

REYNOLDS AMERICAN INC
Form 10-Q
October 28, 2010

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2010

OR

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

For the transition period from _____ to _____

Commission file number: 1-32258

Reynolds American Inc.

(Exact name of registrant as specified in its charter)

North Carolina

(State or other jurisdiction of incorporation or
organization)

20-0546644

(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)

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

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting
company

(Do not check if a smaller
reporting company)

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date: 291,526,107 shares of common stock, par value \$.0001 per share, as of October 8, 2010

INDEX

	Page
Part I Financial Information	
Item 1. Financial Statements	
Condensed Consolidated Statements of Income (Unaudited) Three and Nine Months Ended September 30, 2010 and 2009	3
Condensed Consolidated Statements of Cash Flows (Unaudited) Nine Months Ended September 30, 2010 and 2009	4
Condensed Consolidated Balance Sheets September 30, 2010 (Unaudited) and December 31, 2009	5
Notes to Condensed Consolidated Financial Statements (Unaudited)	6
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	72
Item 3. Quantitative and Qualitative Disclosures about Market Risk	91
Item 4. Controls and Procedures	92
Part II Other Information	
Item 1. Legal Proceedings	92
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	92
Item 6. Exhibits	92
Signature	94

Part I Financial Information**Item 1. Financial Statements**

REYNOLDS AMERICAN INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(Dollars in Millions, Except Per Share Amounts)
(Unaudited)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2010	2009	2010	2009
Net sales ⁽¹⁾	\$ 2,146	\$ 2,045	\$ 6,141	\$ 6,017
Net sales, related party	93	107	329	306
Net sales	2,239	2,152	6,470	6,323
Costs and expenses:				
Cost of products sold ⁽¹⁾⁽²⁾⁽³⁾⁽⁴⁾	1,184	1,138	3,437	3,337
Selling, general and administrative expenses	387	371	1,124	1,129
Amortization expense	6	7	19	22
Asset impairment and exit charges			38	
Trademark impairment charge				453
Operating income	662	636	1,852	1,382
Interest and debt expense	55	60	176	190
Interest income	(3)	(5)	(9)	(15)
Other expense (income), net	(8)	2	4	9
Income from continuing operations before income taxes	618	579	1,681	1,198
Provision for income taxes	237	217	661	451
Income from continuing operations	381	362	1,020	747
Losses from discontinued operations, net of tax			(216)	
Net income	\$ 381	\$ 362	\$ 804	\$ 747
Basic income per share:				
Income from continuing operations	\$ 1.31	\$ 1.24	\$ 3.50	\$ 2.56
Losses from discontinued operations			(0.74)	
Net income	\$ 1.31	\$ 1.24	\$ 2.76	\$ 2.56
Diluted income per share:				
Income from continuing operations	\$ 1.30	\$ 1.24	\$ 3.49	\$ 2.56
Losses from discontinued operations			(0.74)	
Net income	\$ 1.30	\$ 1.24	\$ 2.75	\$ 2.56
Dividends declared per share	\$ 0.90	\$ 0.85	\$ 2.70	\$ 2.55

- (1) Excludes excise taxes of \$1,130 million and \$1,155 million for the three months ended September 30, 2010 and 2009, respectively, and \$3,279 million and \$2,812 million for the nine months ended September 30, 2010 and 2009, respectively.
- (2) Includes Master Settlement Agreement, referred to as the MSA, and other settlement agreements with the states of Mississippi, Florida, Texas and Minnesota, which together with the MSA are collectively referred to as the State Settlement Agreements, expense of \$650 million and \$643 million for the three months ended September 30, 2010 and 2009, respectively, and \$1,887 million and \$1,917 million for the nine

months ended
September 30,
2010 and 2009,
respectively.

- (3) Includes federal tobacco quota buyout expenses of \$62 million and \$61 million for the three months ended September 30, 2010 and 2009, respectively, and \$184 million and \$179 million for the nine months ended September 30, 2010 and 2009, respectively.

- (4) Includes U.S. Food and Drug Administration, referred to as the FDA, user fees of \$15 million and \$4 million for the three months ended September 30, 2010 and 2009, respectively, and \$45 million and \$6 million for the nine months ended September 30, 2010 and 2009, respectively.

See Notes to Condensed Consolidated Financial Statements (Unaudited)

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

	For the Nine Months Ended September 30,	
	2010	2009
Cash flows from (used in) operating activities:		
Net income	\$ 804	\$ 747
Losses from discontinued operations, net of tax	216	
Adjustments to reconcile to net cash flows from (used in) continuing operating activities:		
Depreciation and amortization	115	109
Asset impairment and exit charges	38	
Restructuring charges, net of cash payments	(36)	(30)
Trademark impairment charge		453
Deferred income tax expense (benefit)	143	(184)
Pension and postretirement	(225)	(86)
Tobacco settlement	(224)	79
Other, net	187	(199)
Net cash flows from operating activities	1,018	889
Cash flows from (used in) investing activities:		
Proceeds from redemption of long-term investments	12	4
Capital expenditures	(115)	(75)
Proceeds from termination of joint venture	28	24
Other, net	5	30
Net cash flows used in investing activities	(70)	(17)
Cash flows from (used in) financing activities:		
Dividends paid on common stock	(787)	(743)
Repayment of long-term debt	(300)	(200)
Other, net		(3)
Net cash flows used in financing activities	(1,087)	(946)
Effect of exchange rate changes on cash and cash equivalents	(6)	9
Net cash flows related to discontinued operations, net of tax benefit	(326)	
Net change in cash and cash equivalents	(471)	(65)
Cash and cash equivalents at beginning of period	2,723	2,578
Cash and cash equivalents at end of period	\$ 2,252	\$ 2,513

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

Income taxes paid, net of refunds	\$ 438	\$ 584
Interest paid, net of capitalized interest (2010 \$3)	\$ 135	\$ 149

See Notes to Condensed Consolidated Financial Statements (Unaudited)

4

REYNOLDS AMERICAN INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Dollars in Millions)

	September 30, 2010 (Unaudited)	December 31, 2009
Assets		
Current assets:		
Cash and cash equivalents	\$ 2,252	\$ 2,723
Accounts receivable	141	109
Accounts receivable, related party	32	96
Notes receivable	33	36
Other receivables	20	15
Inventories	1,020	1,219
Deferred income taxes, net	945	956
Prepaid expenses and other	256	341
 Total current assets	 4,699	 5,495
Property, plant and equipment, net of accumulated depreciation (2010 \$1,599; 2009 \$1,570)	980	1,025
Trademarks and other intangible assets, net of accumulated amortization (2010 \$666; 2009 \$647)	2,701	2,718
Goodwill	8,185	8,185
Other assets and deferred charges	637	586
	\$ 17,202	\$ 18,009
 Liabilities and shareholders equity		
Current liabilities:		
Accounts payable	\$ 100	\$ 196
Tobacco settlement accruals	2,385	2,611
Due to related party	3	3
Deferred revenue, related party	18	57
Current maturities of long-term debt	400	300
Other current liabilities	1,128	1,173
 Total current liabilities	 4,034	 4,340
Long-term debt (less current maturities)	3,710	4,136
Deferred income taxes, net	573	441
Long-term retirement benefits (less current portion)	1,891	2,218
Other noncurrent liabilities	366	376
Commitments and contingencies:		
Shareholders equity:		
Common stock (shares issued: 2010 291,526,107; 2009 291,424,051)		
Paid-in capital	8,524	8,498
Accumulated deficit	(568)	(579)
	(1,328)	(1,421)

Accumulated other comprehensive loss (Defined benefit pension and
postretirement plans: 2010 \$(1,282) and 2009 \$(1,376), net of tax)

Total shareholders' equity	6,628	6,498
	\$ 17,202	\$ 18,009

See Notes to Condensed Consolidated Financial Statements (Unaudited)

Notes to Condensed Consolidated Financial Statements (Unaudited)

Note 1 Business and Summary of Significant Accounting Policies

Overview

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

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

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

RAI's reportable operating segments are RJR Tobacco and American Snuff (formerly the Conwood segment). The RJR Tobacco segment consists of the primary operations of R. J. Reynolds Tobacco Company. The American Snuff segment consists of the primary operations of American Snuff Co. and Lane. RAI's wholly owned subsidiaries, 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. Certain of 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 accompanying interim condensed consolidated financial statements (unaudited) have been prepared in accordance with accounting principles generally accepted in the United States of America, referred to as GAAP, for interim financial information and, in management's opinion, contain all adjustments, consisting only of normal recurring items, necessary for a fair presentation of the results for the periods presented. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. All material intercompany balances have been eliminated. RAI has no investments that are accounted for under the equity or cost methods. For interim reporting purposes, certain costs and expenses are charged to operations in proportion to the estimated total annual amount expected to be incurred primarily based on sales volumes. The results for the interim period ended September 30, 2010, are not necessarily indicative of the results that may be expected for the year ending December 31, 2010.

The condensed consolidated financial statements (unaudited) should be read in conjunction with the consolidated financial statements and related footnotes, which appear in RAI's Annual Report on Form 10-K for the year ended December 31, 2009. Certain reclassifications were made to conform prior years' financial statements to the current presentation. All dollar amounts, other than per share amounts, are presented in millions, except for amounts set forth in note 11 and as otherwise noted.

Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)*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 either in 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.

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

	For The Three Months Ended September 30,				For The Nine Months Ended September 30,			
	Pension Benefits		Postretirement Benefits		Pension Benefits		Postretirement Benefits	
	2010	2009	2010	2009	2010	2009	2010	2009
Service cost	\$ 7	\$ 8	\$ 1	\$ 1	\$ 22	\$ 24	\$ 3	\$ 3
Interest cost	80	80	20	20	239	239	60	60
Expected return on plan assets	(90)	(84)	(5)	(5)	(269)	(253)	(14)	(15)
Amortization of prior service cost (credit)	1	1	(6)	(6)	3	3	(18)	(18)
Amortization of net loss	30	24	5	4	90	74	14	11
Curtailment			1				1	
Total benefit cost	\$ 28	\$ 29	\$ 16	\$ 14	\$ 85	\$ 87	\$ 46	\$ 41

Employer Contributions

RAI disclosed in its financial statements for the year ended December 31, 2009, that it expected to contribute a minimum of \$309 million to its pension plans in 2010. As of September 30, 2010, RAI expected to contribute up to \$812 million to its pension plans in 2010, of which \$309 million was contributed during the first nine months of 2010.

Recently Adopted Accounting Guidance

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 2010, authoritative GAAP requiring new disclosures and clarifications of existing disclosures of fair value measurements.

Effective February 2010, authoritative GAAP that amends date disclosure of events that occur after the balance sheet date, but before financial statements are issued or are available to be issued.

Note 2 Fair Value

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

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

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.

Financial assets/(liabilities) carried at fair value in the condensed consolidated balance sheet (unaudited) as of September 30, 2010, were as follows:

	Level 1	Level 2	Level 3	Total
Cash and cash equivalents:				
Cash equivalents	\$2,176	\$	\$	\$2,176
Other assets and deferred charges:				
Auction rate securities - corporate credit risk			32	32
Auction rate securities - financial insurance companies			7	7
Mortgage-backed security			15	15
Marketable equity security	20			20
Assets held in grantor trusts	12			12
Interest rate swaps - fixed to floating rate		302		302
Other noncurrent liabilities:				
Interest rate swaps - floating to fixed rate		(78)		(78)

Financial assets/(liabilities) carried at fair value in the consolidated balance sheet (unaudited) as of December 31, 2009, were as follows:

	Level 1	Level 2	Level 3	Total
Cash and cash equivalents:				
Cash equivalents	\$2,679	\$	\$	\$2,679
Other assets and deferred charges:				
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
Other noncurrent liabilities:				
Interest rate swaps - floating to fixed rate		(2)		(2)

There were no changes among the levels in the nine months ended September 30, 2010.

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

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.

The fair value of the auction rate securities, either related to certain financial insurance companies or linked to the longer-term 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 its auction rate securities to be inactive. The income approach model utilized observable inputs, including LIBOR-based interest rate curves, corporate credit spreads and corporate ratings/market valuations. Additionally, unobservable factors incorporated into the model included default probability assumptions, recovery potential and how these factors changed as ratings on the underlying collateral migrated from one level to another. There are no defined maturity dates for any of the auction rate securities before 2016.

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 its mortgage-backed security to be inactive. The maturity of the mortgage-backed security has been extended to March 2011, with the annual option to extend an additional year. Given the underlying collateral and RAI's intent to continue to extend this security, it is classified as a noncurrent asset.

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

In determining if the impairment of the auction rate securities or the mortgage-backed security was deemed either temporary or other-than-temporary, 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.

Financial assets classified as Level 3 investments were as follows:

	September 30, 2010				December 31, 2009		
	Cost	Gross Realized Loss	Gross Unrealized (Loss) Gain ⁽¹⁾	Estimated Fair Value	Cost	Gross Unrealized Loss ⁽¹⁾	Estimated Fair Value
Auction rate securities							
corporate credit risk	\$ 95	\$	\$ (63)	\$ 32	\$ 95	\$ (65)	\$ 30
Auction rate securities							
financial insurance							
companies	8	(2)	1	7	17		17
Mortgage-backed							
security	28		(13)	15	31	(15)	16
	\$ 131	\$ (2)	\$ (75)	\$ 54	\$ 143	\$ (80)	\$ 63

- (1) Unrealized gains and losses, net of tax, are reported in accumulated other comprehensive loss in RAI s condensed consolidated balance sheets as of September 30, 2010 and December 31, 2009.

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

The changes in the Level 3 investments during the nine months ended September 30, 2010, were as follows:

	Mortgage-Backed Security		
	Cost	Gross (Loss) Gain	Estimated Fair Value
Balance as of January 1, 2010	\$ 31	\$ (15)	\$ 16
Unrealized gains		2	2
Redemptions	(3)		(3)
Balance as of September 30, 2010	\$ 28	\$ (13)	\$ 15

	Auction Rate Securities Corporate Credit Risk			Auction Rate Securities Financial Insurance Companies		
	Cost	Gross (Loss) Gain	Estimated Fair Value	Cost	Gross (Loss) Gain	Estimated Fair Value
Balance as of January 1, 2010	\$ 95	\$ (65)	\$ 30	\$ 17	\$	\$ 17
Realized losses					(2)	(2)
Unrealized gains		2	2		1	1
Redemptions				(9)		(9)
Balance as of September 30, 2010	\$ 95	\$ (63)	\$ 32	\$ 8	\$ (1)	\$ 7

The fair value of the property, plant and equipment measured on a nonrecurring basis, classified as Level 3, represent certain facilities and equipment, for which impairment during the second quarter of 2010 reduced their book value to fair value. The fair value determinations utilized an income approach model and were based on a cash flow valuation model. This approach utilized unobservable factors, including allocated production volumes, contract selling prices and standard costs. Because the service life and cash flows of the facilities and equipment are less than one year, no discount rate was applied to the estimated cash flows. See note 4 for additional information with respect to the event during the second quarter of 2010 that required impairment testing.

The fair value of nonfinancial assets was not measured as of September 30, 2010. Nonfinancial assets measured at fair value on a nonrecurring basis as of June 30, 2010, were as follows:

	Level 1	Level 2	Level 3	Total	Total Loss
Buildings	\$	\$	\$18	\$18	\$ (7)
Equipment	\$	\$	\$10	\$10	\$ (29)

Fair Value of Debt

The estimated fair value of RAI's and RJR's outstanding long-term notes in the aggregate, was \$4.4 billion and \$4.4 billion with an effective average annual interest rate of approximately 5.4% and 5.5%, as of September 30, 2010 and December 31, 2009, respectively. The fair values are based on available market quotes, credit spreads and discounted cash flows, as appropriate.

Interest Rate Management

RAI and RJR use interest rate swaps to manage interest rate risk on a portion of their respective debt obligations. In 2009, RAI and RJR entered into offsetting floating to fixed interest rate swap agreements in the notional amount of

\$1.5 billion with maturity dates ranging from June 1, 2012 to June 15, 2017, 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, and effectively reduced net interest costs over the remaining life of the notes. At the same time, RAI and RJR terminated an interest rate swap agreement in the notional amount of \$100 million with a maturity date of June 1, 2012. 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%. At September 30, 2010, RAI and RJR had no derivative instruments designated as hedges.

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

As of September 30, 2010, 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	5.22 years	5.22 years

Interest rate swaps are included in the condensed consolidated balance sheets at fair value as follows:

	September 30, 2010	December 31, 2009
Not designated as hedging instrument:		
Other assets and deferred charges	\$ 302	\$ 239
Long-term debt (less current maturities)	(208)	(235)
Other noncurrent liabilities	(78)	(2)

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2010	2009	2010	2009
Interest and debt expense	\$(12)	\$(12)	\$(36)	\$(36)
Other expense (income), net	(9)	(11)	(4)	(7)

Credit Risk

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

Note 3 Intangible Assets

There were no changes to the carrying amount of goodwill during the nine months ended September 30, 2010.

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

	RJR Tobacco		American Snuff	All Other		Consolidated	
	Trademarks	Other	Trademarks	Trademarks	Other	Trademarks	Other
Finite-lived:							
Balance as of December 31, 2009	\$ 20	\$ 69	\$ 13	\$	\$	\$ 33	\$ 69
Amortization	(6)	(11)	(2)			(8)	(11)
Balance as of September 30, 2010	\$ 14	\$ 58	\$ 11	\$	\$	\$ 25	\$ 58
Indefinite-lived:							
Balance as of December 31, 2009	\$ 1,163	\$ 99	\$ 1,152	\$ 155	\$ 47	\$ 2,470	\$ 146
Foreign currency translation					2		2

Balance as of September 30, 2010	\$ 1,163	\$ 99	\$ 1,152	\$ 155	\$ 49	\$ 2,470	\$ 148
---	----------	-------	----------	--------	-------	----------	--------

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

Details of finite-lived intangible assets subject to amortization as of September 30, 2010, were as follows:

	Gross	Accumulated Amortization	Net
Contract manufacturing	\$ 151	\$ 93	\$ 58
Trademarks	95	70	25
	\$ 246	\$ 163	\$ 83

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

Year	Amount
Remainder of 2010	\$ 7
2011	23
2012	20
2013	16
2014	10
Thereafter	7
	\$ 83

Note 4 Asset Impairment and Exit Charges

On May 28, 2010, RAI announced that its operating companies are taking steps to optimize cigarette-manufacturing efficiencies, while complying with new regulatory requirements. One of RJR Tobacco's cigarette factories in Winston-Salem, North Carolina will close by mid-2011 and a factory in Yabucoa, Puerto Rico closed in August 2010. Production from those facilities will transfer to RJR Tobacco's facility in Tobaccoville, North Carolina. As a result of these actions, approximately 60 manufacturing positions in Puerto Rico were eliminated, and affected employees received severance benefits. In connection with these actions, during the second quarter of 2010, RJR Tobacco recorded an asset impairment of \$24 million, and \$14 million was recorded in the All Other segment, primarily for asset impairment, and to a lesser extent, severance that will be paid during 2010.

Note 5 Restructuring Charges*2009 Restructuring Charge*

In 2009, RJR Tobacco announced the elimination of approximately 400 full-time production positions to be substantially completed by December 31, 2010. The cash benefits are expected to be substantially paid by December 31, 2011.

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. The cash benefits are expected to be substantially paid by December 31, 2011.

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

The activity in the restructuring accruals, comprised of employee severance and related benefits, was as follows:

	2009 Restructuring Charge	2008 Restructuring Charge
Balance as of December 31, 2009	\$ 48	\$ 40
Cash paid in 2010	(14)	(22)
Balance as of September 30, 2010	\$ 34	\$ 18

The restructuring accruals were included in the condensed consolidated balance sheet (unaudited) as of September 30, 2010, as follows:

	2009 Restructuring Charge	2008 Restructuring Charge
Other current liabilities	\$ 29	\$ 14
Other noncurrent liabilities	5	4
	\$ 34	\$ 18

Note 6 Discontinued Operations

In 1999, RJR and RJR Tobacco sold the international tobacco business to Japan Tobacco Inc., referred to as JTI. Northern Brands International, Inc., referred to as Northern Brands, was part of the international business of R.J. Reynolds International B.V., a former Netherlands subsidiary of RJR Tobacco, which was managed by RJR-Macdonald, Inc., referred to as RJR-MI. Northern Brands ceased being an operating company in 1997 and has been an inactive subsidiary of RJR since that time.

Effective April 13, 2010, RJR Tobacco entered into a comprehensive agreement with the Canadian federal, provincial and territorial governments, referred to as the Comprehensive Agreement, resolving a variety of civil claims related to cigarette smuggling in Canada during the period from 1985 through 1999. The Comprehensive Agreement covers all civil claims related to the movement of contraband tobacco products in Canada during the period 1985 through 1999 that the governments have asserted or could assert against RJR Tobacco and its affiliates. On April 13, 2010, RJR Tobacco paid the governments a total of CAD \$325 million to bring this complex, lengthy and costly litigation to an end. Should RJR Tobacco or its affiliates decide in the future to sell tobacco products in Canada, they also have agreed to adopt packaging, marking and other measures that will assist the Canadian governments in their efforts to combat the movement of contraband tobacco products in Canada.

Separately, on April 13, 2010, Northern Brands entered into a plea agreement with the Ministry of the Attorney General of Ontario. Under the terms of this agreement, Northern Brands pled guilty to a one count violation of the Canadian Criminal Code for conspiring to aid other persons to sell and be in possession of tobacco products that were not packaged and stamped in conformity with the Canadian Excise Act during the period February 18, 1993 through December 31, 1996. The Judge of the Ontario Court of Justice accepted the plea by Northern Brands and required it to pay a fine of CAD \$75 million, which was paid on April 13, 2010. By this plea, the criminal charges that were originally commenced against Northern Brands and certain of its affiliates in 2003 and any other charges that could be commenced against Northern Brands and its affiliates by the Canadian governments relating to contraband tobacco activities have now come to an end.

In addition to the \$91 million liability previously accrued by RJR, an adjustment, to reflect the impact of the separate RJR Tobacco settlement to resolve civil claims and the separate Northern Brands plea agreement, in the aggregate of \$307 million, or \$216 million after tax, was recorded during the first quarter of 2010.

This accrual adjustment has been included in losses from discontinued operations in the condensed consolidated statement of income (unaudited) for the nine months ended September 30, 2010. Of the aggregate accrual adjustments of \$307 million, \$303 million, or \$213 million after tax, is classified as a loss on discontinued operations and \$4 million, or \$3 million after tax, is classified as a loss on the sale of discontinued operations. The payments by RJR Tobacco of \$320 million, offset by a realized tax benefit to date of \$68 million, and by Northern

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

Brands of \$74 million have been included as net cash flows related to discontinued operations, net of tax benefit, in the condensed consolidated statement of cash flows (unaudited) for the nine months ended September 30, 2010. The remaining \$4 million loss accrual is included in other current liabilities in the condensed consolidated balance sheet (unaudited) as of September 30, 2010.

Note 7 Income Per Share

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2010	2009	2010	2009
Income from continuing operations	\$ 381	\$ 362	\$ 1,020	\$ 747
Losses from discontinued operations			(216)	
Net income	\$ 381	\$ 362	\$ 804	\$ 747
Basic weighted average shares, in thousands	291,526	291,371	291,489	291,380
Effect of dilutive potential shares:				
Options	5	130	39	137
Stock units	974	419	791	224
Diluted weighted average shares, in thousands	292,505	291,920	292,319	291,741

The basic income per share calculation includes the unvested restricted shares awarded under the RAI Long-Term Incentive Plan, referred to as the LTIP, as the shares have been determined to be participating securities because they have non-forfeitable dividend rights equivalent to common shares.

Note 8 Inventories

The major components of inventories were as follows:

	September 30, 2010	December 31, 2009
Leaf tobacco	\$ 905	\$ 1,052
Other raw materials	50	65
Work in process	76	80
Finished products	156	180
Other	28	32
Total	1,215	1,409
Less LIFO allowance	195	190
	\$ 1,020	\$ 1,219

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

Note 9 Income Taxes

The provision for income taxes from continuing operations was as follows:

	For the Three Months Ended September 30,	For the Nine Months Ended September 30,
--	---	--

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

	2010	2009	2010	2009
Provision for income taxes from continuing operations	\$ 237	\$ 217	\$ 661	\$ 451
Effective tax rate	38.3%	37.5%	39.3%	37.6%

14

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

The effective tax rate for the first nine months of 2010 was unfavorably impacted by a \$27 million increase in tax attributable to the Patient Protection and Affordable Care Act of 2010 and the Health Care and Education Reconciliation Act of 2010. The effective tax rate for the first nine months of 2009 was impacted by increases in unrecognized income tax benefits and increases in tax attributable to accumulated and undistributed foreign earnings. The effective tax rate includes the impact of federal and state taxes and certain nondeductible items, offset by the domestic production activities deduction of the American Jobs Creation Act of 2004.

Note 10 Borrowing Arrangements

In 2007, RAI entered into a Fifth Amended and Restated Credit Agreement, which, as subsequently amended, 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 15, 2010, RAI entered into a third amendment to the credit facility, which, among other things, permits the refinancing of certain existing RAI and RJR notes within ten months after maturity.

Note 11 Commitments and Contingencies

Tobacco Litigation General

Introduction

Various legal proceedings or claims, including litigation claiming that cancer and other diseases, as well as addiction, have resulted from the use of, or exposure to, RAI's operating subsidiaries' products, are pending or may be instituted against RJR Tobacco, American Snuff Co. or their affiliates, including RAI and RJR, or indemnitees, including B&W. These pending legal proceedings include claims relating to cigarette products manufactured by RJR Tobacco or certain of its affiliates and indemnitees, as well as claims relating to smokeless tobacco products manufactured by American Snuff Co. A discussion of the legal proceedings relating to cigarette products is set forth below under the heading *Litigation Affecting the Cigarette Industry*. All of the references under that heading to tobacco-related litigation, smoking and health litigation and other similar references are references to legal proceedings relating to cigarette products and are not references to legal proceedings involving smokeless tobacco products, and case numbers under that heading include only cases involving cigarette products. The legal proceedings relating to the smokeless tobacco products manufactured by American Snuff Co. are discussed separately under the heading *Smokeless Tobacco Litigation* below.

In connection with the B&W business combination, RJR Tobacco has agreed to indemnify B&W and its affiliates, including its indirect parent, 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 the first nine months of each of 2010 and 2009 for funds to be reimbursed to BAT for costs and expenses incurred arising out of certain tobacco-related litigation.

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

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

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

Accounting for Tobacco-Related Litigation Contingencies

In accordance with GAAP, RAI and its subsidiaries, including RJR Tobacco and American Snuff Co., 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 or indemnitees, or the loss of any particular claim concerning the use of smokeless tobacco against American Snuff Co., when viewed on an individual basis, is not probable.

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

No liability for pending smoking and health tobacco litigation was recorded in RAI's condensed consolidated balance sheet (unaudited) as of September 30, 2010.

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

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.

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.

RJR Tobacco's Comprehensive Agreement with the Canadian federal, provincial and territorial governments resolved all civil claims related to the movement of contraband tobacco products in Canada during the period 1985 through 1999 that the Canadian governments could assert against RJR Tobacco and its affiliates. These claims were separate from any smoking and health tobacco litigation. A comprehensive discussion of the Canadian matters is set forth below under Other Litigation and Developments Canadian Matters, and additional details regarding the settlement are set forth in note 6.

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. The plaintiffs asserted that the defendants conspired to fix the price of tobacco leaf and to destroy the federal government's tobacco quota and price support program. Despite legal defenses they believed to be valid, RJR Tobacco and B&W separately settled this case to avoid a long and contentious trial with the tobacco growers. The *DeLoach* case and the antitrust case currently pending against RJR Tobacco and B&W involve different types of plaintiffs and different theories of recovery under the antitrust laws than the smoking and health cases pending against RJR Tobacco and its affiliates and indemnitees.

Finally, as discussed under Litigation Affecting the Cigarette Industry State Settlement Agreements Enforcement and Validity; Adjustments, RJR Tobacco and B&W each has settled certain cases brought by states concerning the enforcement of State Settlement Agreements. Despite legal defenses believed to be valid, these cases

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

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.

American Snuff Co. also believes that it has valid defenses to the smokeless tobacco litigation against it. American Snuff Co. asserted and will continue to assert some or all of these defenses in each case at the time and in the manner deemed appropriate by American Snuff Co. and its counsel. No verdict or judgment has been returned or entered against American Snuff Co. on any claim for personal injuries allegedly resulting from the use of smokeless tobacco. American Snuff Co. intends to defend vigorously all smokeless tobacco litigation claims asserted against it. No liability for pending smokeless tobacco litigation was recorded in RAI's condensed consolidated balance sheet (unaudited) as of September 30, 2010.

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 American Snuff Co., 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, American Snuff Co. or their affiliates or indemnitees, or to reasonably estimate the amount or range of any possible loss.

Although RJR Tobacco believes that it has valid bases for appeals of adverse verdicts in its pending cases, and RJR Tobacco and RAI believe they have valid defenses to all actions, and intend to defend all actions vigorously, it is possible that there could be further adverse developments in pending cases, and that additional cases could be decided unfavorably against RAI, RJR Tobacco or their affiliates or indemnitees. Determinations of liability or adverse rulings in such cases or in similar cases involving other cigarette manufacturers as defendants, even if such judgments are not final, could 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 RJR Tobacco and its affiliates and indemnitees in litigation matters, it is possible that RAI's results of operations, cash flows or financial position could be materially adversely affected by the ultimate outcome of certain pending litigation matters against RJR Tobacco or its affiliates or indemnitees.

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

Litigation Affecting the Cigarette Industry

Overview

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

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

During the third quarter of 2010, 15 tobacco-related cases were served against RJR Tobacco or its affiliates or indemnitees. On September 30, 2010, there were 194 cases pending against RJR Tobacco or its affiliates or indemnitees: 184 in the United States; nine in Canada and one in Israel. The U.S. case number does not include the 611 individual smoker cases pending in West Virginia state court as a consolidated action, 7,733 *Engle* Progeny cases (as hereinafter defined), involving approximately 9,153 individual plaintiffs, and 2,594 *Broin II* cases (as hereinafter defined), pending in the United States against RJR Tobacco or its affiliates or indemnitees, as compared with 184 total cases on September 30, 2009. Of the U.S. cases pending on September 30, 2010, 28 are pending in federal court, 155 in state court, primarily in the following states: Florida (28 cases); Maryland (27 cases); Missouri (21 cases); New York (19 cases); Louisiana (15 cases); and California (10 cases).

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

Case Type	RJR Tobacco's	Change in	Page
	Case Numbers	Number of	
	as	Cases Since	
	of September	June 30, 2010	Reference
	30, 2010	Increase/(Decrease)	
Individual Smoking and Health	116	8	25
West Virginia IPIC (Number of Plaintiffs)*	1 (611)	(-24)	26
<i>Engle</i> Progeny (Number of Plaintiffs)**	7,733 (9,153)	35 (-29)	26
<i>Broin II</i>	2,594	No Change	31
Class-Action	15	No Change	32
Health Care Cost Recovery	4	No Change	36
State Settlement Agreements-Enforcement and Validity;			
Adjustments	33	(1)	42
Antitrust	1	No Change	46
Other Litigation and Developments	14	1	46

* Includes as one case the 611 cases pending as a consolidated action *In Re: Tobacco Litigation Individual Personal Injury Cases*, sometimes referred to as *West Virginia IPIC* cases, described

below. The *West Virginia IPIC* cases have been separated from the Individual Smoking and Health cases for reporting purposes.

** The *Engle* Progeny cases have been separated from the Individual Smoking and Health cases for reporting purposes. Plaintiffs counsel are attempting to include multiple plaintiffs in most of the cases filed. The number of cases may increase as the result of the multiple plaintiff cases being dismissed with instructions to file individual cases.

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 September 30, 2010, RJR Tobacco had been served in 7,733 *Engle* Progeny cases in both state and federal courts in Florida. These cases include approximately 9,153 plaintiffs. The number of cases will likely change due to individual plaintiffs being severed from multi-plaintiff cases. In addition, as of September 30, 2010, RJR Tobacco was aware of 28 additional cases that had been filed but not served (with 302 plaintiffs). A number of the *Engle* Progeny cases are scheduled for trial or are in trial.

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

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 Appeal 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. On April 23, 2010, the Louisiana Fourth Circuit Court of Appeal amended the final judgment, and as amended, affirmed the judgment. Pursuant to the judgment, the defendants are required to deposit with the court \$242 million with judicial interest from July 21, 2008, until paid. The defendants' application for rehearing was denied on May 12, 2010. In September 2010, the defendants' application for writ of certiorari with the Louisiana Supreme Court and emergency motion to stay execution of judgment in the Supreme Court of Louisiana were denied. On September 24, 2010, the U.S. Supreme Court granted the application to stay the judgment pending applicants' timely filing, and the Court's disposition, of a petition of writ of certiorari.

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 findings 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. RJR Tobacco and B&W filed their petitions for writ of certiorari to the U.S. Supreme Court on February 19, 2010. The Department of Justice filed its petition for writ of certiorari on February 19, 2010, which included a request for reinstatement of its claims for remedies, including disgorgement of profits. On June 28, 2010, the U.S. Supreme Court denied the parties' petitions for writ of certiorari. Post-remand proceedings are underway.

For a detailed description of these cases, see *Engle* and *Engle Progeny Cases*, *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 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. There are five cases, exclusive of *Engle* Progeny cases, scheduled for trial as of

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

September 30, 2010, for RJR Tobacco or its affiliates and indemnitees: West Virginia IPIC, one class action, one health care cost recovery case, and two individual smoking and health cases. There are 60 *Engle* Progeny cases against RJR Tobacco and/or B&W set for trial through September 30, 2011, but it is not known how many of these cases will actually be tried.

Trial Results. From January 1, 2008 through September 30, 2010, 28 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 12 cases, including 10 mistrials, tried in Florida (7), Missouri (1) and West Virginia (2). Verdicts in favor of the plaintiffs were returned in 16 cases tried in Florida.

In the third quarter of 2010, six *Engle* Progeny cases in which RJR Tobacco was a defendant were tried:

In *Piendle v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of the plaintiff on August 5, 2010, determined the decedent to be 45% at fault, RJR Tobacco to be 27.5% at fault and the remaining defendant to be 27.5% at fault, and awarded \$4 million in compensatory damages. On August 19, 2010, the jury returned a punitive damages verdict in the amount of \$180,000 against RJR Tobacco.

In *Warrick v. R. J. Reynolds Tobacco Co.*, the court declared a mistrial on August 4, 2010, due to the jury's inability to reach a verdict. Retrial began on September 13, 2010. On October 4, 2010, the jury returned a complete defense verdict.

In *Budnick v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of the defendant RJR Tobacco on August 26, 2010.

In *Willis v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of the defendants, including RJR Tobacco, on October 6, 2010.

In *Frazier v. Philip Morris USA Inc.*, the jury returned a verdict in favor of the defendants, including RJR Tobacco, on October 15, 2010.

In *Campbell v. Philip Morris USA Inc.*, the jury returned a verdict in favor of the defendants, including RJR Tobacco, on October 15, 2010.

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

In the third quarter of 2010, no non-*Engle* Progeny smoking and health cases (and no health care cost recovery cases) in which RJR Tobacco was a defendant were tried.

The following chart reflects the verdicts in the smoking and health cases or health care cost recovery cases that have been tried and remain pending as of September 30, 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
December 18, 2003	<i>Frankson v. Brown & Williamson Tobacco Corp.</i> [Individual]	Supreme Court, Kings County (Brooklyn, NY)	\$350,000 compensatory damages; 50% fault assigned to B&W; \$20 million in punitive damages, of which \$6 million was assigned to B&W, and \$2 million to a predecessor company.	See Individual Smoking and Health Cases below.

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

May 21, 2004	<i>Scott v. American Tobacco Co.</i> [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.
--------------	--	---	--	---

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

Date of Verdict	Case Name/Type	Jurisdiction	Verdict	Cross-Reference to Post-Trial Status
February 2, 2005	<i>Smith v. Brown & Williamson Tobacco Corp.</i> [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.
August 17, 2006	<i>United States v. Philip Morris USA, Inc.</i> [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 5, 2009	<i>Sherman v. R. J. Reynolds Tobacco Co.</i> [Engle Progeny]	Circuit Court, Broward County, (Ft. Lauderdale, FL)	\$1.55 million in compensatory damages; 50% of fault assigned to RJR Tobacco, which reduced the award to \$775,000. No punitive damages awarded.	See <i>Engle</i> and <i>Engle</i> Progeny Cases below.
May 22, 2009	<i>Brown v. R. J. Reynolds Tobacco Co.</i> [Engle Progeny]	Circuit Court, Broward County, (Ft. Lauderdale, FL)	\$1.2 million in compensatory damages; 50% of fault assigned to RJR Tobacco, which reduced the award to \$600,000. No punitive damages awarded.	See <i>Engle</i> and <i>Engle</i> Progeny Cases below.

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

Date of Verdict	Case Name/Type	Jurisdiction	Verdict	Cross-Reference to Post-Trial Status
May 29, 2009	<i>Martin v. R. J. Reynolds Tobacco Co.</i> [Engle Progeny]	Circuit Court, Escambia County, (Pensacola, FL)	\$5 million in compensatory damages; 66% of fault assigned to RJR Tobacco, which reduced the award to \$3.3 million; \$25 million in punitive damages.	See <i>Engle</i> and <i>Engle Progeny Cases</i> below.
August 19, 2009	<i>Campbell v. R. J. Reynolds Tobacco Co.</i> [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. No punitive damages awarded.	See <i>Engle</i> and <i>Engle Progeny Cases</i> below.
February 8, 2010	<i>Gray v. R. J. Reynolds Tobacco Co.</i> [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 awarded.	See <i>Engle</i> and <i>Engle Progeny cases</i> below.
March 10, 2010	<i>Douglas v. Philip Morris USA, Inc.</i> [Engle Progeny]	Circuit Court, Hillsborough County, (Tampa, FL)	\$5 million in compensatory damages; 5% of fault assigned to RJR Tobacco, which reduced the award to \$250,000. No punitive damages awarded.	See <i>Engle</i> and <i>Engle Progeny cases</i> below.
March 11, 2010	<i>Hall v. R. J. Reynolds Tobacco Co.</i> [Engle Progeny]	Circuit Court, Alachua County, (Gainesville, FL)	\$5 million compensatory damages; 65% of fault assigned to RJR Tobacco, which reduced the award to \$3.25 million; \$12.5 million in punitive damages.	See <i>Engle</i> and <i>Engle Progeny cases</i> below.
March 24, 2010	<i>Cohen v. R. J. Reynolds Tobacco</i>	Circuit Court, Broward County,	\$10 million compensatory damages;	See <i>Engle</i> and <i>Engle Progeny cases</i> below.

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

Co. (Ft. Lauderdale, FL) 33.3% of fault assigned to RJR Tobacco, which reduced the award to \$3.3 million; \$20 million in punitive damages, of which \$10 million was assigned to RJR Tobacco.

April 13, 2010 *Clay v. R. J. Reynolds Tobacco Co.* [Engle Progeny] Circuit Court, Escambia County, (Pensacola, FL) \$3.5 million compensatory damages; 60% of fault assigned to RJR Tobacco, which reduced the award to \$2.1 million; \$18 million in punitive damages, of which \$17 million was assigned to RJR Tobacco. See *Engle* and *Engle Progeny* cases below.

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

Date of Verdict	Case Name/Type	Jurisdiction	Verdict	Cross-Reference to Post-Trial Status
April 21, 2010	<i>Townsend v. R. J. Reynolds Tobacco Co.</i> [Engle Progeny]	Circuit Court, Alachua County, (Gainesville, FL)	\$10.8 million compensatory damages and \$80 million punitive damages; 51% of fault assigned to RJR Tobacco, which reduced the award to \$5.5 million in compensatory damages and \$40.8 million in punitive damages.	See <i>Engle</i> and <i>Engle</i> Progeny cases below.
April 26, 2010	<i>Putney v. R. J. Reynolds Tobacco Co.</i> [Engle Progeny]	Circuit Court, Broward County, (Ft. Lauderdale, FL)	\$15.1 million compensatory damages; 30% of fault assigned to RJR Tobacco, which reduced the award to \$4.5 million; \$5 million in punitive damages, of which \$2.5 million was assigned to RJR Tobacco.	See <i>Engle</i> and <i>Engle</i> Progeny cases below.
April 29, 2010	<i>Grossman v. R. J. Reynolds Tobacco Co.</i> [Engle Progeny]	Circuit Court, Broward County, (Ft. Lauderdale, FL)	\$1.9 million compensatory damages; 25% of fault assigned to RJR Tobacco, which reduced the award to \$483,682. No punitive damages awarded.	See <i>Engle</i> and <i>Engle</i> Progeny cases below.
May 20, 2010	<i>Buonomo v. R. J. Reynolds Tobacco Co.</i> [Engle Progeny]	Circuit Court, Broward County, (Ft. Lauderdale, FL)	\$5.2 million compensatory damages; 77.5% of fault assigned to RJR Tobacco, which reduced the award to \$4.06 million; \$25 million in punitive damages.	See <i>Engle</i> and <i>Engle</i> Progeny cases below.
May 26, 2010	<i>Izzarelli v. R. J. Reynolds Tobacco Co.</i> [Individual S&H]	U.S. District Court, District of Connecticut, (Bridgeport, CT)	\$13.9 million compensatory damages; 58% of fault assigned to RJR Tobacco, which	See Individual Smoking and Health Cases below.

reduced the award to
\$8.06 million against
RJR Tobacco.

June 18, 2010

*Alexander v. R. J.
Reynolds Tobacco
Co.*
[*Engle* Progeny]

Circuit Court,
Alachua County,
(Gainesville, FL)

\$2.5 million
compensatory damages;
51% of fault assigned to
RJR Tobacco, which
reduced the award to
\$1.275 million; \$2.5
million punitive
damages.

See *Engle* and *Engle*
Progeny cases below.

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

Date of Verdict	Case Name/Type	Jurisdiction	Verdict	Cross-Reference to Post-Trial Status
August 5, 2010	<i>Piendle v. R. J. Reynolds Tobacco Co.</i> [<i>Engle</i> Progeny]	Circuit Court, Palm Beach County, (West Palm Beach, FL)	\$4 million compensatory damages; 27.5% of fault assigned to RJR Tobacco, which reduced the award to \$1.1 million; \$180,000 punitive damages.	See <i>Engle</i> and <i>Engle</i> Progeny cases below.

Individual Smoking and Health Cases

As of September 30, 2010, 116 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 113 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 environmental tobacco smoke, referred to as ETS.

Below is a description of the individual smoking and health cases against RJR Tobacco or B&W, or both, which went to trial or were decided during the period from January 1, 2010 to September 30, 2010, or remained on appeal as of September 30, 2010.

On August 15, 2003, the 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. On August 13, 2010, the Superior Court of Pennsylvania entered a memorandum affirming final judgment entered on January 1, 2004. On October 13, 2010, the plaintiff's application for reargument was denied.

On December 18, 2003, the jury returned a verdict in favor of the plaintiff in *Frankson v. Brown & Williamson Tobacco Corp.*, a case filed in August 2000 in Supreme Court, Kings County, New York, awarded \$350,000 in compensatory damages and eventually returned a verdict of \$20 million in punitive damages against the defendants in an action brought against the major U.S. cigarette manufacturers, including RJR Tobacco, who was dismissed prior to trial, and B&W. Other manufacturers were dismissed before trial. The plaintiff, Gladys Frankson, alleged that Mr. Frankson became addicted to nicotine, was unable to 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 and \$2 million to American Tobacco, a predecessor company to B&W. 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.

On June 26, 2007, 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. On March 12, 2010, the plaintiff's motion for leave to reargue was denied. No date has been set for the punitive damages retrial.

On February 1, 2005, the jury returned a split verdict in *Smith v. Brown & Williamson Tobacco Corp.*, a case filed in May 2003 in Circuit Court, Jackson County, Missouri, finding in favor of B&W on two counts, fraudulent

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

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. 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, 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. Briefing is underway.

On May 26, 2010, a jury returned a verdict in favor of the plaintiff in *Izzarelli v. R. J. Reynolds Tobacco Co.*, a case filed in December 1999 in the U.S. District Court for the District of Connecticut. The plaintiff sought to recover damages for personal injuries that the plaintiff alleges she sustained as a result of unsafe and unreasonably dangerous cigarette products and for economic losses she sustained as a result of unfair trade practices of the defendant. The jury found RJR Tobacco to be 58% at fault and the plaintiff to be 42% at fault, awarded \$13.9 million in compensatory damages and found the plaintiff to be entitled to punitive damages. Final judgment will not be entered until the court has ruled on punitive damages. Oral argument on the amount of punitive damages occurred on August 25, 2010. A decision is pending.

West Virginia IPIC

In West Virginia, as of September 30, 2010, there were 650 cases (of which 611 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 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. Retrial began on June 1, 2010. On June 8, 2010, the court declared a second mistrial due to the inability to seat a jury. A new trial tentatively has been scheduled for March 21, 2011.

Engle and Engle Progeny Cases

Trial began in July 1998 in *Engle v. R. J. Reynolds Tobacco Co.*, a case filed in May 1994, in Circuit Court, Miami-Dade County, Florida, in which a class consisting of Florida residents, or their survivors, alleged diseases or medical conditions caused by their alleged addiction to cigarettes. The action was brought against the major U.S. cigarette manufacturers, including RJR Tobacco and B&W, seeking actual damages and punitive damages in excess of \$100 billion each and the creation of a medical fund to compensate individuals for future health care costs. 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.

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

On November 6, 2000, the trial judge denied all post-trial motions and entered judgment. 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.

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

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 eligible plaintiffs are confined to those Florida citizen residents who suffered or died from smoking-related illnesses that manifested themselves on or before November 21, 1996, and that were caused by an addiction to cigarettes.

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 were not sufficiently specific to serve as the basis for further proceedings and that the Florida Supreme Court's decision denied the defendants due process. On the same day, the plaintiffs also filed a rehearing motion arguing that some smokers who became sick after November 21, 1996, and who were therefore not class members, should nevertheless have the statute of limitations tolled since they may have refrained from filing suit earlier in the mistaken belief that they were *Engle* class members. 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 eligible plaintiffs were 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 eligible members to file individual lawsuits.

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

Pursuant to the Florida Supreme Court's July 6, 2006, ruling in *Engle v. R. J. Reynolds Tobacco Co.*, which decertified the class, eligible plaintiffs had one year from January 11, 2007, in which to file individual lawsuits. In addition, some individuals who filed suit prior to January 11, 2007, and who 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 September 30, 2010, RJR Tobacco had been served in 7,733 *Engle* Progeny cases in both state and federal courts in Florida. These cases include approximately 9,153 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 or nearing trial, and several of these cases already have been tried in 2010.

Three federal district courts ruled that the findings in the first phase of the *Engle* proceedings cannot be used to satisfy elements of plaintiffs' claims, and two of those rulings were certified by the trial court for interlocutory review. Oral argument in *Brown v. R. J. Reynolds Tobacco Co.* occurred on January 26, 2010.

On July 22, 2010, the Court of Appeals for the Eleventh Circuit held that the findings from the first phase of the *Engle* proceedings cannot be given greater effect than what the *Engle* jury found. The Eleventh Circuit's decision is binding in the more than 4,400 *Engle* Progeny cases currently pending in federal court in Florida. *Engle* Progeny cases pending in the federal district courts have been stayed pending the resolution of *Brown*, which has now been remanded for further proceedings. State trial court judges have issued contrary rulings that allow plaintiffs to use the *Engle* findings to establish elements of their claims and to strike certain defenses.

In June 2009, Florida amended its existing bond cap statute by adding a \$200 million bond cap that applied to all *Engle* Progeny cases in the aggregate and establishes individual bond caps for individual *Engle* Progeny cases in amounts that vary depending on the number of judgments in effect at a given time. The legislation, which became effective in June 2009, applies to judgments entered after the effective date and remains in effect until December 31, 2012. The constitutionality of the bond cap has been challenged in several of the cases discussed below. Argument on this issue occurred on September 10, 2010. A decision is pending. If the court finds the bond cap unconstitutional, RJR Tobacco will have to post an additional \$52.03 million in those cases. There will also likely be additional challenges in other counties in Florida.

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

Below is a description of the *Engle* Progeny cases against RJR Tobacco or B&W, or both, which went to trial or were decided during the period from January 1, 2010 to September 30, 2010, or remained on appeal as of September 30, 2010.

On May 5, 2009, in *Sherman v. R. J. Reynolds Tobacco Co.*, a case filed in September 2007 in the Circuit Court, Broward County, Florida, a jury returned a verdict in favor of the plaintiff. The plaintiff, Melba Sherman, alleged that as a result of using the defendants' products, the decedent, John Sherman, developed lung cancer and died. The plaintiff sought compensatory damages and an unspecified amount of punitive damages. On May 8, 2009, the jury awarded compensatory damages of \$1.55 million and found the decedent to be 50% at fault. No punitive damages were awarded. The court entered final judgment in the amount of \$775,000 on June 8, 2009. 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 complete. Oral argument has not been scheduled.

On May 20, 2009, in *Brown v. R. J. Reynolds Tobacco Co.*, a case filed in March 2007, in the Circuit Court, Broward County, Florida, a jury returned a verdict in favor of the plaintiff. The plaintiff alleged that the decedent, Roger Brown, developed smoking related diseases, which resulted in his death. The plaintiff sought compensatory damages and an unspecified amount of punitive damages. On May 22, 2009, the jury returned a verdict that the decedent was 50% at fault for his injuries and awarded compensatory damages of \$1.2 million. No punitive damages were awarded. RJR Tobacco's post-trial motions were denied on June 12, 2009. The same day, the court entered final judgment in the amount of \$600,000. 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 complete. Oral argument has not been scheduled.

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 compensatory 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, Mathilde Martin, sought an unspecified amount of compensatory and punitive damages. On June 1, 2009, the jury returned a punitive damages award of \$25 million. 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 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. Oral argument occurred on July 20, 2010. A decision is pending.

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 the remaining defendants to be 4% at fault, 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. The plaintiff sought judgment against each defendant for an amount in excess of \$15,000, taxable costs, punitive damages and interest. On September 13, 2009, the court entered final judgment against RJR Tobacco in the amount of \$3.04 million. 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. Briefing is underway.

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 and 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 compensatory and punitive damages. On March 10, 2010, the

court entered final judgment against RJR Tobacco in the amount of \$4.2 million in compensatory damages and \$2 million in punitive damages. On July 6, 2010, RJR Tobacco filed a notice of appeal and on July 7, 2010, posted a supersedeas bond in the amount of \$5 million. Briefing is underway. On July 28, 2010, the plaintiff filed a notice of cross appeal.

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

On February 25, 2010, in *Grossman v. R. J. Reynolds Tobacco Co.*, a case filed in December 2007 in the Circuit Court, Broward County, Florida, the court declared a mistrial due to the jury's inability to reach a decision. The plaintiff alleged that as a result of the decedent, Laura Grossman's, addiction to cigarettes, she developed lung cancer and died. The plaintiff sought damages in excess of \$15,000 and all taxable costs and interest. Retrial began on March 29, 2010. On April 21, 2010, the jury returned a verdict in favor of the plaintiff in Phase I, finding that the decedent was addicted to cigarettes containing nicotine and the addiction was the legal cause of her death by lung cancer. On April 29, 2010, the jury awarded \$1.9 million in compensatory damages and no punitive damages. The jury also found RJR Tobacco to be 25% at fault, the decedent to be 70% at fault and the decedent's spouse to be 5% at fault. Final judgment was entered on June 21, 2010, in the amount of \$483,682. RJR Tobacco filed a notice of appeal on July 14, 2010. On July 19, 2010, RJR Tobacco posted a supersedeas bond in the amount of approximately \$484,000, and the plaintiff filed a notice of cross appeal.

On March 10, 2010, in *Douglas v. Philip Morris USA, Inc.*, a case filed in October 2007 in Circuit Court, Hillsborough County, Florida, a jury returned a verdict for the plaintiff, found the decedent, Charlotte Douglas, to be 50% at fault, RJR Tobacco to be 5% at fault and the remaining defendants to be 45% at fault, and awarded \$5 million in compensatory damages. No punitive damages were awarded. The plaintiff alleged that as a result of the decedent's addiction to smoking the defendants' cigarettes, she suffered bodily injury and died. On March 12, 2010, the court entered final judgment against RJR Tobacco in the amount of \$250,000. On June 28, 2010, RJR Tobacco filed a notice of appeal to the Second District Court of Appeal and posted a supersedeas bond in the amount of \$250,000 on June 29, 2010. Briefing is underway.

In *Hall v. R. J. Reynolds Tobacco Co.*, a case filed in December 2007 in the Circuit Court, Alachua County, Florida, the jury returned a verdict in favor of the plaintiff on March 11, 2010. The jury also found the decedent, Arthur Hall, to be 35% at fault and RJR Tobacco to be 65% at fault, and awarded \$5 million in compensatory damages. On March 12, 2010, the jury returned a \$12.5 million punitive damages award. The plaintiff alleged that as a result of the decedent's use of the defendant's products he suffered from lung cancer and died. On March 23, 2010, the court entered final judgment in the amount of \$3.25 million in compensatory damages and \$12.5 million in punitive damages. On May 25, 2010, RJR Tobacco filed a notice of appeal and posted a supersedeas bond in the amount of \$5 million. On June 3, 2010, the plaintiff filed a notice of cross appeal. Briefing is underway.

On March 10, 2010, in *Cohen v. R. J. Reynolds Tobacco Co.*, a case filed in May 2007 in the Circuit Court, Broward County, Florida, a jury returned a verdict in favor of the plaintiff. The plaintiff alleged that the decedent, Nathan Cohen, developed lung cancer as a result of using the defendants' products. The plaintiff sought in excess of \$15,000 compensatory damages and unspecified punitive damages. On March 24, 2010, the jury awarded the plaintiff \$10 million in compensatory damages, and found the decedent to be 33.3% at fault, RJR Tobacco to be 33.3% at fault and the remaining defendant to be 33.3% at fault. The jury also awarded \$20 million in punitive damages, of which \$10 million was assigned to RJR Tobacco. Post-trial motions were denied, and on July 21, 2010, the court entered final judgment against RJR Tobacco in the amount of \$3.33 million in compensatory damages, and \$10 million in punitive damages. On July 27, 2010, the plaintiff filed a motion to amend or alter the final judgment. On August 23, 2010, RJR Tobacco filed a notice of appeal. Briefing is underway. On September 22, 2010, the court entered an amended judgment to include interest from the date of the verdict. A second notice of appeal was filed on October 1, 2010. The plaintiff filed a notice of cross appeal on October 13, 2010.

On April 13, 2010, in *Clay 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. The jury also found the decedent, Janie Mae Clay, to be 30% at fault, RJR Tobacco to be 60% at fault and the remaining defendant to be 10% at fault, and awarded \$3.5 million in compensatory damages. The plaintiff alleged that the decedent developed addiction, chronic obstructive pulmonary disease and other conditions and diseases as a result of using the defendants' products. On April 14, 2010, the jury awarded \$18 million in punitive damages, of which \$17 million was assigned to RJR Tobacco. The defendants' post-trial motions were denied on June 10, 2010. On September 20, 2010, the court entered final judgment against RJR Tobacco in the amount of \$2.1 million in compensatory damages and \$17 million in punitive damages. RJR Tobacco filed a notice of appeal on October 13, 2010.

On April 26, 2010, in *Putney v. R. J. Reynolds Tobacco Co.*, a case filed in December 2008 in the Circuit Court, Broward County, Florida, the jury returned a verdict in favor of the plaintiff, finding the decedent, Margot Putney, to be 35% at fault, RJR Tobacco to be 30% at fault and the remaining defendants to be 35% at fault, and awarded

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

\$15.1 million in compensatory damages and \$2.5 million in punitive damages each against RJR Tobacco and the remaining defendants. The plaintiff alleged that the decedent, Margot Putney, suffered from nicotine addiction and lung cancer as a result of using the defendants' products. Post-trial motions were denied, and on August 24, 2010, final judgment was entered against RJR Tobacco in the amount of \$4.5 million in compensatory damages, and \$2.5 million in punitive damages. RJR Tobacco filed a notice of appeal on August 30, 2010. The plaintiff filed a notice of cross appeal on August 31, 2010. Briefing is underway.

On April 21, 2010, in *Townsend v. R. J. Reynolds Tobacco Co.*, a case filed in December 2007 in the Circuit Court, Alachua County, Florida, the jury returned a verdict in favor of the plaintiff, found RJR Tobacco to be 51% at fault and the decedent, Frank Townsend, to be 49% at fault, and awarded \$10.8 million in compensatory damages and \$80 million in punitive damages. The plaintiff alleged that the decedent suffered from lung cancer and other conditions and diseases as a result of smoking the defendant's products. Final judgment was entered on April 29, 2010, in the amount of \$5.5 million in compensatory and \$40.8 million in punitive damages, which represents 51% of the original damages awards. On May 3, 2010, RJR Tobacco's post-trial motions were denied. RJR Tobacco filed a notice of appeal on August 17, 2010, and posted a supersedeas bond in the amount of \$5 million on August 19, 2010. Briefing is underway.

In *Willis v. R. J. Reynolds Tobacco Co.*, a case filed in December 2007 in the Circuit Court, Manatee County, Florida, the court granted a mistrial due to the jury's inability to reach a verdict on May 12, 2010. The plaintiff alleged that he had been addicted to cigarettes and developed unspecified diseases as a result of smoking. The plaintiff sought unspecified compensatory and punitive damages. Retrial began on September 13, 2010. On October 6, 2010, the jury returned a verdict in favor of the defendants.

On May 20, 2010, in *Buonomo v. R. J. Reynolds Tobacco Co.*, a case filed in October 2007 in the Circuit Court, Broward County, Florida, the jury returned a verdict in favor of the plaintiff, found RJR Tobacco to be 77.5% at fault and the decedent, Matthew Buonomo, to be 22.5% at fault, and awarded \$5.2 million in compensatory damages and \$25 million in punitive damages. The plaintiff alleged that the decedent was addicted to cigarettes and as a result developed one or more smoking related medical conditions and/or diseases. Post-trial motions were denied on July 19, 2010, but the court, in accordance with the Florida statutory limitation on punitive damage awards, ordered the punitive damage award of \$25 million be reduced to \$15.7 million—three times the compensatory damages award of \$5.2 million. On August 6, 2010, the court entered final judgment in the amount of \$4.06 million in compensatory damages and \$15.7 million in punitive damages. On August 24, 2010, RJR Tobacco filed a notice of appeal and posted a supersedeas bond in the amount of \$5 million. On September 1, 2010, the plaintiff filed a notice of appeal.

In *Frazier v. Philip Morris USA Inc.*, the court declared a mistrial due to the inability to seat a jury on May 14, 2010, in a case filed in December 2007 in the Circuit Court, Miami-Dade County, Florida. The plaintiff alleges that as a result of smoking defendants', including RJR Tobacco's, products she developed chronic obstructive pulmonary disease. Retrial began on September 20, 2010. On October 15, 2010, the jury returned a verdict in favor of the defendants.

On June 18, 2010, in *Alexander v. R. J. Reynolds Tobacco Co.*, a case filed in January 2008, in the Circuit Court, Alachua County, Florida, the jury returned a verdict in favor of the plaintiff, found RJR Tobacco to be 51% at fault and the defendant to be 49% at fault, and awarded \$2.5 million in compensatory damages and \$2.5 million in punitive damages. The plaintiff alleged that as a result of smoking the defendant's products, the decedent suffered from chronic obstructive pulmonary disease, lung cancer and emphysema. On July 20, 2010, the court entered final judgment in the amount of \$1.275 million in compensatory damages and \$2.5 million in punitive damages. On September 2, 2010, the court denied RJR Tobacco's post-trial motions. On September 24, 2010, RJR Tobacco filed a notice of appeal. RJR Tobacco posted a supersedeas bond in the amount of approximately \$3.8 million on September 29, 2010. The plaintiff filed a notice of cross appeal on October 8, 2010.

On June 7, 2010, in *Soffer v. R. J. Reynolds Tobacco Co.*, the court declared a mistrial due to the inability to seat a jury. The case was filed in December 2007 in the Circuit Court, Alachua County, Florida. The plaintiff alleged that the decedent, Maurice Soffer, was addicted to cigarettes manufactured by the defendants, and as a result, developed one or more smoking related medical conditions and/or diseases, including lung cancer. The plaintiff seeks compensatory

damages in excess of \$15,000 and no punitive damages. Retrial has been scheduled for June 6, 2011.

30

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

On August 5, 2010, in *Piendle v. R. J. Reynolds Tobacco Co.*, a case filed in November 2007, in the Circuit Court, Palm Beach County, Florida, the jury returned a verdict in favor of the plaintiff, found RJR Tobacco to be 27.5% at fault, the defendant to be 45% at fault and the remaining defendants to be 27.5% at fault, and awarded \$4 million in compensatory damages. On August 19, 2010, the jury returned a punitive damages verdict in the amount of \$180,000 against RJR Tobacco. The plaintiff filed a motion for new trial as to the amount of the punitive damages. Post-trial motions are pending. On September 8, 2010, the court entered final judgment against RJR Tobacco in the amount of \$1.1 million and \$180,000 in punitive damages. After post-trial motions are ruled upon, a notice of appeal will be filed if necessary.

On August 4, 2010, in *Warrick v. R. J. Reynolds Tobacco Co.*, the court declared a mistrial due to the jury's inability to reach a verdict. The case was filed in December 2007, in the Circuit Court, Duval County, Florida. The plaintiff alleged that the decedent, Evaline Warrick, was addicted to cigarettes manufactured by the defendants, and as a result, developed chronic obstructive pulmonary disease and lung cancer. Retrial began on September 13, 2010. On October 4, 2010, the jury returned a verdict in favor of the defendants, RJR Tobacco and Philip Morris USA.

On August 26, 2010, in *Budnick v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of the defendant, RJR Tobacco. The case was filed in December 2007, in the Circuit Court, Broward County, Florida. The plaintiff alleged that the decedent, Leonard Budnick, was addicted to cigarettes manufactured by the defendants, and as a result, developed one or more smoking related medical conditions and/or diseases. On September 13, 2010, the court denied the motion for a new trial and entered final judgment pursuant to the jury's verdict. The plaintiff filed a notice of appeal on October 4, 2010.

On October 15, 2010, in *Campbell v. Philip Morris USA Inc.*, the jury returned a verdict in favor of the defendants, including RJR Tobacco. The case was filed in December 2007, in the Circuit Court, Hillsborough County, Florida. The plaintiffs alleged that Claudette Campbell was addicted to cigarettes manufactured by the defendants, and as a result, developed, chronic obstructive pulmonary disease, bladder cancer and other smoking related medical conditions and/or diseases.

Broin II Cases

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

On October 5, 2000, the *Broin* court entered an order applicable to all *Broin II* cases that the terms of the *Broin* settlement agreement do not require the individual *Broin II* plaintiffs to prove the elements of strict liability, breach of warranty or negligence. Under this order, there is a rebuttable presumption in the plaintiffs' favor on those elements, and the plaintiffs bear the burden of proving that their alleged adverse health effects actually were caused by exposure to ETS in airplane cabins, that is, specific causation.

As of September 30, 2010, there were 2,594 *Broin II* lawsuits pending in Florida.

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

Class Action Suits

Overview. As of September 30, 2010, 15 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, New Mexico and Arizona. All pending class-action cases are discussed below.

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. 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

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

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. On April 23, 2010, the court of appeals amended but largely affirmed the trial court's July 21, 2008 judgment. The defendants' motion for rehearing was denied on May 12, 2010. On September 3, 2010, the defendants' application for writ of certiorari or review with the Louisiana Supreme Court was denied. On September 10, 2010, the defendants' emergency motion to stay execution of judgment in the Supreme Court of Louisiana was denied. On September 24, 2010, the U.S. Supreme Court granted the defendant's motion to stay the judgment pending applicants' timely filing, and the Court's disposition, of a petition for writ of certiorari. The deadline for the defendants to file a petition for writ of certiorari is December 2, 2010.

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 reversed 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. On March 10, 2010, the California Superior Court found that the plaintiffs' lights' claims were not preempted by the Federal Cigarette Labeling and Advertising Act, rendered the court's September 30, 2004 ruling on the issue no longer viable, and denied the defendants' second motion for summary judgment. Trial is scheduled to begin May 6, 2011. The plaintiffs filed a tenth amended complaint on September 10, 2010. RJR Tobacco and B&W filed their answers to the complaint on October 13, 2010. Discovery is underway.

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. On February 22, 2010, the plaintiffs filed an amended complaint. The class definition changed to a class consisting of all persons who reside in the U.S. and tried unsuccessfully to redeem Camel Cash certificates from October 1, 2006 (six months before the defendant ended the Camel Cash program) or who held Camel Cash certificates as of March 31, 2007. The plaintiffs also brought the class on behalf of a proposed California subclass, consisting of all California residents meeting the same criteria. On May 3, 2010, RJR Tobacco's motion to dismiss the amended complaint for lack of jurisdiction over subject matter and, alternatively, for failure to state a claim was granted with leave to amend. On May 7, 2010, the plaintiffs filed a second amended complaint, and on May 24, 2010, filed a corrected second amended complaint. On July 12, 2010, RJR Tobacco's motion to dismiss the corrected second amended complaint was granted with leave to amend. The plaintiffs filed a third amended complaint. RJR Tobacco

filed a motion to dismiss the plaintiffs' third amended complaint on September 20, 2010. A hearing is scheduled for December 6, 2010.

Lights Cases. As noted above, lights class-action cases are pending against RJR Tobacco or B&W in Illinois (2), 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

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

relief, and attorneys' fees and costs from RJR Tobacco and/or B&W. In general, the plaintiffs allege that RJR Tobacco or B&W made false and misleading claims that lights cigarettes were lower in tar and nicotine and/or were less hazardous or less mutagenic than other cigarettes. The cases typically are filed pursuant to state consumer protection and related statutes.

Many of these lights cases were stayed pending review of the *Good v. Altria Group, Inc.* case by the U.S. Supreme Court. In that lights class-action case pending against Altria Group, Inc. and Philip Morris USA, 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 defendant's motion to dismiss and for entry of final judgment was granted, and the case was dismissed with prejudice the same day. 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. Oral argument occurred on February 2, 2010. 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 court's 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 nominal trial date of January 10, 2011 has been scheduled, but it is not expected to proceed at that time.

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.* A nominal trial date of January 10, 2011, has been scheduled, but it is not expected to proceed at that time.

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

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

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 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. On February 26, 2010, a stipulation and order was entered to stay proceedings in this case, and in *Thompson* below.

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. 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 their 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 their 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. On February 22, 2010, the court denied the plaintiffs' motion for class certification of all three putative classes. However, the court ruled that the plaintiffs may reinstate the class dealing with the conspiracy to conceal the addictive nature of nicotine if they identify a new class representative. On April 18, 2010, the court granted the plaintiffs' motion to file a fourth amended complaint and withdraw the motion to reinstate count I by identifying a new plaintiff. On May 7, 2010, the defendants filed a motion to dismiss the plaintiffs' fourth amended complaint, which was granted on June 22, 2010. On July 22, 2010, the court denied the plaintiffs' motion to reconsider. On August 20, 2010, the plaintiffs filed a notice of appeal in the U.S. Court of Appeals for the Seventh Circuit.

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 against RJR Tobacco and RAI, 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. Discovery is underway.

In *Shaffer v. R. J. Reynolds Tobacco Co.*, a case filed in October 2009 in the Superior Court of Pima County, Arizona against RJR Tobacco, RAI and other defendants, 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

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

consumer fraud, concealment, nondisclosure, negligent misrepresentation and unjust enrichment. The plaintiffs seek a variety of damages, including compensatory, restitutionary and punitive damages. On November 13, 2009, the defendants removed the case to the U.S. District Court for the District of Arizona. On November 30, 2009, RJR Tobacco and RAI filed their answers to the complaint. Discovery is underway.

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

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

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 multidistrict 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, by tobacco product users and purchasers on behalf of all similarly situated Missouri consumers. The plaintiffs allege that their use of the defendants' tobacco products has caused them to become addicted to nicotine. The plaintiffs seek to recover an unspecified amount of compensatory and punitive damages. The case was remanded to the Circuit Court on February 17, 1999. There has been limited activity in this case.

Health Care Cost Recovery Cases

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

As of September 30, 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. A limited number of claimants have filed suit against RJR Tobacco, its current or former affiliates, B&W and other tobacco industry defendants to recover funds for health care, medical and other assistance paid by foreign provincial governments in treating their citizens. For more information on these cases, see *International Cases* below.

State Settlement Agreements. In June 1994, the Mississippi attorney general brought an action, *Moore v. American Tobacco Co.*, against various industry members, including RJR Tobacco and B&W. This case was brought on behalf of the state to recover state funds paid for health care and other assistance to state citizens

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

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.

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 2008 and beyond:

Unadjusted Original Participating Manufacturers Settlement Payment Schedule

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

RAI's Operating Subsidiaries Settlement Expenses and Payment Schedule

Settlement expenses	\$ 2,703	\$ 2,540	\$		
Settlement cash payments	\$ 2,830	\$ 2,249	\$		
Projected settlement expenses			\$ >2,500	\$ >2,500	\$ >2,500
Projected settlement cash payments			\$ >2,500	\$ >2,500	\$ >2,500

(1)

Subject to adjustments for changes in sales volume, inflation and other factors.

All payments are to be allocated among the companies on the basis of relative market share. For further information, see State Settlement Agreements-Enforcement and Validity; Adjustments below.

- (2) The Growers Trust payments expire December 2010 and will be offset by certain 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

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

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, based on several federal statutes. In addition, the government sought, pursuant to the civil provisions of RICO, disgorgement of profits the government contends were earned as a consequence of a RICO racketeering enterprise. In September 2000, the court dismissed the government's claims asserted under the Medical Care Recovery Act as well as those under the Medicare Secondary Payer provisions of the Social Security Act, but did not dismiss the RICO claims. In February 2005, the U.S. Court of Appeals for the District of Columbia ruled that disgorgement is not an available remedy in this case. The government's petition for writ of certiorari with the U.S. Supreme Court was denied in October 2005. The non-jury, bench trial began in September 2004, and closing arguments concluded 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 Brown & Williamson Holdings' control over tobacco operations was remanded for further fact finding and clarification;

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

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

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

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.

RJR Tobacco and B&W filed their petitions for writ of certiorari to the U.S. Supreme Court on February 19, 2010. The Department of Justice filed its petition for writ of certiorari on February 19, 2010, which included a request for reinstatement of its claims for remedies, including disgorgement of profits. On June 28, 2010, the U.S. Supreme Court denied both parties' petitions for writ of certiorari. Post-remand proceedings are underway.

International Cases. 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. In these actions, foreign governments are seeking to recover for health care, medical and other assistance paid in treating their citizens for tobacco-related disease. No such actions are pending in the United States. Pursuant to the terms of the 1999 sale of RJR Tobacco's international tobacco business, RJR Tobacco has tendered the defense of these actions to JTI. Subject to a reservation of rights, JTI has assumed the defense of RJR Tobacco and its current or former affiliates in these actions.

In 1997, British Columbia enacted the *Tobacco Damages Recovery Act*, S.B.C. 1997, c. 41, which was amended and renamed the *Tobacco Damages Recovery Amendment Act*, S.C.B. 1998, c. 45. The act created a civil cause of action for the government to recover the costs of health care benefits incurred for insured populations of British Columbia residents resulting from tobacco-related disease. The subsequent suit by Her Majesty the Queen in Right of the Province of British Columbia against Canadian and non-Canadian tobacco-related entities, including RJR Tobacco and certain of its affiliates, was dismissed in February 2000 when the British Columbia Supreme Court ruled that the legislation was unconstitutional and set aside service ex juris against the foreign defendants for that reason. British Columbia then enacted a revised statute, the *Tobacco Damages and Health Care Costs Recovery Act*, S.B.C. 2000, c. 30, and Her Majesty the Queen in Right of the Province of British Columbia brought a new action, filed in January 2001, against many of the same defendants, including RJR Tobacco and one of its affiliates, that is pending in Supreme Court, British Columbia. In this action, the British Columbia government seeks to recover the present value of its total expenditures for health care benefits provided for insured persons resulting from tobacco-related disease or the risk of tobacco-related disease caused by alleged breaches of duty by the manufacturers, the present value of its estimated total expenditures for health care benefits that reasonably could be expected to be provided for those insured persons resulting from tobacco-related disease or the risk of tobacco-related disease in the future, court ordered interest, and costs, or in the alternative, special or increased costs. The government alleges that the defendants are liable under the British Columbia statute by reason of their tobacco related wrongs, which are alleged to include: selling defective products, failure to warn, sale of cigarettes to children and adolescents, illegal importation, strict liability, deceit and misrepresentation, violation of trade practice and competition acts, concerted action, and joint liability. RJR Tobacco filed a statement of defense on January 12, 2007. In February 2010, the trial date was adjourned and no new date has been set.

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 Canadian and non-Canadian tobacco-related entities, including RJR Tobacco and one of its affiliates, in the Trial Division in the Court of Queen's Bench of New Brunswick. The claim is brought pursuant to New Brunswick legislation enacted in 2006, the *Tobacco Damages and Health Care Costs Recovery Act*, S.N.B. 2006, c. T-7.5, which is substantially similar to the British Columbia statute enacted in 2000 described above and

created a civil cause of action for the government to recover the costs of health care benefits incurred for insured populations of New Brunswick residents resulting from tobacco-related disease. In this action, the New Brunswick government seeks to recover the present value of its total expenditures for health care benefits provided for insured persons resulting from tobacco-related disease or the risk of tobacco-related disease caused by alleged

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

breaches of duty by the manufacturers, the present value of its estimated total expenditures for health care benefits that reasonably could be expected to be provided for those insured persons resulting from tobacco-related disease or the risk of tobacco-related disease in the future, court ordered interest, and costs, or in the alternative, special or increased costs. The government alleges that the defendants are liable under the New Brunswick statute by reason of their tobacco related wrongs, which are alleged to include: selling defective products, failure to warn, sale of cigarettes to children and adolescents, strict liability, deceit and misrepresentation, and violation of trade practice and competition acts. On June 26, 2008, RJR Tobacco filed a notice of intent to defend and has since filed defenses to these claims.

On September 30, 2009, a case was filed on behalf of Her Majesty the Queen in Right of the Province of Ontario, Canada, against Canadian and non-Canadian tobacco-related entities, including RJR Tobacco and one of its affiliates, in the Ontario Superior Court of Justice. The claim is brought pursuant to New Brunswick legislation enacted in 2009, the *Tobacco Damages and Health Care Costs Recovery Act*, S.O. 2009, c. 13, which is substantially similar to the British Columbia statute enacted in 2000 described above and created a civil cause of action for the government to recover the costs of health care benefits incurred for insured populations of Ontario residents resulting from tobacco-related disease. In this action, the Ontario government seeks to recover the present value of its total expenditure for health care benefits provided for insured persons resulting from tobacco-related disease or the risk of tobacco-related disease caused by alleged breaches of duty by the manufacturers, the present value of its estimated total expenditure for health care benefits that reasonably could be expected to be provided for those insured persons resulting from tobacco-related disease or the risk of tobacco-related disease in the future, court ordered interest, and costs, or in the alternative, special or increased costs. The government alleges that the defendants are liable under the Ontario statute by reason of their tobacco related wrongs, which are alleged to include: selling defective products, failure to warn, sale of cigarettes to children and adolescents, illegal importation, strict liability, deceit and misrepresentation, and violation of trade practice and competition acts. RJR Tobacco and one of its affiliates filed statements of defense on March 4, 2010, and the government filed an amended statement of claim on August 25, 2010, that deleted the illegal importation claims.

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 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 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 defendants' applications for a strike out of the claim. A decision is pending.

The following six putative Canadian class actions were filed against various Canadian and non-Canadian tobacco-related entities, including RJR Tobacco and one of its affiliates, in courts in the provinces of Alberta, British Columbia, Manitoba, Nova Scotia, and Saskatchewan, although only the action pending in Saskatchewan is being taken forward at this stage:

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

In *Dorion v. Canadian Tobacco Manufacturers Council*, a case filed in June 2009, in the Court of Queen's Bench of Alberta against Canadian and non-Canadian tobacco-related entities, including RJR Tobacco and one of its affiliates, the plaintiffs brought the case on behalf of all individuals, including their estates, dependants

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

and family members, who purchased or smoked cigarettes designed, manufactured, marketed or distributed by the defendants.

In *Kunka v. Canadian Tobacco Manufacturers Council*, a case filed in 2009 in the Court of Queen's Bench of Manitoba against Canadian and non-Canadian tobacco-related entities, including RJR Tobacco and one of its affiliates, the plaintiffs brought the case on behalf of all individuals, including their estates, and their 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 Canadian and non-Canadian tobacco-related entities, including RJR Tobacco and one of its affiliates, the plaintiffs brought the case on behalf of all individuals, including their estates, 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 *Bourassa v. Imperial Tobacco Canada Limited*, a case filed in June 2010 in the Supreme Court of British Columbia against Canadian and non-Canadian tobacco-related entities, including RJR Tobacco and one of its affiliates, the plaintiffs brought the case on behalf of all individuals, including their estates, who were alive on June 12, 2007, and who have suffered, or who currently suffer from chronic respiratory diseases, after having smoked a minimum of 25,000 cigarettes designed, manufactured, imported, marketed, or distributed by the defendants.

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

In each of these six cases, the plaintiffs allege fraud, fraudulent concealment, breach of warranty, breach of warranty of merchantability and of fitness for a particular purpose, failure to warn, design defects, negligence, breach of a special duty to children and adolescents, conspiracy, concert of action, unjust enrichment, market share liability, joint liability, and violations of various trade practices and competition statutes. The plaintiffs seek compensatory and aggravated damages; punitive or exemplary damages; the right to waive the torts described above and claim disgorgement of the amount of revenues or profits the defendants received from the sale of tobacco products to putative class members; interest pursuant to the Pre-judgment Interest Act and other similar legislation; and other relief the court deems just.

Pursuant to the terms of the 1999 sale of RJR Tobacco's international tobacco business, RJR Tobacco has tendered the defense of these six actions to JTI. Subject to a reservation of rights, JTI has assumed the defense of RJR Tobacco and its current or former affiliates in these actions.

Native American Tribe Cases. As of September 30, 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 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 September 30, 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. 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

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

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, in *National Committee to Preserve Social Security and Medicare v. Philip Morris USA Inc.*, 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 and 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 February 4, 2010, the defendants filed a motion to dismiss the appeal before the Second Circuit. On June 23, 2010, the Second Circuit denied the defendants' motion to dismiss the appeal. On October 8, 2010, a summary order was entered by the Second Circuit that vacated the judgment of the Eastern District of New York and remanded the case with instructions for the court to dismiss the complaint for lack of subject matter jurisdiction.

On August 31, 2009, RJR Tobacco and American Snuff Co. 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 restricts the few remaining channels available to communicate with adult tobacco consumers. RAI believes these provisions cannot be justified on any basis consistent with the demands of the First Amendment. The suit does not challenge the U.S. Congress's decision to give 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 of the FDA Tobacco Act. 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 imagery in labeling and advertising and the right to make statements that their products conform to FDA regulatory requirements. The court granted summary judgment to the U.S. Government as to all other challenged provisions. On March 5, 2010, the plaintiffs filed a notice of appeal of the court's judgment with the Sixth Circuit Court of Appeals. The U.S. Government filed its own notice of appeal with the Sixth Circuit Court of Appeals on March 8, 2010. Briefing is underway.

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; Adjustments

As of September 30, 2010, there were 33 cases concerning the enforcement, validity or interpretation of the State Settlement Agreements in which RJR Tobacco or B&W is a party. This number includes those cases, discussed below, relating to disputed payments under the State Settlement Agreements.

The Vermont Attorney General filed suit in July 2005, in the Vermont Superior Court, Chittenden County, alleging that certain advertising for the Eclipse cigarette brand violated both the MSA and the Vermont Consumer Fraud Statute. The State of Vermont is seeking declaratory, injunctive, and monetary relief. The bench trial in this action began on October 6, 2008, and lasted a total of five weeks. Closing arguments occurred on March 11, 2009. On March 10, 2010, the court issued its opinion, finding that three of the advertising claims made by RJR Tobacco were not supported by the appropriate degree of scientific evidence. The court did, however, rule that the remaining six

advertising claims challenged by the State of Vermont were not actionable. The court indicated that remedies and any damages to be awarded, as well as the issue of attorney's fees and litigation expenses, will be addressed in additional proceedings. On March 22, 2010, RJR Tobacco filed a motion to amend findings of fact that it believes

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

are demonstrably contrary to, or unsupported by, the record. A status conference and hearing on RJR Tobacco's motion occurred on July 8, 2010. 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.

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 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 remanded the case for further proceedings. The Washington Supreme Court recently declined to review the decision by the Court of Appeals.

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. No monetary sanctions were awarded. 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. The State petitioned the Ohio Supreme Court for review, and that petition was denied.

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

The court in California ruled that the company was not liable for preventing the use of cartoons in magazine-created content next to the RJR Tobacco advertisement, but that a few of the images in the RJR Tobacco advertisement itself were technical and unintentional cartoons. No monetary sanctions were awarded by the California court. The parties' appeals are ongoing. The California Court of Appeals recently affirmed the judgment, but has yet to hear a separate appeal on the issue of the State's entitlement to attorneys' fees. Briefing on the issue of the State's entitlement to attorneys' fees is complete. A hearing date has not yet been set.

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. RJR Tobacco has appealed. On August 17, 2010, the Pennsylvania Court of Appeals reversed the trial court on both claims. The Commonwealth has filed a motion for reargument, which is currently pending.

In Illinois, RJR Tobacco received a complete defense ruling. The State requested reconsideration of the court's ruling, and the court reaffirmed its ruling in favor of RJR Tobacco. The State has filed an appeal.

The three remaining cases in Maryland, New York and Connecticut were individually settled in the first quarter of 2010 for a non-material amount.

Finally, in *Stewart v. R. J. Reynolds Tobacco Co.*, a class action suit was filed in Superior Court, Alameda County, California, in December 2007, against the Rolling Stone'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. The California Appellate Court recently issued an order favoring Wenner Media and remanded the case for further proceedings consistent with the order. More specifically, it ruled that the trial court erred in concluding that a triable issue exists as to whether the editorial feature constitutes commercial speech and also erred in finding that the plaintiffs presented evidence sufficient to establish that they have probability of prevailing on the merits. The plaintiff subsequently entered an agreement dismissing its claims against RJR Tobacco, and it was approved by the court.

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 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

44

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

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 September 30, 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. The orders compelling arbitration in these states are now final and/or non-appealable. The Montana Supreme Court ruled that the state of Montana did not agree to arbitrate the question of whether it diligently enforced a qualifying statute.

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 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.

The arbitration panel contemplated by the MSA and the Agreement Regarding Arbitration has been selected and proceedings before the panel with respect to the 2003 NPM Adjustment Claim have begun. An initial administrative conference was held on July 20, 2010. A further hearing, focused primarily on jurisdictional and procedural issues, was held on October 5, 2010. Additional proceedings currently are scheduled for December 6-7, 2010. It is anticipated that it will be 12 to 18 months before a decision on the merits with respect to this claim is reached.

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. Based on revised calculations by the MSA independent auditor, in April 2010, RJR Tobacco withheld an additional amount, bringing the total amount withheld with respect to the 2006 NPM Adjustment to approximately \$420 million.

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.

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

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 established under Section VIII(c) of the MSA for each year covered by that agreement, with RJR Tobacco paying approximately 47% of such amounts.

Based on the payment calculations of the MSA independent auditor and the agreement described above regarding in pertinent part the 2007 significant factor determination, the Adjustment Requirements were satisfied with respect to the NPM Adjustment for 2007. As a result, in April 2010, RJR Tobacco placed approximately \$448 million of its 2010 MSA payment (representing its share of the 2007 NPM Adjustment as calculated by the MSA independent auditor) into the disputed payments account.

In addition to the NPM Adjustment claims described above, RJR Tobacco has filed dispute notices with respect to its 2008 and 2009 annual MSA payments relating to the NPM Adjustments potentially applicable to those years. The amount at issue for those two years is approximately \$944 million.

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

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 September 30, 2010, all of the federal and state court cases on behalf of indirect purchasers had been dismissed, except for one state court case pending in Kansas.

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.

Other Litigation and Developments

Canadian Matters. 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 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

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

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.

On April 13, 2010, Northern Brands entered into a plea agreement with the Ministry of the Attorney General of Ontario. Under the terms of this agreement, Northern Brands pled guilty to a one count violation of the Canadian Criminal Code for conspiring to aid other persons to sell and be in possession of tobacco products that were not packaged and stamped in conformity with the Canadian Excise Act during the period February 18, 1993 through December 31, 1996. The Judge of the Ontario Court of Justice accepted the plea by Northern Brands and required it to pay a fine of CAD \$75 million, which was paid on April 13, 2010. By this plea, the criminal charges that were originally commenced against Northern Brands and certain of its affiliates in 2003 and any other charges that could be commenced against Northern Brands and its affiliates by the Canadian governments relating to contraband tobacco activities have now come to an end.

RJR and JTI entered into a Settlement Agreement and Mutual Release dated as of April 13, 2010, referred to as the SA-MR, pursuant to which the parties have resolved, by mutual release, JTI's request for indemnification of the claims referenced in the four preceding paragraphs and, among other things, (1) RJR Tobacco has agreed to give up its reservation of rights with respect to all moneys already advanced to JTI for certain attorneys fees, expenses and costs in the criminal proceedings and to pay for any additional fees, expenses and costs of like kind incurred in those proceedings up to a specified date; (2) JTI has paid for all Canadian Goods and Services Taxes incurred to date and has agreed to pay for all such taxes incurred in the future in connection with the foregoing attorney services already provided or to be provided in the criminal proceedings; (3) the parties have agreed to split evenly the payment of certain other attorneys fees already incurred in connection with the Canadian matters; and (4) the parties have resolved other issues related to the preceding matters.

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 CAD \$1.5 billion in compensatory damages and CAD \$50 million 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 CAD \$4.3 billion. The parties 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.

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

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

amount of about CAD \$1.36 billion; (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. 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, CAD \$4.3 billion; Ontario, CAD \$1.5 billion; New Brunswick, CAD \$1.5 billion; Quebec, CAD \$1.4 billion; British Columbia, CAD \$450 million; Nova Scotia, CAD \$326 million; Prince Edward Island, CAD \$75 million; and Manitoba, CAD \$23 million. In the CCAA Proceedings, the Canadian federal government and some of the provincial governments had asserted that they could make the same tax and related claims against RJR and certain of its subsidiaries, including RJR Tobacco.

Effective April 13, 2010, RJR Tobacco entered into the Comprehensive Agreement with the Canadian federal, provincial and territorial governments, resolving a variety of civil claims related to cigarette smuggling in Canada during the period 1985 through 1999. The Comprehensive Agreement covers all civil claims related to the movement of contraband tobacco products in Canada during the period 1985 through 1999 that the governments have asserted or could assert against RJR Tobacco and its affiliates. RJR Tobacco has paid the governments a total of CAD \$325 million. Should RJR Tobacco or its affiliates decide in the future to sell tobacco products in Canada, they have also agreed to adopt packaging, marking and other measures that will assist the Canadian governments in their efforts to combat the movement of contraband tobacco products in Canada.

Pursuant to the SA-MR, JTI's indemnification claims with respect to the matters described in the three preceding paragraphs also have been resolved by mutual release.

On July 26, 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 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 August 3, 2010, the parties settled this action, and this action was among the disputed issues that JTI and RJR Tobacco resolved in the SA-MR.

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 CAD \$840,000 for salary allegedly owed under his severance agreement with RJR-MI, as well as other unspecified compensatory and punitive damages. On January 10, 2005, 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. On August 3, 2010, the parties settled this action, and this action was among the disputed issues that JTI and RJR Tobacco resolved in the SA-MR.

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.

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,

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

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.

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

By letter dated February 2, 2010, JTI stated that it would be seeking indemnification under the 1999 Purchase Agreement for any damages it may incur in connection with an investigation commenced in January 2010 by the Canada Revenue Agency, referred to as CRA, regarding interest deductions that JTI-MC took on its income tax returns for the period 2005-2008 while it was in the CCAA Proceedings. This matter was resolved between JTI and RJR Tobacco in the SA-MR.

Although RJR and RJR Tobacco recognize that, under certain circumstances, they may have other unresolved indemnification obligations to JTI under the 1999 Purchase Agreement, RJR and RJR Tobacco disagree with JTI as to (1) what circumstances relating to any such matters may give rise to indemnification obligations by RJR and RJR Tobacco, and (2) the nature and extent of any such obligation. RJR and RJR Tobacco have conveyed their position to JTI, and the parties have agreed to resolve their differences at a later time. In the interim, RJR and RJR Tobacco have been paying defense costs and expenses incurred by JTI in connection with some, but not all, of the Canadian litigation matters described above. RJR Tobacco expensed \$4 million during the first nine months of 2010 and \$6 million during the first nine months of 2009, for funds to be reimbursed to JTI for costs and expenses arising out of the Canadian litigation.

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. With the termination of the criminal proceedings, the Canadian government also has confirmed that the subpoena served on RAI on May 15, 2007 pursuant to the Mutual Legal Assistance Treaty between the United States and Canada will be withdrawn and that continued compliance is no longer necessary.

See note 6 for additional information related to the Comprehensive Agreement entered into by RJR Tobacco with the Canadian federal, provincial and territorial governments, and the plea agreement of Northern Brands in connection with certain Canadian matters.

European Community. On October 30, 2002, the European Community and ten of its member states filed a complaint in the EDNY against RJR, RJR Tobacco and several currently and formerly related companies. The complaint contains many of the same or similar allegations found in an earlier complaint, now dismissed, filed in August 2001 and also alleges that the defendants, together with certain identified and unidentified persons, engaged in money laundering and other conduct violating civil RICO and a variety of common laws. The complaint also alleges that the defendants manufactured cigarettes that were eventually sold in Iraq in violation of U.S. sanctions. The plaintiffs seek compensatory, punitive and treble damages among other types of relief. This matter has been stayed and largely inactive since November 24, 2009 when, with the court's permission, the European Community and member states filed and served a second amended complaint. The second amended complaint added 16 member states

as plaintiffs and RAI, RJR Tobacco and R. J. Reynolds Global Products, Inc., referred to as GPI, as defendants. The allegations contained in the second amended complaint are in most respects either identical or similar to those found in the prior complaint, but now add new allegations primarily regarding the activities of RAI, RJR Tobacco and GPI following the B&W business combination. Pursuant to a stipulation and order, the defendants filed a motion to dismiss the plaintiffs' second amended complaint on February 15, 2010. Oral argument of the motion occurred on October 26, 2010. A decision is pending. There has been no other activity in the case.

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

Star Patent Infringement. 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, referred to as *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 in *Star I*.

Shortly after trial began in *Star I*, on May 29, 2009, Star filed a follow-on lawsuit in the U.S. District Court for the District of Maryland, referred to as *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.

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.

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 re-examination 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 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. Briefing is complete. Oral argument has not yet been scheduled.

Finally, both of Star's patents are the subject of re-examination 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

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

currently under re-examination. On November 10, 2009, Star filed responses in the re-examinations. On May 13, 2010, the PTO issued notices of intent to issue re-examination certificates, cancelling the claims under re-examination and terminating the re-examination proceedings due to Star's failure to comply with federal patent examining procedures. On May 14, 2010, Star filed petitions to reopen the re-examination proceedings. On October 1, 2010, the PTO ruled on the petitions and requested Star to either explain why it failed to comply with the patent examining procedures, or to file a petition that explains why its failure was either unavoidable or unintentional. Star has until October 31, 2010, to comply with the PTO's request.

Other Matters. 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 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. Certain defendants responded to the plaintiffs' filings on October 19, 2009, requesting that the plaintiffs' fourth amended complaint not be permitted to be filed or that it should be dismissed with prejudice. On July 30, 2010, the Northern District of Illinois denied the plaintiffs' motion to file a fourth amended complaint and dismissed the Hurdle plaintiffs' consumer protection claim with prejudice. On August 30, 2010, the plaintiffs filed a notice of appeal.

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 September 30, 2010, American Snuff Co. was a defendant in six actions brought by individual plaintiffs in West Virginia state court seeking damages in connection with personal injuries allegedly sustained as a result of the usage of American Snuff Co. s smokeless tobacco products. These actions are pending before the same West

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

Virginia court as the 611 consolidated individual smoker cases against RJR Tobacco, B&W, as RJR Tobacco's indemnitee, or both. Pursuant to the court's December 3, 2001, order, the smokeless tobacco claims and defendants remain severed.

Pursuant to a second amended complaint filed in September 2006, American Snuff Co. is a defendant in *Vassallo v. United States Tobacco Company*, pending in the Eleventh Circuit Court in Miami-Dade County, Florida. The individual plaintiff alleges that he sustained personal injuries, including addiction and cancer, as a result of his use of smokeless tobacco products, allegedly including products manufactured by American Snuff Co. The plaintiff seeks unspecified compensatory and consequential damages in an amount greater than \$15,000. There is 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, American Snuff Co. and 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. American Snuff Co. contends the statute violates the constitutions of Oregon and the United States. On June 21, 2010, the court denied American Snuff's motion for a preliminary injunction against enforcement of the statute.

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 \$230 million to \$260 million.

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.

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 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)

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

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 April 15, 2010, in *Hapes v. Santa Fe Natural Tobacco Company*, the plaintiff filed a complaint in the Santa Fe County, New Mexico District Court. The plaintiff alleges hostile work environment, sex discrimination, retaliation and discriminatory failure to promote in violation of Title VII and the Family & Medical Leave Act. She is seeking unspecified lost wages and benefits, as well as emotional distress damages and attorneys' fees. Punitive damages are not specifically requested. Santa Fe has filed its answer and intends to remove the case to the U.S. District Court for the District of New Mexico.

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.

In September 2009, the U.S. Environmental Protection Agency, referred to as EPA, passed a rule which requires companies to monitor greenhouse gas, referred to as GHG, emissions beginning in January, 2010 and, depending upon the industry in which the particular company operates or the amount of the company's GHG emissions, report these emissions to EPA on an annual basis, beginning in 2011. Based upon its current GHG emission levels, RJR Tobacco expects that it will be necessary to submit GHG emissions reports to the EPA pertaining to at least one of its facilities. RJR Tobacco is fully prepared to submit this data in accordance with the EPA's regulations.

RAI and its operating subsidiaries believe that climate change is an environmental issue primarily driven by carbon dioxide emissions from the use of energy. RAI's operating subsidiaries are working to reduce carbon dioxide emissions by minimizing the use of energy, minimizing waste to landfills and increasing recycling. Climate change is not viewed by RAI's operating subsidiaries as a significant direct economic risk to their businesses, but rather an indirect risk involving the potential for a longer term general increase in the cost of doing business. Regulatory changes are difficult to predict but the current regulatory risks to the business of RAI's operating subsidiaries with respect to climate change are relatively low and financial impacts will be driven more by the cost of natural gas and electricity.

Efforts are made to mitigate the effect of increases in fuel costs directly impacting

53

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

RAI's operating subsidiaries by evaluating market conditions and occasionally purchasing forward contracts, limited to a three-year period, for natural gas. In addition, RAI's operating subsidiaries are constantly evaluating electrical energy conservation measures and energy efficient equipment to mitigate impacts of increases in electrical energy costs.

Regulations promulgated by the EPA and other governmental agencies under various statutes have resulted in, and likely will continue to result in, substantial expenditures for pollution control, waste treatment, 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* *Canadian Matters*, RJR Tobacco has received claims for indemnification from JTI, and several of these have been resolved pursuant to the SA-MR. Although RJR and RJR Tobacco recognize that, under certain circumstances, they may have other unresolved indemnification obligations to JTI under the 1999 Purchase Agreement, RJR and RJR Tobacco disagree what circumstances described in such claims give rise to any indemnification obligations by RJR and RJR Tobacco and the nature and extent of any such obligation. RJR and RJR Tobacco have conveyed their position to JTI, and the parties have agreed to resolve their differences at a later date.

RJR Tobacco, Santa Fe, American Snuff Co. 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, American Snuff Co. 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.

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.

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

Note 12 Shareholders Equity

	Common Stock	Paid-In Capital	Accumulated Deficit	Accumulated Other Comprehensive Loss	Total Shareholders Equity	Comprehensive Income
Balance as of December 31, 2009	\$	\$ 8,498	\$ (579)	\$ (1,421)	\$ 6,498	
Net income			804		804	\$ 804
Retirement benefits, includes \$8 million tax expense				94	94	94
Unrealized gain on long-term investments, net of \$2 million tax expense				4	4	4
Cumulative translation adjustment, net of \$8 million tax benefit				(5)	(5)	(5)
Total comprehensive income						\$ 897
Dividends \$2.70 per share			(793)		(793)	
Common stock repurchased		(5)			(5)	
Equity incentive award plan and stock-based compensation		29			29	
Excess tax benefit on stock-based compensation plans		2			2	
Balance as of September 30, 2010	\$	\$ 8,524	\$ (568)	\$ (1,328)	\$ 6,628	

Due to RAI's incorporation in North Carolina, which does not recognize treasury shares, the shares repurchased are cancelled at the time of repurchase. During the first nine months of 2010, RAI purchased 89,048 shares that were forfeited with respect to tax liabilities associated with restricted stock vesting under the LTIP, a plan which expired in 2009 and was replaced by the Reynolds American Inc. 2009 Omnibus Incentive Compensation Plan, referred to as the Omnibus Plan.

On February 2, 2010, May 7, 2010 and July 15, 2010, RAI's board of directors declared a quarterly cash dividend of \$0.90 per common share, or \$3.60 on an annualized basis, to shareholders of record as of March 10, 2010, June 10, 2010 and September 10, 2010, respectively.

Note 13 Stock Plans

In February 2010, the board of directors of RAI approved a grant to key employees of RAI and its subsidiaries of 990,083 nonvested restricted stock units under the Omnibus Plan, effective March 1, 2010. The restricted stock units

generally will vest on March 1, 2013. Upon settlement, each grantee will receive a number of shares of RAI's common stock equal to the product of the number of vested units and a percentage from 0%-150% based on the average RAI annual incentive award plan score over the three-year period ending December 31, 2012.

As an equity-based grant, compensation expense relating to the 2010 Omnibus Plan grant will take into account the vesting period lapsed and will be calculated based on the per share closing price of RAI common stock on the date of grant, or \$53.24. Dividends paid on shares of RAI common stock will accumulate on the restricted stock units and will be paid to the grantee on the vesting date. If RAI fails to pay its shareholders cumulative dividends of at least \$10.80 per share for the three-year performance period ending December 31, 2012, then each award will be reduced by an amount equal to three times the percentage of the dividend underpayment, up to a maximum reduction of 50%.

Note 14 Segment Information

RAI's reportable operating segments are RJR Tobacco and American Snuff. The RJR Tobacco segment consists of the primary operations of R. J. Reynolds Tobacco Company. The American Snuff segment consists of the primary operations of American Snuff Co. and Lane. RAI's wholly owned subsidiaries, Santa Fe and Nicovum 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. Certain of 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.

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

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, DORAL and KOOL were five of the ten best-selling brands of cigarettes in the United States as of September 30, 2010. Those brands, and its other brands, including SALEM, MISTY and CAPRI, are manufactured in a variety of styles and marketed in the United States. As part of its total tobacco strategy, RJR Tobacco also offers two types of smoke-free tobacco products, CAMEL Snus and CAMEL Dissolvables. RJR Tobacco also manages contract manufacturing of cigarette and tobacco products through arrangements with BAT affiliates and manages the export of tobacco products to certain U.S. territories, U.S. duty-free shops and U.S. overseas military bases.

RAI's other reportable operating segment, American Snuff, is the second largest smokeless tobacco products manufacturer in the United States. American Snuff's primary brands include its largest-selling moist snuff brands, GRIZZLY and KODIAK. American Snuff's other products include 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. The financial position and results of operations of this operating segment do not meet the materiality criteria to be reportable.

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

Segment Data:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2010	2009	2010	2009
Net sales:				
RJR Tobacco	\$ 1,917	\$ 1,867	\$ 5,579	\$ 5,513
American Snuff	185	177	528	512
All Other	137	108	363	298
Consolidated net sales	\$ 2,239	\$ 2,152	\$ 6,470	\$ 6,323
Operating income:				
RJR Tobacco	\$ 561	\$ 532	\$ 1,572	\$ 1,170
American Snuff	95	93	253	193
All Other	33	36	91	85
Corporate expense	(27)	(25)	(64)	(66)
Consolidated operating income	\$ 662	\$ 636	\$ 1,852	\$ 1,382
Reconciliation to income from continuing operations before income taxes:				
Operating income	\$ 662	\$ 636	\$ 1,852	\$ 1,382
Interest and debt expense	55	60	176	190
Interest income	(3)	(5)	(9)	(15)
Other expense (income), net	(8)	2	4	9
Income from continuing operations before income taxes	\$ 618	\$ 579	\$ 1,681	\$ 1,198

Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**Note 15 Related Party Transactions**

RAI's operating subsidiaries engage in transactions with affiliates of BAT. The following is a summary of balances and transactions with such BAT affiliates.

Balances:

	September 30, 2010	December 31, 2009
Accounts receivable	\$ 32	\$ 96
Accounts payable	3	3
Deferred revenue	18	57

Transactions for the nine months ended September 30:

	2010	2009
Net sales	\$ 329	\$ 306
Purchases	10	10

RAI's operating subsidiaries sell contract-manufactured cigarettes, processed strip leaf, pipe tobacco and little cigars to BAT affiliates. During the second quarter of 2010, RJR Tobacco and BAT concluded their negotiations over certain contract manufacturing arrangements, which resulted in the termination of a prior contract manufacturing agreement between RJR Tobacco and an affiliate of BAT and entering into a new contract manufacturing agreement with pricing based on negotiated cost plus 10% for 2010. For contract years 2011 through 2014, prices will increase or decrease by a multiple equal to changes in the Producer Price Index, reported by the U.S. Bureau of Labor Statistics. Net sales to BAT affiliates, primarily cigarettes, represented approximately 5.0% of RAI's total net sales during the nine months ended September 30, 2010.

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

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

RJR Tobacco recorded in selling, general and administrative expenses, funds to indemnify B&W and its affiliates for costs and expenses related to tobacco-related litigation in the United States. For additional information relating to this indemnification, see note 11.

Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)**Note 16 RAI Guaranteed, Unsecured Notes Condensed Consolidating Financial Statements**

The following condensed consolidating financial statements have been prepared pursuant to Rule 3-10 of Regulation S-X, relating to the guaranties of RAI's \$4.0 billion unsecured 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, American Snuff Co., Rosswil, LLC, 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.

Condensed Consolidating Statements of Income
(Dollars in Millions)

	Parent Issuer	Guarantors	Non- Guarantors	Eliminations	Consolidated
For the Three Months Ended					
September 30, 2010					
Net sales	\$	\$ 2,123	\$ 41	\$ (18)	\$ 2,146
Net sales, related party		93			93
Cost of products sold		1,179	23	(18)	1,184
Selling, general and administrative expenses	3	364	21	(1)	387
Amortization expense		6			6
Asset impairment and exit charges					
Operating income (loss)	(3)	667	(3)	1	662
Interest and debt expense	53	2			55
Interest income		(1)	(2)		(3)
Intercompany interest (income) expense	(29)	29			
Intercompany dividend income		(11)		11	
Other income, net	(7)		(1)		(8)
Income (loss) from continuing operations before income taxes	(20)	648		(10)	618
Provision for (benefit from) income taxes	(7)	244	(1)	1	237
Equity income from subsidiaries	394	3		(397)	
Net income	\$ 381	\$ 407	\$ 1	\$ (408)	\$ 381
For the Three Months Ended					
September 30, 2009					
Net sales	\$	\$ 2,035	\$ 40	\$ (30)	\$ 2,045
Net sales, related party		107			107
Cost of products sold		1,149	19	(30)	1,138
Selling, general and administrative expenses		354	17		371
Amortization expense		7			7

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

Operating income		632	4		636
Interest and debt expense	58	2			60
Interest income		(2)	(3)		(5)
Intercompany interest (income) expense	(30)	29	1		
Intercompany dividend income		(11)		11	
Other (income) expense, net	(9)	11			2
Income (loss) before income taxes	(19)	603	6	(11)	579
Provision for (benefit from) income taxes	(8)	224	1		217
Equity income from subsidiaries	373	6		(379)	
Net income	\$ 362	\$ 385	\$ 5	\$ (390)	\$ 362

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

	Parent Issuer	Guarantors	Non- Guarantors	Eliminations	Consolidated
For the Nine Months Ended September 30, 2010					
Net sales	\$	\$ 6,102	\$ 120	\$ (81)	\$ 6,141
Net sales, related party		329			329
Cost of products sold		3,456	62	(81)	3,437
Selling, general and administrative expenses	12	1,055	58	(1)	1,124
Amortization expense		19			19
Asset impairment and exit charges		24	14		38
Operating income (loss)	(12)	1,877	(14)	1	1,852
Interest and debt expense	170	6			176
Interest income		(3)	(6)		(9)
Intercompany interest (income) expense	(90)	90			
Intercompany dividend income		(32)		32	
Other expense, net		4			4
Income (loss) from continuing operations before income taxes	(92)	1,812	(8)	(31)	1,681
Provision for (benefit from) income taxes	(30)	697	(7)	1	661
Equity income (loss) from subsidiaries	866	(69)		(797)	
Income (loss) from continuing operations	804	1,046	(1)	(829)	1,020
Losses from discontinued operations, net of tax		(142)	(74)		(216)
Net income (loss)	\$ 804	\$ 904	\$ (75)	\$ (829)	\$ 804
For the Nine Months Ended September 30, 2009					
Net sales	\$	\$ 5,998	\$ 120	\$ (101)	\$ 6,017
Net sales, related party		306			306
Cost of products sold		3,378	59	(100)	3,337
Selling, general and administrative expenses	10	1,070	49		1,129
Amortization expense		22			22
Trademark impairment charge		453			453
Operating income (loss)	(10)	1,381	12	(1)	1,382
Interest and debt expense	183	7			190

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

Interest income		(7)	(8)		(15)
Intercompany interest					
(income) expense	(85)	84	1		
Intercompany dividend income		(32)		32	
Other (income) expense, net	(3)	12			9
Income (loss) before income taxes	(105)	1,317	19	(33)	1,198
Provision for (benefit from) income					
taxes	(38)	488	1		451
Equity income from subsidiaries	814	20		(834)	
Net income	\$ 747	\$ 849	\$ 18	\$ (867)	\$ 747

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

	Parent Issuer	Guarantors	Non- Guarantors	Eliminations	Consolidated
For the Nine Months Ended September 30, 2010					
Cash flows from operating activities	\$ 120	\$ 1,220	\$ 10	\$ (332)	\$ 1,018
Cash flows from (used in) investing activities:					
Proceeds from redemption of long-term investments		12			12
Capital expenditures		(113)	(2)		(115)
Proceeds from termination of joint venture			28		28
Other, net		5			5
(Contributions to) return of intercompany investments	897	(75)		(822)	
Intercompany notes receivable	40	22		(62)	
Net cash flows from (used in) investing activities	937	(149)	26	(884)	(70)
Cash flows from (used in) financing activities:					
Dividends paid on common stock	(787)	(300)		300	(787)
Dividends paid on preferred stock	(32)			32	
Repayment of long-term debt	(300)				(300)
Receipt (distribution) of equity		(897)	75	822	
Intercompany notes payable	(21)	(40)	(1)	62	
Net cash flows from (used in) financing activities	(1,140)	(1,237)	74	1,216	(1,087)
Effect of exchange rate changes on cash and cash equivalents			(6)		(6)
Net cash flows related to discontinued operations, net of tax benefit	72	(324)	(74)		(326)
Net change in cash and cash equivalents	(11)	(490)	30		(471)
Cash and cash equivalents at beginning of period	361	2,136	226		2,723
	\$ 350	\$ 1,646	\$ 256	\$	\$ 2,252

Cash and cash equivalents at end of
period

60

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

	Parent Issuer	Guarantors	Non- Guarantors	Eliminations	Consolidated
For the Nine Months Ended September 30, 2009					
Cash flows from operating activities	\$ 274	\$ 1,071	\$ 16	\$ (472)	\$ 889
Cash flows from (used in) investing activities:					
Proceeds from redemption of long-term investments		4			4
Capital expenditures		(72)	(3)		(75)
Proceeds from termination of joint venture			24		24
Other, net	1	29			30
Return of intercompany investments	610			(610)	
Intercompany notes receivable	40	17		(57)	
Net cash flows from (used in) investing activities	651	(22)	21	(667)	(17)
Cash flows from (used in) financing activities:					
Dividends paid on common stock	(743)	(440)		440	(743)
Dividends paid on preferred stock	(32)			32	
Distribution of equity		(610)		610	
Repayment of long-term debt	(189)	(11)			(200)
Other, net	(3)				(3)
Intercompany notes payable	(17)	(40)		57	
Net cash flows used in financing activities	(984)	(1,101)		1,139	(946)
Effect of exchange rate changes on cash and cash equivalents			9		9
Net change in cash and cash equivalents	(59)	(52)	46		(65)
Cash and cash equivalents at beginning of period	272	2,091	215		2,578
Cash and cash equivalents at end of period	\$ 213	\$ 2,039	\$ 261	\$	\$ 2,513

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

	Parent Issuer	Guarantors	Non- Guarantors	Eliminations	Consolidated
September 30, 2010					
Assets					
Cash and cash equivalents	\$ 350	\$ 1,646	\$ 256	\$	\$ 2,252
Accounts receivable		110	31		141
Accounts receivable, related party		32			32
Notes receivable		1	32		33
Other receivables	3	9	8		20
Inventories		986	36	(2)	1,020
Deferred income taxes, net	7	937	1		945
Prepaid expenses and other	56	177	24	(1)	256
Short-term intercompany notes and interest receivable	80	46		(126)	
Other intercompany receivables	165			(165)	
Total current assets	661	3,944	388	(294)	4,699
Property, plant and equipment, net	6	967	6	1	980
Trademarks and other intangible assets, net		2,652	49		2,701
Goodwill		8,166	19		8,185
Long-term intercompany notes	2,000	1,366		(3,366)	
Investment in subsidiaries	9,513	468		(9,981)	
Other assets and deferred charges	347	215	99	(24)	637
Total assets	\$ 12,527	\$ 17,778	\$ 561	\$ (13,664)	\$ 17,202
Liabilities and shareholders equity					
Accounts payable	\$ 1	\$ 95	\$ 4	\$	\$ 100
Tobacco settlement accruals		2,385			2,385
Due to related party		3			3
Deferred revenue, related party		18			18
Current maturities of long-term debt	400				400
Other current liabilities	366	716	46		1,128
Short-term intercompany notes and interest payable	32	80	14	(126)	
Other intercompany payables		146	20	(166)	
Total current liabilities	799	3,443	84	(292)	4,034
Intercompany notes and interest payable	1,366	2,000		(3,366)	
Long-term debt (less current maturities)	3,589	121			3,710
Deferred income taxes, net		591	6	(24)	573

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

Long-term retirement benefits (less current portion)	49	1,833	9		1,891
Other noncurrent liabilities	96	268	2		366
Shareholders' equity	6,628	9,522	460	(9,982)	6,628
Total liabilities and shareholders equity	\$ 12,527	\$ 17,778	\$ 561	\$ (13,664)	\$ 17,202

Notes to Condensed Consolidated Financial Statements (Unaudited) (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
Accounts receivable		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	315	11		341
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

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

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

63

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

Note 17 RJR Guaranteed, Unsecured Notes Condensed Consolidating Financial Statements

The following condensed consolidating financial statements have been prepared pursuant to Rule 3-10 of Regulation S-X, relating to the guaranties of RJR's \$61 million unsecured 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, American Snuff Co. and Rosswil, LLC that are not Guarantors; and elimination adjustments.

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

	Parent Guarantor	Issuer	Other Guarantors	Non- Guarantors	Eliminations	Consolidated
For the Three Months Ended September 30, 2010						
Net sales	\$	\$	\$ 1,851	\$ 328	\$ (33)	\$ 2,146
Net sales, related party			90	3		93
Cost of products sold			1,098	120	(34)	1,184
Selling, general and administrative expenses	3	1	292	92	(1)	387
Amortization expense			6			6
Asset impairment and exit charges						
Operating income (loss)	(3)	(1)	545	119	2	662
Interest and debt expense	53	1	1			55
Interest income			(1)	(2)		(3)
Intercompany interest (income) expense	(29)	(2)	(11)	42		
Intercompany dividend income		(11)			11	
Other expense (income), net	(7)		1	(2)		(8)
Income (loss) from continuing operations before income taxes	(20)	11	555	81	(9)	618
Provision for (benefit from) income taxes	(7)		214	29	1	237
Equity income from subsidiaries	394	346	3		(743)	
Net income	\$ 381	\$ 357	\$ 344	\$ 52	\$ (753)	\$ 381
For the Three Months Ended September 30, 2009						
Net sales	\$	\$	\$ 1,790	\$ 295	\$ (40)	\$ 2,045
Net sales, related party			106	1		107
Cost of products sold			1,080	99	(41)	1,138
Selling, general and administrative expenses		1	292	78		371
Amortization expense			7			7
Operating income (loss)		(1)	517	119	1	636

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

Interest and debt expense	58	3		(1)		60
Interest income			(2)	(3)		(5)
Intercompany interest (income) expense	(30)	(1)	(12)	43		
Intercompany dividend income		(11)			11	
Other (income) expense, net	(9)	12	(1)			2
Income (loss) before income taxes	(19)	(4)	532	80	(10)	579
Provision for (benefit from) income taxes	(8)	(5)	204	26		217
Equity income from subsidiaries	373	333	6		(712)	
Net income	\$ 362	\$ 334	\$ 334	\$ 54	\$ (722)	\$ 362

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

	Parent Guarantor	Issuer	Other Guarantors	Non- Guarantors	Eliminations	Consolidated
For the Nine Months Ended September 30, 2010						
Net sales	\$	\$	\$ 5,346	\$ 919	\$ (124)	\$ 6,141
Net sales, related party			321	8		329
Cost of products sold			3,235	327	(125)	3,437
Selling, general and administrative expenses	12	2	854	257	(1)	1,124
Amortization expense			18	1		19
Asset impairment and exit charges			24	14		38
Operating income (loss)	(12)	(2)	1,536	328	2	1,852
Interest and debt expense	170	5	1			176
Interest income			(3)	(6)		(9)
Intercompany interest (income) expense	(90)	(4)	(31)	125		
Intercompany dividend income		(32)			32	
Other expense (income), net		1	6	(3)		4
Income (loss) from continuing operations before income taxes	(92)	28	1,563	212	(30)	1,681
Provision for (benefit from) income taxes	(30)		618	72	1	661
Equity income from subsidiaries	866	649	8		(1,523)	
Income from continuing operations	804	677	953	140	(1,554)	1,020
Gains (losses) from discontinued operations, net of tax		88	(230)	(74)		(216)
Net income	\$ 804	\$ 765	\$ 723	\$ 66	\$ (1,554)	\$ 804
For the Nine Months Ended September 30, 2009						
Net sales	\$	\$	\$ 5,319	\$ 854	\$ (156)	\$ 6,017
Net sales, related party			299	7		306

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

Cost of products sold			3,195	298	(156)	3,337
Selling, general and administrative expenses	10	2	896	221		1,129
Amortization expense			21	1		22
Trademark impairment charge			377	76		453
Operating income (loss)	(10)	(2)	1,129	265		1,382
Interest and debt expense	183	7				190
Interest income			(6)	(9)		(15)
Intercompany interest (income) expense	(85)	(5)	(39)	129		
Intercompany dividend income		(32)			32	
Other (income) expense, net	(3)	12				9
Income (loss) before income taxes	(105)	16	1,174	145	(32)	1,198
Provision for (benefit from) income taxes	(38)	(5)	452	42		451
Equity income from subsidiaries	814	740	18		(1,572)	
Net income	\$ 747	\$ 761	\$ 740	\$ 103	\$ (1,604)	\$ 747

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

	Parent Guarantor	Issuer	Other Guarantors	Non- Guarantors	Eliminations	Consolidated
For the Nine Months Ended September 30, 2010						
Cash flows from operating activities	\$ 120	\$ 433	\$ 1,033	\$ 169	\$ (737)	\$ 1,018
Cash flows from (used in) investing activities:						
Proceeds from redemption of long-term investments			12			12
Capital expenditures			(38)	(77)		(115)
Proceeds from termination of joint venture				28		28
Other, net		2	2	1		5
(Contributions to) return of intercompany investments, net	897	720			(1,617)	
Intercompany notes receivable	40	22	22		(84)	
Net cash flows from (used in) investing activities	937	744	(2)	(48)	(1,701)	(70)
Cash flows from (used in) financing activities:						
Dividends paid on common stock	(787)	(300)	(405)		705	(787)
Dividends paid on preferred stock	(32)				32	
Repayment of long-term debt	(300)					(300)
Receipt (distribution) of equity		(897)	(795)	75	1,617	
Intercompany notes payable	(21)	1		(64)	84	
Net cash flows from (used in) financing activities	(1,140)	(1,196)	(1,200)	11	2,438	(1,087)
Effect of exchange rate changes on cash and cash equivalents				(6)		(6)

Net cash flows related to discontinued operations, net of tax benefit	72		(324)	(74)		(326)
Net change in cash and cash equivalents	(11)	(19)	(493)	52		(471)
Cash and cash equivalents at beginning of period	361	24	2,001	337		2,723
Cash and cash equivalents at end of period	\$ 350	\$ 5	\$ 1,508	\$ 389	\$	\$ 2,252

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

	Parent Guarantor	Issuer	Other Guarantors	Non- Guarantors	Eliminations	Consolidated
For the Nine Months Ended September 30, 2009						
Cash flows from operating activities	\$ 274	\$ 1,127	\$ 834	\$ 146	\$ (1,492)	\$ 889
Cash flows from (used in) investing activities:						
Proceeds from redemption of long-term investments			4			4
Capital expenditures			(33)	(42)		(75)
Proceeds from termination of joint venture				24		24
Other, net	1	6	22	1		30
Return of intercompany investments	610				(610)	
Intercompany notes receivable	40	8	14		(62)	
Net cash flows from (used in) investing activities	651	14	7	(17)	(672)	(17)
Cash flows from (used in) financing activities:						
Dividends paid on common stock	(743)	(440)	(1,020)		1,460	(743)
Other, net	(3)					(3)
Dividends paid on preferred stock	(32)				32	
Distribution of equity		(610)			610	
Repayment of long-term debt	(189)	(11)				(200)
Intercompany notes payable	(17)	3		(48)	62	
Net cash flows used in financing activities	(984)	(1,058)	(1,020)	(48)	2,164	(946)
Effect of exchange rate changes on cash and cash equivalents				9		9

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

Net change in cash and cash equivalents	(59)	83	(179)	90	(65)
Cash and cash equivalents at beginning of period	272	6	1,977	323	2,578
Cash and cash equivalents at end of period	\$ 213	\$ 89	\$ 1,798	\$ 413	\$ 2,513

68

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

	Parent Guarantor	Issuer	Other Guarantors	Non- Guarantors	Eliminations	Consolidated
September 30, 2010						
Assets						
Cash and cash equivalents	\$ 350	\$ 5	\$ 1,508	\$ 389	\$	\$ 2,252
Accounts receivable			48	93		141
Accounts receivable, related party			31	1		32
Notes receivable		1		32		33
Other receivables	3		8	9		20
Inventories			599	423	(2)	1,020
Deferred income taxes, net	7	1	903	34		945
Prepaid expenses and other	56	1	163	36		256
Short-term intercompany notes and interest receivable	80	24	175		(279)	
Other intercompany receivables	165				(165)	
Total current assets	661	32	3,435	1,017	(446)	4,699
Property, plant and equipment, net	6		701	272	1	980
Trademarks and other intangible assets, net			1,333	1,368		2,701
Goodwill			5,303	2,882		8,185
Long-term intercompany notes	2,000	174	1,366		(3,540)	
Investment in subsidiaries	9,513	7,497	443		(17,453)	
Other assets and deferred charges	347	55	169	100	(34)	637
Total assets	\$ 12,527	\$ 7,758	\$ 12,750	\$ 5,639	\$ (21,472)	\$ 17,202
Liabilities and shareholders equity						
Accounts payable	\$ 1	\$	\$ 83	\$ 16	\$	\$ 100
Tobacco settlement accruals			2,343	42		2,385
Due to related party			3			3
Deferred revenue, related party			18			18

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

Current maturities on long-term debt	400					400
Other current liabilities	366	10	608	144		1,128
Short-term intercompany notes and interest payable	32	132		115	(279)	
Other intercompany payables		44	121		(165)	
Total current liabilities	799	186	3,176	317	(444)	4,034
Intercompany notes and interest payable	1,366			2,174	(3,540)	
Long-term debt (less current maturities)	3,589	121				3,710
Deferred income taxes, net			122	485	(34)	573
Long-term retirement benefits (less current portion)	49	22	1,704	116		1,891
Other noncurrent liabilities	96	13	252	5		366
Shareholders equity	6,628	7,416	7,496	2,542	(17,454)	6,628
Total liabilities and shareholders equity	\$ 12,527	\$ 7,758	\$ 12,750	\$ 5,639	\$ (21,472)	\$ 17,202

Notes to Condensed Consolidated Financial Statements (Unaudited) (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
Accounts receivable			47	62		109
Accounts receivable, related party			96			96
Notes 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	1	297	28		341
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
						131

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

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

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

Note 18 Subsequent event

On October 12, 2010, RAI's Board of Directors approved a two-for-one stock split of RAI's common stock, to be issued on November 15, 2010, to shareholders of record on November 1, 2010. Shareholders on the record date will receive one additional share of RAI common stock for each share owned. After the split, there will be approximately 583 million shares outstanding of RAI common stock.

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

The following is a discussion and analysis of RAI's business, initiatives, critical accounting 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 compares the third quarter of 2010 with the third quarter of 2009 and the first nine months of 2010 with the first nine months of 2009. Disclosures related to liquidity and financial position complete management's discussion and analysis. You should read this discussion and analysis of RAI's consolidated financial position and results of operations in conjunction with the financial information included in the condensed consolidated financial statements (unaudited).

Overview and Business Initiatives

RAI's reportable operating segments are RJR Tobacco and American Snuff. The RJR Tobacco segment consists of the primary operations of R. J. Reynolds Tobacco Company. The American Snuff segment consists of the primary operations of American Snuff Co. and Lane. RAI's wholly owned subsidiaries, Santa Fe and Nicovum AB, among other RAI subsidiaries, are included in All Other. Certain of 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.

During the second quarter of 2010, RAI announced that its operating companies are taking steps to optimize cigarette-manufacturing efficiencies, while complying with new regulatory requirements. One of RJR Tobacco's cigarette factories in Winston-Salem, North Carolina will close by mid-2011 and a factory in Yabucoa, Puerto Rico closed in August 2010. Production from those facilities will transfer to RJR Tobacco's facility in Tobaccoville, North Carolina. As a result of these actions, approximately 60 manufacturing positions in Puerto Rico were eliminated, and affected employees received severance benefits. In connection with these actions, during the second quarter of 2010, RJR Tobacco recorded an asset impairment of \$24 million, and \$14 million was recorded in the All Other segment, primarily for asset impairment, and to a lesser extent, severance that will be paid during 2010.

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, DORAL and KOOL were five of the ten best-selling brands of cigarettes in the United States as of September 30, 2010. 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 and manages the export of tobacco products to certain U.S. territories, U.S. duty-free shops and U.S. overseas military bases.

RAI's other reportable operating segment, American Snuff, is the second largest smokeless tobacco products manufacturer in the United States. American Snuff's primary brands include its largest selling moist snuff brands, GRIZZLY and KODIAK. American Snuff's other products include WINCHESTER and CAPTAIN BLACK little cigars, and BUGLER roll-your-own tobacco.

American Snuff Co. is expanding its manufacturing operations in Memphis, Tennessee, expecting the new facility to be fully operational by early 2012, and increasing its tobacco-processing capacity in Clarksville, Tennessee, expecting the new facility to be fully operational by the end of 2011.

In order to improve efficiencies, increase speed to market and provide stronger retail support, the field trade-marketing group at RJR Tobacco expanded during 2010 to provide services to American Snuff through a services agreement.

Santa Fe manufactures and markets cigarettes and other tobacco products under the NATURAL AMERICAN SPIRIT brand and manages RJR Tobacco's super premium cigarette brands, DUNHILL and STATE EXPRESS 555, which are licensed from BAT.

RJR Tobacco

RJR Tobacco primarily conducts 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 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. Trade inventory adjustments may result in short-term changes in demand for RJR Tobacco's products when wholesale and retail tobacco distributors adjust the timing of their purchases of product to manage their inventory levels. RJR Tobacco believes it is not appropriate for it to speculate on other external factors that may impact the purchasing decisions of the wholesale and retail tobacco distributors.

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. As such, RJR Tobacco continues to de-emphasize private-label brands. 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. As part of its total tobacco strategy, RJR Tobacco also offers two types of smoke-free tobacco products, CAMEL Snus and CAMEL Dissolvables. CAMEL Snus is pasteurized tobacco in a small pouch that provides convenient tobacco consumption. CAMEL Dissolvables, currently available in certain lead markets, include CAMEL Orbs, Sticks and Strips, all of which are made of finely milled tobacco and dissolve completely in the mouth.

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 increasing focus on product innovation and expansion into smoke-free tobacco categories, such as moist snuff and snus.

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

American Snuff

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

In contrast to the declining U.S. cigarette market, U.S. moist snuff volumes grew nearly 9% in the first nine months of 2010 and have grown at an average rate of approximately 6% per year over the last five years, driven by the accelerated growth of price-value brands. The growth in moist snuff volumes is higher in 2010 than the prior year due to competitive promotional strategies during 2010 and a change in competitive shipments reporting, which excludes product returns. Profit margins on moist snuff products are generally higher than on cigarettes. Moist snuff's growth is partially attributable to cigarette smokers switching from cigarettes to smokeless tobacco products or using both.

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

Critical Accounting Policies and Estimates

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

Litigation

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

As discussed in note 11 to condensed consolidated financial statements (unaudited), RJR Tobacco, American Snuff Co. and their affiliates, including RAI, and indemnitees, have been named in a number of tobacco-related legal actions, proceedings or claims seeking damages in amounts ranging into the hundreds of millions or even billions of dollars. Unfavorable judgments have been returned in a number of tobacco-related cases and state enforcement actions.

RAI and its subsidiaries believe that they have valid bases for appeal of adverse verdicts against them and believe they have valid defenses to all actions and intend to defend all actions vigorously. RAI's management continues to conclude that the loss of any particular smoking and health tobacco litigation claim against RJR Tobacco or its affiliates or indemnitees, including B&W, or the loss of any particular claim concerning the use of smokeless tobacco against American Snuff Co., when viewed on an individual basis, is not probable or estimable.

Litigation is subject to many uncertainties, and it is possible that some of the tobacco-related legal actions, proceedings or claims could ultimately be decided against RJR Tobacco, American Snuff Co. or their affiliates, including RAI, and indemnitees. Any unfavorable outcome of such actions could have a material adverse effect on the consolidated results of operations, cash flows or financial position of RAI or its subsidiaries. For further discussion of the litigation and legal proceedings pending against RAI or its affiliates or indemnitees, see note 11 to condensed consolidated financial statements (unaudited).

State Settlement Agreements

RJR Tobacco, Santa Fe and Lane are participants in the MSA, and RJR Tobacco is a participant in the 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. American Snuff Co. is not a participant 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 note 11 to condensed consolidated financial statements (unaudited).

Intangible Assets

Intangible assets include goodwill, trademarks and other intangible assets. 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 tested for impairment annually, in the fourth quarter. All trademarks and other intangible assets are tested more frequently if events and circumstances indicate that the asset might be impaired.

Fair Value Measurement

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

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

RAI reviews investments for impairment on a quarterly basis. For those investments in an inactive market, RAI uses assumptions about future cash flows and risk-adjusted discount rates to determine fair value.

As of September 30, 2010, RAI held investments primarily in auction rate securities, a mortgage-backed security and a marketable equity security. Adverse changes in financial markets caused certain auction rate securities and the mortgage-backed security to revalue lower than carrying value and become less liquid. Auction rate securities and the mortgage-backed security will not become liquid until a successful auction occurs or a buyer is found.

These investments will be evaluated on a quarterly basis to determine if it is probable that RAI will realize some portion of the unrealized loss. For those securities that RAI does not intend to sell and it is more likely than not that RAI will not be required to sell such securities prior to recovery, RAI recognizes the credit loss component of an other-than-temporary impairment in earnings and recognizes the noncredit component in other comprehensive loss. For additional information relating to these investments, see note 2 to condensed consolidated financial statements (unaudited).

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, based on projections of future income, it is more likely than not that the deferred tax assets recorded in RAI's condensed consolidated balance sheets (unaudited) 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 Guidance

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

Results of Operations

	For the Three Months Ended September 30,			For the Nine Months Ended September 30,		
	2010	2009	% Change	2010	2009	% Change
Net sales ⁽¹⁾ :						
RJR Tobacco	\$ 1,917	\$ 1,867	2.7%	\$ 5,579	\$ 5,513	1.2%
American Snuff	185	177	4.6%	528	512	3.1%
All other	137	108	26.9%	363	298	21.8%
Net sales	2,239	2,152	4.0%	6,470	6,323	2.3%
Cost of products sold ⁽¹⁾⁽²⁾	1,184	1,138	4.0%	3,437	3,337	3.0%
Selling, general and administrative expenses	387	371	4.3%	1,124	1,129	(0.4)%
Amortization expense	6	7	(14.3)%	19	22	(13.6)%
Asset impairment and exit charges				38		NM ⁽³⁾
Trademark impairment charge					453	NM ⁽³⁾
Operating income:						
RJR Tobacco	561	532	5.5%	1,572	1,170	34.4%
American Snuff	95	93	1.7%	253	193	31.2%
All other	33	36	(8.3)%	91	85	7.1%
Corporate expense	(27)	(25)	8.0%	(64)	(66)	(3.0)%
Operating income	\$ 662	\$ 636	4.1%	\$ 1,852	\$ 1,382	34.0%

(1) Excludes excise taxes of:

	2010	2009	2010	2009
RJR Tobacco	\$ 1,009	\$ 1,035	\$ 2,945	\$ 2,528
American Snuff	27	39	81	89
All other	94	81	253	195
	\$ 1,130	\$ 1,155	\$ 3,279	\$ 2,812

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

(3) Percentage change not meaningful.

RJR Tobacco
Net Sales

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

	For the Three Months Ended September 30,			For the Nine Months Ended September 30,		
	2010	2009	% Change	2010	2009	% Change
Growth brands:						
CAMEL excluding non-filter	5.6	5.5	1.5%	16.1	16.2	(0.2)%
PALL MALL	5.5	3.8	45.1%	14.9	10.2	45.7%
	11.0	9.3	19.2%	31.0	26.4	17.6%
Support brands	8.0	9.3	(14.2)%	23.9	29.1	(17.8)%
Non-support brands	1.0	2.0	(48.8)%	3.6	6.2	(41.5)%
Total domestic	20.1	20.6	(2.6)%	58.5	61.7	(5.1)%
Total premium	11.5	12.2	(6.1)%	33.7	36.8	(8.6)%
Total value	8.6	8.4	2.5%	24.9	24.9	0.1%
Premium/total mix	57.2%	59.3%		57.5%	59.7%	
Industry⁽²⁾:						
Premium	55.5	56.5	(1.7)%	161.7	168.7	(4.1)%
Value	24.0	23.6	1.4%	68.2	69.7	(2.1)%

Total domestic	79.5	80.1	(0.8)%	229.9	238.3	(3.5)%
Premium/total mix	69.8%	70.5%		70.3%	70.8%	

(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 Management Science Associates, Inc., referred to as MSAi. Prior year amounts have been restated to reflect 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's net sales for the quarter ended September 30, 2010, increased from the prior-year quarter, driven by higher pricing of \$136 million, partially offset by \$72 million attributable to lower cigarette volume and an unfavorable premium-to-value mix. RJR Tobacco's net sales for the nine months ended September 30, 2010, increased from the prior-year period, driven by higher pricing of \$425 million, partially offset by \$342 million attributable to lower cigarette volume and an unfavorable premium-to-value mix.

The shares of RJR Tobacco's brands as a percentage of total share of U.S. retail cigarette sales according to Information Resources Inc., referred to as IRI/Capstone⁽¹⁾, were as follows⁽²⁾:

	For the Three Months Ended				
	September 30, 2010	June 30, 2010	Share Point Change	September 30, 2009	Share Point Change
Growth brands:					
CAMEL excluding non-filter	8.0%	7.8%	0.2	7.7%	0.4
PALL MALL	7.8%	7.0%	0.8	5.0%	2.8
Total growth brands	15.8%	14.8%	1.0	12.7%	3.2
Support brands	11.0%	11.3%	(0.3)	12.7%	(1.7)
Non-support brands	1.4%	1.8%	(0.4)	2.8%	(1.4)
Total domestic	28.2%	27.9%	0.3	28.2%	

(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 data 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.

The retail share of market of CAMEL's filtered styles at 8.0 share points in the third quarter of 2010 was higher compared with the third quarter of 2009. CAMEL's cigarette market share was favorably impacted by product upgrades in two core menthol styles, which now feature the same innovative capsule technology used in CAMEL Crush, allowing adult smokers to choose the level of menthol flavor on demand. CAMEL Crush, featuring the menthol capsule, allows adult smokers the choice between regular or menthol.

CAMEL Snus, a smoke-free tobacco product, was launched in select outlets, nationally, in 2009 and continues to bring awareness to this new smoke-free category. Two new styles of CAMEL Snus, Robust and Winterchill, were launched nationwide during the third quarter of 2010. These two new styles are packaged in larger pouches and offer a richer and more full-bodied tobacco taste.

PALL MALL's market share increased 2.8 share points in the third quarter of 2010 compared with the third quarter of 2009. 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.

The combined share of market of RJR Tobacco's growth brands during the third quarter of 2010 showed a strong improvement of 3.2 share points over the same period in 2009. RJR Tobacco's total cigarette market share has remained stable from the prior year despite the fact that RJR Tobacco has discontinued many of its non-core cigarette styles and de-emphasized low-margin private-label brands. These actions are consistent with RJR Tobacco's strategy of focusing on growth brands.

Operating Income

RJR Tobacco's operating income for the three- and nine-month periods ended September 30, 2010, was favorably impacted by higher cigarette pricing and continued productivity gains. These gains were partially offset by lower cigarette volume, the payment of a legal judgment and higher FDA user fees. Additionally, unfavorable premium-to-value mix and asset impairment charges of \$24 million related to a plant closing impacted the operating

income in the first nine months of 2010. During the first quarter of 2009, RJR Tobacco recorded a trademark impairment charge of \$377 million related to the forecasted sales impact due to the increase in the federal excise tax.

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2010	2009	2010	2009
Settlements	\$ 630	\$ 630	\$ 1,841	\$ 1,880
Federal tobacco quota buyout	\$ 58	\$ 58	\$ 176	\$ 173
FDA user fees	\$ 14	\$ 4	\$ 43	\$ 6

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 \$240 million in 2010. For additional information, see *Litigation Affecting the Cigarette Industry*, *Health Care Cost Recovery Cases*, *State Settlement Agreements* and *Tobacco Buyout Legislation and Related Litigation* in note 11 to condensed consolidated financial statements (unaudited). Expenses for FDA user fees are expected to be approximately \$70 million to \$80 million in 2010. For additional information, see *Governmental Activity* below.

Selling, general and administrative expenses include the costs of litigating and administering product liability claims, as well as other legal expenses. RJR Tobacco's product liability defense costs were \$40 million and \$31 million for the three months ended September 30, 2010 and 2009, respectively; and \$116 million and \$92 million for the nine months ended September 30, 2010 and 2009, respectively. The increase in product liability defense costs in 2010 compared with 2009 is due primarily to the increase in the number of *Engle* Progeny cases in or scheduled for trial. For additional information, see *Individual Smoking and Health Cases*, *Engle Progeny Cases* in note 11 to condensed consolidated financial statements (unaudited).

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 note 11 to condensed consolidated financial statements (unaudited) for detailed information regarding the number and type of cases pending, and

Litigation Affecting the Cigarette Industry Scheduled Trials in note 11 to condensed consolidated financial statements (unaudited) for detailed information regarding the number and nature of cases in trial and scheduled for trial through September 30, 2011.

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

American Snuff

Net Sales

The moist snuff shipment volume, in millions of cans, for American Snuff was as follows⁽¹⁾:

	For the Three Months Ended September 30,			For the Nine Months Ended September 30,		
	2010	2009	% Change	2010	2009	% Change
KODIAK	12.0	12.6	(5.2)%	35.5	35.5	
GRIZZLY	82.5	80.7	2.3%	239.3	226.5	5.7%
Other	1.1	1.1	(0.9)%	3.6	3.1	14.4%
Total moist snuff	95.5	94.4	1.2%	278.4	265.1	5.0%

(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.

American Snuff's net sales for the three- and nine-month periods ended September 30, 2010, were favorably impacted by higher moist snuff volume and pricing. Shipments of GRIZZLY, American Snuff's leading price-value brand, increased in the third quarter of 2010 with gains on core styles and new product introductions such as GRIZZLY 1900 Long Cut. Shipments of KODIAK, American Snuff's leading premium brand, declined in the third quarter of 2010 due to competitive promotional activity.

American Snuff's share 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 Three Months Ended

	September 30, 2010	June 30, 2010	Share Point Change	September 30, 2009	Share Point Change
KODIAK	3.6%	3.5%	0.1	3.9%	(0.3)
GRIZZLY	25.3%	25.5%	(0.2)	25.6%	(0.3)
Other	0.3%	0.4%	(0.1)	0.4%	(0.1)
Total moist snuff	29.2%	29.4%	(0.2)	29.9%	(0.7)

- (1) Distributor shipments-to-retail share of U.S. moist snuff is included in this document because it is used by American Snuff primarily as an indicator of the relative performance of industry participants, and brands and market trends. You should not rely on the market share data reported by 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 American Snuff's overall growth and profitability within the U.S. smokeless tobacco market. Moist snuff accounted for approximately 75% of American Snuff's revenue in the third quarter of 2010 and approximately 73% in the first nine months of 2010 compared with approximately 73% of American Snuff's revenue in the third quarter of 2009 and approximately 70% for the first nine months of 2009. Moist snuff industry shipment volume grew 8.6% in the third quarter of 2010 compared with the same period in 2009, due to competitive promotional strategies in 2010.

The decrease in GRIZZLY's market share of moist snuff shipments in the third quarter of 2010, from the third quarter of 2009, was due to competitive promotional activity and line extensions. In the first quarter of 2010, embossed metal lids were launched across the entire brand. In the industry, pouch styles have grown nearly 17% through September 30, 2010, and now account for nearly 9% of moist snuff sales. GRIZZLY's pouch styles accounted for over 21% of the pouch segment at September 30, 2010.

The shipment share of KODIAK in the third quarter and first nine months of 2010 was down slightly compared with the third quarter and first nine months of 2009, due to competitive promotional activity. KODIAK upgraded to embossed metal lids late in the first quarter to further enhance the brand's premium image.

American Snuff continues to evaluate opportunities for CAMEL Dip, a premium moist snuff product.

Operating Income

American Snuff's operating income for the three months ended September 30, 2010, increased compared with the three months ended September 30, 2009, due to higher pricing and sales volume. Operating income for the nine months ended September 30, 2010, increased as the 2009 operating income was unfavorably impacted by a trademark impairment charge of \$76 million related to the forecasted sales impact due to the increase in federal excise tax.

RAI Consolidated

Interest and debt expense was \$55 million for the quarter and \$176 million for the nine months ended September 30, 2010, a decrease of \$5 million and \$14 million from the respective comparable prior-year periods. These decreases were primarily due to lower debt balances in 2010 as compared with 2009.

Other expense (income), net was \$8 million income for the quarter and \$4 million expense for the nine months ended September 30, 2010, and \$2 million expense for the quarter and \$9 million expense for the nine months ended September 30, 2009.

Provision for income taxes was \$237 million, for an effective rate of 38.3%, for the three months ended September 30, 2010, compared with \$217 million, for an effective rate of 37.5%, for the three months ended September 30, 2009. The provision for income taxes was \$661 million, for an effective rate of 39.3%, for the nine months ended September 30, 2010, compared with \$451 million, for an effective rate of 37.6%, for the nine months ended September 30, 2009. The effective tax rate for the first nine months of 2010 was unfavorably impacted by a \$27 million increase in tax attributable to the Patient Protection and Affordable Care Act of 2010 and the Health Care and Education Reconciliation Act of 2010. The effective tax rate for the first nine months of 2009 was unfavorably impacted by increases in unrecognized income tax benefits and increases in tax attributable to accumulated and undistributed foreign earnings. RAI expects its effective tax rate for the full-year of 2010 to be approximately 39%. 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 of 2004.

Losses from discontinued operations relates to \$307 million accrued during the first quarter of 2010, to adjust previous contingency accruals, resulting from settlements in April 2010 associated with the former international businesses of RJR Tobacco and Northern Brands that were sold to JTI in 1999. RJR Tobacco entered into a Comprehensive Agreement requiring it to pay the Canadian federal, provincial and territorial governments CAD \$325 million. In a separate matter, Northern Brands entered into a plea agreement with the Ministry of the Attorney General of Ontario, requiring it to pay a fine of CAD \$75 million. The payments by RJR Tobacco of \$320 million, offset by a realized tax benefit to date of \$68 million, and by Northern Brands of \$74 million have been included as net cash flows related to discontinued operations, net of tax benefit, in the condensed consolidated statement of cash flows (unaudited) for the nine months ended September 30, 2010. A comprehensive discussion of the Canadian matters is set forth in note 11 to condensed consolidated financial statements (unaudited) under *Litigation Affecting the Cigarette Industry Other Litigation and Developments Canadian Matters*, and additional details regarding the settlement are set forth in note 6 to condensed consolidated financial statements (unaudited).

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.

Generally, the negative impact, if any, on the sources of liquidity that could result from a decrease in demand for products due to short-term inventory adjustments by wholesale and retail distributors, changes in competitive pricing, accelerated declines in consumption, particularly from increases in regulation or excise taxes, or adverse impacts from financial markets, cannot be predicted.

RAI cannot predict its cash requirements or those of its subsidiaries related to any future settlements or judgments, including cash required to be held in escrow or to bond any appeals, if necessary, and RAI makes no assurance that it or its subsidiaries will be able to meet all of those requirements.

RAI's operating companies monitor the liquidity of key suppliers and customers, and where liquidity concerns are identified, appropriate contingency or response plans are developed. During the quarter ended September 30, 2010, no business interruptions occurred due to key supplier liquidity, and no liquidity issues were identified involving significant customers.

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

As of September 30, 2010, RAI held investments primarily in auction rate securities, a mortgage-backed security and a marketable equity security. 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 mortgage-backed security will not become liquid until a successful auction occurs or a buyer is found. RAI intends, and has the ability, to hold these auction rate securities and mortgage-backed security for a period of time sufficient to allow for sale, redemption or anticipated recovery in fair value. For additional information on these investments, see note 2 to condensed consolidated financial statements (unaudited).

Cash Flows

Net cash flows from operating activities were \$1,018 million in the first nine months of 2010, compared with \$889 million in the first nine months of 2009. This change was driven primarily by higher pricing, reduced inventories in 2010, lower excise tax payments on deployed inventory and lower income tax payments partially offset by higher pension contributions and the payment of the full MSA obligation.

Net cash flows used in investing activities were \$70 million in the first nine months of 2010, compared with \$17 million for the first nine months of 2009 due to higher capital expenditures in 2010 for American Snuff facility expansion projects.

Net cash flows used in financing activities were \$1,087 million in the first nine months of 2010, compared with \$946 million in the prior-year period. This increase was the result of a higher debt payment in 2010 as well as higher dividends paid on common stock in 2010 as a result of the increase in the dividend per share amount.

Net cash flows related to discontinued operations, net of tax benefit, include payments made in 2010, by RJR Tobacco of \$320 million and by Northern Brands of \$74 million to certain Canadian governments, resulting from the terms of a Comprehensive Agreement and plea agreement, respectively, associated with the former international businesses that were sold to JTI in 1999. RJR Tobacco's payment is offset by tax benefits of \$68 million, realized in the first nine months of 2010. See notes 6 and 11 to condensed consolidated financial statements (unaudited) for additional details of these payments.

Borrowing Arrangements

The principal amount of RAI's and RJR's outstanding long-term notes was \$3.9 billion as of September 30, 2010. RAI and RJR use interest rate swaps to manage interest rate risk on a portion of their debt obligations. In 2009, RAI and RJR entered 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, 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, and effectively reduced net interest costs over the remaining life of the notes. At the same time, RAI and RJR terminated an interest rate swap agreement in the notional amount of \$100 million with a maturity date of June 1, 2012. 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%. For additional information regarding RAI's interest rate swap transactions, see note 2 to condensed consolidated financial statements (unaudited).

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.

On July 15, 2010, RAI repaid \$300 million of matured long-term notes from existing cash.

In 2007, RAI entered into a Fifth Amended and Restated Credit Agreement, which, as subsequently amended, 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 15, 2010, RAI entered into a third amendment to the credit facility, which, among other things, permits the refinancing of certain existing RAI and RJR notes within ten months after maturity.

At September 30, 2010, RAI had \$9 million in letters of credit outstanding under the credit facility. At such date, no borrowings were outstanding, and the remaining \$489 million of the credit facility was available for borrowing.

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 September 30, 2010.

Stock Split

On October 12, 2010, RAI's Board of Directors approved a two-for-one stock split of RAI's common stock, to be issued on November 15, 2010, to shareholders of record on November 1, 2010. Shareholders on the record date will receive one additional share of RAI common stock for each share owned. After the split, there will be approximately 583 million shares outstanding of RAI common stock.

Dividends

On February 2, 2010, RAI's board of directors declared a quarterly cash dividend of \$0.90 per common share. The dividends were paid on April 1, 2010, to shareholders of record as of March 10, 2010.

On May 7, 2010, RAI's board of directors declared a quarterly cash dividend of \$0.90 per common share. The dividends were paid on July 1, 2010, to shareholders of record as of June 10, 2010.

On July 15, 2010, RAI's board of directors declared a quarterly cash dividend of \$0.90 per common share. The dividends were paid on October 1, 2010, to shareholders of record as of September 10, 2010.

On October 12, 2010, RAI's board of directors declared a quarterly cash dividend of \$0.98 per common share, on a pre-split basis. The dividend will be paid on January 3, 2011, to shareholders of record as of December 10, 2010. On an annualized basis, the dividend rate is \$3.92 per common share. The current dividend reflects RAI's policy of paying dividends to the holders of RAI's common stock in an aggregate amount that is approximately 75% of RAI's annual consolidated net income.

Stock Repurchases

Due to RAI's incorporation in North Carolina, which does not recognize treasury shares, any shares of RAI common stock repurchased by RAI are cancelled at the time of repurchase. During the first nine months of 2010, at a cost of \$5 million, RAI purchased 89,048 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 \$115 million and \$75 million for the first nine months of 2010 and 2009, respectively. The increase was primarily the result of American Snuff facility expansion projects. RAI's operating subsidiaries plan to spend an additional \$70 million to \$80 million for capital expenditures during the remainder of 2010. Approximately \$50 million of the remaining capital expenditures for 2010 is associated with capacity expansion and FDA compliance at American Snuff. 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 September 30, 2010.

Retirement Benefits

RAI expects to contribute up to \$812 million to its pension plans in 2010, of which \$309 million was contributed as of September 30, 2010. The remaining \$503 million is expected to be contributed in the fourth quarter of 2010. RAI increased the expected 2010 contribution amount from what it had anticipated in the first quarter of 2010 in order to possibly reduce RAI's future contributions.

Litigation and Settlements

RJR Tobacco, American Snuff Co., and their affiliates, including RAI, and indemnitees, including B&W, have been named in a number of tobacco-related legal actions, proceedings or claims seeking damages in amounts

ranging into the hundreds of millions or even billions of dollars. For further discussion of specific cases, see note 11 to condensed consolidated financial statements (unaudited). Unfavorable judgments have been returned in a number of tobacco-related cases and state enforcement actions. As of September 30, 2010, RJR Tobacco has paid approximately \$24 million since January 1, 2008, related to unfavorable smoking and health litigation judgments.

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

As a result from settlements in April 2010 associated with the former international businesses of RJR Tobacco and Northern Brands that were sold to JTI in 1999, RJR Tobacco entered into a Comprehensive Agreement requiring it to pay the Canadian federal, provincial and territorial governments CAD \$325 million. In a separate matter, Northern Brands entered into a plea agreement with the Ministry of the Attorney General of Ontario, requiring it to pay a fine of CAD \$75 million. A comprehensive discussion of the Canadian matters is set forth in note 11 to condensed consolidated financial statements (unaudited) under *Litigation Affecting the Cigarette Industry* *Other Litigation and Developments* *Canadian Matters*, and additional details regarding the settlement are set forth in note 6 to condensed consolidated financial statements (unaudited).

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 note 11 to condensed consolidated financial statements (unaudited), the State Settlement Agreements impose a perpetual stream of future payment obligations on RJR Tobacco and the other major U.S. cigarette manufacturers, and place significant restrictions on their ability to market and sell cigarettes in the future. For more information related to historical and expected settlement expenses and payments under the State Settlement Agreements, see *Litigation Affecting the Cigarette Industry* *Health Care Cost Recovery Cases* *State Settlement Agreements* in note 11 to condensed consolidated financial statements (unaudited). The State Settlement Agreements have materially adversely affected RJR Tobacco's shipment volumes. RAI believes that these settlement obligations may materially adversely affect the results of operations, cash flows or financial position of RAI and RJR Tobacco in future periods.

RJR Tobacco and certain of the other 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 \$3.4 billion for the years 2003 through 2009. For more information related to this dispute, see *Litigation Affecting the Cigarette Industry* *Health Care Cost Recovery Cases* *State Settlement Agreements* *Enforcement and Validity* in note 11 to condensed consolidated financial statements (unaudited).

Governmental Activity

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

significantly increase their taxes on tobacco products;

regulate the manufacture, sale, marketing and packaging of 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.

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

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

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

the federal excise tax rate for chewing tobacco is \$0.5033 per pound, and for snuff is \$1.51 per pound.

All states and the District of Columbia currently impose cigarette excise taxes at levels ranging from \$0.17 per pack in Missouri to \$4.35 per pack in New York. As of September 30, 2010, the weighted average state cigarette excise tax per pack, calculated on a 12-month rolling average basis, was approximately \$1.24, compared with the 12-month rolling average of \$1.16 as of December 31, 2009. As of September 30, 2010, six states had passed cigarette excise tax increases since January 1, 2010, 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.

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 September 30, 2010, 31 states taxed moist snuff, and 44 states taxed chewing tobacco, on an ad valorem basis. Ad valorem rates on moist snuff range from 5% in South Carolina to 100% in Wisconsin, and chewing tobacco rates range from 5% in South Carolina to 95% in Washington. Other states have a unit tax or a weight-based tax. As of June 30, 2010, weight-based taxes on moist snuff range from \$0.02 for cans weighing between 5/8 of an ounce and 1-5/8 ounces in Alabama to \$2.02 per ounce in Maine, and Kentucky has a unit tax of \$0.19 per unit. Weight-based taxes on chewing tobacco range from \$0.015 per ounce in Alabama to \$2.02 per ounce in Maine. Legislation to convert from an ad valorem to a weight-based tax has been introduced in several states in 2010. As of September 30, 2010, six states had passed tax increases on smokeless tobacco products since January 1, 2010, and a number of other states are considering an increase in their taxes on smokeless tobacco products for 2010.

On March 31, 2010, President Obama signed into law the Prevent All Cigarette Trafficking Act. This legislation, among other things, restricts the sale of tobacco products directly to consumers or unlicensed recipients, including over the Internet, through expanded reporting requirements, requirements for delivery, sales and penalties. It is not anticipated that this legislation will have a material adverse effect on the sale of tobacco products by RAI's operating companies.

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, pursuant to the FDA Tobacco Act:

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

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

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

as of April 30, 2010, manufacturers were required to produce health-related documents generated from and after June 22, 2009 through December 31, 2009;

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

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

require manufacturers to report harmful constituents;

require different and larger warnings on packaging and advertising for cigarettes;

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 for 2010 will be approximately \$75 million to \$85 million.

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

a recommendation on modified risk applications;

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

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.

The TPSAC held meetings on March 30-31 and July 15-16 and October 7-8, 2010, to discuss the impact on the use of menthol in cigarettes on the public health. A subcommittee of the TPSAC met on September 27, 2010, to discuss the drafting of a report on this topic that is expected to be issued by March 22, 2011. A subcommittee of the TPSAC also met on June 8-9 and July 7, 2010, to discuss recommendations for the development of a list of harmful and potentially harmful tobacco constituents. At a meeting held on August 30, 2010, the subcommittee provided to the full TPSAC its recommendations and a draft initial list of harmful and potentially harmful tobacco constituents, which the TPSAC adopted.

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 TPSAC'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, responded to FDA's information request on April 1, 2010. In May 2010, the Center for Tobacco Products sent letters to various tobacco manufacturers, including RJR Tobacco, Santa Fe, American Snuff Co. and Lane, containing a document request for certain information concerning the use of menthol in cigarettes. Each of these companies responded to the FDA's information request on August 26, 2010. Due to the breadth of the request and the volume of potentially relevant documents, RJR Tobacco intends to supplement its response with a second submission, which it intends to complete by the end of October 2010.

On August 31, 2009, RJR Tobacco and American Snuff Co. 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 note 11 to condensed consolidated financial statements (unaudited).

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

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

Tobacco Buyout Legislation

For information relating to tobacco buyout legislation, see Tobacco Buyout Legislation and Related Litigation in note 11 to condensed consolidated financial statements (unaudited).

Other Contingencies

For information relating to other contingencies of RAI, RJR, RJR Tobacco and American Snuff Co., see Other Contingencies in note 11 to condensed consolidated financial statements (unaudited).

Off-Balance Sheet Arrangements

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

Cautionary Information Regarding Forward-Looking Statements

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

the substantial and increasing taxation and regulation of tobacco products, including the 2009 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 prohibit mint or wintergreen as a flavor in smokeless tobacco products;

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

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

the potential difficulty of obtaining bonds as a result of litigation outcomes and the challenges to the Florida bond statute applicable to the *Engle* Progeny cases;

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;

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 and expansion of RJR Tobacco's field trade-marketing organization, without negatively affecting financial or operating results;

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

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

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

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

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

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

the substantial amount of RAI debt;

the credit 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; and

the expiration of the standstill provisions of the governance agreement.

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

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Market risk represents the risk of loss that may impact the consolidated results of operations, cash flows and financial position due to adverse changes in financial market prices and rates. RAI and its subsidiaries are exposed to interest rate risk directly related to their normal investing and funding activities. In addition, RAI and its subsidiaries have immaterial exposure to foreign currency exchange rate risk related primarily to purchases and 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.

The table below provides information, as of September 30, 2010, about RAI's financial instruments that are sensitive to changes in interest rates. The table presents notional amounts and weighted average interest rates by contractual maturity dates.

	2010	2011	2012	2013	2014	Thereafter	Total	Fair Value ⁽¹⁾
Investments:								
Variable rate	\$2,192	\$	\$	\$	\$	\$ 33	\$2,225	\$2,225
Average interest rate	0.1%					2.4%	0.2%	
Fixed-rate	\$	\$	\$	\$	\$	\$ 6	\$ 6	\$ 6
Average interest rate ⁽²⁾						4.7%	4.7%	
Debt:								
Fixed-rate	\$	\$	\$450	\$685	\$	\$2,375	\$3,510	\$3,962
Average interest rate ⁽²⁾			7.3%	7.4%		7.3%	7.3%	
Variable rate	\$	\$400	\$	\$	\$	\$	\$ 400	\$ 400
Average interest rate ⁽²⁾		1.0%					1.0%	
Swaps fixed to floating:								
Notional amount ⁽³⁾	\$	\$	\$350	\$	\$	\$1,150	\$1,500	\$ 302
Average variable interest pay rate ⁽²⁾			2.1%			1.7%	1.8%	
Average fixed interest receive rate ⁽²⁾			7.3%			7.1%	7.1%	
Swaps floating to fixed:								
Notional amount ⁽³⁾	\$	\$	\$350	\$	\$	\$1,150	\$1,500	\$ (78)
Average variable interest receive rate ⁽²⁾			2.1%			1.7%	1.8%	
Average fixed interest pay 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 September 30, 2010, RAI and RJR 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.

RAI's exposure to foreign currency transactions was not material to results of operations for the nine months ended September 30, 2010, but may become material in future periods in relation to activity associated with RAI's international operations. RAI currently has no hedges for its exposure to foreign currency.

Item 4. Controls and Procedures

- (a) RAI's chief executive officer and chief financial officer have concluded that RAI's disclosure controls and procedures were effective as of the end of the period covered by this report, based on their evaluation of these controls and procedures.
- (b) There have been no changes in RAI's internal controls over financial reporting that occurred during the third quarter of 2010 that have materially affected, or are reasonably likely to materially affect, RAI's internal controls over financial reporting.

PART II-Other Information

Item 1. Legal Proceedings

For a discussion of the litigation and legal proceedings pending against RJR Tobacco, American Snuff Co. or their affiliates, including RAI and RJR, or indemnitees, including B&W, see note 11 to condensed consolidated financial statements (unaudited) and Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies Litigation included in Part I, Item 2.

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

RAI conducts its business through its subsidiaries and is dependent on the earnings and cash flows of its subsidiaries to satisfy its obligations and other cash needs. For more information, see Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Financial Condition in Part I, Item 2. RAI believes that the provisions of its credit facility and the guarantees of the credit facility, interest rate swaps and notes will not impair its payment of quarterly dividends.

Item 6. Exhibits

- (a) Exhibits

Exhibit Number	Description
10.1	Third Amendment to Credit Agreement, dated July 15, 2010, among Reynolds American Inc. and the agents and lending institutions named therein (incorporated by reference to Exhibit 10.1 to RAI's Form 8-K dated July 19, 2010).
31.1	Certification of Chief Executive Officer relating to RAI's Quarterly Report on Form 10-Q for the quarter ended September 30, 2010.

Edgar Filing: REYNOLDS AMERICAN INC - Form 10-Q

- 31.2 Certification of Chief Financial Officer relating to RAI s Quarterly Report on Form 10-Q for the quarter ended September 30, 2010.
- 32.1* Certification of Chief Executive Officer and Chief Financial Officer relating to RAI s Quarterly Report on Form 10-Q for the quarter ended September 30, 2010, pursuant to Section 18 U.S.C. §1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101.INS* XBRL instance document
- 101.SCH* XBRL taxonomy extension schema
- 101.CAL* XBRL taxonomy extension calculation linkbase

Exhibit Number	Description
101.LAB*	XBRL taxonomy extension label linkbase
101.PRE*	XBRL taxonomy extension presentation linkbase

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

SIGNATURES

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

REYNOLDS AMERICAN INC.

(Registrant)

Dated: October 28, 2010

/s/ Thomas R. Adams

Thomas R. Adams

Executive Vice President and Chief Financial
Officer

(principal financial officer)