

**REYNOLDS AMERICAN INC.**

**Consolidated Financial Statements**

**December 31, 2017 and 2016**

**(With Independent Auditors' Report Thereon)**

**REYNOLDS AMERICAN INC.**  
**Consolidated Financial Statements**

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KPMG LLP  
Suite 400  
300 North Greene Street  
Greensboro, NC 27401

## Independent Auditors' Report

The Board of Directors  
Reynolds American Inc.:

We have audited the accompanying consolidated financial statements of Reynolds American Inc. and its subsidiaries, which comprise the consolidated balance sheets as of December 31, 2017 and 2016, and the related consolidated statements of income, comprehensive income, cash flows, and shareholders' equity for the years then ended, and the related notes to the consolidated financial statements.

### *Management's Responsibility for the Financial Statements*

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

### *Auditors' Responsibility*

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### *Opinion*

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Reynolds American Inc. and its subsidiaries as of December 31, 2017 and 2016, and the results of their operations and their cash flows for the years then ended in accordance with U.S. generally accepted accounting principles.

**KPMG LLP**

Greensboro, North Carolina  
February 21, 2018

**REYNOLDS AMERICAN INC.**  
**CONSOLIDATED STATEMENTS OF INCOME**  
(Dollars in Millions)

	For the Years Ended December 31,	
	2017	2016
Net sales <sup>(1)</sup>	\$ 12,459	\$ 12,277
Net sales, related party	104	226
<b>Net sales</b>	<b>12,563</b>	<b>12,503</b>
Costs and expenses:		
Cost of products sold <sup>(1)</sup>	4,742	4,841
Selling, general and administrative expenses	2,074	1,931
Gain on divestiture	—	(4,861)
Amortization expense	23	23
<b>Operating income</b>	<b>5,724</b>	<b>10,569</b>
Interest and debt expense	597	626
Interest income	(6)	(8)
Interest income on notes due from related party	(10)	—
Other expense, net	19	260
<b>Income before income taxes</b>	<b>5,124</b>	<b>9,691</b>
Provision for (benefit from) income taxes	(1,897)	3,618
<b>Net income</b>	<b>\$ 7,021</b>	<b>\$ 6,073</b>

<sup>(1)</sup> Excludes excise taxes of \$4,135 million and \$4,343 million for the years ended December 31, 2017 and 2016, respectively.

*See Notes to Consolidated Financial Statements*

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

	<b>For the Years Ended December 31,</b>	
	<b>2017</b>	<b>2016</b>
Net income	\$ 7,021	\$ 6,073
Other comprehensive income (loss), net of tax expense (benefit):		
Retirement benefits, net of tax (2017 — \$47; 2016 — \$(6))	143	(11)
Long-term investments, net of tax (2016 — \$10)	—	14
Hedging instruments, net of tax (2016 — \$6)	—	11
Cumulative translation adjustment and other, net of tax (2017 — \$8; 2016 — \$6)	27	10
<b>Comprehensive income</b>	<b>\$ 7,191</b>	<b>\$ 6,097</b>

*See Notes to Consolidated Financial Statements*

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

	<b>For the Years Ended December 31,</b>	
	<u>2017</u>	<u>2016</u>
<b>Cash flows from (used in) operating activities:</b>		
Net income	\$ 7,021	\$ 6,073
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	129	123
Deferred income tax expense (benefit)	(3,058)	387
Other changes that provided (used) cash:		
Accounts and other receivables	7	24
Inventories	117	89
Related party, net	88	(5)
Accounts payable	(86)	42
Accrued liabilities, including other working capital	(87)	(167)
Income taxes	(383)	7
Tobacco settlement accruals	(1,750)	(314)
Pension and postretirement	(249)	(415)
Other, net	150	58
Net cash flows from operating activities	<u>1,899</u>	<u>1,280</u>
<b>Cash flows from (used in) investing activities:</b>		
Capital expenditures	(200)	(206)
Issuance of note receivable due from related party	(307)	—
Note receivable due from related party – zero balance account credit agreement	(17)	—
Proceeds from settlement of investments	—	266
Proceeds from divestiture	—	5,015
Other, net	1	3
Net cash flows from (used in) investing activities	<u>(523)</u>	<u>5,078</u>
<b>Cash flows from (used in) financing activities:</b>		
Dividends paid on common stock	(2,834)	(2,369)
Repurchase of common stock	(146)	(226)
Capital contributions from parent	49	—
Repayments of long-term debt	(500)	(500)
Early extinguishment of debt	—	(3,650)
Premiums paid for early extinguishment of debt	—	(207)
Proceeds from termination of interest rate swaps	—	66
Debt issuance costs and financing fees	—	(8)
Borrowings under revolving credit facility	500	—
Repayments of borrowings under revolving credit facility	(500)	—
Excess tax benefit on stock-based compensation plans	—	28
Net cash flows used in financing activities	<u>(3,431)</u>	<u>(6,866)</u>
<b>Effect of exchange rate changes on cash and cash equivalents</b>	<u>24</u>	<u>(8)</u>
Net change in cash and cash equivalents	(2,031)	(516)
Cash and cash equivalents at beginning of year	2,051	2,567
Cash and cash equivalents at end of year	<u>\$ 20</u>	<u>\$ 2,051</u>
Income taxes paid, net of refunds	\$ 1,470	\$ 3,179
Interest paid	\$ 650	\$ 712

*See Notes to Consolidated Financial Statements*

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

	December 31,	
	2017	2016
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 20	\$ 2,051
Accounts receivable	57	66
Accounts receivable, related party	—	113
Other receivables	12	10
Inventories	1,527	1,645
Note and interest receivable due from related party	343	—
Other current assets	710	353
Total current assets	2,669	4,238
Property, plant and equipment, at cost:		
Land and land improvements	86	95
Buildings and leasehold improvements	692	757
Machinery and equipment	2,066	2,064
Construction-in-process	147	94
Total property, plant and equipment	2,991	3,010
Accumulated depreciation	(1,572)	(1,662)
Property, plant and equipment, net	1,419	1,348
Trademarks and other intangible assets, net of accumulated amortization	29,421	29,444
Goodwill	15,993	15,992
Other assets and deferred charges	47	73
	\$ 49,549	\$ 51,095
<b>Liabilities and shareholders' equity</b>		
Current liabilities:		
Accounts payable	\$ 135	\$ 221
Tobacco settlement accruals	746	2,498
Due to related party	4	7
Deferred revenue, related party	83	66
Current maturities of long-term debt	1,249	501
Dividends payable on common stock	—	656
Other current liabilities	941	1,036
Total current liabilities	3,158	4,985
Long-term debt (less current maturities)	11,361	12,664
Long-term deferred income taxes, net	6,610	9,607
Long-term retirement benefits (less current portion)	1,430	1,869
Long-term deferred revenue, related party	—	39
Other noncurrent liabilities	257	220
Commitments and contingencies:		
Shareholders' equity:		
Common stock (shares issued: 2017 — 1,426,125,631; 2016 — 1,425,824,955)	—	—
Paid-in capital	18,298	18,285
Retained earnings	8,579	3,740
Accumulated other comprehensive loss	(144)	(314)
Total shareholders' equity	26,733	21,711
	\$ 49,549	\$ 51,095

*See Notes to Consolidated Financial Statements*

**REYNOLDS AMERICAN INC.**

**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY**  
(Dollars in Millions, Except Per Share Amounts)

	<u>Common Stock</u>	<u>Paid-In Capital</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Loss</u>	<u>Total Shareholders' Equity</u>
<b>Balance at December 31, 2015</b>	\$ —	\$ 18,402	\$ 188	\$ (338)	\$ 18,252
Net income	—	—	6,073	—	6,073
Retirement benefits, net of \$6 tax benefit	—	—	—	(11)	(11)
Long-term investments, net of \$10 tax expense	—	—	—	14	14
Hedging instruments, net of \$6 tax expense	—	—	—	11	11
Cumulative translation adjustment and other, net of \$6 tax expense	—	—	—	10	10
Dividends — \$1.76 per share	—	—	(2,521)	—	(2,521)
Common stock repurchased	—	(226)	—	—	(226)
Equity incentive award plan and stock-based compensation	—	81	—	—	81
Excess tax benefit on stock-based compensation plans	—	28	—	—	28
<b>Balance at December 31, 2016</b>	<u>—</u>	<u>18,285</u>	<u>3,740</u>	<u>(314)</u>	<u>21,711</u>
Net income	—	—	7,021	—	7,021
Retirement benefits, net of \$47 tax expense	—	—	—	143	143
Cumulative translation adjustment and other, net of \$8 tax expense	—	—	—	27	27
Dividends — \$1.53 per share	—	—	(2,182)	—	(2,182)
Capital contributions from parent	—	49	—	—	49
Common stock repurchased	—	(146)	—	—	(146)
Equity incentive award plan and stock-based compensation	—	110	—	—	110
<b>Balance at December 31, 2017</b>	<u>\$ —</u>	<u>\$ 18,298</u>	<u>\$ 8,579</u>	<u>\$ (144)</u>	<u>\$ 26,733</u>

*See Notes to Consolidated Financial Statements*



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### Note 1 — Business and Summary of Significant Accounting Policies

#### *Overview*

The consolidated financial statements include the accounts of Reynolds American Inc., referred to as RAI, and its wholly owned subsidiaries. RAI's wholly owned 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 in note 3, 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.

RAI elected not to apply pushdown accounting in its separate consolidated financial statements upon completion of the BAT Merger. See note 2 for further discussion regarding the BAT Merger.

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. Additionally on June 12, 2015, shortly after the completion of the Lorillard Merger, Lorillard Tobacco Company, LLC, a wholly owned subsidiary of Lorillard, referred to as Lorillard Tobacco, merged with and into RJR Tobacco, with RJR Tobacco continuing as the surviving entity, referred to as the Lorillard Tobacco Merger.

#### *Operating segments*

RAI's 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. and Niconovum AB. The segments were identified based on how RAI's chief operating decision maker allocates resources and assesses performance. Certain of RAI's operating subsidiaries have entered into intercompany agreements for products or services with other subsidiaries. As a result, certain activities of an operating subsidiary may be included in a different segment of RAI.

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

#### *Basis of Presentation*

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, referred to as GAAP, requires estimates and assumptions to be made that affect the reported amounts in the consolidated financial statements and accompanying notes. Volatile credit and equity markets, changes to regulatory and legal environments, and consumer spending may affect the uncertainty inherent in such estimates and assumptions. Actual results could materially differ from those estimates. All material intercompany balances have been eliminated.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

Certain reclassifications were made to conform prior years' financial statements to the current presentation. Certain amounts presented in note 11 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 11 and as otherwise noted.

### *Cash and Cash Equivalents*

Cash balances are recorded net of book overdrafts when a bank right-of-offset exists. All other book overdrafts are recorded in accounts payable. Cash equivalents may include money market funds, commercial paper and time deposits in major institutions to minimize investment risk. As short-term, highly liquid investments readily convertible to known amounts of cash, with remaining maturities of three months or less at the time of purchase, cash equivalents have carrying values that approximate fair values.

### *Fair Value Measurement*

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.

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

The levels of the fair value hierarchy are:

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

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

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

RAI sponsors a number of non-contributory defined benefit pension plans covering certain employees of RAI and its subsidiaries, and holds investments in plan assets to support these obligations. For additional information regarding the fair value of these plan assets, see note 14.

### *Inventories*

Inventories, other than those accounted for under the last-in, first-out, or LIFO, method are stated at the lower of cost or net realizable value. Inventories accounted for under the LIFO method are stated at the lower of cost or market. The cost of RJR Tobacco's leaf tobacco inventories is determined principally under LIFO and is calculated at the end of each year. The cost of work in process and finished goods includes materials, direct labor, variable costs and overhead and full absorption of fixed manufacturing overhead. Stocks of tobacco, which have an operating cycle that exceeds 12 months due to aging requirements, are classified as current assets, consistent with recognized industry practice. The remaining inventories not valued under LIFO are valued under the first-in, first-out method.

### *Long-lived Assets*

Long-lived assets, such as property, plant and equipment, trademarks and other intangible assets with finite lives, are reviewed for impairment whenever events or changes in circumstances indicate that the book value of the asset may not be recoverable. Impairment of the carrying value of long-lived assets would be indicated if the best estimate of future undiscounted cash flows expected to be generated by the asset grouping is less than its carrying value. If an impairment is indicated, any loss is measured as the difference between estimated fair value and carrying value and is recognized in operating income.

### *Property, Plant and Equipment*

Property, plant and equipment are recorded at cost and depreciated using the straight-line method over the estimated useful lives of the assets. Useful lives range from 20 to 50 years for buildings and improvements, and from 3 to 30 years for machinery and

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

equipment. The cost and related accumulated depreciation of assets sold or retired are removed from the accounts and the gain or loss on disposition is recognized in operating income. Depreciation expense was \$106 million and \$100 million for the years ended December 31, 2017 and 2016, respectively.

### *Software Costs*

Computer software and software development costs incurred in connection with developing or obtaining computer software for internal use that has an extended useful life are capitalized. These costs are amortized over their estimated useful life, which is typically five years or less. The following is a summary of balances and expenses for software costs as of and for the years ended December 31:

#### Balances:

	<u>2017</u>	<u>2016</u>
Unamortized software costs balance	\$ 54	\$ 49
Software costs — capitalized or included in construction-in-process	18	27

#### Expenses:

	<u>2017</u>	<u>2016</u>
Software amortization expense	\$ 14	\$ 14

### *Intangible Assets*

Intangible assets include goodwill, trademarks and other intangible assets and are capitalized when acquired. The determination of fair value involves considerable estimates and judgment. In particular, the fair value of a reporting unit involves, among other things, developing forecasts of future cash flows, determining an appropriate discount rate, and when goodwill impairment is implied, determining the fair value of individual assets and liabilities, including unrecorded intangibles. Although RAI believes it has based its impairment testing of its intangible assets on reasonable estimates and assumptions, the use of different estimates and assumptions could result in materially different results. If the current legal and regulatory environment, business or competitive climate worsens, or RAI's operating companies' strategic initiatives adversely affect their financial performance, the fair value of goodwill, trademarks and other intangible assets could be impaired in future periods. Goodwill, trademarks and other intangible assets with indefinite lives are not amortized, but are tested for impairment annually, in the fourth quarter, and more frequently if events and circumstances indicate that the asset might be impaired.

Finite lived trademarks and acquired customer lists are amortized using the straight-line method over their remaining useful lives, of 1 to 18 years, consistent with the pattern of economic benefits estimated to be received.

### *Revenue Recognition*

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

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

### *Cost of Products Sold*

RJR Tobacco (itself, and as successor by merger to Lorillard Tobacco) and SFNTC are participants in the Master Settlement Agreement, referred to as the MSA, and RJR Tobacco (itself, and as successor by merger to Lorillard Tobacco) is a participant in the other state 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. RJR Tobacco's and SFNTC's 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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

subsidiaries, their relative market share, their operating profit and inflation. Since relative market share is based on cigarette shipments, the best estimate of the allocation of charges to RJR Tobacco and SFNTC under these agreements is recorded in cost of products sold as the products are shipped. Included in these adjustments is the MSA non-participating manufacturer adjustment, referred to as the NPM Adjustment, that potentially reduces the annual payment obligation of RJR Tobacco, SFNTC and other participating manufacturers, referred to as the PMs. Adjustments to these estimates are recorded in the period that the change becomes probable and the amount can be reasonably estimated. American Snuff Co. is not a participant in the State Settlement Agreements.

Cost of products sold includes, among other expenses, the expenses for 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 years ended December 31:

	<u>2017</u>	<u>2016</u>
State Settlement Agreements	\$ 2,856	\$ 2,727
FDA user fees	188	194

In 2012, RJR Tobacco, 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 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 2017 and, as a result, expenses for the MSA were reduced by \$17 million for the year ended December 31, 2017. The parties to the Term Sheet represent an allocable share of 51.73%.

During 2017, the NPM Adjustment Settlement Agreement, a formal agreement incorporating the terms and provisions of the Term Sheet, was executed by the PMs and the states that previously joined the Term Sheet. With execution of the agreement, the PMs and the states settled the 2015 volume year.

As a result of meeting the performance requirements associated with the Term Sheet, RJR Tobacco and SFNTC, collectively, recognized additional credits of \$130 million and \$295 million for the years ended December 31, 2017 and 2016, respectively. Credits recognized in the years ended December 31, 2017 and 2016, include the benefit of the additional credits received as a result of the Lorillard Tobacco Merger. RJR Tobacco expects to recognize additional credits through 2020.

In October 2015, RJR Tobacco, SFNTC and certain other PMs entered into a settlement agreement, referred to as 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, 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 SFNTC, collectively, recognized credits of \$99 million and \$95 million as a reduction to cost of products sold for the years ended December 31, 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, see “— Litigation Affecting the Cigarette Industry — State Settlement Agreements — Enforcement and Validity; Adjustments” in note 11.

### *Advertising*

Advertising costs, which are expensed as incurred, were \$66 million and \$80 million for the years ended December 31, 2017 and 2016, respectively.

### *Research and Development*

Research and development costs, which are expensed as incurred, were \$69 million and \$101 million for the years ended December 31, 2017 and 2016, respectively.

### *Income Taxes*

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Interest and penalties related to uncertain tax positions are accounted for as tax expense. Federal income taxes for RAI and its subsidiaries are calculated on a consolidated basis. State income taxes for RAI and its subsidiaries are primarily calculated on a separate return basis.

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

### *Stock-Based Compensation*

Stock-based compensation expense is recognized for all forms of share-based payment awards, including shares issued to employees under restricted stock units.

### *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 these 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. For additional information related to litigation, see note 11.

### *Pension and Postretirement*

Pension and postretirement benefits require balance sheet recognition of the net asset or liability for the overfunded or underfunded status of defined benefit pension and 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.

### *Subsequent Events*

Subsequent events have been evaluated through February 21, 2018, the date the financial statements were issued.

### *Recently Adopted Accounting Pronouncements*

In January 2016, the FASB issued ASU 2016-01, *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 fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. As permitted, RAI adopted the amended guidance as of January 1, 2017, and it did not have a material impact on RAI's results of operations, cash flows and financial position.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

In March 2016, the FASB issued ASU 2016-09, *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 is 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, and it did not have a material impact to RAI's 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 for the year ended December 31, 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 Derivative 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 EITF Meeting*;
- ASU 2016-12, *Revenue Recognition 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 thirteen technical corrections and improvements affecting narrow aspects of the guidance issued in ASU 2014-09.

During 2016, RAI substantially completed its assessment of ASC 606 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. RAI adopted the new standard retrospectively with a cumulative effect of approximately \$80.1 million, on a pre-tax basis, that was recognized as an increase in current liabilities and a reduction in retained earnings in the opening balance sheet as of January 1, 2018 (modified retrospective method). The primary change as a result of the adoption of ASC 606 is the acceleration of recognition of certain discounting expenses. The Company believes the changes made to the amount and timing of revenue recognition will not be material to its results of operations in 2018.

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 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 December 31, 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 2018.

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326)*, 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. The amended guidance will not have a material impact on RAI's results of operations, cash flows and financial position.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

In August 2016, the FASB issued ASU 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments*, 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 will not 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*, 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 will not have a material impact on RAI's statements of cash flows.

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 will 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 adopted this amended guidance effective January 1, 2018, and the amended guidance will not have a material effect 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 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. RAI has adopted this amended guidance effective January 1, 2018. As of the date of adoption, the amended guidance will not have a material impact on RAI's results of operations, cash flows and financial position.

In August 2017, the FASB issued ASU No. 2017-12 *Derivatives and Hedging (Topic 815)—Targeted Improvements to Accounting for Hedging Activities*. This guidance eliminates the requirement to separately measure and report hedge ineffectiveness and generally requires, for qualifying hedges, the entire change in the fair value of a hedging instrument to be presented in the same income statement line as the hedged item. The guidance also modifies the accounting for components excluded from the assessment of hedge effectiveness, eases documentation and assessment requirements and modifies certain disclosure requirements. The new standard will be effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted in any interim period or fiscal year before the effective date for all entities. If the guidance is early adopted in an interim period, any adjustments would be reflected as of the beginning of the fiscal year that includes that interim period. RAI is evaluating the timing of when this amended guidance will be adopted and the effect this guidance will have on its results of operations, cash flows and financial position.

### Note 2 — BAT Merger

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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

into the right to receive 0.5260 of an American Depositary Share, referred to as ADS, of BAT and \$29.44 in cash, without interest, collectively referred to as the Merger Consideration.

BAT is subject to the applicable U.S. Securities and Exchange Commission, referred to as the 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 Amended and Restated 2009 Omnibus Incentive Compensation Plan, referred to as the Omnibus Plan, were met, which resulted in the immediate pro-rata vesting of certain equity awards and the full vesting of certain other equity awards. With respect to the equity awards that vested 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 to vest were assumed and replaced with equity awards issued by BAT. For further discussion on equity awards, see note 13.

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. For further discussion on equity awards, see note 13.

Also, after completion of the BAT Merger:

- The Share Repurchase Program, approved by the Board of Directors on July 25, 2016, terminated.
- RAI terminated the credit agreement entered into in December 2014, referred to as the 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.
- RAI guaranteed all debt securities outstanding, or which may be issued in the future, under BAT's £25 billion Euro Medium Term Note program, referred to as EMTN.
- RAI guaranteed outstanding debt securities previously issued by a BAT subsidiary in transactions exempt from registration under the U.S. securities laws pursuant to Rule 144A and Regulation S under the U.S. Securities Act of 1933, as amended, in the aggregate principal amount of \$5.4 billion.
- RAI guaranteed \$17.25 billion in aggregate principal amount of debt securities newly issued by a BAT subsidiary in an exempt transaction pursuant to Rule 144A and Regulation S to partially refinance borrowings under the acquisition facility used to fund the cash portion of the Merger Consideration, to pay merger-related fees and expenses and for general corporate purposes.

RAI's guarantees of the EMTN and Rule 144A/Regulation S securities are unsecured.

*EMTN Guarantee.* At December 31, 2017, there were multiple series of EMTN securities denominated in Euros, British pounds, Swiss francs and United States dollars, with maturities ranging from 2018 to 2052. EMTN securities may be issued by several subsidiaries of BAT, and are guaranteed by BAT and certain BAT subsidiaries. RAI's guarantee of the EMTN securities is unconditional and irrevocable, joint and several with the other guarantors and is triggered when the issuer of the EMTN securities defaults in payment. If RAI is required by law to withhold any U.S. taxes (or taxes of any of its political subdivisions) from payments it makes under its guarantee, RAI is required to pay additional amounts so that security holders receive the same payment they would receive absent such withholding, subject to exceptions.

RAI will be automatically and unconditionally released from its EMTN guarantee if at any time the aggregate amount of indebtedness for borrowed money for which RAI is an obligor does not exceed 10% of the outstanding long-term debt of BAT. For these purposes, the amount of RAI's indebtedness for borrowed money does not include (1) RAI's guarantee of the EMTN securities; (2) any other debt guaranteed by RAI, the terms of which permit the termination of such guarantee under similar circumstances, as long as RAI's obligations in respect of such other debt are terminated at substantially the same time as its guarantee of the EMTN securities; (3) any debt issued or guaranteed by RAI that is being refinanced at substantially the same time as the release of the guarantee, provided



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

that any obligations of RAI in respect of debt that is incurred in any such refinancing shall be included in the calculation of RAI's indebtedness for borrowed money; and (4) intercompany debt.

*Rule 144A/Regulation S Guarantee.* At December 31, 2017, RAI guaranteed \$22.65 billion in aggregate principal amount of debt securities in multiple series issued by a BAT subsidiary pursuant to Rule 144A and Regulation S, with maturities ranging from 2018 to 2025. The Rule 144A/Regulation S securities are guaranteed by BAT and certain BAT subsidiaries. RAI's guarantee of the Rule 144A/Regulation S securities is full and unconditional, joint and several with the other guarantors and is triggered when the issuer of the Rule 144A/Regulation S securities defaults in payment. The guarantee is an unsubordinated obligation of RAI, and ranks pari passu in right of payment with all other direct, unsecured and unsubordinated obligations of RAI (except those obligations preferred by law). RAI's obligations under the guarantee are limited to the maximum amount resulting in its obligations not constituting a fraudulent conveyance or fraudulent transfer under any applicable law. If RAI is required by law to withhold any U.S. taxes (or taxes of any of its political subdivisions) from payments it makes under its guarantee, RAI is required to pay additional amounts so that security holders receive the same payment they would receive absent such withholding, subject to exceptions.

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 has deregistered its common stock with the SEC under Section 12(g) of the Exchange Act and suspended the reporting obligations it and its subsidiaries had under Sections 13(a) and 15(d) of the Exchange Act by filing a Form 15 with the SEC.

### Note 3 — 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, in an all-cash transaction of approximately \$5 billion and recognized a pre-tax gain of approximately \$4.9 billion.

The purchase agreement, dated as of September 28, 2015, between the Sellers and JTI Holding, referred to as the 2015 Purchase Agreement, contains customary representations, warranties and covenants made by the Sellers and JTI Holding, and, for certain provisions, RAI and Japan Tobacco Inc., referred to as JTI, and contains indemnification provisions, subject to customary limitations, with respect to these and other matters, including potential litigation relating to specified claims. The 2015 Purchase Agreement also contains a guarantee of Sellers' obligations by RAI, and a guarantee of JTI Holding's obligations by JTI. Further, in the 2015 Purchase Agreement, RAI has agreed not to, and agreed to cause its controlled affiliates not to, engage in the business of producing, selling, distributing and developing natural, organic and additive-free combustible tobacco cigarettes and roll-your-own or make-your-own tobacco products outside of the United States, and JTI has agreed not to, and agreed to cause its controlled affiliates not to, engage in the conduct of such business in the United States, in each case, for five years following the closing of the transaction.

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 have been 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.

The components of the pre-tax gain, which was recorded during the year ended December 31, 2016, were as follows:

Purchase price	\$	5,015
Net assets and liabilities divested		(154)
Gain on divestiture	\$	<u>4,861</u>

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued**

**Note 4 — Fair Value Measurement**

*Fair Value of Financial Assets*

Financial assets carried at fair value as of December 31, 2016 were comprised solely of cash equivalents and were classified as Level 1. The fair value of these cash equivalents were \$2,006 million at December 31, 2016. At December 31, 2017, there were no cash equivalents on hand. There were no transfers between the levels during the years ended December 31, 2017 and 2016.

**Note 5 — 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>
<b>Balance as of December 31, 2015</b>	\$ 13,306	\$ 197	\$ 2,473	\$ 17	\$ 15,993
<b>2016 Activity</b>					
Foreign currency translation	—	—	—	(1)	(1)
<b>Balance as of December 31, 2016</b>					
Goodwill	17,069	197	2,501	16	19,783
Less: accumulated impairment charges	<u>(3,763)</u>	<u>—</u>	<u>(28)</u>	<u>—</u>	<u>(3,791)</u>
<b>Net goodwill balance as of December 31, 2016</b>	13,306	197	2,473	16	15,992
<b>2017 Activity</b>					
Foreign currency translation	—	—	—	1	1
<b>Balance as of December 31, 2017</b>					
Goodwill	17,069	197	2,501	17	19,784
Less: accumulated impairment charges	<u>(3,763)</u>	<u>—</u>	<u>(28)</u>	<u>—</u>	<u>(3,791)</u>
<b>Net goodwill balance as of December 31, 2017</b>	<u>\$ 13,306</u>	<u>\$ 197</u>	<u>\$ 2,473</u>	<u>\$ 17</u>	<u>\$ 15,993</u>

There were no changes in the carrying amounts of indefinite-lived intangible assets not subject to amortization. The carry amounts by segment were as follows:

	<u>RJR Tobacco</u>	<u>Santa Fe</u>	<u>American Snuff</u>	<u>Consolidated</u>
	<u>Trademarks</u>	<u>Other</u>	<u>Trademarks</u>	<u>Trademarks</u>
<b>Balance as of December 31, 2017 and 2016</b>	<u>\$ 27,826</u>	<u>\$ 87</u>	<u>\$ 136</u>	<u>\$ 1,136</u>
				<u>\$ 29,098</u>
				<u>\$ 87</u>

The changes in the carrying amounts of finite-lived intangible assets by segment subject to amortization were as follows:

	<u>RJR Tobacco</u>	<u>American Snuff</u>	<u>All Other</u>	<u>Consolidated</u>
	<u>Trademarks</u>	<u>Other</u>	<u>Trademarks</u>	<u>Trademarks</u>
<b>Balance as of December 31, 2015</b>	\$ 17	\$ 259	\$ 6	\$ 23
Intercompany transfer	—	(13)	—	—
Amortization	<u>(5)</u>	<u>(17)</u>	<u>(1)</u>	<u>(6)</u>
<b>Balance as of December 31, 2016</b>	12	229	5	17
Amortization	<u>(5)</u>	<u>(16)</u>	<u>(1)</u>	<u>(6)</u>
<b>Balance as of December 31, 2017</b>	<u>\$ 7</u>	<u>\$ 213</u>	<u>\$ 4</u>	<u>\$ 11</u>
				<u>\$ 225</u>

Details of finite-lived intangible assets were as follows:

	<u>December 31, 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	\$ (31)	\$ 209	\$ 240	\$ (19)	\$ 221
Contract manufacturing agreement	151	(147)	4	151	(143)	8
Trademarks	124	(113)	11	124	(107)	17
Other intangibles	15	(3)	12	15	(2)	13
	<u>\$ 530</u>	<u>\$ (294)</u>	<u>\$ 236</u>	<u>\$ 530</u>	<u>\$ (271)</u>	<u>\$ 259</u>

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued**

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

<u>Year</u>	<u>Amount</u>
2018	\$ 22
2019	16
2020	15
2021	14
2022	14
Thereafter	155
	<u>\$ 236</u>

The impairment testing of trademarks in the fourth quarters of 2017 and 2016 assumed a rate of decline in projected net sales of certain brands, comparable with that assumed in RAI’s strategic plan. The fair value of trademarks used in impairment testing was determined by an income approach using a discounted cash flow valuation model under a relief-from-royalty methodology. The relief-from-royalty model includes the estimates of the royalty rate that a market participant might assume, projected revenues and judgment regarding the discount rate applied to those estimated cash flows, with that discount rate being 10.0% during 2017 and 2016. The determination of the discount rate was based on a cost of equity model, using a risk-free rate, adjusted by a stock beta-adjusted risk premium and a size premium. As a result of these analyses, an impairment charge is recognized if the carrying value of a trademark exceeds its estimated fair value. No impairment charges were recognized in 2017 or 2016.

For the annual impairment testing of the goodwill of RAI’s reporting units, each reporting unit’s estimated fair value was compared with its carrying value. A reporting unit is an operating segment or one level below an operating segment. The determination of estimated fair value of each reporting unit was calculated primarily utilizing an income approach model, based on the present value of the estimated future cash flows of the reporting unit assuming a discount rate during each of 2017 and 2016 of 9.75% for each of RJR Tobacco and American Snuff and 10.25% for Santa Fe. The determination of the discount rate was based on a weighted average cost of capital. Additionally, the aggregate estimated fair value of the reporting units, determined with the use of the income approach model, was compared with RAI’s market capitalization. No impairment charges were recognized in 2017 or 2016.

Effective January 1, 2018, RAI reclassified certain trademarks previously accounted for as indefinite-lived intangibles as finite-lived intangibles and began amortizing these intangibles over periods ranging from 5 years to 20 years. The intangibles now treated as finite-lived were primarily in the RJR Tobacco and American Snuff segments.

**Note 6 — Inventories**

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

	<u>2017</u>	<u>2016</u>
Leaf tobacco	\$ 1,323	\$ 1,436
Other raw materials	100	77
Work in process	71	81
Finished products	140	165
Other	23	25
Total	<u>1,657</u>	<u>1,784</u>
LIFO allowance	<u>(130)</u>	<u>(139)</u>
	<u>\$ 1,527</u>	<u>\$ 1,645</u>

Inventories valued under the LIFO method were \$735 million and \$791 million at December 31, 2017 and 2016, respectively, net of the LIFO allowance. The LIFO allowance reflects the excess of the current cost of LIFO inventories at December 31, 2017 and 2016, over the amount at which these inventories were carried on the consolidated balance sheets. RAI recognized income of \$9 million and \$15 million from LIFO inventory changes during 2017 and 2016, respectively.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued**

**Note 7 — Other Current Liabilities**

Other current liabilities at December 31 included the following:

	<u>2017</u>	<u>2016</u>
Payroll and employee benefits	\$ 172	\$ 268
Pension and postretirement benefits	89	89
Marketing and advertising	108	155
Excise, franchise and property tax	136	172
Litigation	137	44
Interest payable	117	121
Other	182	187
	<u>\$ 941</u>	<u>\$ 1,036</u>

**Note 8 — Income Taxes**

The components of the provision for (benefit from) income taxes for the years ended December 31 were as follows:

	<u>2017</u>	<u>2016</u>
Current:		
Federal	\$ 974	\$ 2,794
State and other	187	437
	<u>1,161</u>	<u>3,231</u>
Deferred:		
Federal	(3,173)	350
State and other	115	37
	<u>(3,058)</u>	<u>387</u>
Provision for (benefit from) income taxes	<u>\$ (1,897)</u>	<u>\$ 3,618</u>

Significant components of deferred tax assets and liabilities for the years ended December 31 included the following:

	<u>2017</u>	<u>2016</u>
Deferred tax assets:		
Pension and postretirement liabilities	\$ 388	\$ 759
Tobacco settlement accruals	181	955
Other accrued liabilities	88	169
Other noncurrent liabilities	138	210
Subtotal	795	2,093
Less: valuation allowance	(3)	—
	<u>792</u>	<u>2,093</u>
Deferred tax liabilities:		
LIFO inventories	(160)	(257)
Property and equipment	(182)	(290)
Trademarks and other intangibles	(7,035)	(10,972)
Other	(25)	(181)
	<u>(7,402)</u>	<u>(11,700)</u>
Net deferred tax liability	<u>\$ (6,610)</u>	<u>\$ (9,607)</u>

RAI had no federal capital loss carryforwards at December 31, 2017 and 2016, respectively.

As of December 31, 2017, a valuation allowance of \$3 million was recorded on deferred tax assets attributable to the state net operating losses of one of RAI's subsidiaries. RAI believes it is more likely than not that these deferred tax assets will not be realized through the generation of future state taxable income. RAI believes that it is more likely than not that the results of future operations will generate sufficient taxable income to realize the remaining deferred tax assets. As of December 31, 2016, no valuation allowance was recorded.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued**

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

	<u>2017</u>	<u>2016</u>
Domestic (includes U.S. exports)	\$ 5,139	\$ 9,610
Foreign	(15)	81
	<u>\$ 5,124</u>	<u>\$ 9,691</u>

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

	<u>2017</u>	<u>2016</u>
Income taxes computed at the statutory U.S. federal income tax rate	\$ 1,793	\$ 3,392
State and local income taxes, net of federal tax benefits	174	306
Domestic manufacturing deduction	(82)	(114)
Nondeductible goodwill	—	9
Tax impact of U.S. federal tax reform	(3,793)	—
Other items, net	11	25
Provision for (benefit from) income taxes	<u>\$ (1,897)</u>	<u>\$ 3,618</u>
Effective tax rate	<u>(37.0%)</u>	<u>37.3%</u>

The effective tax rate for 2017 was impacted by the enactment of the Tax Cuts and Jobs Act, referred to as the Tax Reform Act, on December 22, 2017 which, among other things, reduced the U.S. federal statutory corporate income tax rate to 21 percent, effective January 1, 2018. The Tax Reform Act resulted in net tax benefits attributable to the remeasurement of RAI's deferred tax liabilities and the reduced federal tax rate on the mandatory deemed repatriation of RAI's accumulated and undistributed foreign earnings. Excluding the impact of the Tax Reform Act, the 2017 effective tax rate was approximately 37.0 percent. The effective tax rate for 2016 was 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. The effective tax rate for each period differed from the federal statutory rate due to the domestic manufacturing deduction, state income taxes and certain nondeductible items.

Staff Accounting Bulletin 118, referred to as SAB 118, provides guidance on accounting for enactment effects of the Tax Reform Act. SAB 118 provides a measurement period of up to one year from the Tax Reform Act's enactment date for companies to complete their accounting under ASC 740. In accordance with SAB 118, to the extent that a company's accounting for certain income tax effects of the Tax Reform Act is incomplete but it is able to determine a reasonable estimate, it must record a provisional estimate in its financial statements. The FASB staff has stated that it would not object to private companies and not-for-profit companies applying SAB 118.

The effects of the Tax Reform Act for the year ended December 31, 2017 include two major categories: (1) remeasurement of deferred tax assets/liabilities and (2) recognition of liabilities for taxes on mandatory deemed repatriation. As RAI does not have all the necessary information to analyze all income tax effects of the Tax Reform Act, RAI has recorded a provisional amount which it believes represents a reasonable estimate of the accounting implications of this tax reform. RAI will continue to evaluate the Tax Reform Act and adjust the provisional amounts as additional information is obtained. The ultimate impact of tax reform may differ from RAI's provisional amounts due to changes in its interpretations and assumptions, as well as additional regulatory guidance that may be issued.

At December 31, 2017, there were \$379 million of accumulated and undistributed foreign earnings. Of this amount, RAI has invested \$17 million overseas. RAI has recorded either current or deferred income taxes related to the \$362 million of accumulated foreign earnings in excess of its historical and planned overseas investments.

The components of deferred tax benefits included in accumulated other comprehensive loss for the years ended December 31 were as follows:

	<u>2017</u>	<u>2016</u>
Retirement benefits	\$ 168	\$ 215
Cumulative translation adjustment and other	17	25
	<u>\$ 185</u>	<u>\$ 240</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

The accruals for gross unrecognized income tax benefits, including interest and penalties, reflected in other noncurrent liabilities for the years ended December 31 were as follows:

	2017	2016
Unrecognized tax benefits	\$ 147	\$ 118
Accrued interest	17	13
Accrued penalties	6	7
	\$ 170	\$ 138

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

	2017	2016
Balance at beginning of year	\$ 118	\$ 97
Gross increases related to current period tax positions	32	30
Gross increases related to tax positions in prior periods	2	3
Gross decreases related to tax positions in prior periods	(2)	(3)
Gross decreases related to audit settlements	1	(2)
Gross decreases related to lapse of applicable statute of limitations	(4)	(7)
<b>Balance at end of year</b>	<b>\$ 147</b>	<b>\$ 118</b>

At December 31, 2017, \$112 million of unrecognized income tax benefits including interest and penalties, if recognized, would decrease RAI's effective tax rate.

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

RAI and its subsidiaries file income tax returns in the U.S. federal and various state and foreign jurisdictions. The U.S. federal statute of limitations remains open for the year 2014 and forward. State and foreign jurisdictions have statutes of limitations generally ranging from three to five years. Certain of RAI's state tax returns are currently under examination by various states as part of routine audits conducted in the ordinary course of business.

RAI and its subsidiaries are included in the consolidated U.S. federal income tax return of BATUS Holdings, Inc. for the tax period year beginning July 25, 2017 and ending December 31, 2017. RAI calculates the provision for income taxes by using a "separate return" method. Under this method, RAI is assumed to file a separate return, thereby reporting its taxable income or loss and paying the applicable tax to or receiving the appropriate refund from the tax authority. RAI's current provision is the amount of tax payable or refundable on the basis of a current-year separate return. RAI provides deferred taxes on temporary differences and on any carryforwards that it could claim on its separate return and assesses the need for a valuation allowance on the basis of RAI's separate return results.

### Note 9 — Credit Agreement

#### *Credit Agreement*

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. 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 2. 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.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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 10.

Prior to the Credit Agreement termination, RAI borrowed and repaid \$500 million in 2017 under the Credit Agreement at an interest rate of 2.15%.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued**

**Note 10 — Long-Term Debt**

Information, including a schedule of maturities, regarding RAI's and RJR Tobacco's long-term debt is provided below:

*RAI and RJR Tobacco Long-Term Debt*

	<b>For the years ended December 31,</b>	
	<b>2017</b>	<b>2016</b>
<b>RAI</b>		
2.300% notes due 08/21/2017	\$ —	\$ 447
2.300% notes due 06/12/2018	1,250	1,250
8.125% notes due 06/23/2019*	669	669
6.875% notes due 05/01/2020	641	641
3.250% notes due 06/12/2020	771	771
4.000% notes due 06/12/2022	1,000	1,000
3.250% notes due 11/01/2022	158	158
3.750% notes due 05/20/2023	30	30
4.850% notes due 09/15/2023	550	550
4.450% notes due 06/12/2025	2,500	2,500
5.700% notes due 08/15/2035	750	750
7.250% notes due 06/15/2037	450	450
8.125% notes due 05/01/2040	237	237
7.000% notes due 08/04/2041	240	240
4.750% notes due 11/01/2042	173	173
6.150% notes due 09/15/2043	550	550
5.850% notes due 08/15/2045	2,250	2,250
Total principal	<u>12,219</u>	<u>12,666</u>
Fair value adjustments	225	282
Unamortized discounts	(26)	(28)
Unamortized debt issuance costs	(60)	(68)
Total RAI long-term debt at carrying value	<u>\$ 12,358</u>	<u>\$ 12,852</u>
<b>RJR Tobacco</b>		
2.300% notes due 08/21/2017	\$ —	\$ 53
8.125% notes due 06/23/2019*	81	81
6.875% notes due 05/01/2020	109	109
3.750% notes due 05/20/2023	19	19
8.125% notes due 05/01/2040	13	13
7.000% notes due 08/04/2041	9	9
Total principal	<u>231</u>	<u>284</u>
Fair value adjustments	21	29
Total RJR Tobacco long-term debt at carrying value	<u>\$ 252</u>	<u>\$ 313</u>
Total long-term debt at carrying value	<u>\$ 12,610</u>	<u>\$ 13,165</u>
Less current maturities of long-term debt at carrying value	1,249	501
Total long-term debt (less current maturities) at carrying value	<u>\$ 11,361</u>	<u>\$ 12,664</u>

\* The interest rate payable on these notes generally is subject to adjustment from time to time (as detailed in the form of these notes) based upon the credit rating assigned to these notes, provided that in no event will (1) the interest rate for these notes be reduced below 8.125% or (2) the total increase in the interest rate on these notes exceed 2.0% above 8.125%.



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

During the year ended December 31, 2016, RJR Tobacco repurchased \$8 million of its outstanding notes. As of December 31, 2017, the maturities of RAI's and RJR Tobacco's notes, excluding fair value adjustments and unamortized discounts and debt issuance costs, were as follows:

Year	RAI	RJR Tobacco	Total
2018	\$ 1,250	\$ —	\$ 1,250
2019	669	81	750
2020	1,412	109	1,521
2022	1,158	—	1,158
2023 and thereafter	7,730	41	7,771
	<u>\$ 12,219</u>	<u>\$ 231</u>	<u>\$12,450</u>

### *Fair Value of Debt*

The estimated fair value of RAI's outstanding consolidated debt, in the aggregate, was \$14.1 billion and \$14.3 billion as of December 31, 2017 and 2016, respectively, with an effective annual interest rate of approximately 5.1% and 5.0% for the years ended December 31, 2017 and 2016, respectively. The fair value is derived from a third party pricing source and is classified in Level 2 of the fair value hierarchy.

### *Termination of Interest Rate Swap Agreements*

On June 12, 2015, as part of the Lorillard Tobacco Merger, RJR Tobacco assumed the interest rate swap agreements designated as fair value hedges of the 8.125% Lorillard Tobacco Notes due June 23, 2019. The interest rate swap agreements qualified for hedge accounting. Under the swap agreements, RJR Tobacco received interest based on a fixed rate of 8.125% and paid interest based on a floating one-month LIBOR rate plus a spread of 4.625%. The net settlement reduced interest expense by approximately \$3 million for the year ended December 31, 2016. During 2016, RJR Tobacco terminated these interest rate swap agreements and received \$66 million in cash. The remaining fair value adjustment of \$7 million for the 8.125% notes due June 23, 2019, is being amortized as a reduction of interest expense over the expected remaining life of the notes. As of December 31, 2017 and 2016, there were no outstanding interest rate swap agreements.

### *Tender Offer and Redemption*

RAI completed a cash tender offer for an aggregate purchase price of \$2.81 billion (excluding accrued and unpaid interest to, but not including, the settlement date of February 22, 2016, and excluding related fees and expenses), referred to as the Tender Cap, for certain of its outstanding notes listed in the table below, collectively referred to as the Tender Notes.

RAI accepted for purchase \$2.69 billion in aggregate principal amount of Tender Notes. On February 22, 2016, RAI paid, with cash on hand, aggregate consideration of \$2.81 billion (including a premium of approximately \$118 million, but excluding accrued and unpaid interest) for such Tender Notes accepted for purchase. In addition, RAI recognized \$22 million of unamortized discount and unamortized debt issuance costs related to the Tender Notes as a loss on early extinguishment of debt.

RAI accepted for purchase 100% of the Tender Notes for the series listed in the table below in acceptance priority levels 1 through 3. Due to oversubscription, RAI accepted for purchase Tender Notes for the series listed in the table below in acceptance priority level 4 on a pro rata basis in accordance with the proration procedures described in the tender offer documents. RAI did not accept for purchase any of the Tender Notes for the series listed in the table below in acceptance priority levels 5 through 7.

Title of Security	Acceptance Priority Level	Principal Amount Tendered at Expiration	Principal Amount of Tender Notes Accepted for Purchase	Percentage of Outstanding Tender Notes Purchased
4.750% Senior Notes due 2042	1	\$ 827	\$ 827	82.71%
3.250% Senior Notes due 2022	2	942	942	85.59%
3.750% Senior Notes due 2023	3	444	444	93.76%
3.250% Senior Notes due 2020 <sup>(1)</sup>	4	1,039	479	38.34%
4.000% Senior Notes due 2022	5	766	—	0.00%
4.450% Senior Notes due 2025	6	1,773	—	0.00%
4.850% Senior Notes due 2023	7	416	—	0.00%

<sup>(1)</sup> Series Prorated

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

In May 2012, RAI entered into forward starting interest rate contracts with an aggregate notional amount of \$1 billion. RAI designated those derivatives as cash flow hedges of a future debt issuance. In October 2012, RAI completed the sale of notes that had been forecasted, and the 3.250% Tender Notes due 2022 and the 4.750% Tender Notes due 2042 were designated as the hedged instruments under these derivative contracts. The forward starting interest rate contracts were immediately terminated, and the effective portion of the loss incurred was recorded in accumulated other comprehensive loss in the consolidated balance sheets and was amortized over the life of the related debt. The amount of 3.250% Tender Notes due 2022 and the 4.750% Tender Notes due 2042 repurchased in the tender offer exceeded the original notional amount of the forward starting interest rate contracts and, accordingly, the remaining unamortized loss related to the forward starting interest rate contracts of \$16 million was recognized as expense upon completion of the tender offer.

The 3.750% Tender Notes due 2023 have a carrying value that exceeds face value as these notes, which were assumed in the Lorillard Tobacco Merger, were recorded at fair value in purchase accounting. Approximately 94% of this fair value adjustment, or \$11 million, which represents the proportional amount of Tender Notes repurchased in this series, was recognized as part of the loss on early extinguishment of debt.

Pursuant to its previously announced redemption call, on March 5, 2016, 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 connection with the redemption, RAI recorded a loss on early extinguishment of debt of \$90 million, which consisted of \$88 million in make-whole premiums paid to noteholders as part of the redemption and \$2 million for unamortized discount and unamortized debt issuance costs related to the redeemed notes.

In 2009, RAI and RJR entered into offsetting floating to fixed interest rate swap agreements with the same financial institution that held certain fixed to floating interest rate swaps for the same notional amount. The swaps were designated as fair value hedges. In September 2011, the original and offsetting interest rate swap agreements were terminated with the carrying value of the hedged debt reflecting a fair value adjustment treated as a premium, at the date of termination. At that point, RAI began amortizing the fair value adjustment. The \$700 million of 6.750% notes due 2017 represented the remaining debt that had been hedged with these interest rate swap agreements. Upon the redemption of these notes, the remaining unamortized fair value adjustment for the terminated swaps of \$25 million was recognized and, accordingly, reduced the loss on early extinguishment of debt.

In the aggregate, expenses related to the cash tender offer and redemption of approximately \$239 million, which included legal and bank fees of approximately \$7 million, were recognized in other (income) expense, net in the consolidated statement of income for the year ended December 31, 2016.

### **Note 11 — 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 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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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.

### *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.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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 consolidated balance sheet as of December 31, 2017, contains accruals for approximately \$136.5 million for *Engle* Progeny cases as set forth below under “— Litigation Affecting the Cigarette Industry – *Engle* and *Engle* Progeny Cases.” In 2017, RJR Tobacco paid approximately \$47.6 million in satisfaction of judgments, including attorneys' fees and interest, in *Engle* Progeny Cases. 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.”

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.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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.

### *Litigation Affecting the Cigarette Industry*

#### *Overview*

*Introduction.* In connection with the B&W business combination, RJR Tobacco agreed to indemnify B&W and its affiliates against, among other things, certain litigation liabilities, costs and expenses incurred by B&W or its affiliates arising out of the U.S. cigarette and tobacco business of B&W. 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. 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 2017, 104 tobacco-related cases were served against Reynolds Defendants. On December 31, 2017, there were, subject to the exclusions described immediately below, 236 cases pending against Reynolds Defendants: 219 in the United States and 17 in Canada, as compared with 304 total cases on December 31, 2016. Of the U.S. cases pending on December 31, 2017, 35 are pending in federal court, 183 in state court and one in tribal court, primarily in the following states: Illinois (47 cases); Florida (40 cases); Massachusetts (38 cases); New York (17 cases); New Mexico (17 cases); and Louisiana (10 cases). The U.S. case number excludes the approximately

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued**

564 individual smoker cases pending in West Virginia state court as a consolidated action, 2,569 *Engle* Progeny cases, involving approximately 3,276 individual plaintiffs, and 2,321 *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 December 31, 2017, and the change in the number of cases pending against Reynolds Defendants since December 31, 2016, and a cross-reference to the discussion of each case type.

Case Type	U.S. Case Numbers as of December 31, 2017	Change in Number of Cases Since December 31, 2016 Increase/(Decrease)
Individual Smoking and Health Cases	99	(33)
<i>West Virginia IPIC</i> (Number of Plaintiffs)*	1 (approx. 564)	No change
<i>Engle</i> Progeny Cases (Number of Plaintiffs)**	2,569 (approx. 3,276)	(253) (369)
<i>Broin II</i> Cases	2,321	(85)
Class-Action Suits	27	2
Filter Cases	70	(8)
Health-Care Cost Recovery Cases	2	No change
State Settlement Agreements—Enforcement and Validity; Adjustments	2	(26)
Other Litigation and Developments	18	(3)

\* 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, 2,569 *Engle* Progeny cases were pending as of December 31, 2017, that included claims asserted on behalf of 3,276 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 250 *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*”

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

below for a detailed discussion of the State Settlement Agreements, including RAI’s operating subsidiaries’ monetary obligations under these agreements. RJR Tobacco records the allocation of settlement charges as products are shipped.

*Scheduled Trials.* Trial schedules are subject to change, and many cases are dismissed before trial. There are 41 cases, exclusive of *Engle* Progeny cases, scheduled for trial as of December 31, 2017 through December 31, 2018, for RJR Tobacco, B&W, Lorillard Tobacco or their affiliates and indemnitees: nine individual smoking and health cases, 29 Filter Cases, and three other non-smoking and health cases. There are also approximately 126 *Engle* Progeny cases against RJR Tobacco, B&W and/or Lorillard Tobacco set for trial through December 31, 2018. It is not known how many of these cases will actually be tried.

*Trial Results.* From January 1, 2015 through December 31, 2017, 111 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 seven 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 29 cases, tried in Florida (27), California (1) and New Jersey (1). There were also 22 mistrials in Florida. Verdicts in favor of the plaintiffs were returned in 51 cases tried in Florida. Six cases in Florida were dismissed during trial. Two cases were continued during trial. 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 2017, 30 *Engle* Progeny cases in which RJR Tobacco and/or Lorillard Tobacco was a defendant were tried:

Total number of trials	30
Number of trials resulting in plaintiffs' verdicts	11
Total damages awarded in final judgments against RJR Tobacco	\$46,121,000
Amount of overall damages comprising 'compensatory damages' (approximately)	\$20,831,000 (of overall \$46,121,000)
Amount of overall damages comprising 'punitive damages' (approximately)	\$25,290,000 (of overall \$46,121,000)
Number of adverse judgments appealed by RJR Tobacco	7
Number of adverse judgments (not yet appealed), in which RJR Tobacco still has time to file an appeal	3

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

- In *Kelsey v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of RJR Tobacco.
- In *Schlefstein v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of the plaintiff and awarded approximately \$14 million in compensatory damages and \$27.8 million in punitive damages.
- In *Gloger v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of the plaintiff, found the decedent 20% at fault, RJR Tobacco 50% at fault and the remaining defendant 30% at fault, and awarded \$7.5 million in compensatory damages and \$5 million in punitive damages against each defendant.
- In *Hardin v. R. J. Reynolds Tobacco Co.*, the court granted RJR Tobacco’s motion for a directed verdict after the jury indicated they were unable to reach a verdict.
- In *Graffeo v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of the plaintiff, found the decedent 30% at fault and RJR Tobacco 70% at fault, and awarded \$4.5 million in compensatory damages. The punitive damages phase is underway.

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

In 2017, one non-*Engle* Progeny individual smoking and health case, in which RJR Tobacco, B&W and/or Lorillard Tobacco was a defendant, was tried:

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued**

- In *Quackenbush v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of the plaintiff, found the decedent 80% at fault and RJR Tobacco 20% at fault, and awarded approximately \$358,000 in compensatory damages and \$930,000 in punitive damages.

In 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 December 31, 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, health-care cost recovery cases or Filter Cases that have been tried and remain pending as of December 31, 2017, in which verdicts have been returned against RJR Tobacco, B&W or Lorillard Tobacco, or all three.

<u>Date of Verdict</u>	<u>Case Name/Type</u>	<u>Jurisdiction</u>	<u>Verdict</u>	<u>Status</u>
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.	Corrective communications began running in November 2017.
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.	RJR Tobacco filed a petition for writ of certiorari with the U.S. Supreme Court on November 28, 2017; decision is pending.
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.	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 is scheduled for March 6, 2018.
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.	RJR Tobacco paid approximately \$7.1 million in satisfaction of the judgment on December 1, 2017.
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.	On January 23, 2018, the Florida Supreme Court declined to accept jurisdiction of the case.



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

November 17, 2017	<i>Quackenbush v. R. J. Reynolds Tobacco Co.</i> [Individual]	Circuit Court, Volusia County, (DeLand, FL)	\$358,000 in compensatory damages; 20% of fault assigned to RJR Tobacco; \$930,000 in punitive damages.	Final judgment has not been entered; post-trial motions are pending.
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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 December 31, 2017, 99 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.

### *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. In 2017, the 30 potential failure to instruct plaintiffs agreed to resolve their claims on favorable terms. The resolutions are pending court approval.

In addition to the foregoing claims, various plaintiffs in 1999 and 2000 asserted claims against retailers and distributors. Those claims were severed and had not been pursued in light of 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. On January 27, 2017, the trial court denied the defendants’ motion to dismiss those claims as abandoned. The plaintiffs subsequently agreed to dismiss their claims without prejudice. The court declined to permit such dismissals and has ordered all 41 smokeless plaintiffs to appear in court in person on March 23, 2018, to either announce that they seek to proceed with their claims with new counsel or otherwise have their claims dismissed with prejudice.

### *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.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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 December 31, 2017, 2,558 *Engle* Progeny cases were pending in state courts, and 11 *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 3,276 plaintiffs. As of December 31, 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. 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 8, 2018, the U.S. Supreme Court denied RJR Tobacco's petition for writ of certiorari. 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 plaintiffs' claims and remanded for further proceedings on punitive damages. On May 2, 2017, the Fourth DCA remanded *Marotta* to the trial court for a trial on punitive damages. The trial has been scheduled for July 16, 2018.

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 then 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.

One hundred and seven *Engle* Progeny cases have been tried in Florida state and federal courts since the beginning of 2015 through December 31, 2017, and additional state court trials are scheduled for 2018. Since the beginning of 2015 through December 31, 2017, RJR Tobacco or Lorillard Tobacco has paid judgments in 20 *Engle* Progeny cases. Those payments totaled \$173.5 million and included \$116.6 million for compensatory or punitive damages and \$56.9 million for attorneys' fees and statutory interest. In addition, as of December 31, 2017, \$136.5 million for compensatory and punitive damages and attorneys' fees and statutory interest for the following *Engle* Progeny cases were accrued in RAI's consolidated balance sheet as reflected in the following chart:

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued**

Plaintiff Case Name	RJR Tobacco Allocation of Fault	Lorillard Tobacco Allocation of Fault	Compensatory Damages (as adjusted) <sup>(1)</sup>	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 began on February 12, 2018
<i>Monroe</i>	58%	—	6,380,000		— RJR Tobacco filed petition for writ of certiorari with the U.S. Supreme Court on November 7, 2017; RJR Tobacco's petition was dismissed on January 19, 2018; RJR Tobacco paid approximately \$8.8 million in satisfaction of the judgment on January 31, 2018
<i>Lourie</i>	3%	7%	137,000		— RJR Tobacco filed a petition for writ of certiorari with the U.S. Supreme Court on September 15, 2017; the petition was dismissed on January 18, 2018; RJR Tobacco paid approximately \$280,000 in satisfaction of the judgment on January 31, 2018
<i>Lewis</i>	25%	—	187,500		— RJR Tobacco filed a petition for writ of certiorari with the U.S. Supreme Court on September 29, 2017; the petition was dismissed on January 19, 2018; RJR Tobacco paid approximately \$205,000 in satisfaction of the judgment on January 31, 2018
<i>Block</i>	50%	—	463,000	800,000	RJR Tobacco filed a petition for writ of certiorari with the U.S. Supreme Court on September 25, 2017; the petition was dismissed on January 10, 2018; RJR Tobacco paid approximately \$3.1 million in satisfaction of the judgment on January 31, 2018
<i>Turner</i>	80%	—	2,400,000	10,000,000	Fourth DCA affirmed the final judgment, <i>per curiam</i> , on August 3, 2017; RJR Tobacco filed a petition for writ of certiorari with the U.S. Supreme Court on October 30, 2017; the petition was dismissed on January 12, 2018; RJR Tobacco paid approximately \$14.7 million in satisfaction of the judgment on January 25, 2018
<i>Schoeff</i>	75%	—	10,500,000	30,000,000	Florida Supreme Court reinstated the \$30 million punitive damages award; RJR Tobacco paid approximately \$52.4 million in satisfaction of the judgment on January 31, 2018

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued**

<i>Ahrens</i>	44%	—	5,800,000 <sup>(2)</sup>	2,500,000	Second DCA affirmed the final judgment, per curiam; defendants' motion for a written opinion granted; new opinion substituted; defendants filed a notice to invoke the discretionary jurisdiction of the Florida Supreme Court on August 11, 2017; decision is pending
<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; on subsequent appeal, the Second DCA affirmed the final judgment; RJR Tobacco filed a motion for rehearing, which was denied on January 3, 2018; RJR Tobacco paid approximately \$18.8 million in satisfaction of the judgment on January 31, 2018
<i>Ledoux</i>	47%	—	5,000,000 <sup>(2)</sup>	12,500,000	Third DCA affirmed the final judgment; defendants filed a notice to invoke the discretionary jurisdiction of the Florida Supreme Court; on January 19, 2018, the Florida Supreme Court issued an order to show cause why its decision in <i>Schoeff</i> is not controlling in this case and why the court should not decline to accept jurisdiction; decision is pending
<i>Mathis</i>	55%	—	5,000,000 <sup>(2)</sup>	—	Third DCA affirmed the final judgment, per curiam on December 13, 2017; RJR Tobacco paid approximately \$7.2 million in satisfaction of the judgment on January 31, 2018
<i>Marchese</i>	22.5%	—	500,000	250,000	Fourth DCA reversed the trial court's reduction for comparative fault and ordered the trial court to enter final judgment in the full amount of damages awarded by the jury; RJR Tobacco paid approximately \$835,000 in satisfaction of the judgment on January 31, 2018
<i>Graham</i>	20%	—	550,000	—	Eleventh Circuit, sitting en banc, rejected the defendants' due process and implied preemption claims with dissents; the defendants filed a petition for writ of certiorari with the U.S. Supreme Court on September 15, 2017; the petition was denied on January 8, 2018; RJR Tobacco paid approximately \$1.5 million in satisfaction of the judgment on January 31, 2018
Totals			<u>\$ 39,917,500</u>	<u>\$ 68,410,000</u>	

<sup>(1)</sup> 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 \$26.6 million in *Starr-Blundell, Monroe, Lourie, Lewis, Block, Turner, Schoeff, Ahrens, Evers, Ledoux, Mathis, Marchese* and *Graham* or approximately \$1.6 million in attorneys' fees and statutory interest in *Ward*.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued**

<sup>(2)</sup> The court did not apply comparative fault in the final judgment.

The following chart lists judgments in all other individual *Engle* Progeny cases pending as of December 31, 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 on appeal. No liability for any of these cases has been recorded in RAI's consolidated balance sheet as of December 31, 2017. This chart does not include the mistrials or verdicts returned in favor of RJR Tobacco, B&W, and/or Lorillard Tobacco.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued**

<b>Plaintiff Case Name</b>	<b>RJR Tobacco Allocation of Fault</b>	<b>Lorillard Tobacco Allocation of Fault</b>	<b>Compensatory Damages (as adjusted)<sup>(1)</sup></b>	<b>Punitive Damages</b>	<b>Appeal Status</b>
<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; the plaintiff rejected the remittitur and the new trial on non-economic damages has not been scheduled
<i>Andy Allen</i>	24%	—	2,475,000	7,756,000	First DCA affirmed the judgment of the trial court after granting the defendants' motion for rehearing <i>en banc</i> ; the First DCA dissolved <i>en banc</i> proceedings on October 18, 2017; Florida Supreme Court denied the defendants' petition for review on February 9, 2018
<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, which was denied on October 2, 2017; a new trial date has not been scheduled
<i>James Smith</i>	55%	—	600,000 <sup>(2)</sup>	20,000	Eleventh Circuit affirmed the final judgment of the trial court on January 25, 2018
<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 July 16, 2018
<i>Searcy</i>	30%	—	500,000 <sup>(2)</sup>	1,670,000	Pending – Eleventh Circuit
<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; Florida Supreme Court denied RJR Tobacco's petition for review but did not rule on the plaintiff's petition; RJR Tobacco filed a petition for writ of certiorari with the U.S. Supreme Court on November 28, 2017; the petition was dismissed on January 16, 2018; Florida Supreme Court entered an order to show cause as to why the court should not review the case, quash the decision being reviewed and remand the case for reconsideration in light of its decision in <i>Schoeff</i> ; decision is pending
<i>Burkhart</i>	25%	10%	3,500,000 <sup>(2)</sup>	1,750,000	Pending – Eleventh Circuit

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

<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; Florida Supreme Court accepted jurisdiction on December 5, 2017; briefing is underway
<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 December 4, 2017, the Florida Supreme Court denied the plaintiff's petition for review; deadline for the plaintiff to file a petition for writ of certiorari with the U.S. Supreme Court is March 5, 2018
<i>Harris</i>	15%	10%	1,100,000 <sup>(2)</sup>	—	Post-trial motions are pending <sup>(3)</sup>
<i>Irimi</i>	14.5%	14.5%	—	—	Fourth DCA affirmed the grant of a new trial to RJR Tobacco on October 11, 2017; Fourth DCA denied plaintiff's motion for rehearing on January 10, 2018; no retrial date has been set; plaintiff filed a notice to invoke the discretionary jurisdiction of the Florida Supreme Court on February 8, 2018; decision is pending
<i>Kerrivan</i>	31%	—	6,046,660 <sup>(2)</sup>	9,600,000	Post-trial motions are pending <sup>(3)</sup>
<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 June 1, 2018
<i>Ellen Gray</i>	50%	—	3,000,000	—	Pending – Eleventh Circuit
<i>Sowers</i>	50%	—	2,125,000	—	Post-trial motions are pending <sup>(3)</sup>
<i>Caprio</i>	20%	10%	167,700	—	Retrial granted on partial jury verdict; retrial originally scheduled for August 9, 2017, has been stayed pending resolution of bankruptcy issue
<i>Zamboni</i>	30%	—	102,000	—	Final judgment was entered against RJR Tobacco in the amount of \$102,000 and against the remaining defendant in the amount of \$34,000.
<i>Pollari</i>	42.5%	—	—	—	Fourth DCA reversed and remanded the case for a new trial on August 30, 2017; plaintiff filed a notice to invoke the discretionary jurisdiction of the Florida Supreme Court on December 6, 2017; briefing is underway
<i>Gore</i>	23%	—	460,000	—	Pending – Fourth DCA
<i>Ryan</i>	65%	—	—	—	Fourth DCA reversed and remanded the case for a new trial on December 13, 2017; plaintiff filed a notice to invoke the discretionary jurisdiction of the Florida Supreme Court on January 3, 2018; Florida Supreme Court stayed proceedings pending the disposition of <i>Pollari</i>
<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 began February 5, 2018

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued**

<i>McCoy</i>	25%	20%	—		— Fourth DCA reversed and remanded the case for a new trial on November 8, 2017; plaintiff filed a notice to invoke the discretionary jurisdiction of the Florida Supreme Court on December 7, 2017; Florida Supreme Court stayed proceedings pending the disposition of <i>Pollari</i>
<i>Blackwood</i>	40%	—	1,200,000		— On January 10, 2018, the Fourth DCA affirmed judgment on compensatory damages for plaintiff and remanded for a new trial on punitive damages on the non-intentional tort claims; case has been remanded back to the trial court for further proceedings
<i>Duignan</i>	30%	—	—		— Second DCA reversed and remanded for a new trial on November 15, 2017; plaintiff filed a motion for certification of a conflict on November 30, 2017; decision is pending; new trial is scheduled for November 26, 2018
<i>O'Hara</i>	85%	—	14,700,000	20,000,000	First DCA affirmed judgment for plaintiff on October 11, 2017; RJR Tobacco's motion for rehearing was denied on February 8, 2018
<i>Ewing</i>	2%	—	4,800		— Pending – First DCA
<i>Enochs</i>	66%	—	13,860,000	6,250,000	Fourth DCA affirmed the final judgment on August 16, 2017; defendants filed a notice to invoke the discretionary jurisdiction of the Florida Supreme Court on November 10, 2017; decision is pending
<i>Dion</i>	75%	—	12,000,000 <sup>(2)</sup>	30,000	Second DCA affirmed the final judgment, <i>per curiam</i> , on November 8, 2017; RJR Tobacco filed a notice to invoke the discretionary jurisdiction of the Florida Supreme Court on December 6, 2017; decision is pending
<i>Nally</i>	75%	—	6,000,000 <sup>(2)</sup>	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 <sup>(3)</sup>
<i>Oshinsky-Blacker</i>	25%	—	—		— Pending – Fourth DCA
<i>Sherry Smith</i>	65%	—	3,000,000 <sup>(2)</sup>		— 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		— Pending – Third DCA
<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 <sup>(2)</sup>	6,750,000	Pending – First DCA
<i>John Brown</i>	35%	—	2,700,000 <sup>(2)</sup>	200,000	Pending – Second DCA
<i>Fox</i>	50%	—	3,000,000		— Pending – Fourth DCA
<i>Whitmire</i>	67%	—	3,000,000 <sup>(2)</sup>		— Pending – First DCA
<i>Santoro</i>	26%	—	417,000	90,000	Post-trial motions are pending <sup>(3)</sup>
<i>Lima</i>	60%	—	1,800,000	12,000,000	Pending – Second DCA
<i>Shadd</i>	5%	—	3,250		— Plaintiff filed a notice of dismissal of her appeal in the Fourth DCA
<i>Sheffield</i>	60%	—	1,800,000 <sup>(2)</sup>	5,000,000	Pending – Fifth DCA
<i>Maloney</i>	50%	—	1,650,000 <sup>(2)</sup>		— Pending – Second DCA
<i>Thomas</i>	55%	—	2,200,000		— Pending – Fourth DCA



**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued**

<i>Wallace</i>	33%	—	3,960,000	8,000,000	Pending – Fifth DCA
<i>Schlefstein</i>	100%	—	13,965,000	27,800,000	Post-trial motions are pending <sup>(3)</sup>
<i>Gloger</i>	50%	—	4,688,000	5,000,000	Post-trial motions are pending <sup>(3)</sup>
Totals			<u>\$ 168,922,340</u>	<u>\$ 192,633,075</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 December 31, 2017, verdicts or judgments in favor of *Engle* Progeny plaintiffs have been entered and remain outstanding against RJR Tobacco or Lorillard Tobacco totaling \$168,922,340 in compensatory damages (as adjusted) and \$192,633,075 in punitive damages, which is a combined total of \$361,555,415. 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 December 31, 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.

*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 December 31, 2017, there were 2,321 *Broin II* lawsuits pending in Florida. There have been no *Broin II* trials since 2007. Since December 31, 2017, three *Broin II* cases have been scheduled for trial.

*Class-Action Suits*

*Overview.* As of December 31, 2017, 24 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.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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, District of Columbia, Florida, Illinois, Louisiana, Missouri, New Mexico, New York, North Carolina, West Virginia and the U.S. Virgin Islands. All pending class-action cases are discussed below.

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, alleging that the use of the term "lights" constitutes unfair and deceptive trade practices under state law or violates federal RICO. 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.

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 a stay pending the court's final appeal decision in *Price v. Philip Morris Companies, Inc.* 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 *Price v. Philip Morris Companies, Inc.* 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 June 4, 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 June 4, 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.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

### *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. On August 23, 2017, the court granted RJR Vapor's motion to dismiss. The parties filed a stipulation for voluntary dismissal with prejudice on September 20, 2017.

### *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. 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 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 sought class certification, payment for class notice, injunctive relief, monetary damages, prejudgment interest, statutory damages, restitution, and attorneys' fees and costs. On January 12, 2017, the plaintiffs filed a second amended class action complaint seeking essentially the same relief as the initial consolidated complaint. On February 23, 2017, the defendants moved to dismiss the second amended class action complaint. On December 21, 2017, the transferee court granted the motion to dismiss in part, dismissing a number of claims with prejudice, and denied the motion in part. The transferee court's scheduling order, as amended, provides for the plaintiffs to file a motion for class certification by July 19, 2018, and a hearing on the class certification motion in January 2019.

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 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. Briefing is complete, and a decision is pending.

### *Other Class Actions*

In *April 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.*

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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, Nital 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 *Diana 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 for injuries 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 December 31, 2017, Lorillard Tobacco and/or Lorillard was a defendant in 70 Filter Cases. Since January 1, 2015, Lorillard Tobacco and RJR Tobacco have paid, or have reached agreement to pay, a total of approximately \$31 million in settlements to resolve 131 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 is scheduled for March 6, 2018.

### *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 December 31, 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.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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.

RAI’s operating subsidiaries expenses and payments under the State Settlement Agreements for 2016, 2017 and the projected expenses and payments for 2018 and thereafter (in millions) are set forth below. Such payments are 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. The 2017 cash payments include a \$1.8 billion partial prepayment related to the April 2018 annual payment. For Further information, see “— State Settlement Agreements—Enforcement and Validity; Adjustments” below.<sup>(1)</sup>

	2016	2017	2018	2019 and thereafter
Settlement expenses	\$ 2,727	\$ 2,856	—	—
Settlement cash payments	\$ 3,042	\$ 4,612	—	—
Projected settlement expenses			\$>3,000	\$>3,000
Projected settlement cash payments			\$>1,000	\$>3,000

<sup>(1)</sup> 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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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;
- 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 writs of certiorari.

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 stayed 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 appealed to the D.C. Circuit from the district court’s order adopting the government’s proposed corrective-statement preambles. On May 6, 2016, the defendants and post-judgment parties regarding remedies appealed to the D.C. Circuit from the superseding consent order, and the D.C. Circuit then consolidated the two appeals. On April 25, 2017, the D.C. Circuit affirmed in part, reversed in part, and remanded for further proceedings. 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, which order the D.C. Circuit upheld on November 1, 2016. The corrective statements began running in newspapers and on television in November 2017. In light of the corrective-statements implementation requirements, \$20 million was accrued in the fourth quarter of 2013 for the estimated costs of the corrective communications, of which \$17 million remains as a liability in the consolidated balance sheet as of December 31, 2017.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

### *Native American Tribe Case.*

As of December 31, 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 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. Pretrial discovery is ongoing.
- *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. Pretrial discovery is ongoing.
- *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.
- *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.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

- *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 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,



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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 December 31, 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, referred to as the Acquired Brands. Under the asset purchase agreement relating to the 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 Acquired Brands.

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 Acquired 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 for leave to allow a supplemental pleading for breach by ITG of its obligations regarding joinder into the Florida Settlement Agreement. The supplemental pleading that RJR Tobacco sought leave to file was 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. On March 30, 2017, the Florida court ruled that ITG should be joined into the enforcement action.

On December 18, 2017 through December 20, 2017, a three-day bench trial was held on the State's and PM USA's Motions to Enforce the Settlement Agreement (excluding the issues relating to Profit Adjustment). On December 27, 2017, the Court entered an order holding that RJR Tobacco (not ITG) is liable for annual settlement payments for the Acquired Brands. The court found that ITG did not assume liability for annual settlement payments under the terms of the asset purchase agreement relating to the Divestiture. As to RJR Tobacco, the court ruled that RJR Tobacco's liability for payments under the Florida Settlement Agreement continues with regard to the Acquired Brands. On January 23, 2018, RJR Tobacco filed a notice of appeal in the Fourth DCA, and on January 25, 2018, RJR Tobacco filed an amended notice of appeal and PM USA filed a notice of appeal as to ITG only. There are two issues that remain to be decided as to Profit Adjustment: 1) whether RJR Tobacco is now required to make Profit Adjustment payments based on profits that ITG makes on the Acquired Brands and how those payments would be determined, and 2) how the allocation provisions of the separate agreement between the State, RJR Tobacco, and PM USA set forth in the PwC engagement letter, dated December 2, 2002, are to be applied. On January 26, 2018, the State filed a motion to determine entitlement to recover its attorneys' fees and costs from RJR Tobacco. RJR Tobacco filed a motion for case management conference on January 30, 2018. The State and PM USA filed a joint motion

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

for the entry of final judgment and response to RJR Tobacco's motion for case management conference on February 1, 2018. RJR Tobacco's motion for case management conference and the State and PM USA's joint motion for the entry of final judgement are set for hearing on March 8, 2018.

In January 2018, PwC adjusted the final 2017 invoice for the annual payment and amended the 2015 and 2016 invoices for the respective annual payment and the net operating profit penalty for each of those years under the Florida Settlement Agreement based on its interpretation of the Court's order holding RJR Tobacco liable for annual settlement payments for the Acquired Brands. Under the terms of the Florida Settlement Agreement, the PwC invoices reflected amounts due to both the State of Florida and PM USA. In total, the estimated additional amounts due were \$99.4 million, \$83.5 million to the State of Florida and \$15.9 million to PM USA.

RJR Tobacco notified PwC on January 30, 2018, that it was disputing the amounts in the new invoices from PwC, that the court order had made no determination as to whether RJR Tobacco had any obligations relative to the net operating profit penalty or how such amounts would be allocated and that those points would be addressed in a separate trial. Finally, RJR Tobacco notified PwC that, relative to the 2017 annual payment estimate paid in December 2017 pursuant to the Florida Settlement Agreement, it was in an overpayment position for 2017 and no further amounts would be remitted relative to that portion of its obligation to Florida and that PwC should not apply any of the overpayment to Florida. RJR Tobacco also notified PwC that, as to 2015 and 2016, RJR Tobacco had paid its obligation in full under the Florida Settlement Agreement, and therefore no further amounts were due or would be paid for those years, pending the final resolution of RJR Tobacco's appeal of the Court order.

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) relating to the Divestiture. 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. Oral argument on the cross motion was held on September 11, 2017. On November 30, 2017, the Delaware court entered a ruling in favor of RJR Tobacco, holding that ITG's obligation under Section 2.2 of the Agreed Assumption Terms to use its reasonable best efforts to join the Florida Settlement Agreement did not terminate due to the closing of the asset purchase agreement relating to the Divestiture. RJR Tobacco is considering its next steps.

*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 for the 2003 volume year NPM Adjustment, in accordance with a procedure established by the MSA.

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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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 motions is as follows:

- Indiana participated in a joint motion to stay indefinitely further proceedings on the motions it had filed to vacate the settlement and to modify the adverse diligent enforcement ruling against it. On November 27, 2017, the state court of Indiana granted Indiana’s unopposed motion to dismiss the motions to vacate.
- Kentucky subsequently joined the NPM Adjustment Settlement Agreement. On November 29, 2017, the parties filed in the Circuit Court of Kentucky an agreed order withdrawing the Commonwealth of Kentucky’s motion to vacate and/or modify partial and final arbitration awards and for declaration of MSA violations. A status conference was held on February 12, 2018, at which time the agreed order was taken under advisement by the court.
- 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 was recognized as a reduction of cost of products sold in RAI’s consolidated statements of income for the year ended December 31, 2016.

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 consolidated financial statements as of December 31, 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.

In subsequent years, RJR Tobacco, Lorillard Tobacco, certain other PMs and the settling states entered into four 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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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 2015. The approximate maximum principal amounts of RJR Tobacco's and Lorillard Tobacco's shares of the disputed NPM Adjustments for the years 2004 through 2015 (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 <sup>(1)</sup>:

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
2015	482	175	41	15

<sup>(1)</sup> The amounts 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 2015 is approximately \$85 million and the remaining amount after the settlements is approximately \$31 million.

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 four 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 began in November 2017 and will likely conclude by the end of the first quarter of 2019. Diligent enforcement rulings from the panels are likely by the end of the first quarter of 2010. 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. This matter is currently in the discovery phase in Montana. 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. RAI has not recognized any credits related to the 2004-2016 NPM Adjustment in its consolidated financial statements.

*Settlement/Partial Settlement of Certain NPM Adjustment Claims.* In 2012, RJR Tobacco, 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 NPM Adjustment. The Term Sheet resolved claims related

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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. In April 2017, Rhode Island and Oregon joined the Term Sheet settlement on financial terms more favorable to the industry than those agreed to by the initial states. Twenty-six jurisdictions have now joined the Term Sheet settlement representing approximately 51.73% allocable share. In the fourth quarter of 2017, the NPM Adjustment Settlement Agreement, a formal agreement incorporating the terms and provisions of the Term Sheet, was executed by the PMs and the states that previously joined the Term Sheet. With execution of the agreement, the PMs and the states settled the 2015 volume year.

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 2015 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 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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

manufactured cigarettes that were eventually sold in Iraq in violation of U.S. sanctions. The plaintiffs sought 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 did not affect the plaintiffs' common-law claims. After remand, the parties resolved the case. On August 17, 2017, the district court dismissed the action with prejudice.

*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. Four of the petitions have been granted and 13 have been denied. Additional petitions for *inter partes* review will be filed. The U.S. Patent Office has issued final written decisions in two of the granted petitions for *inter partes* review. In one, the Patent Office held that all challenged claims are unpatentable, and in the other held that RJR Vapor failed to show the claims are unpatentable.

*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 heard oral argument on August 8, 2017. On August 10, 2017, the Oklahoma Supreme Court struck down the \$1.50 cigarette fee as unconstitutional.

### *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. On January 25, 2017, the trial court denied the defendants' motion to dismiss those claims as abandoned. The plaintiffs subsequently agreed to dismiss their claims without prejudice. The court declined to permit such dismissals and has ordered all 41 smokeless plaintiffs to appear in court in person on March 23, 2018, to either announce that they seek to proceed with their claims with new counsel or otherwise have their claims dismissed with prejudice.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

### *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. Oral argument occurred on January 9, 2018. A decision is pending.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – 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 believed that the claims asserted in these cases were 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. The plaintiffs agreed to dismiss their cases after RAI agreed to file a supplemental disclosure.

Following BAT's acquisition of the remaining 57.8% of RAI in July 2017, pursuant to North Carolina law, under which RAI was incorporated, a number of RAI shareholders dissented and asserted their rights to a judicial appraisal of the value of their RAI stock. On November 29, 2017, RAI filed a complaint for judicial appraisal in North Carolina state court against 20 dissenting shareholders, comprised of three groups of affiliated entities. The complaint asks the court to determine the fair value of the dissenting shareholders' shares of RAI stock and any accrued interest. An initial case management conference is set for March 9, 2018.

### **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



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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, 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.

### *Lease Commitments*

RAI has operating lease agreements that are primarily for automobiles, office space, warehouse space and equipment. The majority of these leases expire within the next five years and some contain renewal or purchase options and escalation clauses or restrictions to subleases. Total rent expense was \$27 million during each of 2017 and 2016.

Future minimum lease payments as of December 31, 2017 (in millions) were as follows:

Year	Noncancellable Operating Leases
2018	\$ 19
2019	3
2020	2
2021	1
2022	1
Thereafter	3
	<u>\$ 29</u>

### **Note 12 — Shareholders' Equity**

RAI's authorized capital stock at December 31, 2017 and 2016, consisted of 100 million shares of preferred stock, par value \$.01 per share, and 3.2 billion shares of common stock, par value \$.0001 per share. Four million shares of the preferred stock are designated as Series A Junior Participating Preferred Stock, none of which is issued or outstanding. The Series A Junior Participating Preferred Stock will rank junior as to dividends and upon liquidation to all other series of RAI preferred stock, unless specified otherwise. Also, of the preferred stock, one million shares are designated as Series B Preferred Stock, all of which are issued and outstanding. The Series B Preferred Stock ranks senior upon liquidation, but not with respect to dividends, to all other series of RAI capital stock, unless specified otherwise. As a part of the B&W business combination, RJR is the holder of the outstanding Series B Preferred Stock. In each of 2017 and 2016, RAI declared \$43 million in dividends to RJR with respect to the Series B Preferred Stock.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued**

RAI's board of directors declared the following quarterly cash dividends per share of RAI common stock:

	<u>2017</u>	<u>2016</u>
First	\$ 0.51	\$ 0.42
Second	0.51	0.42
Third	NA	0.46
Fourth	0.51	0.46

Subsequent to the BAT Merger, RAI paid a dividend to certain BAT subsidiaries that hold RAI's common stock. RAI anticipates continuing to pay quarterly dividends to those subsidiaries in 2018 and going forward.

*Accumulated Other Comprehensive Loss*

The components of accumulated other comprehensive loss, net of tax, 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>
<b>Balance at December 31, 2015</b>	\$ (244)	\$ (14)	\$ (11)	\$ (69)	\$ (338)
Other comprehensive income before reclassifications	(18)	—	—	(17)	(35)
Amounts reclassified from accumulated other comprehensive income (loss)	7	14	11	27	59
Net current-period other comprehensive income	(11)	14	11	10	24
<b>Balance at December 31, 2016</b>	<u>(255)</u>	<u>—</u>	<u>—</u>	<u>(59)</u>	<u>(314)</u>
Other comprehensive income before reclassifications	147	—	—	27	174
Amounts reclassified from accumulated other comprehensive income (loss)	(4)	—	—	—	(4)
Net current-period other comprehensive income	143	—	—	27	170
<b>Balance at December 31, 2017</b>	<u><u>(112)</u></u>	<u><u>—</u></u>	<u><u>—</u></u>	<u><u>(32)</u></u>	<u><u>(144)</u></u>

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued**

Details about the reclassifications out of accumulated other comprehensive loss and the affected line items in the consolidated statements of income for the years ended December 31, 2017 and 2016, were as follows:

<u>Components</u>	<u>Amounts Reclassified</u>		<u>Affected Line Item</u>
	<u>2017</u>	<u>2016</u>	
<b>Retirement benefits:</b>			
Amortization of prior service cost	\$ (17)	\$ (20)	Cost of products sold
Amortization of prior service cost	(16)	(19)	Selling, general and administrative expenses
Settlement cost	—	2	Selling, general and administrative expenses
MTM adjustment	7	21	Cost of products sold
MTM adjustment	20	24	Selling, general and administrative expenses
	(6)	8	Operating income
Deferred taxes	2	(1)	Provision for income taxes
Net of tax	(4)	7	Net income
<b>Long-term investments:</b>			
Realized loss, net on long-term investments	—	24	Other (income) expense, net
Deferred taxes	—	(10)	Provision for income taxes
Net of tax	—	14	Net income
<b>Hedging instruments:</b>			
Forward starting interest rate contracts	—	16	Other (income) expense, 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
<b>Cumulative translation adjustment and other:</b>			
Derecognition of cumulative translation adjustment	—	27	Gain on divestiture
<b>Total reclassifications</b>	<b>\$ (4)</b>	<b>\$ 59</b>	<b>Net income</b>

*Share Repurchases and Other*

In November 2011, RAI, B&W and BAT entered into Amendment No. 3 to the governance agreement dated as of July 30, 2004, as amended, referred to as 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 the Governance Agreement be made within the time period set forth in the Governance Agreement, 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 waived compliance with the general prohibition on repurchases contained in the Merger Agreement to permit RAI to make these repurchases. During the period from January 1, 2017 to July 24, 2017 and for the year ended December 31, 2016, RAI repurchased and cancelled 1,372,067 shares of RAI common stock for \$88 million and 1,817,846 shares of RAI common stock for \$93 million, respectively, in accordance with the Governance Agreement.

Prior to the BAT Merger, restricted stock units granted in March 2014 and May 2016 under 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 period from January 1, 2017 to July 24, 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.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

Restricted stock units granted in March 2013, May 2015, September 2014 and January 2016 under the Omnibus Plan, vested in March 2016, May 2016, September 2016 and December 2016, respectively, and were settled with the issuance of 2,938,567 shares of RAI common stock. In addition, during the year ended December 31, 2016, at a cost of \$58 million, RAI purchased 1,146,978 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, and the program could be terminated or suspended at any time. 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 will participate in the Share Repurchase Program on a basis approximately proportionate with BAT 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 2017. The Share Repurchase Program terminated effective with the completion of the BAT Merger on July 25, 2017.

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

Changes in RAI common stock outstanding were as follows:

	2017	2016
Shares outstanding at beginning of year	1,425,824,955	1,427,341,341
Omnibus Plan tax shares repurchased and cancelled	(940,607)	(1,146,978)
Omnibus Plan shares issued from vesting of restricted stock units	2,434,400	2,938,567
Shares repurchased and cancelled	(1,372,067)	(3,383,544)
Equity incentive award plan shares issued	178,950	75,569
Shares outstanding at end of year	1,426,125,631	1,425,824,955

### Note 13 — Stock Plans

As of December 31, 2017, RAI had two stock plans, the EIAP and the Omnibus Plan.

Prior to the BAT Merger, under the EIAP, RAI provided grants of deferred stock units to eligible directors on a quarterly and annual basis, with the annual grant being made generally on the date of RAI's annual shareholders' meeting. Prior to September 13, 2012, upon election to RAI's board of directors, an eligible director received an initial grant of 3,500 deferred stock units under the EIAP. After September 13, 2012, grants were no longer made to directors upon their initial election to the board of directors, but eligible directors initially elected to RAI's board of directors after such date on a date other than the annual meeting date, and who, therefore, were not eligible to receive the annual stock award for such year, would receive a pro rata portion of the annual award upon election. Directors could elect to receive shares of common stock in lieu of their initial and annual grants of deferred stock units. Deferred stock units granted under the EIAP had a value equal to, and bore dividend equivalents at the same rate as, one share of RAI common stock, and had no voting rights. The dividends were paid as additional units in an amount equal to the number of shares of RAI common stock that could be purchased with the dividends on the date of payment. Generally, distribution of a director's deferred stock units would be made on January 2 following his or her last year of service on the board; however, for all grants made under the EIAP after December 31, 2007, a director could elect to receive his or her deferred stock units on the later of January 2 of a specified year or January 2 following his or her last year of service on the board. At the election of a director, distribution could be made in one lump sum or in up to ten annual installments. A director was paid in cash for the units granted quarterly and in common stock for the units granted initially and annually, unless the director elected to receive cash for the initial and annual grants. Effective July 25, 2017 and in accordance with the BAT Merger, certain deferred stock units granted to eligible directors of RAI under the EIAP were settled in cash of \$40 million 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 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. Prior to the BAT Merger, cash payments were based on the average closing price of RAI common stock during December of the year preceding payment. Subsequent to the BAT Merger, cash payments are based on the average closing price of BAT ADS

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

during December of the year preceding payment. Compensation expense related to the EIAP was \$14 million during each of 2017 and 2016.

Awards to key employees under the Omnibus Plan may be in the form of cash awards, incentive or non-incentive stock options, stock appreciation rights, restricted stock, restricted stock units, performance shares, performance units or other awards. Subject to adjustments as set forth in the Omnibus Plan and prior to the BAT Merger, the number of shares of RAI common stock that could be issued with respect to awards under the Omnibus Plan would not exceed 76,000,000 shares in the aggregate. Subsequent to the BAT Merger, share-based awards will be settled in BAT ADSs. Upon retirement, a holder's grant under the Omnibus Plan generally vests on a pro rata basis for the portion of the vesting service period that has elapsed, thereby maintaining an appropriate approximation of forfeitures related to retirement.

### *BAT Merger Restricted Stock Grants Changes*

In conjunction with the BAT Merger, restricted stock grants issued by RAI under the Omnibus Plan, prior to the BAT Merger were impacted as the BAT Merger was considered a change of control resulting in RAI becoming an indirect, wholly owned subsidiary of BAT. Restricted stock grants outstanding at the date of the BAT Merger were the 2015, 2016 and 2017 annual grants as well as various off cycle retention and make whole grants made to certain executives. The terms of each grant are governed by its respective grant agreement. Upon completion of the BAT Merger, certain grants were immediately vested while other grants were assumed by BAT.

Grants in 2015 and 2016 under the Omnibus Plan included provisions relative to a change of control. Upon the completion of the BAT Merger and in accordance with the corresponding grant agreements, the shares granted in 2015, that had not subsequently been cancelled or vested, vested pro rata as of July 25, 2017, as there was no provision for the grants to be assumed. Upon the completion of the BAT Merger and in accordance with the corresponding grant agreement, the shares granted in 2016, that had not subsequently been cancelled or vested, vested in full as BAT elected not to assume and replace these grants. As part of the consideration paid in the BAT Merger, the 2015 and 2016 grants that immediately vested were settled with \$69.7 million in cash consideration and the issuance of 326,510 BAT ADSs to the grantees. An additional 918,048 BAT ADSs were withheld to cover the payroll taxes of the grantees associated with the restricted stock units that vested for which RAI paid \$63.6 million to the relevant taxing authorities. BAT reimbursed RAI for the cash tax withholdings paid by RAI as part of the consideration paid in the BAT Merger.

Upon completion of the BAT Merger and in accordance with the corresponding grant agreement, the restricted stock grants in 2017 were assumed by BAT and the terms of the 2017 grant continues unchanged, except that the target award has been adjusted such that each Performance Share granted under the 2017 grant will now be converted into a BAT ADS rather than a RAI share pursuant to a restricted stock exchange ratio as defined in the Merger Agreement. The restricted stock exchange ratio converted the restricted stock grants in a manner that provided the same value the grantee would have received upon the BAT Merger. Per the Merger Agreement, the restricted stock exchange ratio was the aggregate of 0.5260 of a BAT ADS plus the ratio from dividing the \$29.44 in cash consideration by the BAT ADS closing price of \$69.25 on July 24, 2017. This resulted in a restricted stock exchange ratio of 0.9511 BAT ADSs with 0.95 BAT ADS replacing every RAI share with the fractional amount paid out in cash to the grantee. Upon assumption of the 2017 grants by BAT, the replacement awards maintained the same vesting date and same performance period. Further, the 2017 grant contains a vesting provision that provided if the awards were assumed by BAT but in the two-year period subsequent to the change of control the grantee has a qualified termination, then the awards vest in full. Other make whole and retention grants remaining outstanding at July 25, 2017 were treated in a similar manner.

Subsequent to the BAT Merger, restricted stock units granted in 2016 and 2017 under the Omnibus Plan vested and were settled with the issuance of 25,092 BAT ADSs to the grantees. An additional 19,562 BAT ADSs were withheld to cover the payroll taxes of the grantees associated with the restricted stock units that vested for which RAI paid \$1.3 million to the relevant taxing authorities. Further, in accordance with the 2017 grant agreement, 327,463 restricted stock units granted in 2017 had vested as a result of qualified terminations. These grants are expected to be settled during 2018.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued**

Information regarding restricted stock unit awards outstanding as of December 31, 2017, under the Omnibus Plan was as follows:

<u>Grant Year</u>	<u>Number of Shares Granted (BAT ADS)</u>	<u>Grant Price Per Share (BAT ADS)</u>	<u>Vesting Date</u>	<u>Number of Shares Cancelled and Vested (BAT ADS)</u>	<u>Cumulative Dividends Per Share</u>	<u>Ending Date of Performance Period</u>
<i>Three-year grant</i>						
2017	903,845	\$ 65.866	March 1, 2020	343,267	\$ 2.36	December 31, 2019
<i>Other grants</i>						
2016	15,307	\$ 65.866	December 15, 2018	—	N/A	N/A
2016	10,034	\$ 65.866	December 15, 2018	—	N/A	N/A

*Three-Year Grant and Other Grants*

The grant date fair value was based on the per share closing price of BAT ADSs on the date of the merger. The actual number of shares granted is fixed. As an equity-based grant, compensation expense includes the vesting period lapsed. There were no shares issued during 2017 with respect to awards outstanding as of December 31, 2017. All outstanding grants will be settled exclusively in BAT ADSs.

Upon settlement, each grantee of a three-year grant will receive a number of 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 on December 31 of the year prior to the vesting date. The other grants do not contain a performance measure.

*Restricted Stock Unit Dividends*

Prior to the BAT Merger, dividends paid on shares of RAI common stock would accumulate on the restricted stock units and be paid to the grantee on the vesting date. Upon the completion of the BAT Merger, \$8 million was paid for accumulated dividends on the 2015 and 2016 grants that immediately vested. Subsequent to the BAT Merger, dividends paid on BAT ADSs will accumulate on the restricted stock units and be paid to the grantee on the vesting date. Prior to the BAT Merger, if RAI failed to pay its shareholders cumulative dividends of at least the amounts shown above, then each award would be reduced by an amount equal to three times the percentage of the dividend underpayment, up to a maximum reduction of 50%. Subsequent to the BAT Merger, the three-year cumulative minimum dividend requirement was eliminated. Dividends are accrued on the grants and included in other current liabilities, based on the vesting date of less than one year, and in other noncurrent liabilities, based on the vesting date of greater than one year, in the consolidated balance sheets as of December 31, 2017 and 2016.

Prior to the BAT Merger, the changes in the number of RAI restricted stock units during 2017 were as follows:

	<u>Number of Stock Units (RAI)</u>	<u>Weighted Average Grant Date Fair Value Per Share (RAI)</u>
Outstanding at beginning of year	4,201,711	\$ 36.81
Granted	974,446	61.89
Forfeited	(288,246)	39.14
Vested	(3,876,571)	37.52
Outstanding at July 24, 2017 <sup>(1)</sup>	<u>1,011,340</u>	57.60

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

Subsequent to the BAT Merger, the changes in the number of BAT restricted ADS units during 2017 were as follows:

	Number of Stock Units (BAT ADS)	Weighted Average Grant Date Fair Value Per Share (BAT ADS)
Replacement awards issued on July 25, 2017 <sup>(1)</sup>	961,672	\$ 65.866
Forfeited	(3,636)	65.866
Vested	(372,117)	65.866
Outstanding at December 31, 2017	585,919	65.866

<sup>(1)</sup> Upon completion of the BAT Merger, the 1,011,340 outstanding RAI restricted stock units were replaced with 961,672 BAT restricted ADS units based on the restricted stock exchange ratio with fractional units paid in cash.

Total compensation expense related to stock-based compensation and the related tax benefits recognized in selling, general and administrative expenses in the consolidated statements of income as of December 31, were as follows:

Grant/Type	2017	2016
2013 restricted stock units	\$ —	\$ 3
2014 restricted stock units	4	20
2015 restricted stock units	10	30
2016 restricted stock units	59	24
2017 restricted stock units	35	—
Total compensation expense	\$ 108	\$ 77
Total related tax benefits	\$ 37	\$ 27

The amounts related to the unvested Omnibus Plan restricted stock unit grants included in the consolidated balance sheets as of December 31, were as follows:

	2017	2016
Other current liabilities	\$ —	\$ 10
Other noncurrent liabilities	2	7
Paid-in capital	34	111

As of December 31, 2017, there were \$29 million of unrecognized compensation costs related to restricted stock units, calculated at the grant-date price, which are expected to be recognized over a weighted-average period of 2.1 years. The excess tax benefits related to stock-based compensation were \$28 million in 2016. During 2017, RAI adopted ASU 2016-09 and no longer recognizes excess tax benefits and deficiencies as a change to paid-in capital. For additional information regarding employee share-based payment accounting changes, see note 1.

### Note 14 — Retirement Benefits

#### *Pension and Postretirement Benefit Plans*

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.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued**

The changes in benefit obligations and plan assets, as well as the funded status of these plans at December 31 were as follows:

	Pension Benefits		Postretirement Benefits	
	2017	2016	2017	2016
Change in benefit obligations:				
Obligations at beginning of year	\$ 6,674	\$ 6,738	\$ 1,162	\$ 1,210
Service cost	17	16	1	2
Interest cost	268	295	45	49
Actuarial (gain) loss	285	95	(5)	(12)
Plan amendments	4	—	—	—
Benefits paid	(433)	(434)	(77)	(87)
Settlements	—	(36)	—	—
Obligations at end of year	<u>\$ 6,815</u>	<u>\$ 6,674</u>	<u>\$ 1,126</u>	<u>\$ 1,162</u>
Change in plan assets:				
Fair value of plan assets at beginning of year	\$ 5,648	\$ 5,351	\$ 230	\$ 241
Actual return on plan assets	853	432	24	10
Employer contributions	114	335	63	66
Benefits paid	(433)	(434)	(77)	(87)
Settlements	—	(36)	—	—
Fair value of plan assets at end of year	<u>\$ 6,182</u>	<u>\$ 5,648</u>	<u>\$ 240</u>	<u>\$ 230</u>
Funded status	<u>\$ (633)</u>	<u>\$ (1,026)</u>	<u>\$ (886)</u>	<u>\$ (932)</u>

For the pension benefit plans, the benefit obligation is the projected benefit obligation. For the postretirement benefit plans, the benefit obligation is the accumulated postretirement benefit obligation.

As of December 31, 2017, the improvement in pension benefits funded status is primarily due to employer contributions, updated mortality and other assumptions and higher return on plan assets partially offset by the decrease in the discount rate.

As of December 31, 2017, the improvement in postretirement benefits funded status is primarily due to updated mortality assumptions and higher return on plan assets partially offset by the decrease in the discount rate.

As of December 31, 2016, the improvement in pension benefits funded status is primarily due to employer contributions, updated mortality and other assumptions and higher return on plan assets partially offset by the decrease in the discount rate.

As of December 31, 2016, the improvement in postretirement benefits funded status is primarily due to updated mortality and health-care claims assumptions offset by the decrease in the discount rate.

The changes in net actuarial (gain) loss impacted the funded status as follows:

	Pension Benefits		Postretirement Benefits	
	2017	2016	2017	2016
Net actuarial (gain) loss:				
Change in discount rate	\$ 351	\$ 266	\$ 51	\$ 38
Change in mortality table	(70)	(101)	(8)	(14)
Actual return on plan assets	(853)	(432)	(24)	(10)
Expected return on plan assets	388	372	10	12
Other	4	(69)	(49)	(37)
Net actuarial (gain) loss	<u>\$ (180)</u>	<u>\$ 36</u>	<u>\$ (20)</u>	<u>\$ (11)</u>



**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued**

	Pension Benefits		Postretirement Benefits	
	2017	2016	2017	2016
Amounts recognized in the consolidated balance sheets consist of:				
Accrued benefit — other current liabilities	\$ (16)	\$ (11)	\$ (73)	\$ (78)
Accrued benefit — long-term retirement benefits	(617)	(1,015)	(813)	(854)
Net amount recognized	(633)	(1,026)	(886)	(932)
Accumulated other comprehensive loss	410	616	(130)	(146)
Net amounts recognized in the consolidated balance sheets	<u>\$ (223)</u>	<u>\$ (410)</u>	<u>\$ (1,016)</u>	<u>\$ (1,078)</u>

Amounts included in accumulated other comprehensive loss were as follows as of December 31:

	2017			2016		
	Pension Benefits	Postretirement Benefits	Total	Pension Benefits	Postretirement Benefits	Total
Prior service cost (credit)	\$ 8	\$ (59)	\$ (51)	\$ 7	\$ (95)	\$ (88)
Net actuarial (gain) loss	402	(71)	331	609	(51)	558
Deferred income taxes	(205)	37	(168)	(256)	41	(215)
Accumulated other comprehensive loss	<u>\$ 205</u>	<u>\$ (93)</u>	<u>\$ 112</u>	<u>\$ 360</u>	<u>\$ (105)</u>	<u>\$ 255</u>

Changes in accumulated other comprehensive loss were as follows:

	2017			2016		
	Pension Benefits	Postretirement Benefits	Total	Pension Benefits	Postretirement Benefits	Total
Net actuarial (gain) loss	\$ (180)	\$ (20)	\$ (200)	\$ 36	\$ (11)	\$ 25
Amortization of prior service cost (credit)	(3)	36	33	(3)	42	39
Prior service cost	4	—	4	—	—	—
Settlement cost	—	—	—	(2)	—	(2)
MTM adjustment	(27)	—	(27)	(51)	6	(45)
Deferred income tax (benefit) expense	51	(4)	47	6	(12)	(6)
Change in accumulated other comprehensive loss	<u>\$ (155)</u>	<u>\$ 12</u>	<u>\$ (143)</u>	<u>\$ (14)</u>	<u>\$ 25</u>	<u>\$ 11</u>

The pension MTM adjustment expense in 2017 is primarily a result of a decrease in the discount rate and was partially offset by updated mortality assumptions.

The pension MTM adjustment expense in 2016 is primarily a result of a decrease in the discount rate and was partially offset by pension asset return gains of \$432 million versus an expected return of \$372 million and updated mortality and other assumptions. The postretirement MTM adjustment gain in 2016 is primarily a result of updated mortality and health-care claims assumptions and was partially offset by a decrease in the discount rate.

In March 2010, the Patient Protection Affordable Care Act, referred to as the PPACA, as amended by the Health Care and Reconciliation Act of 2010, was signed into law. The PPACA mandates health-care reforms with staggered effective dates from 2010 to 2018. The additional postretirement liability resulting from the material impacts of the PPACA have been included in the accumulated postretirement benefit obligation at December 31, 2017 and 2016. Given the complexity of the PPACA and the extended time period in which implementation is expected to occur, further adjustments to the accumulated postretirement benefit obligation may be necessary in the future.

	Pension Benefits		Postretirement Benefits	
	2017	2016	2017	2016
Weighted-average assumptions used to determine benefit obligations at December 31:				
Discount rate	3.68%	4.16%	3.65%	4.12%
Rate of compensation increase	4.00%	4.00%	—	—

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued**

The measurement date used for all plans was December 31.

Pension plans experiencing accumulated benefit obligations, which represent benefits earned to date, in excess of plan assets are summarized below:

	December 31,	
	2017	2016
Projected benefit obligation	\$ 6,815	\$ 6,674
Accumulated benefit obligation	6,776	6,625
Plan assets	6,182	5,648

The components of net benefit cost (income) and assumptions are set forth below:

	Pension Benefits		Postretirement Benefits	
	2017	2016	2017	2016
Service cost	\$ 17	\$ 16	\$ 1	\$ 2
Interest cost	268	295	45	49
Expected return on plan assets	(388)	(372)	(10)	(12)
Amortization of prior service cost (credit)	3	3	(36)	(42)
Settlements	—	2	—	—
MTM adjustment	27	51	—	(6)
Net benefit cost (income)	<u>\$ (73)</u>	<u>\$ (5)</u>	<u>\$ —</u>	<u>\$ (9)</u>

The estimated amortization of prior service cost for the pension plans is expected to be \$3 million during 2018. The estimated amortization of prior service credit for the postretirement plans is expected to be \$34 million during 2018.

	Pension Benefits		Postretirement Benefits	
	2017	2016	2017	2016
Weighted-average assumptions used to determine net periodic benefit cost for years ended December 31:				
Discount rate	4.16%	4.54%	4.12%	4.47%
Expected long-term return on plan assets	7.07%	6.82%	4.50%	4.60%
Rate of compensation increase	4.00%	4.00%	—	—

Additional information relating to RAI's significant postretirement plans is as follows:

	2017	2016
Weighted-average health-care cost trend rate assumed for the following year	7.00%	7.00%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	5.00%	5.00%
Year that the rate reaches the ultimate trend rate	2025	2025

Assumed health-care cost trend rates have a significant effect on the amounts reported for the health-care plans. A one-percentage-point change in assumed health-care cost trend rates would have had the following effects at December 31, 2017:

	1-Percentage Point Increase	1-Percentage Point Decrease
Effect on total of service and interest cost components	\$ 2	\$ (2)
Effect on benefit obligation	53	(45)

During 2018, RAI expects to contribute \$116 million to its pension plans and \$73 million to its postretirement plans.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

Estimated future benefit payments:

Year	Pension Benefits	Postretirement Benefits		
		Gross Projected Benefit Payments Before Medicare Part D Subsidies	Expected Medicare Part D Subsidies	Net Projected Benefit Payments After Medicare Part D Subsidies
2018	\$ 454	\$ 99	\$ (2)	\$ 97
2019	441	84	(1)	83
2020	437	82	(2)	80
2021	432	80	(2)	78
2022	428	78	(2)	76
2023-2027	2,049	365	(11)	354

### *Pension and Postretirement Assets*

RAI generally uses a hypothetical bond matching analysis to determine the discount rate. The discount rate modeling process involves selecting a portfolio of high quality corporate bonds whose cash flows, via coupons and maturities, match the projected cash flows of the obligations.

The overall expected long-term rate of return on asset assumptions for pension and postretirement assets are based on: (1) the target asset allocation for plan assets, (2) long-term capital markets forecasts for asset classes employed, and (3) excess return expectations of active management to the extent asset classes are actively managed.

Plan assets are invested using active investment strategies and multiple investment management firms. Managers within each asset class cover a range of investment styles and approaches and are combined in a way that controls for capitalization, style bias, and interest rate exposures, while focusing primarily on security selection as a means to add value. Risk is controlled through diversification among asset classes, managers, investment styles and securities. Risk is further controlled both at the manager and asset class level by assigning excess return and tracking error targets against related benchmark indices. Investment manager performance is evaluated against these targets.

RAI employs a risk mitigation strategy, which seeks to balance pension plan returns with a reasonable level of funded status volatility. Based on this framework, the asset allocation has two primary components. The first component is the “hedging portfolio,” which uses extended duration fixed income holdings and derivatives to match a portion of the interest rate risk associated with the benefit obligations, thereby reducing expected funded status volatility. The second component is the “return seeking portfolio,” which is designed to enhance portfolio returns. The return seeking portfolio is broadly diversified across asset classes.

Allowable investment types include domestic equity, international equity, global equity, emerging market equity, fixed income, real assets, private equity and absolute return. The range of allowable investment types utilized for pension assets provides enhanced returns and more widely diversifies the plan. Domestic equities are composed of common stocks of large, medium and small companies. International equities include equity securities issued by companies domiciled outside the United States and in depository receipts, which represent ownership of securities of non-U.S. companies. Global equities include a combination of both domestic and international equities. Emerging market equities are comprised of stocks that are domiciled in less developed, fast growing countries. Fixed income includes corporate debt obligations, fixed income securities issued or guaranteed by the U.S. government, and to a lesser extent by non-U.S. governments, mortgage backed securities, high yield securities, asset backed securities, municipal bonds and dollar-denominated obligations issued in the United States by non-U.S. banks and corporations. Real assets consist of publicly traded real estate investment trust securities, private real estate investments and private energy investments. Private equity consists of the unregistered securities of private and public companies. Absolute return investments are diversified portfolios utilizing multiple strategies that invest primarily in public securities, including equities and fixed income.

For pension assets, futures and forward contracts are used for portfolio rebalancing and to approach fully invested portfolio positions. Otherwise, a small number of investment managers employ limited use of derivatives, including futures contracts, options on futures, forward contracts and interest rate swaps in place of direct investment in securities to gain efficient exposure to markets.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued**

RAI's pension and postretirement plans asset allocations at December 31, 2017 and 2016, by asset category were as follows:

<b>Asset Category:</b>	<b>Pension Plans</b>			
	<b>2017 Target <sup>(1)</sup></b>	<b>2017</b>	<b>2016 Target <sup>(1)</sup></b>	<b>2016</b>
Domestic equities	9%	9%	10%	12%
International equities	7%	7%	8%	8%
Global equities	9%	9%	9%	12%
Emerging market equities	3%	3%	3%	2%
Fixed income	45%	45%	53%	53%
Absolute return	13%	13%	6%	7%
Private equity	8%	8%	2%	2%
Real assets	6%	6%	5%	4%
Commodities	—	—	4%	—
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

<b>Asset Category:</b>	<b>Postretirement Plans</b>			
	<b>2017 Target <sup>(1)</sup></b>	<b>2017</b>	<b>2016 Target <sup>(1)</sup></b>	<b>2016</b>
Domestic equities	21%	20%	21%	22%
International equities	21%	20%	21%	20%
Fixed income	55%	52%	55%	51%
Cash and other	3%	8%	3%	7%
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

<sup>(1)</sup> Allows for a rebalancing range of up to 5 percentage points around target asset allocations.

RAI's pension and postretirement plan assets, excluding uninvested cash and unsettled trades, carried at fair value on a recurring basis as of December 31, 2017 and 2016, were as follows <sup>(1)</sup>:

<b>Pension Plans</b>	<b>2017</b>				<b>2016</b>			
	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
<b>Asset Category:</b>								
Domestic equities	\$ 557	\$ —	\$ —	\$ 557	\$ 457	\$ —	\$ —	\$ 457
International equities	182	—	—	182	137	—	—	137
Global equities	814	—	—	814	635	—	—	635
Real assets	26	—	—	26	23	—	—	23
Agency bonds	—	—	—	—	—	29	—	29
Asset backed securities	—	47	1	48	—	52	1	53
Corporate bonds	—	1,318	1	1,319	—	1,797	1	1,798
Government bonds	—	51	—	51	—	78	—	78
High yield fixed income	—	10	—	10	—	20	—	20
Mortgage backed securities	—	18	—	18	—	75	—	75
Municipal bonds	—	137	—	137	—	201	—	201
Treasuries	—	1,096	—	1,096	—	554	—	554
Cash equivalents and other	35	453	1	489	28	332	2	362
Total investments in the fair value hierarchy	<u>\$ 1,614</u>	<u>\$ 3,130</u>	<u>\$ 3</u>	<u>4,747</u>	<u>\$ 1,280</u>	<u>\$ 3,138</u>	<u>\$ 4</u>	<u>4,422</u>
Investments measured at net asset value				1,409				1,250
<b>Total</b>				<u>\$ 6,156</u>				<u>\$ 5,672</u>

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued**

Postretirement Plans	2017				2016			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
<b>Asset Category:</b>								
Short-term bonds	\$ 11	\$ —	\$ —	\$ 11	\$ 8	\$ —	\$ —	\$ 8
Cash equivalents and other	—	7	—	7	—	7	—	7
Total investments in the fair value hierarchy	<u>\$ 11</u>	<u>\$ 7</u>	<u>\$ —</u>	18	<u>\$ 8</u>	<u>\$ 7</u>	<u>\$ —</u>	15
Investments measured at net asset value				210				205
Total				<u>\$ 228</u>				<u>\$ 220</u>

<sup>(1)</sup> See note 1 for additional information on the fair value hierarchy.

For the years ended December 31, 2017 and 2016, there were no transfers among the fair value hierarchy levels.

At December 31, 2017 and 2016, the fair value of pension and postretirement assets classified as Level 1 was determined using a combination of third party pricing services for certain domestic equities, global equities, international equities, real assets and cash equivalents and other.

At December 31, 2017 and 2016, the fair value of pension and postretirement assets classified as Level 2 was determined using a combination of third party pricing services for certain agency bonds, asset backed securities, corporate bonds, government bonds, high yield fixed income, mortgage backed securities, municipal bonds, treasuries and cash equivalents and other.

The fair value of assets classified as asset backed securities, corporate bonds and other, classified as Level 3, was determined primarily using an income approach that utilized cash flow models and benchmarking strategies. This approach utilized inputs, including market-based interest rate curves, corporate credit spreads and corporate ratings. Additionally, unobservable factors incorporated into these models included default probability assumptions, potential recovery, discount rates and other entity specific factors.

In instances where the plans have invested in commingled pools, the net asset value was used as the practical expedient and no adjustments were made to the provided fair value. This approach utilized the net asset value of the underlying investment fund adjusted by the investment manager for restrictions or illiquidity of the disposition of the interest, if any, valuations provided by the fund's cash flows, and the rights and obligations of the ownership interest of the fund.

Transfers of pension and postretirement plan assets in and out of Level 3 during 2017, by asset category were as follows <sup>(1)</sup>:

	Balance as of January 1, 2017	Purchases, Sales, Issuances and Settlements (net)	Realized Gains (Losses)	Unrealized Gains (Losses)	Transferred From Other Levels	Balance as of December 31, 2017
Asset backed securities	\$ 1	\$ —	\$ —	\$ —	\$ —	\$ 1
Corporate bonds	1	—	—	—	—	1
Other	2	—	(2)	1	—	1
Total	<u>\$ 4</u>	<u>\$ —</u>	<u>\$ (2)</u>	<u>\$ 1</u>	<u>\$ —</u>	<u>\$ 3</u>

Transfers of pension and postretirement plan assets in and out of Level 3 during 2016, by asset category were as follows <sup>(1)</sup>:

	Balance as of January 1, 2016	Purchases, Sales, Issuances and Settlements (net)	Realized Gains (Losses)	Unrealized Gains (Losses)	Transferred From Other Levels	Balance as of December 31, 2016
Asset backed securities	\$ 3	\$ —	\$ —	\$ (2)	\$ —	\$ 1
Corporate bonds	1	—	—	—	—	1
Other	2	—	(28)	28	—	2
Total	<u>\$ 6</u>	<u>\$ —</u>	<u>\$ (28)</u>	<u>\$ 26</u>	<u>\$ —</u>	<u>\$ 4</u>

<sup>(1)</sup> See note 1 for additional information on the fair value hierarchy.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

### *Defined Contribution Plans*

RAI sponsors qualified defined contribution plans. The expense related to these plans was \$41 million during each of 2017 and 2016. Included in the plans is a non-leveraged employee stock ownership plan, which holds shares of the Reynolds Stock Fund. Participants can elect to contribute to the fund. Dividends paid on shares are reflected as a reduction of equity.

### **Note 15 — Segment Information**

RAI's 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. and Niconovum AB. The segments were identified based on how RAI's chief operating decision maker allocates resources and assesses performance. Certain of RAI's operating subsidiaries have entered into intercompany agreements for products or services with other subsidiaries. As a result, certain activities of an operating subsidiary may be included in a different segment of RAI.

RAI's largest operating segment, RJR Tobacco, 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 also offers a smoke-free tobacco product, CAMEL Snus. RJR Tobacco manages contract manufacturing of cigarette 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. RJR Tobacco also manages the super-premium cigarettes, DUNHILL and STATE EXPRESS 555, which are licensed from BAT. For additional information regarding related parties, see note 16.

Santa Fe manufactures and markets super-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. American Snuff's primary brands include its largest selling moist snuff brands, GRIZZLY and KODIAK.

RJR Vapor is a marketer of digital vapor cigarettes, manufactured on its behalf by RJR Tobacco, 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.

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued**

Segment Data:

	<u>2017</u>	<u>2016</u>
Net sales:		
RJR Tobacco	\$ 10,147	\$ 10,314
Santa Fe	1,059	973
American Snuff	1,028	914
All Other	329	302
Consolidated net sales	<u>\$ 12,563</u>	<u>\$ 12,503</u>
Operating income (loss):		
RJR Tobacco <sup>(1)(2)</sup>	\$ 4,819	\$ 4,922
Santa Fe	635	546
American Snuff	672	541
All Other	(122)	(145)
Gain on divestiture	—	4,861
Corporate Expense <sup>(2)</sup>	(280)	(156)
Consolidated operating income	<u>\$ 5,724</u>	<u>\$ 10,569</u>
Cash capital expenditures:		
RJR Tobacco	\$ 156	\$ 130
Santa Fe	8	12
American Snuff	16	22
All Other	20	42
Consolidated capital expenditures	<u>\$ 200</u>	<u>\$ 206</u>
Depreciation and amortization expense:		
RJR Tobacco	\$ 83	\$ 77
Santa Fe	4	4
American Snuff	17	16
All Other	25	26
Consolidated depreciation and amortization expense	<u>\$ 129</u>	<u>\$ 123</u>
Reconciliation to income before income taxes:		
Consolidated operating income <sup>(1)(2)</sup>	\$ 5,724	\$ 10,569
Interest and debt expense	597	626
Interest income	(6)	(8)
Interest income on notes due from related party	(10)	—
Other expense, net	19	260
Income before income taxes	<u>\$ 5,124</u>	<u>\$ 9,691</u>

<sup>(1)</sup> Includes NPM Adjustment credits of \$241 million and \$388 million for RJR Tobacco for the years ended December 31, 2017 and 2016, respectively.

<sup>(2)</sup> Includes MTM adjustment expense of \$14 million for RJR Tobacco and \$13 million for Corporate Expense for the year ended December 31, 2017. Includes MTM adjustment expense of \$42 million for RJR Tobacco and \$3 million for Corporate Expense for the year ended December 31, 2016.

Sales to McLane Company, Inc., a distributor, constituted approximately 29% of RAI's consolidated revenue in 2017 and 28% in 2016. Sales to Core-Mark International, Inc., a distributor, represented approximately 14% of RAI's consolidated revenue during each of 2017 and 2016. McLane Company, Inc. and Core-Mark International, Inc. are customers of RJR Tobacco, Santa Fe and American Snuff. No other customer accounted for 10% or more of RAI's consolidated revenue during those periods.

RAI's operating subsidiaries' sales to foreign countries, primarily to related parties, for the years ended December 31, 2017 and 2016 were \$227 million and \$351 million, respectively.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued**

**Note 16 — 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.

The following is a summary of balances and transactions with such BAT affiliates as of and for the years ended December 31:

	2017	2016
<b>Current Balances:</b>		
Accounts receivable, related party	\$ —	\$ 113
Note and interest receivable due from related party	343	—
Due to related party	4	7
Deferred revenue, related party	83	66
 <b>Long-term Balances:</b>		
Long-term deferred revenue, related party	\$ —	\$ 39
	2017	2016
<b>Significant Transactions:</b>		
Net sales	\$ 104	\$ 226
Purchases	40	21
Share repurchase agreements	—	32
Research and development services billings	—	1
Termination of vapor collaboration agreement	10	—
Allocation of technical, advisory, information technology and integration fee	18	—
Interest income on notes due from related party	10	—

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, requires either party to provide three years' notice to the other party to terminate the agreement without cause, with any such notice to be given no earlier than January 1, 2016. On January 4, 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. The amendment provided for a BAT affiliate to make a payment 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. 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 to December 31, 2018. In its consolidated balance sheets, RAI had \$38.7 million recorded as current deferred revenue at December 31, 2017 and \$40.2 million in current deferred revenue and \$38.9 million in long-term deferred revenue at December 31, 2016. Net sales to BAT affiliates, primarily cigarettes, represented approximately 1% of RAI's total net sales in 2017 and 2% in 2016.

RJR Tobacco recorded deferred sales revenue relating to leaf sold to BAT affiliates that had not been delivered as of December 31, in each of 2017 and 2016, given that RJR Tobacco has a legal right to bill the BAT affiliates. Leaf sales revenue to BAT affiliates is recognized when the product is shipped to the customer.

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



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

RJR Tobacco performs certain research and development for BAT affiliates pursuant to a joint technology sharing agreement entered into as a part of the B&W business combination. These services were billed to BAT affiliates and were recorded in RJR Tobacco's selling, general and administrative expenses, net of associated costs.

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 2016 consolidated statement of income.

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 12.

A €300 million Euro Uncommitted Revolving Credit Facility was entered into on July 26, 2017, with B.A.T. International Finance p.l.c., an indirect, wholly owned subsidiary of BAT, and is payable on demand or no later than the maturity date of July 25, 2018. Interest is based on a rate of 1.3% over LIBOR and is payable at note repayment. The amount outstanding was \$316 million at December 31, 2017.

On July 25, 2017, RAI entered into a zero balance account credit agreement and revolving note with B.A.T. Capital Corporation, an indirect, wholly owned subsidiary of BAT. Under the credit agreement and revolving note, RAI principal borrowings may not exceed \$900 million at any one time and bear interest at a rate of 0.75% over LIBOR. The outstanding principal and interest shall be due and payable no later than the maturity date of July 25, 2019. Under the zero balance credit agreement, RAI's cash balances are transferred daily into BAT's global cash pooling program managed by BAT's treasury team resulting in cash advances to B.A.T. Capital Corporation in excess of the outstanding principal amount. These excess cash advances are payable to RAI on demand and shall bear interest at a rate of 0.275% under LIBOR. The amount outstanding was \$27 million at December 31, 2017.

The allocation of technical, advisory, information technology and integration fees represent an allocation of certain BAT subsidiaries centralized services per intercompany agreements.