
**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 June 30, 2017

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, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer

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

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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:
1,426,125,631 shares of common stock, par value \$.0001 per share, as of July 24, 2017.

Introduction

As previously announced, on January 16, 2017, Reynolds American Inc., referred to as RAI, British American Tobacco p.l.c., referred to as BAT, BATUS Holdings Inc., a wholly owned subsidiary of BAT, and Flight Acquisition Corporation, a wholly owned subsidiary of BAT, referred to as Merger Sub, entered into an Agreement and Plan of Merger, as it and the plan of merger contained therein were amended on June 8, 2017, referred to as the Merger Agreement, pursuant to which, subject to the satisfaction or waiver of certain conditions, Merger Sub would merge with and into RAI, referred to as the BAT Merger, with RAI surviving as a wholly owned subsidiary of BAT. Pursuant to the terms of the Merger Agreement, the BAT Merger was completed on July 25, 2017. As a result of the BAT Merger, there are no longer any publicly held shares of RAI common stock. On July 25, 2017, the New York Stock Exchange, referred to as NYSE, filed with the U.S. Securities and Exchange Commission, referred to as the SEC, a Form 25 to delist and deregister the RAI common stock. As a result, shares of RAI common stock were suspended from trading on the NYSE as of 8:40 a.m. on July 25, 2017. RAI is in the process of deregistering its common stock with the SEC under Section 12(g) of the Securities Exchange Act of 1934, referred to as the Exchange Act, and suspending its reporting obligations under Sections 13(a) and 15(d) of the Exchange Act by filing a Form 15 with the SEC promptly after the Form 25 becomes effective. After the filing of this Quarterly Report on Form 10-Q, RAI will no longer file periodic reports under the Exchange Act with the SEC with respect to its common stock. For additional information on the BAT Merger see note 14 to condensed consolidated financial statements (unaudited).

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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 June 30,		For the Six Months Ended June 30,	
	2017	2016	2017	2016
Net sales ⁽¹⁾	\$ 3,290	\$ 3,141	\$ 6,201	\$ 6,003
Net sales, related party	28	54	66	109
Net sales	3,318	3,195	6,267	6,112
Costs and expenses:				
Cost of products sold ⁽¹⁾	1,278	1,275	2,477	2,440
Selling, general and administrative expenses	478	499	896	964
Gain on divestiture	—	—	—	(4,861)
Amortization expense	6	6	12	12
Operating income	1,556	1,415	2,882	7,557
Interest and debt expense	150	152	299	326
Interest income	(3)	(2)	(5)	(5)
Other expense (income), net	11	(1)	15	251
Income before income taxes	1,398	1,266	2,573	6,985
Provision for income taxes	479	470	874	2,624
Net income	\$ 919	\$ 796	\$ 1,699	\$ 4,361
Net income per share:				
Basic	\$ 0.64	\$ 0.56	\$ 1.19	\$ 3.06
Diluted	\$ 0.64	\$ 0.56	\$ 1.19	\$ 3.05
Dividends declared per share	\$ 0.51	\$ 0.42	\$ 1.02	\$ 0.84

⁽¹⁾ Excludes excise taxes of \$1,083 million and \$1,120 million for the three months ended June 30, 2017 and 2016, respectively; and \$2,065 million and \$2,150 million for the six months ended June 30, 2017 and 2016, respectively.

See Notes to Condensed Consolidated Financial Statements (Unaudited)

REYNOLDS AMERICAN INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Dollars in Millions)
(Unaudited)

	For the Three Months Ended June 30,	
	2017	2016
	Net income	\$ 919
Other comprehensive income (loss), net of tax (benefit) expense:		
Retirement benefits, net of tax (2017 — \$9; 2016 — \$25)	13	39
Long-term investments, net of tax (2016 — \$2)	—	4
Cumulative translation adjustment and other, net of tax (2017 — \$5; 2016 — \$(2))	11	(5)
Comprehensive income	\$ 943	\$ 834

	For the Six Months Ended June 30,	
	2017	2016
	Net income	\$ 1,699
Other comprehensive income, net of tax expense:		
Retirement benefits, net of tax (2017 — \$5; 2016 — \$21)	9	33
Long-term investments, net of tax (2016 — \$3)	—	3
Hedging instruments, net of tax (2016 — \$6)	—	11
Cumulative translation adjustment and other, net of tax (2017 — \$6; 2016 — \$9)	14	17
Comprehensive income	\$ 1,722	\$ 4,425

See Notes to Condensed Consolidated Financial Statements (Unaudited)

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

	For the Six Months Ended June 30,	
	2017	2016
Cash flows from (used in) operating activities:		
Net income	\$ 1,699	\$ 4,361
Adjustments to reconcile to net cash flows from (used in) operating activities:		
Gain on divestiture	—	(4,861)
Loss on early extinguishment of debt and related expenses	—	239
Depreciation and amortization expense	63	61
Deferred income tax expense (benefit)	(10)	104
Pension and postretirement	(88)	(397)
Tobacco settlement accruals	(663)	(1,114)
Income taxes	61	770
Other, net	215	112
Net cash flows from (used in) operating activities	1,277	(725)
Cash flows from (used in) investing activities:		
Capital expenditures	(66)	(94)
Proceeds from settlement of investments	—	182
Proceeds from divestiture	—	5,015
Other, net	1	—
Net cash flows from (used in) investing activities	(65)	5,103
Cash flows from (used in) financing activities:		
Dividends paid on common stock	(1,384)	(1,113)
Repurchase of common stock	(139)	(149)
Borrowings under revolving credit facility	500	—
Repayments of borrowings under revolving credit facility	(500)	—
Early extinguishment of debt	—	(3,650)
Premiums paid for early extinguishment of debt	—	(207)
Proceeds from termination of interest rate swaps	—	66
Debt financing fees	—	(7)
Excess tax benefit on stock-based compensation plans	—	26
Net cash flows used in financing activities	(1,523)	(5,034)
Effect of exchange rate changes on cash and cash equivalents	18	7
Net change in cash and cash equivalents	(293)	(649)
Cash and cash equivalents at beginning of period	2,051	2,567
Cash and cash equivalents at end of period	\$ 1,758	\$ 1,918
Income taxes paid, net of refunds	\$ 804	\$ 1,699
Interest paid	\$ 325	\$ 378

See Notes to Condensed Consolidated Financial Statements (Unaudited)

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

	June 30, 2017 (Unaudited)	December 31, 2016
Assets		
Current assets:		
Cash and cash equivalents	\$ 1,758	\$ 2,051
Accounts receivable	123	66
Accounts receivable, related party	1	113
Other receivables	11	10
Inventories	1,448	1,645
Other current assets	295	353
Total current assets	3,636	4,238
Property, plant and equipment, net of accumulated depreciation (2017 — \$1,534; 2016 — \$1,662)	1,338	1,348
Trademarks and other intangible assets, net of accumulated amortization	29,432	29,444
Goodwill	15,992	15,992
Other assets and deferred charges	65	73
	\$ 50,463	\$ 51,095
Liabilities and shareholders' equity		
Current liabilities:		
Accounts payable	\$ 193	\$ 221
Tobacco settlement accruals	1,833	2,498
Due to related party	—	7
Deferred revenue, related party	106	66
Current maturities of long-term debt	1,748	501
Dividends payable on common stock	727	656
Other current liabilities	935	1,036
Total current liabilities	5,542	4,985
Long-term debt (less current maturities)	11,390	12,664
Long-term deferred income taxes, net	9,614	9,607
Long-term retirement benefits (less current portion)	1,768	1,869
Long-term deferred revenue, related party	19	39
Other noncurrent liabilities	244	220
Commitments and contingencies:		
Shareholders' equity:		
Common stock (shares issued: 2017 — 1,426,238,791; 2016 — 1,425,824,955)	—	—
Paid-in capital	18,197	18,285
Retained earnings	3,980	3,740
Accumulated other comprehensive loss	(291)	(314)
Total shareholders' equity	21,886	21,711
	\$ 50,463	\$ 51,095

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 subsidiaries. RAI's wholly owned operating subsidiaries include R. J. Reynolds Tobacco Company; Santa Fe Natural Tobacco Company, Inc., referred to as SFNTC; American Snuff Company, LLC, referred to as American Snuff Co.; R. J. Reynolds Vapor Company, referred to as RJR Vapor; Niconovum USA, Inc.; Niconovum AB; and until their sale on January 13, 2016, as described below, SFR Tobacco International GmbH, referred to as SFRTI, and various foreign subsidiaries affiliated with SFRTI.

On January 16, 2017, RAI, British American Tobacco p.l.c., referred to as BAT, BATUS Holdings Inc., an indirect, wholly owned subsidiary of BAT, and Flight Acquisition Corporation, an indirect, wholly owned subsidiary of BAT, referred to as Merger Sub, entered into an Agreement and Plan of Merger, as it and the plan of merger contained therein were amended on June 8, 2017, referred to as the Merger Agreement, pursuant to which, subject to the satisfaction or waiver of certain conditions, Merger Sub would merge with and into RAI, referred to as the BAT Merger, with RAI surviving as an indirect, wholly owned subsidiary of BAT. Pursuant to the terms of the Merger Agreement, the BAT Merger was completed on July 25, 2017. For additional information related to the BAT Merger, see note 14.

RAI was incorporated as a holding company in the State of North Carolina in 2004, and, prior to the completion of the BAT Merger, its common stock was listed on the New York Stock Exchange, referred to as NYSE, under the symbol "RAI." RAI was created to facilitate the business combination of the U.S. business of Brown & Williamson Holdings, Inc., referred to as B&W, an indirect wholly owned subsidiary of BAT, with R. J. Reynolds Tobacco Company, a wholly owned subsidiary of R.J. Reynolds Tobacco Holdings, Inc., referred to as RJR, on July 30, 2004, with such combination referred to as the B&W business combination.

References to RJR Tobacco prior to July 30, 2004, relate to R. J. Reynolds Tobacco Company, a New Jersey corporation. References to RJR Tobacco on and subsequent to July 30, 2004 and until June 12, 2015, relate to the combined U.S. assets, liabilities and operations of B&W and R. J. Reynolds Tobacco Company. Concurrent with the completion of the B&W business combination, RJR Tobacco became a North Carolina corporation. References to RJR Tobacco on and subsequent to June 12, 2015, relate to R. J. Reynolds Tobacco Company, a North Carolina corporation, and reflect the effects of (1) RAI's acquisition, referred to as the Lorillard Merger, on June 12, 2015, of Lorillard, Inc., n/k/a Lorillard, LLC, referred to as Lorillard, and (2) the divestiture, referred to as the Divestiture, of certain assets, on June 12, 2015, by subsidiaries or affiliates of RAI and Lorillard, together with the transfer of certain employees and certain liabilities, to a wholly owned subsidiary of Imperial Brands PLC.

Sale of International Rights to the NATURAL AMERICAN SPIRIT Brand

On January 13, 2016, RAI, through various subsidiaries, referred to as the Sellers, completed the sale of the international rights to the NATURAL AMERICAN SPIRIT brand name and associated trademarks, along with SFRTI and other international companies that distributed and marketed the brand outside the United States to JT International Holding BV, referred to as JTI Holding, a subsidiary of Japan Tobacco Inc., referred to as JTI, in an all-cash transaction of approximately \$5 billion and recognized a pre-tax gain of approximately \$4.9 billion. The transaction did not include the rights to the NATURAL AMERICAN SPIRIT brand name and associated trademarks in the U.S. market, U.S. duty-free locations and U.S. territories or in U.S. military outlets, all of which were retained by SFNTC. With this transaction completed, the international rights to nearly all of RAI's operating companies' cigarette trademarks are now owned by international tobacco companies. For additional information regarding indemnities related to this sale, see note 7.

Operating Segments

RAI's reportable operating segments are RJR Tobacco, Santa Fe and American Snuff. The RJR Tobacco segment consists of the primary operations of R. J. Reynolds Tobacco Company. The Santa Fe segment consists of the primary operations of SFNTC. The American Snuff segment consists of the primary operations of American Snuff Co. Included in All Other, among other RAI subsidiaries, are RJR Vapor, Niconovum USA, Inc., Niconovum AB, and until their sale on January 13, 2016, as described above, SFRTI and various foreign subsidiaries affiliated with SFRTI. The segments were identified based on how RAI's chief operating decision maker allocates resources and assesses performance. Certain of RAI's operating subsidiaries have entered into intercompany agreements for products or services with other subsidiaries. As a result, certain activities of an operating subsidiary may be included in a different segment of RAI. For additional information regarding segments, see note 10.

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

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

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. 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 periods ended June 30, 2017, are not necessarily indicative of the results that may be expected for a full fiscal year.

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, 2016. Certain reclassifications were made to conform prior years' financial statements to the current presentation. Certain amounts presented in note 7 are rounded in the aggregate and may not sum from the individually presented components. All dollar amounts, other than per share amounts, are presented in millions, except for amounts set forth in note 7 and as otherwise noted.

Cost of Products Sold

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

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2017	2016	2017	2016
State Settlement Agreements	\$ 758	\$ 719	\$ 1,485	\$ 1,349
FDA user fees	46	49	93	99

In 2012, RJR Tobacco, Lorillard Tobacco Company, LLC., referred to as Lorillard Tobacco, SFNTC and certain other participating manufacturers, referred to as the PMs, entered into a term sheet, referred to as the Term Sheet, with 17 states, the District of Columbia and Puerto Rico to settle certain claims related to the MSA non-participating manufacturer adjustment, referred to as the NPM Adjustment. The Term Sheet resolved claims related to volume years from 2003 through 2012 and puts in place a revised method to determine future adjustments from 2013 forward. In 2013 and 2014, five additional states joined the Term Sheet, including two states that were found to not have diligently enforced their qualifying statutes in 2003. An additional two states joined the Term Sheet in the second quarter of 2017 and, as a result, expenses for the MSA were reduced by \$17 million for the three and six months ended June 30, 2017. The parties to the Term Sheet represent an allocable share of 51.73%.

As a result of meeting the performance requirements associated with the Term Sheet, RJR Tobacco and Santa Fe, collectively, recognized credits of \$16 million and \$74 million for the three months ended June 30, 2017 and 2016, respectively, and \$26 million and \$143 million for the six months ended June 30, 2017 and 2016, respectively. RJR Tobacco expects to recognize additional credits through the remainder of 2017.

In October 2015, RJR Tobacco, SFNTC and certain other PMs entered into a settlement agreement with the State of New York, referred to as the NY Settlement Agreement, to settle certain claims related to the NPM Adjustment. The NY Settlement Agreement resolves NPM Adjustment claims related to payment years from 2004 through 2014, providing RJR Tobacco and SFNTC, collectively, with credits, of approximately \$290 million, plus interest, subject to meeting various performance obligations. These credits will be applied against annual payments under the MSA over a four-year period, which commenced with the April 2016 MSA payment. RJR Tobacco and Santa Fe, collectively, recognized credits of \$26 million and \$24 million as a reduction to costs of products sold for the three months ended June 30, 2017 and 2016, respectively, and \$49 million and \$46 million for the six months ended June 30, 2017 and 2016, respectively. In addition, the NY Settlement Agreement put in place a new method to determine future adjustments from 2015 forward as to New York.

For additional information related to the NPM Adjustment settlement and the 2003 NPM Adjustment claim, see “— Litigation Affecting the Cigarette Industry — State Settlement Agreements—Enforcement and Validity; Adjustments” in note 7.

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

Pension and Postretirement

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

Actuarial (gains) losses are changes in the amount of either the benefit obligation or the fair value of plan assets resulting from experience different from that assumed or from changes in assumptions. Differences between actual results and actuarial assumptions are accumulated and recognized as a mark-to-market adjustment, referred to as an MTM adjustment, to the extent such accumulated net (gains) losses exceed 10% of the greater of the fair value of plan assets or benefit obligations, referred to as the corridor. Net (gains) losses outside the corridor are generally recognized annually as of December 31, or when a plan is remeasured during an interim period.

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

The components of the net benefit income are set forth below:

	For the Three Months Ended June 30,				For the Six Months Ended June 30,			
	Pension Benefits		Postretirement Benefits		Pension Benefits		Postretirement Benefits	
	2017	2016	2017	2016	2017	2016	2017	2016
Service cost	\$ 5	\$ 4	\$ 1	\$ —	\$ 9	\$ 8	\$ 1	\$ 1
Interest cost	67	74	11	11	134	148	22	24
Expected return on plan assets	(97)	(93)	(3)	(2)	(194)	(186)	(5)	(5)
Amortization of prior service cost (credit)	—	—	(9)	(10)	1	1	(18)	(21)
Net benefit income	<u>\$ (25)</u>	<u>\$ (15)</u>	<u>\$ —</u>	<u>\$ (1)</u>	<u>\$ (50)</u>	<u>\$ (29)</u>	<u>\$ —</u>	<u>\$ (1)</u>

RAI disclosed in its financial statements for the year ended December 31, 2016, that it expects to contribute \$111 million to its pension plans in 2017, of which \$7 million was contributed during the first six months of 2017.

Fair Value Measurement

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. RAI determines the 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.

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.

As of June 30, 2017 and December 31, 2016, the fair value of RAI's cash equivalents was \$1.7 billion and \$2.0 billion, respectively, and was classified in Level 1 of the fair value hierarchy for both periods. The estimated fair value of RAI's outstanding consolidated debt, in the aggregate, was \$14.7 billion and \$14.3 billion as of June 30, 2017 and December 31, 2016, respectively. The fair value is derived from a third party pricing source utilizing market quotes, credit spreads and discounted cash flows, as appropriate, and is classified in Level 2 of the fair value hierarchy. Additionally, RAI sponsors a number of non-contributory defined benefit pension plans covering certain employees of RAI and its subsidiaries, and investments in plan assets to fund these obligations are carried at their fair

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

value as of December 31, 2016, and after adjustments for expected returns, cash contributions and benefit payments made in the interim period.

Recently Adopted Accounting Pronouncements

In March 2016, the Financial Accounting Standards Board, referred to as FASB, issued Accounting Standards Update, referred to as ASU, 2016-09, *Compensation—Stock Compensation (Topic 718)—Improvements to Employee Share-Based Payment Accounting*, which simplifies several aspects of the accounting for employee share-based payment transactions, including accounting for income tax, forfeitures, statutory tax withholding requirements, classifications of awards as either equity or liabilities, and classification of taxes in the statement of cash flows. The amended guidance also requires an entity to record excess tax benefits and deficiencies in the income statement rather than as a change to paid-in capital. The amended guidance was effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. RAI adopted this amended guidance effective January 1, 2017, on a prospective basis, with no material impact to its results of operations, cash flows and financial position. The adoption resulted in a \$29 million decrease to income tax expense for the excess tax benefits and an immaterial increase in potential dilutive weighted average shares for the six months ended June 30, 2017.

Recently Issued Accounting Pronouncements

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, which replaces most existing GAAP revenue recognition guidance. The effective date for adoption of this guidance was subsequently deferred to interim and annual reporting periods beginning after December 15, 2017. In 2016, the FASB issued supplemental implementation guidance related to ASU 2014-09, including:

- ASU 2016-08, *Revenue from Contracts with Customers (Topic 606)—Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*, which is intended to provide further clarification on the application of the principal versus agent implementation;
- ASU 2016-10, *Revenue from Contracts with Customers (Topic 606)—Identifying Performance Obligations and Licensing*, which is intended to clarify the guidance for identifying promised goods or services in a contract with a customer;
- ASU 2016-11, *Revenue Recognition (Topic 605) and Derivatives and Hedging (Topic 815)—Rescission of SEC Guidance Because of Accounting Standards Updates 2014-09 and 2014-16 Pursuant to Staff Announcements at the March 3, 2016 Emerging Issues Task Force Meeting*;
- ASU 2016-12, *Revenue from Contracts with Customers (Topic 606)—Narrow-Scope Improvements and Practical Expedients*, which amends certain aspects of ASU 2014-09 to address certain implementation issues; and
- ASU 2016-20, *Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers*, which includes 13 technical corrections and improvements affecting narrow aspects of the guidance issued in ASU 2014-09.

During 2016, RAI substantially completed its assessment of ASU 2014-09 to identify any potential changes in the amount and timing of revenue recognition for its current contracts and the expected impact on its business processes, systems and controls. Based on this assessment, RAI does not expect the adoption of ASU 2014-09 to have a material impact on RAI's results of operations, cash flows and financial position. The new guidance may be applied retrospectively to each prior period presented (full retrospective method) or retrospectively with the cumulative effect recognized as of the date of initial application (modified retrospective method). RAI is continuing to evaluate the impact of ASU 2014-09 primarily to determine the transition method to utilize at adoption and the additional disclosures required. The new guidance will be adopted effective January 1, 2018.

In January 2016, the FASB issued ASU 2016-01, *Financial Instruments—Overall (Subtopic 825-10)—Recognition and Measurement of Financial Assets and Liabilities*, which supersedes existing guidance to classify equity securities with readily determinable fair values into different categories and requires equity securities to be measured at fair value with changes in the fair value recognized through net income. An entity's equity investments that are accounted for under the equity method of accounting or result in consolidation of an investee are not included within the scope of this amended guidance. The amendments allow equity investments that do not have readily determinable fair values to be remeasured at fair value either upon the occurrence of an observable price change or upon identification of impairment. The amended guidance is effective for RAI for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. As permitted, RAI early adopted the application guidance as of January 1, 2017, and will adopt the remaining guidance as of January 1, 2018, with no material impact expected on its results of operations, cash flows and financial position.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*, requiring lessees to recognize lease assets and lease liabilities in the balance sheet and disclose key information about leasing arrangements, such as information about variable lease payments and

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

options to renew and terminate leases. The amended guidance will require both operating and finance leases to be recognized in the balance sheet. Additionally, the amended guidance aligns lessor accounting to comparable guidance in Accounting Standard Codification Topic 606, *Revenue from Contracts with Customers*. The amended guidance is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. RAI expects to adopt the amended guidance in ASU 2016-02 effective January 1, 2019, and is currently early in its assessment of the impact of this new standard. However, if at adoption RAI has similar obligations for leases as it had at June 30, 2017, RAI believes this guidance will not have a material impact on its results of operations, cash flows and financial position. RAI expects to substantially complete its assessment of the new standard during 2017.

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, which replaces the current incurred loss impairment methodology for recognizing credit losses for financial instruments with a methodology that reflects expected credit losses and requires consideration for a broader range of reasonable and supportable information for estimating credit losses. The amended guidance is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted for fiscal years beginning after December 15, 2018. RAI has not yet determined if it will adopt this amended guidance earlier than the effective date and has not initiated its assessment of the impact that this guidance will have on its results of operations, cash flows and financial position.

In August 2016, the FASB issued ASU 2016-15, *Statement of Cash Flows (Topic 230)—Classification of Certain Cash Receipts and Cash Payments (a consensus of the FASB Emerging Issues Task Force)*, addressing eight specific cash flow issues in an effort to reduce diversity in practice. The amended guidance is effective for fiscal years beginning after December 31, 2017, and for interim periods within those years. RAI will adopt this amended guidance effective January 1, 2018. The amended guidance is not expected to have a material impact on RAI's statements of cash flows.

In November 2016, the FASB issued ASU 2016-18, *Statement of Cash Flows (Topic 230)—Restricted Cash (a consensus of the FASB Emerging Issues Task Force)*, addressing the diversity in practice that exists regarding the classification and the presentation of changes in restricted cash on the statement of cash flows. The amended guidance requires that a statement of cash flows explain the change during the period in the total of cash, cash equivalents, restricted cash and restricted cash equivalents. The amended guidance does not provide a definition of restricted cash or restricted cash equivalents. The amended guidance is effective for fiscal years beginning after December 15, 2017, and for interim periods within those years. RAI will adopt this amended guidance effective January 1, 2018. The amended guidance is not expected to have a material impact on RAI's statements of cash flows.

In January 2017, the FASB issued ASU 2017-01, *Business Combinations (Topic 805)—Clarifying the Definition of a Business*, which clarifies the definition of a business and provides guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. The amended guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within those years. RAI will adopt this amended guidance effective January 1, 2018, and the impact of the guidance will be applied prospectively. The amended guidance is not expected to have a material impact on RAI's results of operations, cash flows and financial position.

In January 2017, the FASB issued ASU 2017-04, *Intangibles—Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*, which simplifies the manner in which an entity tests goodwill for impairment by eliminating Step 2 from the goodwill impairment test. The amended guidance requires that an entity perform its annual or interim goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount and recognizes an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. The amended guidance is effective for annual or interim goodwill impairment tests performed in fiscal years beginning after December 15, 2019. Early adoption is permitted for goodwill impairment tests performed after January 1, 2017. RAI is evaluating the timing of adoption and the effect this guidance will have on its results of operations, cash flows and financial position.

In March 2017, the FASB issued ASU 2017-07, *Compensation—Retirement Benefits (Topic 715)—Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*, which requires an employer to disaggregate the service cost component from the other components of net benefit (income) cost. The other components of net benefit (income) cost are required to be presented in the income statement separately from the service cost component and outside of operating income. The amendments also allow only the service cost component of net benefit (income) cost to be eligible for capitalization. The amendments in this ASU are effective for fiscal years beginning after December 15, 2017. The amendments in this ASU should be applied (1) retrospectively for the presentation of the service cost component and the other components of net periodic pension (income) cost and net periodic postretirement benefit (income) cost on the income statement, and (2) prospectively, on and after the effective date, for the capitalization of the service cost component of net periodic pension (income) cost and net periodic postretirement benefit (income) cost in assets. RAI is evaluating the effect this guidance will have on its results of operations, cash flows and financial position.

In May 2017, the FASB issued ASU 2017-09, *Compensation—Stock Compensation (Topic 718)—Scope of Modification Accounting*, which amends the scope of modification accounting for share-based payment arrangements and provides guidance on the types of

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

changes to the terms or conditions of share-based payment awards to which an entity would be required to apply modification accounting under Topic 718. The amendments in this ASU are effective for fiscal years beginning after December 15, 2017, including interim periods within those years. Early adoption is permitted, including adoption in any interim period, for reporting periods for which financial statements have not yet been issued. RAI has not yet determined when it will adopt this amended guidance. The amended guidance is not expected to have a material impact on RAI's results of operations, cash flows and financial position.

Note 2 — Intangible Assets

The changes in the carrying amounts of goodwill by segment were as follows:

	<u>RJR Tobacco</u>	<u>Santa Fe</u>	<u>American Snuff</u>	<u>All Other</u>	<u>Consolidated</u>
Balance as of December 31, 2016					
Goodwill	\$ 17,069	\$ 197	\$ 2,501	\$ 16	\$ 19,783
Less: accumulated impairment charges	(3,763)	—	(28)	—	(3,791)
	<u>\$ 13,306</u>	<u>\$ 197</u>	<u>\$ 2,473</u>	<u>\$ 16</u>	<u>\$ 15,992</u>
Balance as of June 30, 2017					
Goodwill	\$ 17,069	\$ 197	\$ 2,501	\$ 16	\$ 19,783
Less: accumulated impairment charges	(3,763)	—	(28)	—	(3,791)
	<u>\$ 13,306</u>	<u>\$ 197</u>	<u>\$ 2,473</u>	<u>\$ 16</u>	<u>\$ 15,992</u>

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

	<u>RJR Tobacco</u>		<u>Santa Fe</u>	<u>American Snuff</u>	<u>All Other</u>	<u>Consolidated</u>	
	<u>Trademarks</u>	<u>Other</u>	<u>Trademarks</u>	<u>Trademarks</u>	<u>Other</u>	<u>Trademarks</u>	<u>Other</u>
Indefinite-lived:							
Balance as of December 31, 2016	\$ 27,826	\$ 87	\$ 136	\$ 1,136	\$ —	\$ 29,098	\$ 87
Balance as of June 30, 2017	<u>\$ 27,826</u>	<u>\$ 87</u>	<u>\$ 136</u>	<u>\$ 1,136</u>	<u>\$ —</u>	<u>\$ 29,098</u>	<u>\$ 87</u>
Finite-lived:							
Balance as of December 31, 2016	\$ 12	\$ 229	\$ —	\$ 5	\$ 13	\$ 17	\$ 242
Amortization	(3)	(8)	—	—	(1)	(3)	(9)
Balance as of June 30, 2017	<u>\$ 9</u>	<u>\$ 221</u>	<u>\$ —</u>	<u>\$ 5</u>	<u>\$ 12</u>	<u>\$ 14</u>	<u>\$ 233</u>

Details of finite-lived intangible assets were as follows:

	<u>June 30, 2017</u>			<u>December 31, 2016</u>		
	<u>Gross</u>	<u>Accumulated Amortization</u>	<u>Net</u>	<u>Gross</u>	<u>Accumulated Amortization</u>	<u>Net</u>
Customer lists	\$ 240	\$ (25)	\$ 215	\$ 240	\$ (19)	\$ 221
Contract manufacturing agreement	151	(145)	6	151	(143)	8
Trademarks	124	(110)	14	124	(107)	17
Other intangibles	15	(3)	12	15	(2)	13
	<u>\$ 530</u>	<u>\$ (283)</u>	<u>\$ 247</u>	<u>\$ 530</u>	<u>\$ (271)</u>	<u>\$ 259</u>

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

Year	Amount
Remainder of 2017	\$ 11
2018	22
2019	16
2020	15
2021	14
Thereafter	169
	<u>\$ 247</u>

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

Note 3 — Income Per Share

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

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2017	2016	2017	2016
Net income	\$ 919	\$ 796	\$ 1,699	\$ 4,361
Basic weighted average shares, in thousands	1,426,578	1,427,413	1,426,412	1,427,430
Effect of dilutive potential shares:				
Restricted stock units	2,138	2,554	2,697	3,088
Diluted weighted average shares, in thousands	1,428,716	1,429,967	1,429,109	1,430,518

For additional information regarding dilutive shares, see “— Recently Adopted Accounting Pronouncements” in note 1.

Note 4 — Inventories

The major components of inventories were as follows:

	June 30, 2017	December 31, 2016
Leaf tobacco	\$ 1,222	\$ 1,436
Other raw materials	99	77
Work in process	72	81
Finished products	175	165
Other	23	25
Total	1,591	1,784
LIFO allowance	(143)	(139)
	\$ 1,448	\$ 1,645

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

Note 5 — Income Taxes

The provision for income taxes was as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2017	2016	2017	2016
Provision for income taxes	\$ 479	\$ 470	\$ 874	\$ 2,624
Effective tax rate	34.3%	37.1%	34.0%	37.6%

The effective tax rate for the six months ended June 30, 2017, was primarily impacted by a \$29 million decrease in tax attributable to excess tax benefits on stock-based compensation plans and a reduction in state taxes. The effective tax rate for the six months ended June 30, 2016, was primarily impacted by an increase in tax attributable to the sale of the international rights to the NATURAL AMERICAN SPIRIT brand name and associated trademarks, along with the international companies that distributed and marketed the brand outside the United States. Additionally, the effective tax rate for each period differed from the federal statutory rate of 35% due to the domestic manufacturing deduction, state income taxes and certain nondeductible items.

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

Note 6 — Credit Agreement

In December 2014, RAI entered into a credit agreement, referred to as the Credit Agreement, with a syndicate of lenders, providing for a five-year, \$2 billion senior unsecured revolving credit facility. The maturity date of the Credit Agreement had been extended to December 18, 2021.

Effective July 25, 2017, RAI terminated the Credit Agreement in connection with the completion of the BAT Merger. For additional information related to the Credit Agreement termination and the BAT Merger, see note 14. The following information is a description of the Credit Agreement prior to its termination on July 25, 2017.

Subject to certain conditions, RAI was able to use the revolving credit facility under the Credit Agreement for borrowings and issuances of letters of credit at its option, subject to a \$300 million sublimit on the aggregate amount of letters of credit. Issuances of letters of credit reduced availability under such revolving credit facility.

The Credit Agreement contained certain customary restrictive covenants, and two financial covenants – a consolidated leverage ratio covenant and a consolidated interest coverage ratio covenant. The Credit Agreement contained customary events of default, including upon a change in control, as defined therein, which could result in the acceleration of all amounts outstanding and cancellation of all commitments outstanding under the Credit Agreement.

The lenders' obligations under the Credit Agreement to fund borrowings were subject to the accuracy of RAI's representations and warranties and the absence of any default, provided, however, that the accuracy of RAI's representation as to the absence of any material adverse effect, as defined in the Credit Agreement, was not a condition to borrowing for the purpose of refinancing any maturing commercial paper.

Under the terms of the Credit Agreement, RAI was required to pay a facility fee per annum of between 0.100% and 0.275%, based generally on the ratings of RAI's senior, unsecured, long-term indebtedness, on the lender commitments in respect of the revolving credit facility thereunder.

Borrowings under the Credit Agreement bore interest, at the option of RAI, at a rate equal to an applicable margin based generally on the ratings of RAI's senior, unsecured, long-term indebtedness, plus:

- the alternate base rate – the higher of (1) the federal funds effective rate from time to time plus 0.5%, (2) the prime rate and (3) the reserve adjusted eurodollar rate for a one month interest period plus 1%; or
- the eurodollar rate – the reserve adjusted rate at which eurodollar deposits for one, two, three or six months are offered in the interbank eurodollar market.

Overdue principal outstanding under the revolving credit facility of the Credit Agreement bore interest at a rate equal to the rate then in effect with respect to such borrowings, plus 2.0% per annum. Any amount besides principal that became overdue bore interest at a rate equal to 2.0% per annum in excess of the rate of interest applicable to base rate loans.

Certain of RAI's subsidiaries, including its Material Subsidiaries, as defined in the Credit Agreement, had guaranteed, on an unsecured basis, RAI's obligations under the Credit Agreement. The same subsidiaries that guaranteed the Credit Agreement also guaranteed RAI's outstanding notes. Under the terms of the indenture governing RAI's outstanding notes, if any guarantor of such notes ceased to be a guarantor under the Credit Agreement (or any replacement or refinancing thereof), that guarantor would be released automatically from all of its obligations under the RAI indenture and its guarantee of the RAI notes. In connection with the termination of the Credit Agreement on July 25, 2017, the subsidiary guarantees of the Credit Agreement also terminated. For information regarding the impact of the BAT Merger on the guarantees of RAI's indenture and outstanding notes, see note 14.

In the first six months of 2017, RAI borrowed and repaid \$500 million under the Credit Agreement at an interest rate of 2.15%. As of June 30, 2017, there were no outstanding borrowings and no letters of credit outstanding under the Credit Agreement.

Note 7 — Commitments and Contingencies

Tobacco Litigation — General

Introduction

Litigation, claims, and other legal proceedings relating to the use of, exposure to, or purchase of tobacco products are pending or may be instituted in the future against RJR Tobacco (including as successor by merger to Lorillard Tobacco), American Snuff Co., SFNTC, RJR Vapor, RAI, Lorillard, other RAI affiliates, and indemnitees (including but not limited to B&W), sometimes referred to

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

collectively as Reynolds Defendants. These pending legal proceedings include claims relating to cigarette products manufactured by RJR Tobacco, Lorillard Tobacco, SFNTC or certain of their affiliates or indemnitees, smokeless tobacco products manufactured by American Snuff Co., and e-cigarette products manufactured on behalf of and marketed by RJR Vapor. A discussion of the legal proceedings relating to cigarette products (and e-cigarettes) 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 or e-cigarettes, as the case may be, and are not references to legal proceedings involving smokeless tobacco products, and case numbers under that heading include only cases involving cigarette products and e-cigarettes. 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 undertook certain indemnification obligations with respect to B&W and its affiliates, including its indirect parent, BAT. As a result of the BAT Merger, these indemnification obligations are now intercompany obligations. See “— Litigation Affecting the Cigarette Industry — Overview — Introduction” below. In connection with the Lorillard Merger and the Divestiture, as applicable, RAI and RJR Tobacco undertook certain indemnification obligations. See “— Litigation Affecting the Cigarette Industry — Overview — Introduction,” “— Other Contingencies — ITG Indemnity,” and “— Other Contingencies — Loews Indemnity” below. In addition, in connection with the sale of the non-U.S. operations and business of the NATURAL AMERICAN SPIRIT brand, the Sellers have agreed to indemnify the buyer for certain claims. See “— Other Contingencies — JTI Indemnities” below.

Certain Terms and Phrases

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

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

The term “*per curiam*” refers to a decision entered by an appellate court that is not signed by an individual judge. In most cases, it is used to indicate that the opinion entered is a brief announcement of the court’s decision and is not accompanied by an opinion explaining the court’s reasoning.

The term “settlement” refers to certain types of cases in which cigarette manufacturers, including RJR Tobacco, B&W and Lorillard Tobacco, have agreed to resolve disputes with certain plaintiffs without resolving the cases through trial. The principal terms of certain settlements entered into by RJR Tobacco, B&W and Lorillard Tobacco 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, failure to warn, fraud, misrepresentation, violations of unfair and deceptive trade practices statutes, conspiracy, medical monitoring 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 or, in the case of certain claims asserted against Lorillard Tobacco, that they were injured by exposure to filters containing asbestos used in one cigarette brand for roughly four years before 1957, the latter cases referred to as Filter Cases.

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

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

Defenses

The defenses raised by Reynolds Defendants 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, statutes of limitations or repose and others. RAI, RJR and Lorillard 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 record any loss concerning litigation at such time as an unfavorable outcome becomes probable and the amount can be reasonably estimated on an individual case-by-case basis. For the reasons set forth below, RAI's management continues to conclude that the loss of any particular pending tobacco-related litigation claim against the Reynolds Defendants, when viewed on an individual basis, is not probable, except for certain *Engle* Progeny cases noted below.

Reynolds Defendants believe that they have valid defenses to the tobacco-related litigation claims against them, as well as valid bases for appeal of adverse verdicts against them. Reynolds Defendants have, through their counsel, filed pleadings and memoranda in pending tobacco-related 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 the *Engle* Progeny cases described below, Reynolds Defendants continue to win the majority of tobacco-related litigation claims that reach trial, and a very high percentage of the tobacco-related litigation claims brought against them, including *Engle* Progeny cases, continue to be dismissed at or before trial. Based on their experience in tobacco-related litigation and the strength of the defenses available to them in such litigation, Reynolds Defendants believe that their successful defense of tobacco-related litigation in the past will continue in the future.

RAI's condensed consolidated balance sheet (unaudited) as of June 30, 2017, contains accruals for the following *Engle* Progeny cases: *Starr-Blundell*, *Monroe*, *Lourie*, *Lewis*, *Block* and *Ward* (for attorneys' fees and interest only with respect to *Ward*). In the second quarter of 2017, RJR Tobacco paid approximately \$3.5 million in satisfaction of the judgment, including attorneys' fees and interest, in *Lawrence* and attorneys' fees and interest in *Buonomo*. Other accruals include an amount for the estimated costs of the corrective communications in the *U.S. Department of Justice* case. As other cases proceed through the appellate process, RAI will evaluate the need for further accruals on an individual case-by-case basis if an unfavorable outcome becomes probable and the amount can be reasonably estimated.

It is the policy of Reynolds Defendants to defend tobacco-related litigation claims vigorously; generally, Reynolds Defendants and indemnitees do not settle such claims. However, Reynolds Defendants may enter into settlement discussions in some cases, if they believe it is in their best interests to do so. Exceptions to this general approach include, but are not limited to, actions taken pursuant to "offer of judgment" statutes, as described below in "— Litigation Affecting the Cigarette Industry — Overview," and Filter Cases, as described below in "— Litigation Affecting the Cigarette Industry – Filter Cases," as well as other historical examples discussed below.

With respect to smoking and health tobacco litigation claims, the only significant settlements reached by RJR Tobacco, Lorillard 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;
- the original *Broin* flight attendant case discussed below under "— Litigation Affecting the Cigarette Industry — *Broin II* Cases," and
- most of the *Engle* Progeny cases pending in federal court, after the initial docket of over 4,000 such cases was reduced to approximately 400 cases.

The circumstances surrounding the State Settlement Agreements and the funding of a trust fund to benefit the tobacco growers are readily distinguishable from the current categories of tobacco-related litigation claims involving Reynolds Defendants. In the claims underlying the State Settlement Agreements, the states sought 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."

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

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 the Reynolds Defendants. The original *Broin* case, discussed below under “— Litigation Affecting the Cigarette Industry — *Broin II* Cases,” was settled in the middle of trial during negotiations concerning a possible nation-wide settlement of claims similar to those underlying the State Settlement Agreements.

The federal *Engle* Progeny cases likewise presented exceptional circumstances not present in the state *Engle* Progeny cases or elsewhere. All of the federal *Engle* Progeny cases subject to the settlement were pending in the same court, were coordinated by the same judge, and involved the same sets of plaintiffs’ lawyers. Moreover, RJR Tobacco settled only after approximately 90% of the federal *Engle* Progeny cases otherwise had been resolved. A discussion of the *Engle* Progeny cases and the settlement of the federal *Engle* Progeny cases is set forth below under “— Litigation Affecting the Cigarette Industry — *Engle* and *Engle* Progeny Cases.”

In 2010, RJR Tobacco entered into a comprehensive agreement with the Canadian federal, provincial and territorial governments, which resolved all civil claims related to the movement of contraband tobacco products in Canada during the period 1985 through 1999 that the Canadian governments could assert against RJR Tobacco and its affiliates. These claims involved different theories of recovery than the other tobacco-related litigation claims pending against the Reynolds Defendants.

Also, in 2004, RJR Tobacco and B&W separately settled the antitrust case *DeLoach v. Philip Morris Cos., Inc.*, which was brought by a unique class of plaintiffs: a class of all tobacco growers and tobacco allotment holders. The plaintiffs asserted that the defendants conspired to fix the price of tobacco leaf and to destroy the federal government’s tobacco quota and price support program. Despite legal defenses they believed to be valid, RJR Tobacco and B&W separately settled this case to avoid a long and contentious trial with the tobacco growers. The *DeLoach* case involved different types of plaintiffs and different theories of recovery under the antitrust laws than the other tobacco-related litigation claims pending against the Reynolds Defendants.

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

Cautionary Statement

Even though RAI’s management continues to believe that the loss of particular pending tobacco-related litigation claims against Reynolds Defendants, when viewed on an individual case-by-case basis, is not probable or estimable (except for certain *Engle* Progeny cases described below), 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 Reynolds Defendants, or to reasonably estimate the amount or range of any possible loss.

Although Reynolds Defendants believe that they have valid bases for appeals of adverse verdicts in their pending cases and valid defenses to all actions and intend to defend them vigorously as described above, it is possible that there could be further adverse developments in pending cases, and that additional cases could be decided unfavorably against Reynolds Defendants. Determinations of liability or adverse rulings in such cases or in similar cases involving other cigarette manufacturers as defendants, even if such judgments are not final, could have a material adverse effect on the litigation against Reynolds Defendants and could encourage the commencement of additional tobacco-related litigation. Reynolds Defendants also may enter into settlement discussions in some cases, if they believe it is in their best interests to do so. 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 may be filed against Reynolds Defendants, 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 Reynolds Defendants 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 or future claims against Reynolds Defendants.

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Litigation Affecting the Cigarette Industry

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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. Also, in connection with the Lorillard Merger, Lorillard Tobacco was merged into RJR Tobacco with RJR Tobacco being the surviving entity, Lorillard Tobacco ceasing to exist, and RJR Tobacco succeeding to Lorillard Tobacco's liabilities, including Lorillard Tobacco's litigation liabilities, costs and expenses, referred to as the Lorillard Tobacco Merger. Although Lorillard Tobacco no longer exists as a result of the Lorillard Tobacco Merger, it will remain as a named party in cases pending on the date of the Lorillard Tobacco Merger until courts grant motions to substitute RJR Tobacco for Lorillard Tobacco or the claims are dismissed. The cases discussed below include cases brought against RJR Tobacco, Lorillard Tobacco and their affiliates and indemnitees, including RAI, RJR, B&W and Lorillard. Cases brought against SFNTC and RJR Vapor also are discussed.

During the second quarter of 2017, 35 tobacco-related cases were served against Reynolds Defendants. On June 30, 2017, there were, subject to the exclusions described immediately below, 249 cases pending against Reynolds Defendants: 232 in the United States and 17 in Canada, as compared with 286 total cases on June 30, 2016. Of the U.S. cases pending on June 30, 2017, 37 are pending in federal court, 194 in state court and one in tribal court, primarily in the following states: Illinois (51 cases); Massachusetts (35 cases); Florida (29 cases); New York (18 cases); Missouri (16 cases); New Mexico (16 cases); and Louisiana (10 cases). The U.S. case number excludes the approximately 564 individual smoker cases pending in West Virginia state court as a consolidated action, 2,694 *Engle* Progeny cases, involving approximately 3,492 individual plaintiffs, and 2,346 *Broin II* cases, pending in the United States against RJR Tobacco, Lorillard Tobacco or certain other Reynolds Defendants.

The following table lists the categories of the U.S. tobacco-related cases pending against Reynolds Defendants as of June 30, 2017, and the increase or decrease from the number of cases pending against Reynolds Defendants as of March 31, 2017, as reported in RAI's

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

Quarterly Report on Form 10-Q for the fiscal quarter ended March 31, 2017, filed with the U.S. Securities and Exchange Commission, referred to as the SEC, on May 3, 2017, and a cross-reference to the discussion of each case type.

Case Type	U.S. Case Numbers as of June 30, 2017	Change in Number of Cases Since March 31, 2017 Increase/(Decrease)
Individual Smoking and Health Cases	104	(33)
<i>West Virginia IPIC</i> (Number of Plaintiffs)*	1 (approx. 564)	No change
<i>Engle</i> Progeny Cases (Number of Plaintiffs)**	2,694 (approx. 3,492)	(83) (78)
<i>Broin II</i> Cases	2,346	(6)
Class-Action Suits	28	1
Filter Cases	73	(5)
Health-Care Cost Recovery Cases	2	No change
State Settlement Agreements—Enforcement and Validity; Adjustments	2	No change
Other Litigation and Developments	22	(2)

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

** The *Engle* Progeny cases have been separated from the Individual Smoking and Health cases for reporting purposes. The number of cases will fluctuate as cases are dismissed or if any of the dismissed cases are appealed.

The Florida state court class-action case, *Engle v. R. J. Reynolds Tobacco Co.*, and the related cases commonly referred to as *Engle* Progeny cases have attracted significant attention. After the Florida Supreme Court's 2006 ruling that members of the formerly certified class could file individual actions, roughly 10,000 claims or actions were filed in Florida state or federal courts before the deadline set by the Florida Supreme Court. No new or additional such claims may be filed. As reflected in the table above, 2,694 *Engle* Progeny cases were pending as of June 30, 2017, that included claims asserted on behalf of 3,492 plaintiffs. Following an agreement to settle most *Engle* Progeny cases that remained pending in federal courts in the first quarter of 2015, nearly all *Engle* Progeny cases currently pending are in Florida state courts. Since 2009, there have been over 200 *Engle* Progeny trials in Florida state or federal courts involving RJR Tobacco or Lorillard Tobacco. As described more fully immediately below in “— *Scheduled Trials*” and “— *Trial Results*,” additional *Engle* Progeny cases involving RJR Tobacco are being tried and set for trial on an ongoing basis. Juries in *Engle* Progeny cases have awarded substantial amounts in compensatory and punitive damage awards, many of which currently are at various stages in the appellate process. RJR Tobacco and Lorillard Tobacco also have paid substantial amounts in compensatory and punitive damage awards in *Engle* Progeny cases. For a detailed description of these cases, see “— *Engle and Engle Progeny cases*” below.

In November 1998, the major U.S. cigarette manufacturers, including RJR Tobacco, B&W and Lorillard Tobacco, 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, Lorillard Tobacco 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, relative market share, operating profit 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.

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

Scheduled Trials. Trial schedules are subject to change, and many cases are dismissed before trial. There are 32 cases, exclusive of *Engle* Progeny cases, scheduled for trial as of June 30, 2017 through June 30, 2018, for RJR Tobacco, B&W, Lorillard Tobacco or their affiliates and indemnitees: five individual smoking and health cases, 25 Filter Cases, and two other non-smoking and health cases. There are also approximately 117 *Engle* Progeny cases against RJR Tobacco, B&W and/or Lorillard Tobacco set for trial through June 30, 2018. It is not known how many of these cases will actually be tried.

Trial Results. From January 1, 2014 through June 30, 2017, 141 individual smoking and health, *Engle* Progeny, Filter and health-care cost recovery cases in which RJR Tobacco, B&W and/or Lorillard Tobacco were defendants were tried, including ten trials for cases where mistrials were declared in the original proceedings. Verdicts in favor of RJR Tobacco, B&W and Lorillard Tobacco and, in some cases, other defendants, were returned in 67 cases, tried in Florida (41), California (1) and New Jersey (1). There were also 24 mistrials in Florida. Verdicts in favor of the plaintiffs were returned in 65 cases tried in Florida, and one in California. Six cases in Florida were dismissed during trial. One case in Florida was a retrial only as to the amount of damages. In another case in Florida, the jury entered a partial verdict that did not include compensatory or punitive damages, and post-trial motions are pending.

In the second quarter of 2017, eight *Engle* Progeny cases in which RJR Tobacco and/or Lorillard Tobacco was a defendant were tried:

- In *Schlefstein v. R. J. Reynolds Tobacco Co.*, the court declared a mistrial during jury selection.
- In *Lima v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of the plaintiff, found the decedent 40% at fault, RJR Tobacco 60% at fault and the remaining defendant 0% at fault, and awarded \$3 million in compensatory damages and \$12 million in punitive damages against RJR Tobacco.
- In *Shadd v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of the plaintiff, found the decedent 95% at fault and RJR Tobacco 5% at fault, and awarded \$0 in compensatory damages. Punitive damages were not awarded.
- In *Lawrence v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of the plaintiff, found the decedent 65% at fault and RJR Tobacco 35% at fault, awarded approximately \$858,200 in compensatory damages, and found that the plaintiff was entitled to punitive damages. Prior to the punitive damages phase, the parties resolved the matter.
- In *Sheffield v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of the plaintiff, found the decedent 40% at fault and RJR Tobacco 60% at fault, awarded \$1.8 million in compensatory damages and \$5 million in punitive damages.
- In *Olson v. R. J. Reynolds Tobacco Co.*, the court granted RJR Tobacco's motion for a mistrial.
- In *Kogan v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of RJR Tobacco and the remaining defendant.
- In *Gay v. R. J. Reynolds Tobacco Co.*, a mistrial was granted due to comments made by a prospective juror during jury selection.

In addition, since the end of the second quarter of 2017, two other *Engle* Progeny cases, in which RJR Tobacco, B&W, and/or Lorillard were a defendant were tried:

- In *Maloney v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of the plaintiff, found the decedent 50% at fault and RJR Tobacco 50% at fault, and awarded \$1.65 million in compensatory damages. Punitive damages were not awarded.
- In *Thomas v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of the plaintiff, found the decedent 45% at fault and RJR Tobacco 55% at fault, and awarded \$4 million in compensatory damages. Punitive damages were not awarded.

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

In the second quarter of 2017, no non-*Engle* Progeny individual smoking and health cases, in which RJR Tobacco, B&W and/or Lorillard Tobacco was a defendant, were tried.

In the second quarter of 2017, no Filter cases, in which RJR Tobacco and/or Lorillard Tobacco was a defendant, were tried.

For information on the verdicts in the *Engle* Progeny cases that have been tried and remain pending as of June 30, 2017, in which verdicts have been returned against RJR Tobacco, Lorillard Tobacco or B&W, or all three, see the *Engle* Progeny cases charts at “— *Engle* and *Engle* Progeny Cases” below. The following chart reflects the verdicts in the non-*Engle* Progeny smoking and health cases,

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

health-care cost recovery cases or Filter Cases that have been tried and remain pending as of June 30, 2017, in which verdicts have been returned against RJR Tobacco, B&W or Lorillard Tobacco, or all three.

Date of Verdict	Case Name/Type	Jurisdiction	Verdict
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, D.C.)	RJR Tobacco, B&W and Lorillard Tobacco 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.
May 26, 2010	<i>Izzarelli v. R. J. Reynolds Tobacco Co.</i> [Individual]	U.S. District Court, District of Connecticut, (Bridgeport, CT)	\$13.76 million in compensatory damages; 58% of fault assigned to RJR Tobacco, which reduced the award to \$7.98 million against RJR Tobacco; \$3.97 million in punitive damages.
September 13, 2013	<i>DeLisle v. A. W. Chesterton Co.</i> [Filter]	Circuit Court, Broward County, (Ft. Lauderdale, FL)	\$8 million in compensatory damages; 44% of fault assigned to Lorillard Tobacco, which reduced the award to \$3.52 million against Lorillard Tobacco.
July 30, 2014	<i>Major v. Lorillard Tobacco Co.</i> [Individual]	Superior Court, Los Angeles County, (Los Angeles, CA)	\$17.74 million in compensatory damages; 17% of fault assigned to Lorillard Tobacco, which reduced the award to \$3.78 million against Lorillard Tobacco.
July 8, 2015	<i>Larkin v. R. J. Reynolds Tobacco Co.</i> [Individual]	Circuit Court, Miami-Dade County, (Miami, FL)	\$4.96 million in compensatory damages; 62% of fault assigned to RJR Tobacco; \$8.5 million in punitive damages. Comparative fault did not apply to the final judgment.

For information on the post-trial status of individual smoking and health cases, the governmental health-care cost recovery case and the Filter Cases, see “— Individual Smoking and Health Cases,” “— Health-Care Cost Recovery Cases — U.S. Department of Justice Case,” and “— Filter Cases,” respectively, below.

Individual Smoking and Health Cases

As of June 30, 2017, 104 individual cases were pending in the United States against RJR Tobacco, B&W (as RJR Tobacco’s indemnitee), Lorillard Tobacco or all three. This category of cases includes smoking and health cases alleging personal injuries caused by tobacco use or exposure brought by or on behalf of individual plaintiffs based on theories of negligence, strict liability, breach of express or implied warranty, and violations of state deceptive trade practices or consumer protection statutes. The plaintiffs seek to recover compensatory damages, attorneys’ fees and costs, and punitive damages. The category does not include the *Broin II*, *Engle Progeny*, *Filter* or *West Virginia IPIC* cases discussed below. One of the individual cases is brought by or on behalf of an individual or his/her survivors alleging personal injury as a result of exposure to environmental tobacco smoke, referred to as ETS.

Below is a description of the non-*Engle Progeny* individual smoking and health cases against RJR Tobacco, B&W, and/or Lorillard Tobacco that went to trial or were decided during the period from January 1, 2017 to June 30, 2017, or remained on appeal as of June 30, 2017.

On May 26, 2010, in *Izzarelli v. R. J. Reynolds Tobacco Co.* (U.S.D.C. D. Conn., filed 1999), the jury awarded the plaintiff \$13.76 million in compensatory damages on the negligence and strict liability claims, found RJR Tobacco 58% at fault and the plaintiff 42% at fault, and found that the plaintiff was entitled to punitive damages. The plaintiff sought to recover damages for personal injuries allegedly sustained as a result of unsafe and unreasonably dangerous cigarette products and for economic losses she sustained as a result of supposed unfair trade practices. On December 5, 2010, the district court (1) awarded the plaintiff \$3.97 million in punitive damages based on Connecticut’s common-law rule limiting punitive damage awards to the amount of litigation expenses less taxable costs, (2) entered judgment in the amount of \$11.95 million (the \$13.76 million compensatory damages award reduced by the allocation of fault plus the \$3.97 million punitive damages award), and (3) granted the plaintiff \$15.8 million in offer of judgment interest through that date and, going forward, approximately \$4,000 per day until entry of an amended judgment. In March 2011, the district court entered an amended judgment of approximately \$28.1 million. RJR Tobacco appealed to the U.S. Court of Appeals for the Second Circuit, referred to as the Second Circuit, and the plaintiff cross appealed. In a non-precedential summary order dated July 7, 2017, the Second Circuit affirmed the \$7.98 million compensatory damages award, vacated the \$3.97 million punitive damages award, and remanded for a re-determination of punitive damages in light of the Connecticut Supreme Court’s decision in the *Bifolck v. Philip Morris, Inc.* case,

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

which ruled that punitive damages in a product liability action are not capped at the amount of litigation expenses less taxable costs under Connecticut's common-law rule, but instead are capped under the Connecticut Product Liability Act at twice the compensatory damages award. RJR Tobacco filed a motion for rehearing and rehearing *en banc* on July 21, 2017. A decision is pending.

On July 30, 2014, in *Major v. Lorillard Tobacco Co.* (Super. Ct. Los Angeles County, Cal., filed 2011), the jury awarded the plaintiff approximately \$17.74 million in compensatory damages on the negligence and strict liability claims and found the plaintiff 50% at fault, Lorillard Tobacco 17% at fault, and RJR Tobacco and another manufacturer collectively 33% at fault. Punitive damages were not at issue. RJR Tobacco and the other manufacturer had been dismissed prior to trial. The plaintiffs alleged that as a result of the use of the defendants' products and exposure to asbestos, the decedent, William Major, suffered from lung cancer, and sought an unspecified amount of damages. In August 2014, the trial court entered an initial final judgment of approximately \$3.9 million against Lorillard Tobacco. On July 1, 2015, the trial court entered an amended final judgment in the amount of approximately \$3.78 million in compensatory damages, approximately \$135,000 in costs, approximately \$1.9 million in prejudgment interest, and post-judgment interest from August 25, 2014 in the amount of approximately \$1,100 per day. Lorillard Tobacco appealed from the original and amended judgments, which appeals have been consolidated, and posted a supersedeas bond in the amount of approximately \$9.1 million. On October 20, 2015, the appellate court granted RJR Tobacco's motion to substitute itself for Lorillard Tobacco. Oral argument occurred on June 27, 2017. Before oral argument, the court issued a tentative ruling in which it indicated it was inclined to affirm the judgment. A decision is pending.

On July 8, 2015, in *Larkin v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Miami-Dade County, Fla., filed 2002) the jury awarded the plaintiff approximately \$4.96 million in compensatory damages on the strict liability and intentional tort claims, found RJR Tobacco 62% at fault and the decedent 38% at fault, and awarded \$8.5 million in punitive damages. The plaintiff alleged that as a result of using the defendant's products, the decedent suffered from mouth and lung cancer, and sought an unspecified amount of compensatory and punitive damages. In July 2015, the trial court entered judgment in the amount of approximately \$13.46 million. On March 22, 2016, the trial court granted RJR Tobacco's motion for a new trial on claims of defective product and damages only and denied the remaining post-trial motions. The new trial has not been scheduled. In April 2016, RJR Tobacco appealed to the Third District Court of Appeal, referred to as DCA, and the plaintiff cross appealed. Oral argument occurred on May 3, 2017. On June 28, 2017, the Third DCA affirmed the final judgment and order denying the motion for a new trial as to the fraudulent concealment and conspiracy to conceal claims, reversed the new trial order, and remanded with directions to reinstate the jury verdict. RJR Tobacco filed a motion for clarification and motion for rehearing *en banc* or certification to the Florida Supreme Court on July 13, 2017. A decision is pending.

On February 8, 2016, in *Poosh v. Philip Morris USA, Inc.* (U.S.D.C. N.D. Cal., filed 2004) the jury returned a verdict in favor of the defendants, including RJR Tobacco. The plaintiff alleged that as a result of using the defendants' products, the plaintiff suffers from lung cancer. Final judgment was entered on February 9, 2016. The plaintiff filed a notice of appeal to the U.S. Court of Appeals for the Ninth Circuit on March 9, 2016. The case has been stayed through September 20, 2017, pending a decision in *Major*, described above.

West Virginia IPIC

In re: Tobacco Litigation Individual Personal Injury Cases (Cir. Ct. Ohio County, W. Va., filed beginning in 1999), is a series of roughly 1,200 individual cases asserting claims against Philip Morris USA Inc., Lorillard Tobacco, RJR Tobacco, B&W and The American Tobacco Company based on alleged personal injuries. The cases were consolidated for a Phase I trial on various defense conduct issues, to be followed in Phase II by individual trials of remaining claims. On May 15, 2013, the Phase I jury found that defendants' cigarettes were not defectively designed; defendants' cigarettes were not defective due to a failure to warn before July 1, 1969; defendants were not negligent, did not breach warranties, and did not engage in conduct warranting punitive damages; and defendants' ventilated filter cigarettes manufactured and sold between 1964 and July 1, 1969 were defective for a failure to instruct. In November 2014, the West Virginia Supreme Court affirmed the verdict. On June 8, 2015, the U.S. Supreme Court denied the plaintiffs' petition for writ of certiorari. On the same date, the trial court issued an order finding that only 30 plaintiffs are alleged to have smoked ventilated filter cigarettes in the relevant period. On October 9, 2015, the trial court outlined the procedures for resolving the claims of the 30 Phase II plaintiffs, which claims will focus on whether plaintiffs blocked cigarette vents and, if so, whether blocking proximately caused their alleged injuries. Five cases were selected to be the first claims tried, and they are tentatively scheduled to be tried beginning in May 2018. In June 2017, the defendants filed a motion to dismiss the failure to instruct claims because the plaintiffs failed to meet the court's deadline to produce experts to support this theory of liability. A decision is pending.

In addition to the foregoing claims, various plaintiffs in 1999 and 2000 asserted claims against retailers and distributors. Those claims were severed and stayed pending the outcome of Phase I. Also, 41 plaintiffs asserted smokeless tobacco claims against various smokeless manufacturers, including 14 claims against certain Reynolds Defendants. Those claims were severed from *IPIC* in 2001, and the plaintiffs took no action to prosecute the claims. They now seek to activate their smokeless claims. On January 25, 2017, the trial court denied the defendants' motion to dismiss those claims as abandoned. The plaintiffs are now free to move forward with their claims.

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Engle and Engle Progeny Cases

In July 1998, trial began in *Engle v. R. J. Reynolds Tobacco Co.*, a then-certified class action filed in Circuit Court, Miami-Dade County, Florida, against U.S. cigarette manufacturers, including RJR Tobacco, B&W, Lorillard Tobacco, Philip Morris USA Inc., and others. The then-certified class consisted of Florida citizens and residents, and their survivors, who suffered from smoking-related diseases that first manifested between May 5, 1990, and November 21, 1996, and were caused by an addiction to cigarettes. In July 1999, the jury in Phase I found against RJR Tobacco, B&W, Lorillard Tobacco and the other defendants on common issues relating to the defendants' conduct, general causation, the addictiveness of cigarettes, and entitlement to punitive damages.

On July 14, 2000, the jury in Phase II awarded the class a total of approximately \$145 billion in punitive damages, which were apportioned \$36.3 billion to RJR Tobacco, \$17.6 billion to B&W, and \$16.3 billion to Lorillard Tobacco. The defendants appealed.

On December 21, 2006, the Florida Supreme Court prospectively decertified the class and set aside the jury's Phase II punitive damages award. But the court preserved certain of the jury's Phase I findings, including that cigarettes can cause certain diseases, nicotine is addictive, and defendants placed defective cigarettes on the market, breached duties of care, concealed health-related information, and conspired. The court also authorized former class members to file individual lawsuits within one year, and it stated that the preserved findings would have *res judicata* effect in those actions.

In the year after the Florida Supreme Court's *Engle* decision, putative class members filed thousands of individual actions against RJR Tobacco, B&W, Lorillard Tobacco, Philip Morris USA Inc., and the other *Engle* defendants, which actions commonly are referred to as *Engle* Progeny cases. As of June 30, 2017, 2,682 *Engle* Progeny cases were pending in state courts, and 12 *Engle* Progeny cases were pending in federal court against RJR Tobacco, B&W and/or Lorillard Tobacco. Those cases include claims by or on behalf of approximately 3,492 plaintiffs. As of June 30, 2017, RJR Tobacco also was aware of nine additional *Engle* Progeny cases that have been filed but not served. The number of pending cases fluctuates for a variety of reasons, including voluntary and involuntary dismissals. Voluntary dismissals include cases in which a plaintiff accepts an "offer of judgment," referred to in Florida statutes as "proposals for settlement," from RJR Tobacco, Lorillard Tobacco and/or RJR Tobacco's affiliates and indemnitees. An offer of judgment, if rejected by the plaintiff, preserves RJR Tobacco's and Lorillard Tobacco's right to recover attorneys' fees under Florida law in the event of a verdict favorable to RJR Tobacco or Lorillard Tobacco. Such offers are sometimes made through court-ordered mediations.

At the beginning of the *Engle* Progeny litigation, a central issue was the proper use of the preserved *Engle* findings. RJR Tobacco has argued that use of the *Engle* findings to establish individual elements of progeny claims (such as defect, negligence and concealment) is a violation of federal due process. In 2013, however, both the Florida Supreme Court and the U.S. Court of Appeals for the Eleventh Circuit, referred to as the Eleventh Circuit, rejected that argument. As noted below, the Eleventh Circuit, this time sitting *en banc*, recently heard argument on this issue again. In addition to this global due process argument, RJR Tobacco and Lorillard Tobacco raise many other factual and legal defenses as appropriate in each case. These defenses may include, among other things, arguing that the plaintiff is not a proper member of the *Engle* class, that the plaintiff did not rely on any statements by any tobacco company, that the trial was conducted unfairly, that some or all claims are preempted or barred by applicable statutes of limitation, or that any injury was caused by the smoker's own conduct. In *Hess v. Philip Morris USA Inc.* and *Russo v. Philip Morris USA Inc.*, decided on April 2, 2015, the Florida Supreme Court held that, in *Engle* Progeny cases, the defendants cannot raise a statute of repose defense to claims for concealment or conspiracy. On April 8, 2015, in *Graham v. R. J. Reynolds Tobacco Co.*, the Eleventh Circuit held that federal law impliedly preempts use of the preserved *Engle* findings to establish claims for strict liability or negligence. On January 21, 2016, the Eleventh Circuit granted the plaintiff's motion for rehearing *en banc* and vacated the panel decision. On May 18, 2017, the *en banc* Eleventh Circuit rejected RJR Tobacco's due process and implied preemption arguments. On January 6, 2016, in *Marotta v. R. J. Reynolds Tobacco Co.*, the Fourth DCA disagreed with the *Graham* panel decision and held that federal law does not impliedly preempt any tort claims against cigarette manufacturers, including those of *Engle* Progeny plaintiffs. The Florida Supreme Court accepted jurisdiction in *Marotta*, heard oral argument, and on April 6, 2017, found that federal law does not preempt the *Engle* Progeny plaintiff's claims and remanded for further proceedings on punitive damages.

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

During 2015, RJR Tobacco and Lorillard Tobacco, together with Philip Morris USA Inc., settled virtually all of the *Engle* Progeny cases then pending against them in federal district court. The total amount of the settlement was \$100 million divided as follows: RJR Tobacco - \$42.5 million; Philip Morris USA Inc. - \$42.5 million; and Lorillard Tobacco - \$15 million. The settlement covered more than 400 federal progeny cases but did not cover 12 federal progeny cases previously tried to verdict and currently pending on post-trial motions or appeal; and 2 federal progeny cases filed by different lawyers from the ones who negotiated the settlement for the plaintiffs.

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Between August 3, 2015 and January 4, 2016, RJR Tobacco and Philip Morris USA Inc. removed 39 *Engle* Progeny cases from state to federal courts in Florida. These cases were not part of the settlement described above and were all remanded back to state court.

One hundred thirty-seven *Engle* Progeny cases have been tried in Florida state and federal courts since the beginning of 2014 through June 30, 2017, and additional state court trials are scheduled for 2017 and 2018. Since the beginning of 2014 through June 30, 2017, RJR Tobacco or Lorillard Tobacco has paid judgments in 39 *Engle* Progeny cases. Those payments totaled \$344.1 million and included \$246.3 million for compensatory or punitive damages and \$97.8 million for attorneys' fees and statutory interest. In addition, accruals for damages and attorneys' fees and statutory interest for *Starr-Blundell*, *Monroe*, *Lourie*, *Lewis*, and *Block* and an accrual for attorneys' fees and interest for *Ward* were recorded in RAI's condensed consolidated balance sheet (unaudited) as of June 30, 2017. The following chart reflects the details of accrued compensatory damages related to *Starr-Blundell*, *Monroe*, *Lourie*, *Lewis* and *Block*.

Plaintiff Case Name	RJR Tobacco Allocation of Fault	Lorillard Tobacco Allocation of Fault	Compensatory Damages (as adjusted) ⁽¹⁾	Punitive Damages	Appeal Status
<i>Starr-Blundell</i>	10%	—	\$ 50,000	\$ —	First DCA, <i>per curiam</i> , reversed and remanded its May 29, 2015 opinion to the trial court for reconsideration in light of the decision in <i>Soffer</i> ; retrial limited to punitive damages on the plaintiff's non-intentional tort claims is scheduled for February 2018
<i>Monroe</i>	58%	—	6,380,000	—	First DCA affirmed the final judgment, <i>per curiam</i> , on March 23, 2017; Florida Supreme Court declined to accept jurisdiction on June 13, 2017; deadline to file petition for writ of certiorari with the U.S. Supreme Court is September 11, 2017
<i>Lourie</i>	3%	7%	137,000	—	Second DCA affirmed the final judgment; Florida Supreme Court declined to accept jurisdiction based on their decision in <i>Marotta</i> ; deadline to file a petition for writ of certiorari with the U.S. Supreme Court is September 18, 2017
<i>Lewis</i>	25%	—	187,500	—	Fifth DCA affirmed the final judgment, <i>per curiam</i> , on May 2, 2017; deadline to file a petition for writ of certiorari with the U.S. Supreme Court is September 29, 2017
<i>Block</i>	50%	—	463,000	800,000	Fourth DCA affirmed the final judgment, <i>per curiam</i> , on April 27, 2017; deadline to file a petition for writ of certiorari with the U.S. Supreme Court is September 22, 2017
Totals			<u>\$ 7,217,500</u>	<u>\$ 800,000</u>	

⁽¹⁾ Compensatory damages are adjusted to reflect the reduction that may be required by the allocation of fault. Punitive damages are not adjusted and reflect the amount of the final judgment(s) signed by the trial court judge(s). The amount listed above does not include attorneys' fees or statutory interest of approximately \$3.6 million in *Starr-Blundell*, *Monroe*, *Lourie*, *Lewis* and *Block* or approximately \$1.6 million in attorneys' fees and statutory interest in *Ward*.

The following chart lists judgments in all other individual *Engle* Progeny cases pending as of June 30, 2017, in which a verdict or judgment has been returned against RJR Tobacco, B&W, and/or Lorillard Tobacco and the verdict or judgment has not been set aside

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

on appeal. No liability for any of these cases has been recorded in RAI's condensed consolidated balance sheet (unaudited) as of June 30, 2017. This chart does not include the mistrials or verdicts returned in favor of RJR Tobacco, B&W, and/or Lorillard Tobacco.

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

Plaintiff Case Name	RJR Tobacco Allocation of Fault	Lorillard Tobacco Allocation of Fault	Compensatory Damages (as adjusted) ⁽¹⁾	Punitive Damages	Appeal Status
<i>Putney</i>	30%	—	\$ —	\$ 2,500,000	Fourth DCA reinstated the punitive damages awards of \$2.5 million each against RJR Tobacco and the remaining defendant; court's opinion that previously granted remittitur of the compensatory damages awards still stands; remanded to trial court for further proceedings
<i>Andy Allen</i>	24%	—	2,475,000	7,756,000	First DCA affirmed the judgment of the trial court; First DCA granted defendants' motion for rehearing <i>en banc</i> on June 15, 2017, and ordered further briefing
<i>Calloway</i>	27%	18%	—	—	Fourth DCA granted rehearing <i>en banc</i> and substituted a new opinion ordering a new trial based on improper argument; plaintiff filed a petition for writ of certiorari with the U.S. Supreme Court on June 14, 2017; a new trial date has not been scheduled
<i>James Smith</i>	55%	—	600,000 ⁽²⁾	20,000	Pending – Eleventh Circuit
<i>Evers</i>	60%	9%	2,950,000	12,360,000	Second DCA reinstated punitive damage award of \$12.36 million the trial court had set aside; the verdict was reinstated on remand; a subsequent appeal is pending in the Second DCA; oral argument occurred on February 7, 2017; decision is pending
<i>Schoeff</i>	75%	—	7,875,000	—	Pending – Florida Supreme Court
<i>Marotta</i>	58%	—	3,480,000	—	Florida Supreme Court found that federal law does not preempt the plaintiff's claims; remanded for further proceedings regarding punitive damages; trial has been scheduled for the July 4, 2018 through September 28, 2018 trial calendar
<i>Searcy</i>	30%	—	500,000 ⁽²⁾	1,670,000	Pending – Eleventh Circuit
<i>Earl Graham</i>	20%	—	550,000	—	Eleventh Circuit, sitting <i>en banc</i> , rejected the defendants' due process and implied preemption claims with dissents; deadline to file a petition for writ of certiorari with the U.S. Supreme Court is September 15, 2017
<i>Grossman</i>	75%	—	11,514,000	22,500,000	Fourth DCA ordered award of compensatory damages reduced to reflect comparative fault, but otherwise affirmed; RJR Tobacco's motion for rehearing was denied on March 16, 2017; plaintiff and RJR Tobacco filed notices to invoke the discretionary jurisdiction of the Florida Supreme Court; decision is pending
<i>Burkhart</i>	25%	10%	3,500,000 ⁽²⁾	1,750,000	Pending – Eleventh Circuit
<i>Bakst (Odom)</i>	75%	—	—	—	Fourth DCA reversed the judgment of the trial court and remanded the case for a new trial on damages only; motion for rehearing was denied on February 27, 2017; the plaintiff filed a notice to invoke the discretionary jurisdiction of the Florida Supreme Court on March 27, 2017; decision is pending
<i>Robinson</i>	71%	—	—	—	First DCA reversed judgment and remanded case for a new trial and denied rehearing; new trial has not been scheduled; on June 14, 2017, the plaintiff filed a notice to invoke the discretionary jurisdiction of the Florida Supreme Court; decision is pending
<i>Harris</i>	15%	10%	1,100,000 ⁽²⁾	—	Post-trial motions are pending ⁽³⁾

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

<i>Irimi</i>	14.5%	14.5%	—	—	Pending – Fourth DCA
<i>Kerrivan</i>	31%	—	6,046,660 ⁽²⁾	9,600,000	Post-trial motions are pending ⁽³⁾
<i>Schleider</i>	70%	—	14,700,000	—	Pending – Third DCA
<i>Perrotto</i>	20%	6%	1,063,000	—	Plaintiff's motion for a new trial granted as to punitive damages; new trial scheduled for December 1, 2017
<i>Ellen Gray</i>	50%	—	3,000,000	—	Post-trial motions are pending ⁽³⁾
<i>Sowers</i>	50%	—	2,125,000	—	Post-trial motions are pending ⁽³⁾
<i>Caprio</i>	20%	10%	167,700	—	New trial scheduled for August 9, 2017
<i>Zamboni</i>	30%	—	102,000	—	Final judgment has not been entered
<i>Pollari</i>	42.5%	—	4,250,000	1,500,000	Pending – Fourth DCA
<i>Gore</i>	23%	—	460,000	—	Pending – Fourth DCA
<i>Ryan</i>	65%	—	13,975,000	25,000,000	Pending – Fourth DCA
<i>Hardin</i>	13%	—	100,880	—	Third DCA remanded the case for a new trial on punitive damages for the non-intentional tort claims; new trial is scheduled to begin August 21, 2017
<i>McCoy</i>	25%	20%	670,000	6,000,000	Pending – Fourth DCA
<i>Cooper</i>	40%	—	1,200,000	—	Pending – Fourth DCA
<i>Duignan</i>	30%	—	2,690,000 ⁽²⁾	2,500,000	Pending – Second DCA
<i>O'Hara</i>	85%	—	14,700,000	20,000,000	Pending – First DCA
<i>Marchese</i>	22.5%	—	225,000	250,000	Pending – Fourth DCA
<i>Barbose</i>	42.5%	—	5,000,000 ⁽²⁾	500,000	Pending – Second DCA
<i>Ledoux</i>	47%	—	5,000,000 ⁽²⁾	12,500,000	Pending – Third DCA
<i>Ewing</i>	2%	—	4,800	—	Post-trial motions denied; final judgment has not been entered
<i>Ahrens</i>	44%	—	5,800,000 ⁽²⁾	2,500,000	Second DCA affirmed the final judgment, <i>per curiam</i> ; defendants' motion for a written opinion granted; new opinion substituted; deadline for the defendants to file a notice to invoke the discretionary jurisdiction of the Florida Supreme Court is August 11, 2017
<i>Turner</i>	80%	—	2,400,000	10,000,000	Pending – Fourth DCA
<i>Enochs</i>	66%	—	13,860,000	6,250,000	Pending – Fourth DCA
<i>Dion</i>	75%	—	12,000,000 ⁽²⁾	30,000	Pending – Second DCA
<i>Nally</i>	75%	—	6,000,000 ⁽²⁾	12,000,000	Pending – Second DCA
<i>McCabe</i>	30%	—	1,500,000	6,500,000	Pending – Second DCA
<i>Sermons</i>	5%	—	3,250	17,075	Post-trial motions are pending ⁽³⁾
<i>Mathis</i>	55%	—	5,000,000 ⁽²⁾	—	Pending – Third DCA
<i>Oshinsky-Blacker</i>	25%	—	—	—	Pending – Fourth DCA
<i>Sherry Smith</i>	65%	—	3,000,000 ⁽²⁾	—	Pending – Fifth DCA
<i>Prentice</i>	40%	—	2,560,000	—	Pending – First DCA
<i>Konzelman</i>	85%	—	7,476,000	20,000,000	Pending – Fourth DCA
<i>Ledo</i>	49%	—	2,940,000	—	Post-trial motions are pending ⁽³⁾
<i>Johnston</i>	90%	—	6,750,000	14,000,000	Pending – Second DCA
<i>Howles</i>	50%	—	2,000,000	3,000,000	Pending – Fourth DCA
<i>Ford</i>	15%	—	153,400	—	Pending – Fourth DCA
<i>Martin</i>	22%	—	1,190,400	200,000	Pending – Fourth DCA
<i>Pardue</i>	50%	—	3,467,000 ⁽²⁾	6,750,000	Pending – First DCA
<i>John Brown</i>	35%	—	2,700,000 ⁽²⁾	200,000	Post-trial motions are pending ⁽³⁾
<i>Fox</i>	50%	—	3,000,000	—	Post-trial motions denied; RJR Tobacco filed a notice of appeal to the Fourth DCA on July 24, 2017
<i>Whitmire</i>	67%	—	3,000,000 ⁽²⁾	—	Pending – First DCA
<i>Santoro</i>	26%	—	417,000	90,000	Post-trial motions are pending ⁽³⁾
<i>Lima</i>	60%	—	1,800,000	12,000,000	Post-trial motions are pending ⁽³⁾

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

<i>Sheffield</i>	60%	—	1,800,000 ⁽²⁾	5,000,000	Post-trial motions denied and final judgment entered against RJR Tobacco in the amount of \$1.8 million in compensatory damages and \$5 million in punitive damages; deadline for RJR Tobacco to file a notice of appeal to the Fifth DCA is August 9, 2017
<i>Maloney</i>	50%	—	1,650,000 ⁽²⁾	—	Post-trial motions are pending ⁽³⁾
<i>Thomas</i>	55%	—	2,200,000	—	Post-trial motions are pending ⁽³⁾
Totals			<u>\$202,691,090</u>	<u>\$224,943,075</u>	

⁽¹⁾ Unless otherwise noted, compensatory damages in these cases are adjusted to reflect the jury’s allocation of comparative fault. Punitive damages are not so adjusted. The amounts listed above do not include attorneys’ fees or statutory interest that may apply to the judgments and such fees and interest may be material.

⁽²⁾ The court did not apply comparative fault in the final judgment.

⁽³⁾ Should the pending post-trial motions be denied, RJR Tobacco will likely file a notice of appeal with the appropriate appellate court.

As reflected in the preceding chart, as of June 30, 2017, verdicts or judgments in favor of *Engle* Progeny plaintiffs have been entered and remain outstanding against RJR Tobacco or Lorillard Tobacco totaling \$202,691,090 in compensatory damages (as adjusted) and \$224,943,075 in punitive damages, which is a combined total of \$427,634,165. These verdicts or judgments are at various stages in the post-trial or appellate process. RJR Tobacco believes that RJR Tobacco and Lorillard Tobacco have valid defenses in these cases, including case-specific issues beyond the due process issue discussed above, and, as described in more detail above in “— Accounting for Tobacco-Related Litigation Contingencies,” RJR Tobacco and its affiliates vigorously defend smoking and health claims, including *Engle* Progeny cases.

Should RJR Tobacco or Lorillard Tobacco not prevail in any particular individual *Engle* Progeny case or determine that in any individual *Engle* Progeny case an unfavorable outcome has become probable and the amount can be reasonably estimated, a loss would be recognized, which could have a material adverse effect on the results of operations, cash flows and financial position of RAI. This position on loss recognition for *Engle* Progeny cases as of June 30, 2017, is consistent with RAI’s and RJR Tobacco’s historic position on loss recognition for other smoking and health litigation. It is the policy of RJR Tobacco to record any loss concerning litigation at such time as an unfavorable outcome becomes probable and the amount can be reasonably estimated on an individual case-by-case basis.

Below is a description of the *Engle* Progeny cases against RJR Tobacco, B&W, and/or Lorillard Tobacco that went to trial or were decided during the period from January 1, 2017 to June 30, 2017, or remained on appeal as of June 30, 2017, listed chronologically by the date of the verdict. In each case, the plaintiff: (1) alleged that the smoker was addicted to nicotine in cigarettes and, as a result of that addiction, suffered or died from one or more smoking-related diseases; (2) asserted claims based on theories of negligence, strict liability, and intentional tort; and (3) sought to recover unspecified compensatory damages, as well as attorneys’ fees and costs. The plaintiffs in most, but not all, cases also sought to recover punitive damages.

On April 13, 2010, in *Putney v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Broward County, Fla., filed 2007), a jury in Phase I of the trial returned a verdict for the plaintiff. On April 26, 2010, the jury in Phase II of the trial found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$15.1 million in compensatory damages; found the decedent 35% at fault, RJR Tobacco 30% at fault and the remaining defendants collectively 35% at fault; and awarded \$2.5 million in punitive damages against each of RJR Tobacco and one of the remaining defendants. In August 2010, the trial court entered final judgment against RJR Tobacco in the amount of \$4.5 million in compensatory damages and \$2.5 million in punitive damages. In December 2010, the trial court entered an amended final judgment to provide that interest would run from April 26, 2010. In June 2013, the Fourth DCA held that the trial court erred in denying the defendants’ motion for remittitur of the compensatory damages for loss of consortium and in striking the defendants’ statute of repose affirmative defenses. As a result, the Fourth DCA reversed and remanded for further proceedings. After its April 2, 2015, ruling in *Hess v. Philip Morris USA Inc.* that *Engle* Progeny defendants cannot raise a statute of repose defense to claims for concealment or conspiracy, the Florida Supreme Court, on February 1, 2016, accepted jurisdiction in *Putney*, quashed the Fourth DCA’s decision and reinstated the verdict. On March 15, 2016, the Florida Supreme Court granted the defendants’ motion for clarification in an order stating that remand was for reconsideration only on the issue of the statute of repose. On August 31, 2016, the Fourth DCA entered a new opinion following remand from the Florida Supreme Court. The court reinstated the punitive damages awards of \$2.5 million each against RJR Tobacco and the remaining defendant. The court’s opinion that previously granted remittitur of the compensatory damages awards still stands. The matter has been remanded to the trial court for further proceedings.

On April 21, 2010, in *Grossman v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Broward County, Fla., filed 2007), the jury, in Phase I of a retrial that followed a mistrial, returned a verdict for the plaintiff. On April 29, 2010, the jury in Phase II of the retrial found for the plaintiff on the strict liability claim and for RJR Tobacco on the negligence, warranty, and intentional tort claims; awarded \$1.9 million

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

in compensatory damages; found RJR Tobacco 25% at fault, the decedent 70% at fault, and the decedent's spouse 5% at fault; and did not reach the issue of entitlement to punitive damages. In June 2010, the trial court entered final judgment against RJR Tobacco in the amount of approximately \$484,000 in compensatory damages. In June 2012, the Fourth DCA affirmed the trial court's judgment, but remanded for a new trial on all Phase II issues. On July 31, 2013, the jury in the second retrial found for the plaintiff on the intentional tort claims, awarded \$15.35 million in compensatory damages, found the decedent 25% at fault and RJR Tobacco 75% at fault, and awarded \$22.5 million in punitive damages. The trial court entered final judgment in August 2013 and did not include a reduction for comparative fault. RJR Tobacco appealed, and the plaintiff cross appealed. On January 4, 2017, the Fourth DCA ordered the award of compensatory damages be reduced to reflect the comparative fault allocation assigned by the jury, but otherwise affirmed the final judgment. RJR Tobacco's motion for rehearing was denied on March 16, 2017. The plaintiff filed a notice to invoke the discretionary jurisdiction of the Florida Supreme Court on April 13, 2017. RJR Tobacco filed a notice to invoke the discretionary jurisdiction of the Florida Supreme Court on April 14, 2017. In orders dated April 19, 2017, and April 21, 2017, the Florida Supreme Court stayed those matters pending the resolution of *Schoeff*, described below. On May 11, 2017, the Florida Supreme Court lifted the stay as to RJR Tobacco's notice to invoke the court's jurisdiction. Jurisdictional briefing is complete, and a decision is pending.

On April 26, 2011, in *Andy Allen v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Duval County, Fla., filed 2007), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$6 million in compensatory damages; found RJR Tobacco 45% at fault, the decedent 40% at fault, and the remaining defendant 15% at fault; and awarded \$17 million in punitive damages against each defendant. The trial court entered final judgment against RJR Tobacco in the amount of \$19.7 million in May 2011 and, in October 2011, entered a remittitur of the punitive damages to \$8.1 million. In May 2013, the First DCA reversed and remanded the case for a new trial. On November 24, 2014, the jury in the retrial found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$3.1 million in compensatory damages; found the decedent 70% at fault, RJR Tobacco 24% at fault, and the remaining defendant to be 6% at fault; and found that the plaintiff was entitled to punitive damages. On November 26, 2014, the jury awarded approximately \$7.75 million in punitive damages against each defendant. In August 2015, the trial court entered final judgment against RJR Tobacco and the remaining defendant, jointly and severally, in the amount of approximately \$3.1 million in compensatory damages and \$7.75 million in punitive damages from each defendant. In September 2015, the defendants filed a notice of appeal to the First DCA. On February 24, 2017, the First DCA affirmed the judgment of the trial court. The court granted the defendants' motion for rehearing *en banc* on June 15, 2017. Supplemental briefing is underway.

On May 17, 2012, in *Calloway v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Broward County, Fla., filed 2007), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$20.5 million in compensatory damages; found the decedent 20.5% at fault, RJR Tobacco 27% at fault, Lorillard Tobacco 18% at fault, and the remaining defendants collectively 34.5% at fault; and found that the plaintiff was entitled to punitive damages. On May 31, 2012, the jury awarded punitive damages in the amount of \$17.25 million against RJR Tobacco, \$12.6 million against Lorillard Tobacco, and \$25 million collectively against the remaining defendants. The trial court later determined that the jury's apportionment of comparative fault did not apply to the compensatory damages award and, in August 2012, entered final judgment. On January 6, 2016, the Fourth DCA reversed the fraudulent concealment and conspiracy claims, reversed the punitive damages award, and remanded the case for a new trial on those issues. On September 23, 2016, the Fourth DCA, sitting *en banc*, reversed the judgment in its entirety and remanded the case for a new trial. On March 16, 2017, the Florida Supreme Court declined to accept jurisdiction of the case. The new trial has not been scheduled. On June 14, 2017, the plaintiff filed a petition for writ of certiorari with the U.S. Supreme Court. A decision is pending.

On October 17, 2012, in *James Smith v. R. J. Reynolds Tobacco Co.* (U.S.D.C. M.D. Fla., filed 2007), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$600,000 in compensatory damages; found the decedent 45% at fault and RJR Tobacco 55% at fault; and found that the plaintiff was entitled to punitive damages. On October 18, 2012, the jury awarded \$20,000 in punitive damages. The trial court entered final judgment against RJR Tobacco in the amount of \$620,000. RJR Tobacco appealed to the Eleventh Circuit and posted a supersedeas bond in the amount of approximately \$620,000. Oral argument occurred on October 17, 2014. A decision is pending.

On February 11, 2013, in *Evers v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Hillsborough County, Fla., filed 2007), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$3.23 million in compensatory damages; found the decedent 31% at fault, RJR Tobacco 60% at fault and Lorillard Tobacco 9% at fault; and found that the plaintiff was entitled to punitive damages from RJR Tobacco but not from Lorillard Tobacco. On February 12, 2013, the jury awarded \$12.36 million in punitive damages against RJR Tobacco. In March 2013, the trial court granted the defendants' post-trial motions for directed verdict on fraudulent concealment, conspiracy and punitive damages and set aside the \$12.36 million punitive damages award. The trial court entered final judgment in the amount of \$1.77 million against RJR Tobacco and approximately \$266,000 against Lorillard Tobacco. On November 6, 2015, the Second DCA concluded that the trial court erred in granting the defendants' motion for directed verdict on claims for fraud by concealment and conspiracy to commit fraud by concealment, and reversed and reinstated the jury's verdict on those two claims. As a result, the punitive damages award was reinstated. On remand, the jury's verdict was reinstated. On March 14, 2016, the trial court entered an amended final judgment against RJR Tobacco in the amount of \$2.95 million in compensatory damages and \$12.36 million

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

in punitive damages. In April 2016, RJR Tobacco appealed to the Second DCA and posted a supersedeas bond in the amount of \$5 million. Oral argument occurred on February 7, 2017. A decision is pending.

On February 13, 2013, in *Schoeff v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Broward County, Fla., filed 2007), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$10.5 million in compensatory damages; found the decedent 25% at fault and RJR Tobacco 75% at fault; and found that the plaintiff was entitled to punitive damages. On February 14, 2013, the jury awarded \$30 million in punitive damages. In April 2013, the trial court entered final judgment against RJR Tobacco in the amount of \$7.88 million in compensatory damages and \$30 million in punitive damages. On November 4, 2015, the Fourth DCA reversed the punitive damages portion of the final judgment and remanded the case to the trial court, directing the trial court to grant RJR Tobacco's motion for remittitur and, if RJR Tobacco does not agree with the remitted amount, to hold a new trial on punitive damages. On May 26, 2016, the Florida Supreme Court accepted jurisdiction of the case. Oral argument occurred on March 8, 2017. A decision is pending.

On March 20, 2013, in *Marotta v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Broward County, Fla., filed 2007), the jury, in a retrial following a mistrial, found for the plaintiff on the strict liability claim and for RJR Tobacco on the negligence and intentional tort claims, awarded \$6 million in compensatory damages, found the decedent 42% at fault and RJR Tobacco 58% at fault, and did not reach the issue of entitlement to punitive damages. The trial court later entered final judgment against RJR Tobacco in the amount of \$3.48 million. On January 6, 2016, the Fourth DCA affirmed, disagreeing with the Eleventh Circuit panel decision in *Graham*, discussed below, regarding whether federal law preempts the plaintiff's claims. The Fourth DCA also certified a question presenting the preemption issue to the Florida Supreme Court. On March 8, 2016, the Florida Supreme Court accepted jurisdiction of the case. On April 6, 2017, the Florida Supreme Court rephrased the certified question and then found that federal law does not preempt the plaintiff's claims. The Florida Supreme Court then remanded the case to the Fourth DCA for further proceedings regarding punitive damages in light of its decision in *Soffer*. On May 2, 2017, the Fourth DCA remanded the case to the trial court for a trial on punitive damages. The trial has been scheduled for the July 4, 2018 through September 28, 2018 trial calendar.

On April 1, 2013, in *Searcy v. R. J. Reynolds Tobacco Co.* (U.S.D.C. M.D. Fla., filed 2008), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$6 million in compensatory damages; found the decedent 40% at fault, RJR Tobacco 30% at fault and the remaining defendant 30% at fault; and awarded \$10 million in punitive damages against each defendant. The trial court later entered final judgment against RJR Tobacco in the amount of \$6 million in compensatory damages and \$10 million in punitive damages. In September 2013, the trial court granted the defendants' motion for a new trial, or in the alternative, reduction or remittitur of the damages awarded to the extent it sought remittitur of the damages. The compensatory damage award was remitted to \$1 million, and the punitive damage award was remitted to \$1.67 million against each defendant. The plaintiff filed a notice of acceptance of remittitur in November 2013, and the trial court issued an amended final judgment. The defendants appealed to the Eleventh Circuit, and RJR Tobacco posted a supersedeas bond in the amount of approximately \$2.2 million. Oral argument occurred on October 17, 2014. The court ordered the parties to file supplemental briefs addressing the impact of *Graham*, described below. Briefs have been submitted, and a decision is pending.

On May 2, 2013, in *David Cohen v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Palm Beach County, Fla., filed 2007), a jury found for the plaintiff on the negligence and strict liability claims and for the defendants on the intentional tort claims; awarded \$2.06 million in compensatory damages; found the decedent 40% at fault, RJR Tobacco 30% at fault, Lorillard Tobacco 20% at fault and the remaining defendant 10% at fault; and did not reach the issue of entitlement to punitive damages. In May 2013, the trial court entered final judgment against RJR Tobacco in the amount of \$617,000 and against Lorillard Tobacco in the amount of approximately \$411,000. In July 2013, the court granted the defendants' motion for a new trial due to the plaintiff's improper arguments during closing. The new trial date has not been scheduled. The plaintiff filed a notice of appeal to the Fourth DCA, and the defendants filed a notice of cross appeal. On September 7, 2016, the Fourth DCA affirmed the trial court's order granting RJR Tobacco's motion for a new trial. The Florida Supreme Court declined to accept jurisdiction of the case on March 16, 2017. The plaintiff did not seek further review.

On May 23, 2013, in *Earl Graham v. R. J. Reynolds Tobacco Co.* (U.S.D.C. M.D. Fla., filed 2008), a jury found for the plaintiff on the negligence and strict liability claims and for the defendants on the intentional tort claims; awarded \$2.75 million in compensatory damages; found the decedent 70% at fault, RJR Tobacco 20% at fault, and the remaining defendant 10% at fault, and did not reach the issue of entitlement to punitive damages. In May 2013, the trial court entered final judgment against RJR Tobacco in the amount of \$550,000. On April 8, 2015, the Eleventh Circuit reversed and ordered entry of judgment for RJR Tobacco. The Eleventh Circuit held that federal law impliedly preempts claims for strict liability and negligence based on the defect and negligence findings from *Engle*. On January 21, 2016, the plaintiff's motion for rehearing *en banc* was granted, and the panel's decision was vacated. On March 23, 2016, the Eleventh Circuit requested briefing on the issues of whether plaintiff's claims are preempted and, if not, whether the defendants' due process rights are violated. On May 18, 2017, the Eleventh Circuit issued its *en banc* opinion. The court held that giving preclusive effect to the findings of negligence and strict liability by the *Engle* jury in individual actions by *Engle* class members against the tobacco companies is not preempted by federal tobacco laws and does not deprive the tobacco companies of due process. The judgment against RJR Tobacco and the remaining defendant was affirmed. The deadline for the defendants to file a petition for writ of certiorari with the U.S. Supreme Court is September 15, 2017.

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

On June 4, 2013, in *Starr-Blundell v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Duval County, Fla., filed 2007), a jury found for the plaintiff on the negligence and strict liability claims and for the defendants on the intentional tort claims; awarded \$500,000 in compensatory damages; found the decedent 80% at fault, RJR Tobacco 10% at fault and the remaining defendant 10% at fault; and did not reach the issue of entitlement to punitive damages. In November 2013, the trial court entered final judgment in the amount of \$50,000 against each defendant. On May 29, 2015, the First DCA affirmed the final judgment of the trial court, *per curiam*. On June 29, 2015, the plaintiff filed a notice to invoke the discretionary jurisdiction of the Florida Supreme Court. On May 24, 2016, the Florida Supreme Court accepted jurisdiction of the case, quashed the decision of the First DCA, and remanded the case for reconsideration in light of *Soffer*. On September 6, 2016, the First DCA, *per curiam*, reversed and remanded its May 29, 2015 opinion to the trial court for reconsideration in light of the decision in *Soffer*. Retrial is scheduled for February 2018.

On May 15, 2014, in *Burkhart v. R. J. Reynolds Tobacco Co.* (U.S.D.C. M.D. Fla., filed 2008), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$5 million in compensatory damages; found the plaintiff 50% at fault, RJR Tobacco 25% at fault, Lorillard Tobacco 10% at fault and the remaining defendant 15% at fault; and found that the plaintiff was entitled to punitive damages. On May 16, 2014, the jury awarded punitive damages of \$1.25 million against RJR Tobacco, \$500,000 against Lorillard Tobacco, and \$750,000 against the remaining defendant. In June 2014, the trial court entered final judgment without a reduction for comparative fault. The defendants appealed to the Eleventh Circuit, RJR Tobacco posted a supersedeas bond in the amount of approximately \$3.8 million, and Lorillard Tobacco posted a supersedeas bond in the amount of approximately \$1.5 million. Oral argument occurred on September 29, 2015. A decision is pending.

On June 23, 2014, in *Bakst v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Palm Beach County, Fla., filed 2007), a case now known as *Odom v. R. J. Reynolds Tobacco Co.*, a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded approximately \$6 million in compensatory damages; found the decedent 25% at fault and RJR Tobacco 75% at fault; and found that the plaintiff was entitled to punitive damages. On June 23, 2014, the jury awarded \$14 million in punitive damages. The trial court later entered final judgment against RJR Tobacco in the amount of \$4.5 million in compensatory damages and \$14 million in punitive damages. RJR Tobacco appealed to the Fourth DCA. On November 30, 2016, the Fourth DCA reversed the trial court's judgment and remanded the case with directions that the trial court grant the motion for remittitur or order a new trial on damages only. RJR Tobacco filed a motion for rehearing on January 9, 2017, requesting that the Fourth DCA grant rehearing or withdraw the section of its opinion addressing the propriety of the plaintiff's closing argument or grant rehearing *en banc* on the improper argument issue. On February 27, 2017, the Fourth DCA denied RJR Tobacco's motion for rehearing. The plaintiff filed a notice to invoke the discretionary jurisdiction of the Florida Supreme Court on March 27, 2017. A decision is pending.

On July 17, 2014, in *Robinson v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Escambia County, Fla., filed 2008), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$16.9 million in compensatory damages; found the decedent 29.5% at fault and RJR Tobacco 70.5% at fault; and found that the plaintiff was entitled to punitive damages. On July 18, 2014, the jury awarded \$23.6 billion in punitive damages. In July 2014, the trial court entered partial judgment on compensatory damages against RJR Tobacco in the amount of \$16.9 million. On January 27, 2015, the trial court remitted the punitive damages award to approximately \$16.9 million. In February 2015, RJR Tobacco filed an objection to the remitted award of punitive damages and a demand for a new trial on damages. The trial court granted a new trial on the amount of punitive damages only. The new trial on punitive damages has been stayed pending RJR Tobacco's appeal to the First DCA of the partial judgment of compensatory damages and of the order granting a new trial on the amount of punitive damages only. On February 24, 2017, the First DCA reversed the judgment of the trial court and remanded the case for a new trial. The new trial has not been scheduled. On May 17, 2017, the First DCA denied the plaintiff's motion for rehearing. The plaintiff filed a notice to invoke the discretionary jurisdiction of the Florida Supreme Court on June 14, 2017. A decision is pending.

On July 31, 2014, in *Harris v. R. J. Reynolds Tobacco Co.* (U.S.D.C. M.D. Fla., filed 2008), a jury found for the plaintiff on the negligence and strict liability claims and for the defendants on the intentional tort claims; awarded \$400,000 in compensatory damages for the wrongful death claim and \$1.3 million in compensatory damages for the survival claim; allocated fault to the decedent (60% survival/70% wrongful death), RJR Tobacco (15% survival/10% wrongful death), Lorillard Tobacco (10% survival/10% wrongful death), and the remaining defendant (15% survival/10% wrongful death), and found that the plaintiff was not entitled to punitive damages. In December 2014, the trial court entered final judgment. Post-trial motions are pending, but in April 2015, the court stayed all post-trial proceedings pending resolution of the petition for *en banc* consideration in *Graham*, described above. On May 31, 2017, the plaintiff asked the court to lift the stay. A decision is pending.

On August 28, 2014, in *Irimi v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Broward County, Fla., filed 2007), a jury found for the plaintiff on the negligence, strict liability, and certain intentional tort claims and for one or more defendants on certain intentional tort claims; awarded approximately \$3.1 million in compensatory damages; found the decedent 70% at fault, RJR Tobacco 14.5% at fault, Lorillard Tobacco 14.5% at fault and the remaining defendant 1% at fault; and did not reach the issue of entitlement to punitive damages. The trial court entered final judgment against each of RJR Tobacco and Lorillard Tobacco in the amount of approximately \$453,000 and against the remaining defendant in the amount of approximately \$31,000. On January 29, 2015, the court granted the defendants' motion

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for a new trial. The plaintiff appealed to the Fourth DCA, and the defendants cross appealed. Oral argument occurred on July 12, 2017. A decision is pending.

On October 10, 2014, in *Lourie v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Hillsborough County, Fla., filed 2007), a jury found for the plaintiff on the negligence and strict liability claims and for the defendants on the intentional tort claims; awarded approximately \$1.37 million in compensatory damages; found the decedent 63% at fault, RJR Tobacco 3% at fault, Lorillard Tobacco 7% at fault and the remaining defendant 27% at fault; and found that the plaintiff was not entitled to punitive damages. The trial court later entered final judgment. The defendants appealed to the Second DCA in November 2014. On August 10, 2016, the Second DCA affirmed the final judgment. The defendants filed a notice to invoke the discretionary jurisdiction of the Florida Supreme Court on September 8, 2016. On June 19, 2017, the Florida Supreme Court denied the defendants' petition for review based on their decision in *Marotta*, described above. The deadline for the defendants to file a petition for writ of certiorari with the U.S. Supreme Court is September 18, 2017.

On October 20, 2014, in *Kerrivan v. R. J. Reynolds Tobacco Co.* (U.S.D.C. M.D. Fla., filed 2008), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$15.8 million in compensatory damages; found the plaintiff 19% at fault, RJR Tobacco 31% at fault and the remaining defendant 50% at fault; and found that the plaintiff was entitled to punitive damages. On October 22, 2014, the jury awarded \$9.6 million in punitive damages against RJR Tobacco and \$15.7 million against the remaining defendant. In November 2014, the trial court entered final judgment. RJR Tobacco filed its post-trial motions on December 11, 2014. On June 23, 2017, the court lifted the stay that had been in place pending the *en banc* decision in *Graham*, described above, and directed the parties to file supplemental briefs. Briefs have been submitted, and a decision is pending.

On November 18, 2014, in *Schleider v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Miami-Dade County, Fla., filed 2008), a jury found for the plaintiff on the negligence, strict liability, and certain intentional tort claims and for RJR Tobacco on certain intentional tort claims, awarded \$21 million in compensatory damages, found the decedent 30% at fault and RJR Tobacco 70% at fault, and found that the plaintiff was not entitled to punitive damages. In June 2015, the trial court entered final judgment against RJR Tobacco in the amount of \$14.7 million. RJR Tobacco appealed to the Third DCA and posted a supersedeas bond in the amount of \$5 million. Briefing is complete. Oral argument occurred on June 19, 2017. A decision is pending.

On November 21, 2014, in *Perrotto v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Palm Beach County, Fla., filed 2007), a jury found for the plaintiff on the negligence and strict liability claims and for the defendants on the intentional tort claims; awarded \$4.1 million in compensatory damages; found the decedent 49% at fault, RJR Tobacco 20% at fault, Lorillard Tobacco 6% at fault and the remaining defendant 25% at fault; and did not reach the issue of entitlement to punitive damages. Final judgment was entered against RJR Tobacco in the amount of approximately \$818,000 and against Lorillard Tobacco in the amount of approximately \$245,000. In May 2016, the court granted the plaintiff's motion for a new trial on punitive damages but denied it in all other respects. The new trial is scheduled to begin December 1, 2017.

On December 19, 2014, in *Haliburton v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Palm Beach County, Fla., filed 2008), a jury found that the plaintiff's claims were time-barred, which resulted in a verdict for RJR Tobacco. On April 14, 2015, the trial court entered final judgment in favor of RJR Tobacco. The plaintiff appealed to the Fourth DCA, and RJR Tobacco cross appealed. On February 22, 2017, the Fourth DCA affirmed the judgment of the trial court, *per curiam*. On May 5, 2017, the Fourth DCA denied the plaintiff's motion for written opinion or for certification of a question of great public importance and/or certification of direct conflict to the Florida Supreme Court. The deadline for the plaintiff to file a petition for writ of certiorari with the U.S. Supreme Court is August 3, 2017.

On January 29, 2015, in *Ellen Gray v. R. J. Reynolds Tobacco Co.* (U.S.D.C. M.D. Fla., filed 2008), a jury found for the plaintiff on the negligence and strict liability claims and for RJR Tobacco on the intentional tort claims, awarded \$6 million in compensatory damages, and found the decedent 50% at fault and RJR Tobacco 50% at fault. Although the jury ignored an instruction on the verdict form and found that the plaintiff was entitled to punitive damages, there was no punitive damage award. In February 2015, the trial court entered final judgment against RJR Tobacco in the amount of \$3 million. Post-trial motions are pending. On June 10, 2015, the court granted RJR Tobacco's motion to stay the case pending resolution of the petition for *en banc* consideration in *Graham*, described above. On June 14, 2017, the court lifted the stay and directed the parties to file supplemental briefs. Briefing is complete. A decision is pending.

On February 10, 2015, in *Hecht v. R. J. Reynolds Tobacco Co.* (U.S.D.C. M.D. Fla., filed 2008), a jury found that the plaintiff's claims were time-barred, which resulted in a verdict in favor of RJR Tobacco. Post-trial proceedings have been stayed until resolution of the petition for *en banc* consideration in *Graham*, described above. However, the trial court entered final judgment in favor of RJR Tobacco on January 7, 2016. On February 2, 2016, the plaintiff appealed to the Eleventh Circuit. Oral argument occurred on January 26, 2017. A decision is pending.

On February 11, 2015, in *Sowers v. R. J. Reynolds Tobacco Co.* (U.S.D.C. M.D. Fla., filed 2008), a jury found for the plaintiff on the negligence and strict liability claims and for RJR Tobacco on the intentional tort claims, awarded \$4.25 million in compensatory damages, found the decedent 50% at fault and RJR Tobacco 50% at fault, and did not reach the issue of entitlement to punitive damages.

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On February 12, 2015, the trial court entered final judgment against RJR Tobacco in the amount of approximately \$2.13 million. Post-trial motions are pending. On April 17, 2015, the court stayed post-trial proceedings until resolution of the petition for *en banc* consideration in *Graham*, described above. On June 28, 2017, the court lifted the stay and directed the parties to complete post-trial briefing by August 28, 2017.

On February 24, 2015, in *Caprio v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Broward County, Fla., filed 2007), a jury advised the trial court that it could not reach a unanimous verdict, but the trial court directed the jury to complete the verdict form on those individual verdict questions where there was unanimous agreement. In the partially completed verdict, the jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; found the plaintiff 40% at fault, RJR Tobacco 20% at fault, Lorillard Tobacco 10% at fault, and the remaining defendants 30% at fault; and awarded \$559,000 in economic damages. The jury did not answer the verdict form questions relating to noneconomic damages and entitlement to punitive damages. In May 2015, the court denied the defendants' motion for a mistrial and advised that it accepted the questions answered by the jurors as a partial verdict. A new trial will be held on the remaining issues, including comparative fault allocation. The defendants appealed to the Fourth DCA. On January 22, 2017, the defendants dismissed their appeal. The case remains pending in the trial court. The new trial is scheduled for August 9, 2017.

On February 26, 2015, in *Zamboni v. R. J. Reynolds Tobacco Co.* (U.S.D.C. M.D. Fla., filed 2008), a jury found for the plaintiff on the negligence and strict liability claims and for the defendants on the intentional tort claims; awarded the plaintiff \$340,000 in compensatory damages; found the decedent 60% at fault, RJR Tobacco 30% at fault and the remaining defendant 10% at fault; and did not reach the issue of entitlement to punitive damages. Post-trial motions are pending. The court stayed the case pending resolution of the petition for *en banc* consideration in *Graham*, described above. On June 2, 2017, the plaintiff asked the court to lift the stay. A decision is pending.

On March 23, 2015, in *Pollari v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Broward County, Fla., filed 2007), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$10 million in compensatory damages; found the decedent 15% at fault, RJR Tobacco 42.5% at fault and the remaining defendant 42.5% at fault; and found that the plaintiff was entitled to punitive damages. On March 25, 2015, the jury awarded \$1.5 million in punitive damages against each defendant. The trial court later entered final judgment against the defendants in the amount of \$10 million in compensatory damages and, against each defendant, \$1.5 million in punitive damages. On January 12, 2016, the trial court entered a second amended final judgment against RJR Tobacco that awarded \$4.25 million in compensatory damages and \$1.5 million in punitive damages. The defendants appealed to the Fourth DCA, RJR Tobacco posted a supersedeas bond in the amount of \$2.5 million, and the plaintiff cross appealed. Oral argument occurred on June 27, 2017. A decision is pending.

On March 26, 2015, in *Gore v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Indian River County, Fla., filed 2008), a jury, in a retrial following a mistrial, found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$2 million in compensatory damages; found the decedent 54% at fault, RJR Tobacco 23% at fault and the remaining defendant 23% at fault; and found that the plaintiff was not entitled to punitive damages. In September 2015, the trial court entered final judgment against RJR Tobacco and the remaining defendant, each in the amount of \$460,000. RJR Tobacco posted a supersedeas bond in the amount of \$460,000 in September 2015, and in October 2015, the defendants appealed to the Fourth DCA, and the plaintiff cross appealed. Briefing is complete. Oral argument has not been scheduled.

On April 17, 2015, in *Ryan v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Broward County, Fla., filed 2007), a jury, in a retrial following a mistrial, found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$21.5 million in compensatory damages; found the plaintiff 35% at fault and RJR Tobacco 65% at fault; and found that the plaintiff was entitled to punitive damages. On April 21, 2015, the jury awarded \$25 million in punitive damages. In May 2015, the trial court entered final judgment against RJR Tobacco in the amount of \$21.5 million in compensatory damages and \$25 million in punitive damages. On April 29, 2016, the court entered an amended final judgment against RJR Tobacco in the amount of approximately \$14 million in compensatory damages and \$25 million in punitive damages. RJR Tobacco filed a notice of appeal to the Fourth DCA and posted a supersedeas bond in the amount of \$5 million on May 27, 2016. The plaintiff filed a notice of cross appeal on June 13, 2016. Briefing is complete. Oral argument has not been scheduled.

On June 18, 2015, in *Hardin v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Miami-Dade County, Fla., filed 2007), a jury found for the plaintiff on the negligence and strict liability claims and for RJR Tobacco on the intentional tort claims, awarded \$776,000 in compensatory damages, found the decedent 87% at fault and RJR Tobacco 13% at fault, and found that the plaintiff was not entitled to punitive damages. In June 2015, the trial court entered final judgment against RJR Tobacco in the amount of \$100,880. The plaintiff appealed to the Third DCA, and RJR Tobacco cross appealed. On December 21, 2016, the Third DCA remanded the case for a new trial limited to the issue of punitive damages for the plaintiff's non-intentional tort claims. Otherwise, the final judgment was affirmed. Neither party sought further review. The new trial is scheduled to begin August 21, 2017.

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On July 13, 2015, in *McCoy v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Broward County, Fla., filed 2007), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$1.5 million in compensatory damages; found the decedent 35% at fault, RJR Tobacco 25% at fault, Lorillard Tobacco 20% at fault and the remaining defendant 20% at fault; and found that the plaintiff was entitled to punitive damages. On July 17, 2015, the jury awarded \$3 million in punitive damages against each defendant. In August 2015, the trial court entered final judgment against RJR Tobacco, RJR Tobacco as successor-by-merger to Lorillard Tobacco, and the remaining defendant, jointly and severally, in the amount of \$1.5 million in compensatory damages and, against each of them, \$3 million in punitive damages. On January 4, 2016, the trial court entered an amended final judgment in the amount of \$370,000 in compensatory damages and \$3 million in punitive damages against RJR Tobacco, \$300,000 in compensatory damages and \$3 million in punitive damages against RJR Tobacco as successor-by-merger to Lorillard Tobacco, and \$300,000 in compensatory damages and \$3 million in punitive damages against the remaining defendant. RJR Tobacco appealed to the Fourth DCA and posted a supersedeas bond in the amount of approximately \$3.35 million, and the plaintiff filed a notice of cross appeal. Oral argument is scheduled for September 26, 2017.

On July 29, 2015, in *Collar v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Indian River County, Fla., filed 2008), a jury found that the plaintiff was not a class member, which resulted in a verdict for the defendants, including RJR Tobacco. In September 2015, the trial court entered final judgment. The plaintiff appealed to the Fourth DCA, and the defendants cross appealed. Oral argument occurred on June 13, 2017. On July 5, 2017, the Fourth DCA reversed the judgment of the trial court and remanded the case for a new trial. The deadline for the defendants to file a notice to invoke the discretionary jurisdiction of the Florida Supreme Court is August 4, 2017.

On August 6, 2015, in *Bloch v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Broward County, Fla., filed 2007), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded approximately \$1.03 million in compensatory damages; found the decedent 50% at fault and RJR Tobacco 50% at fault; and found that the plaintiff was entitled to punitive damages. On August 7, 2015, the jury awarded \$800,000 in punitive damages. In September 2015, the trial court entered final judgment against RJR Tobacco in the amount of approximately \$926,000 in compensatory damages and \$800,000 in punitive damages. On December 9, 2015, the trial court granted RJR Tobacco's motion to alter or amend the judgment in part in light of the Fourth DCA's decision in *Schoeff v. R. J. Reynolds Tobacco Co.*, described above, finding that the intentional tort exception in Section 768.81, Florida Statutes, does not apply to the fraud and conspiracy claims brought by *Engle* Progeny plaintiffs. As a result, an amended final judgment was entered in the amount of approximately \$463,000 in compensatory damages and \$800,000 in punitive damages. RJR Tobacco appealed to the Fourth DCA and posted a supersedeas bond in the amount of approximately \$1.3 million, and the plaintiff filed a notice of cross appeal. On February 3, 2017, the Fourth DCA entered an order dispensing with oral argument. On April 27, 2017, the Fourth DCA affirmed the judgment of the trial court, *per curiam*. The deadline for RJR Tobacco to file a petition for writ of certiorari with the U.S. Supreme Court is September 22, 2017.

On September 1, 2015, in *Lewis v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Volusia County, Fla., filed 2007), a jury found for the plaintiff on the negligence and strict liability claims and for RJR Tobacco on the intentional tort claims, awarded \$750,000 in compensatory damages, found the decedent 75% at fault and RJR Tobacco 25% at fault, and found that the plaintiff was not entitled to punitive damages. Final judgment was entered against RJR Tobacco in the amount of \$187,500 in March 2016. RJR Tobacco appealed to the Fifth DCA and posted a supersedeas bond in the amount of \$187,500. On May 2, 2017, the Fifth DCA affirmed the final judgment of the trial court, *per curiam*. The deadline for RJR Tobacco to file a petition for writ of certiorari with the U.S. Supreme Court is September 29, 2017.

On September 8, 2015, in *Cooper v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Broward County, Fla., filed 2007), a jury found for the plaintiff on the negligence and strict liability claims and for the defendants on the intentional tort claims; awarded \$4.5 million in compensatory damages; found the plaintiff 50% at fault, RJR Tobacco 40% at fault and the remaining defendant 10% at fault; and did not reach the issue of entitlement to punitive damages. Post-trial motions were denied on December 2, 2015. In February 2016, the trial court entered final judgment against RJR Tobacco in the amount of approximately \$1.2 million. The defendants appealed to the Fourth DCA, and the plaintiff cross appealed. RJR Tobacco posted a supersedeas bond in the amount of approximately \$1.2 million. Briefing is complete. Oral argument has not been scheduled.

On September 10, 2015, in *Duignan v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Pinellas County, Fla., filed 2007), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$6 million in compensatory damages; found the decedent 33% at fault, RJR Tobacco 30% at fault, and the remaining defendant 37% at fault; and found that the plaintiff was entitled to punitive damages. On September 11, 2015, the jury awarded \$2.5 million in punitive damages against RJR Tobacco and \$3.5 million in punitive damages against the remaining defendant. The trial court later entered final judgment against RJR Tobacco and the remaining defendant in the amount of \$6 million in compensatory damages and \$2.5 million in punitive damages against RJR Tobacco and \$3.5 million in punitive damages against the remaining defendant. The defendants appealed to the Second DCA, and RJR Tobacco posted a supersedeas bond in the amount of approximately \$2.3 million. Oral argument occurred on December 5, 2016. A decision is pending.

On September 10, 2015, in *O'Hara v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Escambia County, Fla., filed 2007), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$14.7 million in compensatory damages; found the

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decedent 15% at fault and RJR Tobacco 85% at fault; and found that the plaintiff was entitled to punitive damages. On September 11, 2015, the jury awarded \$20 million in punitive damages. In September 2015, the trial court entered final judgment against RJR Tobacco in the amount of \$14.7 million in compensatory damages and \$20 million in punitive damages. RJR Tobacco appealed to the First DCA and posted a supersedeas bond in the amount of \$5 million. Oral argument occurred on May 10, 2017. A decision is pending.

On September 22, 2015, in *Suarez v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Miami-Dade County, Fla., filed 2008), a jury found that the decedent was not a class member, which resulted in a verdict for the defendants, including RJR Tobacco. In November 2015, the trial court entered final judgment. The plaintiff appealed to the Third DCA, and the defendants cross appealed. On October 19, 2016, the Third DCA affirmed the judgment of the trial court, *per curiam*. On October 27, 2016, the plaintiff filed a motion for a written opinion and certification to the Florida Supreme Court, which was denied on May 19, 2017. The deadline for the plaintiff to file a petition for writ of certiorari with the U.S. Supreme Court is August 17, 2017.

On October 2, 2015, in *Marchese v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Broward County, Fla., filed 2007), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$1 million in compensatory damages; found the decedent 55% at fault, RJR Tobacco 22.5% at fault, and the remaining defendant 22.5% at fault; and found that the plaintiff was entitled to punitive damages. On October 6, 2015, the jury awarded \$250,000 in punitive damages against each defendant. Final judgment was entered on November 5, 2015. On May 17, 2016, an amended final judgment was entered in the amount of \$450,000 in compensatory damages against RJR Tobacco and the remaining defendant, jointly and severally, and \$250,000 in punitive damages against each defendant. RJR Tobacco appealed to the Fourth DCA and posted a supersedeas bond in the amount of \$475,000. Briefing is complete. Oral argument has not been scheduled.

On November 17, 2015, in *Barbose v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Pasco County, Fla., filed 2007), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$10 million in compensatory damages, found the decedent 15% at fault, RJR Tobacco 42.5% at fault and the remaining defendant 42.5% at fault; and found that the plaintiff was entitled to punitive damages. On November 18, 2015, the jury awarded \$500,000 in punitive damages against each of RJR Tobacco and the other defendant. The defendants appealed to the Second DCA, and RJR Tobacco posted a supersedeas bond in the amount of \$2.5 million. Oral argument is scheduled for August 8, 2017.

On November 20, 2015, in *Fanali v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Palm Beach County, Fla., filed 2008), a jury found that cigarette smoking was not a legal cause of the decedent's coronary artery disease and death, which resulted in a verdict for RJR Tobacco. On December 17, 2015, the trial court entered final judgment in favor of RJR Tobacco. The plaintiff appealed to the Fourth DCA, and RJR Tobacco cross appealed. On June 21, 2017, the Fourth DCA affirmed the final judgment of the trial court. On July 13, 2017, the plaintiff filed a motion for rehearing and filed an amended motion for rehearing on July 14, 2017. A decision is pending.

On November 24, 2015, in *Green v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Miami-Dade County, Fla., filed 2007), a jury found that the plaintiff does not have chronic obstructive pulmonary disease, which resulted in a verdict for RJR Tobacco. Post-trial motions were denied on March 23, 2016. On April 4, 2016, final judgment was entered in favor of RJR Tobacco. The plaintiff appealed to the Third DCA, and RJR Tobacco cross appealed. On May 3, 2017, the Third DCA affirmed the final judgment of the trial court, *per curiam*. The plaintiff did not seek further review.

On December 9, 2015, in *Monroe v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Gadsden County, Fla., filed 2007), a jury found for the plaintiff on the negligence and strict liability claims and for RJR Tobacco on the intentional tort claims, awarded \$11 million in compensatory damages, found the plaintiff 42% at fault and RJR Tobacco 58% at fault, and did not reach the issue of entitlement to punitive damages. On December 31, 2015, the trial court entered final judgment against RJR Tobacco in the amount of \$6.38 million in compensatory damages. RJR Tobacco appealed to the First DCA and posted a supersedeas bond in the amount of \$5 million. On March 23, 2017, the First DCA affirmed the judgment of the trial court, *per curiam*. On April 19, 2017, RJR Tobacco filed a notice to invoke the discretionary jurisdiction of the Florida Supreme Court. On June 13, 2017, the Florida Supreme Court declined to accept jurisdiction. The deadline for RJR Tobacco to file a petition for writ of certiorari with the U.S. Supreme Court is September 11, 2017.

On December 18, 2015, in *Ledoux v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Miami-Dade County, Fla., filed 2007), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$10 million in compensatory damages; found the decedent 6% at fault, RJR Tobacco 47% at fault and the remaining defendant 47% at fault; and found that the plaintiff was entitled to punitive damages. On December 22, 2015, the jury awarded \$12.5 million in punitive damages against each defendant. The trial court later entered final judgment against the defendants, jointly and severally, in the amount of \$10 million in compensatory damages and, against each defendant, \$12.5 million in punitive damages. The defendants appealed to the Third DCA, and RJR Tobacco posted a supersedeas bond in the amount of \$5 million. On May 27, 2016, RJR Tobacco filed a rider amending the supersedeas bond reducing the amount from \$5 million to \$2.5 million. Oral argument occurred on April 11, 2017. A decision is pending.

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On January 26, 2016, in *Ewing v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Escambia County, Fla., filed 2008), a jury found for the plaintiff on the negligence and strict liability claims and for the defendants on the intentional tort claims; awarded \$240,000 in compensatory damages; found the decedent 98% at fault, RJR Tobacco 2% at fault and the remaining defendant 0% at fault, and did not reach the issue of entitlement to punitive damages. Post-trial motions were denied on February 25, 2016. Final judgment has not been entered.

On February 12, 2016, in *Ahrens v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Pinellas County, Fla., filed 2008), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$9 million in compensatory damages; found the decedent 32% at fault, RJR Tobacco 44% at fault, and the remaining defendant 24% at fault; and found that the plaintiff was entitled to punitive damages. On February 13, 2016, the jury awarded \$2.5 million in punitive damages against each defendant. In February 2016, the trial court entered final judgment. On April 13, 2016, RJR Tobacco appealed to the Second DCA and posted a supersedeas bond in the amount of \$2.5 million. On May 12, 2017, the Second DCA affirmed the final judgment of the trial court, *per curiam*. On May 24, 2017, the defendants filed a motion for a written opinion or citation. On July 14, 2017, the Second DCA granted the defendants' motion for a written opinion, withdrew the May 12, 2017 decision and substituted the July 14, 2017 opinion, which affirmed the final judgment in all respects without further discussion while certifying a conflict to the Florida Supreme Court on the application of comparative fault. The deadline for the defendants to file a notice to invoke the discretionary jurisdiction of the Florida Supreme Court is August 11, 2017.

On March 8, 2016, in *Gamble v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Duval County, Fla., filed 2008), a jury found for the plaintiff on class membership, but found for RJR Tobacco on addiction causation, which resulted in a verdict for RJR Tobacco. Final judgment was entered in favor of RJR Tobacco on June 9, 2016. The plaintiff appealed to the First DCA on July 8, 2016. Briefing is complete. Oral argument has not been scheduled.

On April 7, 2016, in *Davis v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Miami-Dade County, Fla., filed 2008), a jury found for the plaintiff on class membership, but found for RJR Tobacco on addiction causation, which resulted in a verdict for RJR Tobacco. On August 17, 2016, the court granted the plaintiff's motion for a new trial. RJR Tobacco filed a notice of appeal to the Third DCA on August 25, 2016. Oral argument is scheduled for August 16, 2017.

On April 21, 2016, in *Turner v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Broward County, Fla., filed 2007), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$3 million in compensatory damages; found the decedent 20% at fault and RJR Tobacco 80% at fault; and found that the plaintiff was entitled to punitive damages. On April 22, 2016, the jury awarded \$10 million in punitive damages. The court entered judgment against RJR Tobacco in the amount of \$2.4 million in compensatory damages and \$10 million in punitive damages. In July 2016, RJR Tobacco filed a notice of appeal to the Fourth DCA and posted a supersedeas bond in the amount of \$5 million. The plaintiff filed a notice of cross appeal in August 2016. Oral argument occurred on July 25, 2017. A decision is pending.

On April 26, 2016, in *Enochs v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Palm Beach County, Fla., filed 2007), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$21 million in compensatory damages; found the decedent 22% at fault, RJR Tobacco 66% at fault and the remaining defendant 12% at fault; and found that the plaintiff was entitled to punitive damages. On April 27, 2016, the jury awarded \$6.25 million in punitive damages against each defendant. Final judgment was entered against RJR Tobacco in the amount of approximately \$13.9 million in compensatory damages and \$6.25 million in punitive damages on May 9, 2016. The defendants appealed to the Fourth DCA, and RJR Tobacco posted a supersedeas bond in the amount of approximately \$3.5 million. Oral argument occurred on July 18, 2017. A decision is pending.

On May 11, 2016, in *Dion v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Sarasota County, Fla., filed 2007), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$12 million in compensatory damages; found the decedent 25% at fault and RJR Tobacco 75% at fault; and found that the plaintiff was entitled to punitive damages. On May 12, 2016, the jury awarded \$30,000 in punitive damages. On August 9, 2016, RJR Tobacco filed a notice of appeal to the Second DCA and posted a supersedeas bond in the amount of \$5 million. Oral argument is scheduled for September 28, 2017.

On May 16, 2016, in *Nally v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Polk County, Fla., filed 2007), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$6 million in compensatory damages; found the decedent 25% at fault and RJR Tobacco 75% at fault; and found that the plaintiff was entitled to punitive damages. On May 17, 2016, the jury awarded \$12 million in punitive damages. Final judgment was entered against RJR Tobacco in the amount of \$6 million in compensatory damages and \$12 million in punitive damages on May 25, 2016. In September 2016, RJR Tobacco filed a notice of appeal to the Second DCA and posted a supersedeas bond in the amount of \$5 million. Briefing is underway.

On May 19, 2016, in *McCabe v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Hillsborough County, Fla., filed 2007), a jury found for the plaintiff on the negligence and strict liability claims, awarded \$5 million in compensatory damages, found the decedent 70% at fault and RJR Tobacco 30% at fault, and found that the plaintiff was entitled to punitive damages. On May 20, 2016, the jury awarded \$6.5 million

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in punitive damages. Final judgment was entered against RJR Tobacco in the amount of \$1.5 million in compensatory damages and \$6.5 million in punitive damages on May 31, 2016. Post-trial motions were denied on January 26, 2017. On February 24, 2017, RJR Tobacco filed a notice of appeal to the Second DCA. RJR Tobacco posted a supersedeas bond in the amount of \$5 million on February 27, 2017. Briefing is underway.

On June 21, 2016, in *Mooney v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Miami-Dade County, Fla., filed 2008), a jury found that the decedent's addiction to nicotine was not a legal cause of her death, which resulted in a verdict for the defendants, including RJR Tobacco. Final judgment has not been entered.

On July 1, 2016, in *Sermons v. Philip Morris USA Inc.* (Cir. Ct. Duval County, Fla., filed 2008), a jury found for the plaintiff on the negligence and strict liability claims; awarded \$65,000 in compensatory damages; found the decedent 80% at fault, RJR Tobacco 5% at fault, and the remaining defendant 15% at fault; and found that the plaintiff was entitled to punitive damages. On July 6, 2016, the jury awarded \$17,075 in punitive damages against RJR Tobacco and \$51,225 in punitive damages against the remaining defendant. Post-trial motions are pending.

On August 15, 2016, in *Mathis v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Miami-Dade County, Fla., filed 2007), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$5 million in compensatory damages; found the decedent 45% at fault and RJR Tobacco 55% at fault; and found that the plaintiff was not entitled to punitive damages. Final judgment was entered on August 17, 2016. RJR Tobacco filed a notice of appeal to the Third DCA and posted a supersedeas bond in the amount of \$5 million on November 18, 2016. Briefing is underway.

On August 25, 2016, in *Coursey v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Volusia County, Fla., filed 2007), a jury found that the decedent was not a class member, which resulted in a verdict for RJR Tobacco. Final judgment was entered in RJR Tobacco's favor on September 27, 2016. On October 27, 2016, the plaintiff filed a notice of appeal to the Fifth DCA. RJR Tobacco filed a notice of cross appeal on November 8, 2016. Briefing is underway.

On September 6, 2016, in *Hackimer v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Palm Beach County, Fla., filed 2007), a jury found that the deceased smoker knew or should have known of his chronic obstructive pulmonary disease before May 5, 1990, and, for that reason, the claims were barred by the statute of limitations, which resulted in a verdict for RJR Tobacco. On January 4, 2017, final judgment was entered in favor of RJR Tobacco. The plaintiff filed a notice of appeal to the Fourth DCA on February 1, 2017. RJR Tobacco filed a notice of cross appeal on February 9, 2017. Briefing is underway.

On September 22, 2016, in *Oshinsky-Blacker v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Broward County, Fla., filed 2007), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$6.15 million in compensatory damages; found the decedent 15% at fault, RJR Tobacco 25% at fault, and the remaining defendant 60% at fault; and found that the plaintiff was entitled to punitive damages. On September 23, 2016, the jury awarded \$2 million in punitive damages against RJR Tobacco and \$1 million in punitive damages against the remaining defendant. On March 6, 2017, the court granted the defendants' motion for a new trial. The new trial has not been scheduled. The plaintiff filed a notice of appeal to the Fourth DCA on March 24, 2017. The defendants filed a notice of cross appeal on March 31, 2017. Briefing is underway.

On September 23, 2016, in *Sherry Smith v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Volusia County, Fla., filed 2008), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$3 million in compensatory damages; found the decedent 35% at fault and RJR Tobacco 65% at fault; and found that the plaintiff was not entitled to punitive damages. Final judgment was entered against RJR Tobacco in the amount of \$3 million. In January 2017, RJR Tobacco filed a notice of appeal to the Fifth DCA and posted a supersedeas bond in the amount of \$3 million. Briefing is underway.

On September 28, 2016, in *Prentice v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Duval County, Fla., filed 2007), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$6.4 million in compensatory damages; found the decedent 60% at fault and RJR Tobacco 40% at fault; and found that the plaintiff was entitled to punitive damages. On September 29, 2016, the jury awarded \$0 in punitive damages. Post-trial motions were denied on April 11, 2017, and final judgment was entered against RJR Tobacco in the amount of \$6.4 million. RJR Tobacco filed a notice of appeal to the First DCA on May 11, 2017, and the plaintiff filed a notice of cross appeal on May 19, 2017. Briefing is underway.

On October 24, 2016, in *Konzelman v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Broward County, Fla., filed 2007), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded approximately \$8.8 million in compensatory damages; found the decedent 15% at fault and RJR Tobacco 85% at fault; and found that the plaintiff was entitled to punitive damages. On October 26, 2016, the jury awarded \$20 million in punitive damages. On December 1, 2016, the trial court entered final judgment against RJR Tobacco in the amount of approximately \$7.48 million in compensatory damages and \$20 million in punitive damages. RJR Tobacco

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filed a notice of appeal to the Fourth DCA and posted a supersedeas bond in the amount of \$5 million on December 22, 2016. The plaintiff filed a notice of cross appeal on January 2, 2017. Briefing is underway.

On November 2, 2016, in *Johnston v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Sarasota County, Fla., filed 2007), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$7.5 million in compensatory damages; found the decedent 10% at fault and RJR Tobacco 90% at fault; and found that the plaintiff was entitled to punitive damages. On November 5, 2016, the jury awarded \$14 million in punitive damages. Final judgment was entered against RJR Tobacco in the amount of \$6.75 million in compensatory damages and \$14 million in punitive damages on November 28, 2016. Post-trial motions were denied on March 30, 2017. RJR Tobacco filed a notice of appeal to the Second DCA on April 25, 2017, and posted a supersedeas bond in the amount of \$5 million on April 26, 2017. The plaintiff filed a notice of cross appeal on May 17, 2017. Briefing is underway.

On November 3, 2016, in *Ledo v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Miami-Dade County, Fla., filed 2008), a jury found for the plaintiff on the negligence and strict liability claims and for RJR Tobacco on the intentional tort claims; awarded \$6 million in compensatory damages; found the decedent 51% at fault and RJR Tobacco 49% at fault; and found that the plaintiff was entitled to punitive damages. After receiving the verdict, the trial court granted a directed verdict in favor of RJR Tobacco on entitlement to punitive damages. Final judgment was entered against RJR Tobacco in the amount of \$2.94 million in compensatory damages on December 22, 2016. Post-trial motions are pending.

On November 10, 2016, in *Howles v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Broward County, Fla., filed 2007), a jury found for the plaintiff on the negligence, strict liability and intentional tort claims; awarded \$4 million in compensatory damages; found RJR Tobacco 50% at fault and the remaining defendant 50% at fault; and found that the plaintiff was entitled to punitive damages. On November 14, 2016, the jury awarded \$3 million in punitive damages against RJR Tobacco and \$3 million against the remaining defendant. Final judgment was entered against RJR Tobacco in the amount of \$2 million in compensatory damages and \$3 million in punitive damages. On December 30, 2016, the defendants filed a joint notice of appeal to the Fourth DCA. Briefing is underway.

On November 16, 2016, in *Ford v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Palm Beach County, Fla., filed 2008), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded approximately \$1.02 million in compensatory damages; found the plaintiff 85% at fault and RJR Tobacco 15% at fault; and found that the plaintiff was not entitled to punitive damages. The trial court entered final judgment against RJR Tobacco in the amount of approximately \$153,400 on March 13, 2017. Post-trial motions were denied on June 6, 2017. On June 12, 2017, the plaintiff filed a notice of appeal to the Fourth DCA. RJR Tobacco filed a notice of cross appeal on June 21, 2017. Briefing is underway.

On November 16, 2016, in *Stanley Martin v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Broward County, Fla., filed 2007), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded approximately \$5.41 million in compensatory damages; found the decedent 32% at fault, RJR Tobacco 22% at fault and the remaining defendant 46% at fault; and found that the plaintiff was entitled to punitive damages. On November 18, 2016, the jury awarded \$200,000 in punitive damages against RJR Tobacco and \$450,000 against the remaining defendant. Final judgment was entered against RJR Tobacco in the amount of approximately \$1.2 million in compensatory damages and \$200,000 in punitive damages and against the remaining defendant in the amount of \$2.5 million in compensatory damages and \$450,000 in punitive damages. Post-trial motions were denied on January 26, 2017. On February 23, 2017, the defendants filed a joint notice of appeal to the Fourth DCA, and RJR Tobacco posted a supersedeas bond in the amount of approximately \$1.4 million. The plaintiff filed a notice of cross appeal on February 24, 2017. Briefing is underway.

On December 16, 2016, in *Dubinsky v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Brevard County, Fla., filed 2008), a jury found that the decedent was not a class member, which resulted in a verdict for the defendants, including RJR Tobacco. Final judgment was entered in favor of the defendants on April 3, 2017. The plaintiff did not seek further review.

On December 16, 2016, in *Pardue v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Alachua County, Fla., filed 2008), a jury, in a retrial following a mistrial, found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded approximately \$5.9 million in compensatory damages; found the decedent 25% at fault, RJR Tobacco 50% at fault, and the remaining defendant 25% at fault; and found that the plaintiff was entitled to punitive damages. On December 19, 2016, the jury awarded \$6.75 million in punitive damages against RJR Tobacco and \$6.75 million in punitive damages against the remaining defendant. Final judgment was entered against RJR Tobacco in the amount of approximately \$5.9 million in compensatory damages (jointly and severally with the remaining defendant) and, against each defendant, \$6.75 million in punitive damages on December 29, 2016. An amended final judgment was entered against RJR Tobacco in the amount of approximately \$5.2 million in compensatory damages (jointly and severally with the remaining defendant) and, against each defendant, \$6.75 million in punitive damages. Post-trial motions were denied on April 19, 2017. On March 8, 2017, the defendants filed a notice of appeal to the First DCA, and RJR Tobacco posted a supersedeas bond in the amount of \$2.5 million on March 9, 2017. Briefing is underway.

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On February 8, 2017, in *Durrance v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Highlands County, Fla., filed 2011), a jury found that the decedent knew or should have known of her chronic obstructive pulmonary disease before May 5, 1990, which resulted in a verdict for RJR Tobacco. Final judgment was entered in favor of RJR Tobacco on April 26, 2017. On May 16, 2017, the plaintiff filed a notice of appeal to the Second DCA. RJR Tobacco filed a notice of cross appeal on May 17, 2017. Briefing is underway.

On February 15, 2017, in *John Brown v. Philip Morris USA Inc.* (Cir. Ct. Pinellas County, Fla., filed 2007), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$5.4 million in compensatory damages; found the decedent 30% at fault, RJR Tobacco 35% at fault and the remaining defendant 35% at fault; and found that the plaintiff was entitled to punitive damages. On February 17, 2017, the jury awarded \$200,000 each in punitive damages against RJR Tobacco and the remaining defendant. Post-trial motions are pending.

On February 23, 2017, in *Fox v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Broward County, Fla., filed 2007), a jury found for the plaintiff on the negligence and strict liability claims and for RJR Tobacco on the intentional tort claims; awarded \$6 million in compensatory damages; found the decedent 50% at fault and RJR Tobacco 50% at fault; and found that the plaintiff was not entitled to punitive damages. Post-trial motions were denied on May 3, 2017, and final judgment was entered against RJR Tobacco in the amount of \$3 million. RJR Tobacco filed a notice of appeal to the Fourth DCA on July 24, 2017. Briefing is underway.

On March 28, 2017, in *Whitmire v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Leon County, Fla., filed 2008), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$3 million in compensatory damages; found the decedent 33% at fault and RJR Tobacco 67% at fault; and found that the plaintiff was entitled to punitive damages. On March 29, 2017, the court declared a mistrial in the punitive damages phase because the jury was deadlocked. On April 6, 2017, final judgment was entered against RJR Tobacco in the amount of \$3 million in compensatory damages. Post-trial motions were denied on April 19, 2017. RJR Tobacco filed a notice of appeal to the First DCA on May 15, 2017, and posted a supersedeas bond in the amount of \$3 million on June 6, 2017. Briefing is underway.

On March 29, 2017, in *Santoro v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Broward County, Fla., filed 2007), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded approximately \$1.6 million in compensatory damages; found the decedent 36% at fault, RJR Tobacco 26% at fault, and the remaining defendants 38% at fault; and found that the plaintiff was entitled to punitive damages. On March 31, 2017, the jury awarded \$90,000 in punitive damages against RJR Tobacco and \$115,000 against the remaining defendants. On April 5, 2017, an amended final judgment was entered against RJR Tobacco in the amount of \$507,300 and against the remaining defendant in the amount of \$724,900. Post-trial motions are pending.

On April 18, 2017, in *Schlefstein v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Broward County, Fla., filed 2007), the court declared a mistrial during jury selection. Retrial has been scheduled for January 16, 2018.

On April 20, 2017, in *Lima v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Hillsborough County, Fla., filed 2007), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$3 million in compensatory damages; found the decedent 40% at fault, RJR Tobacco 60% at fault, and the remaining defendant 0% at fault; and found that the plaintiff was entitled to punitive damages with respect to RJR Tobacco and that the plaintiff was not entitled to punitive damages with respect to the other defendant. On April 21, 2017, the jury awarded \$12 million in punitive damages against RJR Tobacco. Final judgment was entered against RJR Tobacco in the amount of \$1.8 million in compensatory damages and \$12 million in punitive damages on April 25, 2017. Post-trial motions are pending.

On April 24, 2017, in *Shadd v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Palm Beach County, Fla., filed 2007), a jury found for the plaintiff on the negligence and strict liability claims and for RJR Tobacco on the intentional tort claims; awarded \$0 in compensatory damages; found that the decedent was 95% at fault and RJR Tobacco 5% at fault; and found that the plaintiff was not entitled to punitive damages. Post-trial motions are pending.

On May 9, 2017, in *Lawrence v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Marion County, Fla., filed 2007), a jury found for the plaintiff on the negligence and strict liability claims and for RJR Tobacco on the intentional tort claims; awarded approximately \$858,200 in compensatory damages; found the decedent was 65% at fault and RJR Tobacco 35% at fault, and found that the plaintiff was entitled to punitive damages. Prior to the punitive damages phase, the parties resolved the matter. Final judgment was entered against RJR Tobacco in the amount of approximately \$300,000. RJR Tobacco paid approximately \$2.9 million on June 29, 2017 in satisfaction of the judgment (including fees and interest).

On May 11, 2017, in *Sheffield v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Orange County, Fla., filed 2007), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$1.8 million in compensatory damages; found the decedent 40% at fault and RJR Tobacco 60% at fault; and found that the plaintiff was entitled to punitive damages. On May 12, 2017, the jury awarded \$5 million in punitive damages against RJR Tobacco. Post-trial motions were denied on July 10, 2017, and final judgment was entered

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against RJR Tobacco in the amount of \$1.8 million in compensatory damages and \$5 million in punitive damages. The deadline for RJR Tobacco to file a notice of appeal to the Fifth DCA is August 9, 2017.

On May 23, 2017, in *Olson v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Duval County, Fla., filed 2008), the court granted RJR Tobacco's motions for a mistrial due to an error with the instructions provided to the jury. Retrial is scheduled for August 6, 2018.

On June 2, 2017, in *Kogan v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Palm Beach County, Fla., filed 2007), a jury found that an addiction to cigarettes containing nicotine was not the legal cause of the plaintiff's bladder cancer, which resulted in a verdict for the defendants, including RJR Tobacco. Final judgment was entered on June 22, 2017. On July 18, 2017, the plaintiff filed a notice of appeal to the Fourth DCA. Briefing is underway.

On June 7, 2017, in *Gay v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Hillsborough County, Fla., filed 2007), the court declared a mistrial due to comments made by a prospective juror during jury selection. Retrial is rescheduled tentatively for September 8, 2017.

On July 18, 2017, in *Maloney v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Lee County, Fla., filed 2007), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$1.65 million in compensatory damages; found the decedent 50% at fault and RJR Tobacco 50% at fault; and found that the plaintiff was not entitled to punitive damages. Post-trial motions are pending.

On July 28, 2017, in *Thomas v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Broward County, Fla., filed 2007), a jury found for the plaintiff on the negligence, strict liability, and intentional tort claims; awarded \$4 million in compensatory damages; found the decedent 45% at fault and RJR Tobacco 55% at fault; and found that the plaintiff was not entitled to punitive damages. Post-trial motions are pending.

Broin II Cases

Broin v. Philip Morris, Inc. (Cir. Ct. Miami-Dade County, Fla., filed 1991), was a class action brought on behalf of flight attendants alleged to have suffered from diseases or ailments caused by exposure to ETS in airplane cabins. In October 1997, RJR Tobacco, Lorillard Tobacco, B&W and other cigarette manufacturer defendants settled *Broin*, agreeing 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; Lorillard Tobacco's was approximately \$57 million; and B&W's was approximately \$31 million. The settlement agreement, among other things, limits the types of claims class members may bring and eliminates claims for punitive damages. The settlement agreement also provides that, in individual cases by class members that are referred to as *Broin II* lawsuits, 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 liability issues, including whether an individual plaintiff's disease was caused by his or her exposure to ETS in airplane cabins, referred to as "specific causation," individual plaintiffs will bear the burden of proof. On September 7, 1999, the Florida Supreme Court approved the settlement.

As of June 30, 2017, there were 2,346 *Broin II* lawsuits pending in Florida. There have been no *Broin II* trials since 2007.

Class-Action Suits

Overview. As of June 30, 2017, 25 class-action cases, excluding the shareholder cases described below, were pending in the United States against Reynolds Defendants. These class actions seek recovery for personal injuries allegedly caused by cigarette smoking or, in some cases, for economic damages allegedly incurred by cigarette or e-cigarette purchasers.

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In 1996, the Fifth Circuit Court of Appeals in *Castano v. American Tobacco Co.* overturned the certification of a nation-wide class of persons whose claims related to alleged addiction to tobacco products, finding that the district court failed to properly assess variations in the governing state laws and whether common issues predominated over individual issues. Since the Fifth Circuit's ruling in *Castano*, 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 *Castano*, only two smoker class actions have been certified by a federal court – *In re Simon (II) Litigation* and *Schwab [McLaughlin] v. Philip Morris USA Inc.*, both of which were filed in the U.S. District Court for the Eastern District of New York and were later decertified.

Class-action suits based on claims that class members are at a greater risk of injury or injured by the use of tobacco or exposure to ETS, or claims that seek primarily economic damages are pending against RJR Tobacco, Lorillard Tobacco, or their affiliates or indemnitees in state or federal courts in California, Florida, Illinois, Louisiana, Missouri, New Mexico, New York, North Carolina and West Virginia. All pending class-action cases are discussed below.

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

E-cigarette class-action cases are pending against RJR Vapor, RAI, and other RAI affiliates in California state and federal courts. In general, the plaintiffs allege that RJR Vapor, Lorillard Tobacco, and other RAI affiliates made false and misleading claims that e-cigarettes are less hazardous than other cigarette products or failed to disclose that e-cigarettes expose users to certain substances. The cases are typically filed pursuant to state consumer protection and related statutes and seek recovery of economic damages and are discussed below under “— E-Cigarette Cases.”

Several class actions relating to claims in advertising and promotional materials for SFNTC's NATURAL AMERICAN SPIRIT brand cigarettes are pending in federal courts. In general, these plaintiffs allege that use of the words “natural,” “additive-free,” or “organic” in NATURAL AMERICAN SPIRIT advertising and promotional materials suggests that those cigarettes are less harmful than other cigarettes and, for that reason, violated state consumer protection statutes or amounted to fraud or a negligent or intentional misrepresentation. These cases are discussed below under “— No Additive/Natural Claim Cases.”

Additional class actions relating to alleged personal injuries purportedly caused by use of cigarettes or exposure to ETS are pending. These cases are discussed below under “— Other Class Actions.”

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

“Lights” Cases.

As noted above, four “lights” class-action cases are pending against RJR Tobacco or B&W, two in Illinois state court and two in Missouri state court. The classes in these cases generally seek to recover compensatory and punitive damages, injunctive and other forms of relief, and attorneys' fees and costs from RJR Tobacco and/or B&W. In general, the plaintiffs allege that RJR Tobacco or B&W made false and misleading claims that “lights” cigarettes were lower in tar and nicotine and/or were less hazardous or less mutagenic than other cigarettes. The cases typically are filed pursuant to state consumer protection and related statutes.

The seminal “lights” class-action case is *Price v. Philip Morris, Inc.* (Cir. Ct. Madison County, Ill., filed 2000), an action filed against the predecessor of Philip Morris USA Inc., referred to as Philip Morris. In March 2003, the trial court entered judgment against Philip Morris in the amount of \$7.1 billion in compensatory damages and \$3 billion in punitive damages. In December 2005, the Illinois Supreme Court issued an opinion reversing and remanding with instructions to dismiss the case. On December 5, 2006, the Illinois Supreme Court issued its mandate, and the trial court entered a judgment of dismissal later in December 2006. In multiple filings since December 2008, the *Price* plaintiffs have argued that the U.S. Supreme Court's decision in *Good v. Altria Group, Inc.* rejected the basis upon which the Illinois Supreme Court had reversed the *Price* trial court's 2003 judgment and, on that basis, have attempted to reinstate that judgment. In April 2014, the intermediate appellate court reinstated the trial court's 2003 judgment. In November 2015, the Illinois Supreme Court (1) vacated the lower courts' judgments, (2) dismissed the case without prejudice to allow the plaintiffs to file a motion to have the Illinois Supreme Court recall its December 5, 2006, mandate that had reversed the trial court's 2003 judgment, and (3) directed entry of a judgment of dismissal. The plaintiffs then moved in the Illinois Supreme Court to have that court recall its December 5, 2006 mandate. On January 11, 2016, the Illinois Supreme Court denied the plaintiffs' motion. The plaintiffs filed a petition for writ of certiorari with the U.S. Supreme Court on January 22, 2016, which was denied on June 20, 2016.

In *Turner v. R. J. Reynolds Tobacco Co.* (Cir. Ct. Madison County, Ill., filed 2000), the trial court certified a class of purchasers of RJR Tobacco “lights” cigarettes in November 2001. In November 2003, the Illinois Supreme Court granted RJR Tobacco's motion for

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a stay pending the court's final appeal decision in the *Price* case described above. The stay subsequently expired, and the court accordingly scheduled a series of status conferences, all of which were continued by agreement of the parties. The status conference scheduled for March 29, 2017 did not occur and has not been rescheduled.

In *Howard v. Brown & Williamson Tobacco Corp.* (Cir. Ct. Madison County, Ill., filed 2000), the trial court certified a class of purchasers of B&W "lights" cigarettes in December 2001. In June 2003, the trial judge issued an order staying all proceedings pending resolution of the *Price* case described above. In August 2005, the Illinois Fifth District Court of Appeals affirmed the Circuit Court's stay order. There is currently no activity in the case.

In *Collora v. R. J. Reynolds Tobacco Co.* (Cir. Ct. City of St. Louis, Mo., filed 2000), the trial court certified a class of purchasers of RJR Tobacco "lights" cigarettes in December 2003. A status conference is scheduled for January 8, 2018.

In *Black v. Brown & Williamson Tobacco Corp.* (Cir. Ct. City of St. Louis, Mo., filed 2000), a putative class action filed on behalf of a class of purchasers of B&W "lights" cigarettes, a status conference is scheduled for January 8, 2018.

In the event RJR Tobacco and its affiliates or indemnitees lose one or more of the pending "lights" class-action suits, RJR Tobacco, depending upon the amount of any damages ordered, could face difficulties in its ability to pay the judgment or obtain any bond required to stay execution of the judgment which could have a material adverse effect on RJR Tobacco's, and consequently RAI's, results of operations, cash flows or financial position.

E-Cigarette Cases.

In *Harris v. R. J. Reynolds Vapor Co.* (U.S.D.C. N.D. Cal., filed 2015), the plaintiff brought a class action against RJR Vapor on behalf of a putative class of purchasers of VUSE e-cigarettes. The plaintiff alleges that RJR Vapor failed to advise users that they potentially could be exposed to formaldehyde and acetaldehyde. The plaintiff asserts failure to warn claims under California's Proposition 65, as well as California Business & Professions Code § 17,200 *et seq.* and California Civil Code § 1,750 *et seq.* and seeks declaratory relief, restitution, disgorgement, injunctive relief and damages. RJR Vapor moved to dismiss contending, among other things, that plaintiff's action was governed in its entirety by Proposition 65 and that the plaintiff failed to give the 60-day pre-suit notice required by Proposition 65, requiring that the entire case be dismissed with prejudice. The motion to dismiss was argued on March 2, 2016. On September 30, 2016, the court granted RJR Vapor's motion to dismiss but provided the plaintiff leave to amend. The plaintiff filed a second amended complaint on October 31, 2016, and RJR Vapor has again moved to dismiss. Oral argument occurred on January 19, 2017. A decision is pending.

No Additive/Natural/Organic Claim Cases.

Following the FDA's August 27, 2015, warning letter to SFNTC relating to the use of the words "natural" and "additive-free" in the labeling, advertising and promotional materials for NATURAL AMERICAN SPIRIT brand cigarettes, plaintiffs purporting to bring claims on behalf of themselves and others have filed putative nationwide and/or state-specific class actions against SFNTC and, in some instances, RAI. A total of 16 such actions have been filed in nine U.S. district courts. Each of these cases is discussed below. In various combinations, plaintiffs in these cases generally allege violations of state deceptive and unfair trade practice statutes, and claim state common law fraud, negligent misrepresentation, and unjust enrichment based on the use of descriptors such as "natural," "organic" and "100% additive-free" in the marketing, labeling, advertising, and promotion of SFNTC's NATURAL AMERICAN SPIRIT brand cigarettes. The actions seek various categories of recovery, including economic damages, injunctive relief (including medical monitoring and cessation programs), interest, restitution, disgorgement, treble and punitive damages, and attorneys' fees and costs.

On January 6, 2016, the plaintiffs in one action filed a motion before the U.S. Judicial Panel on Multidistrict Litigation ("JPML") to consolidate these actions before one district court for pre-trial purposes. On April 11, 2016, the JPML ordered that these cases be consolidated for pre-trial purposes before Judge James O. Browning in the U.S. District Court for the District of New Mexico, referred to as the transferee court, and the then-pending and later-filed cases now are consolidated for pre-trial purposes in that court. The cases that were filed in or transferred for pre-trial purposes to the transferee court are as follows:

- *Sproule v. Santa Fe Natural Tobacco Co., Inc.* (U.S.D.C. S.D. Fla., filed 2015), is an action against SFNTC and RAI on behalf of a putative nationwide class of purchasers of NATURAL AMERICAN SPIRIT brand cigarettes.
- *Brattain v. Santa Fe Natural Tobacco Co., Inc.* (U.S.D.C. N.D. Cal., filed 2015), is an action against SFNTC and RAI on behalf of a putative class of California purchasers of NATURAL AMERICAN SPIRIT brand cigarettes.
- *Rothman v. Santa Fe Natural Tobacco Co., Inc.* (U.S.D.C. S.D.N.Y., filed 2015), is an action against SFNTC and RAI on behalf of a putative class of New York purchasers of NATURAL AMERICAN SPIRIT brand cigarettes.

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- *Dunn v. Santa Fe Natural Tobacco Co., Inc.* (U.S.D.C. D.N.M., filed 2015), is an action against SFNTC on behalf of a putative nationwide class (and Minnesota subclass) of purchasers of NATURAL AMERICAN SPIRIT brand cigarettes.
- *Haksal v. Santa Fe Natural Tobacco Co., Inc.* (U.S.D.C. D.N.M., filed 2015), is an action against SFNTC and RAI on behalf of a putative nationwide class (and California, Illinois, Minnesota, and New Mexico subclasses) of purchasers of NATURAL AMERICAN SPIRIT brand cigarettes.
- *Cuebas v. Santa Fe Natural Tobacco Co., Inc.* (U.S.D.C. S.D.N.Y., filed 2016), is an action against SFNTC and RAI on behalf of a putative nationwide class (and New York subclass) of purchasers of NATURAL AMERICAN SPIRIT brand cigarettes.
- *Okstad v. Santa Fe Natural Tobacco Co., Inc.* (U.S.D.C. M.D. Fla., filed 2016), is an action against SFNTC and RAI on behalf of a putative nationwide class and sixteen putative state-based subclasses (Alabama, California, Colorado, Florida, Georgia, Iowa, Illinois, Maryland, Maine, North Carolina, New Jersey, Ohio, Oregon, Pennsylvania, Texas and Wisconsin subclasses) of purchasers of NATURAL AMERICAN SPIRIT brand cigarettes.
- *Ruggiero v. Santa Fe Natural Tobacco Co., Inc.* (U.S.D.C. D.D.C., filed 2016), is an action against SFNTC and RAI on behalf of a putative nationwide class (and Maryland subclass) of purchasers of NATURAL AMERICAN SPIRIT brand cigarettes.
- *Waldo v. Santa Fe Natural Tobacco Co., Inc.* (U.S.D.C. M.D. Fla., filed 2016), is an action against SFNTC and RAI on behalf of a putative nationwide class (and Florida subclass) of purchasers of NATURAL AMERICAN SPIRIT brand cigarettes.
- *Grandison v. Santa Fe Natural Tobacco Co., Inc.* (U.S.D.C. E.D.N.Y., filed 2016), is an action against SFNTC and RAI on behalf of a putative nationwide class (and California, Florida and New York subclasses) of purchasers of NATURAL AMERICAN SPIRIT brand cigarettes.
- *Gudmundson v. Santa Fe Natural Tobacco Co., Inc.* (U.S.D.C. V.I., filed 2016), is an action against SFNTC and RAI on behalf of a putative class of U.S. Virgin Islands purchasers of NATURAL AMERICAN SPIRIT brand cigarettes.
- *LeCompte v. Santa Fe Natural Tobacco Co., Inc.* (U.S.D.C. D.N.M., filed 2016), is an action against SFNTC and RAI on behalf of a putative class of California purchasers of NATURAL AMERICAN SPIRIT brand cigarettes.
- *White v. Santa Fe Natural Tobacco Co., Inc.* (U.S.D.C. D.N.M., filed 2016), is an action against SFNTC on behalf of a putative nationwide class of purchasers of NATURAL AMERICAN SPIRIT brand cigarettes.
- *Johnston v. Santa Fe Natural Tobacco Co., Inc.* (U.S.D.C. S.D. Fla., filed 2016), is an action against SFNTC and RAI on behalf of a putative nationwide class (and Florida subclass) of purchasers of NATURAL AMERICAN SPIRIT brand cigarettes.
- *Cole v. Santa Fe Natural Tobacco Co., Inc.* (U.S.D.C. M.D. N.C., filed 2016), is an action against SFNTC and RAI on behalf of a putative nationwide class (and North Carolina subclass) of purchasers of NATURAL AMERICAN SPIRIT brand cigarettes.
- *Hebert v. Santa Fe Natural Tobacco Co., Inc.* (U.S.D.C. M.D. N.C., filed 2016), is an action against SFNTC, RAI and RJR Tobacco on behalf of a putative class of purchasers in California, Colorado, Florida, Illinois, Massachusetts, Michigan, New Jersey, New Mexico, New York, Ohio and Washington of NATURAL AMERICAN SPIRIT cigarettes, and a nationwide putative class of NATURAL AMERICAN SPIRIT brand menthol cigarette purchasers (and subclass of such purchasers in California, Colorado, Florida, Illinois and New Mexico).

The transferee court entered a scheduling order requiring the plaintiffs to file a consolidated amended complaint. On September 19, 2016, the plaintiffs filed a consolidated amended complaint naming SFNTC, RAI, and RJR Tobacco as defendants. That complaint alleges violations of 12 states' deceptive and unfair trade practices statutes – California, Colorado, Florida, Illinois, Massachusetts, Michigan, North Carolina, New Jersey, New Mexico, New York, Ohio, and West Virginia – based on the use of descriptors such as “natural,” “organic” and “100% additive-free” in the marketing, labeling, advertising, and promotion of SFNTC's NATURAL AMERICAN SPIRIT brand cigarettes. It also asserts unjust enrichment claims under those 12 states' laws and asserts breach of express warranty claims on behalf of a national class of NATURAL AMERICAN SPIRIT menthol purchasers. The state deceptive and unfair trade practice statutory and unjust enrichment claims are brought on behalf of state-specific classes in the 12 states listed above and, in some instances, state-specific subclasses. The consolidated amended complaint seeks class certification, payment for class notice, injunctive relief, monetary damages, prejudgment interest, statutory damages, restitution, and attorneys' fees and costs. On November 18, 2016, the defendants filed a motion to dismiss. Before responding to the motion to dismiss, the plaintiffs filed a second amended class action complaint on January 12, 2017. On February 23, 2017, the defendants moved to dismiss the second amended complaint. Oral argument on the defendants' motion to dismiss commenced on June 9, 2017 and is now completed. A decision is pending. The transferee court's scheduling order, as amended, provides for the plaintiffs to file a motion for class certification by April 3, 2018, and a hearing on the class certification motion on July 13-14, 2018.

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

On November 7, 2016, a public health advocacy organization filed *Breathe DC v. Santa Fe Natural Tobacco Co., Inc.* (D.C. Super. Ct.), an action against SFNTC, RAI and RJR Tobacco based on allegations relating to the labeling, advertising and promotional materials for NATURAL AMERICAN SPIRIT brand cigarettes that are similar to the allegations in the actions consolidated for pre-trial purposes in the transferee court described immediately above. The complaint seeks injunctive and other non-monetary relief, but does not seek monetary damages. On December 6, 2016, the defendants removed the action to the U.S. District Court for the District of Columbia and, on December 7, 2016, filed a notice with the JPML to have the action transferred to the transferee court. On December 7, 2016, the plaintiff moved in the U.S. District Court for the District of Columbia to remand the action to the Superior Court for the District of Columbia. On February 14, 2017, the U.S. District Court for the District of Columbia granted the plaintiffs' motion to remand, and the case was remanded to the Superior Court of the District of Columbia. On June 9, 2017, the defendants moved to dismiss, and the court entered an order providing for briefing on that motion to conclude by August 29, 2017.

Other Class Actions.

In *Young v. American Tobacco Co., Inc.* (Cir. Ct. Orleans Parish, La., filed 1997), the plaintiff brought a 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 a putative class of Louisiana residents who, though not themselves cigarette smokers, allegedly suffered injury as a result of exposure to ETS from cigarettes manufactured by defendants. The plaintiffs seek to recover an unspecified amount of compensatory and punitive damages. In March 2016, the court entered an order staying the case, including all discovery, pending the completion of the smoking cessation program ordered by the court in *Scott v. The American Tobacco Co.*

In *Parsons v. A C & S, Inc.* (Cir. Ct. Ohio County, W. Va., filed 1998), the plaintiff brought a class action against asbestos manufacturers, U.S. cigarette manufacturers, including RJR Tobacco, B&W, Lorillard Tobacco, and parent companies of U.S. cigarette manufacturers, including RJR and Lorillard, on behalf of a putative class of persons who allegedly have personal injury claims arising from their exposure to respirable asbestos fibers and cigarette smoke. The plaintiff seeks to recover \$1 million in compensatory and punitive damages individually for her purported injuries and an unspecified amount for the class in compensatory and punitive damages. In December 2000, three defendants, Nitral Liquidators, Inc., Desseaux Corporation of North America 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 who filed for bankruptcy. The case remains pending against the other defendants, including RJR Tobacco and Lorillard Tobacco, but it has long been dormant.

In *Jones v. American Tobacco Co., Inc.* (Cir. Ct., Jackson County, Mo., filed 1998), the plaintiff filed a class action against the major U.S. cigarette manufacturers, including RJR Tobacco, B&W, Lorillard Tobacco, and parent companies of U.S. cigarette manufacturers, including RJR and Lorillard, on behalf of a putative class of Missouri tobacco product users and purchasers who allegedly became addicted to nicotine. The plaintiffs seek an unspecified amount of compensatory and punitive damages. There is currently no activity in this case.

Filter Cases

Claims have been brought against Lorillard Tobacco and Lorillard by individuals who seek damages resulting from their alleged exposure to asbestos fibers that were incorporated into filter material used in one brand of cigarettes manufactured by a predecessor to Lorillard Tobacco for a limited period of time ending more than 50 years ago. As of June 30, 2017, Lorillard Tobacco and/or Lorillard was a defendant in 73 Filter Cases. Since January 1, 2014, Lorillard Tobacco and RJR Tobacco have paid, or have reached agreement to pay, a total of approximately \$42.3 million in settlements to resolve 165 Filter Cases.

Pursuant to the terms of a 1952 agreement between P. Lorillard Company and H&V Specialties Co., Inc. (the manufacturer of the filter material), Lorillard Tobacco is required to indemnify Hollingsworth & Vose for legal fees, expenses, judgments and resolutions in cases and claims alleging injury from finished products sold by P. Lorillard Company that contained the filter material.

On September 13, 2013, the jury in a Filter Case, *DeLisle v. A. W. Chesterton Co.* (Cir. Ct. Broward County, Fla., filed 2012), found for the plaintiffs on the negligence and strict liability claims; awarded the plaintiffs \$8 million in compensatory damages; and found Lorillard Tobacco 22% at fault, Hollingsworth & Vose 22% at fault, and the other defendants 56% at fault. Punitive damages were not at issue. On November 6, 2013, the trial court entered final judgment against Lorillard Tobacco in the amount of \$3.52 million. Lorillard Tobacco appealed to the Fourth DCA. On September 14, 2016, the Fourth DCA ordered a new trial because the trial court erred in admitting certain expert testimony and concluded that the \$8 million compensatory damages award should have been remitted. On July 7, 2017, the Florida Supreme Court granted the plaintiff's motion and stayed proceedings in the Fourth DCA and in the trial court, pending disposition of the petition for discretionary review, and it accepted jurisdiction and granted review on July 11, 2017. Oral argument has not been scheduled.

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

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 June 30, 2017, two health-care cost recovery cases were pending in the United States against RJR Tobacco, B&W, Lorillard Tobacco, or all three, as discussed below after the discussion of the State Settlement Agreements. A limited number of claimants have filed suit against RJR Tobacco, one of its affiliates, and other tobacco industry defendants to recover funds for health care, medical and other assistance paid by foreign provincial governments in treating their citizens. For additional information on these cases, see "— International Cases" below.

State Settlement Agreements. In June 1994, the Mississippi Attorney General brought an action, *Moore v. American Tobacco Co.*, against various industry members, including RJR Tobacco, B&W and Lorillard Tobacco. This case was brought on behalf of the state to recover state funds paid for health care and other assistance to state citizens suffering from diseases and conditions allegedly related to tobacco use. Most other states, through their attorneys general or other state agencies, sued RJR Tobacco, B&W, Lorillard Tobacco and other U.S. cigarette manufacturers based on similar theories. The cigarette manufacturer defendants, including RJR Tobacco, B&W and Lorillard Tobacco, 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, B&W and Lorillard Tobacco, 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, Lorillard Tobacco, and their affiliates and indemnitees, including RAI and Lorillard, 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 is the unadjusted tobacco industry settlement payment schedule (in millions) for 2015 and thereafter:

	2015 and thereafter
First Four States' Settlements: ⁽¹⁾	
Mississippi Annual Payment	\$ 136
Florida Annual Payment	440
Texas Annual Payment	580
Minnesota Annual Payment	204
Master Settlement Agreement:	
Annual Payments ⁽¹⁾	8,004
Total	\$ 9,364

RAI's operating subsidiaries expenses and payments under the State Settlement Agreements for 2015, 2016 and the projected expenses and payments for 2017 and thereafter (in millions) are set forth below. ⁽¹⁾⁽²⁾

	2015	2016	2017	2018 and thereafter
Settlement expenses	\$ 2,403	\$ 2,727	—	—
Settlement cash payments	\$ 2,166	\$ 3,042	—	—
Projected settlement expenses			\$>3,000	\$>3,000
Projected settlement cash payments			\$>2,700	\$>3,000

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

- (1) Subject to adjustments for changes in sales volume, inflation, operating profit and other factors. Payments are allocated among the companies on the basis of relative market share or other methods. For further information, see “— State Settlement Agreements—Enforcement and Validity; Adjustments” below.
- (2) The amounts above reflect the impact of the Term Sheet and the NY State Settlement described below under “— State Settlement Agreements—Enforcement and Validity; Adjustments — Partial Settlement of Certain NPM Adjustment Claims.”

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

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

U.S. Department of Justice Case.

In *United States v. Philip Morris USA Inc.* (U.S.D.C. D.D.C., filed 1999), the U.S. Department of Justice brought an action against RJR Tobacco, B&W, Lorillard Tobacco and other tobacco companies seeking (1) recovery of federal funds expended in providing health care to smokers who developed alleged smoking-related diseases pursuant to the Medical Care Recovery Act and Medicare Secondary Payer provisions of the Social Security Act and (2) equitable relief under the civil provisions of RICO, including disgorgement of roughly \$280 billion in profits the government contended were earned as a consequence of a purported racketeering “enterprise.” In September 2000, the district court dismissed the government’s Medical Care Recovery Act and Medicare Secondary Payer claims. In February 2005, the U.S. Court of Appeals for the D.C. Circuit, referred to as the D.C. Circuit, ruled that disgorgement was not an available remedy.

On August 17, 2006, after a non-jury bench trial, the district court found certain defendants, including RJR Tobacco, B&W and Lorillard Tobacco, had violated RICO, but did not impose any direct financial penalties. The district court instead enjoined RJR Tobacco, Lorillard Tobacco and the other defendants from committing future racketeering acts, participating in certain trade organizations, making misrepresentations concerning smoking and health and youth marketing, and using certain brand descriptors such as “low tar,” “light,” “ultra light,” “mild” and “natural.” The district court also ordered RJR Tobacco, Lorillard Tobacco and the other 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 district court placed restrictions on the defendants’ ability to dispose of certain assets for use in the United States, unless the transferee agrees to abide by the terms of the district court’s order, and ordered certain defendants to reimburse the U.S. Department of Justice its taxable costs incurred in connection with the case.

Defendants, including RJR Tobacco, B&W, and Lorillard Tobacco, appealed, the government cross appealed, and the defendants moved in the district court for clarification and a stay pending appeal. After the district court denied the defendants’ motion to stay, the D.C. Circuit granted a stay in October 2006.

The district court then granted the motion for clarification in part and denied it in part. With respect to the meaning and applicability of the general injunctive relief of the August 2006 order, the district court denied the motion for clarification. With respect to 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, the district court granted the motion and also ruled that the provisions prohibiting the use of express or implied health messages or descriptors do apply to the actions of the defendants taken outside of the United States.

In May 2009, the D.C. Circuit largely affirmed both the finding of liability against the tobacco defendants and the remedial order, including the denial of additional remedies, but vacated the order and remanded for further proceedings as to the following four discrete issues:

- the issue of the extent of B&W’s control over tobacco operations was remanded for further fact finding and clarification;
- the remedial order was vacated to the extent that it binds all defendants’ subsidiaries and was remanded to the district 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;

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

- the D.C. Circuit 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 district 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.

In June 2010, the U.S. Supreme Court denied all parties’ petitions for writ of certiorari.

Post-remand proceedings are underway. On December 22, 2010, the district court dismissed B&W from the litigation. In November 2012, the trial court entered an order setting forth the text of the corrective statements and directed the parties to engage in discussions with the Special Master to implement them. After extensive mediation led the parties to an implementation agreement, the district court entered an implementation order on June 2, 2014. The defendants filed a consolidated appeal challenging both the content of the court-ordered statements and the requirement that those statements be published in redundant media. On May 22, 2015, the D.C. Circuit reversed the corrective statements order in part, affirmed in part, and remanded to the district court for further proceedings. On October 1, 2015, the district court ordered the parties to propose new corrective-statements preambles. On February 8, 2016, the district court entered an order adopting the government’s proposed corrective-statements preamble. The parties then mediated, per the district court’s order, changes to the implementation order necessitated by the new preamble. On April 19, 2016, the district court accepted the parties’ mediated agreement on implementation and entered a superseding consent order with respect to implementation. The superseding consent order stays implementation of the corrective statements until the exhaustion of appeals from the orders establishing the text of those statements and governing implementation details. On April 7, 2016, the defendants and the post-judgment parties regarding remedies noticed an appeal to the D.C. Circuit from the order adopting the government’s proposed corrective-statement preambles. On May 6, 2016, the defendants and post-judgment parties regarding remedies noticed an appeal to the D.C. Circuit from the superseding consent order. On June 7, 2016, the D.C. Circuit granted the unopposed motion of the defendants and the post-judgment parties regarding remedies to consolidate the two appeals. Briefing in the consolidated appeals concluded in late December 2016, and oral argument occurred on February 14, 2017. On April 25, 2017, the D.C. Circuit affirmed in part, reversed in part, and remanded for further proceedings. The court has not yet set a schedule for the proceedings on remand. Additionally, RJR Tobacco appealed the district court’s May 28, 2015, order requiring RJR Tobacco to televise an additional set of corrective statements on behalf of B&W. On November 1, 2016, the D.C. Circuit upheld the order. In light of the corrective-statements implementation requirements, \$20 million has been accrued for the estimated costs of the corrective communications and is included in the condensed consolidated balance sheet (unaudited) as of June 30, 2017.

Native American Tribe Case.

As of June 30, 2017, one Native American tribe case was pending before a tribal court against RJR Tobacco, B&W and Lorillard Tobacco, *Crow Creek Sioux Tribe v. American Tobacco Co.* (Tribal Ct., Crow Creek Sioux, S.D., filed 1997). The plaintiffs seek to recover actual and punitive damages, restitution, funding of a clinical cessation program, funding of a corrective public education program, and disgorgement of unjust profits from sales to minors. The plaintiffs claim that the defendants are liable under the following theories: unlawful marketing and targeting of minors, contributing to the delinquency of minors, unfair and deceptive acts or practices, unreasonable restraint of trade and unfair method of competition, negligence, negligence per se, conspiracy and restitution of unjust enrichment. The case is dormant.

International Cases.

Each of the ten Canadian provinces has filed a health-care cost recovery action against Canadian and non-Canadian tobacco-related entities, including RJR Tobacco and one of its affiliates. In these actions, which are described below, each of the Canadian provinces seeks to recover for health care, medical and other assistance paid and to be paid for treating tobacco-related disease. 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 affiliate in these actions.

- *British Columbia* (British Columbia Sup. Ct., Vancouver Registry, filed 1997) - In 1997, British Columbia enacted a statute creating a civil cause of action against tobacco-related entities for the provincial government to recover the costs of health-care benefits incurred for insured British Columbia residents resulting from tobacco-related disease. An initial action brought pursuant to the statute against Canadian and non-Canadian tobacco-related entities, including RJR Tobacco and certain of its affiliates, was dismissed in February 2000 when the British Columbia Supreme Court ruled that the legislation was unconstitutional. British Columbia then enacted a revised statute, pursuant to which an action was filed in January 2001 against many of the same defendants, including RJR Tobacco and one of its affiliates. In that action, the British Columbia government

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

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, strict liability, deceit and misrepresentation, violation of trade practice and competition acts, concerted action, and joint liability. RJR Tobacco and its affiliate filed statements of defense in January 2007. Pre-trial discovery is ongoing.

- *New Brunswick* (Ct. of Queen’s Bench of New Brunswick, Jud. Dist. Fredericton, filed 2008) - This claim is brought pursuant to New Brunswick legislation enacted in 2008 that is substantially similar to the revised British Columbia statute described above. It seeks recovery of essentially the same types of damages sought in the British Columbia action based on analogous theories of liability. RJR Tobacco and its affiliate filed statements of defense in March 2010. Pre-trial discovery is ongoing. Trial has been set to begin on November 4, 2019.
- *Ontario* (Ontario Super. Ct. Justice, Toronto, filed 2009) - This claim is brought pursuant to Ontario legislation that is substantially similar to the revised British Columbia statute described above. It seeks recovery of essentially the same types of damages sought in the British Columbia action based on analogous theories of liability, although the government also asserted claims based on the illegal importation of cigarettes, which claims were deleted in an amended statement of claim filed in August 2010. RJR Tobacco and its affiliate filed statements of defense in April 2016.
- *Newfoundland and Labrador* (Sup. Ct. Newfoundland and Labrador, St. John’s, filed 2011) - This claim is brought pursuant to Newfoundland and Labrador legislation that is substantially similar to the revised British Columbia statute described above. It seeks recovery of essentially the same types of damages sought in the British Columbia action based on analogous theories of liability. RJR Tobacco and its affiliate filed statements of defense in May 2016.
- *Manitoba* (Ct. of Queen’s Bench, Winnipeg Jud. Centre, filed 2012) - This claim is brought pursuant to Manitoba legislation that is substantially similar to the revised British Columbia statute described above. It seeks recovery of essentially the same types of damages sought in the British Columbia action based on analogous theories of liability. RJR Tobacco and its affiliate filed statements of defense in September 2014. Pre-trial discovery is ongoing.
- *Quebec* (Super. Ct. Quebec, Dist. Montreal, filed 2012) - This claim is brought pursuant to Quebec legislation that is substantially similar to the revised British Columbia statute described above. It seeks recovery of essentially the same types of damages being sought in the British Columbia action based on analogous theories of liability. RJR Tobacco and its affiliate filed defenses in December 2014. Pre-trial discovery is ongoing.
- *Saskatchewan* (Ct. of Queen’s Bench, Jud. Centre Saskatoon, filed 2012) - This claim is brought pursuant to Saskatchewan legislation that is substantially similar to the revised British Columbia statute described above. It seeks recovery of essentially the same types of damages sought in the British Columbia action based on analogous theories of liability. RJR Tobacco and its affiliate filed statements of defense in February 2015.
- *Alberta* (Ct. of Queen’s Bench, Alberta Jud. Centre of Calgary, filed 2012) - This claim is brought pursuant to Alberta legislation that is substantially similar to the revised British Columbia statute described above. It seeks recovery of essentially the same types of damages sought in the British Columbia action based on analogous theories of liability. RJR Tobacco and its affiliate filed statements of defense in March 2016.
- *Prince Edward Island* (Sup. Ct. P.E.I., Charlottetown, filed 2012) - This claim is brought pursuant to Prince Edward Island legislation that is substantially similar to the revised British Columbia statute described above. It seeks recovery of essentially the same types of damages sought in the British Columbia action based on analogous theories of liability. RJR Tobacco and its affiliate filed statements of defense in February 2015.
- *Nova Scotia* (Sup. Ct. Nova Scotia, Halifax, filed 2015) - This claim is brought pursuant to Nova Scotia legislation that is substantially similar to the revised British Columbia statute described above. It seeks recovery of essentially the same types of damages sought in the British Columbia action based on analogous theories of liability. RJR Tobacco and its affiliate filed statements of defense in July 2015.

Seven putative class actions, which are described below, have been filed against various Canadian and non-Canadian tobacco-related entities, including RJR Tobacco and one of its affiliates, in Canadian provincial courts. In these cases, the plaintiffs allege claims based on 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, and violations of various trade practices and competition statutes. The plaintiffs seek recovery on behalf of proposed classes of persons allegedly suffering from tobacco-related disease as a result of smoking defendants’ cigarettes and

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

seek recovery of compensatory and punitive damages, restitution, recovery of government health-care benefits, interest, and costs. Pursuant to the terms of the 1999 sale of RJR Tobacco's international tobacco business, RJR Tobacco has tendered the defense of these seven actions to JTI. Subject to a reservation of rights, JTI has assumed the defense of RJR Tobacco and its current or former affiliates in these actions. Plaintiffs' counsel have been actively pursuing only *Bourassa*, the action pending in British Columbia, at this time.

- In *Kunka v. Canadian Tobacco Manufacturers' Council* (Ct. of Queen's Bench, Winnipeg Jud. Centre, filed 2009), the plaintiff seeks compensatory and punitive damages on behalf of a proposed class of persons who purchased or smoked defendants' cigarettes and suffered, or currently suffer, from tobacco-related disease, as well as restitution of profits and reimbursement of government expenditure for health-care benefits allegedly caused by the use of tobacco products.
- In *Dorion v. Canadian Tobacco Manufacturers' Council* (Ct. of Queen's Bench, Alberta Jud. Centre of Calgary – filed 2009), the plaintiff seeks compensatory and punitive damages on behalf of a proposed class of persons who purchased or smoked defendants' cigarettes and suffered, or currently suffer, from tobacco-related disease, as well as restitution of profits and reimbursement of government expenditure for health-care benefits allegedly caused by the use of tobacco products.
- In *Semple v. Canadian Tobacco Manufacturers' Council* (Sup. Ct. Nova Scotia, Halifax, filed 2009), the plaintiff seeks compensatory and punitive damages on behalf of a proposed class comprised of persons who purchased or smoked defendants' cigarettes for the period from January 1, 1954, to the expiry of the opt-out period as set by the court and suffered, or currently suffer, from tobacco-related disease, as well as restitution of profits and reimbursement of government expenditure for health-care costs allegedly caused by the use of tobacco products.
- In *Adams v. Canadian Tobacco Manufacturers' Council* (Ct. of Queen's Bench, Jud. Centre of Regina, filed 2009), the plaintiff seeks compensatory and punitive damages on behalf of a proposed class of persons who were alive on July 10, 2009, and suffered, or currently suffer, from chronic obstructive pulmonary disease, emphysema, heart disease or cancer, after having smoked a minimum of 25,000 of defendants' cigarettes, as well as disgorgement of revenues earned by the defendants. RJR Tobacco and its affiliate have brought a motion challenging the jurisdiction of the Saskatchewan court.
- In *Bourassa v. Imperial Tobacco Canada Ltd.* (Sup. Ct. of British Columbia, Victoria Registry, filed 2010), the plaintiff seeks compensatory and punitive damages on behalf of a proposed class of persons who were alive on June 12, 2007, and suffered, or currently suffer, from chronic respiratory diseases, after having smoked a minimum of 25,000 of defendants' cigarettes, as well as disgorgement of revenues earned by the defendants from January 1, 1954, to the date the claim was filed. RJR Tobacco and its affiliate have filed a challenge to the jurisdiction of the British Columbia court. The plaintiff filed a motion for certification in April 2012, and filed affidavits in support in August 2013. An amended claim was filed in December 2014.
- In *McDermid v. Imperial Tobacco Canada Ltd.* (Sup. Ct. of British Columbia, Victoria Registry, filed 2010), the plaintiff seeks compensatory and punitive damages on behalf of a proposed class of persons who were alive on June 12, 2007, and suffered, or currently suffer, from heart disease, after having smoked a minimum of 25,000 of defendants' cigarettes, as well as disgorgement of revenues earned by the defendants from January 1, 1954, to the date the claim was filed. RJR Tobacco and its affiliate have filed a challenge to the jurisdiction of the British Columbia court.
- In *Jacklin v. Canadian Tobacco Manufacturers' Council* (Ontario Super. Ct. of Justice, St. Catherines, filed 2012), the plaintiff seeks compensatory and punitive damages on behalf of a proposed class of persons who were alive on June 12, 2007, and suffered, or currently suffer, from chronic obstructive pulmonary disease, heart disease, or cancer, after having smoked a minimum of 25,000 of defendants' cigarettes, as well as restitution of profits, and reimbursement of government expenditure for health-care benefits allegedly caused by the use of tobacco products.

State Settlement Agreements—Enforcement and Validity; Adjustments

As of June 30, 2017, there were two cases concerning the enforcement, validity or interpretation of the State Settlement Agreements in which RJR Tobacco, B&W or Lorillard Tobacco is a party. This number includes the motion to enforce, discussed below, relating to disputed payments under the State Settlement Agreements.

In May 2006, the State of Florida filed a motion, in the Circuit Court of the Fifteenth Judicial Circuit, in and for Palm Beach County, Florida, to enforce the Florida settlement agreement, referred to as the Florida Settlement Agreement, for an accounting by B&W and for an Order of Contempt. The State asserted that B&W failed to report in its net operating profit on its shipments, cigarettes manufactured by B&W under contract for Star Tobacco or its parent, Star Scientific, Inc. The State is seeking approximately \$12.4 million in additional payments under the Florida Settlement Agreement, as well as \$17.0 million in interest payments. This matter is currently in the discovery phase.

On January 18, 2017, the State of Florida filed a motion to enjoin ITG as a defendant and to enforce the Florida Settlement Agreement. The State's motion seeks payment under the Florida Settlement Agreement with respect to the four brands (WINSTON, SALEM, KOOL and MAVERICK) that were sold to ITG in the Divestiture. Under the asset purchase agreement relating to the

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

Divestiture (and related documents), ITG was to assume responsibility with respect to these brands. Since the closing of the Divestiture and the transfer of these brands to it, ITG has not made settlement payments to the State with respect to these brands. The State's motion asserts that it "is presently owed more than \$45 million and will continue to suffer annual losses of approximately \$30 million absent the Court's enforcement of the Settlement Agreement...." The State's motion seeks, among other things, an order from the court declaring that RJR Tobacco and ITG are in breach of the Florida Settlement Agreement and are required, jointly and severally, to make annual payments to the State under the Florida Settlement Agreement with respect to the brands transferred to ITG in the Divestiture.

Also on January 18, 2017, Philip Morris USA, Inc. filed a motion to enforce the Florida Settlement Agreement. Philip Morris USA, Inc.'s motion asserted that RJR Tobacco and ITG have breached the Florida Settlement Agreement by failing to comply with the obligations under the Florida Settlement Agreement with respect to the transferred brands. Philip Morris USA, Inc.'s motion asserts that RJR Tobacco and ITG have "...deprived the State...of over \$40 million in settlement payments and improperly shifted millions of the remaining settlement payment obligations from themselves to Philip Morris USA, Inc., amounts that will increase greatly going forward absent intervention by [the] Court." Philip Morris USA, Inc.'s motion seeks various forms of relief to modify the settlement payment calculations to address the issues raised in its motion.

On January 27, 2017, RJR Tobacco filed a motion asserting that ITG failed to use its reasonable best efforts to join the Florida Settlement Agreement and breached the asset purchase agreement relating to the Divestiture. Accordingly, RJR Tobacco filed a motion for leave to allow a supplemental pleading for breach by ITG of its obligations regarding joinder into the Florida Settlement Agreement.

On March 30, 2017, the Florida court ruled that ITG should be joined into the enforcement action. Discovery related to the various motions is now underway. Court ordered mediation occurred on July 17, 2017, and the parties did not reach a resolution.

On February 17, 2017, ITG filed a complaint in the Court of Chancery of the State of Delaware seeking declaratory relief and a motion for a temporary restraining order against RAI and RJR Tobacco. In its complaint, ITG asked the court to declare various matters related to its rights and obligations under the asset purchase agreement (and related documents). In its motion, ITG asked for an injunction barring RAI and/or RJR Tobacco from alleging in the Florida enforcement litigation that ITG had breached the asset purchase agreement and requiring these companies to litigate issues under the asset purchase agreement in Delaware. A hearing was held on ITG's complaint and motion on March 1, 2017. After argument, the court entered a temporary restraining order that enjoined RAI and RJR Tobacco from "taking offensive action to assert claims against ITG Brands" in the Florida enforcement action, but the order does not prevent RJR Tobacco from making arguments in response to claims asserted by the State of Florida, Philip Morris USA, Inc. or ITG in the Florida enforcement litigation. On March 24, 2017, RAI and RJR Tobacco answered the ITG complaint and filed a motion to stay proceedings in Delaware pending the outcome of the Florida enforcement litigation. The motion for stay filed by RAI and RJR Tobacco was denied on May 18, 2017. Cross motions for partial judgment on the pleadings were filed focusing on whether ITG's obligation to use "reasonable best efforts" to join the Florida Settlement continued after the June 12, 2015 closing. Briefing is in progress, and oral argument on the cross motions has been scheduled for September 8, 2017.

NPM Adjustment Claims. The MSA includes an adjustment that potentially reduces the annual payment obligations of RJR Tobacco, Lorillard 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 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 of market share. This finding is known as a significant factor determination.

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, based on revised numbers calculated by the Independent Auditor, RJR Tobacco placed approximately \$615 million, and Lorillard Tobacco placed approximately \$109 million, of its 2006 and 2007 MSA payments into a disputed payments account, in accordance with a procedure established by the MSA.

As a result of this action, 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

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

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 an arbitration panel consisting of three retired federal court 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.

Forty-seven of the 48 courts that addressed the question whether the dispute concerning the 2003 NPM Adjustment is arbitrable ruled that arbitration was required under the MSA. 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. Subsequently, Montana and the PMs reached an agreement whereby the PMs agreed not to contest Montana's claim that it diligently enforced the Qualifying Statute during 2003.

In January 2009, RJR Tobacco and certain other PMs entered into an Agreement Regarding Arbitration, referred to as the Arbitration Agreement, with 45 of the MSA settling states (representing approximately 90% of the allocable share of the settling states) pursuant to which those states agreed to participate in a multistate arbitration of issues related to the 2003 NPM Adjustment. Under the Arbitration Agreement, the signing states had 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, without releasing or waiving any claims, authorized the release of those funds to the settling states.

The arbitration panel contemplated by the MSA and the Arbitration Agreement was selected, and proceedings before the panel with respect to the 2003 NPM Adjustment claim began in July 2010. Following the completion of document and deposition discovery, on November 3, 2011, RJR Tobacco and the other PMs advised the Arbitration Panel that they were not contesting the "diligent enforcement" of 12 states and the four U.S. territories with a combined allocable share of less than 14%. The "diligent enforcement" of the remaining 33 settling states, the District of Columbia and Puerto Rico was contested and became the subject of further proceedings. A common issues hearing was held in April 2012, and state specific evidentiary hearings with respect to the contested states were initiated.

As a result of the partial settlement of certain NPM Adjustment claims, as described in more detail below, as well as the earlier decisions not to contest the diligent enforcement of 12 states, two of which are participants in the partial settlement, and the four U.S. territories, only 15 contested settling states required state specific diligent enforcement rulings. State specific evidentiary hearings were completed in May 2013.

In September 2013, the Arbitration Panel issued rulings with respect to the 15 remaining contested states. The Arbitration Panel ruled that six states – Indiana, Kentucky, Maryland, Missouri, New Mexico and Pennsylvania (collectively representing approximately 14.68% allocable share) – had not diligently enforced their Qualifying Statutes in 2003. Each of these six states filed motions to vacate and/or modify the diligent enforcement rulings on the 2003 NPM Adjustment claim. The status of the remaining pending motion is as follows:

- New Mexico filed motions challenging the finding of non-diligence and seeking a modification of the judgment reduction method adopted by the Arbitration Panel. The New Mexico trial court denied the state's motion to vacate the finding of non-diligence, but granted the state's motion challenging the judgment reduction method that had been adopted by the Arbitration Panel, which reduced RJR Tobacco's and Lorillard Tobacco's recovery from this state by \$5.6 million and \$1 million, respectively. RJR Tobacco has appealed the court's ruling on the judgment reduction method. The State did not appeal the trial court's denial of its motion to vacate the finding on non-diligence.

The effect from the four non-diligent states, Pennsylvania, Missouri, Maryland and New Mexico, no longer challenging the findings of non-diligence entered against them by the Arbitration Panel was that a certain portion of the potential recovery from these four states was probable and reasonably estimable. Consequently, \$6 million and \$93 million was recognized as a reduction of cost of products sold in RAI's consolidated statements of income for the year ended December 31, 2016 and 2015, respectively.

RJR Tobacco now estimates that the maximum remaining amount of its claim and Lorillard Tobacco's claim with respect to the 2003 NPM Adjustment claim is \$6 million and \$1 million, respectively, plus any applicable interest and earnings. Until such time RJR Tobacco's appeal of the New Mexico state court's ruling that modified the judgment reduction method adopted by the Arbitration Panel has been resolved, including any necessary appeals, uncertainty exists as to the timing, process and amount of RJR Tobacco's ultimate recovery with respect to its remaining share of the 2003 NPM Adjustment claim and, accordingly, no additional amounts have been recognized in RAI's condensed consolidated financial statements (unaudited) as of June 30, 2017.

NPM Adjustment Claims for 2004-2016. From 2006 to 2008, proceedings (including significant factor arbitrations before an independent economic consulting firm) were initiated with respect to the NPM Adjustment for 2004, 2005 and 2006. Ultimately, the Adjustment Requirements were satisfied with respect to each of these NPM Adjustments.

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

In subsequent years, RJR Tobacco, Lorillard Tobacco, certain other PMs and the settling states entered into three separate agreements, covering fiscal years 2007 to 2009, fiscal years 2010 to 2012, fiscal years 2013 to 2014, and fiscal years 2015 to 2017 respectively, wherein the settling states would 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 years covered by the four agreements became effective in February of the year a final determination by the firm of independent economic consultants would otherwise have been expected if the issue had been arbitrated on the merits. For fiscal years 2015 to 2017, RJR Tobacco and PM USA paid certain amounts to certain of the settling states for each year covered by these agreements, with RJR Tobacco paying approximately 67% of such amounts.

Based on the payment calculations of the Independent Auditor and the agreements described above regarding the significant factor determinations, the Adjustment Requirements have been satisfied with respect to the NPM Adjustments for fiscal years 2007 to 2014. The approximate maximum principal amounts of RJR Tobacco’s and Lorillard Tobacco’s shares of the disputed NPM Adjustments for the years 2004 through 2014 (in millions), as currently calculated by the Independent Auditor, and the remaining amounts after the settlements of certain NPM Adjustments claims (see below), are as follows ⁽¹⁾:

Volume Year	RJR Tobacco		Lorillard Tobacco	
	Disputed	Remaining after settlements	Disputed	Remaining after settlements
2004	\$ 562	\$ 200	\$ 111	\$ 39
2005	445	158	76	27
2006	419	149	73	26
2007	435	157	83	30
2008	468	169	104	38
2009	472	171	107	39
2010	470	170	119	44
2011	422	152	88	32
2012	430	156	97	36
2013	457	165	92	34
2014	433	156	93	34

⁽¹⁾ The amounts shown above do not include the interest or earnings thereon to which RJR Tobacco and Lorillard Tobacco believe they would be entitled under the MSA.

In addition to the above, SFNTC’s portion of the disputed NPM Adjustments for the years 2004 through 2014 is approximately \$67 million and the remaining amount after the settlements is approximately \$25 million.

The 2015 volume year NPM Adjustments for RJR Tobacco, Lorillard Tobacco and SFNTC are \$482 million, \$41 million, and \$18 million, respectively.

The 2016 volume year NPM Adjustments for RJR Tobacco and SFNTC are \$505 million and \$22 million, respectively.

The 2004 NPM Adjustment proceeding is underway before two overlapping panels, with one panel hearing the issues with respect to five states and the other panel hearing the issues as to the remaining states that will be part of the arbitration. A revised case management order governing the arbitration was entered on January 4, 2017. Under the timing established by that case management order, discovery in the arbitration proceedings was completed by the end of the second quarter of 2017. A hearing on common issues took place starting in June 2017. State specific evidentiary hearings will begin in the fourth quarter of 2017 and will likely conclude by the end of the third quarter of 2018. Diligent enforcement rulings from the panels are likely by the end of the fourth quarter of 2018. RJR Tobacco’s and Lorillard Tobacco’s remaining claim with respect to 2004 is approximately \$239 million collectively.

Missouri obtained an order from the Missouri court of appeals for a separate state specific arbitration of the diligent enforcement issue, but on appeal, the Missouri Supreme Court ordered Missouri to participate in the nationwide arbitration of the 2004 NPM Adjustment. Also, in the context of the 2003 NPM Adjustment proceedings, Montana obtained a ruling from the Montana Supreme Court that the issue of diligent enforcement under the MSA must be heard before that state’s MSA court. Finally, New Mexico and the four U.S. territories have been asked to join the 2004 NPM Adjustment Arbitration, but have not yet done so. New Mexico has, however, been ordered by its state court to participate in the nationwide arbitration, although it is appealing that order.

Due to the uncertainty over the final resolution of the 2004-2016 NPM Adjustment claims asserted by RJR Tobacco (including Lorillard Tobacco claims) and SFNTC, no assurances can be made related to the amounts, if any, that will be realized or any amounts (including interest) that will be owed, except as described below related to the partial settlement of certain NPM Adjustment claims.

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

Settlement/Partial Settlement of Certain NPM Adjustment Claims. In November 2012, RJR Tobacco, certain other PMs and certain settling states entered into a Term Sheet that set forth terms on which accrued and potential NPM Adjustment claims for 2003 through 2014 could be resolved. The Term Sheet also set forth a restructured NPM Adjustment process to be applied on a going-forward basis, starting with the 2013 volume year. The Term Sheet was provided to all of the MSA settling states for their review and consideration. A total of 17 states, the District of Columbia and Puerto Rico, collectively representing approximately 42% allocable share, joined the proposed settlement. RJR Tobacco and the other PMs indicated that they were prepared to go forward with the proposed settlement with that level of jurisdictional participation.

The Term Sheet provided that the Arbitration Panel in place to deal with the 2003 NPM Adjustment (and other NPM Adjustment-related matters) must review the proposed settlement and enter an appropriate order to confirm for the Independent Auditor that it should implement, as necessary, the terms of the settlement agreement.

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

Subsequently in 2013, Oklahoma, Connecticut and South Carolina joined the Term Sheet. Efforts by two states, Colorado and Ohio, to obtain injunctions to prevent implementation of the Award were unsuccessful that year.

In June 2014, Kentucky and Indiana, both of which were among the states found “non-diligent” by the Arbitration Panel, joined the Term Sheet on financial terms more favorable to the industry than those agreed to by the original signatory states. In April 2017, Rhode Island and Oregon joined the Term Sheet settlement. Twenty-six jurisdictions have now joined the Term Sheet settlement representing approximately 51.73% allocable share.

On October 20, 2015, RJR Tobacco and certain other PMs (including SFNTC) entered into the NY Settlement Agreement with the State of New York to settle certain claims related to the NPM Adjustment. The NY Settlement Agreement resolves NPM Adjustment claims related to payment years from 2004 through 2014 and puts in place a new method to determine future adjustments from 2015 forward as to New York. With the addition of New York’s allocable share of 12.76%, RJR Tobacco has resolved the 2004 through 2014 NPM Adjustments with 27 jurisdictions, representing approximately 64.49% allocable share.

For additional information related to the Term Sheet and the NY Settlement Agreement, see “— Cost of Products Sold” in note 1.

Other Litigation and Developments

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

- In a letter dated March 31, 2006, counsel for JTI stated that JTI would be seeking indemnification under the 1999 Purchase Agreement for any damages it may incur or may have incurred arising out of a Southern District of New York grand jury investigation, a now-terminated Eastern District of North Carolina grand jury investigation, and various actions filed by the European Community and others in the U.S. District Court for the Eastern District of New York, referred to as the EDNY, against RJR Tobacco and certain of its affiliates on November 3, 2000, August 6, 2001, and (as discussed in greater detail below) October 30, 2002, and against JTI on January 11, 2002.
- JTI also has sought indemnification relating to a Statement of Claim filed on April 23, 2010, in the Ontario Superior Court of Justice, London, against JTI Macdonald Corp., referred to as JTI-MC, by the Ontario Flue-Cured Tobacco Growers’ Marketing Board, referred to as the Board, Andy J. Jacko, Brian Baswick, Ron Kichler, and Aprad Dobrenty, proceeding on their own behalf and on behalf of a putative class of Ontario tobacco producers that sold tobacco to JTI-MC during the period between January 1, 1986 and December 31, 1996, referred to as the Class Period, through the Board pursuant to certain agreements. The Statement of Claim seeks recovery for damages allegedly incurred by the class representatives and the putative class for tobacco sales during the Class Period made at the contract price for duty free or export cigarettes with respect to cigarettes that, rather than being sold duty free or for export, purportedly were sold in Canada, which allegedly breached one or more of a

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

series of contracts dated between June 4, 1986, and July 3, 1996. Appeals taken from an unsuccessful motion to dismiss the action as barred by the statute of limitations were ultimately denied on November 4, 2016. Certification proceedings are pending.

- Finally, JTI has advised RJR and RJR Tobacco of its view that, under the terms of the 1999 Purchase Agreement, RJR and RJR Tobacco are liable for approximately \$1.85 million related to a judgment entered in 1998, plus interest and costs, in an action filed in Brazil by Lutz Hanneman, a former employee of a former RJR Tobacco subsidiary. RJR and RJR Tobacco deny that they are liable for this judgment under the terms of the 1999 Purchase Agreement.

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

European Community. In *European Community v. RJR Nabisco, Inc.* (U.S.D.C. E.D.N.Y., filed 2002), the European Community and several of its member states allege that RJR, RJR Tobacco and other currently and formerly related companies engaged in money laundering and other conduct violating civil RICO and a variety of common laws. The plaintiffs also allege 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. On February 15, 2010, the defendants moved to dismiss, and the action has been stayed and largely inactive since then while the parties have litigated that motion. On March 8, 2011, the district court granted the defendants' motion in part and dismissed the plaintiffs' RICO claims. On May 13, 2011, the district court granted the remaining portion of the defendants' motion and dismissed the plaintiffs' state-law claims based on the court's lack of subject matter jurisdiction. The plaintiffs appealed to the Second Circuit.

On April 29, 2014, the Second Circuit vacated and remanded in a decision concluding that (1) as pled, the RICO claims are within the scope of the RICO statute, and (2) the federal court has subject matter jurisdiction over the state-law claims. The defendants sought rehearing and rehearing *en banc*. On August 20, 2014, the Second Circuit denied panel rehearing and issued an amended opinion that, in addition to adhering to the earlier opinion, held that a civil RICO cause of action extends to extraterritorial injuries. The U.S. Supreme Court granted certiorari and, on June 20, 2016, reversed the Second Circuit's decision and ordered the dismissal of the plaintiffs' RICO damages claims, finding that RICO civil causes of action extend only to domestic injuries, which claims the plaintiffs had abandoned. The court also held that any private RICO claims for equitable relief must also rest on domestic injuries but reserved decision on whether the plaintiffs had alleged such claims. The court's decision does not affect the plaintiffs' common-law claims. After remand, the district court entered an order allowing the plaintiffs to file an amended complaint by October 24, 2016, which later was extended indefinitely. Once the amended complaint is filed, the parties have been directed to submit a joint briefing schedule for the defendants' anticipated motion to dismiss. Further, the district court stayed discovery until ten days after entry of an order deciding the defendants' anticipated motion to dismiss.

Fontem Patent Litigation. On April 4, 2016, a case was filed in federal court, *Fontem Ventures B.V. and Fontem Holdings I B.V. v. R. J. Reynolds Vapor Company* (U.S.D.C. C.D. Cal.), which alleges that VUSE products infringe four patents owned by Fontem purportedly directed to e-cigarettes. On May 3, 2016, Fontem filed a second complaint asserting that the VUSE products infringe two additional Fontem patents purportedly directed to e-cigarettes. On June 22, 2016, Fontem filed a third complaint asserting that the VUSE products infringe one additional Fontem patent purportedly directed to e-cigarettes. RJR Vapor filed an answer in the first case on June 27, 2016, and an amended answer on July 25, 2016. RJR Vapor also filed answers in the second and third cases on July 25, 2016. On June 29, 2016, RJR Vapor filed a motion to transfer the three cases to the Middle District of North Carolina, which was granted on August 8, 2016. On December 14, 2016, the transferred cases were consolidated with lead case *Fontem Ventures B.V. and Fontem Holdings I B.V. v. R. J. Reynolds Vapor Company*, 16-cv-1255 (M.D.N.C.) On March 1, 2017, Fontem filed a fourth complaint in the Middle District of North Carolina asserting that the VUSE products infringe eight additional Fontem patents. RJR Vapor filed an answer to the fourth complaint on April 24, 2017. On April 14, 2017, Fontem filed a motion to amend the consolidated three prior actions to add certain Reynolds entities as additional defendants, which was denied as moot on May 30, 2017, due to an agreed stipulation where the additional Reynolds entities agreed to be bound by any judgment and to provide discovery as if they were named parties. On May 9, 2017, the fourth action was also consolidated with the lead case.

Also, to date, RJR Vapor has filed multiple petitions for *inter partes* review against seven of the 15 asserted patents. Three of the petitions have been granted, five denied, and the others are still pending decision.

Oklahoma Tax Litigation. On June 7, 2017, Philip Morris USA Inc. and R. J. Reynolds Tobacco Company, among others, filed suit in the Oklahoma Supreme Court alleging that the Oklahoma legislature improperly enacted legislation that would increase the price of cigarettes by \$1.50 per pack because the legislature failed to abide by the State's procedures for passing a tax measure. The Oklahoma Supreme Court will hear oral argument on August 8, 2017.

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Smokeless Tobacco Litigation

In 1999, when the IPIC litigation was first filed, the named defendants included manufacturers of smokeless products, including Conwood Company, LLC (now known as American Snuff Company, LLC) and others. When the IPIC plaintiffs filed discovery responses in IPIC listing the products they used, 41 of them listed a smokeless product. Six of those 41 plaintiffs listed a brand owned by American Snuff (Levi Garrett). Seven listed a brand (Beechnut) once manufactured by Lorillard Tobacco (now manufactured by National Tobacco Company). On December 3, 2001, the IPIC court severed all smokeless claims and all smokeless defendants from IPIC. There was no order staying the case during IPIC. In the ensuing 15 years, the plaintiffs in the severed cases did nothing to pursue the cases. The plaintiffs now seek to activate various smokeless claims, including certain plaintiffs whose cases were dismissed in IPIC after severance of the smokeless claims and whose claims are not counted in the 41 claims described above. After a status conference on July 11, 2016, the court set a schedule for briefing the issue of whether the severed claims should be dismissed because of the prolonged inaction in the case. On January 25, 2017, the trial court denied the defendants' motion to dismiss those claims as abandoned. The plaintiffs are now free to move forward with their claims, and an initial schedule for discovery has been set through 2019.

ERISA Litigation

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

In July 2002, the defendants filed a motion to dismiss, which the court granted in December 2003. In December 2004, the U.S. Court of Appeals for the Fourth Circuit reversed the dismissal of the complaint, holding that the 1999 Amendment did contain sufficient discretion for the defendants to have retained the NGH and Nabisco funds as of February 1, 2000, and remanded the case for further proceedings. The court granted the plaintiff leave to file an amended complaint and denied all pending motions as moot. In April 2007, the defendants moved to dismiss the amended complaint. The court granted the motion in part and denied it in part, dismissing all claims against the RJR Employee Benefits Committee and the RJR Pension Investment Committee. The plaintiff filed a motion for class certification, which the court granted in September 2008.

A non-jury trial was held in January and February 2010. On February 25, 2013, the district court dismissed the case with prejudice, finding that a hypothetical prudent fiduciary could have made the same decision and thus the plan's loss was not caused by the procedural prudence which the court found to have existed. On August 4, 2014, the Fourth Circuit Court of Appeals, referred to as Fourth Circuit, reversed, holding that the district court applied the wrong standard when it held that the defendants did not cause any loss to the plan, determined the test was whether a hypothetical prudent fiduciary would have made the same decision and remanded the case back to the district court to apply the "would have standard." On February 18, 2016, the district court dismissed the case with prejudice, finding that the defendants have shown by a preponderance of the evidence that a fiduciary acting with prudence would have divested the NGH and Nabisco Funds at the time and in the manner that the defendants did. On March 17, 2016, the plaintiff appealed arguing that the district court erred in finding that a hypothetical prudent fiduciary would have divested the NGH and Nabisco Funds at the same time and in the same manner as RJR. On April 28, 2017, the Fourth Circuit affirmed the district court's judgment in favor of RJR. The plaintiff filed a petition for rehearing *en banc* on May 12, 2017, which was denied on May 26, 2017. The plaintiff agreed to forgo filing a petition for writ of certiorari with the U.S. Supreme Court in exchange for RJR withdrawing its motion for costs in the district court. Therefore, the matter has concluded.

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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 or facility 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.

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

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 or handling, facility modification and similar activities. RAI and its subsidiaries are engaged in a continuing program to comply with federal, state and local environmental laws and regulations, and dependent upon the probability of occurrence and reasonable estimation of cost, accrue or disclose any material liability. Although it is difficult to reasonably estimate the portion of capital expenditures or other costs attributable to compliance with environmental laws and regulations, RAI does not expect such expenditures or other costs to have a material adverse effect on the business, results of operations, cash flows or financial position of RAI or its subsidiaries.

Shareholder Cases

Lorillard Transaction. RAI, the members of the RAI board of directors and BAT have been named as defendants in a putative class-action lawsuit captioned *Corwin v. British American Tobacco PLC*, brought in North Carolina state court, referred to as *Corwin*, by a person identifying himself as a shareholder of RAI. *Corwin* was initiated on August 8, 2014, and an amended complaint was filed on November 7, 2014. The amended complaint generally alleges, among other things, that the members of the RAI board of directors breached their fiduciary duties to RAI shareholders by approving the share purchase by BAT and the sharing of technology with BAT, as well as that there were various conflicts of interest in the transaction. More specifically, the amended complaint alleges that (1) RAI aided and abetted the alleged breaches of fiduciary duties by its board of directors and (2) BAT was a controlling shareholder of RAI and, as a consequence, owed other RAI shareholders fiduciary duties in connection with the BAT Share Purchase. *Corwin* seeks injunctive relief, damages and reimbursement of costs, among other remedies. On January 2, 2015, the plaintiff in *Corwin* filed a motion for a preliminary injunction seeking to enjoin temporarily the RAI shareholder meeting and votes scheduled for January 28, 2015. RAI and the RAI board of directors timely opposed that motion prior to a hearing that was scheduled to occur on January 16, 2015.

RAI believed that *Corwin* was without merit and that no further disclosure was necessary to supplement the Joint Proxy Statement/Prospectus under applicable laws. However, to eliminate certain burdens, expenses and uncertainties, on January 17, 2015, RAI and the director defendants in *Corwin* entered into the North Carolina Memorandum of Understanding regarding the settlement of the disclosure claims asserted in that lawsuit. The North Carolina Memorandum of Understanding outlines the terms of the parties' agreement in principle to settle and release the disclosure claims which were or could have been asserted in *Corwin*. In consideration of the partial settlement and release, RAI agreed to make certain supplemental disclosures to the Joint Proxy Statement/Prospectus, which it did on January 20, 2015. On August 4, 2015, the trial court granted the defendants' motions to dismiss all of the remaining non-disclosure claims. The plaintiff appealed. On February 17, 2016, the trial court approved the partial settlement, including the plaintiff's unopposed request for \$415,000 in attorneys' fees and costs. The partial settlement did not affect the consideration paid to Lorillard shareholders in connection with the Lorillard Merger. On December 20, 2016, the North Carolina Court of Appeals affirmed the trial court's dismissal of the claims against RAI and RAI's Board of Directors on the grounds that the plaintiff could not state a direct claim against RAI's Board of Directors for breach of fiduciary duties. The Court of Appeals reversed the dismissal of the claims against BAT. On January 4, 2017, BAT filed a motion for rehearing *en banc* of the Court of Appeals' opinion, which was denied on February 2, 2017. BAT petitioned the North Carolina Supreme Court for review of the Court of Appeals' decision, which was accepted on June 9, 2017.

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

BAT Transaction. In connection with the Merger Agreement, two putative class action lawsuits were filed in the U.S. District Court for the Middle District of North Carolina against RAI and the members of the RAI board of directors, which are captioned *Drew v. Reynolds American Inc., et al.* (filed June 16, 2017), and *Sneed v. Reynolds American Inc., et al.* (filed June 26, 2017), referred to as the Merger Litigation. The complaints, which were filed by alleged RAI shareholders, generally allege that the definitive proxy statement that RAI filed with the SEC on June 14, 2017, referred to as the RAI Proxy Statement, omitted certain material information in connection with the BAT Merger in violation of Sections 14(a) and 20(a) of the Exchange Act. The complaints seek injunctive relief to prevent the consummation of the BAT Merger unless the allegedly material information is disclosed, damages and attorneys' fees and costs.

RAI believes that the claims asserted in these cases are without merit and that no supplemental disclosure was required under applicable law. Nevertheless, in order to avoid the risk of the Merger Litigation delaying or otherwise adversely affecting the BAT Merger and to minimize the costs, risks and uncertainties inherent in litigation, and without admitting any liability or wrongdoing, on July 11, 2017, RAI filed supplemental disclosures to the RAI Proxy Statement with certain additional information relating to the BAT Merger.

Other Contingencies

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

- any liabilities, costs and expenses arising out of the imposition or assessment of any tax with respect to the international tobacco business arising prior to the sale, other than as reflected on the closing balance sheet;
- any liabilities, costs and expenses that JTI or any of its affiliates, including the acquired entities, may incur after the sale with respect to any of RJR's or RJR Tobacco's employee benefit and welfare plans; and
- any liabilities, costs and expenses incurred by JTI or any of its affiliates arising out of certain activities of Northern Brands.

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

In connection with the sale of the international rights to the NATURAL AMERICAN SPIRIT brand name and associated trademarks to JTI Holding, along with the international companies that distribute and market the brand outside the United States, pursuant to the 2015 Purchase Agreement, SFNTC, R. J. Reynolds Global Products, Inc., and R. J. Reynolds Tobacco B.V. agreed to indemnify JTI Holding against, among other things, any liabilities, costs, and expenses relating to actions:

- commenced on or before (1) January 13, 2019, to the extent relating to alleged personal injuries, and (2) in all other cases, January 13, 2021;
- brought by (1) a governmental authority to enforce legislation implementing European Union Directive 2001/37/EC or European Directive 2014/40/EU or (2) consumers or a consumer association; and
- arising out of any statement or claim (1) made on or before January 13, 2016, (2) by any company sold to JTI Holding in the transaction, (3) concerning NATURAL AMERICAN SPIRIT brand products consumed or intended to be consumed outside of the United States and (4) that the NATURAL AMERICAN SPIRIT brand product is natural, organic, or additive free.

ITG Indemnity. In the purchase agreement relating to the Divestiture, RAI agreed to defend and indemnify, subject to certain conditions and limitations, ITG in connection with claims relating to the purchase or use of one or more of the WINSTON, KOOL, SALEM, or MAVERICK cigarette brands on or before June 12, 2015, as well as in actions filed before June 13, 2023, relating to the purchase or use of one or more of the WINSTON, KOOL, SALEM, or MAVERICK cigarette brands. In the purchase agreement relating to the Divestiture, ITG agreed to defend and indemnify, subject to certain conditions and limitations, RAI and its affiliates in connection with claims relating to the purchase or use of blu brand e-cigarettes. ITG also agreed to defend and indemnify, subject to certain conditions and limitations, RAI and its affiliates in actions filed after June 12, 2023, relating to the purchase or use of one or more of the WINSTON, KOOL, SALEM, or MAVERICK cigarette brands after June 12, 2015.

Loews Indemnity. In 2008, Loews Corporation, referred to as Loews, entered into an agreement with Lorillard, Lorillard Tobacco, and certain of their affiliates, which agreement is referred to as the Separation Agreement. In the Separation Agreement, Lorillard agreed to indemnify Loews and its officers, directors, employees and agents against all costs and expenses arising out of third party claims (including, without limitation, attorneys' fees, interest, penalties and costs of investigation or preparation of defense), judgments, fines,

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

losses, claims, damages, liabilities, taxes, demands, assessments, and amounts paid in settlement based on, arising out of or resulting from, among other things, Loews's ownership of or the operation of Lorillard and its assets and properties, and its operation or conduct of its businesses at any time prior to or following the separation of Lorillard and Loews (including with respect to any product liability claims). Loews is a defendant in three pending product liability actions, each of which is a putative class action. Pursuant to the Separation Agreement, Lorillard is required to indemnify Loews for the amount of any losses and any legal or other fees with respect to such cases. Following the closing of the Lorillard Merger, RJR Tobacco assumed Lorillard's obligations under the Separation Agreement as was required under the Separation Agreement.

Indemnification of Distributors and Retailers. RJR Tobacco, Lorillard Tobacco, SFNTC, American Snuff Co. and RJR Vapor have entered into agreements to indemnify certain distributors and retailers from liability and related defense costs arising out of the sale or distribution of their products. Additionally, SFNTC has entered into an agreement to indemnify a supplier from liability and related defense costs arising out of the sale or use of SFNTC's products. The cost has been, and is expected to be, insignificant. RJR Tobacco, SFNTC, American Snuff Co. and RJR Vapor 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.

Note 8 — Shareholders' Equity

	<u>Common Stock</u>	<u>Paid- In Capital</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Loss</u>	<u>Total Shareholders' Equity</u>
Balance as of December 31, 2016	\$ —	\$ 18,285	\$ 3,740	\$ (314)	\$ 21,711
Net income	—	—	1,699	—	1,699
Retirement benefits, net of \$5 million tax expense	—	—	—	9	9
Cumulative translation adjustment and other, net of \$6 million tax expense	—	—	—	14	14
Dividends - \$1.02 per share	—	—	(1,459)	—	(1,459)
Common stock repurchased	—	(139)	—	—	(139)
Equity incentive award plan and stock-based compensation	—	51	—	—	51
Balance as of June 30, 2017	<u>\$ —</u>	<u>\$ 18,197</u>	<u>\$ 3,980</u>	<u>\$ (291)</u>	<u>\$ 21,886</u>

	<u>Common Stock</u>	<u>Paid- In Capital</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Loss</u>	<u>Total Shareholders' Equity</u>
Balance as of December 31, 2015	\$ —	\$ 18,402	\$ 188	\$ (338)	\$ 18,252
Net income	—	—	4,361	—	4,361
Retirement benefits, net of \$21 million tax expense	—	—	—	33	33
Long-term investments, net of \$3 million tax expense	—	—	—	3	3
Hedging instruments, net of \$6 million tax expense	—	—	—	11	11
Cumulative translation adjustment and other, net of \$9 million tax expense	—	—	—	17	17
Dividends - \$0.84 per share	—	—	(1,204)	—	(1,204)
Common stock repurchased	—	(149)	—	—	(149)
Equity incentive award plan and stock-based compensation	—	50	—	—	50
Excess tax benefit on stock-based compensation plans	—	26	—	—	26
Balance as of June 30, 2016	<u>\$ —</u>	<u>\$ 18,329</u>	<u>\$ 3,345</u>	<u>\$ (274)</u>	<u>\$ 21,400</u>

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

Accumulated Other Comprehensive Loss

The components of accumulated other comprehensive loss, net of tax, for the six months ended June 30, 2017 were as follows:

	<u>Retirement Benefits</u>	<u>Cumulative Translation Adjustment and Other</u>	<u>Total</u>
Balance as of December 31, 2016	\$ (255)	\$ (59)	\$ (314)
Other comprehensive income before reclassifications	20	14	34
Amounts reclassified from accumulated other comprehensive loss	<u>(11)</u>	<u>—</u>	<u>(11)</u>
Net current-period other comprehensive income	9	14	23
Balance as of June 30, 2017	<u>\$ (246)</u>	<u>\$ (45)</u>	<u>\$ (291)</u>

The components of accumulated other comprehensive loss, net of tax, for the six months ended June 30, 2016, were as follows:

	<u>Retirement Benefits</u>	<u>Long-Term Investments</u>	<u>Hedging Instruments</u>	<u>Cumulative Translation Adjustment and Other</u>	<u>Total</u>
Balance as of December 31, 2015	\$ (244)	\$ (14)	\$ (11)	\$ (69)	\$ (338)
Other comprehensive income (losses) before reclassifications	45	5	—	(10)	40
Amounts reclassified from accumulated other comprehensive loss	<u>(12)</u>	<u>(2)</u>	<u>11</u>	<u>27</u>	<u>24</u>
Net current-period other comprehensive income	33	3	11	17	64
Balance as of June 30, 2016	<u>\$ (211)</u>	<u>\$ (11)</u>	<u>\$ —</u>	<u>\$ (52)</u>	<u>\$ (274)</u>

Details about the reclassifications out of accumulated other comprehensive loss and the affected line items in the condensed consolidated statement of income (unaudited) for the three months ended June 30, were as follows:

<u>Components</u>	<u>Amounts Reclassified</u>		<u>Affected Line Item</u>
	<u>2017</u>	<u>2016</u>	
Retirement benefits:			
Amortization of prior service credit	\$ (5)	\$ (5)	Cost of products sold
Amortization of prior service credit	(4)	(5)	Selling, general and administrative expenses
Deferred taxes	(9)	(10)	Operating income
Net of tax	<u>(7)</u>	<u>(6)</u>	Provision for income taxes
Total reclassifications	<u>\$ (7)</u>	<u>\$ (6)</u>	Net income

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

Details about the reclassifications out of accumulated other comprehensive loss and the affected line items in the condensed consolidated statement of income (unaudited) for the six months ended June 30, were as follows:

Components	Amounts Reclassified		Affected Line Item
	2017	2016	
Defined benefit pension and postretirement plans:			
Amortization of prior service credit	\$ (9)	\$ (10)	Cost of products sold
Amortization of prior service credit	(8)	(10)	Selling, general and administrative expenses
	(17)	(20)	Operating income
Deferred taxes	6	8	Provision for income taxes
Net of tax	(11)	(12)	Net income
Long-term investments:			
Realized gain on long-term investments	—	(3)	Other expense (income), net
Deferred taxes	—	1	Provision for income taxes
Net of tax	—	(2)	Net income
Hedging instruments:			
Forward starting interest rate contracts	—	16	Other expense (income), net
Amortization of realized loss	—	1	Interest and debt expense
	—	17	Income before income taxes
Deferred taxes	—	(6)	Provision for income taxes
Net of tax	—	11	Net income
Cumulative translation adjustment and other:			
Derecognition of cumulative translation adjustment	—	27	Gain on divestiture
Total reclassifications	<u>\$ (11)</u>	<u>\$ 24</u>	Net income

Share Repurchases and Other

Restricted stock units granted in March 2014 and May 2016 under the Amended and Restated 2009 Omnibus Incentive Compensation Plan, referred to as the Omnibus Plan, vested in March 2017 and May 2017, respectively, and were settled with the issuance of 2,434,400 shares of RAI common stock. In addition, during the first six months of 2017, at a cost of \$58 million, RAI purchased 940,607 shares of RAI common stock that were forfeited and cancelled with respect to tax liabilities associated with restricted stock units vesting under the Omnibus Plan.

On July 25, 2016, the board of directors of RAI authorized the repurchase, from time to time, on or before December 31, 2018, of up to \$2 billion of outstanding shares of RAI common stock in open-market or privately negotiated transactions, referred to as the Share Repurchase Program. The purchases were subject to prevailing market and business conditions. In connection with the Share Repurchase Program, B&W and Louisville Securities Limited, referred to as LSL, wholly owned subsidiaries of BAT, entered into an agreement, referred to as the Share Repurchase Agreement, with RAI, pursuant to which BAT and its subsidiaries agreed to participate in the Share Repurchase Program on a basis approximately proportionate with BAT's and its subsidiaries' ownership of RAI's common stock. During 2016, RAI repurchased 1,565,698 shares of RAI common stock for \$75 million in accordance with the Share Repurchase Program. Subject to certain exceptions, the Merger Agreement placed restrictions on RAI's ability to repurchase its common stock. As a result, RAI did not repurchase any shares under the Share Repurchase Program during the first six months of 2017. The Share Repurchase Program terminated effective with the completion of the BAT Merger on July 25, 2017. For additional information related to the BAT Merger and the termination of the Share Repurchase Program, see note 14.

In November 2011, RAI, B&W and BAT entered into Amendment No. 3 to the Governance Agreement, pursuant to which RAI agreed that, so long as the beneficial ownership interest of BAT and its subsidiaries in RAI had not dropped below 25%, if RAI issued shares of its common stock or any other RAI equity security to certain designated persons, including its directors, officers or employees, then RAI would repurchase a number of shares of outstanding RAI common stock so that the number of outstanding shares of RAI common stock would not increase, and the beneficial ownership interest of BAT and its subsidiaries in RAI would not decrease, by such issuance after taking into account such repurchase. In February 2017, RAI and BAT entered into a letter agreement, pursuant to which BAT waived the requirement that RAI share repurchases required to be made by RAI pursuant to Amendment No. 3 to the Governance Agreement be made within the time period set forth in that amendment, and permitted RAI to make repurchases in a manner that

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

qualified for the affirmative defense and safe harbor provided by Rules 10b5-1 and 10b-18 under the Exchange Act, respectively. Pursuant to the letter agreement, BAT also waived compliance with the general prohibition on repurchases contained in the Merger Agreement to permit RAI to make these repurchases. During the first six months of 2017, RAI repurchased 1,258,907 shares of RAI common stock for \$81 million in accordance with the Governance Agreement.

Due to RAI's incorporation in North Carolina, which does not recognize treasury shares, the shares repurchased were cancelled at time of purchase.

On February 8, 2017, and May 4, 2017, RAI's board of directors declared a quarterly cash dividend of \$0.51 per common share, payable to shareholders of record as of March 10, 2017 and June 12, 2017, respectively.

Note 9 — Stock Plans

Outstanding grants under the Omnibus Plan have certain change-of-control terms that either permit assumption of the grants by the acquiring entity for the remaining term or provide for pro-rata or full vesting of the awards upon a change of control. Effective with completion of the BAT Merger on July 25, 2017, a change-of-control event occurred resulting in certain outstanding grants vesting or being assumed by BAT. For additional information related to the impact of the BAT Merger on the outstanding grants, see note 14.

Three-Year Grant

In February 2017, the board of directors of RAI approved a grant to key employees of RAI and its subsidiaries, effective March 1, 2017, of 970,310 nonvested restricted stock units under the Omnibus Plan, referred to as the 2017 Grant. The restricted stock units granted in the 2017 Grant were assumed by BAT upon completion of the BAT Merger and generally will vest on March 1, 2020. Upon settlement, each grantee will receive a number of BAT American Depositary Shares, referred to as BAT ADSs, equal to the product of the number of vested units and a percentage up to 150% based on the average RAI annual incentive award plan score over the three-year period ending December 31, 2019.

As an equity-based grant, compensation expense relating to the 2017 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 \$61.93. Following the vesting date, each grantee will receive a cash dividend equivalent payment equal to the aggregate amount of dividends per share paid on shares of RAI common stock or with respect to BAT ADSs, as applicable, during the performance period multiplied by the actual number of restricted stock units earned by the grantee.

Note 10 — Segment Information

RAI's reportable operating segments are RJR Tobacco, Santa Fe and American Snuff. The RJR Tobacco segment consists of the primary operations of R. J. Reynolds Tobacco Company. The Santa Fe segment consists of the primary operations of SFNTC. The American Snuff segment consists of the primary operations of American Snuff Co. Included in All Other, among other RAI subsidiaries, are RJR Vapor, Nicovum USA, Inc., Nicovum AB, and until their sale on January 13, 2016, SFRTI and various foreign subsidiaries affiliated with SFRTI. The segments were identified based on how RAI's chief operating decision maker allocates resources and assesses performance. Certain of RAI's operating subsidiaries have entered into intercompany agreements for products or services with other subsidiaries. As a result, certain activities of an operating subsidiary may be included in a different segment of RAI.

RJR Tobacco is RAI's largest reportable operating segment, and is the second largest tobacco company in the United States. Its brands include three of the top four best-selling cigarettes in the United States: NEWPORT, CAMEL and PALL MALL. These brands, and its other brands, including DORAL, 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 offers a smokeless tobacco product, CAMEL Snus. Through the second quarter of 2017, RJR Tobacco manages contract manufacturing of cigarettes and tobacco products through arrangements with BAT affiliates. RJR Tobacco also manages the export of tobacco products to U.S. territories, U.S. duty-free shops and U.S. overseas military bases. In the United States, RJR Tobacco also manages the premium cigarette brands DUNHILL, which RJR Tobacco licenses from BAT and one or more of its subsidiaries, collectively referred to as the BAT Group, and STATE EXPRESS 555, which RJR Tobacco licenses from CTBAT International Co. Ltd., referred to as CTBAT, a joint venture between the BAT Group and China National Tobacco Corporation, referred to as CNTC.

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

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

American Snuff is the second largest smokeless tobacco products manufacturer in the United States, and offers adult tobacco consumers a range of differentiated smokeless tobacco products, primarily moist snuff. The moist snuff category is divided into premium, price-value and popular-price brands. American Snuff's primary brands include its largest selling moist snuff brands, GRIZZLY, in the price-value category, and KODIAK, in the premium category.

RJR Vapor is a marketer of digital vapor cigarettes under the VUSE brand name in the United States. Niconovum USA, Inc. and Niconovum AB are marketers of nicotine replacement therapy products in the United States and Sweden, respectively, under the ZONNIC brand name.

SFRTI and various foreign subsidiaries affiliated with SFRTI distributed the NATURAL AMERICAN SPIRIT brand outside of the United States. On January 13, 2016, RAI, through the Sellers, completed the sale of the international rights to the NATURAL AMERICAN SPIRIT brand name and associated trademarks, along with the international companies that distributed and marketed the brand outside the United States to JTI Holding, in an all-cash transaction of approximately \$5 billion and recognized a pre-tax gain of approximately \$4.9 billion.

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 June 30,		For the Six Months Ended June 30,	
	2017	2016	2017	2016
Net sales:				
RJR Tobacco	\$ 2,675	\$ 2,646	\$ 5,046	\$ 5,057
Santa Fe	278	247	516	465
American Snuff	261	232	503	448
All Other	104	70	202	142
Consolidated net sales	\$ 3,318	\$ 3,195	\$ 6,267	\$ 6,112
Operating income (loss):				
RJR Tobacco	\$ 1,291	\$ 1,216	\$ 2,374	\$ 2,323
Santa Fe	169	133	313	256
American Snuff	169	138	326	271
All Other	(21)	(43)	(48)	(77)
Gain on divestiture	—	—	—	4,861
Corporate expense	(52)	(29)	(83)	(77)
Consolidated operating income	\$ 1,556	\$ 1,415	\$ 2,882	\$ 7,557
Reconciliation to income before income taxes:				
Consolidated operating income	\$ 1,556	\$ 1,415	\$ 2,882	\$ 7,557
Interest and debt expense	150	152	299	326
Interest income	(3)	(2)	(5)	(5)
Other expense (income), net	11	(1)	15	251
Income before income taxes	\$ 1,398	\$ 1,266	\$ 2,573	\$ 6,985

Note 11 — Related Party Transactions

On July 25, 2017, as a result of the BAT Merger, RAI became an indirect, wholly owned subsidiary of BAT. Prior to the BAT Merger, BAT, through certain indirect wholly owned subsidiaries, beneficially owned approximately 42% of RAI's outstanding common stock. RAI and RAI's operating subsidiaries engage in transactions with affiliates of BAT.

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

A summary of balances and transactions with such BAT affiliates is as follows:

	<u>June 30, 2017</u>		<u>December 31, 2016</u>	
Current Balances:				
Accounts receivable, related party	\$	1	\$ 113	
Due to related party		—	7	
Deferred revenue, related party		106	66	
Long-term Balances:				
Long-term deferred revenue, related party	\$	19	\$ 39	
Significant transactions:				
	<u>For the Three Months Ended June 30,</u>		<u>For the Six Months Ended June 30,</u>	
	<u>2017</u>	<u>2016</u>	<u>2017</u>	<u>2016</u>
Net sales	\$ 28	\$ 54	\$ 66	\$ 109
Purchases	1	6	2	8

RJR Tobacco sells contract-manufactured cigarettes, tobacco leaf and processed tobacco to BAT affiliates. In December 2012, RJR Tobacco entered into an amendment to its contract manufacturing agreement (relating to the production of cigarettes to be sold in Japan) with a BAT affiliate, which amendment, among other things, required either party to provide three years' notice to the other party to terminate the agreement without cause, with any such notice to be given no earlier than January 1, 2016. In January 2016, RJR Tobacco received written notice from a BAT affiliate terminating that contract manufacturing agreement effective January 5, 2019. In July 2016, RJR Tobacco further amended the contract manufacturing agreement with a BAT affiliate to permit an early transition of the cigarette production covered by the agreement to BAT facilities over several months beginning in the fourth quarter of 2016. RJR Tobacco ended its contract manufacturing production for BAT in the second quarter of 2017. The amendment provided for a BAT affiliate to make payments to RJR Tobacco of \$89.6 million, in exchange for RJR Tobacco's commitment to provide contingent manufacturing capacity to a BAT affiliate through December 31, 2018. Of this amount, \$38.7 million was recorded as current deferred revenue, and \$19.4 million was recorded as long-term deferred revenue in RAI's condensed consolidated balance sheet (unaudited) as of June 30, 2017. The first installment of \$7.4 million was received in September 2016. The second installment of \$82.2 million was received in March 2017. RJR Tobacco is recognizing the income ratably from the effective date of the amendment to December 31, 2018. Net sales to BAT affiliates, primarily cigarettes, represented approximately 1% and 2% of RAI's total net sales during the three months ended June 30, 2017 and 2016, respectively. Net sales to BAT affiliates represented approximately 1% and 2% of RAI's total net sales during the six months ended June 30, 2017 and 2016, respectively.

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

In connection with the Share Repurchase Program, B&W and LSL, wholly owned subsidiaries of BAT, entered into the Share Repurchase Agreement on July 25, 2016, with RAI, pursuant to which BAT and its subsidiaries agreed to participate in the Share Repurchase Program on a basis approximately proportionate with BAT's and its subsidiaries' ownership of RAI's common stock. Under the Share Repurchase Agreement, RAI repurchased 660,385 shares of RAI common stock for \$32 million from BAT and its subsidiaries during 2016. Subject to certain exceptions, the Merger Agreement placed restrictions on RAI's ability to repurchase its common stock. As a result, RAI did not repurchase any shares under the Share Repurchase Program during the first six months of 2017. The Share Repurchase Program terminated effective with the completion of the BAT Merger on July 25, 2017. For additional information related to the BAT Merger and the termination of the Share Repurchase Program, see note 14.

In January 2016, prior to the sale of the international rights to the NATURAL AMERICAN SPIRIT brand to JTI, SFRTI paid \$6 million to a BAT affiliate pursuant to a contract manufacturing agreement, whereby the BAT affiliate agreed to contract manufacture certain tobacco products for SFRTI. The \$6 million fee paid to amend the contract was recognized within selling, general and administrative expenses in the condensed consolidated statements of income (unaudited).

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

Note 12 — RAI Guaranteed, Unsecured Notes — Condensed Consolidating Financial Statements

The following condensed consolidating financial statements relate to the guaranties of RAI's \$12.7 billion aggregate principal amount of unsecured notes. Certain of RAI's direct, wholly owned subsidiaries and certain of its indirectly owned subsidiaries fully and unconditionally, and jointly and severally, guaranteed these notes. Pursuant to the terms of the indenture governing such notes, (1) such guaranties were released and terminated automatically upon termination of the Credit Agreement at the closing of the BAT Merger, and (2) RJR provided a new guaranty of RAI's notes given RJR's continuing guaranty of RJR Tobacco's outstanding notes. For additional information on the BAT Merger, see note 14. The following condensed consolidating financial statements include: the accounts and activities of RAI, the parent issuer; RJR, RJR Tobacco, American Snuff Co., SFNTC and certain of RAI's other subsidiaries, the Guarantors; other direct and indirect subsidiaries of RAI that are not Guarantors; and elimination adjustments.

**Condensed Consolidating Statements of Income
(Dollars in Millions)**

	<u>Parent Issuer</u>	<u>Guarantors</u>	<u>Non- Guarantors</u>	<u>Eliminations</u>	<u>Consolidated</u>
For the Three Months Ended June 30, 2017					
Net sales	\$ —	\$ 3,261	\$ 54	\$ (25)	\$ 3,290
Net sales, related party	—	28	—	—	28
Net sales	—	3,289	54	(25)	3,318
Cost of products sold	—	1,252	53	(27)	1,278
Selling, general and administrative expenses	12	445	21	—	478
Amortization expense	—	6	—	—	6
Operating income (loss)	(12)	1,586	(20)	2	1,556
Interest and debt expense	148	13	4	(15)	150
Interest income	(15)	(2)	(1)	15	(3)
Other expense (income), net	1	(11)	9	12	11
Income (loss) before income taxes	(146)	1,586	(32)	(10)	1,398
Provision for (benefit from) income taxes	(50)	533	(4)	—	479
Equity income from subsidiaries	1,015	(8)	—	(1,007)	—
Net income (loss)	<u>\$ 919</u>	<u>\$ 1,045</u>	<u>\$ (28)</u>	<u>\$ (1,017)</u>	<u>\$ 919</u>
For the Three Months Ended June 30, 2016					
Net sales	\$ —	\$ 3,122	\$ 48	\$ (29)	\$ 3,141
Net sales, related party	—	54	—	—	54
Net sales	—	3,176	48	(29)	3,195
Cost of products sold	—	1,254	52	(31)	1,275
Selling, general and administrative expenses	6	457	34	2	499
Amortization expense	—	6	—	—	6
Operating income (loss)	(6)	1,459	(38)	—	1,415
Interest and debt expense	149	22	2	(21)	152
Interest income	(21)	(2)	—	21	(2)
Other expense (income), net	—	(9)	(3)	11	(1)
Income (loss) before income taxes	(134)	1,448	(37)	(11)	1,266
Provision for (benefit from) income taxes	(48)	532	(14)	—	470
Equity income from subsidiaries	882	2	—	(884)	—
Net income (loss)	<u>\$ 796</u>	<u>\$ 918</u>	<u>\$ (23)</u>	<u>\$ (895)</u>	<u>\$ 796</u>

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 Six Months Ended June 30, 2017					
Net sales	\$ —	\$ 6,164	\$ 102	\$ (65)	\$ 6,201
Net sales, related party	—	66	—	—	66
Net sales	—	6,230	102	(65)	6,267
Cost of products sold	—	2,446	96	(65)	2,477
Selling, general and administrative expenses	27	819	50	—	896
Amortization expense	—	11	1	—	12
Operating income (loss)	(27)	2,954	(45)	—	2,882
Interest and debt expense	295	31	8	(35)	299
Interest income	(35)	(4)	(1)	35	(5)
Other expense (income), net	2	(21)	12	22	15
Income (loss) before income taxes	(289)	2,948	(64)	(22)	2,573
Provision for (benefit from) income taxes	(125)	1,013	(14)	—	874
Equity income from subsidiaries	1,863	(13)	—	(1,850)	—
Net income (loss)	<u>\$ 1,699</u>	<u>\$ 1,922</u>	<u>\$ (50)</u>	<u>\$ (1,872)</u>	<u>\$ 1,699</u>
For the Six Months Ended June 30, 2016					
Net sales	\$ —	\$ 5,961	\$ 97	\$ (55)	\$ 6,003
Net sales, related party	—	109	—	—	109
Net sales	—	6,070	97	(55)	6,112
Cost of products sold	—	2,403	95	(58)	2,440
Selling, general and administrative expenses	22	858	82	2	964
Gain on divestiture	—	(4,843)	(16)	(2)	(4,861)
Amortization expense	—	12	—	—	12
Operating income (loss)	(22)	7,640	(64)	3	7,557
Interest and debt expense	323	45	4	(46)	326
Interest income	(47)	(4)	—	46	(5)
Other expense (income), net	240	(15)	4	22	251
Income (loss) before income taxes	(538)	7,614	(72)	(19)	6,985
Provision for (benefit from) income taxes	(190)	2,840	(26)	—	2,624
Equity income from subsidiaries	4,709	2	—	(4,711)	—
Net income (loss)	<u>\$ 4,361</u>	<u>\$ 4,776</u>	<u>\$ (46)</u>	<u>\$ (4,730)</u>	<u>\$ 4,361</u>

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

**Condensed Consolidating Statements of Comprehensive Income
(Dollars in Millions)**

	<u>Parent Issuer</u>	<u>Guarantors</u>	<u>Non- Guarantors</u>	<u>Eliminations</u>	<u>Consolidated</u>
For the Three Months Ended June 30, 2017					
Net income (loss)	\$ 919	\$ 1,045	\$ (28)	\$ (1,017)	\$ 919
Other comprehensive income (loss), net of tax:					
Retirement benefits	13	29	(15)	(14)	13
Cumulative translation adjustment and other	11	12	16	(28)	11
Comprehensive income (loss)	<u>\$ 943</u>	<u>\$ 1,086</u>	<u>\$ (27)</u>	<u>\$ (1,059)</u>	<u>\$ 943</u>
For the Three Months Ended June 30, 2016					
Net income (loss)	\$ 796	\$ 918	\$ (23)	\$ (895)	\$ 796
Other comprehensive income (loss), net of tax:					
Retirement benefits	39	40	(1)	(39)	39
Long-term investments	4	4	—	(4)	4
Cumulative translation adjustment and other	(5)	(5)	(7)	12	(5)
Comprehensive income (loss)	<u>\$ 834</u>	<u>\$ 957</u>	<u>\$ (31)</u>	<u>\$ (926)</u>	<u>\$ 834</u>
For the Six Months Ended June 30, 2017					
Net income (loss)	\$ 1,699	\$ 1,922	\$ (50)	\$ (1,872)	\$ 1,699
Other comprehensive income (loss), net of tax:					
Retirement benefits	9	26	(14)	(12)	9
Cumulative translation adjustment and other	14	15	20	(35)	14
Comprehensive income (loss)	<u>\$ 1,722</u>	<u>\$ 1,963</u>	<u>\$ (44)</u>	<u>\$ (1,919)</u>	<u>\$ 1,722</u>
For the Six Months Ended June 30, 2016					
Net income (loss)	\$ 4,361	\$ 4,776	\$ (46)	\$ (4,730)	\$ 4,361
Other comprehensive income (loss), net of tax:					
Retirement benefits	33	34	(1)	(33)	33
Long-term investments	3	3	—	(3)	3
Hedging instruments	11	—	—	—	11
Cumulative translation adjustment and other	17	17	26	(43)	17
Comprehensive income (loss)	<u>\$ 4,425</u>	<u>\$ 4,830</u>	<u>\$ (21)</u>	<u>\$ (4,809)</u>	<u>\$ 4,425</u>

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

Details about the reclassifications out of accumulated other comprehensive loss and the affected line items in the condensed consolidating statements of income (unaudited) for the three months ended June 30, 2017, were as follows:

Components	Amounts Reclassified					Affected Line Item
	Parent Issuer	Guarantors	Non-Guarantors	Eliminations	Consolidated	
Defined benefit pension and postretirement plans:						
Amortization of prior service credit	\$ —	\$ (5)	\$ —	\$ —	\$ (5)	Cost of products sold
Amortization of prior service credit	—	(4)	—	—	(4)	Selling, general and administrative expenses
	—	(9)	—	—	(9)	Operating income (loss)
Deferred taxes	—	2	—	—	2	Provision for (benefit from) income taxes
Net of tax	—	(7)	—	—	(7)	Net income (loss)
Equity income from subsidiaries	(7)	—	—	7	—	Equity income from subsidiaries
Total reclassifications	<u>\$ (7)</u>	<u>\$ (7)</u>	<u>\$ —</u>	<u>\$ 7</u>	<u>\$ (7)</u>	Net income (loss)

Details about the reclassifications out of accumulated other comprehensive loss and the affected line items in the condensed consolidating statements of income (unaudited) for the three months ended June 30, 2016, were as follows:

Components	Amounts Reclassified					Affected Line Item
	Parent Issuer	Guarantors	Non-Guarantors	Eliminations	Consolidated	
Defined benefit pension and postretirement plans:						
Amortization of prior service credit	\$ —	\$ (5)	\$ —	\$ —	\$ (5)	Cost of products sold
Amortization of prior service credit	—	(5)	—	—	(5)	Selling, general and administrative expenses
	—	(10)	—	—	(10)	Operating income (loss)
Deferred taxes	—	4	—	—	4	Provision for (benefit from) income taxes
Net of tax	—	(6)	—	—	(6)	Net income (loss)
Equity income from subsidiaries	(6)	—	—	6	—	Equity income from subsidiaries
Total reclassifications	<u>\$ (6)</u>	<u>\$ (6)</u>	<u>\$ —</u>	<u>\$ 6</u>	<u>\$ (6)</u>	Net income (loss)

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

Details about the reclassifications out of accumulated other comprehensive loss and the affected line items in the condensed consolidating statements of income (unaudited) for the six months ended June 30, 2017, were as follows:

Components	Amounts Reclassified					Affected Line Item
	Parent Issuer	Guarantors	Non-Guarantors	Eliminations	Consolidated	
Defined benefit pension and postretirement plans:						
Amortization of prior service credit	\$ —	\$ (9)	\$ —	\$ —	\$ (9)	Cost of products sold
Amortization of prior service credit	—	(8)	—	—	(8)	Selling, general and administrative expenses
	—	(17)	—	—	(17)	Operating income (loss)
Deferred taxes	—	6	—	—	6	Provision for (benefit from) income taxes
Net of tax	—	(11)	—	—	(11)	Net income (loss)
Equity income from subsidiaries	(11)	—	—	11	—	Equity income from subsidiaries
Total reclassifications	<u>\$ (11)</u>	<u>\$ (11)</u>	<u>\$ —</u>	<u>\$ 11</u>	<u>\$ (11)</u>	Net income (loss)

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

Details about the reclassifications out of accumulated other comprehensive loss and the affected line items in the condensed consolidating statements of income (unaudited) for the six months ended June 30, 2016, were as follows:

Components	Amounts Reclassified					Affected Line Item
	Parent Issuer	Guarantors	Non-Guarantors	Eliminations	Consolidated	
Defined benefit pension and postretirement plans:						
Amortization of prior service credit	\$ —	\$ (10)	\$ —	\$ —	\$ (10)	Cost of products sold
Amortization of prior service credit	—	(10)	—	—	(10)	Selling, general and administrative expenses
	—	(20)	—	—	(20)	Operating income (loss)
Deferred taxes	—	8	—	—	8	Provision for (benefit from) income taxes
Net of tax	—	(12)	—	—	(12)	Net income (loss)
Long-term investments:						
Realized gain on long-term investments	—	(3)	—	—	(3)	Other expense (income), net
Deferred taxes	—	1	—	—	1	Provision for (benefit from) income taxes
Net of tax	—	(2)	—	—	(2)	Net income (loss)
Hedging instruments:						
Forward starting interest rate contracts	16	—	—	—	16	Other expense (income), net
Amortization of realized loss	1	—	—	—	1	Interest and debt expense
	17	—	—	—	17	Income (loss) before income taxes
Deferred taxes	(6)	—	—	—	(6)	Provision for (benefit from) income taxes
Net of tax	11	—	—	—	11	Net income (loss)
Cumulative translation adjustment and other:						
Derecognition of cumulative translation adjustment	—	—	27	—	27	Gain on divestiture
Equity income from subsidiaries	13	27	—	(40)	—	Equity income from subsidiaries
Total reclassifications	<u>\$ 24</u>	<u>\$ 13</u>	<u>\$ 27</u>	<u>\$ (40)</u>	<u>\$ 24</u>	Net income (loss)

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

**Condensed Consolidating Statements of Cash Flows
(Dollars in Millions)**

	<u>Parent Issuer</u>	<u>Guarantors</u>	<u>Non- Guarantors</u>	<u>Eliminations</u>	<u>Consolidated</u>
For the Six Months Ended June 30, 2017					
Cash flows from (used in) operating activities	\$ 1,714	\$ 606	\$ (37)	\$ (1,006)	\$ 1,277
Cash flows from (used in) investing activities:					
Capital expenditures	—	(65)	(1)	—	(66)
Return of intercompany investments	145	—	—	(145)	—
Other, net	205	12	—	(216)	1
Net cash flows from (used in) investing activities	<u>350</u>	<u>(53)</u>	<u>(1)</u>	<u>(361)</u>	<u>(65)</u>
Cash flows from (used in) financing activities:					
Dividends paid on common stock	(1,384)	(985)	—	985	(1,384)
Repurchase of common stock	(139)	—	—	—	(139)
Borrowings under revolving credit facility	500	—	—	—	500
Repayments of borrowings under revolving credit facility	(500)	—	—	—	(500)
Dividends paid on preferred stock	(21)	—	—	21	—
Distribution of equity	—	(145)	—	145	—
Other, net	(11)	(250)	45	216	—
Net cash flows from (used in) financing activities	<u>(1,555)</u>	<u>(1,380)</u>	<u>45</u>	<u>1,367</u>	<u>(1,523)</u>
Effect of exchange rate changes on cash and cash equivalents	—	—	18	—	18
Net change in cash and cash equivalents	509	(827)	25	—	(293)
Cash and cash equivalents at beginning of period	726	997	328	—	2,051
Cash and cash equivalents at end of period	<u>\$ 1,235</u>	<u>\$ 170</u>	<u>\$ 353</u>	<u>\$ —</u>	<u>\$ 1,758</u>

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 Six Months Ended June 30, 2016					
Cash flows from (used in) operating activities	\$ (1,012)	\$ 603	\$ (23)	\$ (293)	\$ (725)
Cash flows from (used in) investing activities:					
Capital expenditures	—	(89)	(5)	—	(94)
Proceeds from settlement of investments	—	182	—	—	182
Proceeds from divestiture	5,015	—	—	—	5,015
Return of intercompany investments	412	26	—	(438)	—
Other, net	260	11	—	(271)	—
Net cash flows from (used in) investing activities	<u>5,687</u>	<u>130</u>	<u>(5)</u>	<u>(709)</u>	<u>5,103</u>
Cash flows from (used in) financing activities:					
Dividends paid on common stock	(1,113)	(247)	(25)	272	(1,113)
Repurchase of common stock	(149)	—	—	—	(149)
Early extinguishment of debt	(3,642)	(8)	—	—	(3,650)
Premiums paid for early extinguishment of debt	(206)	(1)	—	—	(207)
Proceeds from termination of interest rate swaps	—	66	—	—	66
Debt financing fees	(7)	—	—	—	(7)
Excess tax benefit on stock-based compensation plans	26	—	—	—	26
Dividends paid on preferred stock	(21)	—	—	21	—
Distribution of equity	—	(412)	(26)	438	—
Other, net	(11)	(260)	—	271	—
Net cash flows used in financing activities	<u>(5,123)</u>	<u>(862)</u>	<u>(51)</u>	<u>1,002</u>	<u>(5,034)</u>
Effect of exchange rate changes on cash and cash equivalents	—	—	7	—	7
Net change in cash and cash equivalents	(448)	(129)	(72)	—	(649)
Cash and cash equivalents at beginning of period	575	1,544	448	—	2,567
Cash and cash equivalents at end of period	<u>\$ 127</u>	<u>\$ 1,415</u>	<u>\$ 376</u>	<u>\$ —</u>	<u>\$ 1,918</u>

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

Condensed Consolidating Balance Sheets
(Dollars in Millions)

	Parent Issuer	Guarantors	Non- Guarantors	Eliminations	Consolidated
June 30, 2017					
Assets					
Cash and cash equivalents	\$ 1,235	\$ 170	\$ 353	\$ —	\$ 1,758
Accounts receivable	—	118	5	—	123
Accounts receivable, related party	—	1	—	—	1
Other receivables	60	1,128	88	(1,265)	11
Inventories	—	1,400	50	(2)	1,448
Other current assets	13	287	4	(9)	295
Total current assets	1,308	3,104	500	(1,276)	3,636
Property, plant and equipment, net of accumulated depreciation	2	1,303	33	—	1,338
Trademarks and other intangible assets, net of accumulated amortization	—	29,420	14	(2)	29,432
Goodwill	—	15,976	16	—	15,992
Long-term intercompany notes receivable	1,184	138	—	(1,322)	—
Investment in subsidiaries	34,501	339	—	(34,840)	—
Other assets and deferred charges	70	44	64	(113)	65
Total assets	<u>\$ 37,065</u>	<u>\$ 50,324</u>	<u>\$ 627</u>	<u>\$ (37,553)</u>	<u>\$ 50,463</u>
Liabilities and shareholders' equity					
Accounts payable	\$ 2	\$ 182	\$ 9	\$ —	\$ 193
Tobacco settlement accruals	—	1,833	—	—	1,833
Due to related party	—	—	—	—	—
Deferred revenue, related party	—	106	—	—	106
Current maturities of long-term debt	1,695	53	—	—	1,748
Dividends payable on common stock	727	—	—	—	727
Other current liabilities	1,378	756	78	(1,277)	935
Total current liabilities	3,802	2,930	87	(1,277)	5,542
Long-term intercompany notes payable	138	650	534	(1,322)	—
Long-term debt (less current maturities)	11,134	256	—	—	11,390
Long-term deferred income taxes, net	—	9,725	—	(111)	9,614
Long-term retirement benefits (less current portion)	58	1,587	123	—	1,768
Long-term deferred revenue, related party	—	19	—	—	19
Other noncurrent liabilities	47	194	3	—	244
Shareholders' equity (deficit)	21,886	34,963	(120)	(34,843)	21,886
Total liabilities and shareholders' equity	<u>\$ 37,065</u>	<u>\$ 50,324</u>	<u>\$ 627</u>	<u>\$ (37,553)</u>	<u>\$ 50,463</u>

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

Condensed Consolidating Balance Sheets
(Dollars in Millions)

	Parent Issuer	Guarantors	Non- Guarantors	Eliminations	Consolidated
December 31, 2016					
Assets					
Cash and cash equivalents	\$ 726	\$ 997	\$ 328	\$ —	\$ 2,051
Accounts receivable	—	62	4	—	66
Accounts receivable, related party	—	113	—	—	113
Other receivables	63	3,572	17	(3,642)	10
Inventories	—	1,604	43	(2)	1,645
Other current assets	112	238	—	3	353
Total current assets	901	6,586	392	(3,641)	4,238
Property, plant and equipment, net of accumulated depreciation	2	1,314	32	—	1,348
Trademarks and other intangible assets, net of accumulated amortization	—	29,432	14	(2)	29,444
Goodwill	—	15,976	16	—	15,992
Long-term intercompany notes receivable	1,390	148	—	(1,538)	—
Investment in subsidiaries	36,865	333	—	(37,198)	—
Other assets and deferred charges	80	52	37	(96)	73
Total assets	<u>\$ 39,238</u>	<u>\$ 53,841</u>	<u>\$ 491</u>	<u>\$ (42,475)</u>	<u>\$ 51,095</u>
Liabilities and shareholders' equity					
Accounts payable	\$ 1	\$ 213	\$ 7	\$ —	\$ 221
Tobacco settlement accruals	—	2,498	—	—	2,498
Due to related party	—	7	—	—	7
Deferred revenue, related party	—	66	—	—	66
Current maturities of long-term debt	448	53	—	—	501
Dividends payable on common stock	656	—	—	—	656
Other current liabilities	3,767	871	40	(3,642)	1,036
Total current liabilities	4,872	3,708	47	(3,642)	4,985
Long-term intercompany notes payable	148	900	490	(1,538)	—
Long-term debt (less current maturities)	12,404	260	—	—	12,664
Long-term deferred income taxes, net	—	9,700	—	(93)	9,607
Long-term retirement benefits (less current portion)	59	1,767	43	—	1,869
Long-term deferred revenue, related party	—	39	—	—	39
Other noncurrent liabilities	44	176	—	—	220
Shareholders' equity (deficit)	21,711	37,291	(89)	(37,202)	21,711
Total liabilities and shareholders' equity	<u>\$ 39,238</u>	<u>\$ 53,841</u>	<u>\$ 491</u>	<u>\$ (42,475)</u>	<u>\$ 51,095</u>

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

Note 13 — RJR Tobacco Guaranteed, Unsecured Notes — Condensed Consolidating Financial Statements

The following condensed consolidating financial statements relate to the guaranties of RJR Tobacco's \$284 million aggregate principal amount of unsecured notes. RAI and RJR have fully and unconditionally, and jointly and severally, guaranteed these notes. For information on the impact from the BAT Merger, see note 14. The following condensed consolidating financial statements include: the accounts and activities of RAI, the Parent Guarantor; RJR Tobacco, the Issuer; RJR, a Guarantor; other direct and indirect subsidiaries of RAI that are not Guarantors; and elimination adjustments.

**Condensed Consolidating Statements of Income
(Dollars in Millions)**

	<u>Parent Guarantor</u>	<u>Issuer</u>	<u>Guarantor</u>	<u>Non- Guarantors</u>	<u>Eliminations</u>	<u>Consolidated</u>
For the Three Months Ended June 30, 2017						
Net sales	\$ —	\$ 2,677	\$ —	\$ 651	\$ (38)	\$ 3,290
Net sales, related party	—	28	—	—	—	28
Net sales	—	2,705	—	651	(38)	3,318
Cost of products sold	—	1,069	—	248	(39)	1,278
Selling, general and administrative expenses, net	12	1,507	—	(1,042)	1	478
Amortization expense	—	4	—	2	—	6
Operating income (loss)	(12)	125	—	1,443	—	1,556
Interest and debt expense	148	2	—	17	(17)	150
Interest income	(15)	(2)	(2)	(1)	17	(3)
Other expense (income), net	1	—	(10)	9	11	11
Income (loss) before income taxes	(146)	125	12	1,418	(11)	1,398
Provision for (benefit from) income taxes	(50)	46	—	483	—	479
Equity income from subsidiaries	1,015	735	813	—	(2,563)	—
Net income	<u>\$ 919</u>	<u>\$ 814</u>	<u>\$ 825</u>	<u>\$ 935</u>	<u>\$ (2,574)</u>	<u>\$ 919</u>
For the Three Months Ended June 30, 2016						
Net sales	\$ —	\$ 2,626	\$ —	\$ 557	\$ (42)	\$ 3,141
Net sales, related party	—	54	—	—	—	54
Net sales	—	2,680	—	557	(42)	3,195
Cost of products sold	—	1,108	—	210	(43)	1,275
Selling, general and administrative expenses, net	6	714	—	(223)	2	499
Amortization expense	—	5	—	1	—	6
Operating income (loss)	(6)	853	—	569	(1)	1,415
Interest and debt expense	149	3	—	22	(22)	152
Interest income	(21)	(1)	(1)	(1)	22	(2)
Other expense (income), net	—	2	(10)	(4)	11	(1)
Income (loss) before income taxes	(134)	849	11	552	(12)	1,266
Provision for (benefit from) income taxes	(48)	325	—	193	—	470
Equity income from subsidiaries	882	220	746	—	(1,848)	—
Net income	<u>\$ 796</u>	<u>\$ 744</u>	<u>\$ 757</u>	<u>\$ 359</u>	<u>\$ (1,860)</u>	<u>\$ 796</u>

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

Condensed Consolidating Statements of Income
(Dollars in Millions)

	Parent Guarantor	Issuer	Guarantor	Non- Guarantors	Eliminations	Consolidated
For the Six Months Ended June 30, 2017						
Net sales	\$ —	\$ 5,053	\$ —	\$ 1,238	\$ (90)	\$ 6,201
Net sales, related party	—	66	—	—	—	66
Net sales	—	5,119	—	1,238	(90)	6,267
Cost of products sold	—	2,094	—	472	(89)	2,477
Selling, general and administrative expenses, net	27	2,826	(1)	(1,957)	1	896
Amortization expense	—	8	—	4	—	12
Operating income (loss)	(27)	191	1	2,719	(2)	2,882
Interest and debt expense	295	4	—	37	(37)	299
Interest income	(35)	(3)	(2)	(2)	37	(5)
Other expense (income), net	2	1	(21)	12	21	15
Income (loss) before income taxes	(289)	189	24	2,672	(23)	2,573
Provision for (benefit from) income taxes	(125)	84	—	915	—	874
Equity income from subsidiaries	1,863	1,378	1,479	—	(4,720)	—
Net income	<u>\$ 1,699</u>	<u>\$ 1,483</u>	<u>\$ 1,503</u>	<u>\$ 1,757</u>	<u>\$ (4,743)</u>	<u>\$ 1,699</u>
For the Six Months Ended June 30, 2016						
Net sales	\$ —	\$ 5,009	\$ —	\$ 1,081	\$ (87)	\$ 6,003
Net sales, related party	—	109	—	—	—	109
Net sales	—	5,118	—	1,081	(87)	6,112
Cost of products sold	—	2,125	—	404	(89)	2,440
Selling, general and administrative expenses, net	22	1,349	—	(409)	2	964
Gain on divestiture	—	—	—	(4,861)	—	(4,861)
Amortization expense	—	9	—	3	—	12
Operating income (loss)	(22)	1,635	—	5,944	—	7,557
Interest and debt expense	323	3	—	48	(48)	326
Interest income	(47)	(3)	(2)	(1)	48	(5)
Other expense (income), net	240	6	(20)	3	22	251
Income (loss) before income taxes	(538)	1,629	22	5,894	(22)	6,985
Provision for (benefit from) income taxes	(190)	652	—	2,162	—	2,624
Equity income from subsidiaries	4,709	404	1,402	—	(6,515)	—
Net income	<u>\$ 4,361</u>	<u>\$ 1,381</u>	<u>\$ 1,424</u>	<u>\$ 3,732</u>	<u>\$ (6,537)</u>	<u>\$ 4,361</u>

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

**Condensed Consolidating Statements of Comprehensive Income
(Dollars in Millions)**

	<u>Parent Guarantor</u>	<u>Issuer</u>	<u>Guarantor</u>	<u>Non- Guarantors</u>	<u>Eliminations</u>	<u>Consolidated</u>
For the Three Months Ended June 30, 2017						
Net income	\$ 919	\$ 814	\$ 825	\$ 935	\$ (2,574)	\$ 919
Other comprehensive income (loss), net of tax:						
Retirement benefits	13	32	31	(18)	(45)	13
Cumulative translation adjustment and other	11	12	12	12	(36)	11
Comprehensive income	<u>\$ 943</u>	<u>\$ 858</u>	<u>\$ 868</u>	<u>\$ 929</u>	<u>\$ (2,655)</u>	<u>\$ 943</u>
For the Three Months Ended June 30, 2016						
Net income	\$ 796	\$ 744	\$ 757	\$ 359	\$ (1,860)	\$ 796
Other comprehensive income (loss), net of tax:						
Retirement benefits	39	44	42	(3)	(83)	39
Long-term investments	4	4	4	—	(8)	4
Cumulative translation adjustment and other	(5)	(4)	(5)	(5)	14	(5)
Comprehensive income	<u>\$ 834</u>	<u>\$ 788</u>	<u>\$ 798</u>	<u>\$ 351</u>	<u>\$ (1,937)</u>	<u>\$ 834</u>
For the Six Months Ended June 30, 2017						
Net income	\$ 1,699	\$ 1,483	\$ 1,503	\$ 1,757	\$ (4,743)	\$ 1,699
Other comprehensive income (loss), net of tax:						
Retirement benefits	9	29	28	(17)	(40)	9
Cumulative translation adjustment and other	14	14	15	15	(44)	14
Comprehensive income	<u>\$ 1,722</u>	<u>\$ 1,526</u>	<u>\$ 1,546</u>	<u>\$ 1,755</u>	<u>\$ (4,827)</u>	<u>\$ 1,722</u>
For the Six Months Ended June 30, 2016						
Net income	\$ 4,361	\$ 1,381	\$ 1,424	\$ 3,732	\$ (6,537)	\$ 4,361
Other comprehensive income (loss), net of tax:						
Retirement benefits	33	38	36	(3)	(71)	33
Long-term investments	3	3	3	—	(6)	3
Hedging instruments	11	—	—	—	—	11
Cumulative translation adjustment and other	17	17	17	17	(51)	17
Comprehensive income	<u>\$ 4,425</u>	<u>\$ 1,439</u>	<u>\$ 1,480</u>	<u>\$ 3,746</u>	<u>\$ (6,665)</u>	<u>\$ 4,425</u>

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

Details about the reclassifications out of accumulated other comprehensive loss and the affected line items in the condensed consolidating statements of income (unaudited) for the three months ended June 30, 2017, were as follows:

Components	Amounts Reclassified						Affected Line Item
	Parent Guarantor	Issuer	Guarantor	Non-Guarantors	Eliminations	Consolidated	
Defined benefit pension and postretirement plans:							
Amortization of prior service credit	\$ —	\$ (5)	\$ —	\$ —	\$ —	\$ (5)	Cost of products sold
Amortization of prior service credit	—	(4)	—	—	—	(4)	Selling, general and administrative expenses, net
	—	(9)	—	—	—	(9)	Operating income (loss)
Deferred taxes	—	2	—	—	—	2	Provision for (benefit from) income taxes
Net of tax	—	(7)	—	—	—	(7)	Net income
Equity income from subsidiaries	(7)	—	(7)	—	14	—	Equity income from subsidiaries
Total reclassifications	<u>\$ (7)</u>	<u>\$ (7)</u>	<u>\$ (7)</u>	<u>\$ —</u>	<u>\$ 14</u>	<u>\$ (7)</u>	Net income

Details about the reclassifications out of accumulated other comprehensive loss and the affected line items in the condensed consolidating statements of income (unaudited) for the three months ended June 30, 2016, were as follows:

Components	Amounts Reclassified						Affected Line Item
	Parent Guarantor	Issuer	Guarantor	Non-Guarantors	Eliminations	Consolidated	
Defined benefit pension and postretirement plans:							
Amortization of prior service credit	\$ —	\$ (5)	\$ —	\$ —	\$ —	\$ (5)	Cost of products sold
Amortization of prior service credit	—	(5)	—	—	—	(5)	Selling, general and administrative expenses, net
	—	(10)	—	—	—	(10)	Operating income (loss)
Deferred taxes	—	4	—	—	—	4	Provision for (benefit from) income taxes
Net of tax	—	(6)	—	—	—	(6)	Net income
Equity income from subsidiaries	(6)	—	(6)	—	12	—	Equity income from subsidiaries
Total reclassifications	<u>\$ (6)</u>	<u>\$ (6)</u>	<u>\$ (6)</u>	<u>\$ —</u>	<u>\$ 12</u>	<u>\$ (6)</u>	Net income

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

Details about the reclassifications out of accumulated other comprehensive loss and the affected line items in the condensed consolidating statements of income (unaudited) for the six months ended June 30, 2017, were as follows:

Components	Amounts Reclassified						Affected Line Item
	Parent Guarantor	Issuer	Guarantor	Non-Guarantors	Eliminations	Consolidated	
Defined benefit pension and postretirement plans:							
Amortization of prior service credit	\$ —	\$ (9)	\$ —	\$ —	\$ —	\$ (9)	Cost of products sold
Amortization of prior service credit	—	(8)	—	—	—	(8)	Selling, general and administrative expenses, net
	—	(17)	—	—	—	(17)	Operating income (loss)
Deferred taxes	—	6	—	—	—	6	Provision for (benefit from) income taxes
Net of tax	—	(11)	—	—	—	(11)	Net income
Equity income from subsidiaries	(11)	—	(11)	—	22	—	Equity income from subsidiaries
Total reclassifications	<u>\$ (11)</u>	<u>\$ (11)</u>	<u>\$ (11)</u>	<u>\$ —</u>	<u>\$ 22</u>	<u>\$ (11)</u>	Net income

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

Details about the reclassifications out of accumulated other comprehensive loss and the affected line items in the condensed consolidating statements of income (unaudited) for the six months ended June 30, 2016, were as follows:

Components	Amounts Reclassified						Affected Line Item
	Parent Guarantor	Issuer	Guarantor	Non-Guarantors	Eliminations	Consolidated	
Defined benefit pension and postretirement plans:							
Amortization of prior service credit	\$ —	\$ (10)	\$ —	\$ —	\$ —	\$ (10)	Cost of products sold
Amortization of prior service credit	—	(10)	—	—	—	(10)	Selling, general and administrative expenses, net
	—	(20)	—	—	—	(20)	Operating income (loss)
Deferred taxes	—	8	—	—	—	8	Provision for (benefit from) income taxes
Net of tax	—	(12)	—	—	—	(12)	Net income
Long-term investments:							
Realized gain on long-term investments	—	(3)	—	—	—	(3)	Other expense (income), net
Deferred taxes	—	1	—	—	—	1	Provision for (benefit from) income taxes
Net of tax	—	(2)	—	—	—	(2)	Net income
Loss on hedging instruments:							
Forward starting interest rate contracts	16	—	—	—	—	16	Other expense (income), net
Amortization of realized loss	1	—	—	—	—	1	Interest and debt expense
	17	—	—	—	—	17	Income (loss) before income taxes
Deferred taxes	(6)	—	—	—	—	(6)	Provision for (benefit from) income taxes
Net of tax	11	—	—	—	—	11	Net income
Cumulative translation adjustment and other:							
Derecognition of cumulative translation adjustment	—	—	—	27	—	27	Gain on divestiture
Equity income from subsidiaries							
	13	27	13	—	(53)	—	Equity income from subsidiaries
Total reclassifications	<u>\$ 24</u>	<u>\$ 13</u>	<u>\$ 13</u>	<u>\$ 27</u>	<u>\$ (53)</u>	<u>\$ 24</u>	Net income

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

Condensed Consolidating Statements of Cash Flows
(Dollars in Millions)

	Parent Guarantor	Issuer	Guarantor	Non- Guarantors	Eliminations	Consolidated
For the Six Months Ended June 30, 2017						
Cash flows from operating activities	\$ 1,714	\$ 510	\$ 442	\$ 1,045	\$ (2,434)	\$ 1,277
Cash flows from (used in) investing activities:						
Capital expenditures	—	(46)	—	(20)	—	(66)
Return of intercompany investments	145	12	679	—	(836)	—
Other, net	205	—	9	11	(224)	1
Net cash flows from (used in) investing activities	350	(34)	688	(9)	(1,060)	(65)
Cash flows from (used in) financing activities:						
Dividends paid on common stock	(1,384)	(365)	(985)	(1,063)	2,413	(1,384)
Repurchase of common stock	(139)	—	—	—	—	(139)
Borrowings under revolving credit facility	500	—	—	—	—	500
Repayments of borrowings under revolving credit facility	(500)	—	—	—	—	(500)
Dividends paid on preferred stock	(21)	—	—	—	21	—
Distribution of equity	—	(679)	(145)	(12)	836	—
Other, net	(11)	—	—	(213)	224	—
Net cash flows used in financing activities	(1,555)	(1,044)	(1,130)	(1,288)	3,494	(1,523)
Effect of exchange rate changes on cash and cash equivalents	—	—	—	18	—	18
Net change in cash and cash equivalents	509	(568)	—	(234)	—	(293)
Cash and cash equivalents at beginning of period	726	670	1	654	—	2,051
Cash and cash equivalents at end of period	\$ 1,235	\$ 102	\$ 1	\$ 420	\$ —	\$ 1,758

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

**Condensed Consolidating Statements of Cash Flows
(Dollars in Millions)**

	<u>Parent Guarantor</u>	<u>Issuer</u>	<u>Guarantor</u>	<u>Non- Guarantors</u>	<u>Eliminations</u>	<u>Consolidated</u>
For the Six Months Ended June 30, 2016						
Cash flows from (used in) operating activities	\$ (1,012)	\$ 120	\$ 38	\$ 611	\$ (482)	\$ (725)
Cash flows from (used in) investing activities:						
Capital expenditures	—	(59)	—	(35)	—	(94)
Proceeds from settlement of investments	—	182	—	—	—	182
Proceeds from divestiture	5,015	—	—	—	—	5,015
Return of intercompany investments	412	495	598	—	(1,505)	—
Other, net	260	—	8	11	(279)	—
Net cash flows from (used in) investing activities	<u>5,687</u>	<u>618</u>	<u>606</u>	<u>(24)</u>	<u>(1,784)</u>	<u>5,103</u>
Cash flows from (used in) financing activities:						
Dividends paid on common stock	(1,113)	(9)	(247)	(205)	461	(1,113)
Repurchase of common stock	(149)	—	—	—	—	(149)
Early extinguishment of debt	(3,642)	(8)	—	—	—	(3,650)
Premiums paid for early extinguishment of debt	(206)	(1)	—	—	—	(207)
Proceeds from termination of interest rate swaps	—	66	—	—	—	66
Debt financing fees	(7)	—	—	—	—	(7)
Excess tax benefit on stock-based compensation plans	26	—	—	—	—	26
Dividends paid on preferred stock	(21)	—	—	—	21	—
Distribution of equity	—	(580)	(412)	(513)	1,505	—
Other, net	(11)	—	—	(268)	279	—
Net cash flows used in financing activities	<u>(5,123)</u>	<u>(532)</u>	<u>(659)</u>	<u>(986)</u>	<u>2,266</u>	<u>(5,034)</u>
Effect of exchange rate changes on cash and cash equivalents	—	—	—	7	—	7
Net change in cash and cash equivalents	(448)	206	(15)	(392)	—	(649)
Cash and cash equivalents at beginning of period	575	809	19	1,164	—	2,567
Cash and cash equivalents at end of period	<u>\$ 127</u>	<u>\$ 1,015</u>	<u>\$ 4</u>	<u>\$ 772</u>	<u>\$ —</u>	<u>\$ 1,918</u>

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

Condensed Consolidating Balance Sheets
(Dollars in Millions)

	Parent Guarantor	Issuer	Guarantor	Non- Guarantors	Eliminations	Consolidated
June 30, 2017						
Assets						
Cash and cash equivalents	\$ 1,235	\$ 102	\$ 1	\$ 420	\$ —	\$ 1,758
Accounts receivable	—	72	—	51	—	123
Accounts receivable, related party	—	1	—	—	—	1
Other receivables	60	95	17	1,158	(1,319)	11
Inventories	—	748	—	702	(2)	1,448
Other current assets	13	202	—	89	(9)	295
Total current assets	1,308	1,220	18	2,420	(1,330)	3,636
Property, plant and equipment, net of accumulated depreciation	2	845	—	491	—	1,338
Trademarks and other intangible assets, net of accumulated amortization	—	309	—	29,124	(1)	29,432
Goodwill	—	3,454	9,853	2,685	—	15,992
Long-term intercompany notes receivable	1,184	—	65	138	(1,387)	—
Investment in subsidiaries	34,501	18,674	21,098	—	(74,273)	—
Other assets and deferred charges	70	1,141	10	14	(1,170)	65
Total assets	<u>\$ 37,065</u>	<u>\$ 25,643</u>	<u>\$ 31,044</u>	<u>\$ 34,872</u>	<u>\$ (78,161)</u>	<u>\$ 50,463</u>
Liabilities and shareholders' equity						
Accounts payable	\$ 2	\$ 165	\$ —	\$ 26	\$ —	\$ 193
Tobacco settlement accruals	—	1,729	—	104	—	1,833
Due to related party	—	—	—	—	—	—
Deferred revenue, related party	—	106	—	—	—	106
Current maturities of long-term debt	1,695	53	—	—	—	1,748
Dividends payable on common stock	727	—	—	—	—	727
Other current liabilities	1,378	592	38	257	(1,330)	935
Total current liabilities	3,802	2,645	38	387	(1,330)	5,542
Long-term intercompany notes payable	138	—	—	1,249	(1,387)	—
Long-term debt (less current maturities)	11,134	256	—	—	—	11,390
Long-term deferred income taxes, net	—	—	—	10,781	(1,167)	9,614
Long-term retirement benefits (less current portion)	58	1,467	26	217	—	1,768
Long-term deferred revenue, related party	—	19	—	—	—	19
Other noncurrent liabilities	47	168	—	29	—	244
Shareholders' equity	21,886	21,088	30,980	22,209	(74,277)	21,886
Total liabilities and shareholders' equity	<u>\$ 37,065</u>	<u>\$ 25,643</u>	<u>\$ 31,044</u>	<u>\$ 34,872</u>	<u>\$ (78,161)</u>	<u>\$ 50,463</u>

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

Condensed Consolidating Balance Sheets
(Dollars in Millions)

	Parent Guarantor	Issuer	Guarantor	Non- Guarantors	Eliminations	Consolidated
December 31, 2016						
Assets						
Cash and cash equivalents	\$ 726	\$ 670	\$ 1	\$ 654	\$ —	\$ 2,051
Accounts receivable	—	27	—	39	—	66
Accounts receivable, related party	—	113	—	—	—	113
Other receivables	63	5	38	4,828	(4,924)	10
Inventories	—	812	—	835	(2)	1,645
Other current assets	112	195	—	43	3	353
Total current assets	901	1,822	39	6,399	(4,923)	4,238
Property, plant and equipment, net of accumulated depreciation	2	855	—	491	—	1,348
Trademarks and other intangible assets, net of accumulated amortization	—	317	—	29,129	(2)	29,444
Goodwill	—	3,453	9,853	2,686	—	15,992
Long-term intercompany notes receivable	1,390	—	73	148	(1,611)	—
Investment in subsidiaries	36,865	22,954	23,938	—	(83,757)	—
Other assets and deferred charges	80	1,204	11	13	(1,235)	73
Total assets	<u>\$ 39,238</u>	<u>\$ 30,605</u>	<u>\$ 33,914</u>	<u>\$ 38,866</u>	<u>\$ (91,528)</u>	<u>\$ 51,095</u>
Liabilities and shareholders' equity						
Accounts payable	\$ 1	\$ 190	\$ —	\$ 30	\$ —	\$ 221
Tobacco settlement accruals	—	2,326	—	172	—	2,498
Due to related party	—	7	—	—	—	7
Deferred revenue, related party	—	66	—	—	—	66
Current maturities of long-term debt	448	53	—	—	—	501
Dividends payable on common stock	656	—	—	—	—	656
Other current liabilities	3,767	1,923	2	268	(4,924)	1,036
Total current liabilities	4,872	4,565	2	470	(4,924)	4,985
Long-term intercompany notes payable	148	—	—	1,463	(1,611)	—
Long-term debt (less current maturities)	12,404	260	—	—	—	12,664
Long-term deferred income taxes, net	—	—	—	10,839	(1,232)	9,607
Long-term retirement benefits (less current portion)	59	1,651	28	131	—	1,869
Long-term deferred revenue, related party	—	39	—	—	—	39
Other noncurrent liabilities	44	153	—	23	—	220
Shareholders' equity	21,711	23,937	33,884	25,940	(83,761)	21,711
Total liabilities and shareholders' equity	<u>\$ 39,238</u>	<u>\$ 30,605</u>	<u>\$ 33,914</u>	<u>\$ 38,866</u>	<u>\$ (91,528)</u>	<u>\$ 51,095</u>

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

Note 14 — Subsequent Event

On July 25, 2017, BAT acquired the remaining approximately 58% of RAI's outstanding common stock not owned by BAT in a cash and stock transaction, valued at approximately \$54.5 billion, pursuant to the Merger Agreement, wherein Merger Sub merged with and into RAI, with RAI surviving as an indirect, wholly owned subsidiary of BAT. At the effective time of the BAT Merger, each share of RAI common stock (other than any shares of RAI common stock owned by BAT or any of its subsidiaries, by RAI or any of its subsidiaries and by shareholders of RAI who properly asserted and did not lose or effectively withdraw appraisal rights) was converted into the right to receive 0.5260 of a BAT ADS, and \$29.44 in cash, without interest, collectively referred to as the merger consideration.

BAT is subject to applicable SEC reporting obligations as a foreign private issuer. The BAT ADSs trade on the NYSE, under the symbol BTI.

Immediately upon the closing of the BAT Merger, certain change-of-control provisions contained in equity awards granted to RAI employees under the Omnibus Plan were met, which resulted in the accelerated vesting of those equity awards. With respect to the equity awards that accelerated in connection with the BAT Merger, such equity awards were converted into the right to receive merger consideration in accordance with the terms of the Omnibus Plan and the applicable equity award agreement. All remaining equity awards that were not eligible for accelerated vesting were assumed and replaced with equity awards issued by BAT.

In addition, certain deferred stock units granted to eligible directors of RAI under the Equity Incentive Award Plan for Directors of Reynolds American Inc., referred to as the EIAP, were settled in cash or merger consideration, as applicable, in accordance with the terms of the EIAP and the elections of each applicable director. Deferred stock units held by eligible directors of RAI under the Deferred Compensation Plan for Directors of Reynolds American Inc., referred to as the DCP, that tracked the value of shares of RAI common stock before the BAT Merger, were converted into deferred stock units tracking the value of BAT ADSs and remain outstanding in accordance with the terms of the DCP.

Also, upon completion of the BAT Merger:

- RAI terminated its Credit Agreement and, in doing so, the related subsidiary guarantees of the Credit Agreement also terminated and were released. The RAI indenture provides that a guarantor that is released from its guarantee of the Credit Agreement (or any successor) also will be released from its guarantee of the RAI notes. Accordingly, in connection with the termination of the Credit Agreement, all of the subsidiary guarantees of the RAI notes were released automatically at the same time. Although RJR's guarantee of the RAI notes also was released automatically, it was replaced simultaneously by a new guarantee in order to comply with a covenant of the RAI indenture. The guarantees by RAI and RJR of the RJR Tobacco notes were not released.
- BAT extended separate guarantees of the outstanding senior notes of RAI and RJR Tobacco.
- The Share Repurchase Program, approved by the board of directors on July 25, 2016, terminated.

After completion of the BAT Merger, RAI notified the NYSE of its intent to remove the RAI common stock from listing on the NYSE and requested that the NYSE file with the SEC an application on Form 25 to report the delisting of the RAI common stock from the NYSE under Section 12(b) of the Exchange Act. On July 25, 2017, the NYSE filed with the SEC a Form 25 to delist and deregister the RAI common stock. As a result, shares of RAI common stock were suspended from trading on the NYSE as of 8:40 AM on July 25, 2017. RAI is in the process of deregistering its common stock with the SEC under Section 12(g) of the Exchange Act and suspending its reporting obligations under Sections 13(a) and 15(d) of the Exchange Act by filing a Form 15 with the SEC promptly after the Form 25 becomes effective. After the filing of this Quarterly Report on Form 10-Q, RAI will no longer file periodic reports under the Exchange Act, with the SEC, with respect to its common stock.

It is further expected that RAI will guarantee all debt securities outstanding, or which may be issued in the future, under BAT's £25 billion Euro Medium Term Note Program issued by a finance subsidiary of BAT and guaranteed by BAT and certain of its other subsidiaries. In addition, RAI is expected to guarantee debt that certain BAT subsidiaries anticipate issuing to refinance a portion of the acquisition facility used to fund the cash portion of the merger consideration.

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

The following is a discussion and analysis of RAI's business, initiatives, critical accounting estimates and its consolidated results of operations and financial position. Following the overview and discussion of business initiatives, the critical accounting estimates disclose certain accounting estimates that are material to RAI's results of operations and financial position for the periods presented in this report. The discussion and analysis of RAI's results of operations compares the second quarter of 2017 with the second quarter of 2016, and the first six months of 2017 with the first six months of 2016. Disclosures related to liquidity and financial position as well as governmental activity 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).

BAT Merger

Pursuant to the terms of the Merger Agreement, upon completion of the BAT Merger on July 25, 2017, RAI became an indirect, wholly owned subsidiary of BAT. As a result of the BAT Merger, shares of RAI common stock are no longer publicly traded. At the effective time of the BAT Merger, each share of RAI common stock (other than any shares of RAI common stock owned by BAT or any of its subsidiaries, RAI or any of its subsidiaries and by shareholders of RAI who properly asserted and did not lose or effectively withdraw appraisal rights) was converted into the right to receive the merger consideration, and subject to adjustment to prevent dilution. For more information on the BAT Merger, see note 14 to condensed consolidated financial statements (unaudited).

Overview and Business Initiatives

RAI's reportable operating segments are RJR Tobacco, Santa Fe and American Snuff. The RJR Tobacco segment consists of the primary operations of R. J. Reynolds Tobacco Company. The Santa Fe segment consists of the primary operations of SFNTC. The American Snuff segment consists of the primary operations of American Snuff Co. Included in All Other, among other RAI subsidiaries, are RJR Vapor, Nicovum USA, Inc., Nicovum AB, and until their sale on January 13, 2016, SFRTI and various foreign subsidiaries affiliated with SFRTI. The segments were identified based on how RAI's chief operating decision maker allocates resources and assesses performance. Certain of RAI's operating subsidiaries have entered into intercompany agreements for products or services with other subsidiaries. As a result, certain activities of an operating subsidiary may be included in a different segment of RAI.

RAI has two wholly owned subsidiaries that provide support services to certain of its operating subsidiaries, the first providing, among others, legal, finance, information management and human resource services and the second providing trade marketing services, pursuant to intercompany service agreements.

RAI's strategy continues to focus on transforming tobacco to deliver sustainable earnings growth and strong cash flow. This transformation strategy includes growing the core cigarette and moist-snuff businesses, focusing on innovation and engaging with adult tobacco consumers, while maintaining efficient and effective operations.

To achieve its strategy, RAI encourages the migration of adult smokers to smokeless tobacco products and other non-combustible nicotine-containing products, which it believes aligns consumer preferences for new alternatives to traditional tobacco products in view of societal pressure to reduce smoking. RAI's operating companies facilitate this migration through innovation, including the development of digital vapor cigarettes, CAMEL Snus, heat-not-burn cigarettes and nicotine replacement therapy technologies. RAI remains committed to maintaining high standards of corporate governance and business conduct in a high-performing culture.

RAI's largest reportable operating segment, RJR Tobacco, is the second largest tobacco company in the United States. RJR Tobacco's brands include three of the top four best-selling cigarettes in the United States: NEWPORT, CAMEL and PALL MALL. These brands, and its other brands, including DORAL, 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 offers a smokeless tobacco product, CAMEL Snus. RJR Tobacco manages contract manufacturing of cigarettes and tobacco products through arrangements with BAT affiliates, and manages the export of tobacco products to U.S. territories, U.S. duty-free shops and U.S. overseas military bases. In the United States, RJR Tobacco also manages the premium cigarette brands DUNHILL, which RJR Tobacco licenses from the BAT Group, and STATE EXPRESS 555, which RJR Tobacco licenses from CTBAT, a joint venture between the BAT Group and CNTC.

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

American Snuff is the second largest smokeless tobacco products manufacturer in the United States, and offers adult tobacco consumers a range of differentiated smokeless tobacco products, primarily moist snuff. The moist snuff category is divided into premium, price-value and popular-price brands. American Snuff's primary brands include its largest selling moist snuff brands, GRIZZLY, in the price-value category, and KODIAK, in the premium category.

RJR Tobacco

RJR Tobacco primarily conducts business in the highly competitive U.S. cigarette market, which has a few large manufacturers and many smaller participants. The international rights to substantially all of RJR Tobacco's brands were sold in 1999 to JTI, and no international rights were acquired in connection with the B&W business combination in 2004 or the Lorillard Merger in 2015. The U.S. cigarette market is a mature market in which overall adult consumer demand has declined since 1981, and is expected to continue to decline. Profitability of the U.S. cigarette industry and RJR Tobacco continues to be adversely impacted by decreases in consumption, increases in state excise taxes and governmental regulations and restrictions, such as marketing limitations, product standards and ingredients legislation.

RJR Tobacco's cigarette brand portfolio strategy is based upon two brand categories: drive and other. The drive brands consist of two premium brands, NEWPORT and CAMEL, and the largest traditional value brand in the United States, PALL MALL. These three brands are managed for long-term market share and profit growth, and receive the vast majority of RJR Tobacco's equity support with an emphasis on the NEWPORT and CAMEL brands. The other brand category includes the premium brand, CAPRI, and the value brands, DORAL and MISTY, along with other smaller brands. All of the other brands receive limited marketing support and are managed to maximize profitability.

The key objectives of the portfolio strategy are designed to balance the long-term market share growth and profitability of the drive brands while managing the other brands for long-term sustainability and profitability. Consistent with that strategy, RJR Tobacco continues to evaluate some of its non-core cigarette styles for potential elimination.

RJR Tobacco's portfolio also includes CAMEL Snus, a smokeless, heat-treated tobacco product sold in individual pouches that provide convenient tobacco consumption.

Competition is based primarily on brand positioning, including price, product attributes and packaging, consumer loyalty, promotions, advertising and retail presence, as well as finding efficient and effective means of balancing market share and profit growth. 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 continues to be highly competitive and includes product innovation and expansion into smokeless tobacco categories.

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 are distributed by a variety of methods.

Santa Fe

Santa Fe manufactures and markets premium cigarettes and other tobacco products under the NATURAL AMERICAN SPIRIT brand in the United States. Competition in the cigarette category is based primarily on brand positioning, including price, product attributes and packaging, consumer loyalty, promotions, advertising and retail presence.

American Snuff

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

In contrast to the declining U.S. cigarette market, U.S. moist snuff retail volumes grew approximately 2.0% in the twelve months ended June 30, 2017. Profit margins on moist snuff products are generally higher than on cigarette products. Moist snuff's growth is partially attributable to cigarette smokers switching from cigarettes to smokeless tobacco products or using both.

American Snuff faces significant competition in the smokeless tobacco category. 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.

All Other

RJR Vapor markets VUSE Digital Vapor Cigarette products, which include VUSE Solo, VUSE Fob and VUSE Vibe. VUSE is the top-selling vapor product in convenience/gas stores and is available in more than 110,000 retail outlets across the United States. Its innovative digital technology is designed to deliver a consistent flavor and vapor experience. In March 2016, RJR Vapor introduced its VUSE Fob power unit, which integrates Bluetooth® technology and offers an on-device display with information about battery and cartridge levels. RJR Vapor began national distribution, in November 2016, of its VUSE Vibe high-volume cartridge and closed-tank system with a stronger and longer-lasting battery. All production of VUSE Solo cartridges is performed at RJR Tobacco's manufacturing facility, pursuant to a services agreement between RJR Tobacco and RJR Vapor.

In January 2016, RAI, through the Sellers, completed the sale of the international rights to the NATURAL AMERICAN SPIRIT brand name and associated trademarks, along with SFRTI and other international companies that distributed and marketed the brand outside the United States, to JTI Holding, in an all-cash transaction of approximately \$5 billion and recognized a pre-tax gain of approximately \$4.9 billion. The sale did not include the rights to the NATURAL AMERICAN SPIRIT brand name and associated trademarks in the U.S. market, U.S. duty-free locations and U.S. territories or in U.S. military outlets, all of which were retained by SFNTC. With this transaction completed, the international rights to nearly all of RAI's operating companies' cigarette trademarks are now owned by international tobacco companies.

Niconovum USA, Inc. is a marketer of a nicotine replacement therapy gum, ZONNIC, which is available in approximately 40,000 retail outlets across the United States. Niconovum AB is a marketer of nicotine replacement therapy products in Sweden under the ZONNIC brand name.

Critical Accounting Estimates

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

Litigation

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

Reynolds Defendants 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. For a further discussion of the litigation and legal proceedings pending against RAI or its affiliates or indemnitees, see note 7 to condensed consolidated financial statements (unaudited).

State Settlement Agreements

RJR Tobacco (itself, and as successor by merger to Lorillard Tobacco) and SFNTC are participants in the MSA, and RJR Tobacco (itself, and as successor by merger to Lorillard Tobacco) is a participant in the other state settlement agreements. Their obligations and the related expense charges under these agreements are subject to adjustments based upon, among other things, the volume of cigarettes sold by the operating subsidiaries, their relative market share, their operating profits and inflation. Since relative market share is based on cigarette shipments, the best estimate of the allocation of charges to RJR Tobacco and SFNTC under these agreements is recorded in cost of products sold as the products are shipped. Adjustments to these estimates are recorded in the period that the change becomes probable and the amount can be reasonably estimated. American Snuff Co. is not a participant in the State Settlement Agreements. For additional information related to 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; Adjustments” in note 7 to condensed consolidated financial statements (unaudited).

Pension and Postretirement Benefits

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

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

Actuarial (gains) losses are changes in the amount of either the benefit obligation or the fair value of plan assets resulting from experience different from that assumed or from changes in assumptions. Actuarial (gains) losses are immediately recognized in the operating results in the year in which they occur, to the extent the net (gains) losses are outside the corridor. Net (gains) losses outside the corridor generally are recognized annually as of December 31, or when a plan is remeasured during an interim period, and are recorded as an MTM adjustment. Additionally, for the purpose of calculating the expected return on plan assets, RAI uses the actual fair value of plan assets.

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

Intangible Assets

Intangible assets include goodwill, trademarks and other intangible assets. The determination of fair value involves considerable estimates and judgment. Intangible assets with indefinite lives are tested annually for impairment in the fourth quarter or more frequently if events and circumstances indicate that an impairment may have occurred.

For goodwill, the determination of fair value of a reporting unit involves, among other things, RAI's market capitalization, and application of the income approach, which includes developing forecasts of future cash flows and determining an appropriate discount rate. If goodwill impairment is implied, the fair values of individual assets and liabilities, including unrecorded intangibles, must be determined. RAI believes it has based its goodwill impairment testing on reasonable estimates and assumptions, and during the annual testing, the estimated fair value of each of RAI's reporting units was substantially in excess of its respective carrying value.

The methodology used to determine the fair value of trademarks includes assumptions with inherent uncertainty, including projected sales volumes and related projected revenues, long-term growth rates, royalty rates that a market participant might assume and judgments regarding the factors to develop an applied discount rate. The carrying value of intangible assets is at risk of impairment if future projected revenues or long-term growth rates are lower than those currently projected, or if factors used in the development of a discount rate result in the application of a higher discount rate.

Goodwill, trademarks and other intangible assets are tested more frequently if events and circumstances indicate that the asset might be impaired. The carrying value of these intangible assets could be impaired if a significant adverse change in the use, life or brand strategy of the asset is determined, or if a significant adverse change in the legal and regulatory environment, business or competitive climate occurs that would adversely impact the asset. For information related to intangible assets, see note 2 to condensed consolidated financial statements (unaudited).

Fair Value Measurement

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. 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.

For information on assets and liabilities recorded at fair value, see note 1 to condensed consolidated financial statements (unaudited).

Income Taxes

Income 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 recognition and measurement of assets and liabilities under the tax law may differ from recognition and measurement under GAAP, a deferred tax asset or liability is recorded. To the extent that a deferred tax asset is recorded, management evaluates RAI's ability to realize this asset. A valuation allowance is required for deferred tax assets if, based on available evidence, it is more likely than not that all or some portion of the assets will not be realized.

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 deferred tax assets and effective income tax rate. For information on income taxes, see note 5 to condensed consolidated financial statements (unaudited).

Recently Adopted and Issued Accounting Pronouncements

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

Results of Operations

All Other net sales and operating income include SFRTI and the various foreign subsidiaries affiliated with SFRTI, until the date of their sale on January 13, 2016.

	For the Three Months Ended June 30,			For the Six Months Ended June 30,		
	2017	2016	% Change	2017	2016	% Change
Net sales ⁽¹⁾ :						
RJR Tobacco	\$ 2,675	\$ 2,646	1.1%	\$ 5,046	\$ 5,057	(0.2)%
Santa Fe	278	247	12.6%	516	465	11.0%
American Snuff	261	232	12.5%	503	448	12.3%
All Other	104	70	48.6%	202	142	42.3%
Net sales	3,318	3,195	3.8%	6,267	6,112	2.5%
Cost of products sold ⁽¹⁾⁽²⁾	1,278	1,275	0.2%	2,477	2,440	1.5%
Selling, general and administrative expenses	478	499	(4.2)%	896	964	(7.1)%
Gain on divestiture	—	—	—	—	(4,861)	NM ⁽³⁾
Amortization expense	6	6	—	12	12	—
Operating income (loss):						
RJR Tobacco	1,291	1,216	6.2%	2,374	2,323	2.2%
Santa Fe	169	133	27.1%	313	256	22.3%
American Snuff	169	138	22.5%	326	271	20.3%
All Other	(21)	(43)	51.2%	(48)	(77)	37.7%
Gain on divestiture	—	—	—	—	4,861	NM ⁽³⁾
Corporate expense	(52)	(29)	(79.3)%	(83)	(77)	(7.8)%
Operating income	<u>\$ 1,556</u>	<u>\$ 1,415</u>	10.0%	<u>\$ 2,882</u>	<u>\$ 7,557</u>	(61.9)%

⁽¹⁾ Excludes excise taxes of:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2017	2016	2017	2016
RJR Tobacco	\$ 992	\$ 1,031	\$ 1,893	\$ 1,979
Santa Fe	76	74	144	139
American Snuff	15	14	28	27
All Other	—	1	—	5
	<u>\$ 1,083</u>	<u>\$ 1,120</u>	<u>\$ 2,065</u>	<u>\$ 2,150</u>

⁽²⁾ See below for further information related to the State Settlement Agreements and FDA user fees included in cost of products sold.

⁽³⁾ Percentage of change not meaningful.

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

RJR Tobacco

Net Sales

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

	For the Three Months Ended June 30,			For the Six Months Ended June 30,		
	2017	2016	% Change	2017	2016	% Change
RJR Tobacco:						
Drive brands:						
NEWPORT	8.7	8.8	(0.6)%	16.6	16.9	(1.7)%
CAMEL	5.0	5.3	(4.7)%	9.5	10.0	(5.3)%
PALL MALL	4.6	4.9	(6.2)%	8.9	9.4	(6.0)%
Total RJR Tobacco drive brands	18.3	18.9	(3.2)%	35.0	36.4	(3.8)%
Other brands	1.4	1.5	(11.3)%	2.6	3.0	(11.4)%
Total RJR Tobacco domestic cigarette shipment volume	19.7	20.5	(3.8)%	37.6	39.3	(4.4)%
Total premium	14.2	14.5	(2.5)%	26.9	27.8	(3.3)%
Total value	5.5	6.0	(7.0)%	10.7	11.5	(7.0)%
Premium/total mix	71.9%	70.9%		71.6%	70.8%	
Industry⁽¹⁾:						
Premium	46.8	48.0	(2.4)%	90.2	92.8	(2.8)%
Value	17.4	18.2	(4.2)%	33.7	34.9	(3.5)%
Total industry domestic cigarette shipment volume	64.2	66.2	(2.9)%	123.8	127.7	(3.0)%
Premium/total mix	72.9%	72.6%		72.8%	72.7%	

⁽¹⁾ Based on information from Management Science Associates, Inc., referred to as MSAi.

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 and state excise taxes.

RJR Tobacco's net sales for the three months ended June 30, 2017, increased compared with the prior-year quarter, primarily due to higher net pricing of \$151 million, partially offset by lower net volume/product mix of \$96 million and lower related party sales. RJR Tobacco's net sales for the six months ended June 30, 2017, decreased compared with the prior-year period, primarily due to lower related party sales and lower net volume/product mix of \$220 million, offset by higher net pricing of \$271 million.

Market Share

The shares of RJR Tobacco's cigarette brands as a percentage of total share of U.S. cigarette shipments to retail outlets, referred to as STR data, based on information submitted by wholesale locations and processed and managed by MSAi, were as follows:

	For the Three Months Ended				
	June 30, 2017	March 31, 2017	Share Point Change	June 30, 2016	Share Point Change
Drive brands:					
NEWPORT	14.1%	14.1%	0.0	13.9%	0.2
CAMEL	8.3%	8.2%	0.1	8.3%	0.0
PALL MALL	7.5%	7.7%	(0.2)	7.7%	(0.2)
Total drive brands	29.9%	29.9%	(0.1)	29.8%	0.0
Other brands	2.2%	2.3%	(0.1)	2.4%	(0.2)
Total RJR Tobacco domestic cigarette share of retail shipments	32.1%	32.2%	(0.1)	32.2%	(0.1)

The retail share of market of NEWPORT, at 14.1 share points, was up 0.2 share points compared with the prior-year quarter in the highly competitive U.S. cigarette category. NEWPORT's cigarette market share continued to be favorably impacted by its strength in the menthol category, as well as its continued momentum in the non-menthol category.

The retail share of market of CAMEL, at 8.3 share points, was flat compared with the prior-year quarter in the highly competitive U.S. cigarette category. CAMEL's cigarette market share demonstrated relatively stable performance in the quarter across its menthol styles that offer its innovative capsule technology in CAMEL Crush. CAMEL Crush styles provide adult smokers the choice of switching from non-menthol to menthol. CAMEL SNUS, a smokeless tobacco product, continues to lead the U.S. snus category with a market share of over 75%.

PALL MALL is a product that offers a high quality, longer-lasting cigarette at a value price. PALL MALL continues to attract interest from adult tobacco consumers in spite of competitive pressures, yielding second-quarter market share of 7.5%, which was down slightly compared with the prior-year quarter.

The combined share of market of RJR Tobacco's drive brands during the second quarter of 2017 was flat compared with the same period in 2016. RJR Tobacco's total cigarette market share was down slightly compared with the prior-year quarter, primarily due to decreases in the company's other brands, consistent with its strategy of focusing on drive brands.

Operating Income

RJR Tobacco's operating income for the three and six-month periods ended June 30, 2017, was favorably impacted by higher pricing, partially offset by lower net volume/product mix and higher State Settlement Agreement expenses when compared with the same periods in 2016.

RJR Tobacco's expenses under the State Settlement Agreements and its FDA user fees included in cost of products sold were:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2017	2016	2017	2016
State Settlement Agreements	\$ 713	\$ 676	\$ 1,399	\$ 1,272
FDA user fees	42	46	86	92

Expenses under the State Settlement Agreements are expected to be approximately \$2.8 billion in 2017, subject to adjustment based upon, among other things, the volume of cigarettes sold by RJR Tobacco, its relative market share, its operating profits and inflation. Pursuant to the Term Sheet, RJR Tobacco will receive credits with respect to its NPM Adjustment claims to be applied against annual payments under the MSA through 2021. An additional two states joined the Term Sheet in the second quarter of 2017, and as a result, expenses for the MSA were reduced by \$17 million for the three and six months ended June 30, 2017.

As a result of meeting the performance requirements associated with the Term Sheet, RJR Tobacco recognized credits of \$16 million and \$74 million for the three months ended June 30, 2017 and 2016, respectively, and \$26 million and \$143 million for the six months ended June 30, 2017 and 2016, respectively. RJR Tobacco expects to recognize additional credits through the remainder of 2017.

In October 2015, RJR Tobacco and certain other PMs entered into the NY Settlement Agreement to settle certain claims related to the NPM Adjustment. The NY Settlement Agreement resolved NPM Adjustment claims related to payment years from 2004 through 2014, providing RJR Tobacco with credits of approximately \$285 million, plus interest, subject to meeting various performance obligations. These credits will be applied against annual payments under the MSA over a four-year period, which commenced with the April 2016 MSA payment. Accordingly, RJR Tobacco recognized credits of \$25 million and \$23 million as a reduction to cost of products sold for the three months ended June 30, 2017 and 2016, respectively, and \$48 million and \$45 million for the six months ended June 30, 2017 and 2016, respectively. In addition, the NY Settlement Agreement put in place a new method to determine future adjustments from 2015 forward as to New York.

For additional information, see “— Cost of Products Sold” in note 1 and “— Litigation Affecting the Cigarette Industry — Health-Care Cost Recovery Cases — State Settlement Agreements” and “— State Settlement Agreements—Enforcement and Validity; Adjustments” in note 7 to condensed consolidated financial statements (unaudited).

Expenses for FDA user fees are expected to be approximately \$160 million to \$190 million in 2017. 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 \$50 million and \$51 million for the three months ended June 30, 2017 and 2016, respectively; and \$105 million and \$109 million for the six months ended June 30, 2017 and 2016, respectively.

“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;
- Filter Cases; 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 the defense of product liability claims;
- fees and cost reimbursements paid to outside attorneys;
- direct and indirect payments to third party vendors for litigation support activities; and
- expert witness costs and fees.

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 7 to condensed consolidated financial statements (unaudited) for detailed information regarding the number and type of cases pending, and “— Litigation Affecting the Cigarette Industry — Overview — Scheduled Trials” in note 7 to condensed consolidated financial statements (unaudited) for detailed information regarding the number and nature of cases in trial and scheduled for trial through June 30, 2018.

RJR Tobacco expects that the factors described above will continue to have the primary impact on its product liability defense costs in the future. Given the level of activity in RJR Tobacco’s pending cases, including the number of cases in trial and scheduled for trial, particularly with respect to *Engle Progeny* cases, RJR Tobacco’s product liability defense costs continue to remain at a high level. See “— Litigation Affecting the Cigarette Industry — *Engle* and *Engle Progeny* Cases” in note 7 to condensed consolidated financial statements (unaudited) for additional information.

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.

Santa Fe

Net Sales

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

	<u>For the Three Months Ended June 30,</u>			<u>For the Six Months Ended June 30,</u>		
	<u>2017</u>	<u>2016</u>	<u>% Change</u>	<u>2017</u>	<u>2016</u>	<u>% Change</u>
NATURAL AMERICAN SPIRIT	1.5	1.4	2.8%	2.7	2.6	4.0%

Santa Fe’s net sales for the three and six-month periods ended June 30, 2017, increased compared with the prior-year period, primarily due to higher volume and net pricing.

Market Share

The shares of Santa Fe's NATURAL AMERICAN SPIRIT brand as a percentage of total share of U.S. cigarette STR data according to MSAi were as follows:

	For the Three Months Ended				
	June 30, 2017	March 31, 2017	Share Point Change	June 30, 2016	Share Point Change
NATURAL AMERICAN SPIRIT	2.4%	2.3%	0.1	2.2%	0.1

NATURAL AMERICAN SPIRIT is a premium cigarette brand, and is a top ten best-selling cigarette brand in the United States.

Operating Income

Santa Fe's operating income for the three and six-month periods ended June 30, 2017, increased as compared with the prior-year period primarily due to higher volume and net pricing.

Santa Fe's expenses under the MSA and its FDA user fees included in cost of products sold were:

	For the Three Months Ended June 30,				For the Six Months Ended June 30,			
	2017		2016		2017		2016	
MSA	\$	45	\$	43	\$	86	\$	77
FDA user fees		4		3		6		6

Expenses under the MSA are expected to be approximately \$170 million to \$200 million in 2017, subject to adjustment for changes in volume and other factors.

In October 2015, SFNTC and certain other PMs entered into the NY Settlement Agreement to settle certain claims related to the NPM Adjustment. The NY Settlement Agreement resolved NPM Adjustment claims related to payment years from 2004 through 2014, providing SFNTC with credits of approximately \$5 million, plus interest, subject to meeting various performance obligations. These credits will be applied against annual payments under the MSA over a four-year period, which commenced with the April 2016 MSA payment. In addition, the NY Settlement Agreement put in place a new method to determine future adjustments from 2015 forward as to New York.

For additional information, see “— Cost of Products Sold” in note 1 and “— Litigation Affecting the Cigarette Industry — Health-Care Cost Recovery Cases — State Settlement Agreements” and “— State Settlement Agreements—Enforcement and Validity; Adjustments” in note 7 to condensed consolidated financial statements (unaudited).

American Snuff

Net Sales

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

	For the Three Months Ended June 30,			For the Six Months Ended June 30,		
	2017	2016	% Change	2017	2016	% Change
GRIZZLY	122.7	116.8	5.1%	239.0	228.1	4.8%
Other	10.7	11.0	(2.8)%	21.1	21.1	0.2%
Total American Snuff moist snuff shipment volume	133.4	127.8	4.4%	260.1	249.1	4.4%

American Snuff's net sales for the three and six-month periods ended June 30, 2017, increased compared with the same prior-year period primarily due to higher net pricing and higher moist snuff volume.

Market Share

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 93% of American Snuff's revenue for the three and six months ended June 30, 2017, compared with approximately 91% for the three and six months ended June 30, 2016.

The shares of American Snuff's moist snuff brands as a percentage of total share of U.S. moist snuff STR data according to MSAi were as follows:

	For the Three Months Ended				
	June 30, 2017	March 31, 2017	Share Point Change	June 30, 2016	Share Point Change
GRIZZLY	31.5%	31.8%	(0.3)	30.5%	1.0
Other	2.5%	2.6%	(0.1)	2.6%	(0.1)
Total American Snuff moist snuff share of retail shipments	34.0%	34.4%	(0.4)	33.1%	0.9

The retail market share of GRIZZLY, a leading U.S. moist snuff brand, increased 1.0 share point in the second quarter of 2017, compared with the second quarter of 2016, benefitting from supply disruption of competitive products during the first half of the year and the recent national expansion of its Dark Mint style. GRIZZLY's increase in shipment volume was driven by growth in the wintergreen styles and pouch offerings. GRIZZLY continues its market-leading position in wintergreen, with long cut and pouch styles remaining strong and the GRIZZLY Dark Wintergreen style enhancing the GRIZZLY wintergreen offerings. GRIZZLY Dark Wintergreen offers a differentiated and bolder wintergreen flavor, and is made from 100% U.S. tobacco grown in Kentucky and Tennessee.

GRIZZLY continues to show strength with its soft pouch design, which offers adult smokeless tobacco consumers a flavorful, moist experience that is easy to use, positioning it to be the leading pouch brand during the three months ended June 30, 2017. The pouch category represents approximately 20% of the moist snuff industry.

Operating Income

American Snuff's operating income for the three and six-month periods ended June 30, 2017, increased as compared with the prior-year periods primarily due to higher net pricing and volume.

All Other

RJR Vapor markets VUSE Digital Vapor Cigarette products, which include VUSE Solo, VUSE Fob and VUSE Vibe. VUSE is the top-selling vapor product in convenience/gas stores and is available in more than 110,000 retail outlets across the United States. Its innovative digital technology is designed to deliver a consistent flavor and vapor experience. In March 2016, RJR Vapor introduced its VUSE Fob power unit, which integrates Bluetooth® technology and offers an on-device display with information about battery and cartridge levels. RJR Vapor began national distribution, in November 2016, of its VUSE Vibe high-volume cartridge and closed-tank system with a stronger and longer-lasting battery. All production of VUSE Solo cartridges is performed at RJR Tobacco's manufacturing facility, pursuant to a services agreement between RJR Tobacco and RJR Vapor.

Niconovum USA, Inc. is a marketer of a nicotine replacement therapy gum, ZONNIC, which is available in approximately 40,000 retail outlets across the United States. Niconovum AB is a marketer of nicotine replacement therapy products in Sweden under the ZONNIC brand name.

Gain on divestiture

The results of operations of SFRTI were reported in All Other until their sale on January 13, 2016. SFRTI and various foreign subsidiaries affiliated with SFRTI distributed the NATURAL AMERICAN SPIRIT brand outside of the United States. RAI, through the Sellers, completed the sale of the international rights to the NATURAL AMERICAN SPIRIT brand name and associated trademarks, along with the international companies that distributed and marketed the brand outside the United States, to JTI Holding, in an all-cash transaction for approximately \$5 billion in cash and recognized a pre-tax gain of approximately \$4.9 billion in the first quarter of 2016.

RAI Consolidated

Interest and debt expense was \$150 million and \$299 million for the three and six months ended June 30, 2017, compared with \$152 million and \$326 million for the three and six months ended June 30, 2016. The change for the three and six months ended June 30, 2017, as compared with the same periods in 2016, is primarily due to a reduction in the aggregate principal amount of \$4.2 billion of outstanding notes resulting from the repurchase, early redemption and repayment at maturity of debt in 2016.

Other expense (income), net was \$11 million and \$15 million for the three and six months ended June 30, 2017, compared with \$1 million income and \$251 million expense for the three and six months ended June 30, 2016. The change is attributable primarily to

approximately \$239 million in losses and other fees related to the cash tender offer and the redemption of notes in the first six months of 2016.

Provision for income taxes was \$479 million, for an effective rate of 34.3%, for the three months ended June 30, 2017, compared with \$470 million, for an effective rate of 37.1%, for the three months ended June 30, 2016. The provision for income taxes was \$874 million, for an effective tax rate of 34.0%, for the six months ended June 30, 2017, compared with \$2.6 billion, for an effective tax rate of 37.6%, for the six months ended June 30, 2016. The effective tax rate for the six months ended June 30, 2017, was primarily impacted by a \$29 million decrease in tax attributable to excess tax benefits on stock-based compensation plans and a reduction in state taxes. The effective tax rate for the six months ended June 30, 2016, was primarily impacted by the sale of the international rights to the NATURAL AMERICAN SPIRIT brand name and associated trademarks, along with the international companies that distributed and marketed the brand outside the United States. Additionally, the effective tax rate for each period differed from the federal statutory rate of 35% due to the domestic manufacturing deduction, state income taxes and certain nondeductible items.

Liquidity and Financial Condition

Liquidity

The principal sources of liquidity for RAI's operating subsidiaries' businesses and operating needs were historically internally generated funds from their operations and intercompany loans and advances. The principal sources of liquidity for RAI, in turn, were historically proceeds from intercompany dividends and distributions, as well as issuances of debt securities and the Credit Agreement described below under "— Long-Term Debt and Credit Agreement." With the completion of the BAT Merger, through a zero balancing bank account structure, excess cash of RAI and its operating subsidiaries is now invested in the global cash pooling program managed by BAT's treasury team. For the foreseeable future, cash flows from operating activities and intercompany loans and advances from BAT's global cash pooling program are believed to be sufficient to enable RAI and its operating subsidiaries to fund their operations, to meet their obligations under the State Settlement Agreements, to make required debt-service payments, and to fund their capital expenditures.

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, adverse regulatory actions, increases in 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 generate sufficient funds internally or if adequate funding from BAT will be available 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. As of June 30, 2017, no business interruptions have occurred due to key supplier liquidity, and no liquidity issues were identified involving significant suppliers or customers.

Long-Term Debt and Credit Agreement

RAI Notes

As of June 30, 2017, the aggregate principal amount of RAI's outstanding notes was \$12.7 billion, with maturity dates ranging from 2017 to 2045. RAI, at its option, may redeem any or all of its outstanding notes, in whole or in part at any time, subject to the payment of a make-whole premium. Interest on the notes is payable semi-annually. At June 30, 2017, RAI had aggregate principal amount of \$1,697 million of current maturities of long-term debt. On July 25, 2017, BAT granted a guarantee of RAI's outstanding notes.

RJR Tobacco Notes

As of June 30, 2017, the aggregate principal amount of RJR Tobacco's outstanding notes was \$284 million, with maturity dates ranging from 2017 to 2041. Interest on the notes is payable semi-annually. At June 30, 2017, RJR Tobacco had an aggregate principal amount of \$53 million of current maturities of long-term debt. On July 25, 2017, BAT granted a guarantee of RJR Tobacco's outstanding notes.

Tender Offer and Redemption

In February 2016, pursuant to its previously announced cash tender offer, RAI accepted for purchase \$2.69 billion in aggregate principal amount of certain of its outstanding senior notes. In addition to the payment of accrued and unpaid interest, RAI paid, with cash on hand, aggregate total consideration of \$2.81 billion, which included a premium of approximately \$118 million for such notes accepted for purchase.

In March 2016, pursuant to its previously announced redemption call, RAI redeemed all \$700 million outstanding aggregate principal amount of its 6.750% Senior Notes due 2017 and all \$250 million outstanding aggregate principal amount of its 7.750% Senior Notes due 2018. In addition to the payment of accrued and unpaid interest, RAI paid, with cash on hand, aggregate consideration of \$1.0 billion for the redemption, which included \$88 million of early redemption premiums on such notes.

Credit Agreement

Effective July 25, 2017, in connection with the completion of the BAT Merger, RAI terminated the Credit Agreement. For additional information related to the Credit Agreement termination and the BAT Merger, see note 14 to condensed consolidated financial statements (unaudited). The following information represents a description of the Credit Agreement prior to its termination on July 25, 2017.

In December 2014, RAI entered into the Credit Agreement with a syndicate of lenders, providing for a five-year \$2 billion senior unsecured revolving credit facility, which could be increased to \$2.35 billion at the discretion of the lenders upon the request of RAI. The maturity date of the Credit Agreement had been extended to December 18, 2021.

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

During the first six months of 2017, RAI borrowed and repaid \$500 million under the Credit Agreement at an interest rate of 2.15%. Proceeds from the borrowings were used for general corporate purposes of RAI and its subsidiaries, including making payments under the MSA. As of June 30, 2017, there were no outstanding borrowings and no letters of credit outstanding under the Credit Agreement.

RAI, RJR Tobacco and their affiliates were in compliance with all covenants and restrictions imposed by RAI's indebtedness and RJR Tobacco's indebtedness, as the case may be, at June 30, 2017.

For additional information on the Credit Agreement, see note 6 to condensed consolidated financial statements (unaudited).

Dividends

On February 8, 2017, and May 4, 2017, RAI's board of directors declared a quarterly cash dividend of \$0.51 per common share. The dividends were paid on April 3, 2017 and July 3, 2017, to shareholders of record as of March 10, 2017 and June 12, 2017, respectively.

Share Repurchases

During the first six months of 2017, at a cost of \$58 million, RAI purchased 940,607 shares of RAI common stock that were forfeited and cancelled with respect to tax liabilities associated with restricted stock units vesting under the Omnibus Plan.

On July 25, 2016, the board of directors of RAI approved the Share Repurchase Program, which authorized the repurchase, from time to time, on or before December 31, 2018, of up to \$2 billion of outstanding shares of RAI common stock. Subject to certain exceptions, the Merger Agreement placed restrictions on RAI's ability to repurchase its common stock. As a result, RAI did not repurchase any shares under the Share Repurchase Program during the first six months of 2017. The Share Repurchase Program terminated effective with the completion of the BAT Merger on July 25, 2017.

In February 2017, RAI and BAT entered into the Letter Agreement, pursuant to which BAT waived the requirement that RAI share repurchases required to be made by RAI pursuant to Amendment No. 3 to the Governance Agreement be made within the time period set forth in that amendment, and permitted RAI to make repurchases in a manner that qualified for the affirmative defense and safe harbor provided by Rules 10b5-1 and 10b-18 under the Exchange Act, respectively. Pursuant to the Letter Agreement, BAT also waived compliance with the general prohibition on repurchases contained in the Merger Agreement to permit RAI to make these repurchases. During the first six months of 2017, in accordance with the Governance Agreement, at a cost of \$81 million, RAI repurchased 1,258,907 shares of RAI common stock in open-market transactions. Subsequent to June 30, 2017, and through July 13, 2017, RAI repurchased and cancelled an additional 113,160 shares of RAI common stock for \$7 million in accordance with the Governance Agreement.

Due to RAI's incorporation in North Carolina, which does not recognize treasury shares, the shares repurchased were cancelled at the time of purchase.

Capital Expenditures

RAI's operating subsidiaries recorded cash capital expenditures of \$66 million and \$94 million for the first six months of 2017 and 2016, respectively. RAI's operating subsidiaries expect to spend an additional \$165 to \$195 million for capital expenditures during the

remainder of 2017, which include upgrading corporate and manufacturing facilities and information management infrastructure. 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 June 30, 2017.

Retirement Benefits

RAI disclosed in its financial statements for the year ended December 31, 2016, that it expects to contribute \$111 million to its pension plans in 2017, of which \$7 million was contributed during the first six months of 2017.

Litigation and Settlements

Reynolds Defendants 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 7 to condensed consolidated financial statements (unaudited). Unfavorable judgments have been returned in a number of tobacco-related cases and state enforcement actions. As of June 30, 2017, RJR Tobacco had paid approximately \$179 million since January 1, 2015, related to unfavorable smoking and health litigation judgments.

RAI's condensed consolidated balance sheet (unaudited) as of June 30, 2017, contains accruals for certain individual *Engle* Progeny cases. Other accruals include an amount for the estimated costs of the corrective communications in the *U.S. Department of Justice* case. For additional information related to these cases and other litigation, see note 7 to condensed consolidated financial statements (unaudited).

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

In 1998, RJR Tobacco, Lorillard Tobacco, B&W, SFNTC and the other major U.S. cigarette manufacturers entered into the MSA with attorneys general representing most U.S. states, territories and possessions. The State Settlement Agreements, of which the MSA is the most wide-reaching, 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. The State Settlement Agreements have materially adversely affected RJR Tobacco's shipment volumes. RAI believes that these settlement obligations may materially adversely affect the results of operations, cash flows or financial position of RAI and RJR Tobacco in future periods. The degree of the adverse impact will depend, among other things, on the rate of decline in U.S. cigarette sales in the premium and value categories, RJR Tobacco's share of the domestic premium and value cigarette categories, and the effect of any resulting cost advantage of manufacturers not subject to the State Settlement Agreements.

RJR Tobacco and Lorillard Tobacco disputed a total of \$6.6 billion and \$1.2 billion, respectively, with respect to the NPM Adjustment, for the years 2003 through 2016.

In 2012, RJR Tobacco, Lorillard Tobacco, certain other PMs, including SFNTC, and certain settling states entered into a Term Sheet that sets forth terms for resolving accrued and potential NPM Adjustment claims for 2003 through 2012. The Term Sheet also sets forth a restructured NPM Adjustment process to be applied to future volume years, starting with the 2013 volume year. As a result of the Term Sheet settlement, RJR Tobacco and SFNTC are to collectively receive more than \$1.1 billion in credits, a vast majority of which have been applied to their MSA payments in 2014 through 2017, with the remainder to be applied against their 2018 MSA payment. Credits are recognized when RJR Tobacco and Santa Fe meet the performance requirements associated with the Term Sheet. Credits recognized in a given year are available to offset the payments made in April of the following year.

In September 2013, the Arbitration Panel ruled six states had not diligently enforced their qualifying statutes in 2003 related to the NPM Adjustment. Two of the six states subsequently joined the Term Sheet in 2014. In 2015, three of the states dropped their challenge of the finding of non-diligence and in 2016, the remaining state dropped its challenge. As such, a portion of the potential recovery from those states was certain and estimable and RJR Tobacco recognized the appropriate credit in those years. A final issue regarding the judgment reduction method adopted by the Arbitration Panel was being contested in these four states. In 2016, the U.S. Supreme Court denied RJR Tobacco's petition for writ of certiorari against two states, thus eliminating RJR Tobacco's remaining recovery from these states. In the first quarter of 2017, the Missouri Supreme Court ruled that the judgment reduction method adopted by the Arbitration Panel should be modified, thus eliminating RJR Tobacco's remaining recovery from this state. The final outcome in the remaining state is uncertain.

In October 2015, RJR Tobacco, SFNTC and certain other PMs entered into the NY Settlement Agreement to settle certain claims related to the NPM Adjustment. The NY Settlement Agreement resolved NPM Adjustment claims related to payment years from 2004 through 2014, providing RJR Tobacco and SFNTC, collectively, with credits of approximately \$290 million, plus interest, subject to meeting various performance obligations. These credits will be applied against annual payments under the MSA over a four-year period, which commenced with the April 2016 MSA payment. In addition, the NY Settlement Agreement put in place a new method to determine future adjustments from 2015 forward as to New York.

For additional information relating to proceedings involving NPM Adjustment claims, see “— Cost of Products Sold” in note 1 and “— Litigation Affecting the Cigarette Industry — State Settlement Agreements—Enforcement and Validity; Adjustments”, in note 7 to condensed consolidated financial statements (unaudited).

Governmental Activity

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

- significantly increase their taxes on all tobacco products;
- restrict displays, advertising and sampling of tobacco products;
- raise the minimum age to possess or purchase tobacco products;
- restrict or ban the use of menthol in cigarettes or prohibit the use of characterizing flavors in smokeless tobacco products and vapor 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 and vaping in public and private areas; and
- restrict the sale of tobacco products directly to consumers or other unlicensed recipients, including by mail or over the Internet.

Together with substantial increases in state and federal taxes on tobacco products, and the granting to the FDA of broad authority over the manufacture, sale, marketing and packaging of tobacco products, these developments have had and will likely continue to have an adverse effect on the sale of tobacco products. Products that are alternatives to traditional tobacco products also have become subject to increasing regulation. For example, in addition to the regulation by the FDA of e-cigarettes, as described below, various states have adopted, or are considering adoption of, taxes on e-cigarettes, restrictions on the promotion and distribution of e-cigarettes, and tamper resistant and child resistant packaging requirements for e-cigarettes.

Taxation

General

Cigarettes and other tobacco products are subject to substantial taxes in the United States. As a result of a 2009 law which increased taxes on cigarettes and other tobacco products:

- 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.

Currently, there is no federal tax on vapor products, such as e-cigarettes.

Cigarettes

The 2009 federal excise tax increase on tobacco products increased taxes on ready-made cigarettes, such as those made by RJR Tobacco and SFNTC, at a much higher rate than taxes on loose tobacco. As a result of that tax disparity, the number of retailers selling loose tobacco and operating roll-your-own machines, allowing consumers to convert the loose tobacco into finished cigarettes, greatly increased following the 2009 federal tax hike on tobacco products. On July 6, 2012, President Obama signed into law a provision classifying retailers which operate roll-your-own machines as cigarette manufacturers, and thus requiring those retailers to pay the same tax rate as other cigarette manufacturers. As of June 30, 2017, 26 states also had passed legislation classifying retailers operating roll-your-own machines as cigarette manufacturers.

All states and the District of Columbia currently impose cigarette excise taxes at levels ranging from \$0.17 per pack in Missouri to \$4.35 per pack in New York. As of June 30, 2017 and December 31, 2016, the weighted average state cigarette excise tax per pack, calculated on a 12-month rolling average basis, was approximately \$1.53 and \$1.39, respectively. Certain city and county governments, such as New York, Philadelphia and Chicago, also impose substantial excise taxes on cigarettes sold in those jurisdictions. During the first six months of 2017, 23 states proposed legislation to increase their cigarette excise taxes, with such legislation being adopted, effective August 24, 2017, in one state (Oklahoma), failing in 15 states and remaining pending, as of June 30, 2017, in seven states. RJR Tobacco Company, together with wholesalers, retailers and another cigarette manufacturer, have brought a lawsuit challenging, on state constitutional grounds, the basis upon which the Oklahoma tax increase was passed. The case is pending.

Six states now require NPMs to pay a fee on each pack of cigarettes sold in their respective states, ranging from \$0.25 per pack in Alaska to \$0.55 per pack in Texas.

Smokeless

As of June 30, 2017, all states and the District of Columbia subjected smokeless tobacco products to excise taxes, as summarized below:

- 27 states taxed moist snuff on an ad valorem basis, at rates ranging from 5% in South Carolina to 210% in Massachusetts; and
- 23 states and the District of Columbia had weight-based taxes on moist snuff, ranging from \$0.02 for cans weighing between $\frac{5}{8}$ of an ounce and $1\frac{5}{8}$ ounces in Alabama to \$2.02 per ounce in Maine.

During the first six months of 2017, 15 states proposed increases in their excise taxes on smokeless tobacco products, with such legislation failing in eight states and remaining pending, as of June 30, 2017, in seven states.

Vapor Products

As of June 30, 2017, six states and the District of Columbia imposed a tax on vapor products, such as e-cigarettes, as follows: Minnesota, which taxes vapor products at the same rate as it taxes smokeless tobacco products (95% of the wholesale price); Louisiana, North Carolina, Kansas and West Virginia, which tax vapor products at a per fluid milliliter rate of \$0.05, \$0.05, \$0.20 and \$0.075, respectively; and the District of Columbia and Pennsylvania, which tax vapor products at an ad valorem rate of 65% and 40%, respectively. As part of the ballot initiative that was approved in California in November 2016, vapor products were taxed in that state at an ad valorem rate of 27.3% from April 1, 2017 to June 30, 2017. Effective July 1, 2017, California's ad valorem rate on vapor products increased to 65.08%. California's ad valorem rate on vapor products is subject to potential further adjustment on July 1 of each year. Further, during the first six months of 2017, 24 states proposed taxes on vapor products, including, in some cases, implementing a tax on a per fluid milliliter basis, taxing vapor products on the same basis as "other tobacco products" and, in other cases, taxing vapor products at a rate equivalent to cigarette excise taxes. Such legislation was adopted in one state, failed in 15 states, and, as of June 30, 2017, remained pending in eight states.

FDA Tobacco Act

General

In 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. Pursuant to the FDA Tobacco Act:

- charitable distributions of tobacco products are prohibited;
- statements that would lead consumers to believe that a tobacco product is approved, endorsed, or deemed safe by the FDA are prohibited;
- pre-market approval by the FDA is required for claims made with respect to reduced risk or reduced exposure products;
- the marketing of tobacco products in conjunction with any other class of product regulated by the FDA is prohibited;
- tobacco manufacturers are banned from selling cigarettes with characterizing flavors (other than menthol, which under the FDA Tobacco Act is specifically exempt as a characterizing flavor, but the impact of which on public health will be studied as discussed below);
- all manufacturers are required to register with the FDA their domestic manufacturing facilities as well as all cigarette and smokeless tobacco products sold in the United States;
- the FDA reissued regulations addressing advertising and marketing restrictions that were originally promulgated in 1996 (including, among other restrictions, prohibitions on: the sale of cigarettes and smokeless tobacco products to persons under

the age of 18; the sale of packages of cigarettes with less than 20 cigarettes; the distribution of free samples of cigarettes; and brand name sponsorship of any athletic, musical or other social/cultural events);

- manufacturers were required to produce health-related documents generated from and after June 22, 2009 through December 31, 2009 (the FDA has interpreted the FDA Tobacco Act as establishing an ongoing requirement to submit health-related documents; however, the FDA has not yet established a timetable for further production);
- manufacturers are 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”;
- the FDA issued a final regulation for the imposition of larger, graphic health warnings on cigarette packaging and advertising, which was scheduled to take effect September 22, 2012, but the FDA is currently enjoined from enforcing such regulation;
- as described in greater detail below, new or modified products introduced in the market after February 15, 2007 are subject to certain FDA clearance requirements;
- the FDA announced that it would inspect every domestic establishment that manufactured cigarettes, cigarette tobacco, roll-your-own tobacco or smokeless tobacco products once in a two-year cycle, beginning October 1, 2011;
- in April 2012, the FDA issued draft guidance on: (1) the reporting of harmful and potentially harmful constituents in tobacco products and tobacco smoke pursuant to Section 904(a)(3) of the FDA Tobacco Act, and (2) preparing and submitting applications for modified risk tobacco products pursuant to Section 911 of the FDA Tobacco Act; and
- in December 2016, the FDA issued a revised final guidance document entitled, “Demonstrating the Substantial Equivalence of a New Tobacco Product: Response to Frequently Asked Questions (Edition 3).” The revised guidance was the result of a decision by the United States District Court for the District of Columbia finding that the FDA’s prior guidance that labeling changes trigger the requirement for premarket review contradicts the language of the FDA Tobacco Act and exceeds the agency’s authority. However, the court ruled that the FDA could require a premarket review submission for a product quantity change, as such a change would constitute a “new” tobacco product.

The FDA Tobacco Act grants the FDA the authority to impose broad additional restrictions. On a going forward basis, the FDA:

- will require manufacturers to test ingredients and constituents identified by the FDA and disclose this information to the public;
- will prohibit use of tobacco containing a pesticide chemical residue at a level greater than allowed under Federal law;
- will establish “good manufacturing practices” to be followed at tobacco manufacturing facilities;
- may place more severe restrictions on the advertising, marketing and sale of tobacco products; and
- may require the reduction of nicotine and the reduction or elimination of other constituents, as further discussed below.

Pursuant to the foregoing authority, the FDA has proposed a rule that, if adopted, would require the reduction, over a three-year period, of the levels of N-nitrosornicotine (NNN) contained in smokeless tobacco products. The adoption of this proposed rule is currently suspended by virtue of a federal regulatory freeze imposed by the U.S. President. It is not known whether or when this proposed rule will be adopted, and, if adopted, whether the final rule will be the same as or similar to the proposed rule. If the proposed rule is adopted, however, in its current form (or in a form substantially similar to its current form), management expects that compliance or the inability to comply could have a material adverse effect on the results of operations, cash flows and financial position of American Snuff and RAI.

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.

In 2009, a “Center for Tobacco Products,” referred to as the CTP, was 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.

Within the CTP, 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 periodically to address matters brought to it by the Center as well as those required of it by the FDA Tobacco 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.

Potential Regulation of Menthol

At a meeting held on March 18, 2011, the TPSAC presented its final report on the use of menthol, which concluded that removal of menthol cigarettes from the marketplace would benefit public health in the United States. On July 24, 2013, the FDA issued a report detailing its own preliminary scientific evaluation of public health issues related to the use of menthol in cigarettes, including a determination that there is likely a public health impact of menthol in cigarettes. The FDA's report found that the weight of the evidence supports the conclusion that menthol in cigarettes is associated with:

- increased initiation among youth and young adults;
- reduced success in smoking cessation; and
- increased dependence.

The report found that menthol in cigarettes is not associated with:

- increased smoke toxicity;
- increased levels of biomarkers of exposure; or
- increased disease risk.

The FDA concurrently published in the *Federal Register* an Advance Notice of Proposed Rulemaking, referred to as the ANPRM, to obtain information related to the potential regulation of menthol in cigarettes. The ANPRM sought comments from interested stakeholders on the FDA's preliminary evaluation, as well as any data, research or other information on various topics, including, but not limited to:

- potential product standards for menthol and the potential period for compliance with such standards;
- potential restrictions on the sale and/or distribution of menthol products; and
- evidence regarding illicit trade in menthol cigarettes (including the public health impact thereof) should the use of menthol in cigarettes be restricted or banned.

In November 2013, RAI's operating companies submitted comments on the ANPRM. The FDA will evaluate all comments it has received from interested stakeholders in response to the ANPRM, as the agency considers whether to require additional standards or restrictions with respect to menthol cigarettes. The FDA Tobacco Act does not require the FDA to adopt any such standards or restrictions. Any rule that the FDA may propose will be subject to a 60-day comment period, and may only become effective at least one year after the rule's adoption. If the FDA were to adopt a rule banning or severely restricting the use of menthol in cigarettes, such rule could have an adverse effect on the sale of RAI's subsidiaries' products containing menthol and, as a result, on the results of operations, cash flows and financial position of RAI.

In addition to the potential regulation of menthol in cigarettes by the FDA, certain municipalities either have adopted, or are considering the adoption of, a ban on the sale of menthol cigarettes. For instance, on June 27, 2017, the San Francisco Board of Supervisors unanimously voted to amend that city's Health Code to prohibit tobacco retailers from selling flavored tobacco products, including flavored e-cigarettes and menthol cigarettes. Use and possession of flavored tobacco products are not impacted by the ban. The ordinance will go into effect on April 1, 2018.

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

Final Deeming Regulation

On May 10, 2016, the FDA issued a final regulation, referred to as the Final Rule, deeming all products that meet the FDA Tobacco Act's definition of "tobacco product" to be subject to the FDA's regulatory authority under the FDA Tobacco Act. The Final Rule became effective as of August 8, 2016, though each requirement of the Final Rule has its own compliance date. Such newly "deemed" tobacco products subject to the FDA Tobacco Act include, among others, electronic nicotine delivery systems (including e-cigarettes, e-hookah, e-cigars, vape pens, advanced refillable personal vaporizers, electronic pipes and e-liquids mixed in vape shops), certain dissolvable tobacco products, cigars, and pipe tobacco. In addition, "components" and "parts" (e.g., batteries), but not "accessories" (e.g., lighters, pipe pouches), of newly deemed products are themselves subject to the FDA Tobacco Act by virtue of the Final Rule.

Deemed products are subject to the provisions of the FDA Tobacco Act to which currently regulated tobacco products have been subject since the FDA Tobacco Act's adoption in 2009, including: adulteration and misbranding provisions; requirements relating to ingredient listing and reporting of harmful and potentially harmful constituents; registration of tobacco product manufacturing establishments and product listing; restrictions against the sale and distribution of products with modified risk descriptions (such as use of "light," "low," and "mild"); prohibition on the distribution of free samples; a required health warning; and, as described in more detail below, premarket review requirements.

The "grandfather" date under the Final Rule for newly deemed products remains the same as the "grandfather" date for those tobacco products already subject to the FDA Tobacco Act – February 15, 2007. Any tobacco product that was not legally marketed as of February 15, 2007, will be considered a new tobacco product subject to premarket review by the FDA.

The FDA has recognized that few, if any, e-cigarettes were on the market as of February 15, 2007, but thousands of such products (including RJR Vapor's VUSE Digital Vapor Cigarette) subsequently have entered into commerce. To address this issue, the FDA established a compliance policy regarding the premarket review requirements for all newly deemed tobacco products that are not grandfathered products, but were on the market as of August 8, 2016. The FDA will allow such products to remain on the market so long as the manufacturer has filed the appropriate Premarket Tobacco Product Application, referred to as a PMTA, application by a specific deadline. The Final Rule established staggered initial compliance periods based on the expected complexity of the applications to be submitted. On July 28, 2017, as part of FDA's announcement of a comprehensive regulatory plan for nicotine and tobacco, the FDA extended the deadline for submission of PMTAs for newly deemed products by several years. Applications for newly regulated combustible products, such as cigars and pipe tobacco, must be submitted by August 8, 2021. PMTAs for non-combustible products, such as e-cigarettes, must be submitted by August 8, 2022. During the third quarter of 2016, and prior to August 8, 2016, RJR Vapor introduced into the market additional newly deemed tobacco products.

RJR Vapor intends to file a PMTA with respect to VUSE and certain other of its e-cigarette products. Further, RJR Vapor believes that substantially all other e-cigarette manufacturers likewise will be unable to use the substantial equivalence pathway to obtain FDA clearance of their respective e-cigarettes, but instead will be required to file PMTAs to obtain FDA clearance of such products. Based on the FDA's draft guidance setting forth the type of evidence that must be included within a premarket review application, RJR Vapor expects the costs of preparing a PMTA to be significant, and a cost more easily borne by larger manufacturers.

In order for the FDA to clear a PMTA covering an e-cigarette, the applicant must show that the marketing of such e-cigarette would be appropriate for the protection of the public health. Under the FDA Tobacco Act, whether a tobacco product is appropriate for the protection of the public health is to be determined "...with respect to the risks and benefits to the population as a whole, including users and nonusers of the tobacco product, and taking into account – (A) the increased or decreased likelihood that existing users of tobacco products will stop using such products; and (B) the increased or decreased likelihood that those who do not use tobacco products will start using such products." In draft guidance issued by the FDA, the agency has stated that to completely assess whether a PMTA shows that a product is appropriate for the protection of the public health, the "FDA will look at the product in the context of the current tobacco product market. FDA can do this by understanding the spectrum of risk of currently available tobacco products and assessing the new product within that spectrum." At present, there is substantial uncertainty over how the FDA will apply the foregoing principles in practice when determining whether to clear an e-cigarette PMTA. To date, few PMTAs have been filed, and the only PMTAs that the FDA has cleared relate to snus products of another manufacturer.

Pursuant to the revised FDA compliance policy, any product for which the appropriate PMTA has been timely filed may be marketed while the application is under review. For deemed products that were not on the market as of August 8, 2016, manufacturers must file the appropriate PMTA and obtain FDA clearance before marketing such product.

FDA Regulatory Plan for Nicotine

On July 28, 2017, the FDA announced its intent to develop a comprehensive plan for tobacco and nicotine regulation that recognizes the continuum of risk for nicotine delivery. The FDA plans to publish an Advance Notice of Proposed Rulemaking, referred to as ANPRM, to seek public input regarding the potential health benefits and possible adverse effects of lowering the level of nicotine in

cigarettes. The ANPRM will request comments from interested stakeholders regarding the potential impact of a nicotine product standard on, among other things:

- the likelihood that existing users of tobacco products will stop using cigarettes;
- the likelihood that those who do not use tobacco products will start using such products; and
- the illicit trade of cigarettes containing nicotine at levels higher than a non-addictive nicotine threshold.

In addition, the CTP will coordinate with the FDA Center for Drug Evaluation and Research regarding medicinal nicotine and other therapeutic products as part of an agency-wide nicotine framework.

As part of the comprehensive plan, the FDA also announced its intent to issue ANPRMs requesting public stakeholder input on the impact of flavors (including menthol) in increased initiation among youth and young adults as well as assisting adult smokers to switch to potentially less harmful forms of nicotine delivery; and the patterns of use and public health impact of premium cigars.

To balance regulation and the development of innovative tobacco products, the FDA issued the revised enforcement policy noted above for products recently brought under the FDA's authority by the deeming regulation, extending the timelines for the submission of PMTAs for such products. The FDA also noted its plans to develop product standards to protect against known public health risks such as issues with electronic nicotine delivery systems batteries and concerns about children's exposure to liquid nicotine.

The FDA plans to develop foundational regulations to provide clarity and predictability to the tobacco product submission process, to include regulations outlining the information that the FDA expects to be provided in PMTAs, Modified Risk Tobacco Product applications, and substantial equivalence reports, as well as finalized guidance on PMTA reviews. Further, the FDA will evaluate whether its current plan to review the substantial equivalence reports for all provisional products is an effective use of its resources, or if the FDA could take a different approach that would free up resources and provide greater market clarity for manufacturers.

The FDA did not provide a timeline for publication for the ANPRM documents or the commencement of regulatory activities related to the comprehensive nicotine policy.

FDA Warning Letter to SFNTC

On August 27, 2015, the FDA sent a warning letter to SFNTC claiming that SFNTC's use of the terms "Natural" and "Additive Free" in the product labeling and advertising for NATURAL AMERICAN SPIRIT cigarettes violates the Modified Risk Tobacco Products provision of the FDA Tobacco Act. Following discussions between the parties, on January 23, 2017, the FDA and SFNTC reached an agreement whereby, among other things, SFNTC committed to phasing out use of the terms "Natural" and "Additive Free" from product labeling and advertising for NATURAL AMERICAN SPIRIT cigarettes on an established timeframe. The agreement also specifies that SFNTC may continue to use the term "Natural" in the NATURAL AMERICAN SPIRIT brand name and trademarks. SFNTC's scheduled deletion of the terms "Natural" and "Additive Free" from the labeling and advertising of its NATURAL AMERICAN SPIRIT cigarettes could have an adverse effect on the sale of such cigarettes and, as a result, on the results of operations, cash flows and financial position of SFNTC and RAI.

Premarket Review; MRTP Applications

RAI's strategy of focusing on innovation to help transform the tobacco industry is dependent on its operating companies' ability to introduce new products into the market. For a manufacturer to launch a new product or modify an existing one after March 22, 2011, the FDA Tobacco Act requires a manufacturer to file one of three types of product applications (a new product application, a substantial equivalence application or a substantial equivalence exemption application) with the CTP, depending on the type and level of change being sought. In all cases, however, the manufacturer may not market the new or modified product in the United States until the CTP issues a marketing order, allowing the product to be marketed. Although the FDA Tobacco Act has now been in effect for more than six years, uncertainty remains as to the timing of the review and the requirements for clearance of new or modified tobacco products introduced in the market after March 22, 2011. These uncertainties, in conjunction with the clearance requirement itself, could have an adverse impact on the ability of RAI's operating companies to innovate in the future.

Similarly, a manufacturer that introduced a new tobacco product or modified a tobacco product between February 15, 2007 and March 22, 2011, was required to file a substantial equivalence report with the CTP, demonstrating either (1) that the new or modified product had the same characteristics as a product commercially available as of February 15, 2007, referred to as a predicate product, or (2) if the new or modified product had different characteristics than the predicate product, that it did not raise different questions of public health. A product subject to such report is referred to as a provisional product. A manufacturer may continue to market a provisional product unless and until the CTP issues an order that the provisional product is not substantially equivalent, in which case the FDA could then require the manufacturer to remove the provisional product from the market. On September 15, 2015, the CTP

issued four Not Substantially Equivalent orders, referred to as NSE orders, to RJR Tobacco, determining that four cigarette styles are not substantially equivalent to their respective predicate products, and ordering that RJR Tobacco immediately stop all distribution, importation, sale, marketing and promotion of these provisional products. On September 29, 2015, RJR Tobacco provided the FDA with a compliance plan with respect to these NSE orders. On January 20, 2016, RJR Tobacco received notification from the CTP's Office of Compliance and Enforcement that no further action was necessary on the compliance plan.

As with new or modified tobacco products introduced after March 22, 2011, uncertainty remains over the timing of review of substantial equivalence reports for provisional products. Moreover, although the sales of the provisional products subject to the NSE orders described in the preceding paragraph are not material to RJR Tobacco, substantially all of RAI's operating companies' products currently on the market are provisional products. If the CTP were to issue NSE orders with respect to other provisional products of RAI's operating companies, such orders, if not withdrawn or invalidated, would have a material adverse impact on the sales of the products subject to the orders, and could have an adverse impact on the results of operations, cash flows and financial position of RAI.

On March 31, 2017, RJR Tobacco filed with the FDA modified risk tobacco product applications, referred to as MRTP applications, covering six styles of CAMEL Snus. In accordance with the FDA's submission guidelines and in support of its MRTP applications, RJR Tobacco provided the FDA documentation regarding the results and analysis from a number of scientific studies. The FDA initially will review the applications to determine whether to accept them for substantive review; the FDA may ask RJR Tobacco to provide additional information before the agency accepts the applications for review. If the FDA ultimately accepts the applications, then the agency will undertake a scientific review to determine whether (and will grant a modified risk tobacco product order only if) RJR Tobacco has demonstrated that the products subject to the applications will (1) significantly reduce the risk of tobacco-related disease to the users of the products and (2) benefit the health of the population as a whole. There is no deadline by which the FDA is required to make a determination with respect to RJR Tobacco's MRTP applications. If the FDA were to issue a modified risk tobacco product order, then RJR Tobacco would have the ability to communicate the reduced risk claims contained in the approved MRTP applications. To date, the FDA has not granted a modified risk tobacco product order to any manufacturer.

The FDA Tobacco Act could result in a decrease in cigarette, smokeless tobacco product and e-cigarette sales in the United States, including sales of RJR Tobacco's, SFNTC's, American Snuff Co.'s and RJR Vapor's brands, that, together with increased costs incurred by RAI's operating companies arising from the FDA Tobacco Act, could have a material adverse effect on RAI's financial condition, results of operations and cash flows. 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, SFNTC or the cigarette industry in general, but any new legislation or regulations could have an adverse effect on RJR Tobacco, SFNTC 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 or e-cigarettes will be enacted or to predict the effect of new regulations on American Snuff Co. or smokeless tobacco products in general, or on RJR Vapor or e-cigarettes in general, as the case may be, but any new legislation or regulations could have an adverse effect on American Snuff Co. or smokeless tobacco products in general or on RJR Vapor or e-cigarettes in general, as the case may be.

Other Contingencies

For information relating to other contingencies of RAI, RJR, RJR Tobacco, Lorillard Tobacco, American Snuff Co., SFNTC and RJR Vapor, see "— Other Contingencies" in note 7 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. When used in this document and in documents incorporated by reference, forward-looking statements include, without limitation, statements regarding financial forecasts or projections, and RAI's and its subsidiaries' expectations, beliefs, intentions or future strategies that are signified by the words "anticipate," "believe," "could," "estimate," "expect," "intend," "may," "objective," "outlook," "plan," "possible," "potential," "predict," "project," "should" and similar expressions. These statements regarding future events or the future performance or results of RAI and its subsidiaries inherently are subject to a variety of risks, contingencies and other uncertainties that could cause actual results, performance or achievements to differ

materially from those described in or implied by the forward-looking statements. These risks, contingencies and other uncertainties include:

- the effect of (1) possible unfavorable outcomes in litigation based on allegations relating to the sale, distribution, manufacture, development, advertising, marketing and health effects of tobacco products (including smokeless tobacco products and electronic cigarettes) that is pending or may be instituted against RAI or its subsidiaries, including the *Engle Progeny* cases, and (2) potential bonding difficulties related to adverse judgments resulting from such litigation, including *Engle Progeny* cases;
- the possibility that the FDA will issue regulations prohibiting or restricting the use of menthol in cigarettes, which could adversely affect the sales of, among other products, RJR Tobacco's NEWPORT cigarettes;
- the possibility that the CTP fails to grant a marketing order allowing an RAI subsidiary to launch a new tobacco product or modify an existing product;
- the adverse effects (including damage to RAI's reputation, recall costs and decreased sales) arising from potential CTP orders (1) finding that provisional products sold by RAI subsidiaries are not substantially equivalent to predicate products and (2) as a result, requiring that the provisional products be removed from the market;
- the adverse effects arising out of FDA actions (or agreements between the FDA and RAI or its subsidiaries) related to product labeling and advertising, potentially resulting in decreased sales;
- the adverse effects arising from the FDA's May 2016 regulation extending the agency's control and authority over tobacco products to e-cigarettes, which regulation (1) subjects e-cigarettes to restrictions on, among other things, the manufacturing, marketing and sale of such products, and (2) requires FDA clearance of e-cigarettes introduced to the market after February 15, 2007;
- the possibility that the FDA will issue regulations further controlling constituents in cigarettes, including requiring the reduction of nicotine levels or the reduction or elimination of other constituents;
- possible additional effects on the sales of RAI's subsidiaries' products of the substantial, sales-based payment obligations under the State Settlement Agreements, coupled with continuing effects of the State Settlement Agreements' substantial limitations on the sale, advertising and marketing of cigarettes (and of RJR Tobacco's smokeless tobacco products);
- the possibility that NPM Adjustment awards could be vacated or otherwise modified;
- considering RAI's subsidiaries' dependence on the U.S. cigarette market, the continued decline in U.S. cigarette consumption;
- the possible transition of consumers away from premium brands to lower-cost brands considering RAI's subsidiaries' dependence on premium cigarette brands;
- the success or failure of new products (including vapor category product offerings and other non-traditional tobacco products), marketing strategies and promotional programs;
- competitive actions and pricing pressures from other manufacturers, including manufacturers of deep-discount cigarette brands;
- significant current and anticipated federal, state and local governmental regulation of tobacco products, including limitations on advertising, marketing, sale and use of tobacco products;
- substantial and increasing taxation of tobacco products;
- fluctuations in the availability, quality and price of raw materials and commodities, including tobacco leaf, used in the products of RAI's subsidiaries;
- the reliance on a few significant manufacturing facilities and single source suppliers for certain key raw materials;
- the possible impairment of goodwill and other intangible assets, including trademarks;
- the effect of market conditions on the investment returns earned on pension assets or any adverse effects of any new legislation or regulations changing pension and postretirement benefits accounting or required pension funding levels;
- the concentration of a material amount of sales with a limited number of customers and potential loss of these customers;
- possible security breaches or disruptions in critical information technology systems, many of which are managed by third party service providers;
- the possible inability to use digital technologies effectively, including any failure to use such technologies to engage with customers and consumers, automate business processes and support product innovation;

- the impact of the health and social issues associated with the tobacco industry on RAI’s and its subsidiaries’ ability to attract and retain qualified employees, officers, and professionals;
- indemnification obligations for specified matters, and retention of certain liabilities related to assets transferred in transactions with ITG and JTI Holding; and
- additional risks, contingencies and uncertainties associated with the BAT Merger that could have an adverse effect on the results of operations, cash flows and financial position of the combined company, including:
 - the failure to realize projected synergies and other benefits from the BAT Merger;
 - failure to promptly and effectively integrate RAI into BAT;
 - the effect of the BAT Merger on the ability to retain and hire key personnel, and maintain business relationships; and
 - the incurrence of significant post-transaction related costs in connection with the BAT Merger.

Such statements are based on current expectations and are subject to risks, contingencies and other uncertainties, including, without limitation, those discussed in this Quarterly Report on Form 10-Q, and in particular, those discussed in Part I, Item 1A “Risk Factors” in our Annual Report on Form 10-K for the fiscal year ended December 31, 2016, and those discussed in other documents we file from time to time with the SEC. Due to these risks, contingencies and other uncertainties, you are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date of this report. Except as provided by federal securities laws, RAI is not required to publicly update or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

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

The table below provides information, as of June 30, 2017, about RAI’s financial instruments that are sensitive to changes in interest rates. The table presents notional amounts and weighted average interest rates by contractual maturity dates for the years ending December 31:

	<u>2017</u>	<u>2018</u>	<u>2019</u>	<u>2020</u>	<u>2021</u>	<u>Thereafter</u>	<u>Total</u>	<u>Fair Value⁽¹⁾</u>
Investments:								
Variable-rate	\$ 1,733	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 1,733	\$ 1,733
Average interest rate	0.6%	—	—	—	—	—	0.6%	—
Debt:								
Fixed-rate	\$ 500	\$ 1,250	\$ 750	\$ 1,521	\$ —	\$ 8,929	\$12,950	\$14,725
Average interest rate ⁽²⁾	2.3%	2.3%	8.1%	5.0%	—	5.3%	5.0%	—

⁽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 coupon interest rates for fixed-rate instruments.

RAI’s exposure to foreign currency transactions was not material to its results of operations for the six months ended June 30, 2017. RAI currently has no hedges for its exposure to foreign currency.

Item 4. Controls and Procedures

- 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.
- There have been no changes in RAI’s internal controls over financial reporting that occurred during the first six months of 2017 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 Reynolds Defendants, see note 7 to condensed consolidated financial statements (unaudited) and “Management’s Discussion and Analysis of Financial Condition and Results of Operations — Critical Accounting Estimates — Litigation” included in Part I, Item 2.

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

RAI conducts its business through its subsidiaries and is dependent on the earnings and cash flows of its subsidiaries to satisfy its obligations and other cash needs. For additional information, see “Management’s Discussion and Analysis of Financial Condition and Results of Operations — Liquidity and Financial Condition” in Part I, Item 2.

The following table summarizes RAI’s purchases of its common stock during the second quarter of 2017:

	Total Number of Shares Purchased ^{1, 2}	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs ³	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs ⁴
April 1 - 30, 2017	268,755	\$ 63.68	268,755	\$ 1,925
May 1 - 31, 2017	450,500	\$ 65.06	311,190	\$ 1,925
June 1 - 30, 2017	282,900	\$ 66.31	282,900	\$ 1,925
Second Quarter Total	<u>1,002,155</u>		<u>862,845</u>	

¹ During the second quarter of 2017, RAI repurchased and cancelled 136,910 shares of its common stock with respect to the tax liability associated with vesting of restricted stock unit grants under the Omnibus Plan. For equity-based benefit plan information, see notes 8 and 9 to condensed consolidated financial statements (unaudited).

² During the second quarter of 2017, RAI repurchased and cancelled 2,400 shares of its common stock with respect to the tax liability associated with the issuance of shares under the Equity Incentive Award Plan for Directors of Reynolds American Inc.

³ During the second quarter of 2017, RAI repurchased and cancelled 862,845 shares of its common stock in accordance with the Governance Agreement. For additional information, see note 8 to condensed consolidated financial statements (unaudited).

⁴ During the second quarter of 2017, RAI did not repurchase any shares of its common stock under the Share Repurchase Program. For additional information, see note 8 to condensed consolidated financial statements (unaudited).

Item 6. Exhibits

Exhibit Number	Description
2.1	Amendment to Agreement and Plan of Merger, dated as of June 8, 2017, among British American Tobacco p.l.c., BATUS Holdings Inc., Flight Acquisition Corporation and Reynolds American Inc. (incorporated by reference to Exhibit 2.1 to Reynolds American Inc.'s Form 8-K dated June 8, 2017).
3.1	Amended and Restated Articles of Incorporation of Reynolds American Inc., dated July 25, 2017 (incorporated by reference to Exhibit 3.1 to Reynolds American Inc.'s Form 8-K dated July 25, 2017).
3.2	Second Amended and Restated Bylaws of Reynolds American Inc., dated July 25, 2017 (incorporated by reference to Exhibit 3.2 to Reynolds American Inc.'s Form 8-K dated July 25, 2017).
4.1	Fifth Supplemental Indenture, dated July 25, 2017, to Reynolds American Inc. Indenture dated May 31, 2006 (incorporated by reference to Exhibit 4.1 to Reynolds American Inc.'s Form 8-K dated July 25, 2017).
4.2	Sixth Supplemental Indenture, dated July 25, 2017, to Reynolds American Inc. Indenture dated May 31, 2006 (incorporated by reference to Exhibit 4.2 to Reynolds American Inc.'s Form 8-K dated July 25, 2017).
4.3	Ninth Supplemental Indenture, dated July 25, 2017, to R. J. Reynolds Tobacco Company Indenture dated June 23, 2009 (incorporated by reference to Exhibit 4.3 to Reynolds American Inc.'s Form 8-K dated July 25, 2017).
4.4	Guarantee Agreement of British American Tobacco p.l.c. dated July 25, 2017 related to the Ninth Supplemental Indenture dated July 25, 2017, to R. J. Reynolds Tobacco Company Indenture dated June 23, 2009 (incorporated by reference to Exhibit 4.4 to Reynolds American Inc.'s Form 8-K dated July 25, 2017).
10.1	Form of Retention Agreement between Reynolds American Inc. and the executive officer named therein (incorporated by reference to Exhibit 10.1 to Reynolds American Inc.'s Form 8-K dated May 30, 2017).
10.2	Form of Severance Agreement between Reynolds American Inc. and the executive officer named therein (incorporated by reference to Exhibit 10.2 to Reynolds American Inc.'s Form 8-K dated May 30, 2017).
10.3	Form of Transition Agreement between Reynolds American Inc. and the executive officer named therein (incorporated by reference to Exhibit 10.1 to Reynolds American Inc.'s Form 8-K dated July 25, 2017).
31.1	Certification of Chief Executive Officer relating to RAI's Quarterly Report on Form 10-Q for the quarter ended June 30, 2017.
31.2	Certification of Chief Financial Officer relating to RAI's Quarterly Report on Form 10-Q for the quarter ended June 30, 2017.
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 June 30, 2017, 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
101.DEF	XBRL taxonomy extension definition linkbase document
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: August 1, 2017

/s/ Andrew D. Gilchrist
Andrew D. Gilchrist
Executive Vice President and Chief Financial Officer
(principal financial officer)