institute not to recommend CT scans as a routine lung cancer screening test for smokers. The plaintiffs seek a variety of damages, including alleged contemplated damages under RICO, punitive damages, attorney s fees, interest and costs. On July 13, 2009, the defendants filed a motion to stay the case and, in the alternative, motion to dismiss. The defendants also have filed a motion to dismiss for failure to state a claim.

Engle Case. 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, alleges 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. On July 7, 1999, the jury found against RJR Tobacco, B&W and the other cigarette-manufacturer defendants in the initial phase, which included common issues related to certain elements of liability, general causation and a potential award of, or entitlement to, punitive damages.

The second phase of the trial, which consisted of the claims of three of the named class representatives, began on November 1, 1999. On April 7, 2000, the jury returned a verdict against all the defendants. It awarded plaintiff Mary Farnan $2.85 million, the estate of plaintiff Angie Della Vecchia $4.023 million and plaintiff Frank Amodeo $5.831 million.

The trial court also ordered the jury in the second phase of the trial to determine punitive damages, if any, on a class-wide basis. On July 14, 2000, 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.

On November 6, 2000, the trial judge denied all post-trial motions and entered judgment. In November 2000, RJR Tobacco and B&W posted appeal bonds in the amount of $100 million each and initiated the appeals process. On May 21, 2003, Florida s Third District Court of Appeal 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 on May 12, 2004.

On July 6, 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 class is 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. In addition, the court reinstated the compensatory damages awards of $2.85 million to Mary Farnan and $4.023 million to Angie Della Vecchia, but ruled that the claims of Frank Amodeo were barred by the statute of limitations. Finally, the court reversed the Third District Court of Appeal s 2003 ruling that class counsel s improper statements during trial required reversal.

On August 7, 2006, RJR Tobacco and the other defendants filed a rehearing motion arguing, among other things, that the findings from the *Engle* trial are not sufficiently specific to serve as the basis for further proceedings and that the Florida Supreme Court s decision denied the defendants due process. On the same day, the plaintiffs also filed a rehearing motion arguing that some smokers who became sick after November 21, 1996, and who are 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. On December 21, 2006, the Florida Supreme Court withdrew its July 6, 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 class was limited to those individuals who developed alleged smoking-related illnesses that manifested themselves on or before November 21, 1996. The court issued its mandate on January 11, 2007, which began the one-year period for

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

former class members to file individual lawsuits. As of January 29, 2010, 7,711 individual cases were filed in Florida as a result of the *Engle* decision. These cases include approximately 9,246 plaintiffs. For further information on the individual cases, see *Engle* Progeny Cases above.

In the second quarter of 2007, RJR Tobacco s motions for discharge of RJR Tobacco s and B&W s civil supersedeas bonds related to the punitive damages award were granted, and RJR Tobacco received the full amount of the $100 million cash collateral that it had posted. 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. As a result, the verdicts in favor of Mary Farnan and Angie Della Vecchia, mentioned above, became final. On February 8, 2008, RJR Tobacco paid approximately $5.9 million relating to the compensatory damages verdicts mentioned above. In May 2008, the court granted the parties joint motion to sever moving plaintiffs claims. Plaintiffs Raymond Lacey, Michael Matyi and Loren Lowery have filed new cases. Plaintiff Howard Engle filed a stipulation for dismissal with prejudice, which the court ordered on July 2, 2008. On January 7, 2009, plaintiff Marilyn Calhoun s motion for relief from judgment, which sought to extend the deadline for filing *Engle* Progeny Cases beyond January 11, 2008, was denied by the Florida Supreme Court.

Since the Florida Supreme Court s July 6, 2006 opinion, six *Engle* Progeny Cases have proceeded to trial against RJR Tobacco or B&W. RJR Tobacco expects that other *Engle* Progeny Cases will proceed to trial against RJR Tobacco and/or B&W in 2010. For further information on *Engle* Progeny Cases, see *Engle* Progeny Cases above.

California Business and Professions Code Cases. On April 11, 2001, in *Brown v. American Tobacco Co., Inc.,* a case filed in June 1997 in Superior Court, San Diego County, California, the court granted in part the plaintiffs motion for certification of a class composed of residents of California who smoked at least one of the defendants cigarettes from June 10, 1993 through April 23, 2001, and who were exposed to the defendants marketing and advertising activities in California. The action was brought against the major U.S. cigarette manufacturers, including RJR Tobacco and B&W, seeking to recover restitution, disgorgement of profits and other equitable relief under California Business and Professions Code § 17200 et seq. and § 17500 et seq. Certification was granted as to the plaintiffs claims that the defendants violated § 17200 of the California Business and Professions Code pertaining to unfair competition. The court, however, refused to certify the class under the California Legal Remedies Act and on the plaintiffs common law claims. On March 7, 2005, the court granted the defendants motion to decertify the class. On September 5, 2006, the California Court of Appeal affirmed the judge s order decertifying the class. On November 1, 2006, the plaintiffs petition for review with the California Supreme Court was granted. On May 18, 2009, the California Supreme Court issued an opinion reversing the decision issued by the trial court and affirmed by the California Court of Appeal that decertified the class to the extent that it was based upon the conclusion that all class members were required to demonstrate Proposition 64 standing, and remanded the case to the trial court for further proceedings regarding whether the class representatives have, or can demonstrate, standing. The defendants petition for rehearing was denied on August 12, 2009. The case was remanded to the trial court for further proceedings.

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. On January 21, 2010, the defendants filed a motion to dismiss.

Lights Cases. As noted above, lights class-action cases are pending against RJR Tobacco or B&W in Illinois (3), Missouri (2), Minnesota (2), New Mexico (1) and Arizona (1). 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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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.

Many of these lights cases were stayed pending review of the *Good v. Altria Group, Inc.* case by the U.S. Supreme Court. On December 15, 2008, 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, 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 to the State of Illinois. 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. In December 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. In December 2006, the defendants motion to dismiss and for entry of final judgment was granted, and the case was dismissed with prejudice the same day. The plaintiffs motion to vacate and/or withhold judgment was dismissed by the court on August 30, 2007. On December 18, 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 on February 4, 2009. On March 3, 2009, the plaintiffs filed a notice of appeal to the Illinois Appellate Court, Fifth Judicial District, requesting a reversal of the February 4, 2009 order and remand to the circuit court. Briefing is complete. A decision is pending.

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 on November 14, 2001. On June 6, 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 on July 11, 2003. On October 17, 2003, the Illinois Fifth District Court of Appeals denied RJR Tobacco s emergency stay/supremacy order request. On November 5, 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 denial of its emergency stay/supremacy order request and remanded the case to the circuit court. There is currently no activity in the case.

In *Howard v. Brown & Williamson Tobacco Corp.,* another case filed in February 2000 in Circuit Court, Madison County, Illinois, a judge certified a class on December 18, 2001. On June 6, 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 on August 19, 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 on December 31, 2003. On April 9, 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. On April 16, 2008, the court stayed the case pending U.S. Supreme Court review in *Good v. Altria Group, Inc.*, a lights class-action pending against Altria and Philip Morris USA. As a result of the U.S. Supreme Court s decision in *Good v. Altria Group, Inc.*, this case is likely to become active in 2010.

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 on September 23, 2005. On October 25, 2005, the plaintiffs filed a motion to remand, which was granted on March 17, 2006. On April 16, 2008, the court stayed the case pending U.S. Supreme Court review in *Good v. Altria Group, Inc.* As a result of the U.S. Supreme Court s decision in *Good v. Altria Group, Inc*., this case is likely to become active in 2010.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In *Dahl v. R. J. Reynolds Tobacco Co.,* a case filed in April 2003, and pending in District Court, Hennepin County, Minnesota, a judge dismissed the case on May 11, 2005, ruling the lights claims are preempted by the Federal Cigarette Labeling and Advertising Act. On July 11, 2005, the plaintiffs appealed to the Minnesota Court of Appeals for the Fourth Judicial District. During the pendency of the appeal, RJR Tobacco removed the case to the U.S. District Court for the District of Minnesota. On February 28, 2007, the Eighth Circuit remanded the case to the Minnesota Court of Appeals, which on December 4, 2007, reversed the judgment and remanded the case to the District Court. On February 27, 2008, RJR Tobacco s motion to stay its January 3, 2008, petition for review until the completion of the U.S. Supreme Court review in *Good v. Altria Group, Inc.* was granted. On January 20, 2009, the Minnesota Supreme Court issued an order vacating the February 27, 2008, order that granted RJR Tobacco s petition for review. On July 22, 2009, the plaintiffs in this case and in *Thompson v. R. J. Reynolds Tobacco Co.,* discussed below, filed a motion to consolidate for discovery and trial. On October 7, 2009, the court companioned the two cases and reserved its ruling on the motion to consolidate, which it said will be reevaluated as discovery progresses.

In *Thompson v. R. J. Reynolds Tobacco Co.,* a case filed in February 2005 in District Court, Hennepin County, Minnesota, RJR Tobacco removed the case on September 23, 2005, to the U.S. District Court for the District of Minnesota. On August 7, 2006, the parties filed a stipulation to stay the case pending resolution of the appeal in *Dahl v. R. J. Reynolds Tobacco Co.* On October 29, 2007, the U.S. District Court remanded the case to the District Court for Hennepin County. On February 1, 2008, the court stayed the case until the completion of the appeal in *Dahl v. R. J. Reynolds Tobacco Co.* and *Good v. Altria Group, Inc*., and that stay has now been lifted. In May 2009, the court entered an agreed scheduling order that bifurcates merits and class certification discovery, and the parties are engaged in class certification discovery. This case is likely to remain active through 2010. On July 22, 2009, the plaintiffs in this case and in *Dahl v. R. J. Reynolds Tobacco Co*. filed a motion to consolidate for discovery and trial. On October 7, 2009, the court companioned the two cases and reserved its ruling on the motion to consolidate, which it said will be reevaluated as discovery progresses.

In *Cleary v. Philip Morris, Inc.,* a case filed in June 1998, and pending in Circuit Court, Cook County, Illinois, the plaintiffs filed their motion for class certification on December 21, 2001, in an action brought against the major U.S. cigarette manufacturers, including RJR Tobacco and B&W. The case was brought on behalf of persons who have allegedly been injured by (1) the defendants purported conspiracy pursuant to which defendants concealed material facts regarding the addictive nature of nicotine, (2) the defendants alleged acts of targeting its advertising and marketing to minors, and (3) the defendants claimed breach of the public right to defendants compliance with the laws prohibiting the distribution of cigarettes to minors. The plaintiffs requested that the defendants be required to disgorge all profits unjustly received through its sale of cigarettes to plaintiffs and the class, which in no event will be greater than $75,000 per each class member, inclusive of punitive damages, interest and costs. On March 27, 2006, the court dismissed count V, public nuisance, and count VI, unjust enrichment. The plaintiffs filed an amended complaint on March 3, 2009, to add a claim of unjust enrichment and to include in the class individuals who smoked light cigarettes. RJR Tobacco and B&W answered the amended complaint on March 31, 2009. On July 5, 2009, the plaintiffs filed an additional motion for class certification. On September 8, 2009, the court granted the defendants motion for summary judgment on the pleadings concerning the lights claims as to all defendants other than Philip Morris. On October 30, 2009, certain defendants filed a motion for summary judgment on plaintiffs youth-marketing claims. Briefing is complete.

In *VanDyke v. R. J. Reynolds Tobacco Co*., a case filed in August 2009 in the U.S. District Court for the District of New Mexico, the plaintiffs brought the case on behalf of all New Mexico residents who from July 1, 2004, to the date of judgment, purchased, not for resale, the defendants cigarettes labeled as lights or ultra lights. The plaintiffs allege fraudulent misrepresentation, breach of express warranty, breach of implied warranties of merchantability and of fitness for a particular purpose, violations of the New Mexico Unfair Practices Act, unjust enrichment, negligence and gross negligence. The plaintiffs seek a variety of damages, including actual, compensatory and consequential damages to the plaintiff and the class but not damages for personal injury or health-care claims.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In *Shaffer v. R. J. Reynolds Tobacco Co.,* a case filed in October 2009 in the U.S. District Court for the District of Arizona, the plaintiffs brought the case on behalf of all persons residing in Arizona who purchased, not for resale, defendants cigarettes labeled as light or ultra-light from the date of the defendants first sales of such cigarettes in Arizona to the date of judgment. The plaintiffs allege consumer fraud, concealment, nondisclosure, negligent misrepresentation and unjust enrichment. The plaintiffs seek a variety of damages, including compensatory, restitutionary and punitive damages.

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. 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. On October 13, 2004, the trial court stayed this case pending the outcome of the appeal in *Scott v. American Tobacco Co., Inc*., discussed above under Medical Monitoring and Smoking Cessation Cases.

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. The case has been stayed pending a final resolution of the plaintiffs motion to refer tobacco litigation to the judicial panel on multi-district litigation filed in *In Re: Tobacco Litigation* in the Supreme Court of Appeals of West Virginia. On December 26, 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 on February 16, 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, on behalf of 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 on February 17, 1999. There has been limited activity in this case.

Broin Settlement. 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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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, discussed above, arose out of the settlement of 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 January 29, 2010, four 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.

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 Mississippi, Florida, Texas and Minnesota by separate agreements with each such state.

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.

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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 2007 and beyond:

Unadjusted Original Participating Manufacturers Settlement Payment Schedule

	2007	2008	2009	2010	2011	2012	2013 and thereafter
First Four States Settlements:(1)							
Mississippi Annual Payment	$ 136	$ 136	$ 136	$ 136	$ 136	$ 136	$ 136
Florida Annual Payment	440	440	440	440	440	440	440
Texas Annual Payment	580	580	580	580	580	580	580
Minnesota Annual Payment	204	204	204	204	204	204	204
Remaining States Settlement:							
Annual Payments(1)	7,004	8,004	8,004	8,004	8,004	8,004	8,004
Base Foundation Funding	25	25					
Growers Trust(2)	500	500	295	295			
Offset by federal tobacco buyout(2)	(500)	(500)	(295)	(295)			
Total	$ 8,389	$ 9,389	$ 9,364	$ 9,364	$ 9,364	$ 9,364	$ 9,364

RAI s Operating Subsidiaries Settlement Expenses and Payment Schedule

	2007	2008	2009	2010	2011	2012	2013 and thereafter
Settlement expenses	$ 2,821	$ 2,703	$ 2,540				
Settlement cash payments	$ 2,616	$ 2,830	$ 2,249				
Projected settlement expenses				$ >2,700	$ >2,700	$ >2,700	$ >2,700
Projected settlement cash payments				$ >2,500	$ >2,700	$ >2,700	$ >2,700

(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.

(2) The Growers Trust payments scheduled to expire in 2010 will be offset by obligations resulting from the federal tobacco buyout legislation, not included in this table, signed in October 2004. See Tobacco Buyout Legislation and Related Litigation 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.

Department of Justice Case. On September 22, 1999, 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. 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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 on June 10, 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 na 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 on September 11, 2006. The government filed its notice of appeal on October 16, 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 on October 31, 2006.

On November 28, 2006, the court of appeals stayed the appeals pending the trial court s ruling on the defendants motion for clarification. The defendants motion for clarification was granted in part and denied in part on March 16, 2007. The defendants motion as to the meaning and applicability of the general injunctive relief of the August 17, 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.

On May 22, 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 B&W s 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 subsidiaries satisfy Rule 65(d);
- 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

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.

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The defendants motion for rehearing and/or rehearing *en banc* was denied on September 22, 2009. On October 21, 2009, the defendants motion to stay issuance of the mandate pending the filing and disposition of petitions for writ of certiorari to the U.S. Supreme Court was granted. Petitions for writ of certiorari from the U.S. Supreme Court are due on February 19, 2010. In addition, the Department of Justice may include in its writ petition a request for reinstatement of its claims for remedies, including disgorgement of profits.

International Cases. 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 those foreign Provincial governments in treating their citizens. No such cases currently are pending in the United States against RJR Tobacco and its current or former affiliates or indemnitees.

Four health-care reimbursement cases are pending against RJR Tobacco, its current or former affiliates, or B&W outside the United States, three in Canada and one in Israel. 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. JTI has, subject to a reservation of rights, assumed RJR Tobacco and its current or former affiliates liability, if any, and is defending those actions.

On November 12, 1998, the government of British Columbia enacted legislation creating a civil cause of action permitting the government to recover the costs of health-care benefits incurred for insured populations of B.C. residents resulting from tobacco-related disease. The government s subsequent suit against Canadian defendants and foreign defendants, including RJR Tobacco was dismissed in February 2000, when the B.C. Supreme Court ruled that the legislation was unconstitutional and set aside service ex juris against the foreign defendants for that reason. The government then enacted a revised statute and brought a new action, filed in January 2001, and pending in Supreme Court, British Columbia. The plaintiff seeks to recover the present value of the total expenditure by the government 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 the estimated total expenditure by the government 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 plaintiff alleges that the defendants are liable under the following theories: defective product, failure to warn, sale of cigarettes to children and adolescents, strict liability, deceit and misrepresentation, and violation of trade practice and competition acts. In September 2008, the trial date of September 6, 2010, was adjourned to a target trial date in September 2011.

On March 13, 2008, a case was filed on behalf of Her Majesty the Queen in Right of the Province of New Brunswick, Canada, against certain cigarette manufacturers, including RJR Tobacco, in the Trial Division in the Court of Queen s Bench of New Brunswick. The claim is brought pursuant to New Brunswick legislation that is substantially similar to that enacted in British Columbia. The plaintiff seeks to recover the present value of total expenditures by the Province for health care benefits resulting from tobacco-related diseases or risk of tobacco-related diseases, costs or special or increased costs and present value of estimated future expenditure. The plaintiff alleges that the defendants are liable under the following theories: deceit and misrepresentation, failure to warn, promotion of cigarettes to children and adolescents, negligent design and manufacture, breaches of other common law, equitable and statutory duties and obligations action in Canada. On June 26, 2008, RJR Tobacco filed a notice of intent to defend.

On September 30, 2009, a case was filed on behalf of Her Majesty the Queen in Right of the Province of Ontario, Canada, against certain cigarette manufacturers, including RJR Tobacco, in the Ontario Superior Court of Justice. The plaintiff seeks to recover the present value of total expenditures by the Province for health care benefits resulting or expecting to result from tobacco-related diseases or risk of tobacco-related diseases, costs or special or increased costs. The plaintiff alleges that the defendants are liable under the following theories: deceit and misrepresentation, failure to warn, promotion of cigarettes to children and adolescents, negligent design and manufacture, breaches of other common law, equitable and statutory duties and obligations . RJR Tobacco has yet to enter its appearance in the case although it has indicated that it will challenge jurisdiction.

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On September 1, 1998, the General Health Services, Israel s second largest health fund, filed a statement of claim against certain cigarette manufacturers and distributors, including RJR Tobacco, RJR Nabisco and B&W, in the District Court of Jerusalem, Israel. The plaintiff seeks to recover the past and future value of the total expenditures for health-care services provided by it to certain residents of Israel resulting from tobacco-related disease, court ordered interest for past expenditures from date of filing the statement of claim, increased and/or punitive and/or exemplary damages and costs. The plaintiff alleges that the defendants are liable under the following theories: negligence, public nuisance, fraud, misleading advertisement, defective product, failure to warn, sale of cigarettes to children and adolescents, strict liability, deceit, concealment, misrepresentation and conspiracy. In 2002, the plaintiff obtained leave to serve RJR Tobacco and B&W outside the jurisdiction. On behalf of RJR Tobacco, JTI filed a motion challenging the grant of leave, which was denied. JTI appealed the decision to the Supreme Court of Israel alongside other defendant s applications for a strike out of the claim. A decision is pending.

The following four claims and requests for class certification were filed in Canada against various defendants, including RJR Tobacco, although only one, in Saskatchewan, Canada, is being taken forward at this stage. 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. JTI, has, subject to a reservation of rights, assumed RJR Tobacco s and its current or former affiliates liability, if any, and is defending those actions.

In *Adams v. Canadian Tobacco Manufacturers Council,* a case filed in July 2009 in the Court of Queen s Bench for Saskatchewan against certain cigarette manufacturers, including RJR Tobacco, 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 certain cigarette manufacturers, including RJR Tobacco, the plaintiffs brought the case on behalf of all individuals, including their estates, dependants 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 certain cigarette manufacturers, including RJR Tobacco, the plaintiffs brought the case on behalf of all individuals, including their estates, and their dependants 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 certain cigarette manufacturers, including RJR Tobacco, the plaintiffs brought the case on behalf of all individuals, including their estates, dependants 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 each of the above 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, and unjust enrichment. The plaintiffs seek compensatory and aggravated damages; punitive or exemplary damages; reimbursement of tobacco-related health-care costs paid by the government; 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.

Native American Tribe Cases. As of January 29, 2010, 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

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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.

Hospital Cases. As of January 29, 2010, one case brought by hospitals was pending against cigarette manufacturers, including RJR Tobacco and B&W: *City of St. Louis v. American Tobacco Co., Inc.*, filed in November 1998, and pending in the Circuit Court of the City of St. Louis, Missouri. This case seeks recovery of uncompensated, unreimbursed health-care costs expended or to be expended by hospitals on behalf of patients who suffer, or have suffered, from illnesses allegedly resulting from the use of cigarettes. On June 28, 2005, the court granted the defendants motion for summary judgment as to claims for damages which accrued prior to November 16, 1993. The claims for damages which accrued after November 16, 1993, are still pending. The case is in discovery. Trial is scheduled for June 7, 2010. In 2009, RJR Tobacco filed a motion for summary judgment based on the plaintiffs lack of proof linking the defendants allegedly wrongful conduct with the claimed damages. On June 30, 2009, the court denied that motion, but granted leave to the plaintiffs to file additional expert reports on or before September 30, 2009. The plaintiffs filed additional expert reports on September 30, 2009, in which they named a new expert and raised new liability theories. On September 11, 2009, the defendants filed a motion for partial summary judgment on the plaintiffs claims for future damages and for fraud. On December 1, 2009, the defendants renewed their motion for summary judgment based on the plaintiffs lack of proof linking defendants allegedly wrongful conduct with the claimed damages. At the same time, the defendants filed motions for summary judgment based upon plaintiffs failure to prove unreimbursed costs and plaintiffs failure to show fact of injury or damage, as well as motions for partial summary judgment on plaintiffs marketing claims, product liability claims, restitution claims, misrepresentation/concealment claims, failure to warn claims, claims for pre-judgment interest, and motions for partial summary judgment based on release and res judicata and preemption. All of these motions are currently pending before the court. While the parties await rulings on these motions, the case remains in active discovery and now has a tentative trial date of January 10, 2011.

Other Cases. On May 20, 2008, the National Committee to Preserve Social Security and Medicare filed a case against the major U.S. cigarette manufacturers, including RJR Tobacco, in the U.S. District Court for the Eastern District of New York. The case seeks to recover twice the amount paid by Medicare for health services provided to Medicare beneficiaries to treat their diseases attributable to smoking the defendants cigarettes from May 21, 2002, to the present, for which treatment the defendants were required or responsible to make payment under the Medicare Secondary Payer Act. On July 21, 2008, the defendants filed a motion to dismiss for failure to state a claim for lack of standing. On the same day, the plaintiffs filed a motion for summary judgment as to liability under the Federal Rules of Civil Procedure 56(d)(2). On March 5, 2009, the court granted the defendants motion to dismiss and denied the plaintiffs cross-motion for summary judgment. The plaintiffs motion for reconsideration was denied on April 24, 2009. On May 20, 2009, the plaintiffs filed a notice of appeal to the Second Circuit Court of Appeals. On September 1, 2009, the defendants filed a motion for summary affirmance, or in the alternative, to dismiss the appeal for lack of subject matter jurisdiction and for stay of the briefing schedule. The stay was granted on September 3, 2009, pending determination of the motion for summary affirmance. On January 13, 2010, the Second Circuit Court of Appeals referred the motion for summary affirmance to the Merits Panel and ordered briefing on the motion.

On August 31, 2009, RJR Tobacco and Conwood joined other tobacco manufacturers and a tobacco retailer in filing a lawsuit in the U.S. District Court for the Western District of Kentucky (*Commonwealth Brands, Inc., v. United States of America),* challenging certain provisions of the Family Smoking Prevention and Tobacco Control Act of 2009, 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 Congress s decision to give the U.S. Food and Drug

Administration, referred to as the FDA, regulatory authority over tobacco products, nor does it challenge the vast majority of the provisions of the new law. On November 5, 2009, the court denied certain plaintiffs motion for preliminary injunction as to the Modified Risk Tobacco Products Provision. On December 13, 2009, the parties finished briefing their respective cross-motions for summary judgment. On January 5, 2010, the court issued its ruling, granting summary judgment for the plaintiffs so as to allow the continued use of color and

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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 Government as to all other challenged provisions. 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 Item 7.

State Settlement Agreements-Enforcement and Validity

As of January 29, 2010, there were 58 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. A decision is pending.

On April 13, 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. On April 28, 2005, B&W advised the state that it did not owe the state any money. On August 11, 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, Mississippi estimated that its damages exceeded $5.0 million. This matter is currently in the discovery phase.

On May 17, 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. Discovery in this matter is underway.

On October 28, 2008, Vibo Corporation, Inc. d/b/a General Tobacco, referred to as General, filed a complaint in the U.S. District Court for the Western District of Kentucky against RJR Tobacco and other participating manufacturers, referred to as PMs, under the MSA, and the Attorneys General of the 52 states and territories that are parties to the MSA. General sought, among other things, to enjoin enforcement of certain provisions of the MSA and an order relieving it of certain of its payment obligations under the MSA and, in the event such relief was not granted, rescission of General s 2004 agreement to join the MSA. General also moved for a preliminary injunction that, among other things, would have enjoined the states from enforcing certain of General s payment obligations under the MSA. On November 14, 2008, RJR Tobacco and the other defendants moved to dismiss General s complaint. On January 5, 2009, the court issued a memorandum opinion and order granting the defendants motions and dismissing General s lawsuit. Final judgment was entered on January 5, 2010. On January 13, 2010, General noticed its appeal of this decision.

On December 11, 2008, General filed a second complaint, for declaratory relief under the MSA in the California Superior Court for the County of San Diego against the State of California and RJR Tobacco and other PMs under the MSA. General s complaint seeks a declaration that a proposed amendment to its agreement to join the MSA, under which it would no longer have to make certain MSA payments, did not trigger the MSA s most favored nations provision or require that the settling states agree to make similar payment relief available to other PMs. RJR Tobacco filed an answer to the complaint on February 17, 2009. On March 9, 2009, RJR Tobacco and certain other PMs filed a motion for summary judgment or, in the alternative, for summary adjudication. On March 17, 2009, a group of subsequent participating manufacturers, referred to as SPMs, filed a similar motion. The SPMs motion was granted on July 20, 2009. RJR Tobacco s and certain other PMs motion for summary judgment

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was granted on July 21, 2009. On September 4, 2009, the plaintiffs filed a notice of appeal. The defendants filed a motion to dismiss the appeal on December 23, 2009. On January 14, 2010, General voluntarily dismissed its appeal in this action.

In December 2007, nine states (California, Connecticut, Illinois, Maine, Maryland, New York, Ohio, Pennsylvania and Washington) 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 ad itself were prohibited cartoons. In addition, three states (Connecticut, New York and Maryland) also claimed that a direct mail piece distributed by RJR Tobacco violated the MSA prohibition against distributing utilitarian items bearing a tobacco brand name. 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. (The issue has not been resolved definitively by the other court at this time.)

Six of these magazine advertisement cases have been ruled upon following bench trials:

In Maine, RJR Tobacco received a complete defense ruling.

In Washington, the Washington Court of Appeals recently reversed, in part, a favorable ruling in favor of RJR Tobacco at the trial court, holding that some of the images used in the RJR Tobacco advertisement were cartoons, and has remanded the case for further proceedings.

In Ohio, the court agreed that the Camel advertisement did not use any cartoons, but ruled that the company should have prevented the use of cartoons in magazine-created content next to the RJR Tobacco advertisement. RJR Tobacco appealed this decision, and the Court of Appeals reversed the trial court s ruling regarding RJR Tobacco s duty to prevent the use of cartoons in adjacent magazine-created content, thus giving RJR Tobacco a complete defense ruling.

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 Ohio or California courts.

The Pennsylvania court ruled against RJR Tobacco on both claims, agreeing with the Commonwealth that the RJR Tobacco advertisement contained unspecified cartoons and that RJR Tobacco was responsible for the cartoons included in the magazine created content, regardless of whether the company was aware of it in advance. In addition, the Pennsylvania court ordered RJR Tobacco to pay for the creation of a single page youth smoking prevention advertisement in Rolling Stone issues in Pennsylvania within a year, or pay a penalty of approximately $302,000, if it fails to do so.

In Illinois, RJR Tobacco received a complete defense ruling.

RJR Tobacco believes it has strong bases for appeal in the California, Washington and Pennsylvania cases.

Finally, in *Stewart v. R. J. Reynolds Tobacco Co.,* a class-action suit was filed in California state court in December 2007, against the magazine s publisher, Wenner Media, and RJR Tobacco, claiming the mention of bands in the magazine-created content violated their right of publicity. The plaintiffs seek compensatory and punitive damages. This case has been stayed pending interlocutory review of an order denying defendant s motion to dismiss.

NPM Adjustment. The MSA includes an adjustment, referred to as an NPM Adjustment, that potentially reduces the annual payment obligations of RJR Tobacco and the other PMs. Certain requirements, collectively

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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, on April 17, 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. On March 28, 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, on April 19, 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 a single, nationwide arbitration panel of three former federal judges. 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 January 29, 2010, 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. On August 5, 2009, the last court to address the issue, the Montana Supreme Court, revised a ruling by the Montana First Judicial District Court, and ruled that the state of Montana did not agree to arbitrate the question of whether it diligently enforced a qualifying statute. A petition for rehearing was filed by RJR Tobacco and certain other PMs on August 20, 2009. On September 10, 2009, the petition for rehearing was denied. On January 29, 2010, RJR Tobacco and certain other PMs filed a petition for writ of certiorari with the U.S. Supreme Court, seeking review of the decision of the Montana Supreme Court. The orders compelling arbitration in the remaining 47 states are now final and/or non-appealable.

As of January 30, 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. The Arbitration Agreement established October 1, 2009, as the date by which arbitration begins. 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.

Montana is one of the settling states that signed the Arbitration Agreement. Thus, notwithstanding the ruling of the Montana Supreme Court with respect to the arbitrability of the Diligent Enforcement issue, Montana is

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contractually obligated to participate with the other states in the arbitration that will address all remaining issues related to the dispute pertaining to the 2003 NPM Adjustment.

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; 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.

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 addition to the NPM Adjustment claims described above, RJR Tobacco has filed dispute notices with respect to its 2007, 2008, and 2009 annual MSA payments relating to the NPM Adjustments potentially applicable to those years. The total amount at issue for those three years is approximately $1.367 billion.

On June 30, 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 will become 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 for each year covered by that agreement, with RJR Tobacco paying approximately 47% of such amounts.

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.

Antitrust Cases

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 January 29, 2010, all of the federal and state court cases on behalf of indirect purchasers have been dismissed, except for one state court case pending in each of Kansas and in New Mexico.

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 on November 15, 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. The parties are currently engaged in discovery.

In *Romero v. Philip Morris Cos., Inc.,* a case filed in April 2000 in District Court, Rio Arriba County, New Mexico, the court granted class certification on May 14, 2003, in an action brought against the major

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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 amount not to exceed $74,000 per class member in actual and punitive damages, exclusive of interest and costs. The plaintiffs allege that the defendants conspired to fix, raise, advance and/or stabilize prices for cigarettes in the State of New Mexico from at least as early as January 1, 1998, through the present. On June 30, 2006, the court granted the defendants motion for summary judgment. On November 18, 2008, the New Mexico Court of Appeals reversed the grant of summary judgment in favor of RJR Tobacco, B&W and Philip Morris. On January 7, 2009, RJR Tobacco filed a petition for a writ of certiorari, and on February 27, 2009, the Supreme Court of the State of New Mexico granted that petition. Briefing is complete, and oral argument is scheduled for February 22, 2010.

Other Litigation and Developments

By purchase agreement dated May 12, 1999, referred to as the 1999 Purchase Agreement, RJR and RJR Tobacco sold the international tobacco business to JTI. RJR and RJR Tobacco retained certain liabilities relating to the activities of Northern Brands, including those relating to a 1998 guilty plea entered in the U.S. District Court for the Northern District of New York, as well as an investigation conducted by the Royal Canadian Mounted Police, referred to as RCMP, for possible violations of Canadian law related to the activities that led to the Northern Brands guilty plea and certain conduct by Stanley Smith, a former executive of RJR-Macdonald, Inc., referred to as RJR-MI, which led to the termination of his severance agreement. Under its reading of the indemnification provisions of the 1999 Purchase Agreement, JTI has requested indemnification for any damages arising out of the matters described below:

> In February 2003, the RCMP filed criminal charges in the Province of Ontario against, and purported to serve summonses on, JTI-Macdonald Corp., referred to as JTI-MC, Northern Brands, R. J. Reynolds Tobacco International, Inc., referred to as RJR-TI, R. J. Reynolds Tobacco Co., Puerto Rico, referred to as RJR-PR, and eight individuals associated with RJR-MI and/or RJR-TI during the period January 1, 1991, through December 31, 1996. The charges allege fraud and conspiracy to defraud Canada and the Provinces of Ontario and Quebec in connection with the purchase, sale, export, import and/or re-export of cigarettes and/or fine cut tobacco. In October 2003, Northern Brands, RJR-TI and RJR-PR each challenged both the propriety of the service of the summonses and the jurisdiction of the court. On February 9, 2004, the Superior Court of Justice ruled in favor of these companies. The government filed a notice of appeal from that ruling, and in 2007, the Court of Appeal announced a unanimous decision in favor of the companies position and dismissed the government s appeal.

A preliminary hearing commenced on April 11, 2005, for the purpose of determining whether the Canadian prosecutor had sufficient evidence supporting the criminal charges to justify a trial of the defendants that had been properly served to date. On May 30, 2007, the court announced its decision to issue an order committing two of the accused, JTI-MC and Edward Lang, to stand trial on the charges filed in February 2003 and discharging the other six accused. JTI-MC and Mr. Lang separately filed papers seeking an order quashing the order committing them to stand trial, and the government filed papers seeking an order quashing the order discharging six of the accused. On December 19, 2007, JTI-MC abandoned its effort to have the order committing it to trial quashed. On February 19, 2008, the Superior Court of Justice in Ontario denied Mr. Lang s request to quash the order committing him to trial. The court granted the government s request to quash the order discharging six individuals and remanded the matter to the preliminary hearing judge for reconsideration. No appeals were taken from that decision. The matter is currently being reconsidered by the preliminary hearing judge.

On October 31, 2007, the Office of the Attorney General of Ontario confirmed that the prosecutor s request for preferred indictments against RJR-TI, RJR-PR and Northern Brands had been denied at that point in time.

In July 2003, a Statement of Claim was filed against JTI-MC and others in the Superior Court of Justice, Ontario, Canada by Leslie and Kathleen Thompson. Mr. Thompson is a former employee of Northern

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Brands and JTI-MC s predecessor, RJR-MI. Mr. and Mrs. Thompson have alleged breach of contract, breach of fiduciary duty and negligent misrepresentation, among other claims. They are seeking lost wages and other damages, including punitive damages, in an aggregate amount exceeding $12 million.

On September 18, 2003, RJR, RJR Tobacco, RJR-TI, RJR-PR, and Northern Brands were served with a Statement of Claim filed in August 2003 by the Attorney General of Canada in the Superior Court of Justice, Ontario, Canada. Also named as defendants are JTI and a number of its affiliates. The Statement of Claim seeks to recover taxes and duties allegedly not paid as a result of cigarette smuggling and related activities. As filed, the Attorney General s Statement of Claim seeks to recover $1.5 billion Canadian in compensatory damages and $50 million Canadian in punitive damages, as well as equitable and other forms of relief. However, in the Companies Creditor Arrangement Act proceeding described below, the Attorney General amended and increased Canada s claim to $4.3 billion Canadian. The parties have agreed to a stay of all proceedings pending in the Superior Court of Justice, subject to notice by one of the parties that it wishes to terminate the stay. On January 15, 2009, the Court ordered that the deadline for setting the action for trial is January 31, 2011.

In August 2004, the Quebec Ministry of Revenue (1) issued a tax assessment, covering the period January 1, 1990, through December 31, 1998, against JTI-MC for alleged unpaid duties, penalties and interest in an amount of about $1.36 billion Canadian; (2) issued an order for the immediate payment of that amount; and (3) obtained an ex parte judgment to enforce the payment of that amount. On August 24, 2004, JTI-MC applied for protection under the Companies Creditor Arrangement Act in the Ontario Superior Court of Justice, Toronto, Canada, referred to as CCAA Proceedings, and the court entered an order staying the Quebec Ministry of Revenue s proceedings as well as other claims and proceedings against JTI-MC. The stay has been extended to March 15, 2010. In November 2004, JTI-MC filed a motion in the Superior Court, Province of Quebec, District of Montreal, seeking a declaratory judgment to set aside, annul and declare inoperative the tax assessment and all ancillary enforcement measures and to require the Quebec Minister of Revenue to reimburse JTI-MC for funds unduly appropriated, along with interest and other relief. Pursuant to a court-imposed deadline, Canada and several Provinces filed Crown claims against JTI-MC in the CCAA Proceedings in the following amounts: Canada, $4.3 billion Canadian; Ontario, $1.5 billion Canadian; New Brunswick, $1.5 billion Canadian; Quebec, $1.4 billion Canadian; British Columbia, $450 million Canadian; Nova Scotia, $326 million Canadian; Prince Edward Island, $75 million Canadian and Manitoba, $23 million Canadian. In the CCAA Proceedings, the Canadian federal government and some of the provincial governments have asserted that they can make the same tax and related claims against RJR and certain of its subsidiaries, including RJR Tobacco. To date, none of those provincial governments have filed and served RJR or any of its affiliates with a formal Statement of Claim like the Canadian federal government did in August and September 2003. Discussions regarding possible agreed-upon procedures for adjudicating and appellate review of the claims and defenses asserted in the CCAA Proceedings are taking place.

On November 17, 2004, a Statement of Claim was filed against JTI-MC in the Supreme Court of British Columbia by Stanley Smith, a former executive of RJR-MI, for alleged breach of contract and other legal theories. Mr. Smith is claiming $840,000 Canadian for salary allegedly owed under his severance agreement with RJR-MI, as well as other unspecified compensatory and punitive damages. Mr. Smith subsequently filed a substantively identical claim in the Superior Court of Justice in Ontario and proposed that the action be tried in Toronto.

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

On December 14, 2007, the European Community and 26 member states entered into a series of agreements with JTI and/or its subsidiaries regarding, principally, contraband and counterfeit cigarettes bearing JTI trademarks in the European Community. Collectively, those agreements resolved, in pertinent part, all claims that the European Community and member states either had or might have had prior to December 14, 2007, against JTI and/or its subsidiaries with respect to any such contraband and counterfeit cigarettes and claims for which JTI could become the subject of a claim for indemnity by RJR under the terms of the 1999 Purchase Agreement. In addition, the European Community and signatory member states agreed to release RJR and its affiliates from those same claims.

Although RJR and RJR Tobacco recognize that, under certain circumstances, they may have indemnification obligations to JTI under the 1999 Purchase Agreement, RJR and RJR Tobacco disagree with JTI as to whether the circumstances relating to any of these matters give rise to any indemnification obligation by RJR and RJR Tobacco. RJR and RJR Tobacco conveyed their position to JTI, and the parties have agreed to resolve their differences at a later time. In the interim, RJR and RJR Tobacco are paying defense costs and expenses in connection with certain of the Canadian litigation described above. RJR Tobacco expensed $6 million during 2009, $10 million during 2008 and $8 million during 2007, for funds to be reimbursed to JTI for costs and expenses arising out of the Canadian litigation. In addition, as of December 31, 2009, RJR, including its subsidiary RJR Tobacco, had liabilities of $94 million that were recorded in 1999 in connection with certain of the indemnification claims asserted by JTI. For further information on the JTI indemnification claims, see Other Contingencies below.

On May 15, 2007, RAI was served with a subpoena issued by the U.S. District Court for the Middle District of North Carolina. The subpoena seeks documents relating primarily to the business of RJR-TI regarding the manufacture and sale of Canadian brand cigarettes during the period 1990 through 1996. The subpoena was issued at the request of Canada pursuant to a Mutual Legal Assistance Treaty between the United States and Canada.

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 has 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 adds 16 member states as plaintiffs and RAI, RJR Tobacco and 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. The court has established a briefing schedule for defendants motion to dismiss the second amended complaint and set May 19, 2010 as the date for oral argument on that motion.

RJR Tobacco was named a defendant in a number of lawsuits originally filed in various federal courts in 2002 by plaintiffs alleging descent from persons held in slavery in the United States and seeking damages from numerous corporate defendants for having allegedly profited from historic slavery. In October 2002, those actions were consolidated by the Judicial Panel on Multidistrict Litigation for pre-trial proceedings in the U.S. District Court for the Northern District of Illinois. On July 6, 2005, the court dismissed the entire action on a variety of grounds. On

December 13, 2006, the U.S. Court of Appeals for the Seventh Circuit affirmed dismissal in all respects but one. It remanded some cases for further proceedings limited to the claims by some plaintiffs that present-day representations about historic ties to slavery by some defendants violated state consumer fraud laws. On October 1, 2007, the U.S. Supreme Court denied the plaintiffs petition for a writ of certiorari. The plaintiffs in all but one of the cases either voluntarily dismissed their claims or otherwise abandoned the litigation. On August 11, 2008, the district court granted the defendants motion to dismiss the remaining plaintiffs and terminated the case. However, the motion to dismiss excluded plaintiffs Timothy and Chester Hurdle, who filed a third amended complaint on July 31, 2007. At the time, no ruling was made on the motion to dismiss the Hurdle plaintiffs and the plaintiffs named in the

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

third amended complaint. On April 15, 2009, the court granted the defendants motion to dismiss the third amended complaint without prejudice. On September 3, 2009, the court issued a ruling to show cause as to why the case should not be dismissed with prejudice and finality. The Hurdle plaintiffs filed a fourth amended complaint under the Hurdle docket number on October 2, 2009, and filed a motion for leave to file a fourth amended complaint and a notice of filing with the Multidistrict Litigation panel on October 5, 2009.

On May 23, 2001, and July 30, 2002, Star Scientific, Inc., referred to as Star, filed two patent infringement actions, which have been consolidated, against RJR Tobacco in the U.S. District Court for the District of Maryland (*Star I*). Both patents at issue are entitled Method of Treating Tobacco to Reduce Nitrosamine Content, and Products Produced Thereby, and bear U.S. Patent Nos. 6,202,649 and 6,425,401. The plaintiffs sought: the entry of an injunction restraining RJR Tobacco from further acts of infringement, inducement of infringement, or contributory infringement of the patents; an award of damages, including a reasonable royalty, to compensate for the infringement; an award of enhanced damages on account that the defendant s conduct was willful; an award of pre-judgment interest and a further award of post-judgment interest; an award of reasonable attorneys fees; and an order requiring RJR Tobacco to deliver up to the court for destruction all products manufactured from any process which infringes upon, directly or indirectly or otherwise, any claim of such patent. RJR Tobacco filed counterclaims seeking a declaration that the claims of the two Star patents are invalid, unenforceable and not infringed by RJR Tobacco. Between January 31 and February 8, 2005, the court held a first bench trial on RJR Tobacco s affirmative defense and counterclaim based upon inequitable conduct. Additionally, in response to the court s invitation, RJR Tobacco filed two summary judgment motions on January 20, 2005.

On January 19, 2007, the court granted RJR Tobacco s motion for summary judgment of invalidity based on indefiniteness. The court granted in part and denied in part RJR Tobacco s other summary judgment motion concerning the effective filing date of the patents in suit. On June 26, 2007, the court ruled that Star s patents are unenforceable due to inequitable conduct by Star and its representatives in the U.S. Patent & Trademark Office, referred to as the PTO. On June 26, 2007, the court also entered final judgment in favor of RJR Tobacco and against Star, dismissing all of Star s claims with prejudice. On June 27, 2007, Star filed a notice of appeal with the U.S. Court of Appeals for the Federal Circuit.

On August 25, 2008, the Federal Circuit issued a decision reversing the district court s holdings and remanded the case to the district court for further proceedings on the issues of validity and infringement. On March 6, 2009, Star updated its damages calculation based on an alleged reasonable royalty to a range of $294.9 to $362.1 million. Star also claimed treble damages of such amounts based on willful infringement allegations.

Trial began on May 18, 2009. On June 16, 2009, the jury returned a verdict in favor of RJR Tobacco. On July 7, 2009, Star filed a combined motion for a judgment as a matter of law or a new trial, which RJR Tobacco opposed.

In addition, both of Star s patents under went reexamination in the PTO, based on substantial new questions of patentability that exist for both patents. On September 11, 2009, the PTO issued an office action rejecting the claims currently under reexamination. On October 22, 2009, Star s patent counsel held an interview with the examiner in both reexaminations, which was also attended by Star s lead trial counsel and Star s technical expert. No agreement was reached. On November 10, 2009, Star filed responses in the reexaminations. The examiner has not responded to these filings.

On November 30, 2009, RJR Tobacco filed a bill of costs seeking reimbursement of its recoverable costs as the prevailing party, and a motion seeking reimbursement of its attorneys fees and excess costs incurred in defending the

Star I litigation. On December 21, 2009, the district court denied Star s combined motion for judgment as a matter of law or new trial, entered judgment in RJR Tobacco s favor and awarded RJR Tobacco all assessable costs. On December 21, 2009, the district court also deferred proceedings with respect to RJR Tobacco s motion for attorneys fees and excess costs pending final resolution of the reexamination and any appellate proceedings. On December 22, 2009, Star filed a notice of appeal.

After entry of final judgment, RJR Tobacco filed a renewed bill of costs on December 30, 2009. On January 8, 2010, after a request from Star and no objection from RJR Tobacco, the district court deferred briefing on the

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

renewed bill of costs until after the resolution of appellate proceedings and such time as the district court directs the parties to brief RJR Tobacco s motion for attorneys fees and excess costs.

On February 2, 2010, Star s appeal was docketed by the Court of Appeals for the Federal Circuit.

Finally, on May 29, 2009, Star filed a follow-on lawsuit in the U.S. District Court for the District of Maryland (*Star II*) seeking damages for alleged infringement in 2003 and thereafter of the patents held invalid and not infringed in *Star I.* On January 8, 2010, the district court stayed *Star II* pending proceedings in *Star I*, and *Star II* was administratively closed pending further order of the district court upon the application, by December 31, 2012, of any party based on the resolution of *Star I* or other good cause.

In November, 2009, RAI and B&W were served with subpoenas issued by the Office of the Inspector General, U.S. Department of Defense, seeking two broad categories of documents in connection with a civil investigation: documents regarding the sale of U.S. manufactured cigarettes to the Army Air Force Exchange Service and the Navy Exchange Command either directly by the manufacturers or through distributors during the period January 1, 1998 through December 31, 2001; and documents regarding the sale of U.S. manufactured cigarettes by the manufacturers to civilian market customers for resale in non-federal excise tax markets during the periods January 1, 1998 through December 31, 2001 and September 1, 2008 through September 1, 2009. RAI and RJRT intend to respond appropriately to the subpoenas, including the extent to which the subpoenas seek documents regarding the domestic tobacco operations acquired from B&W in 2004, and to otherwise cooperate appropriately with the investigation.

Finally, in the first quarter of 2005, Commonwealth Brands, Inc., referred to as Commonwealth, was served with an individual smoking and health case, *Croft v. Akron Gasket* in Cuyahoga County, Ohio. Commonwealth requested indemnity from RJR Tobacco pursuant to the Asset Purchase Agreement dated July 24, 1996, between Commonwealth and B&W, referred to as the 1996 Purchase Agreement. As a result of the B&W business combination, RJR Tobacco agreed to indemnify Commonwealth for this claim to the extent, if any, required by the 1996 Purchase Agreement. The scope of the indemnity will be at issue and has not been determined.

Smokeless Tobacco Litigation

As of January 29, 2010, Conwood Company, LLC 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 the Conwood companies smokeless tobacco products. These actions are pending before the same West Virginia court as the 654 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, Conwood Company, LLC 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 the Conwood companies. The plaintiff seeks unspecified compensatory and consequential damages in an amount greater than $15,000. There is not a 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.

On September 4, 2009, Conwood Company, LLC, among others, brought suit in the Circuit Court, Marion County, Oregon (*Conwood Company, LLC v. John Kroger*), to enjoin the enforcement of an Oregon statute requiring smokeless tobacco manufacturers to either comply with certain requirements of the Smokeless Tobacco Master Settlement Agreement, referred to as the STMSA, or pay into an escrow account $0.40 per unit sold in Oregon. Conwood contends the statute violates the constitutions of Oregon and the United States. For a more detailed description of the STMSA, see Governmental Activity in Management s Discussion and Analysis of Financial Condition and Results of Operations, below.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Tobacco Buyout Legislation and Related Litigation

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 will be continued as scheduled through the end of 2010, but will be offset against the tobacco quota buyout obligations. RAI s operating subsidiaries annual expense under FETRA for 2010 and thereafter, excluding the tobacco stock liquidation assessment, is estimated to be approximately $240 million to $280 million. Since 2004, RAI s operating subsidiaries have paid approximately $1.4 billion under FETRA.

RAI s operating subsidiaries will record 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 $2.3 billion to $2.8 billion prior to the deduction of permitted offsets under the MSA. In addition, future market pricing could impact the carrying value of inventory, and adversely affect RJR Tobacco s financial position and results of operations.

As noted above, the MSA Phase II obligations are offset against the tobacco quota buyout obligations. Because growers in two states, Maryland and Pennsylvania, did not participate in the quota system, they are not eligible for payments under FETRA. Given that the assessments paid by tobacco product manufacturers and importers under FETRA fully offset their MSA Phase II payment obligations, the growers in Maryland and Pennsylvania would no longer receive payments under the MSA Phase II program. Thus, the growers in these two states do not receive payments under either FETRA or the MSA Phase II program.

On December 17, 2004, Maryland and Pennsylvania filed in the North Carolina Business Court a Motion for Clarification or Modification of the Trust, that is, the Growers Trust that created the MSA Phase II obligations. They later supplemented this filing with a Statement of Claim, filed on June 24, 2005. Maryland and Pennsylvania contend that they are entitled to relief from the operation of the tax offset adjustment provision of the Growers Trust and that payments under the Growers Trust to the growers in their states should continue. Following discovery, the parties filed cross-motions for summary judgment on May 5, 2006. On August 17, 2007, the Business Court granted summary judgment in favor of Maryland and Pennsylvania and denied summary judgment to the tobacco manufacturers, including RJR Tobacco, that were the settlors of the Growers Trust. The Business Court ruled that the Growers Trust, as written and without judicial modification, requires continuing payments to the Growers Trust for the benefit of tobacco growers in Maryland and Pennsylvania. RJR Tobacco and the other tobacco manufacturer/settlors filed their Notice of Appeal on September 14, 2007. On December 16, 2008, the North Carolina Court of Appeals, in a 2-1 decision, reversed the Business Court and remanded the case for entry of judgment in favor of RJR Tobacco and the other tobacco manufacturers/settlors. On January 20, 2009, Maryland and Pennsylvania filed an appeal of right based on the dissenting opinion and also filed a petition for discretionary review on certain additional issues. On January 30, 2009, RJR Tobacco and the other tobacco manufacturers/settlors filed a response to the states petition for discretionary review. On March 19, 2009, the North Carolina Supreme Court granted the states petition for discretionary review. Oral argument before the North Carolina Supreme Court took place on September 10, 2009. On November 6, 2009, the North Carolina Supreme Court affirmed the decision of the North Carolina Court of Appeals.

ERISA Litigation

On May 13, 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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 violated ERISA by not overriding an amendment to RJR s 401(k) plan requiring that, prior to February 1, 2000, the stock funds of the companies involved in the food business, NGH and Nabisco Holdings Corp., referred to as Nabisco, be eliminated as investment options from RJR s 401(k) plan. 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.

On July 29, 2002, the defendants filed a motion to dismiss, which the court granted on December 10, 2003. On December 14, 2004, the U.S. Court of Appeals for the Fourth Circuit reversed the dismissal of the complaint and remanded the case for further proceedings. On January 20, 2005, the defendants filed a second motion to dismiss on other grounds. On March 7, 2007, the court granted the plaintiff leave to file an amended complaint and denied all pending motions as moot. On April 6, 2007, the defendants moved to dismiss the amended complaint. On May 31, 2007, 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 on June 14, 2007. On November 19, 2007, the plaintiff filed a motion for class certification, which the court granted on September 29, 2008. The district court ordered mediation, which occurred on July 10, 2008, but no resolution of the case was reached at that time. On September 18, 2008, each of the plaintiffs and the defendants filed motions for summary judgment, and on January 9, 2009, the defendants filed a motion to decertify the class. A second mediation occurred on June 23, 2009, but again no resolution of the case was reached. On January 11, 2010, the district court overruled the motions for summary judgment and the motion to decertify the class. The non-jury trial began on January 12, 2010, and closing arguments ended on February 9, 2010. A decision is pending.

Employment Litigation

On March 19, 2007, in *Marshall v. R. J. Reynolds Tobacco Co.*, the plaintiff filed a collective action complaint against RJR Tobacco in the U.S. District Court for the Western District of Missouri alleging violations of the Fair Labor Standards Act, referred to as FLSA. The allegations include failure to keep accurate records of all hours worked by RJR Tobacco s employees and failure to pay wages and overtime compensation to non-exempt retail representatives. The total number of current or former retail representatives participating as of October 9, 2009, was 469, including those who have opted in the *Marshall* case and subsequent lawsuits filed in New York and California as described below.

Two other cases alleging violations of the FLSA and other state law wage and hour claims were filed in February 2008: *Radcliffe v. R. J. Reynolds Tobacco Co.*, filed in federal court in California, and *Dinino v. R. J. Reynolds Tobacco Co.*, filed in federal court in New York. The *Dinino* and *Radcliffe* matters have been transferred to the Missouri court and consolidated with the already pending *Marshall* case due to the similarity of issues to be resolved. The plaintiffs in the *Dinino* and *Radcliffe* matters failed to move for class certification on the state law claims.

On December 22, 2008, RJR Tobacco s motion for partial summary judgment was granted. The court ruled that the plaintiffs commutes from their homes to their first assignment of the day, and their commutes from their last assignments of the day to their homes, are non-compensable. On February 5, 2009, the court denied the plaintiffs motion for reconsideration on this issue or, in the alternative, plaintiffs request for certification for interlocutory appeal.

Fact discovery has been completed in this case. Two mediation sessions were held in the first quarter of 2009, but the parties were unable to reach a resolution. An additional mediation session is scheduled for March 2, 2010.

On January 14, 2010, a stipulated dismissal for 73 of the opt in plaintiffs was filed. As a result, the number of current or former retail representatives participating in the lawsuit will be 396.

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The deadline for RJR Tobacco to file motions for summary judgment and to decertify the lawsuit as a collective action is March 29, 2010. If those motions do not resolve the case, the case is scheduled for trial beginning on October 4, 2010.

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.

Regulations promulgated by the U.S. Environmental Protection Agency and other governmental agencies under various statutes have resulted in, and likely will continue to result in, substantial expenditures for pollution control, waste treatment, plant 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 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, RJR Tobacco has received several claims for indemnification from JTI. Although RJR and RJR Tobacco recognize that, under certain circumstances, they may have indemnification obligations to JTI under the 1999 Purchase Agreement, RJR and RJR Tobacco disagree whether the circumstances described in such claims give rise to any indemnification obligations by RJR and RJR Tobacco. RJR and RJR Tobacco have conveyed their position to JTI, and the parties have agreed to resolve their differences at a later date. RJR, including its subsidiary RJR Tobacco, have liabilities totaling $94 million that were recorded in 1999 in connection with these indemnification claims.

RJR Tobacco, Santa Fe, the Conwood companies and Lane 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, Santa Fe has entered into an agreement to indemnify a supplier from liability and related defense costs arising out of the sale or use of Santa Fe s products. The cost has been, and is expected to be, insignificant. RJR Tobacco, Santa Fe, the Conwood companies and Lane 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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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.

Lease Commitments

RAI has operating lease agreements that are primarily for office space, automobiles, warehouse space and computer equipment. The majority of these leases expire within the next five years and some contain renewal or purchase options and escalation clauses or restrictions relating to subleases. Total rent expense was $20 million, $21 million and $20 million for 2009, 2008 and 2007, respectively.

Future minimum lease payments as of December 31, 2009, were as follows:

	Noncancellable Operating Leases
2010	$ 17
2011	15
2012	14
2013	12
2014	8
Thereafter	3
Total	$ 69

Note 15 Shareholders Equity

RAI s authorized capital stock at December 31, 2009, consisted of 100 million shares of preferred stock, par value $.01 per share, and 800 million shares of common stock, par value $.0001 per share. Four million shares of the preferred stock are designated as Series A Junior Participating Preferred Stock, none of which is issued or outstanding. The Series A Junior Participating Preferred Stock will rank junior as to dividends and upon liquidation to all other series of RAI preferred stock, unless specified otherwise. Also, of the preferred stock, one million shares are designated as Series B Preferred Stock, all of which are issued and outstanding. The Series B Preferred Stock ranks senior upon liquidation, but not with respect to dividends, to all other series of RAI capital stock, unless specified otherwise. As a part of the B&W business combination, RJR is the holder of the outstanding Series B Preferred Stock. In 2009, RAI declared $43 million in dividends to RJR with respect to the Series B Preferred Stock.

In 2004, RAI s board of directors adopted a shareholder rights plan, pursuant to which RAI declared a dividend of one preferred stock purchase right on each share of RAI common stock outstanding on July 30, 2004. The board also authorized the issuance of rights for each share of RAI common stock issued after the dividend record date, until the occurrence of certain specified events. The rights will expire on July 30, 2014, unless earlier redeemed, exercised or exchanged under the terms of the rights plan.

The rights are not exercisable until a distribution date that is the earlier of:

ten days following an announcement that a person or group, other than BAT and its subsidiaries, except in certain circumstances, has acquired beneficial ownership of at least 15% of RAI common stock, and

ten business days, or such later date as may be determined by the board, following the announcement of a tender offer which would result in a person becoming an acquiring person.

If the acquiring person or tender offeror is BAT or one of its subsidiaries, then the foregoing 15% threshold is subject to adjustment. The rights are initially exercisable for 1/100th of a share of RAI s Series A Junior Participating Preferred Stock at a purchase price of $130, subject to adjustment. Each fractional share of such preferred stock would give the holder approximately the same dividend, voting and liquidation rights as does one share of RAI common stock. Until the distribution date, the rights will be evidenced by RAI common stock certificates and trade with such shares. Upon the occurrence of certain events after the distribution date, holders of

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

rights, other than the acquiring person, will be entitled to receive upon exercise of the right, in lieu of shares of preferred stock, RAI common stock or common stock of the acquiring corporation having in either case a market value of two times the exercise price of the right.

RAI s board of directors declared the following quarterly cash dividends per share of RAI common stock in 2009, 2008 and 2007:

	2009	2008	2007
First	$ 0.85	$ 0.85	$ 0.75
Second	$ 0.85	$ 0.85	$ 0.75
Third	$ 0.85	$ 0.85	$ 0.85
Fourth	$ 0.90	$ 0.85	$ 0.85

RAI repurchases shares of its common stock forfeited with respect to the tax liability associated with certain stock option exercises and vesting of restricted stock grants under the LTIP. 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 2009, at a cost of $5 million, RAI purchased 154,441 shares that were forfeited with respect to tax liabilities associated with restricted stock vesting under its LTIP.

The $350 million share repurchase program approved by RAI s board of directors in 2008, authorizing RAI to repurchase common stock in open-market or privately negotiated transactions, from time to time, expired on April 30, 2009. In connection with the share repurchase program, RAI and B&W entered into an agreement, 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. RAI repurchased and cancelled 3,817,095 shares of RAI common stock for $207 million under this share repurchase program in 2008; no shares were repurchased by RAI under this program in 2009.

Changes in RAI common stock outstanding were as follows:

	2009	2008	2007
Shares outstanding at beginning of year	291,450,762	295,007,327	295,624,741
LTIP shares granted		322,585	374,326
LTIP shares forfeited	(27,710)	(96,797)	(50,273)
LTIP tax shares repurchased and cancelled	(154,441)	(57,223)	(7,956)
Shares repurchased and cancelled		(3,817,095)	(984,000)
Stock options exercised	122,640	72,571	44,989
Equity incentive award plan shares issued	32,800	19,394	5,500
Shares outstanding at end of year	291,424,051	291,450,762	295,007,327

Note 16 Stock Plans

As of December 31, 2009, RAI had two stock plans, the Equity Incentive Award Plan for Directors of RAI, referred to as the EIAP, and the Reynolds American Inc. 2009 Omnibus Incentive Compensation Plan, referred to as the Omnibus Plan.

Under the EIAP, RAI currently provides (1) grants of deferred stock units to eligible directors upon becoming a director or, provided the director did not receive an initial award upon his/her election to the board, upon appointment to the position of Non-Executive Chairman and (2) grants of deferred stock units to eligible directors on a quarterly and annual basis thereafter. Directors may elect to receive shares of common stock in lieu of their initial and annual grants of deferred stock units. A maximum of 1,000,000 shares of common stock may be issued under this plan, of which 588,612 shares were available for grant as of December 31, 2009. Deferred stock units granted under the EIAP have a value equal to, and bear dividend equivalents at the same rate as, one share of RAI

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

common stock, and have no voting rights. The dividends are paid as additional units in an amount equal to the number of shares of RAI common stock that could be purchased with the dividends on the date of payment. Generally, distribution of a director s deferred stock units will be made on January 2 following his or her last year of service on the board; however, for all grants made under the EIAP after December 31, 2007, a director may elect to receive his or her deferred stock units on the later of January 2 of a specified year or January 2 following his or her last year of service on the board. At the election of a director, distribution may be made in one lump sum or in up to ten annual installments. A director is paid in cash for the units granted quarterly and in common stock for the units granted initially and annually, unless the director elects to receive cash for the initial and annual grants. Cash payments are based on the average closing price of RAI common stock during December of the year preceding payment. Compensation expense related to the EIAP was $3 million expense during 2009, $1 million income during 2008, due to the decline of the price of RAI common stock during 2008, and $4 million expense during 2007.

In May 2009, the shareholders of RAI approved the Omnibus Plan. Awards under the Omnibus Plan may be in the form of cash awards, incentive or non-incentive stock options, stock appreciation rights, restricted stock, restricted stock units, performance shares, performance units or other awards. Subject to adjustments as set forth in the Omnibus Plan, the number of shares of RAI common stock that may be issued with respect to awards under the Omnibus Plan will not exceed 19,000,000 shares in the aggregate. The Omnibus Plan replaced the LTIP, which expired on June 14, 2009. No awards were made under the Omnibus Plan during 2009. The outstanding grants made under the LTIP prior to its expiration will remain outstanding in accordance with their terms.

The LTIP provided for grants of incentive stock options, other stock options, stock appreciation rights, restricted stock, restricted stock units, performance units and performance shares to key employees. Upon retirement, a holder s grant under the LTIP generally vests on a pro rata basis for the portion of the vesting service period that has elapsed, thereby maintaining an appropriate approximation of forfeitures related to retirement.

Information regarding stock-based awards outstanding under the LTIP as of December 31, 2009, was as follows:

Grant Year	Number of Shares Granted	Grant Price	Type	Vesting Date	Number of Shares Cancelled	Number of Shares Vested
2007	373,082	$59.50	Restricted Stock	March 6, 2010	61,930	66,623
2007	1,244	$64.14	Restricted Stock	March 6, 2010		
2008	321,991	$61.89	Restricted Stock	March 6, 2011	53,210	26,638
2008	594	$55.13	Restricted Stock	March 6, 2011		
2009	1,382,243	$33.10	Restricted Stock Units	March 2, 2012	102,748	

The grants consist of restricted shares of RAI common stock and restricted stock units awarded to eligible employees under the LTIP. The grant date fair value was based on the per share closing price of RAI common stock on the date of grant. The actual number of shares granted is fixed. The grants are accounted for as equity-based and compensation expense includes the vesting period elapsed. Dividends are paid on the grants on the same basis as dividends on shares of RAI common stock, and are recognized as a reduction of equity. Related realized income tax benefits are recognized as an increase to additional paid-in-capital.

The restricted stock unit grant will be settled exclusively in shares of RAI common stock. Upon settlement, each grantee will receive a number of shares of RAI common stock equal to the product of the number of vested restricted stock units and a percentage from 0%-150% based on the average RAI annual incentive award plan score over the three-year period ending December 31, 2011.

Dividends paid on shares of RAI common stock will accumulate on the restricted stock units and be paid to the grantee on the vesting date. If RAI fails to pay its shareholders cumulative dividends of at least $10.20 per share for the three-year performance period ending December 31, 2011, 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%. Dividends accrued on the 2009 LTIP grant are included in other noncurrent liabilities in the consolidated balance sheet.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The changes in restricted RAI common stock and restricted stock units during 2009 were as follows:

	Stock and Stock Units	Weighted Average Grant Date Fair Value
Outstanding at beginning of year	898,249	$ 52.92
Granted	1,382,243	33.10
Forfeited	(130,458)	39.01
Vested	(382,029)	35.81
Outstanding at end of year	1,768,005	$ 40.73

Total compensation expense, including dividend equivalents on phantom stock[1], related to stock-based compensation and the related tax benefits recognized in selling, general and administrative expenses in the consolidated statements of income were as follows:

	2009	2008	2007
2004 phantom stock	$	$	$ 3
2005 phantom stock		1	11
2006 restricted stock	(2)	(1)	10
2007 restricted stock and performance shares	5	7	8
2008 restricted stock	5	5	
2009 restricted stock units	14		
Total compensation expense	$ 22	$ 12	$ 32
Total related tax benefits	$ 8	$ 4	$ 12

(1) The phantom stock grants consisted of performance shares payable in cash, based on the closing price of RAI common stock on the date of vesting. Compensation expense included the effects of changes in the stock price, the portion of vesting period elapsed and dividend equivalents paid concurrently with dividends on RAI common stock.

Payments related to stock-based compensation, including dividend equivalents paid on phantom stock, were $15 million, $35 million and $20 million for the years ended 2009, 2008 and 2007, respectively.

The amounts in the consolidated balance sheet as of December 31 related to the 2007 LTIP performance share grants, the 2006, 2007 and 2008 LTIP restricted stock grants and the 2009 LTIP restricted stock units grant were as follows:

	2009	2008
Other current liabilities	$	$ 14
Other noncurrent liabilities	5	
Paid-in capital	36	15

As of December 31, 2009, there were $44 million of unrecognized compensation costs related to restricted stock and restricted stock units, calculated at the grant-date price, which are expected to be recognized over a weighted-average period of 1.99 years.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In the EIAP and the LTIP, options were granted primarily prior to 1999 and to a lesser extent through 2003, all of which are fully vested. The weighted average characteristics of stock options outstanding at December 31, 2009, all of which were exercisable on such date, were as follows:

Exercise Price Range	Shares	Average Remaining Contractual Life (Years)	Weighted Average Exercise Price
$13.05 $15.52	222,734	0.4	$ 13.51
34.90	20,000	2.4	34.90

RAI has a policy of issuing new shares of common stock to satisfy share option exercises. Of the options outstanding as of December 31, 2009, 20,000 were issued under the EIAP, and under the LTIP, 222,734 were issued prior to 1999. The changes in RAI s stock options during 2009, 2008 and 2007 were as follows:

	2009		2008		2007	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Outstanding at beginning of year	388,174	$ 14.75	466,347	$ 14.59	513,924	$ 14.59
Expired			(5,602)	16.21	(2,588)	24.16
Exercised	(145,440)	13.89	(72,571)	13.56	(44,989)	14.13
Outstanding at end of year	242,734	15.27	388,174	14.75	466,347	14.59
Exercisable at end of year	242,734	15.27	388,174	14.75	466,347	14.59

The intrinsic value of options exercised was $4 million, $2 million and $2 million for the years ended December 31, 2009, 2008 and 2007, respectively. The aggregate intrinsic value of fully vested outstanding and exercisable options at December 31, 2009, was $9 million. Cash proceeds related to stock options exercised and excess tax benefits related to stock-based compensation were as follows:

	2009	2008	2007
Proceeds from exercise of stock options	$ 2	$ 1	$ 1
Excess tax benefits from stock-based compensation	2	2	2

Equity compensation plan information is as follows:

Plan Category	Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights (a)	Weighted Average Exercise Price of Outstanding Options, Warrants and Rights (b)	Number of Securities Remaining Available for Future Issuance under Equity Compensation Plans (Excluding Securities Reflected in Column (a)) (c)
Equity Compensation Plans Approved by Security Holders	2,141,977	$ 13.51(2)	19,000,000
Equity Compensation Plans Not Approved by Security Holders[1]	20,000	34.90	588,612
Total	2,161,977	15.27(2)	19,588,612

(1) The EIAP is the only equity compensation plan not approved by RAI s or RJR s public shareholders. The EIAP was approved by RJR s sole shareholder, NGH, prior to RJR s spin-off on June 15, 1999.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(2) The weighted average exercise price is related to 222,734 outstanding options and excludes 1,919,243 restricted stock units granted at $33.10. These restricted stock units represent the maximum number, 150%, of shares to be awarded under the best-case targets that may not be achieved, and accordingly, may overstate expected dilution.

Note 17 Retirement Benefits

RAI and certain of its subsidiaries sponsor a number of non-contributory defined benefit pension plans covering most of their employees, and also provide 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.

The changes in benefit obligations and plan assets, as well as the funded status of these plans at December 31, were as follows:

	Pension Benefits		Postretirement Benefits	
	2009	2008	2009	2008
Change in benefit obligation:				
Obligation at beginning of year	$ 5,106	$ 5,088	$ 1,445	$ 1,485
Service cost	31	36	4	5
Interest cost	319	318	80	90
Actuarial (gain) loss	218	66	13	(25)
Plan amendments		26	(99)	
Benefits paid	(411)	(424)	(92)	(110)
Settlements	(1)	(11)		
Curtailment/special termination benefits	8	7		
Obligation at end of year	$ 5,270	$ 5,106	$ 1,351	$ 1,445
Change in plan assets:				
Fair value of plan assets at beginning of year	$ 3,376	$ 5,421	$ 254	$ 364
Actual return on plan assets	795	(1,631)	43	(78)
Employer contributions	295	21	65	78
Benefits paid	(411)	(424)	(92)	(110)
Settlements	(1)	(11)		
Fair value of plan assets at end of year	$ 4,054	$ 3,376	$ 270	$ 254
Funded status	$ (1,216)	$ (1,730)	$ (1,081)	$ (1,191)
Amounts recognized in the consolidated balance sheets consist of:				
Accrued benefit other current liability	(9)	(6)	(70)	(79)
Accrued benefit long-term retirement benefits	(1,207)	(1,724)	(1,011)	(1,112)

Net amount recognized	(1,216)	(1,730)	(1,081)	(1,191)
Accumulated other comprehensive loss	2,105	2,448	171	271
Net amounts recognized in the consolidated balance sheets	$ 889	$ 718	$ (910)	$ (920)

Due to the adverse changes in the financial markets, RAI s pension assets were negatively impacted in 2008, as the overall rate of return on the investments for the pension assets was negative approximately 30.1%. During 2009, this rate of return improved to 24.8%.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Amounts included in accumulated other comprehensive loss were as follows as of December 31:

	2009			2008		
	Pension Benefits	Postretirement Benefits	Total	Pension Benefits	Postretirement Benefits	Total
Prior service cost (credit)	$ 34	$ (92)	$ (58)	$ 38	$ (17)	$ 21
Net actuarial loss	2,071	263	2,334	2,410	288	2,698
Deferred income taxes	(833)	(67)	(900)	(969)	(107)	(1,076)
Accumulated other comprehensive loss	$ 1,272	$ 104	$ 1,376	$ 1,479	$ 164	$ 1,643

Changes in accumulated other comprehensive loss were as follows:

	2009			2008		
	Pension Benefits	Postretirement Benefits	Total	Pension Benefits	Postretirement Benefits	Total
Prior service cost	$	$ (99)	$ (99)	$ 26	$	$ 26
Net actuarial (gain) loss	(240)	(10)	(250)	2,143	80	2,223
Amortization of prior service cost (credit)	(4)	24	20	(5)	11	6
Amortization of net loss	(99)	(15)	(114)	(18)	(16)	(34)
Deferred income tax (expense) benefit	136	40	176	(853)	(31)	(884)
Change in accumulated other comprehensive loss	$ (207)	$ (60)	$ (267)	$ 1,293	$ 44	$ 1,337

The $99 million reduction in postretirement was the result of RAI switching to a self-insured health plan.

	Pension Benefits		Postretirement	
	2009	2008	2009	2008
Weighted-average assumptions used to determine benefit obligations at December 31:				
Discount rate	6.30%	6.40%	6.20%	6.39%
Rate of compensation increase	5.00%	4.97%	5.00%	5.00%

The measurement date used for all plans was December 31.

Pension plans experiencing accumulated benefit obligations, which represent benefits earned to date, in excess of plan assets are summarized below:

	December 31, 2009	December 31, 2008
Projected benefit obligation	$ 5,270	$ 5,106
Accumulated benefit obligation	5,158	4,970
Plan assets	4,054	3,376

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The components of the total benefit cost (income) and assumptions are set forth below:

	Pension Benefits			Postretirement Benefits		
	2009	**2008**	**2007**	**2009**	**2008**	**2007**
Components of total benefit cost (income):						
Service cost	$ 31	$ 36	$ 40	$ 4	$ 5	$ 5
Interest cost	319	318	314	80	90	91
Expected return on plan assets	(337)	(450)	(436)	(20)	(27)	(27)
Amortization of prior service cost (credit)	4	5	2	(24)	(11)	(12)
Amortization of net loss	99	18	42	15	16	23
Net periodic benefit cost (income)	116	(73)	(38)	55	73	80
Curtailment/special termination benefits	8	7	1			
Settlements	1	4				
Total benefit cost (income)	$ 125	$ (62)	$ (37)	$ 55	$ 73	$ 80

The estimated net loss and prior service cost for pension plans that are expected to be amortized from accumulated other comprehensive loss into net periodic benefit cost during 2010 are $121 million and $4 million, respectively. The estimated net loss and prior service cost for the postretirement plans that are expected to be amortized from accumulated other comprehensive loss into net postretirement health care costs during 2010 are $21 million and ($24) million, respectively.

	Pension Benefits			Postretirement Benefits		
	2009	**2008**	**2007**	**2009**	**2008**	**2007**
Weighted-average assumptions used to determine net periodic benefit cost for years ended December 31:						
Discount rate	6.40%	6.50%	6.10%	6.39%	6.50%	6.10%
Expected long-term return on plan assets	8.24%	8.74%	8.74%	6.80%	8.00%	8.00%
Rate of compensation increase	5.00%	4.97%	4.97%	5.00%	5.00%	5.00%

RAI generally uses a hypothetical bond matching analysis to determine the discount rate. The discount rate modeling process involves selecting a portfolio of high quality corporate bonds whose cash flows, via coupons and maturities, match the projected cash flows of the obligations. For some years, there were no bonds maturing. In these instances, it was assumed that there would be bonds available with the same yield characteristics as the available bond maturing in the immediately preceding year.

RAI incurred special termination benefits due to changes in the organizational structure of RJR Tobacco and settlements due to early retirements under non-qualified pension plans. See note 4 for additional information regarding the restructuring.

The overall expected long-term rate of return on assets assumptions for pension and postretirement assets are based on: (1) the target asset allocation for plan assets, (2) long-term capital markets forecasts for asset classes employed, and (3) excess return expectations of active management to the extent asset classes are actively managed.

RAI uses a five-year period wherein unrealized equity gains and losses are reflected in the expense calculation at 20% per year, beginning the year after the gains or losses occur. In 2009, the combination of an increase in the fair value of plan assets and lower prior service costs, offset by a lower discount rate, resulted in a favorable change in funded status through a charge of $443 million, $267 million after tax, to accumulated other comprehensive loss. In 2008, the combination of a significant decrease in the fair value of plan assets and benefits paid resulted in an unfavorable change in funded status through a charge of $2,221 million, $1,337 million after tax, to accumulated other comprehensive loss.

The majority of plan assets are invested using active investment strategies. Active strategies employ multiple investment management firms. Managers within each asset class cover a range of investment styles and approaches

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

and are combined in a way that controls for capitalization, style biases, and interest rate exposures, while focusing primarily on security selection as a means to add value. Risk is controlled through diversification among asset classes, managers, styles and securities. Risk is further controlled both at the manager and asset class level by assigning excess return and tracking error targets against related benchmark indices. Investment manager performance is evaluated against these targets.

Allowable investment types include domestic equity, international equity, global equity, fixed income, real estate, private equity, hedge funds and global tactical asset allocation. The range of allowable investment types utilized for pension assets provides enhanced returns and more widely diversifies the plan. Domestic equities are composed of common stocks of large, medium and small companies. International equities include equity securities issued by companies domiciled outside the United States and in depository receipts, which represent ownership of securities of non-U.S. companies. Global equities include a combination of both U.S. and non-U.S. securities. Fixed income includes fixed income securities issued or guaranteed by the U.S. government, and to a lesser extent by non-U.S. governments, mortgage backed securities, corporate debt obligations and dollar-denominated obligations issued in the United States by non-U.S. banks and corporations. Up to 25% of the fixed income assets can be in debt securities that are below investment grade. Real estate consists of publicly traded real estate investment trust securities and private real estate investments. Private equity consists of the unregistered securities of private and public companies. Hedge fund investments are diversified portfolios utilizing multiple strategies that invest primarily in public securities, including equities and fixed income. Global tactical asset allocation strategies evaluate relative value within and across asset categories and overweight the attractive markets/assets while simultaneously underweighting less attractive markets/assets.

For pension assets, futures contracts are used for portfolio rebalancing and to approach fully invested portfolio positions. Otherwise, a small number of investment managers employ limited use of derivatives, including futures contracts, options on futures and interest rate swaps in place of direct investment in securities to gain efficient exposure to markets.

RAI s pension and postretirement plans weighted-average asset allocations at December 31, 2009 and 2008, by asset category were as follows:

	Pension Plans		
	2009 Target[(1)]	2009	2008
Asset Category:			
Domestic equities	30%	30%	28%
International equities	14%	13%	13%
Global equities	6%	8%	7%
Fixed income	34%	32%	31%
High yield fixed income	2%	3%	2%
Hedge funds	8%	8%	12%
Private equity	2%	1%	2%
Real estate	2%	3%	3%
Global tactical asset allocation	2%	2%	2%

Total	100%	100%	100%

(1) Allows for a rebalancing range of up to 5 percentage points around target asset allocations.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Postretirement Plans		
	2009 Target(1)	2009	2008
Asset Category:			
Domestic equities	43%	43%	41%
International equities	17%	17%	15%
Fixed income	38%	35%	42%
Hedge funds	1%	1%	1%
Real estate and other	1%	4%	1%
Total	100%	100%	100%

(1) Allows for a rebalancing range of up to 5 percentage points around target asset allocations.

RAI s pension and postretirement plans assets carried at fair value on a recurring basis as of December 31, 2009, were as follows(1):

Pension Plans	**Level 1**	**Level 2**	**Level 3**	**Total**
Asset Category:				
Domestic equities	$ 750	$ 348	$	$ 1,098
International equities	123	419		542
Global equities	310	1		311
Fixed income		1,048	96	1,144
High yield fixed income		121		121
Hedge funds		4	290	294
Private equity		7	43	50
Real estate	92	6	31	129
Global tactical asset allocation		90		90
Cash and other		240	3	243
Total	$ 1,275	$ 2,284	$ 463	$ 4,022

Postretirement Plans	**Level 1**	**Level 2**	**Level 3**	**Total**
Asset Category:				
Domestic equities	$	$ 115	$	$ 115
International equities		46		46
Fixed income	5	90		95

Hedge funds			1	1
Real estate and other		12		12
Total	$ 5	$ 263	$ 1	$ 269

(1) See note 2 for additional information on the fair value hierarchy.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Transfers of pension and postretirement plan assets in and out of Level 3 during 2009, by asset category were as follows:

	Balance as of January 1, 2009	Purchases, Sales, Issuances and Settlements (net)	Realized Gains (Losses)	Unrealized Gains (Losses)	Transferred From Other Levels[1]	Balance as of December 31, 2009
Global equities	$ 1	$ (2)	$ (1)	$ 2	$	$
Fixed income	80	(72)	8	12	68	96
Hedge funds	354	(99)	34	2		291
Private equity	48	1	1	(7)		43
Real estate	47	12		(28)		31
Other	3					3
Total	$ 533	$ (160)	$ 42	$ (19)	$ 68	$ 464

(1) Transfers in and out of Level 3 occur using the fair value at the beginning of the period.

The fair value of pension and postretirement assets classified as fixed income and certain of those classified as real estate and hedge funds, classified as Level 3, was determined primarily using an income approach. This approach utilized the net asset value of the underlying investment fund adjusted for restrictions or illiquidity of the disposition of the interest, the holders requirements to understand and accept the valuations provided by the fund s cash flows, and the rights and obligations of the ownership interest of the fund.

The fair value of pension and postretirement assets classified as private equity and certain of those classified as real estate and hedge funds, classified as Level 3, was determined primarily using an income approach. The fair value was determined by qualified appraisers utilizing observable and unobservable data, including comparable transactions, the fair value of the underlying assets, discount rates, restrictions on disposing interests in the investment s cash flows and other entity specific risk factors.

The fair value of pension and postretirement assets classified as other, classified as Level 3, was determined primarily using an income approach that utilized cash flow models and benchmarking strategies. This approach utilized observable inputs, including market-based interest rate curves, corporate credit spreads and corporate ratings. Additionally, unobservable factors incorporated into these models included default probability assumptions, potential recovery and discount rates.

Additional information relating to RAI s significant postretirement plans is as follows:

	2009	2008
Weighted-average health-care cost trend rate assumed for the following year	8.87%	9.49%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	5.00%	5.00%
Year that the rate reaches the ultimate trend rate	2017	2018

Assumed health-care cost trend rates have a significant effect on the amounts reported for the health-care plans. A one-percentage-point change in assumed health-care cost trend rates would have had the following effects:

	1-Percentage Point Increase	1-Percentage Point Decrease
Effect on total of service and interest cost components	$ 5	$ (4)
Effect on benefit obligation	69	(60)

During 2010, RAI expects to contribute approximately $309 million to its pension plans, of which $300 million is allocated to the 2009 plan year, and expects payments related to its postretirement plans to be $70 million.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Estimated future benefits payments:

		Postretirement Benefits		
Year	Pension Benefits	Gross Projected Benefit Payments Before Medicare Part D Subsidies	Expected Medicare Part D Subsidies	Net Projected Benefit Payments After Medicare Part D Subsidies
2010	$ 415	$ 108	$ 4	$ 104
2011	401	113	4	109
2012	387	115	4	111
2013	383	116	5	111
2014	380	116	5	111
2015-2019	1,961	557	29	528

RAI sponsors qualified defined contribution plans. The expense related to these plans was $37 million, $39 million and $41 million, in 2009, 2008 and 2007, respectively. Included in the plans is a non-leveraged employee stock ownership plan, which holds shares of the Reynolds Stock Fund. Participants can elect to contribute to the fund. Dividends paid on shares are reflected as a reduction of equity. All shares are considered outstanding for earnings per share computations.

Note 18 Segment Information

RAI s reportable operating segments are RJR Tobacco and Conwood. The RJR Tobacco segment consists of the primary operations of R. J. Reynolds Tobacco Company. The Conwood segment consists of Conwood Holdings, Inc., the primary operations of the Conwood companies and Lane. Two of RAI s wholly owned subsidiaries, Santa Fe and Niconovum AB, among others, are included in All Other. The segments were identified based on how RAI s chief operating decision maker allocates resources and assesses performance. RAI s wholly owned operating subsidiaries have entered into intercompany agreements for products or services with other RAI operating 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 cigarette manufacturer in the United States. RJR Tobacco s largest-selling cigarette brands, CAMEL, PALL MALL, WINSTON, KOOL and DORAL, were five of the ten best-selling brands of cigarettes in the United States as of December 31, 2009. Those brands, and its other brands, including SALEM, MISTY and CAPRI, are manufactured in a variety of styles and marketed in the United States. RJR Tobacco also manages contract manufacturing of cigarette and tobacco products through arrangements with BAT affiliates.

RAI s other reportable operating segment, Conwood, is the second largest smokeless tobacco products manufacturer in the United States. Conwood s primary brands include its largest-selling moist snuff brands, GRIZZLY, the best-selling moist snuff brand in the United States as of December 31, 2009, and KODIAK. Conwood also distributes a variety of tobacco products including WINCHESTER and CAPTAIN BLACK little cigars, and BUGLER roll-your-own tobacco.

Santa Fe manufactures and markets cigarettes and other tobacco products under the NATURAL AMERICAN SPIRIT brand, as well as manages RJR Tobacco s super premium cigarette brands, DUNHILL and STATE EXPRESS 555, which are licensed from BAT.

In January 2009, the activities of GPI were transitioned to other operating subsidiaries of RAI. The management and export of tobacco products to certain U.S. territories, U.S. duty-free shops and U.S. overseas military bases was transferred to RJR Tobacco, and sales of NATURAL AMERICAN SPIRIT in Europe and Japan were transferred to other indirect subsidiaries of RAI.

RAI s operating subsidiaries sales to foreign countries, primarily to related parties, for the years ended December 31, 2009, 2008 and 2007 were $547 million, $611 million and $616 million, respectively. Intersegment revenues and

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

items below the operating income line of the consolidated statements of income are not presented by segment, since they are excluded from the measure of segment profitability reviewed by RAI s chief operating decision maker.

Segment Data:

	2009	2008	2007
Net sales:			
RJR Tobacco	$ 7,334	$ 7,755	$ 8,022
Conwood	673	723	670
All Other	412	367	331
Consolidated net sales	$ 8,419	$ 8,845	$ 9,023
Operating income:			
RJR Tobacco	$ 1,487	$ 1,805	$ 1,988
Conwood	276	232	312
All Other	112	104	94
Corporate expense	(100)	(89)	(106)
Consolidated operating income	$ 1,775	$ 2,052	$ 2,288
Assets:			
RJR Tobacco	$ 14,865	$ 15,338	$ 15,956
Conwood	4,419	4,386	4,559
All Other	1,536	1,384	1,104
Corporate	15,491	15,647	16,336
Elimination adjustments	(18,302)	(18,601)	(19,326)
Consolidated assets	$ 18,009	$ 18,154	$ 18,629
Cash capital expenditures:			
RJR Tobacco	$ 55	$ 62	$ 93
Conwood	75	34	23
All Other	11	17	26
Consolidated capital expenditures	$ 141	$ 113	$ 142
Depreciation and amortization expense:			
RJR Tobacco	$ 123	$ 124	$ 125
Conwood	13	11	11
All Other	8	7	7
Consolidated depreciation and amortization expense	$ 144	$ 142	$ 143

Reconciliation to income from continuing operations before income taxes and extraordinary item:			
Operating income[1][2]	$ 1,775	$ 2,052	$ 2,288
Interest and debt expense	251	275	338
Interest income	(19)	(60)	(134)
Gain on termination of joint venture		(328)	
Other expense, net	9	37	11
Income from continuing operations before income taxes and extraordinary item	$ 1,534	$ 2,128	$ 2,073

(1) For information related to trademark impairments, see note 3.

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Sales made to McLane Company, Inc., a distributor, comprised 27%, 29% and 28% of RAI s revenue in 2009, 2008 and 2007, respectively. McLane Company is a customer in all segments. No other customer accounted for 10% or more of RAI s revenue during those periods.

Note 19 Related Party Transactions

RAI and its operating subsidiaries engage in transactions with affiliates of BAT. The following is a summary of balances and transactions with such BAT affiliates as of and for the years ended December 31:

Balances:

	2009	2008
Accounts receivable	$ 96	$ 91
Accounts payable	(3)	(3)
Deferred revenue	(57)	(50)

Significant transactions:

	2009	2008	2007
Net sales	$ 404	$ 468	$ 507
Research and development services billings	2	3	3
Purchases	16	12	18
RAI common stock purchases from B&W		75	

RAI s operating subsidiaries sell contract-manufactured cigarettes, processed strip leaf, pipe tobacco and little cigars to BAT affiliates. In 2009, as in the prior years, pricing for contract-manufactured cigarettes was generally calculated based on 2004 prices, using B&W s forecasted 2004 manufacturing costs plus 10%, increased by a multiple equal to the increase in the Producer Price Index for subsequent years, reported by the U.S. Bureau of Labor Statistics. Net sales, primarily of cigarettes, to BAT affiliates represented approximately 5.0% of RAI s total net sales in each of 2009 and 2008 and 6.0% of RAI s total net sales in 2007.

RJR Tobacco recorded deferred sales revenue relating to leaf sold to BAT affiliates that had not been delivered as of December 31, given that RJR Tobacco had a legal right to bill the BAT affiliates. Leaf sales revenue to BAT affiliates will be recognized when the product is shipped to the customer.

RJR Tobacco performs certain research and development for BAT affiliates pursuant to a joint technology sharing agreement entered into as a part of the B&W business combination. These services were accrued and billed to BAT affiliates and were recorded in RJR Tobacco s selling, general and administrative expenses, net of associated costs.

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

In connection with RAI s share repurchase program, which expired on April 30, 2009, RAI and B&W entered into an agreement on April 29, 2008, 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 1,387,095 shares of RAI common stock from B&W during 2008. No shares of RAI common stock were repurchased by RAI during 2009 under this program.

Note 20 RAI Guaranteed, Unsecured Notes Condensed Consolidating Financial Statements

The following condensed consolidating financial statements relate to the guaranties of RAI s $4.3 billion unsecured notes. See note 12 for additional information relating to these notes. 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 include: the accounts and activities of RAI, the parent issuer; RJR, RJR Tobacco, the Conwood companies, Conwood Holdings, Inc., Santa Fe, Lane, GPI and certain of RJR Tobacco s other subsidiaries, the Guarantors; other indirect subsidiaries of RAI that are not Guarantors; and elimination adjustments.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Condensed Consolidating Statements of Income
(Dollars in Millions)

	Parent Issuer	Guarantors	Non-Guarantors	Eliminations	Consolidated
For the Year Ended December 31, 2009					
Net sales	$	$ 7,985	$ 162	$ (132)	$ 8,015
Net sales, related party		404			404
Cost of products sold		4,541	76	(132)	4,485
Selling, general and administrative expenses	16	1,419	73		1,508
Amortization expense		28			28
Restructuring charge		56			56
Trademark impairment charges		567			567
Operating income (loss)	(16)	1,778	13		1,775
Interest and debt expense	242	9			251
Interest income		(9)	(10)		(19)
Intercompany interest (income) expense	(115)	114	1		
Intercompany dividend income		(43)		43	
Other (income) expense, net	(4)	13			9
Income (loss) before income taxes	(139)	1,694	22	(43)	1,534
Provision for (benefit from) income taxes	(48)	620			572
Equity income from subsidiaries	1,053	25		(1,078)	
Net income	$ 962	$ 1,099	$ 22	$ (1,121)	$ 962
For the Year Ended December 31, 2008					
Net sales	$	$ 8,345	$ 157	$ (125)	$ 8,377
Net sales, related party		468			468
Cost of products sold		4,917	71	(125)	4,863
Selling, general and administrative expenses	15	1,417	68		1,500
Amortization expense		22			22
Restructuring charge	6	81	3		90
Trademark impairment charges		318			318
Operating income (loss)	(21)	2,058	15		2,052
Interest and debt expense	265	9	1		275
Interest income	(1)	(44)	(15)		(60)
Gain on termination of joint venture			(328)		(328)
Intercompany interest (income) expense	(81)	76	5		
Intercompany dividend income		(43)		43	
Other (income) expense, net	5	33	(1)		37

Income (loss) before income taxes		(209)		2,027		353		(43)		2,128
Provision for (benefit from) income taxes		(73)		862		1				790
Equity income from subsidiaries		1,474		352				(1,826)		
Net income	$	1,338	$	1,517	$	352	$	(1,869)	$	1,338
For the Year Ended December 31, 2007										
Net sales	$		$	8,494	$	123	$	(101)	$	8,516
Net sales, related party				507						507
Cost of products sold				5,005		54		(99)		4,960
Selling, general and administrative expenses		53		1,583		51				1,687
Amortization expense				23						23
Trademark impairment charges				65						65
Operating income (loss)		(53)		2,325		18		(2)		2,288
Interest and debt expense		324		14						338
Interest income		(4)		(126)		(4)				(134)
Intercompany interest (income) expense		(114)		109		5				
Intercompany dividend income				(43)				43		
Other (income) expense, net		24				(13)				11
Income (loss) before income taxes and extraordinary item		(283)		2,371		30		(45)		2,073
Provision for (benefit from) income taxes		(100)		864		2				766
Equity income from subsidiaries		1,491		28				(1,519)		
Income before extraordinary item		1,308		1,535		28		(1,564)		1,307
Extraordinary item gain on acquisition				1						1
Net income	$	1,308	$	1,536	$	28	$	(1,564)	$	1,308

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Condensed Consolidating Statements of Cash Flows
(Dollars in Millions)

	Parent Issuer	Guarantors	Non-Guarantors	Eliminations	Consolidated
For the Year Ended December 31, 2009					
Cash flows from operating activities	$ 678	$ 1,630	$ 29	$ (883)	$ 1,454
Cash flows from (used in) investing activities:					
Proceeds from settlement of short-term investments	1	18			19
Proceeds from settlement of long-term investments		6			6
Capital expenditures		(137)	(4)		(141)
Acquisition, net of cash acquired			(43)		(43)
Net proceeds from the sale of fixed assets		11			11
Proceeds from termination of joint venture			24		24
Other, net		1			1
Intercompany investment	610	(610)			
Intercompany notes receivable	40	17		(57)	
Net cash flows from (used in) investing activities	651	(694)	(23)	(57)	(123)
Cash flows from (used in) financing activities:					
Dividends paid on common stock	(991)	(840)		840	(991)
Dividends paid on preferred stock	(43)			43	
Repurchase of common stock	(5)				(5)
Repayments of long-term debt	(189)	(11)			(200)
Other, net	4				4
Intercompany notes payable	(16)	(40)	(1)	57	
Net cash flows used in financing activities	(1,240)	(891)	(1)	940	(1,192)
Effect of exchange rate changes on cash and cash equivalents			6		6
Net change in cash and cash equivalents	89	45	11		145
Cash and cash equivalents at beginning of year	272	2,091	215		2,578
Cash and cash equivalents at end of year	$ 361	$ 2,136	$ 226	$	$ 2,723
For the Year Ended December 31, 2008					
Cash flows from operating activities	$ 1,141	$ 1,387	$ 36	$ (1,249)	$ 1,315

Cash flows from (used in) investing activities:					
Purchases of short-term investments	(8)	(48)			(56)
Proceeds from settlement of short-term investments	7	231			238
Proceeds from settlement of long-term investments		8			8
Capital expenditures		(106)	(7)		(113)
Distributions from equity investments			27		27
Net proceeds from the sale of fixed assets		8			8
Proceed from termination of joint venture			164		164
Other, net		1	1		2
Intercompany notes receivable	40	(29)		(11)	
Net cash flows from investing activities	39	65	185	(11)	278

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Parent Issuer	Guarantors	Non-Guarantors	Eliminations	Consolidated
Cash flows from (used in) financing activities:					
Dividends paid on common stock	(999)	(1,206)		1,206	(999)
Dividends paid on preferred stock	(43)			43	
Repurchase of common stock	(210)				(210)
Other, net	3				3
Intercompany notes payable	98	(40)	(69)	11	
Net cash flows used in financing activities	(1,151)	(1,246)	(69)	1,260	(1,206)
Effect of exchange rate changes on cash and cash equivalents			(24)		(24)
Net change in cash and cash equivalents	29	206	128		363
Cash and cash equivalents at beginning of year	243	1,885	87		2,215
Cash and cash equivalents at end of year	$ 272	$ 2,091	$ 215	$	$ 2,578
For the Year Ended December 31, 2007					
Cash flows from operating activities	$ 356	$ 1,067	$ 6	$ (98)	$ 1,331
Cash flows from (used in) investing activities:					
Purchases of short-term investments		(3,764)			(3,764)
Proceeds from settlement of short-term investments		4,655			4,655
Capital expenditures	(8)	(126)	(8)		(142)
Acquisition, net of cash acquired			(3)		(3)
Distributions from equity investments		5	10		15
Net proceeds from the sale of fixed assets		1	2		3
Other, net		(1)			(1)
Intercompany notes receivable	40	(847)		807	
Net cash flows from (used in) investing activities	32	(77)	1	807	763
Cash flows from (used in) financing activities:					
Dividends paid on common stock	$ (916)	$ (55)	$	$ 55	$ (916)
Dividends paid on preferred stock	(43)			43	
Repurchase of common stock	(60)				(60)
Repayments of long-term debt	(254)	(75)			(329)
Repayments of term loan	(1,542)				(1,542)
Proceeds from issuance of long-term debt	1,547				1,547
Deferred debt issuance costs	(15)				(15)

Other, net	3				3
Intercompany notes payable	839	(40)	8	(807)	
Net cash flows from (used in) financing activities	(441)	(170)	8	(709)	(1,312)
Net change in cash and cash equivalents	(53)	820	15		782
Cash and cash equivalents at beginning of year	296	1,065	72		1,433
Cash and cash equivalents at end of year	$ 243	$ 1,885	$ 87	$	$ 2,215

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Condensed Consolidating Balance Sheets
(Dollars in Millions)

	Parent Issuer	Guarantors	Non-Guarantors	Eliminations	Consolidated
December 31, 2009					
Assets					
Cash and cash equivalents	$ 361	$ 2,136	$ 226	$	$ 2,723
Short-term investments		4			4
Accounts receivable, net		90	19		109
Accounts receivable, related party		96			96
Notes receivable		1	35		36
Other receivables	1	13	1		15
Inventories		1,186	35	(2)	1,219
Deferred income taxes, net	13	942	1		956
Prepaid expenses and other	15	311	11		337
Short-term intercompany notes and interest receivable	80	55		(135)	
Other intercompany receivables	149			(149)	
Total current assets	619	4,834	328	(286)	5,495
Property, plant and equipment, net	7	990	28		1,025
Trademarks and other intangible assets, net		2,671	47		2,718
Goodwill		8,166	19		8,185
Long-term intercompany notes	2,040	1,387		(3,427)	
Investment in subsidiaries	9,708	464		(10,172)	
Other assets and deferred charges	292	186	134	(26)	586
Total assets	$ 12,666	$ 18,698	$ 556	$ (13,911)	$ 18,009
Liabilities and shareholders equity					
Accounts payable	$	$ 190	$ 6	$	$ 196
Tobacco settlement accruals		2,611			2,611
Due to related party		3			3
Deferred revenue, related party		57			57
Current maturities of long-term debt	300				300
Other current liabilities	355	781	37		1,173
Short-term intercompany notes and interest payable	31	80	24	(135)	
Other intercompany payables		149		(149)	
Total current liabilities	686	3,871	67	(284)	4,340
Intercompany notes and interest payable	1,387	2,040		(3,427)	
Long-term debt (less current maturities)	4,014	122			4,136

Deferred income taxes, net		456	11	(26)	441
Long-term retirement benefits (less current portion)	65	2,137	16		2,218
Other noncurrent liabilities	16	360			376
Shareholders equity	6,498	9,712	462	(10,174)	6,498
Total liabilities and shareholders equity	$ 12,666	$ 18,698	$ 556	$ (13,911)	$ 18,009

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Parent Issuer	Guarantors	Non-Guarantors	Eliminations	Consolidated
December 31, 2008					
Assets					
Cash and cash equivalents	$ 272	$ 2,091	$ 215	$	$ 2,578
Short-term investments	1	22			23
Accounts receivable, net		68	16		84
Accounts receivable, related party		91			91
Notes receivable		1	34		35
Other receivables	9	27	1		37
Inventories		1,145	27	(2)	1,170
Deferred income taxes, net	12	825	1		838
Prepaid expenses and other	35	128	4	(4)	163
Short-term intercompany notes and interest receivable	81	65		(146)	
Other intercompany receivables	68		6	(74)	
Total current assets	478	4,463	304	(226)	5,019
Property, plant and equipment, net	7	999	25		1,031
Trademarks and other intangible assets, net		3,266	4		3,270
Goodwill		8,166	8		8,174
Long-term intercompany notes	2,080	1,409		(3,489)	
Investment in subsidiaries	9,751	430		(10,181)	
Other assets and deferred charges	349	180	160	(29)	660
Total assets	$ 12,665	$ 18,913	$ 501	$ (13,925)	$ 18,154
Liabilities and shareholders equity					
Accounts payable	$ 3	$ 199	$ 4	$	$ 206
Tobacco settlement accruals		2,321			2,321
Due to related party		3			3
Deferred revenue, related party		50			50
Current maturities of long-term debt	189	11			200
Other current liabilities	347	775	25	(4)	1,143
Short-term intercompany notes and interest payable	40	81	25	(146)	
Other intercompany payables		74		(74)	
Total current liabilities	579	3,514	54	(224)	3,923
Intercompany notes and interest payable	1,409	2,080		(3,489)	
Long-term debt (less current maturities)	4,362	124			4,486
Deferred income taxes, net		311		(29)	282
Long-term retirement benefits (less current portion)	64	2,755	17		2,836

Other noncurrent liabilities	14	375	1		390
Shareholders equity	6,237	9,754	429	(10,183)	6,237
Total liabilities and shareholders equity	$ 12,665	$ 18,913	$ 501	$ (13,925)	$ 18,154

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 21 RJR Guaranteed, Unsecured Notes Condensed Consolidating Financial Statements

The following condensed consolidating financial statements relate to the guaranties of RJR s $62 million unsecured notes. See note 12 for additional information relating to these notes. RAI and certain of its direct or indirect, wholly owned subsidiaries, have fully and unconditionally, and jointly and severally, guaranteed these notes. The following condensed consolidating financial statements include: the accounts and activities of RAI, the parent Guarantor; RJR, the issuer of the debt securities; RJR Tobacco, GPI and certain of RJR s other subsidiaries, the other Guarantors; other subsidiaries of RAI and RJR, including Santa Fe, Lane and the Conwood companies, that are not Guarantors; and elimination adjustments.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Condensed Consolidating Statements of Income
(Dollars in Millions)

	Parent Guarantor	Issuer	Other Guarantors	Non-Guarantors	Eliminations	Consolidated
For the Year Ended December 31, 2009						
Net sales	$	$	$ 7,078	$ 1,139	$ (202)	$ 8,015
Net sales, related party			396	8		404
Cost of products sold			4,294	393	(202)	4,485
Selling, general and administrative expenses	16	3	1,180	309		1,508
Amortization expense			27	1		28
Restructuring charge			56			56
Trademark impairment charges			491	76		567
Operating income (loss)	(16)	(3)	1,426	368		1,775
Interest and debt expense	242	8	1			251
Interest income		(1)	(7)	(11)		(19)
Intercompany interest (income) expense	(115)	(7)	(49)	171		
Intercompany dividend income		(43)			43	
Other (income) expense, net	(4)	12	2	(1)		9
Income (loss) before income taxes	(139)	28	1,479	209	(43)	1,534
Provision for (benefit from) income taxes	(48)	(5)	565	60		572
Equity income from subsidiaries	1,053	941	25		(2,019)	
Net income	$ 962	$ 974	$ 939	$ 149	$ (2,062)	$ 962
For the Year Ended December 31, 2008						
Net sales	$	$	$ 7,462	$ 1,143	$ (228)	$ 8,377
Net sales, related party			460	8		468
Cost of products sold			4,690	401	(228)	4,863
Selling, general and administrative expenses	15	1	1,205	279		1,500
Amortization expense			21	1		22
Restructuring charge	6		81	3		90
Trademark impairment charges			176	142		318
Operating income (loss)	(21)	(1)	1,749	325		2,052
Interest and debt expense	265	9		1		275

Interest income	(1)	(2)	(40)	(17)		(60)
Gain on termination of joint venture				(328)		(328)
Intercompany interest (income) expense	(81)	(15)	(88)	184		
Intercompany dividend income		(43)			43	
Other (income) expense, net	5	(2)	34			37
Income (loss) before income taxes	(209)	52	1,843	485	(43)	2,128
Provision for (benefit from) income taxes	(73)	1	814	48		790
Equity income from subsidiaries	1,474	1,380	352		(3,206)	
Net income	$ 1,338	$ 1,431	$ 1,381	$ 437	$ (3,249)	$ 1,338
For the Year Ended December 31, 2007						
Net sales	$	$	$ 7,677	$ 1,002	$ (163)	$ 8,516
Net sales, related party			492	15		507
Cost of products sold			4,784	338	(162)	4,960
Selling, general and administrative expenses	53	1	1,395	238		1,687
Amortization expense			22	1		23
Trademark impairment charges			33	32		65
Operating income (loss)	(53)	(1)	1,935	408	(1)	2,288
Interest and debt expense	324	14				338
Interest income	(4)	(6)	(109)	(15)		(134)
Intercompany interest (income) expense	(114)	(4)	(75)	193		
Intercompany dividend income		(43)			43	
Other (income) expense, net	24	(8)	4	(9)		11
Income (loss) before income taxes and extraordinary item	(283)	46	2,115	239	(44)	2,073
Provision for (benefit from) income taxes	(100)	(1)	795	72		766
Equity income from subsidiaries	1,491	1,350	29		(2,870)	
Income before extraordinary item	1,308	1,397	1,349	167	(2,914)	1,307
Extraordinary item gain on acquisition			1			1
Net income	$ 1,308	$ 1,397	$ 1,350	$ 167	$ (2,914)	$ 1,308

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Condensed Consolidating Statements of Cash Flows
(Dollars in Millions)

	Parent Guarantor	Issuer	Other Guarantors	Non-Guarantors	Eliminations	Consolidated
For the Year Ended December 31, 2009						
Cash flows from operating activities	$ 678	$ 1,464	$ 1,394	$ 161	$ (2,243)	$ 1,454
Cash flows from (used in) investing activities:						
Proceeds from settlement of short-term investments	1	5	12	1		19
Proceeds from settlement of long-term investments			6			6
Capital expenditures			(55)	(86)		(141)
Acquisition, net of cash acquired				(43)		(43)
Net proceeds from the sale of fixed assets			11			11
Proceeds from termination of joint venture				24		24
Other, net		1				1
Intercompany investment	610	(610)				
Intercompany notes receivable	40	8	16		(64)	
Net cash flows from (used in) investing activities	651	(596)	(10)	(104)	(64)	(123)
Cash flows from (used in) financing activities:						
Dividends paid on common stock	(991)	(840)	(1,360)		2,200	(991)
Dividends paid on preferred stock	(43)				43	
Repurchase of common stock	(5)					(5)
Repayment of long-term debt	(189)	(11)				(200)
Other, net	4					4
Intercompany notes payable	(16)	1		(49)	64	
Net cash flows used in financing activities	(1,240)	(850)	(1,360)	(49)	2,307	(1,192)
Effect of exchange rate changes on cash and cash equivalents				6		6
	89	18	24	14		145

Net change in cash and cash equivalents						
Cash and cash equivalents at beginning of year	272	6	1,977	323		2,578
Cash and cash equivalents at end of year	$ 361	$ 24	$ 2,001	$ 337	$	$ 2,723
For the Year Ended December 31, 2008						
Cash flows from operating activities	$ 1,141	$ 1,035	$ 1,292	$ 71	$ (2,224)	$ 1,315
Cash flows from (used in) investing activities:						
Purchases of short-term investments	(8)	(11)	(28)	(9)		(56)
Proceeds from settlement of short-term investments	7	4	220	7		238
Proceeds from settlement of long-term investments			8			8
Capital expenditures			(62)	(51)		(113)
Distributions from equity investments				27		27
Net proceeds from the sale of fixed assets			7	1		8
Proceeds from termination of joint venture				164		164
Other, net		3	(3)	2		2
Intercompany notes receivable	40	71	(105)		(6)	
Net cash flows from investing activities	39	67	37	141	(6)	278
Cash flows from (used in) financing activities:						
Dividends paid on common stock	(999)	(1,126)	(975)	(80)	2,181	(999)
Dividends paid on preferred stock	(43)				43	
Repurchase of common stock	(210)					(210)
Other, net	3					3
Intercompany notes payable	98	5		(109)	6	
Net cash flows (used in) from financing activities	(1,151)	(1,121)	(975)	(189)	2,230	(1,206)
Effect of exchange rate changes on cash and cash equivalents				(24)		(24)
Net change in cash and cash equivalents	29	(19)	354	(1)		363
Cash and cash equivalents at beginning of year	243	25	1,623	324		2,215

Cash and cash equivalents at end of year	$	272	$	6	$	1,977	$	323	$		$	2,578

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Parent Guarantor	Issuer	Other Guarantors	Non-Guarantors	Eliminations	Consolidated
For the Year Ended December 31, 2007						
Cash flows from (used in) operating activities	$ 356	$ 224	$ 808	$ 180	$ (237)	$ 1,331
Cash flows from (used in) investing activities:						
Purchases of short-term investments		(2)	(3,660)	(102)		(3,764)
Proceeds from settlement of short-term investments		120	4,437	98		4,655
Acquisition, net of cash acquired				(3)		(3)
Capital expenditures	(8)		(93)	(41)		(142)
Distributions from equity investments			5	10		15
Net proceeds from the sale of fixed assets			1	2		3
Other, net		(1)				(1)
Net intercompany investments		(260)	260			
Intercompany notes receivable	40		(844)		804	
Net cash flows from (used in) investing activities	32	(143)	106	(36)	804	763
Cash flows from (used in) financing activities:						
Dividends paid on common stock	(916)		(139)	(55)	194	(916)
Dividends paid on preferred stock	(43)				43	
Repurchase of common stock	(60)					(60)
Repayments of long-term debt	(254)	(75)				(329)
Repayments of term loan	(1,542)					(1,542)
Proceeds from issuance of long-term debt	1,547					1,547
Deferred debt issuance costs	(15)					(15)
Other, net	3					3
Intercompany notes payable	839	(3)		(32)	(804)	
Net cash flows used in financing activities	(441)	(78)	(139)	(87)	(567)	(1,312)
Net change in cash and cash equivalents	(53)	3	775	57		782
Cash and cash equivalents at beginning of year	296	22	848	267		1,433

Cash and cash equivalents at end of year	$	243	$	25	$	1,623	$	324	$	$	2,215

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Condensed Consolidating Balance Sheets
(Dollars in Millions)

	Parent Guarantor	Issuer	Other Guarantors	Non-Guarantors	Eliminations	Consolidated
December 31, 2009						
Assets						
Cash and cash equivalents	$ 361	$ 24	$ 2,001	$ 337	$	$ 2,723
Short-term investments		1	2	1		4
Accounts receivable, net			47	62		109
Accounts receivable, related party			96			96
Note receivable		1		35		36
Other receivables	1		9	5		15
Inventories			760	461	(2)	1,219
Deferred income taxes, net	13	1	914	28		956
Prepaid expenses and other	15		295	27		337
Short-term intercompany notes and interest receivable	80	31	173		(284)	
Other intercompany receivables	149			26	(175)	
Total current assets	619	58	4,297	982	(461)	5,495
Property, plant and equipment, net	7		781	237		1,025
Trademarks and other intangible assets, net			1,352	1,366		2,718
Goodwill			5,303	2,882		8,185
Long-term intercompany notes	2,040	190	1,387		(3,617)	
Investment in subsidiaries	9,708	7,869	448		(18,025)	
Other assets and deferred charges	292	57	156	134	(53)	586
Total assets	$ 12,666	$ 8,174	$ 13,724	$ 5,601	$ (22,156)	$ 18,009
Liabilities and shareholders equity						
Accounts payable	$	$	$ 117	$ 79	$	$ 196
Tobacco settlement accruals			2,568	43		2,611
Due to related party			3			3
Deferred revenue, related party			57			57
Current maturities of long-term debt	300					300
Other current liabilities	355	6	690	122		1,173
Short-term intercompany notes and interest payable	31	131		122	(284)	
Other intercompany payables		39	136		(175)	

Total current liabilities	686	176	3,571	366	(459)	4,340
Intercompany notes and interest payable	1,387			2,230	(3,617)	
Long-term debt (less current maturities)	4,014	122				4,136
Deferred income taxes, net				494	(53)	441
Long-term retirement benefits (less current portion)	65	31	2,029	93		2,218
Other noncurrent liabilities	16	104	255	1		376
Shareholders equity	6,498	7,741	7,869	2,417	(18,027)	6,498
Total liabilities and shareholders equity	$ 12,666	$ 8,174	$ 13,724	$ 5,601	$ (22,156)	$ 18,009

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Parent Guarantor	Issuer	Other Guarantors	Non-Guarantors	Eliminations	Consolidated
December 31, 2008						
Assets						
Cash and cash equivalents	$ 272	$ 6	$ 1,977	$ 323	$	$ 2,578
Short-term investments	1	6	14	2		23
Accounts receivable, net			38	46		84
Accounts receivable, related party			88	3		91
Note receivable		1		34		35
Other receivables	9	1	23	4		37
Inventories			784	388	(2)	1,170
Deferred income taxes, net	12		806	20		838
Prepaid expenses and other	35		125	10	(7)	163
Short-term intercompany notes and interest receivable	81	35	183		(299)	
Other intercompany receivables	68	19		2	(89)	
Total current assets	478	68	4,038	832	(397)	5,019
Property, plant and equipment, net	7		856	168		1,031
Trademarks and other intangible assets, net			1,869	1,401		3,270
Goodwill			5,303	2,871		8,174
Long-term intercompany notes	2,080	207	1,408		(3,695)	
Investment in subsidiaries	9,751	8,000	413		(18,164)	
Other assets and deferred charges	349	63	310	161	(223)	660
Total assets	$ 12,665	$ 8,338	$ 14,197	$ 5,433	$ (22,479)	$ 18,154
Liabilities and shareholders equity						
Accounts payable	$ 3	$	$ 181	$ 22	$	$ 206
Tobacco settlement accruals			2,288	33		2,321
Due to related party			2	1		3
Deferred revenue, related party			50			50
Current maturities of long-term debt	189	11				200
Other current liabilities	347	7	676	120	(7)	1,143
Short-term intercompany notes and interest payable	40	130	2	127	(299)	
Other intercompany payables			89		(89)	
Total current liabilities	579	148	3,288	303	(395)	3,923

Intercompany notes and interest payable	1,409			2,286	(3,695)	
Long-term debt (less current maturities)	4,362	124				4,486
Deferred income taxes, net				505	(223)	282
Long-term retirement benefits (less current portion)	64	32	2,646	94		2,836
Other noncurrent liabilities	14	106	263	7		390
Shareholders equity	6,237	7,928	8,000	2,238	(18,166)	6,237
Total liabilities and shareholders equity	$ 12,665	$ 8,338	$ 14,197	$ 5,433	$ (22,479)	$ 18,154

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 22 Quarterly Results of Operations (Unaudited)

	First	Second	Third	Fourth
2009				
Net sales	$ 1,921	$ 2,250	$ 2,152	$ 2,096
Gross profit	923	1,049	1,014	948
Net income(1)	8	377	362	215
Per share data(2):				
Basic:				
Net income	$ 0.03	$ 1.29	$ 1.24	$ 0.74
Diluted:				
Net income	$ 0.03	$ 1.29	$ 1.24	$ 0.74
2008				
Net sales	$ 2,057	$ 2,339	$ 2,272	$ 2,177
Gross profit	893	1,034	1,043	1,012
Net income(1)	505	364	211	258
Per share data(2):				
Basic:				
Net income	$ 1.71	$ 1.24	$ 0.72	$ 0.89
Diluted:				
Net income	$ 1.71	$ 1.23	$ 0.72	$ 0.88

(1) First quarter of 2009 net income includes a $453 million trademark impairment charge. First quarter of 2008 net income includes a $328 million gain on termination of joint venture. Third quarter of 2008 net income includes a $91 million restructuring charge and a $173 million trademark impairment charge. Fourth quarter of 2009 net income includes a $56 million restructuring charge and a $114 million trademark impairment charge. Fourth quarter of 2008 net income includes a $(1) million restructuring charge and a $145 million trademark impairment charge.

(2) Income per share is computed independently for each of the periods presented. The sum of the income per share amounts for the quarters may not equal the total for the year.

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Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

Disclosure 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) In the first quarter of 2009, the companies collectively referred to as the Conwood companies and Lane, implemented an SAP enterprise business system. The implementation involved changes in systems and accordingly, have required changes to internal controls. RAI s management has reviewed the controls affected by the implementation and made appropriate changes to internal controls as a part of the implementation. RAI s management believes that the controls, as modified, are appropriate and functioning effectively as of the end of the period covered by this report.

Internal Control over Financial Reporting

Limitation on the Effectiveness of Controls

Internal controls are designed to provide reasonable assurance that assets are safeguarded and transactions are properly recorded, executed and reported in accordance with management s authorization. The effectiveness of internal controls is supported by qualified personnel and an organization structure that provides an appropriate division of responsibility and formalized procedures. An internal audit staff regularly monitors the adequacy and effectiveness of internal controls, including reporting to RAI s audit committee. Because of its inherent limitations, a system of internal control over financial reporting can provide only reasonable assurance and may not prevent or detect misstatements. See Management s Report on Internal Control over Financial Reporting in Item 8.

Changes in Controls

There have been no changes in RAI s internal controls over financial reporting that occurred during the fourth quarter that have materially affected, or are reasonably likely to materially affect, RAI s internal controls over financial reporting.

Item 9B. Other Information

None.

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PART III

Item 10. Directors, Executive Officers and Corporate Governance

Item 10 is incorporated by reference to the following sections of RAI s definitive Proxy Statement to be filed with the SEC on or about March 22, 2010, referred to as the Proxy Statement: The Board of Directors Item 1: Election of Directors; The Board of Directors Biographies of Board Members; The Board of Directors Governance Agreement; The Board of Directors Committees and Meetings of the Board of Directors Audit and Finance Committee; The Board of Directors Code of Conduct; and Security Ownership of Certain Beneficial Owners and Management Section 16(a) Beneficial Ownership Reporting Compliance. For information regarding the executive officers and certain significant employees of RAI, see Executive Officers and Certain Significant Employees of the Registrant in Item 4 of Part I of this report.

Item 11. Executive Compensation

Item 11 is incorporated by reference to the following sections of the Proxy Statement: Executive Compensation; Executive Compensation Compensation Committee Report; The Board of Directors Committees and Meetings of the Board of Directors Compensation and Leadership Development Committee; Compensation Committee Interlocks and Insider Participation; and The Board of Directors Director Compensation.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Item 12 is incorporated by reference to the following sections of the Proxy Statement: Security Ownership of Certain Beneficial Owners and Management Stock Ownership of Principal Shareholders; Security Ownership of Certain Beneficial Owners and Management Stock Ownership of Management; Security Ownership of Certain Beneficial Owners and Management Standstill Provisions; Transfer Restrictions. For information regarding securities authorized for issuance under equity compensation plans, see note 16 to consolidated financial statements.

Item 13. Certain Relationships and Related Transactions, and Director Independence

Item 13 is incorporated by reference to the following sections of the Proxy Statement: Certain Relationships and Related Transactions; and The Board of Directors Determination of Independence of Directors.

Item 14. Principal Accountant Fees and Services

Item 14 is incorporated by reference to the following sections of the Proxy Statement: Audit Matters Audit Committee s Audit and Non-Audit Services Pre-Approval Policy; and Audit Matters Fees of Independent Auditors.

PART IV

Item 15. Exhibits and Financial Statement Schedules

(a) The following documents are filed as a part of this report:

(1) Consolidated Statements of Income for the years ended December 31, 2009, 2008 and 2007.

Consolidated Statements of Cash Flows for the years ended December 31, 2009, 2008 and 2007.

Consolidated Balance Sheets as of December 31, 2009 and 2008.

Consolidated Statements of Shareholders Equity and Comprehensive Income for the years ended December 31, 2009, 2008 and 2007.

(2) Financial Statement Schedules have been omitted because the information required has been separately disclosed in the consolidated financial statements or notes.

(3) See (b) below.

(b) Exhibit Numbers 10.32 through 10.69 below are management contracts, compensatory plans or arrangements. The following exhibits are filed or furnished, as the case may be, as part of this report:

Exhibit Number	
3.1	Amended and Restated Certificate of Incorporation of Reynolds American Inc. (incorporated by reference to Exhibit 1 to Reynolds American Inc. s Form 8-A filed July 29, 2004).
3.2	Articles of Amendment of Amended and Restated Articles of Incorporation of Reynolds American Inc. (incorporated by reference to Exhibit 3.1 to Reynolds American Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 2007, filed August 2, 2007).
3.3	Amended and Restated Bylaws of Reynolds American Inc., dated December 4, 2008 (incorporated by reference to Exhibit 3.1 to Reynolds American Inc. s Form 8-K dated December 4, 2008).
4.1	Rights Agreement, between Reynolds American Inc. and The Bank of New York, as rights agent (incorporated by reference to Exhibit 3 to Reynolds American Inc. s Form 8-A filed July 29, 2004).
4.2	Amended and Restated Indenture, dated as of July 24, 1995, between RJR Nabisco, Inc. and The Bank of New York (incorporated by reference to Exhibit 4.1 to RJR Nabisco, Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 1995, filed August 8, 1995).
4.3	First Supplemental Indenture and Waiver, dated as of April 27, 1999, between RJR Nabisco, Inc. and The Bank of New York, to the Amended and Restated Indenture, dated as of July 24, 1995, between RJR Nabisco, Inc. and The Bank of New York, as successor trustee (incorporated by reference to Exhibit 10.3 to R.J. Reynolds Tobacco Holdings, Inc. s Form 8-A filed May 19, 1999).
4.4	Indenture, dated as of May 20, 2002, by and among R.J. Reynolds Tobacco Holdings, Inc., R. J. Reynolds Tobacco Company, RJR Acquisition Corp. and The Bank of New York (incorporated by reference to Exhibit 4.3 to R.J. Reynolds Tobacco Holdings, Inc. s Form 8-K dated May 15, 2002).
4.5	

	First Supplemental Indenture dated as of June 30, 2003, among GMB, Inc., FSH, Inc., R. J. Reynolds Tobacco Co., Santa Fe Natural Tobacco Company, Inc., RJR Packaging, LLC, R. J. Reynolds Tobacco Holdings, Inc., R.J. Reynolds Tobacco Company, RJR Acquisition Corp. and The Bank of New York, as Trustee, to the Indenture dated as of May 20, 2002, among R. J. Reynolds Tobacco Holdings, Inc., R.J. Reynolds Tobacco Company, RJR Acquisition Corp. and The Bank of New York, as Trustee (incorporated by reference to Exhibit 4.2 to R.J. Reynolds Tobacco Holdings, Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 2003, filed August 8, 2003).
4.6	Second Supplemental Indenture, dated as of July 30, 2004, among R.J. Reynolds Tobacco Holdings, Inc., Reynolds American Inc., R.J. Reynolds Tobacco Company, RJR Acquisition Corp., GMB, Inc., FSH, Inc., R.J. Reynolds Tobacco Co., RJR Packaging, LLC, BWT Brands, Inc. and The Bank of New York, as Trustee, to the Indenture dated May 20, 2002, among R.J. Reynolds Tobacco Holdings, Inc., R.J. Reynolds Tobacco Company, RJR Acquisition Corp. and The Bank of New York (incorporated by reference to Exhibit 4.3 to Reynolds American Inc. s Form 8-K dated July 30, 2004).

Exhibit Number	
4.7	Third Supplemental Indenture, dated May 31, 2006, to Indenture, dated May 20, 2002, among R.J. Reynolds Tobacco Holdings, Inc., Reynolds American Inc. and certain subsidiaries of R.J. Reynolds Tobacco Holdings, Inc. as guarantors and The Bank of New York Trust Company, N.A. as Trustee (incorporated by reference to Exhibit 4.6 to Reynolds American Inc. s Form 8-K dated May 31, 2006).
4.8	Fourth Supplemental Indenture, dated June 20, 2006, to Indenture, dated May 20, 2002, among R.J. Reynolds Tobacco Holdings, Inc., Reynolds American Inc. and certain subsidiaries of R.J. Reynolds Tobacco Holdings, Inc. as guarantors and The Bank of New York Trust Company, N.A. as Trustee (incorporated by reference to Exhibit 4.7 to Reynolds American Inc. s Form 8-K dated June 20, 2006).
4.9	Fifth Supplemental Indenture, dated September 30, 2006, to Indenture, dated May 20, 2002, among R.J. Reynolds Tobacco Holdings, Inc., Reynolds American Inc. and certain subsidiaries of R.J. Reynolds Tobacco Holdings, Inc. as guarantors, and The Bank of New York Trust Company, N.A., as successor to The Bank of New York, as Trustee, as amended (incorporated by reference to Exhibit 4.2 to Reynolds American Inc. s Form 8-K dated September 30, 2006).
4.10	Indenture, dated May 31, 2006, among Reynolds American Inc. and certain of its subsidiaries as guarantors and The Bank of New York Trust Company, N.A. as Trustee (incorporated by reference to Exhibit 4.1 to Reynolds American Inc. s Form 8-K dated May 31, 2006).
4.11	First Supplemental Indenture, dated September 30, 2006, to Indenture, dated May 31, 2006, among Reynolds American Inc. and certain of its subsidiaries as guarantors and The Bank of New York Trust Company, N.A., as successor to The Bank of New York, as Trustee (incorporated by reference to Exhibit 4.1 to Reynolds American Inc. s Form 8-K dated September 30, 2006).
4.12	Second Supplemental Indenture, dated February 6, 2009, to Indenture, dated May 31, 2006, as supplemented by the First Supplemental Indenture, dated September 30, 2006, among Reynolds American Inc. and certain of its subsidiaries as guarantors and The Bank of New York Mellon Trust Company, N.A., f/k/a The Bank of New York Trust Company, N.A., as Trustee (incorporated by reference to Exhibit 4.21 to Reynolds American Inc. s Annual Report on Form 10-K for the fiscal year ended December 31, 2008, filed February 23, 2009).
4.13	In accordance with Item 601(b)(4)(iii) of Regulation S-K, Reynolds American Inc. agrees to furnish to the SEC, upon request, a copy of each instrument that defines the rights of holders of such long term debt not filed or incorporated by reference as an exhibit to this Annual Report on Form 10-K.
10.1	Fifth Amended and Restated Credit Agreement, dated as of June 28, 2007, among Reynolds American Inc., the agents and other parties named therein, and the lending institutions listed from time to time on Annex I thereto (incorporated by reference to Exhibit 10.1 to Reynolds American Inc. s Form 8-K dated June 28, 2007).
10.2	First Amendment to Credit Agreement, dated March 31, 2008, among Reynolds American Inc., the agents and other parties named therein, and the lending institutions listed from time to time on Annex I thereto (incorporated by reference to Exhibit 10.1 to Reynolds American Inc. s Form 8-K dated April 7, 2008).
10.3	Second Amendment to Credit Agreement, dated June 30, 2009, among Reynolds American Inc. and the agents and lending institutions named therein (incorporated by reference to Exhibit 10.1 to Reynolds American Inc. s Form 8-K dated July 8, 2009).
10.4	Sixth Amended and Restated Subsidiary Guaranty, dated as of June 28, 2007, 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 10.4 to Reynolds American Inc. s Form 8-K dated June 28, 2007).
10.5	

Joinder Agreement to Sixth Amended and Restated Subsidiary Guaranty, dated as of January 1, 2009, among JPMorgan Chase Bank, N.A., as Administrative Agent, and RAI Services Company (incorporated by reference to Exhibit 10.4 to Reynolds American Inc. s Annual Report on Form 10-K for the fiscal year ended December 31, 2008, filed February 23, 2009).

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Exhibit Number	
10.6	Underwriting Agreement, dated June 18, 2007, by and among Reynolds American Inc., as issuer, Reynolds American Inc. s subsidiaries that are guaranteeing the Notes and Citigroup Global Markets Inc., J.P. Morgan Securities Inc., Lehman Brothers Inc. and Morgan Stanley & Co. Incorporated, as representatives of the several underwriters named therein (incorporated by reference to Exhibit 1.1 to Reynolds American Inc. s Form 8-K dated June 18, 2007).
10.7	Purchase Agreement, dated April 24, 2006, by and among (i) Reynolds American Inc., (ii) Reynolds American Inc. s direct, wholly owned acquisition subsidiary, Pinch Acquisition Corporation, (iii) Karl J. Breyer, Marshall E. Eisenberg and Thomas J. Pritzker, not individually, but solely as co-trustees of those certain separate and distinct trusts listed therein, and (iv) GP Investor, L.L.C. (incorporated by reference to Exhibit 2.1 to Reynolds American Inc. s Form 8-K dated April 24, 2006).
10.8	Amendment No. 1, dated as of May 31, 2006, to the Purchase Agreement, dated as of April 24, 2006, by and among Karl J. Breyer, Marshall E. Eisenberg and Thomas J. Pritzker, not individually, but solely as co-trustees of those certain separate and distinct trusts listed therein, GP Investor, L.L.C., Reynolds American Inc. and Conwood Holdings, Inc. (f/k/a Pinch Acquisition Corporation) (incorporated by reference to Exhibit 2.1 to Reynolds American Inc. s Form 8-K dated May 31, 2006).
10.9	Formation Agreement, dated as of July 30, 2004, among Brown & Williamson Tobacco Corporation (n/k/a Brown & Williamson Holdings, Inc.), Brown & Williamson U.S.A., Inc. (n/k/a R. J. Reynolds Tobacco Company) and Reynolds American Inc. (incorporated by reference to Exhibit 10.1 to Reynolds American Inc. s Form 8-K dated July 30, 2004).
10.10	Governance Agreement, dated as of July 30, 2004, among British American Tobacco p.l.c., Brown & Williamson Tobacco Corporation (n/k/a Brown & Williamson Holdings, Inc.) and Reynolds American Inc. (incorporated by reference to Exhibit 10.2 to Reynolds American Inc. s Form 8-K dated July 30, 2004).
10.11	Amendment No. 1 to the Governance Agreement, dated as of November 18, 2004, among British American Tobacco p.l.c., Brown & Williamson Holdings, Inc. and Reynolds American Inc. (incorporated by reference to Exhibit 10.1 to Reynolds American Inc. s Form 8-K dated November 18, 2004).
10.12	Amendment No. 2, dated April 29, 2008, to the Governance Agreement, dated as of July 30, 2004, by and among British American Tobacco p.l.c., Brown & Williamson Holdings, Inc. and Reynolds American Inc. (incorporated by reference to Exhibit 10.2 to Reynolds American Inc. s Form 8-K dated April 29, 2008).
10.13	Share Repurchase Agreement, dated April 29, 2008, by and between Reynolds American Inc. and Brown & Williamson Holdings, Inc. (incorporated by reference to Exhibit 10.1 to Reynolds American Inc. s Form 8-K dated April 29, 2008).
10.14	Non-Competition Agreement, dated as of July 30, 2004, between Reynolds American Inc. and British American Tobacco p.l.c. (incorporated by reference to Exhibit 10.3 to Reynolds American Inc. s Form 8-K dated July 30, 2004).
10.15	Contract Manufacturing Agreement, dated as of July 30, 2004, by and between R. J. Reynolds Tobacco Company and BATUS Japan, Inc. (incorporated by reference to Exhibit 10.4 to Reynolds American Inc. s Form 8-K dated July 30, 2004).
10.16	October 2005 Amendments to the Contract Manufacturing Agreement, dated as of July 30, 2004, by and between R. J. Reynolds Tobacco Company and BATUS Japan, Inc. (incorporated by reference to Exhibit 10.2 to Reynolds American Inc. s Quarterly Report on Form 10-Q for the quarter ended September 30, 2005, filed November 3, 2005).
10.17	

	April 30, 2007 Amendments to the Contract Manufacturing Agreement, dated July 30, 2004, by and between R. J. Reynolds Tobacco Company and BATUS Japan, Inc. (incorporated by reference to Exhibit 10.9 to Reynolds American Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 2007, filed August 2, 2007).
10.18	June 12, 2007 Amendments to the Contract Manufacturing Agreement, dated July 30, 2004, by and between R. J. Reynolds Tobacco Company and BATUS Japan, Inc. (incorporated by reference to Exhibit 10.10 to Reynolds American Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 2007, filed August 2, 2007).

Exhibit Number	
10.19	Letter Agreement, dated March 13, 2008, amending the Contract Manufacturing Agreement, dated July 30, 2004, by and between R. J. Reynolds Tobacco Company and BATUS Japan, Inc. (incorporated by reference to Exhibit 10.3 to Reynolds American Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 2008, filed August 4, 2008).
10.20	Contract Manufacturing Agreement, dated as of July 30, 2004, by and between R. J. Reynolds Tobacco Company and B.A.T. (U.K. & Export) Limited (incorporated by reference to Exhibit 10.5 to Reynolds American Inc. s Form 8-K dated July 30, 2004).
10.21	Amendment, effective January 2, 2007, to Contract Manufacturing Agreement, dated as of July 30, 2004, by and between R. J. Reynolds Tobacco Company and B.A.T. (U.K. & Export) Limited (incorporated by reference to Exhibit 10.2 to Reynolds American Inc. s Quarterly Report on Form 10-Q for the quarter ended March 31, 2007, filed May 4, 2007).
10.22	Purchase Agreement dated as of March 9, 1999, as amended and restated as of May 11, 1999, among R. J. Reynolds Tobacco Company, RJR Nabisco, Inc. and Japan Tobacco Inc. (incorporated by reference to Exhibit 2.1 to R. J. Reynolds Tobacco Holdings, Inc. s Form 8-K dated May 12, 1999).
10.23	Settlement Agreement dated August 25, 1997, between the State of Florida and settling defendants in The State of Florida v. American Tobacco Co. (incorporated by reference to Exhibit 2 to R. J. Reynolds Tobacco Holdings, Inc. s Form 8-K dated August 25, 1997).
10.24	Comprehensive Settlement Agreement and Release dated January 16, 1998, between the State of Texas and settling defendants in The State of Texas v. American Tobacco Co. (incorporated by reference to Exhibit 2 to R. J. Reynolds Tobacco Holdings, Inc. s Form 8-K dated January 16, 1998).
10.25	Settlement Agreement and Release in re: The State of Minnesota v. Philip Morris, Inc., by and among the State of Minnesota, Blue Cross and Blue Shield of Minnesota and the various tobacco company defendants named therein, dated as of May 8, 1998 (incorporated by reference to Exhibit 99.1 to R. J. Reynolds Tobacco Holdings, Inc. s Quarterly Report on Form 10-Q for the quarter ended March 30, 1998, filed May 15, 1998).
10.26	Settlement Agreement and Stipulation for Entry of Consent Judgment in re: The State of Minnesota v. Philip Morris, Inc., by and among the State of Minnesota, Blue Cross and Blue Shield of Minnesota and the various tobacco company defendants named therein, dated as of May 8, 1998 (incorporated by reference to Exhibit 99.2 to R. J. Reynolds Tobacco Holdings, Inc. s Quarterly Report on Form 10-Q for the quarter ended March 30, 1998, filed May 15, 1998).
10.27	Form of Consent Judgment by Judge Kenneth J. Fitzpatrick, Judge of District Court in re: The State of Minnesota v. Philip Morris, Inc. (incorporated by reference to Exhibit 99.3 to R. J. Reynolds Tobacco Holdings, Inc. s Quarterly Report on Form 10-Q for the quarter ended March 30, 1998, filed May 15, 1998).
10.28	Stipulation of Amendment to Settlement Agreement and for Entry of Agreed Order dated July 2, 1998, by and among the Mississippi Defendants, Mississippi and the Mississippi Counsel in connection with the Mississippi Action (incorporated by reference to Exhibit 99.2 to R. J. Reynolds Tobacco Holdings, Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 1998, filed August 14, 1998).
10.29	Stipulation of Amendment to Settlement Agreement and for Entry of Consent Decree dated July 24, 1998, by and among the Texas Defendants, Texas and the Texas Counsel in connection with the Texas Action (incorporated by reference to Exhibit 99.4 to R. J. Reynolds Tobacco Holdings, Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 1998, filed August 14, 1998).
10.30	Stipulation of Amendment to Settlement Agreement and for Entry of Consent Decree dated September 11, 1998, by and among the State of Florida and the tobacco companies named therein (incorporated by reference to Exhibit 99.1 to R. J. Reynolds Tobacco Holdings, Inc. s Quarterly Report

on Form 10-Q for the quarter ended September 30, 1998, filed November 12, 1998).

10.31	Master Settlement Agreement, referred to as the MSA, dated November 23, 1998, between the Settling States named in the MSA and the Participating Manufacturers also named therein (incorporated by reference to Exhibit 4 to R. J. Reynolds Tobacco Holdings, Inc. s Form 8-K dated November 23, 1998).
10.32	Amended and Restated Directors and Officers Indemnification Agreement (incorporated by reference to Exhibit 10.1 to Reynolds American Inc. s Form 8-K dated February 1, 2005).

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Exhibit Number	
10.33	Reynolds American Inc. Outside Directors Compensation Summary, effective January 1, 2010.
10.34	Equity Incentive Award Plan for Directors of Reynolds American Inc., referred to as the EIAP (Amended and Restated Effective November 30, 2007) (incorporated by reference to Exhibit 10.40 to Reynolds American Inc. s Annual Report on Form 10-K for the fiscal year ended December 31, 2007, filed February 27, 2008).
10.35	Form of Deferred Stock Unit Agreement between Reynolds American Inc. and the Director named therein, pursuant to the EIAP (incorporated by reference to Exhibit 10.32 to Reynolds American Inc. s Annual Report on Form 10-K for the fiscal year ended December 31, 2008, filed February 23, 2009).
10.36	Form of Deferred Stock Unit Agreement between R. J. Reynolds Tobacco Holdings, Inc. and the Director named therein, pursuant to the EIAP (incorporated by reference to Exhibit 10.9 to R. J. Reynolds Tobacco Holdings, Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 1999, filed August 16, 1999).
10.37	Deferred Compensation Plan for Directors of Reynolds American Inc. (Amended and Restated Effective November 30, 2007) (incorporated by reference to Exhibit 10.43 to Reynolds American Inc. s Annual Report on Form 10-K for the fiscal year ended December 31, 2007, filed February 27, 2008).
10.38	Amended and Restated (effective as of May 11, 2007) Reynolds American Inc. Long-Term Incentive Plan (incorporated by reference to Exhibit 10.6 to Reynolds American Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 2007, filed August 2, 2007).
10.39	Form of Performance Unit Agreement (one-year vesting), dated February 3, 2009, between Reynolds American Inc. and the grantee named therein (incorporated by reference to Exhibit 10.7 to Reynolds American Inc. s Quarterly Report on Form 10-Q for the quarter ended March 31, 2009, filed May 1, 2009).
10.40	Form of Performance Unit Agreement (three-year vesting), dated March 6, 2007, between Reynolds American Inc. and the grantee named therein (incorporated by reference to Exhibit 10.9 to Reynolds American Inc. s Quarterly Report on Form 10-Q for the quarter ended March 31, 2007, filed May 4, 2007).
10.41	Form of Performance Unit Agreement (three-year vesting), dated March 6, 2008, between Reynolds American Inc. and the grantee named therein (incorporated by reference to Exhibit 10.11 to Reynolds American Inc. s Quarterly Report on Form 10-Q for the quarter ended March 31, 2008, filed May 2, 2008).
10.42	Form of Performance Share Agreement (three-year vesting), dated March 2, 2009, between Reynolds American Inc. and the grantee named therein (incorporated by reference to Exhibit 10.1 to Reynolds American Inc. s Form 8-K dated March 2, 2009).
10.43	Performance Unit Agreement (three-year vesting), dated March 6, 2007, between Reynolds American Inc. and Jeffrey A. Eckmann (incorporated by reference to Exhibit 10.10 to Reynolds American Inc. s Quarterly Report on Form 10-Q for the quarter ended March 31, 2007, filed May 4, 2007).
10.44	Performance Unit Agreement (three-year vesting), dated March 6, 2008, between Reynolds American Inc. and Jeffrey A. Eckmann (incorporated by reference to Exhibit 10.12 to Reynolds American Inc. s Quarterly Report on Form 10-Q for the quarter ended March 31, 2008, filed May 2, 2008).
10.45	Form of Restricted Stock Agreement, dated March 6, 2007, between Reynolds American Inc. and the grantee named therein (incorporated by reference to Exhibit 10.11 to Reynolds American Inc. s Quarterly Report on Form 10-Q for the quarter ended March 31, 2007, filed May 4, 2007).
10.46	Form of Restricted Stock Agreement, dated March 6, 2008, between Reynolds American Inc. and the grantee named therein (incorporated by reference to Exhibit 10.13 to Reynolds American Inc. s Quarterly Report on Form 10-Q for the quarter ended March 31, 2008, filed May 2, 2008).

10.47	Restricted Stock Agreement, dated March 6, 2007, between Reynolds American Inc. and Jeffrey A. Eckmann (incorporated by reference to Exhibit 10.12 to Reynolds American Inc. s Quarterly Report on Form 10-Q for the quarter ended March 31, 2007, filed May 4, 2007).

Exhibit Number	
10.48	Offer of Employment Letter, dated July 29, 2004, by Reynolds American Inc. and Susan M. Ivey, accepted by Ms. Ivey on July 30, 2004 (incorporated by reference to Exhibit 10.22 to Reynolds American Inc. s Quarterly Report on Form 10-Q for the quarter ended September 30, 2004, filed November 5, 2004).
10.49	Letter Agreement, dated December 19, 2007, regarding Severance Benefits and Change of Control Protections and amending July 29, 2004, offer of employment letter, between Reynolds American Inc. and Susan M. Ivey (incorporated by reference to Exhibit 10.57 to Reynolds American Inc. s Annual Report on Form 10-K for the fiscal year ended December 31, 2007, filed February 27, 2008).
10.50	Offer of Employment Letter dated July 29, 2004, by Reynolds American Inc. and Jeffrey A. Eckmann, accepted by Mr. Eckmann on July 29, 2004 (incorporated by reference to Exhibit 10.24 to Reynolds American Inc. s Quarterly Report on Form 10-Q for the quarter ended September 30, 2004, filed November 5, 2004).
10.51	Letter Agreement, dated February 2, 2005, between Reynolds American Inc. and Jeffrey A. Eckmann, amending July 29, 2004, offer letter (incorporated by reference to Exhibit 10.5 to Reynolds American Inc. s Form 8-K dated February 1, 2005).
10.52	Letter Agreement, dated December 19, 2007, regarding Severance Benefits and Change of Control Protections and amending certain prior letter agreements, between Reynolds American Inc. and Jeffrey A. Eckmann (incorporated by reference to Exhibit 10.60 to Reynolds American Inc. s Annual Report on Form 10-K for the fiscal year ended December 31, 2007, filed February 27, 2008).
10.53	Offer of Employment Letter, dated August 18, 2006, by Reynolds American Inc. and E. Julia (Judy) Lambeth, accepted by Ms. Lambeth on August 19, 2006 (incorporated by reference to Exhibit 10.1 to Reynolds American Inc. s Form 8-K dated August 19, 2006).
10.54	Offer of Employment Letter, dated December 4, 2006, between R. J. Reynolds Tobacco Company and Daniel M. Delen (incorporated by reference to Exhibit 10.1 to Reynolds American Inc. s Quarterly Report on Form 10-Q for the quarter ended March 31, 2007, filed May 4, 2007).
10.55	May 24, 1999, July 21, 1999, and June 16, 2000, Letter Agreements between R. J. Reynolds Tobacco Company and Thomas R. Adams (incorporated by reference to Exhibit 10.64 to Reynolds American Inc. s Annual Report on Form 10-K for the fiscal year ended December 31, 2007, filed February 27, 2008).
10.56	Form of Amended Letter Agreement regarding Severance Benefits and Change of Control Protections between Reynolds American Inc. and the officer named therein (incorporated by reference to Exhibit 10.67 to Reynolds American Inc. s Annual Report on Form 10-K for the fiscal year ended December 31, 2007, filed February 27, 2008).
10.57	Reynolds American Inc. Executive Severance Plan, as amended and restated effective August 1, 2009 (incorporated by reference to Exhibit 10.1 to Reynolds American Inc. s Form 8-K dated July 21, 2009).
10.58	Reynolds American Inc. Annual Incentive Award Plan, as amended and restated as of January 1, 2009 (incorporated by reference to Exhibit 10.59 to Reynolds American Inc. s Annual Report on Form 10-K for the fiscal year ended December 31, 2008, filed February 23, 2009).
10.59	Amendment No. 1 to the Reynolds American Inc. Annual Incentive Award Plan, as amended and restated as of January 1, 2009 (incorporated by reference to Exhibit 10.2 to Reynolds American Inc. s Form 8-K dated February 3, 2009).
10.60	Reynolds American Inc. 2009 Omnibus Incentive Compensation Plan (incorporated by reference to Appendix A of Reynolds American Inc. s definitive Proxy Statement on Schedule 14A filed on March 23, 2009).
10.61	

	Retention Trust Agreement dated May 13, 1998, by and between RJR Nabisco, Inc. and Wachovia Bank, N.A. (incorporated by reference to Exhibit 10.6 to RJR Nabisco Holdings, Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 1998, filed August 14, 1998).
10.62	Amendment No. 1 to Retention Trust Agreement, dated May 13, 1998, by and between RJR Nabisco, Inc. and Wachovia Bank, N.A., dated October 1, 2006 (incorporated by reference to Exhibit 10.56 to Reynolds American Inc. s S-4 filed October 3, 2006).

Exhibit Number	
10.63	Amendment No. 2 to Retention Trust Agreement, dated May 13, 1998, as amended, by and between R.J. Reynolds Tobacco Holdings, Inc., as successor to RJR Nabisco, Inc., and Wachovia Bank, N.A. (incorporated by reference to Exhibit 10.66 to Reynolds American Inc. s Annual Report on Form 10-K for the fiscal year ended December 31, 2006, filed February 27, 2007).
10.64	Supplemental Pension Plan for Executives of Brown & Williamson Tobacco Corporation (n/k/a Brown & Williamson Holdings, Inc.) (as amended through July 29, 2004) (incorporated by reference to Exhibit 10.67 to Reynolds American Inc. s Annual Report on Form 10-K for the fiscal year ended December 31, 2004, filed March 9, 2005).
10.65	Form of Reynolds American Inc. Trust Agreement, by and among the executive officer named therein, J.P. Morgan Trust Company of Delaware, the trustee, as successor to United States Trust Company, N.A., and Reynolds American Inc., as administrative agent for the executive (incorporated by reference to Exhibit 10.65 to Reynolds American Inc. s Annual Report on Form 10-K for the fiscal year ended December 31, 2008, filed February 23, 2009).
10.66	Brown & Williamson Tobacco Corporation (n/k/a Brown & Williamson Holdings, Inc.) Health Care Plan for Salaried Employees (as amended through July 29, 2004, by Amendment Nos. 1 and 2) (incorporated by reference to Exhibit 10.69 to Reynolds American Inc. s Annual Report on Form 10-K for the fiscal year ended December 31, 2004, filed March 9, 2005).
10.67	Amendment No. 3, entered into as of December 31, 2004, to the Brown & Williamson Tobacco Corporation (n/k/a Brown & Williamson Holdings, Inc.) Health Care Plan for Salaried Employees (incorporated by reference to Exhibit 10.70 to Reynolds American Inc. s Annual Report on Form 10-K for the fiscal year ended December 31, 2004, filed March 9, 2005).
10.68	Amendment No. 4, entered into as of April 20, 2005, to the Brown & Williamson Tobacco Corporation Health Care Plan for Salaried Employees (incorporated by reference to Exhibit 10.71 to Reynolds American Inc. s Annual Report on Form 10-K for the fiscal year ended December 31, 2006, filed February 27, 2007).
10.69	Amendment No. 5, entered into as of December 29, 2006, to the Brown & Williamson Tobacco Corporation Health Care Plan for Salaried Employees (incorporated by reference to Exhibit 10.72 to Reynolds American Inc. s Annual Report on Form 10-K for the fiscal year ended December 31, 2006, filed February 27, 2007).
10.70	Supply Agreement, dated May 2, 2005, by and between R. J. Reynolds Tobacco Company and Alcan Packaging Food and Tobacco Inc. (incorporated by reference to Exhibit 10.1 to Reynolds American Inc. s Form 8-K dated May 2, 2005).
10.71	First Amendment to Supply Agreement, dated September 16, 2005, by and between R. J. Reynolds Tobacco Company and Alcan Packaging Food and Tobacco Inc. (incorporated by reference to Exhibit 10.1 to Reynolds American Inc. s Quarterly Report on Form 10-Q for the quarter ended September 30, 2005, filed November 3, 2005).
10.72	Second Amendment to Supply Agreement, effective December 31, 2008, between R. J. Reynolds Tobacco Company and Alcan Packaging Food and Tobacco Inc. (incorporated by reference to Exhibit 10.1 to Reynolds American Inc. s Form 8-K dated December 31, 2008).
10.73	Supply Agreement, dated May 2, 2005, by and between R. J. Reynolds Tobacco Company and Alcoa Flexible Packaging, LLC (incorporated by reference to Exhibit 10.2 to Reynolds American Inc. s Form 8-K dated May 2, 2005).
10.74	Letter, dated January 28, 2008, between R. J. Reynolds Tobacco Company and Alcoa Flexible Packaging, LLC regarding the May 2, 2005 Supply Agreement between the parties (incorporated by reference to Exhibit 10.6 to Reynolds American Inc. s Quarterly Report on Form 10-Q for the quarter

ended March 31, 2008, filed May 2, 2008).

10.75 Supply Agreement, dated May 2, 2005, by and between R. J. Reynolds Tobacco Company and Mundet Inc. (incorporated by reference to Exhibit 10.3 to Reynolds American Inc. s Form 8-K dated May 2, 2005).

10.76 Valuation Payment Settlement Agreement, dated February 20, 2008, by and between R. J. Reynolds Tobacco C.V. and Gallaher Limited (incorporated by reference to Exhibit 10.1 to Reynolds American Inc. s Form 8-K dated February 20, 2008).

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Exhibit Number	
10.77	Guarantee of JT International Holding B.V., dated February 20, 2008, in favor of R. J. Reynolds Tobacco C.V. (incorporated by reference to Exhibit 10.2 to Reynolds American Inc. s Form 8-K dated February 20, 2008).
12.1	Computation of Ratio of Earnings to Fixed Charges for each of the five years within the period ended December 31, 2009.
21.1	Subsidiaries of the Registrant.
23.1	Consent of Independent Registered Public Accounting Firm.
31.1	Certification of Chief Executive Officer relating to RAI s Annual Report on Form 10-K for the fiscal year ended December 31, 2009.
31.2	Certification of Chief Financial Officer relating to RAI s Annual Report on Form 10-K for the fiscal year ended December 31, 2009.
32.1*	Certification of Chief Executive Officer and Chief Financial Officer relating to RAI s Annual Report on Form 10-K for the fiscal year ended December 31, 2009, pursuant to Section 18 U.S.C. §1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (furnished herewith).
101.INS*	XBRL instance document
101.SCH*	XBRL taxonomy extension schema
101.CAL*	XBRL taxonomy extension calculation linkbase
101.DEF*	XBRL taxonomy extension definition linkbase
101.LAB*	XBRL taxonomy extension label linkbase
101.PRE*	XBRL taxonomy extension presentation linkbase

* 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 given 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.

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SIGNATURES

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

REYNOLDS AMERICAN INC.
(Registrant)

Dated: February 19, 2010

By: /s/ Susan M. Ivey

Susan M. Ivey
Chairman of the Board,
President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the date indicated.

Signature	Title	Date
/s/ Susan M. Ivey Susan M. Ivey	Chairman of the Board, President and Chief Executive Officer (principal executive officer)	February 19, 2010
/s/ Thomas R. Adams Thomas R. Adams	Executive Vice President and Chief Financial Officer (principal financial officer)	February 19, 2010
/s/ Frederick W. Smothers Frederick W. Smothers	Senior Vice President and Chief Accounting Officer (principal accounting officer)	February 19, 2010
/s/ Betsy S. Atkins Betsy S. Atkins	Director	February 19, 2010
/s/ Nicandro Durante Nicandro Durante	Director	February 19, 2010
/s/ Martin D. Feinstein Martin D. Feinstein	Director	February 19, 2010
/s/ Luc Jobin	Director	February 19, 2010

Luc Jobin		
/s/ Holly K. Koeppel	Director	February 19, 2010
Holly K. Koeppel		
/s/ Nana Mensah	Director	February 19, 2010
Nana Mensah		
/s/ Lionel L. Nowell III	Director	February 19, 2010
Lionel L. Nowell III		
/s/ H.G.L. Powell	Director	February 19, 2010
H.G.L. Powell		

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Signature	Title	Date
/s/ Thomas C. Wajnert	Director	February 19, 2010
Thomas C. Wajnert		
/s/ Neil R. Withington	Director	February 19, 2010
Neil R. Withington		
/s/ John J. Zillmer	Director	February 19, 2010
John J. Zillmer		