

**REYNOLDS AMERICAN INC.**

**Consolidated Financial Statements**

**December 31, 2018 and 2017**

**(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 (the Company), which comprise the consolidated balance sheets as of December 31, 2018 and 2017, 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, 2018 and 2017, and the results of their operations and their cash flows for the years then ended in accordance with U.S. generally accepted accounting principles.



*Emphasis of Matter*

As discussed in Note 1 to the consolidated financial statements, in 2018, the Company adopted new accounting guidance related to the recognition of revenue from customers under U.S. generally accepted accounting principles. The Company adopted the new revenue standard using a modified retrospective approach. Our opinion is not modified with respect to this matter.

KPMG LLP

Greensboro, North Carolina  
February 27, 2019

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

	For the Years Ended December 31,	
	2018	2017
Net sales <sup>(1)</sup>	\$ 12,653	\$ 12,459
Net sales, related party	81	104
<b>Net sales</b>	<b>12,734</b>	<b>12,563</b>
Costs and expenses:		
Cost of products sold <sup>(1)</sup>	4,624	4,809
Selling, general and administrative expenses	2,025	2,098
Amortization expense	55	23
<b>Operating income</b>	<b>6,030</b>	<b>5,633</b>
Interest and debt expense	559	597
Interest expense, related party	11	—
Interest income	—	(6)
Interest income, related party	(21)	(10)
Net periodic benefit income, excluding service cost	(198)	(91)
Other expense, net	—	19
<b>Income before income taxes</b>	<b>5,679</b>	<b>5,124</b>
Provision for (benefit from) income taxes	1,395	(1,897)
<b>Net income</b>	<b>\$ 4,284</b>	<b>\$ 7,021</b>

<sup>(1)</sup> Excludes excise taxes of \$3,916 million and \$4,135 million for the years ended December 31, 2018 and 2017, 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>2018</b>	<b>2017</b>
Net income	\$ 4,284	\$ 7,021
Other comprehensive income (loss), net of tax expense (benefit):		
Retirement benefits, net of tax (2018 — (\$42); 2017 — \$47)	(126)	143
Cumulative translation adjustment and other, net of tax (2018 — \$11; 2017 — \$8)	(25)	27
<b>Comprehensive income</b>	<b>\$ 4,133</b>	<b>\$ 7,191</b>

*See Notes to Consolidated Financial Statements*

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

	For the Years Ended December 31,	
	2018	2017
<b>Cash flows from (used in) operating activities:</b>		
Net income	\$ 4,284	\$ 7,021
Adjustments to reconcile to net cash flows from (used in) operating activities:		
Depreciation and amortization expense	174	129
Deferred income tax benefit	(359)	(3,058)
Other changes that provided (used) cash:		
Accounts and other receivables	(11)	7
Inventories	55	117
Related party, net	(73)	88
Accounts payable	13	(86)
Accrued liabilities, including other working capital	61	(87)
Income taxes	652	(383)
Tobacco settlement accruals	1,822	(1,750)
Pension and postretirement	(340)	(249)
Other, net	(31)	150
Net cash flows from operating activities	<u>6,247</u>	<u>1,899</u>
<b>Cash flows from (used in) investing activities:</b>		
Capital expenditures	(196)	(200)
Advances under note receivable from related party	(13)	(307)
Amounts due from related party – cash management agreements	(2,137)	(17)
Acquisition of intangibles	(81)	—
Other, net	20	1
Net cash flows used in investing activities	<u>(2,407)</u>	<u>(523)</u>
<b>Cash flows from (used in) financing activities:</b>		
Dividends paid on common stock	(3,780)	(2,834)
Borrowings under note payable to related party	1,200	—
Repurchase of common stock	—	(146)
Capital contributions from parent	—	49
Repayments of long-term debt	(1,250)	(500)
Borrowings under revolving credit facility	—	500
Repayments of borrowings under revolving credit facility	—	(500)
Other, net	(20)	—
Net cash flows used in financing activities	<u>(3,850)</u>	<u>(3,431)</u>
<b>Effect of exchange rate changes on cash and cash equivalents</b>	<u>(1)</u>	<u>24</u>
Net change in cash and cash equivalents	(11)	(2,031)
Cash and cash equivalents at beginning of year	20	2,051
Cash and cash equivalents at end of year	<u>\$ 9</u>	<u>\$ 20</u>
Income taxes paid, net of refunds	\$ 972	\$ 1,470
Income taxes paid to parent	\$ 150	\$ —
Interest paid	\$ 624	\$ 650

*See Notes to Consolidated Financial Statements*

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

	As of December 31,	
	2018	2017
<b>Assets</b>		
Current assets:		
Cash	\$ 9	\$ 20
Accounts receivable	55	57
Accounts receivable, related party	30	—
Other receivables	25	12
Inventories	1,472	1,527
Notes and interest receivable from related party	314	316
Amounts due from related party – cash management agreements	2,184	27
Other current assets	158	710
Total current assets	4,247	2,669
Property, plant and equipment, at cost:		
Land and land improvements	88	86
Buildings and leasehold improvements	701	692
Machinery and equipment	2,168	2,066
Construction-in-process	172	147
Total property, plant and equipment	3,129	2,991
Accumulated depreciation	(1,655)	(1,572)
Property, plant and equipment, net	1,474	1,419
Trademarks and other intangible assets, net of accumulated amortization	29,447	29,421
Goodwill	15,984	15,993
Long-term deferred income taxes	34	20
Other assets and deferred charges	8	47
	<u>\$ 51,194</u>	<u>\$ 49,569</u>
<b>Liabilities and shareholders' equity</b>		
Current liabilities:		
Accounts payable	\$ 148	\$ 135
Tobacco settlement accruals	2,568	746
Due to related party	23	4
Deferred revenue, related party	21	83
Current maturities of long-term debt	772	1,249
Note and interest payable to related party	1,201	—
Other current liabilities	1,180	941
Total current liabilities	5,913	3,158
Long-term debt (less current maturities)	10,528	11,361
Long-term deferred income taxes	6,234	6,630
Long-term retirement benefits (less current portion)	1,261	1,430
Other noncurrent liabilities	227	257
Commitments and contingencies		
Shareholders' equity:		
Common stock (shares issued: 2018 and 2017 — 1,426,125,631)	—	—
Paid-in capital	18,303	18,298
Retained earnings	9,078	8,579
Accumulated other comprehensive loss	(350)	(144)
Total shareholders' equity	27,031	26,733
	<u>\$ 51,194</u>	<u>\$ 49,569</u>

*See Notes to Consolidated Financial Statements*



**REYNOLDS AMERICAN INC.**

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

	Common Stock	Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Total Shareholders' Equity
<b>Balance at December 31, 2016</b>	\$ —	\$ 18,285	\$ 3,740	\$ (314)	\$ 21,711
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>	—	18,298	8,579	(144)	26,733
Net income	—	—	4,284	—	4,284
Adoption of ASC 606, net of \$20 tax benefit	—	—	(60)	—	(60)
Reclassification due to adoption of ASU 2018-02	—	—	55	(55)	—
Retirement benefits, net of \$42 tax benefit	—	—	—	(126)	(126)
Cumulative translation adjustment and other, inclusive of \$11 tax expense	—	—	—	(25)	(25)
Dividends — \$2.65 per share	—	—	(3,780)	—	(3,780)
Stock-based compensation	—	5	—	—	5
<b>Balance at December 31, 2018</b>	<u>\$ —</u>	<u>\$ 18,303</u>	<u>\$ 9,078</u>	<u>\$ (350)</u>	<u>\$ 27,031</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.; and R. J. Reynolds Vapor Company, referred to as RJR Vapor.

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 referred to as BHI, 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 United States, referred to as 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.

#### *Nature of Operations*

RAI's primary operating subsidiaries are RJR Tobacco, SFNTC and American Snuff Co. RAI's operating subsidiaries conduct substantially all of their business in the United States and its territories.

RAI's largest operating subsidiary, 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 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. As of December 31, 2018, RAI's contract manufacturing agreement with BAT affiliates has been terminated. For additional information regarding related parties, see Note 14.

SFNTC manufactures and markets super-premium cigarettes and other tobacco products under the NATURAL AMERICAN SPIRIT brand in the United States.

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

In addition, RJR Vapor is an operating subsidiary that is a marketer of digital vapor cigarettes and e-liquids under the VUSE brand name in the United States.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

### *Major U.S. Customers and Foreign Sales*

Sales to McLane Company, Inc., a distributor, constituted approximately 28% of RAI's consolidated revenue in 2018 and 29% in 2017. Sales to Core-Mark International, Inc., a distributor, represented approximately 14% of RAI's consolidated revenue during each of 2018 and 2017. McLane Company, Inc. and Core-Mark International, Inc. are customers of RJR Tobacco, SFNTC, American Snuff Co. and RJR Vapor. 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, 2018 and 2017 were \$92 million and \$227 million, respectively.

### *Revenue Recognition*

On January 1, 2018, RAI adopted Accounting Standards Codification, referred to as ASC, 606, *Revenue from Contracts with Customers* using the modified retrospective transition method with a cumulative effect recognized in retained earnings. Under the new guidance, an RAI operating subsidiary recognizes revenue when it has satisfied its performance obligation under the contract, which occurs at a point in time, by shipment of its product to the customer. At this point, the customer obtains control of the product and ownership of such product and risk of loss transfers to the customer. Revenue is measured as the amount of consideration the RAI operating subsidiary expects to receive in exchange for shipping its product, which includes variable consideration such as estimates of customer sales incentives and trade promotional allowances.

RAI's operating subsidiaries generally receive payment either in advance of the shipment of product to the customer or on the date of expected delivery of product to the customer. When payment from the customer is received prior to the shipment of the product, recognition of revenue is deferred until the product is shipped and the RAI operating subsidiary's performance obligation is satisfied, generally within two days of receiving the payment. For product shipments where payment is not received in advance, amounts due from the customer are billed on shipment date and are included in accounts receivable on the consolidated balance sheets.

For further discussion on revenue recognition, refer to Note 13.

### *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.

Certain reclassifications were made to conform the prior year's financial statements to the current presentation. RAI retrospectively adopted the guidance of Accounting Standards Update, referred to as 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 periodic benefit (income) cost. The other components of pension and postretirement net periodic benefit (income) cost are required to be presented in the consolidated statements of income below operating income.

RAI utilized the practical expedient provided in ASU 2017-07 that allows the company to use the amounts disclosed in its retirement benefits note for the prior comparative periods as the estimation basis for applying the retrospective presentation requirements. For the year ended December 31, 2017, the adoption of ASU 2017-07 resulted in a reclassification of \$90 million of pension net periodic benefit income and \$1 million of postretirement net periodic benefit income below operating income.

Certain amounts presented in Note 9 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 9 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's reporting entity 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.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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

The levels of the fair value hierarchy are:

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

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

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

RAI sponsors a number of non-contributory defined benefit pension plans covering certain employees of RAI and its subsidiaries, and invests in debt, equity and other securities and investments, that are carried at fair value, to fund payments required by these retirement obligations. For additional information regarding the fair value of these plan assets, see Note 12.

### *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, goodwill, trademarks and other intangible assets, 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 as an operating expense.

### *Property, Plant and Equipment*

Property, plant and equipment are recorded at cost and depreciated using the straight-line method over the estimated useful lives of the assets. Useful lives range from 20 to 50 years for buildings and improvements, and from 3 to 30 years for machinery and equipment. The cost and related accumulated depreciation of assets sold or retired are removed from the accounts and the gain or loss on disposition is recognized in operating income. Depreciation expense was \$119 million and \$106 million for the years ended December 31, 2018 and 2017, 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>2018</u>	<u>2017</u>
Unamortized software costs balance	\$ 55	\$ 54
Software costs — capitalized or included in construction-in-process	16	18

#### Expenses:

	<u>2018</u>	<u>2017</u>
Software amortization expense	\$ 15	\$ 14

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

### *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. 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. Trademarks and other intangible assets with finite lives, which are amortized using the straight-line method over their remaining useful lives of 1 to 19 years, consistent with the pattern of economic benefits estimated to be received, are tested for impairment if events and circumstances indicate that the asset is impaired.

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.

### *Cost of Products Sold*

RJR Tobacco, as an original participating manufacturer, and SFNTC, as a subsequent participating manufacturer, are participants in the Master Settlement Agreement, referred to as the MSA, and RJR 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 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>2018</u>	<u>2017</u>
State Settlement Agreements	\$ 2,741	\$ 2,856
FDA user fees	198	188

In 2012, RJR Tobacco, Lorillard Tobacco, SFNTC and certain other 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.

During 2017, the NPM Adjustment Settlement Agreement, referred to as NPM 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. An additional ten states joined the NPM Agreement in 2018 and as a result, expenses for the MSA were reduced by \$101 million for the year ended December 31, 2018. The parties to the NPM Agreement represent an allocable share of 62.53%. In 2018, the NPM Agreement signatory states and PMs agreed to settle the 2016 and 2017 volume years.

As a result of meeting the performance requirements associated with the NPM Agreement, RJR Tobacco and SFNTC, collectively, recognized additional credits of \$116 million and \$130 million for the years ended December 31, 2018 and 2017, respectively.

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 \$104 million and \$99 million as a reduction to cost of products sold for the years ended December 31, 2018 and 2017, respectively. In addition, the NY Settlement Agreement put in place a new method to determine future adjustments from 2015 forward as to New York.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

For additional information related to the NPM Adjustment settlement, see “— Litigation Affecting the Cigarette Industry — State Settlement Agreements — Enforcement and Validity; Adjustments” in Note 9.

### *Advertising*

Advertising costs, which are expensed as incurred, were \$78 million and \$66 million for the years ended December 31, 2018 and 2017, respectively.

### *Research and Development*

Research and development costs, which are expensed as incurred, were \$99 million and \$69 million for the years ended December 31, 2018 and 2017, respectively.

### *Income Taxes*

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

For federal income tax purposes, RAI’s results are included in the consolidated United States federal income tax return of BHI. For state income tax purposes RAI’s results are included in 26 combined state income tax returns that include members of the consolidated United States federal income tax return of BHI. For financial reporting purposes, RAI’s current and deferred income taxes are calculated using the separate return method under ASC 740-10-30-27. All current and deferred tax expense and current and deferred tax liabilities are calculated as if RAI files separate federal and state income tax returns that exclude the income, deductions and tax attributes of BHI.

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.

The Tax Cuts and Jobs Act, referred to as the Tax Reform Act, requires a U.S. shareholder of any controlled foreign corporations, referred to as CFC, to include in taxable income its pro rata share of global intangible low-taxed income, referred to as GILTI. GILTI is considered the excess of the shareholder’s net CFC tested income over the shareholder’s net deemed tangible income return. This amount is further reduced by a 50 percent special deduction and foreign tax credits. Although RAI does not expect to have a GILTI inclusion for the foreseeable future, management has made a policy election to treat GILTI income, if applicable, as a current period tax expense.

### *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 9.

### *Pension and Postretirement*

Pension and postretirement benefits require balance sheet recognition of the net asset for the overfunded status or net liability for the 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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

(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 27, 2019, the date the financial statements were issued.

### *Recently Adopted Accounting Pronouncements*

Effective January 1, 2018, RAI adopted the following new accounting standards:

- ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, together with its related supplemental implementation guidance, which replaces most existing GAAP revenue recognition guidance. RAI adopted the new standard retrospectively with a cumulative effect of approximately \$80 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 from adoption of ASC 606 is the acceleration of recognition of certain discounting expenses.
- 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 periodic benefit (income) cost. The other components of net periodic benefit (income) cost are presented in the income statement separately from the service cost component and outside of operating income. This change in presentation has been applied retrospectively. RAI utilized the practical expedient provided in ASU 2017-07 that allows the company to use the amounts disclosed in its retirement benefits note for the prior comparative periods as the estimation basis for applying the retrospective presentation requirements. For the year ended December 31, 2017, the adoption of ASU 2017-07 resulted in a reclassification of \$90 million of pension net periodic benefit income and \$1 million of postretirement net periodic benefit income below operating income.
- 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.
- ASU No. 2017-12, *Derivatives and Hedging (Topic 815)—Targeted Improvements to Accounting for Hedging Activities*, which 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 amended guidance did not have any impact on RAI's results of operations, cash flows and financial position.
- ASU No. 2018-02, *Income Statement—Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income*, which permits, but does not require, companies to reclassify stranded tax effects caused by 2017 tax reform from accumulated other comprehensive income to retained earnings. RAI adopted this guidance in 2018, which resulted in a reclassification of approximately \$55 million in accumulated other comprehensive loss to retained earnings.

### *Recently Issued Accounting Pronouncements*

In February 2016, the Financial Accounting Standards Board, referred to as 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 the lease obligations and related right-of-use assets for both operating and finance leases to be recognized on 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 adopted the new standard on January 1, 2019 and utilized the transition methodology outlined in ASU 2018-11 which allows entities to initially apply ASC 842 at the adoption date and recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption for the difference between the lease obligations

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

and right-of-use assets that are recognized. RAI will not reassess whether any expired or existing contracts are or contain leases. Upon adoption of ASC 842, RAI recognized a right-of-use asset and a lease obligation of approximately \$65 million in its consolidated balance sheet.

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 is not expected to have a material impact on RAI's results of operations, cash flows and financial position.

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

In August 2018, the FASB issued ASU 2018-14, *Compensation—Retirement Benefits - Defined Benefit Plans—General (Subtopic 715-20)—Disclosure Framework—Changes to the Disclosure Requirements for Defined Benefit Plans*, which revises the financial statement footnote disclosure requirements of ASC 715-20 for defined benefit plan sponsors. Certain disclosure requirements will be removed, added or clarified. The ASU is effective for public company financial statements for fiscal periods ending after December 15, 2020, and for all other entities a year later. Early adoption is permitted. The ASU provisions should be applied on a retrospective basis to all periods presented. RAI is evaluating the timing of this amended guidance which is not expected have a material effect 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 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 11.

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 11.

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



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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, 2018 and 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 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, 2018, RAI guaranteed \$4.2 billion in aggregate principal amount of debt securities in multiple series issued by two BAT subsidiaries pursuant to Rule 144A and Regulation S, with maturities ranging from 2020 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.

*Delisting of RAI Common Stock.* 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 Securities Exchange Act of 1934, referred to as 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 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.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

### Note 3 — Intangible Assets

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

<b>Net goodwill balance as of December 31, 2016</b>	\$ 15,992
Foreign currency translation	<u>1</u>
<b>Net goodwill balance as of December 31, 2017</b>	15,993
Foreign currency translation	(1)
Divestiture	<u>(8)</u>
<b>Net goodwill balance as of December 31, 2018</b>	<u>\$ 15,984</u>

Net goodwill balances as of December 31, 2018, 2017 and 2016 have been reduced by accumulated impairment charges of \$3,791 million.

Effective January 1, 2018, RAI determined that certain trademarks and other intangibles previously accounted for as indefinite-lived intangibles should be accounted for as finite-lived intangibles and began amortizing these intangibles over periods ranging from 5 years to 20 years. There were no changes to indefinite-lived intangibles in 2017.

The carrying amounts of indefinite-lived intangibles were as follows:

	<u>Trademarks</u>	<u>Other</u>
<b>Balance as of December 31, 2017 and 2016</b>	\$ 29,098	\$ 87
Reclassified to finite-lived	<u>(250)</u>	<u>(51)</u>
<b>Balance as of December 31, 2018</b>	<u>\$ 28,848</u>	<u>\$ 36</u>

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

	<u>Trademarks</u>	<u>Other</u>
<b>Balance as of December 31, 2016</b>	\$ 17	\$ 242
Amortization	<u>(6)</u>	<u>(17)</u>
<b>Balance as of December 31, 2017</b>	11	225
Acquisitions	2	79
Amortization	(20)	(30)
Impairment	(5)	—
Reclassification from indefinite-lived	<u>250</u>	<u>51</u>
<b>Balance as of December 31, 2018</b>	<u>\$ 238</u>	<u>\$ 325</u>

Details of finite-lived intangible assets at December 31 were as follows:

	<u>2018</u>			<u>2017</u>		
	<u>Gross</u>	<u>Accumulated Amortization</u>	<u>Net</u>	<u>Gross</u>	<u>Accumulated Amortization</u>	<u>Net</u>
Customer lists	\$ 240	\$ (43)	\$ 197	\$ 240	\$ (31)	\$ 209
Contract manufacturing agreement	151	(151)	—	151	(147)	4
Trademarks	376	(138)	238	124	(113)	11
Other intangibles	145	(17)	128	15	(3)	12
	<u>\$ 912</u>	<u>\$ (349)</u>	<u>\$ 563</u>	<u>\$ 530</u>	<u>\$ (294)</u>	<u>\$ 236</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>
2019	\$ 55
2020	54
2021	53
2022	50
2023	43
Thereafter	308
	<u>\$ 563</u>

The impairment testing of trademarks in the fourth quarters of 2018 and 2017 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 2018 and 2017. 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.

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 2018 and 2017 of 9.75% for each of RJR Tobacco and American Snuff Co. and 10.25% for SFNTC. 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 2018 or 2017.

### Note 4 — Inventories

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

	<u>2018</u>	<u>2017</u>
Leaf tobacco	\$ 1,326	\$ 1,323
Other raw materials	74	100
Work in process	80	71
Finished products	143	140
Other	22	23
Total	1,645	1,657
LIFO allowance	(173)	(130)
	<u>\$ 1,472</u>	<u>\$ 1,527</u>

Inventories valued under the LIFO method were \$641 million and \$735 million at December 31, 2018 and 2017, respectively, net of the LIFO allowance. The LIFO allowance reflects the excess of the current cost of LIFO inventories at December 31, 2018 and 2017, over the amount at which these inventories were carried on the consolidated balance sheets. RAI recognized expense of \$43 million and income of \$9 million from LIFO inventory changes during 2018 and 2017, respectively.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

### Note 5 — Other Current Liabilities

Other current liabilities at December 31 included the following:

	2018	2017
Payroll and employee benefits	\$ 154	\$ 172
Pension and postretirement benefits	86	89
Marketing and advertising	251	108
Excise, franchise and property taxes	150	136
Litigation	105	137
Interest payable	116	117
Income taxes	133	—
Other	185	182
	<u>\$ 1,180</u>	<u>\$ 941</u>

### Note 6 — Income Taxes

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

	2018	2017
Current:		
Federal	\$ 1,425	\$ 974
State and other	329	187
	<u>1,754</u>	<u>1,161</u>
Deferred:		
Federal	(272)	(3,173)
State and other	(87)	115
	<u>(359)</u>	<u>(3,058)</u>
Provision for (benefit from) income taxes	<u>\$ 1,395</u>	<u>\$ (1,897)</u>

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

	2018	2017
Deferred tax assets:		
Pension and postretirement liabilities	\$ 343	\$ 388
Tobacco settlement accruals	634	181
Other accrued liabilities	97	88
Other noncurrent liabilities	107	138
Subtotal	1,181	795
Less: valuation allowance	(3)	(3)
	<u>1,178</u>	<u>792</u>
Deferred tax liabilities:		
Inventories	(136)	(160)
Property and equipment	(194)	(182)
Trademarks and other intangibles	(7,010)	(7,035)
Other	(38)	(25)
	<u>(7,378)</u>	<u>(7,402)</u>
Net deferred tax liability	<u>\$ (6,200)</u>	<u>\$ (6,610)</u>

RAI had no federal capital loss carryforwards at December 31, 2018 and 2017, respectively.

As of December 31, 2018, and 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 this deferred tax asset will not be realized through the generation of future state taxable income.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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

	2018	2017
Domestic (includes U.S. exports)	\$ 5,685	\$ 5,139
Foreign	(6)	(15)
	<u>\$ 5,679</u>	<u>\$ 5,124</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:

	2018	2017
Income taxes computed at the statutory U.S. federal income tax rate	\$ 1,193	\$ 1,793
State and local income taxes, net of federal tax benefits	174	174
Domestic manufacturing deduction	—	(82)
Tax impact of U.S. federal tax reform	(7)	(3,793)
Other items, net	35	11
Provision for (benefit from) income taxes	<u>\$ 1,395</u>	<u>\$ (1,897)</u>
Effective tax rate	<u>24.6%</u>	<u>(37.0%)</u>

The effective tax rate for 2018 was impacted by state income taxes and certain nondeductible items. The effective tax rate for 2017 was impacted by federal tax reform, the domestic manufacturing deduction, state income taxes and certain nondeductible items. Enacted on December 22, 2017, the Tax Reform Act reduced the U.S. federal statutory corporate income tax rate from 35 percent to 21 percent for tax years beginning on or after 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%.

Staff Accounting Bulletin, 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 include two major categories: (i) remeasurement of deferred tax assets/liabilities and (ii) recognition of liabilities for taxes on mandatory deemed repatriation (Transition Tax). As of December 31, 2017, the provisional tax benefit of \$3,793 million included a \$3,836 tax benefit for the remeasurement of deferred tax assets/liabilities and a \$43 million tax expense related to the Transition Tax. This provisional amount was based on pretax cumulative timing differences at December 31, 2017 and an estimate of post-1986 earnings and profits of RAI's controlled foreign corporations as of the enactment date. Upon completing the analysis of the Tax Reform Act and subsequent regulations, RAI recorded an additional \$11 million tax benefit for the remeasurement of deferred tax assets/liabilities and a \$4 million tax expense for additional Transition Tax. As of December 31, 2018, RAI's accounting for the Tax Reform Act is complete.

At December 31, 2018, there was \$373 million of accumulated and undistributed foreign earnings. RAI has recorded either current or deferred income taxes related to the \$373 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:

	2018	2017
Retirement benefits	\$ 155	\$ 168
Cumulative translation adjustment and other	6	17
	<u>\$ 161</u>	<u>\$ 185</u>

In February 2018, the Financial Accounting Standard Board issued ASU 2018-02 which permits a reclassification from accumulated other comprehensive income (loss) to retained earnings for stranded tax effects that do not reflect the appropriate tax rates as a result of the Tax Reform Act. RAI adopted this standard during 2018 and reclassified \$55 million from accumulated other comprehensive loss to retained earnings.

## 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:

	<u>2018</u>	<u>2017</u>
Unrecognized tax benefits	\$ 163	\$ 147
Accrued interest	22	17
Accrued penalties	6	6
	<u>\$ 191</u>	<u>\$ 170</u>

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

	<u>2018</u>	<u>2017</u>
Balance at beginning of year	\$ 147	\$ 118
Gross increases related to current period tax positions	23	32
Gross increases related to tax positions in prior periods	36	2
Gross decreases related to tax positions in prior periods	(30)	(2)
Gross (decreases) increases related to audit settlements	(3)	1
Gross decreases related to lapse of applicable statute of limitations	(10)	(4)
Balance at end of year	<u>\$ 163</u>	<u>\$ 147</u>

At December 31, 2018, \$151 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 and various state and foreign 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.

The federal statute of limitations remains open for the year 2016 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 United States federal income tax return of BHI. For state income tax purposes RAI's results are included in 26 combined state income tax returns that include members of the consolidated United States federal income tax return of BHI. For financial reporting purposes, RAI's current and deferred income taxes are calculated using the separate return method under ASC 740-10-30-27. All current and deferred tax expense and current and deferred tax liabilities are calculated as if RAI files separate federal and state income tax returns that exclude the income, deductions and tax attributes of BHI.

### Note 7 — Credit Agreement

RAI entered into a 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 was 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.

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 8 — 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*

	For the years ended December 31,	
	2018	2017
<b>RAI</b>		
2.300% notes due 06/12/2018	\$ —	\$ 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	10,969	12,219
Fair value adjustments	164	225
Unamortized discounts	(24)	(26)
Unamortized debt issuance costs	(53)	(60)
Total RAI long-term debt at carrying value	\$ 11,056	\$ 12,358
<b>RJR Tobacco</b>		
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	231	231
Fair value adjustments	13	21
Total RJR Tobacco long-term debt at carrying value	\$ 244	\$ 252
Total long-term debt at carrying value	\$ 11,300	\$ 12,610
Less current maturities of long-term debt at carrying value	772	1,249
Total long-term debt (less current maturities) at carrying value	\$ 10,528	\$ 11,361

\* 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

As of December 31, 2018, 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
2019	\$ 669	81	\$ 750
2020	1,412	109	1,521
2022	1,158	—	1,158
2023	580	19	599
2024 and thereafter	7,150	22	7,172
	<u>\$ 10,969</u>	<u>\$ 231</u>	<u>\$ 11,200</u>

### *Fair Value of Debt*

The estimated fair value of RAI's outstanding consolidated debt, in the aggregate, was \$11.0 billion and \$14.1 billion as of December 31, 2018 and 2017, respectively, with an effective annual interest rate of approximately 5.4% and 5.1% for the years ended December 31, 2018 and 2017, respectively. The fair value is derived from a third-party pricing source and is classified in Level 2 of the fair value hierarchy.

## **Note 9 — 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 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.



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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.

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, 2018, contains accruals for approximately \$105 million for *Engle* Progeny cases as set forth below under “— Litigation Affecting the Cigarette Industry – *Engle* and *Engle* Progeny Cases.” In 2018, RJR Tobacco paid approximately \$334 million in satisfaction of judgments, including attorneys’ fees and interest, in *Engle* Progeny Cases. 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.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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.

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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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 2018, 85 tobacco-related cases were served against Reynolds Defendants. On December 31, 2018, there were, subject to the exclusions described immediately below, 226 cases pending against Reynolds Defendants: 209 in the United States and 17 in Canada, as compared with 236 total cases on December 31, 2017. Of the U.S. cases pending on December 31, 2018, 37 are pending in federal court, 171 in state court and one in tribal court, primarily in the following states: Florida (49 cases); Massachusetts (38 cases); Illinois (36 cases); New York (17 cases); New Mexico (17 cases); and Louisiana (10 cases). The U.S. case number excludes the 2,268 *Engle* Progeny cases, involving approximately 2,841 individual plaintiffs, and 1,406 *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, 2018, and the change in the number of cases pending against Reynolds Defendants since December 31, 2017, and a cross-reference to the discussion of each case type.

Case Type	U.S. Case Numbers as of December 31, 2018	Change in Number of Cases Since December 31, 2017 Increase/(Decrease)
Individual Smoking and Health Cases	111	12
<i>West Virginia IPIC</i> (Number of Plaintiffs)	1 (1)	No change (563)
<i>Engle</i> Progeny Cases (Number of Plaintiffs)**	2,268 (approx. 2,841)	(301) (435)
<i>Broin II</i> Cases	1,406	(915)
Class-Action Suits	23	(4)
Filter Cases	58	(12)
Health-Care Cost Recovery Cases	2	No change
State Settlement Agreements—Enforcement and Validity; Adjustments	3	1
Other Litigation and Developments	14	(4)

\*\* 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, 2,268 *Engle* Progeny cases were pending as of December 31, 2018, that included claims asserted on behalf of 2,841 plaintiffs. Following an agreement to

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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 300 *Engle* Progeny trials in Florida state or federal courts involving RJR Tobacco or Lorillard Tobacco. As described more fully immediately below in “— *Scheduled Trials*” and “—*Trial Results*,” additional *Engle* Progeny cases involving RJR Tobacco are being tried and set for trial on an ongoing basis. Juries in *Engle* Progeny cases have awarded substantial amounts in compensatory and punitive damage awards, many of which currently are at various stages in the appellate process. RJR Tobacco and Lorillard Tobacco also have paid substantial amounts in compensatory and punitive damage awards in *Engle* Progeny cases. For a detailed description of these cases, see “— *Engle* and *Engle* Progeny cases” below.

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

- settled all health-care cost recovery actions brought by, or on behalf of, the settling jurisdictions;
- released the major U.S. cigarette manufacturers from various additional present and potential future claims;
- imposed future payment obligations in perpetuity on RJR Tobacco, B&W, Lorillard Tobacco and other major U.S. cigarette manufacturers; and
- placed significant restrictions on their ability to market and sell cigarettes and smokeless tobacco products.

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

*Scheduled Trials.* Trial schedules are subject to change, and many cases are dismissed before trial. There are 34 cases, exclusive of *Engle* Progeny cases, scheduled for trial as of December 31, 2018 through December 31, 2019, for RJR Tobacco, B&W, Lorillard Tobacco or their affiliates and indemnitees: 12 individual smoking and health cases, 20 Filter Cases, and one other non-smoking and health cases. There are also approximately 135 *Engle* Progeny cases against RJR Tobacco, B&W and/or Lorillard Tobacco set for trial through December 31, 2019. It is not known how many of these cases will actually be tried.

*Trial Results.* From January 1, 2016 through December 31, 2018, 117 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 13 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 26 mistrials in Florida. Verdicts in favor of the plaintiffs were returned in 50 cases tried in Florida (47), the U.S. Virgin Islands (2), and Massachusetts (1). Five cases in Florida were dismissed during trial. Two cases were continued during trial. Four cases were punitive damages re-trials and one case was resolved during trial.

In 2018, 37 *Engle* Progeny cases in which RJR Tobacco and/or Lorillard Tobacco was a defendant were tried:

Total number of trials	37
Number of trials resulting in plaintiffs' verdicts	18
Total damages awarded in final judgments against RJR Tobacco	\$131,012,250
Amount of overall damages comprising 'compensatory damages' (approximately)	\$56,396,250 (of overall \$131,012,250)
Amount of overall damages comprising 'punitive damages' (approximately)	\$74,616,000 (of overall \$131,012,250)
Number of adverse judgments appealed by RJR Tobacco	11
Number of adverse judgments (not yet appealed), in which RJR Tobacco still has time to file an appeal	4
Number of adverse judgments in which no appeal was sought	3

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

In addition, since the end of 2018, six other *Engle* Progeny cases, in which RJR Tobacco, B&W, and/or Lorillard were a defendant were tried:

- In *Kelley v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of the plaintiff, found the decedent 35% at fault and RJR Tobacco 65% at fault, and awarded \$2 million in compensatory damages and no punitive damages.
- In *Russell v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of RJR Tobacco.
- In *Gaboury v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of RJR Tobacco.
- In the *Pollari v. R. J. Reynolds Tobacco Co.* retrial, the jury returned a verdict in favor of the defendants, including RJR Tobacco.
- In the *Bessent-Dixon v. R. J. Reynolds Tobacco Co.* punitive damages retrial, the jury returned a punitive damages award in the amount of \$13.5 million.
- In *Gafney v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of the plaintiff, found the decedent 75% at fault and RJR Tobacco 25% at fault, and awarded \$1 million in compensatory damages and no punitive damages.

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

In 2018, three non-*Engle* Progeny individual smoking and health cases, in which RJR Tobacco, B&W and/or Lorillard Tobacco was a defendant, were tried:

- In *Brown v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of the plaintiff, found the decedent 30% at fault and Lorillard 70% at fault, and awarded \$70 million in compensatory damages and \$12.3 million in punitive damages.
- In *Gerald v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of the plaintiff, found the decedent 40% at fault and Lorillard 60% at fault, and awarded \$1 million in compensatory damages and \$30 million in punitive damages.
- In *Summerlin v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of the plaintiff and awarded \$13.1 million in compensatory damages and \$30 million in punitive damages.

Since the end of 2018, one non-*Engle* individual smoking and health case, in which RJR Tobacco, B&W, and/or Lorillard was a defendant was tried:

- In *Warshafsky v. R. J. Reynolds Tobacco Co.*, the jury returned a verdict in favor of the plaintiff, found the decedent 49% at fault and RJR Tobacco 51% at fault, and awarded \$300,000 in compensatory damages and no punitive damages.

In 2018, one Filter case, in which RJR Tobacco and/or Lorillard Tobacco was a defendant, was tried.

- In *Berg v. R. J. Reynolds Tobacco Co.*, et al., trial began on April 10, 2018. However, the parties resolved the case during trial on April 25, 2018.

For information on the verdicts in the *Engle* Progeny cases that have been tried and remain pending as of December 31, 2018, 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, 2018, in which verdicts have been returned against RJR Tobacco, B&W or Lorillard Tobacco, or all three.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

<b>Date of Verdict</b>	<b>Case Name/Type</b>	<b>Jurisdiction</b>	<b>Verdict</b>	<b>Status</b>
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.	Compelled public statements began appearing in US newspapers on November 27, 2017 and ran serially over four months. They began appearing on national US broadcast television networks on November 27, 2017 and ran several times per week for one year. The statements also began appearing on RJR Tobacco websites on June 18, 2018 and first appeared on package onserts beginning in November 2018 (the onserts will be distributed periodically through mid-2020). The district court is considering mandating the display of the compelled public statements at retail point of sale and briefing on that issue concluded on September 14, 2018.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

Date of Verdict	Case Name/Type	Jurisdiction	Verdict	Status
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.	On February 26, 2018, the U.S. Supreme Court denied RJR Tobacco's petition for writ of certiorari. On December 13, 2018, the trial court entered final judgment in the amount of \$52 million (\$8 million in compensatory damages, \$8 million in punitive damages and \$36 million in pre-judgment interest). The plaintiff and defendant filed motions to alter or amend the judgment. A decision is pending. RJR Tobacco will appeal.
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 October 15, 2018, the Florida Supreme Court issued a decision reversing the Fourth DCA's opinion, which reversed the trial court's final judgment, and reinstated the full final judgment in favor of the plaintiff. RJR Tobacco filed a motion for rehearing on November 6, 2018, which was denied on December 6, 2018. RJR Tobacco paid approximately \$4.5 million in satisfaction of the judgment on December 20, 2018.
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. RJR Tobacco paid approximately \$15.2 million in satisfaction of the judgment on February 23, 2018.
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.	On May 25, 2018, final judgment was entered against RJR Tobacco in the amount of approximately \$72,000 in compensatory damages and \$930,000 in punitive damages. RJR Tobacco filed a notice of appeal to the Fifth DCA on June 18, 2018 and posted a supersedeas bond in the amount of approximately \$1 million on June 22, 2018. Briefing is underway.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

Date of Verdict	Case Name/Type	Jurisdiction	Verdict	Status
August 23, 2018	<i>Brown v. R. J. Reynolds Tobacco Co.</i> [Individual]	Superior Court, Division of St. Thomas and St. John, Virgin Islands	\$70 million in compensatory damages; 70% of fault assigned to Lorillard; \$12.3 million in punitive damages. Comparative fault did not apply to the final judgment.	Final judgment was entered on December 12, 2018; RJR Tobacco filed post-trial motions on January 10, 2019 and plans to appeal.
August 24, 2018	<i>Gerald v. R. J. Reynolds Tobacco Co.</i> [Individual]	Superior Court, Division of St. Thomas and St. John, Virgin Islands	\$1 million in compensatory damages; 60% of fault assigned to Lorillard; \$30 million in punitive damages. Comparative fault did not apply to the final judgment.	Final judgment was entered on December 12, 2018; RJR Tobacco filed post-trial motions on January 10, 2019 and plans to appeal.
October 12, 2018	<i>Summerlin v. R. J. Reynolds Tobacco Co.</i> [Individual]	Superior Court, Middlesex County, Massachusetts (Boston, MA)	\$13.1 million in compensatory damages; \$30 million in punitive damages	Final judgment has not been entered; hearing occurred on January 18, 2019 on the plaintiff's remaining Chapter 93A claim, which the court decides post-trial under Massachusetts law; a decision is pending; RJR Tobacco will file post-trial motions and will appeal.
February 4, 2019	<i>Warshafsky v. R. J. Reynolds Tobacco Co.</i> [Individual]	Superior Court, Middlesex County, Massachusetts (Boston, MA)	\$300,000 in compensatory damages; no punitive damages	Final judgment on the claims decided by the jury was entered on February 7, 2019, and an amended final judgment in which the judge also denied the Chapter 93A claim was entered on February 13, 2019.

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, 2018, 111 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. All of those claims have been dismissed with prejudice, with the agreement that each plaintiff who submits a release within one year will receive the agreed payment of \$7,000 from the appropriate defendant.



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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. On April 27, 2018, the court dismissed the claims of those 41 plaintiffs with prejudice. In the final weeks of the case in the trial court, one plaintiff sought to pursue a roll-your-own claim that had long been dormant. The trial court denied that request and that one plaintiff appealed to the West Virginia Supreme Court on May 8, 2018. That appeal has been fully briefed, and a decision is pending.

### *Engle and Engle Progeny Cases*

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

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

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

In the year after the Florida Supreme Court's *Engle* decision, putative class members filed thousands of individual actions against RJR Tobacco, B&W, Lorillard Tobacco, Philip Morris USA Inc., and the other *Engle* defendants, which actions commonly are referred to as *Engle* Progeny cases. As of December 31, 2018, 2,262 *Engle* Progeny cases were pending in state courts, and 6 *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 2,841 plaintiffs. As of December 31, 2018, 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.

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,

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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 nine *Engle* Progeny cases have been tried in Florida state and federal courts since the beginning of 2016 through December 31, 2018, and additional state court trials are scheduled for 2019. Since the beginning of 2016 through December 31, 2018, RJR Tobacco or Lorillard Tobacco has paid judgments in 49 *Engle* Progeny cases. Those payments totaled \$503 million and included \$371 million for compensatory or punitive damages and \$132 million for attorneys' fees and statutory interest. The payments made in 2018 are detailed in the following chart:

**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>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.
<i>Ahrens</i>	44%	—	5,800,000 <sup>(2)</sup>	2,500,000	Second DCA affirmed the final judgment, <i>per curiam</i> ; 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; on March 16, 2018, the Florida Supreme Court denied RJR Tobacco's petition for review. RJR Tobacco paid approximately \$10.4 million in satisfaction of the judgment on May 17, 2018.

# 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>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 \$22.5 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 March 16, 2018, the Florida Supreme Court denied the defendants' petition for review. RJR Tobacco paid approximately \$20.4 million in satisfaction of the judgment on May 17, 2018.
<i>Mathis</i>	55%	—	5,000,000 <sup>(2)</sup>	—	Third DCA affirmed the final judgment, <i>per curiam</i> 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.

# 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>Putney</i>	30%	—	\$ 100,000	\$ 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 was scheduled for September 24, 2018. The parties resolved the case on July 11, 2018. RJR Tobacco paid approximately \$6 million in satisfaction of the judgment on July 19, 2018.
<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 en banc; the First DCA dissolved en banc proceedings on October 18, 2017; Florida Supreme Court denied the defendants' petition for review on February 9, 2018; RJR Tobacco paid approximately \$14.3 million in satisfaction of the judgment on May 17, 2018.
<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; RJR Tobacco paid approximately \$624,000 in satisfaction of the judgment on May 17, 2018.
<i>Marotta</i>	58%	—	3,480,000	300,000	Florida Supreme Court found that federal law does not preempt the plaintiff's claims; remanded for further proceedings regarding punitive damages; Retrial on punitive damages began on July 18, 2018; On July 27, 2018, the jury found that punitive damages were warranted, and on July 30, 2018, returned a punitive damages verdict against RJR Tobacco in the amount of \$300,000; on October 2, 2018, an amended final judgment was entered in the amount of approximately \$3.5 million in compensatory damages and \$300,000 in punitive damages against RJR Tobacco; RJR Tobacco paid approximately \$8.24 million in satisfaction of the judgment on October 19, 2018.

# 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>Grossman</i>	75%	—	15,351,700	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; on June 25, 2018, the Florida Supreme Court accepted jurisdiction of the case, quashed the January 4, 2017 opinion of the Fourth DCA, and remanded the case to the Fourth DCA for reinstatement of the jury verdict in favor of the plaintiff without a reduction based on comparative fault in light of <i>Schoeff</i> ; on July 11, 2018, the Fourth DCA quashed its January 4, 2017 opinion, affirmed the final judgment and remanded the case to the trial court for reinstatement of the entire amount of damages awarded by the jury; RJR Tobacco paid approximately \$47 million in satisfaction of the judgment on July 19, 2018.
<i>Burkhart</i>	25%	10%	3,500,000 <sup>(2)</sup>	1,750,000	On March 7, 2018, the Eleventh Circuit affirmed the final judgment of the trial court; defendants filed a motion for rehearing on March 28, 2018, but that motion was denied on May 2, 2018; RJR Tobacco paid approximately \$5.3 million in satisfaction of the judgment on May 17, 2018.

# 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>Perrotto</i>	20%	6%	1,063,000	500,000	Plaintiff's motion for a new trial granted as to punitive damages; new trial on punitive damages began on June 1, 2018; on June 14, 2018, the jury found that punitive damages were warranted against RJR Tobacco but not the remaining defendant; on June 15, 2018, the jury returned a punitive damages award in the amount of \$500,000; a second amended final judgment was entered on July 17, 2018 against RJR Tobacco in the amount of approximately \$1.06 million in compensatory damages and \$500,000 in punitive damages and against the remaining defendant in the amount of approximately \$1.02 million in compensatory damages; on September 14, 2018, RJR Tobacco paid approximately \$1.8 million in satisfaction of the judgment.
<i>Ellen Gray</i>	50%	—	3,000,000	—	On March 19, 2018, RJR Tobacco filed a motion to voluntarily dismiss appeal and joint stipulation of parties; On March 19, 2018, RJR Tobacco paid approximately \$3.5 million in satisfaction of the judgment; the appeal was dismissed on March 20, 2018.
<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; RJR Tobacco paid approximately \$102,000 in satisfaction of the judgment on March 6, 2018.

# 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>Gore</i>	23%	—	1,000,000		— On February 14, 2018, the Fourth DCA found that the plaintiff should be permitted to seek damages on his claims for negligence and strict liability and that the plaintiff's compensatory damages award should not have been reduced by comparative fault because the jury found for the plaintiff on the intentional tort claims; as a result, the trial court's judgment was reversed and the case remanded to the trial court for further proceedings; on July 10, 2018, the court entered an amended partial judgment in the amount of \$2 million in compensatory damages, jointly and severally, against RJR Tobacco and the remaining defendant; on August 6, 2018, the defendants filed a notice of appeal to the Fourth DCA and filed a petition for writ of certiorari with the Fourth DCA seeking to quash the final judgment; on September 18, 2018, the plaintiff filed a notice of waiver and voluntary dismissal of punitive damages claim on his non-intentional tort claims, and the defendants filed notices of dismissal of their cert. petition and notice of appeal in the Fourth DCA; RJR Tobacco paid approximately \$1.15 million in satisfaction of the judgment on September 28, 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; RJR Tobacco paid \$41 million in satisfaction of the judgment on May 17, 2018.
<i>Enochs</i>	66%	—	13,860,000	6,250,000	Defendants filed a notice to invoke the discretionary jurisdiction of the Florida Supreme Court on November 10, 2017, which was denied on March 12, 2018; RJR Tobacco paid approximately \$23.5 million in satisfaction of the judgment on May 17, 2018.
<i>Dion</i>	75%	—	12,000,000 <sup>(2)</sup>	30,000	RJR Tobacco filed a notice to invoke the discretionary jurisdiction of the Florida Supreme Court on December 6, 2017, which was denied on March 16, 2018; RJR Tobacco paid approximately \$17.2 million in satisfaction of the judgment on May 17, 2018.



**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>McCabe</i>	30%	—	1,500,000	6,500,000	Second DCA affirmed the final judgment of the trial court, <i>per curiam</i> , on May 18, 2018; RJR Tobacco paid approximately \$8.8 million in satisfaction of the judgment on June 20, 2018.
<i>Sermons</i>	5%	—	3,250	17,075	On September 12, 2018, the parties filed a stipulation for voluntary dismissal with prejudice as to the defendants; RJR Tobacco paid approximately \$80,000 in satisfaction of the judgment on July 3, 2018.
<i>Sherry Smith</i>	65%	—	3,000,000 <sup>(2)</sup>	—	Fifth DCA affirmed the judgment of the trial court, <i>per curiam</i> , on March 27, 2018; RJR Tobacco paid approximately \$5 million in satisfaction of the judgment on May 17, 2018.
<i>Howles</i>	50%	—	2,000,000	3,000,000	Fourth DCA, on March 15, 2018, affirmed the trial court's final judgment; RJR Tobacco paid approximately \$6 million in satisfaction of the judgment on May 18, 2018.
<i>Shadd</i>	5%	—	3,250	—	Plaintiff filed a notice of dismissal of her appeal in the Fourth DCA; RJR Tobacco paid approximately \$75,000 in satisfaction of the judgment on February 2, 2018.
<i>Simon</i>	45%	—	450,000	—	Final judgment was entered on October 4, 2018 against RJR Tobacco in the amount of \$450,000 in compensatory damages and \$200,000 in compensatory damages against the remaining defendant; RJR Tobacco paid approximately \$484,000 in satisfaction of the judgment on October 10, 2018.
Totals			<u>\$ 118,055,700</u>	<u>\$ 139,533,075</u>	

In addition, as of December 31, 2018, \$104.9 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**

<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>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> ; in the punitive damages retrial, on February 27, 2018, the jury did not award punitive damages; the plaintiff filed a motion for a new trial on March 24, 2018; the motion was denied on January 25, 2019.
<i>Searcy</i>	30%	—	500,000 <sup>(2)</sup>	1,670,000	On September 5, 2018, the Eleventh Circuit affirmed the final judgment of the trial court, after application of the remittitur, which reduced the compensatory damages to \$1 million and the punitive damages against each defendant to \$1.67 million. On November 19, 2018, the defendants filed a petition for writ of certiorari with the U.S. Supreme Court; the U.S. Supreme Court denied RJR Tobacco's petition for review on February 25, 2019.
<i>Bakst (Odom)</i>	75%	—	4,504,029	14,000,000	Florida Supreme Court accepted jurisdiction on December 5, 2017; on September 20, 2018, the Florida Supreme Court remanded the case for reinstatement of the trial court's verdict; on November 7, 2018, the Fourth DCA, in accordance with the Florida Supreme Court's mandate, affirmed the final judgment and remanded the case to the trial court for reinstatement of the final judgment; on December 17, 2018, RJR Tobacco filed a petition for a writ of certiorari with the U.S. Supreme Court; a decision is pending
<i>Nally</i>	75%	—	6,000,000 <sup>(2)</sup>	12,000,000	Second DCA affirmed the final judgment of the trial court, <i>per curiam</i> , on September 28, 2018; on January 10, 2019, RJR Tobacco filed a petition for writ of certiorari with the U.S. Supreme Court; the U.S. Supreme Court denied RJR Tobacco's petition for review on February 25, 2019.
<i>Johnston</i>	90%	—	6,750,000	14,000,000	Second DCA, on September 28, 2018, affirmed the trial court's final judgment, <i>per curiam</i> ; on January 10, 2019, RJR Tobacco filed a petition for writ of certiorari with the U.S. Supreme Court; the U.S. Supreme Court denied RJR Tobacco's petition for review on February 25, 2019.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

<i>Pardue</i>	50%	—	3,467,000 <sup>(2)</sup>	6,750,000	First DCA, on June 13, 2018, affirmed the final judgment of the trial court, <i>per curiam</i> ; on November 9, 2018, RJR Tobacco and the other defendant filed a petition for a writ of certiorari with the U.S. Supreme Court; the U.S. Supreme Court denied RJR Tobacco's petition for review on February 25, 2019.
<i>Fox</i>	50%	—	3,000,000	—	Fourth DCA, on November 29, 2018, affirmed the trial court's final judgment, <i>per curiam</i> ; deadline for RJR Tobacco to file a petition for writ of certiorari with the U.S. Supreme Court is February 27, 2019.
<i>Lima</i>	60%	—	1,800,000	12,000,000	Second DCA, on January 2, 2019, affirmed the trial court's final judgment, <i>per curiam</i> ; deadline for RJR Tobacco to file a petition for writ of certiorari with the U.S. Supreme Court is April 2, 2019.
Totals			<u>\$ 26,071,029</u>	<u>\$ 60,420,000</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 \$18.5 million in *Starr-Blundell*, *Fox*, *Johnston*, *Nally*, *Odom*, *Pardue*, *Searcy* and *Lima*.

<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, 2018, 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, 2018. This chart does not include the mistrials or verdicts returned in favor of RJR Tobacco, B&W, and/or Lorillard Tobacco.

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>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; the new trial is scheduled for August 2019.
<i>Robinson</i>	71%	—	—	—	— On December 4, 2017, the Florida Supreme Court denied the plaintiff's petition for review; the new trial is scheduled for June 10, 2019; on January 28, 2019, RJR Tobacco filed a motion for a change of venue due to prejudicial pretrial publicity; a decision is pending.

# 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>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%	—		— Florida Supreme Court accepted jurisdiction of the case on July 18, 2018; on February 5, 2019, the Florida Supreme Court dismissed the plaintiff's petition for review finding that the court had determined that it lacked jurisdiction, and it therefore dismissed the petition as improvidently granted; deadline for the plaintiff to file a petition for writ of certiorari to the U.S. Supreme Court is May 6, 2019.
<i>Kerrivan</i>	31%	—	6,046,660 <sup>(2)</sup>	9,600,000	Post-trial motions were denied on June 20, 2018; defendants filed a notice of appeal to the Eleventh Circuit on July 19, 2018; plaintiff filed a notice of cross appeal on July 25, 2018; briefing is complete; oral argument has not been scheduled.
<i>Schleider</i>	70%	—	14,700,000		— Third DCA, on December 26, 2018, affirmed the trial court's judgment in a written opinion; on January 23, 2019, the plaintiff filed a motion for rehearing, which was denied on February 14, 2019; deadline for RJR Tobacco to file a notice to invoke the discretionary jurisdiction of the Florida Supreme Court is March 18, 2019.
<i>Sowers</i>	50%	—	2,125,000		— Post-trial motions were denied on April 5, 2018; on May 4, 2018, RJR Tobacco filed a notice of appeal to the Eleventh Circuit, and the plaintiff filed a notice of cross appeal on May 6, 2018; briefing is complete; oral argument has not been scheduled.
<i>Rintoul (Caprio)</i>	20%	10%	—		— In the partially completed verdict, the jury found for the plaintiff on the issues of class membership and product-use causation; and awarded \$559,000 in economic damages. The verdict form indicated that the jury reached a verdict on the plaintiff's intentional tort claims, but the jury reported in a note to the court that it lacked unanimity on those questions. The jury also made findings on comparative fault that were inconsistent with the rest of its verdict, and it did not answer the verdict form questions relating to noneconomic damages and entitlement to punitive damages. In May 2015, the court denied the defendants' motion for a mistrial and advised that it accepted the questions answered by the jurors as a partial verdict. Defendants appealed, and in January 2017 the parties reached an agreement whereby the defendants dismissed their appeal and the plaintiff agreed to a complete retrial on all issues. The case remains pending in the trial court. The new trial has not been scheduled.

# 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>Pollari</i>	—	—	—		— 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, but dismissed her notice on January 28, 2019; the new trial began on January 14, 2019; on January 29, 2019, the jury returned a verdict in favor of the defendants, including RJR Tobacco; plaintiff filed a motion for a new trial on February 11, 2019; a decision is pending.
<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; punitive damages retrial began February 5, 2018; on February 15, 2018, the court granted RJR Tobacco's motion for directed verdict; plaintiff filed a notice of appeal to the Third DCA on May 4, 2018; RJR Tobacco filed a notice of cross appeal on May 15, 2018; briefing is underway.
<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 (Cooper)</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; new trial on punitive damages has not been scheduled.
<i>Duignan</i>	30%	—	—		— Second DCA reversed and remanded for a new trial on November 15, 2017; new trial began on November 26, 2018; the court declared a mistrial on November 28, 2018; retrial is scheduled for July 15, 2019.
<i>Ewing</i>	2%	—	4,800		— Pending – First DCA
<i>Oshinsky-Blacker</i>	25%	—	—		— On July 19, 2018, the Fourth DCA affirmed, <i>per curiam</i> , the trial court's order granting the defendants' motion for a new trial; new trial has not been scheduled.
<i>Prentice</i>	40%	—	6,400,000		— Pending – First DCA

# 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>Konzelman</i>	85%	—	7,476,000	20,000,000	Fourth DCA, on May 19, 2018, held that the pre-1999 version of the punitive damages statute “applies in an Engle Progeny personal injury suit that is converted into a wrongful death action upon the smoker’s death”; on the plaintiff’s cross appeal, the court found that the trial court erred in reducing the compensatory damages award based on comparative fault and remanded for further proceedings consistent with <i>Schoeff</i> ; RJR Tobacco filed a motion for rehearing or rehearing <i>en banc</i> on June 25, 2018; on August 10, 2018, the Fourth DCA denied RJR Tobacco’s motion for rehearing; RJR Tobacco filed a notice to invoke the discretionary jurisdiction of the Florida Supreme Court on September 11, 2018; briefing is complete.
<i>Ledo</i>	49%	—	2,940,000	—	Pending – Third DCA
<i>Marsh (Ford)</i>	15%	—	1,022,800	—	Fourth DCA, on December 5, 2018, found that the trial court erred in reducing the plaintiff’s compensatory damages award based on a finding of comparative fault; as a result, the final judgment was reversed and remanded to the trial court for reinstatement of the jury’s verdict; the issues on cross appeal were affirmed; on January 9, 2019, RJR Tobacco filed a motion for rehearing, rehearing <i>en banc</i> , certification, or written opinion, which was denied on January 28, 2019; deadline for RJR Tobacco to file a petition for writ of certiorari with the U.S. Supreme Court is April 29, 2019.
<i>Martin</i>	22%	—	1,190,400	200,000	Fourth DCA, on December 12, 2018, reversed the punitive damages awards against RJR Tobacco and the other defendant; it also reversed on the plaintiff’s cross appeal and reinstated the full compensatory damages award; the deadline for RJR Tobacco to file a petition for writ of certiorari with the U.S. Supreme Court is March 12, 2019.

# 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>John Brown</i>	35%	—	2,700,000 <sup>(2)</sup>	200,000	Second DCA, on December 7, 2018, affirmed the final judgment of the trial court, <i>per curiam</i> ; on January 7, 2019, the defendants filed motion for written opinion on the question of whether the trial court erred by failing to instruct the jury that plaintiff was required to prove that the decedent relied on a misleading statement in order to prevail on her claims for fraudulent concealment and conspiracy to conceal, motion to include in its opinion a citation to its decision in <i>Duignan</i> , which held that such a statement instruction is not required, and motion to certify a conflict with the First DCA's recent opinion in <i>Whitmire</i> , stating that an opinion that cites <i>Duignan</i> and certifies a conflict with <i>Whitmire</i> will permit the defendants to petition the U.S. Supreme Court for review; a decision on that motion is pending.
<i>Whitmire</i>	67%	—	2,010,000 <sup>(2)</sup>	—	On December 18, 2018, the First DCA affirmed in part and reversed in part. The Court reversed the trial court's denial of RJR Tobacco's motion for a directed verdict on the fraudulent concealment and conspiracy claims, finding that the plaintiff had failed to prove detrimental reliance through direct evidence; the court entered an amended final judgment, reducing the \$3 million compensatory damages award by \$990,000 (33%) to \$2.01 million; deadline for RJR Tobacco to file a petition for writ of certiorari with the U.S. Supreme Court is March 18, 2019.
<i>Santoro</i>	26%	—	417,000	90,000	Post-trial motions were denied on May 14, 2018; defendants filed a notice of appeal to the Fourth DCA on June 6, 2018; RJR Tobacco posted a supersedeas bond in the amount of \$535,000 on June 21, 2018; briefing is underway.
<i>Sheffield</i>	60%	—	1,800,000 <sup>(2)</sup>	—	Fifth DCA, on February 8, 2019, reversed the punitive damages award and remanded the case to the trial court for further proceedings; deadline for either party to file a post-decision motion is March 5, 2019; deadline to file a notice to invoke the discretionary jurisdiction of the Florida Supreme Court is March 12, 2019.
<i>Maloney</i>	50%	—	1,650,000 <sup>(2)</sup>	—	Pending – Second DCA
<i>Thomas</i>	55%	—	4,000,000	—	Fourth DCA, on February 13, 2019, reversed the final judgment and remanded the case to the trial court for reinstatement of the full amount of the jury's compensatory damages verdict.
<i>Wallace</i>	33%	—	3,960,000	8,000,000	Pending – Fifth DCA

# 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>Schleinstein</i>	100%	—	13,965,000	27,800,000	Post-trial motions were denied on March 15, 2018; the same day, the court entered an amended final judgment against RJR Tobacco in the amount of approximately \$13.97 million in compensatory damages and \$28 million in punitive damages; on April 13, 2018, RJR Tobacco filed a notice of appeal to the Fourth DCA; plaintiff filed a notice of cross appeal on April 16, 2018; RJR Tobacco posted a supersedeas bond in the amount of \$5 million on June 15, 2018; briefing is underway.
<i>Gloger</i>	50%	—	4,688,000	5,000,000	Defendants filed a joint notice of appeal to the Third DCA on February 20, 2018; RJR Tobacco posted a supersedeas bond in the amount of \$2.5 million on February 27, 2018; post-trial motions were denied on May 9, 2018; oral argument occurred on February 18, 2019; a decision is pending.
<i>Grafteo</i>	70%	—	4,500,000	15,000,000	Final judgment was entered against RJR Tobacco in the amount of \$4.5 million in compensatory damages and \$15 million in punitive damages on February 20, 2018; RJR Tobacco filed a notice of appeal to the Second DCA and posted a supersedeas bond in the amount of \$5 million on September 26, 2018; briefing is underway.
<i>Margaret Brown</i>	65%	—	3,250,000	8,500,000	Final judgment was entered on April 18, 2018; RJR Tobacco filed a notice of appeal to the Fifth DCA and posted a supersedeas bond in the amount of \$5 million on May 17, 2018; the plaintiff filed a notice of cross appeal on May 25, 2018; briefing is underway.
<i>Rozar</i>	10%	—	57,000	—	Final judgment was entered on August 23, 2018; the plaintiff filed a notice of appeal to the First DCA on September 17, 2018; RJR Tobacco filed a notice of cross appeal on September 24, 2018; briefing is underway.
<i>Theis</i>	15%	—	1,400,000	4,000,000	Final judgment was entered against RJR Tobacco and the remaining defendant, jointly and severally, in the amount of approximately \$7 million in compensatory damages and \$4 million in punitive damages against RJR Tobacco and \$10 million in punitive damages against the remaining defendant; defendants filed a notice to appeal to the Second DCA on August 21, 2018; RJR Tobacco posted a supersedeas bond in the amount of approximately \$1.8 million on August 22, 2018; briefing is underway.



# 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>Landi</i>	35%	—	4,000,000	7,000,000	Final judgment was entered on June 17, 2018 against RJR Tobacco and the remaining defendant, jointly and severally in the amount of \$8 million in compensatory damages and \$7 million in punitive damages against RJR Tobacco and \$5 million in punitive damages against the remaining defendant; post-trial motions were denied on July 27, 2018; defendants filed a notice of appeal to the Fourth DCA and RJR Tobacco posted a supersedeas bond in the amount of \$2.75 million on August 20, 2018; plaintiff filed a notice of cross appeal on September 4, 2018; briefing is underway.
<i>Burgess</i>	80%	—	3,000,000	—	Final judgment was entered against RJR Tobacco on June 24, 2018; RJR Tobacco filed a notice of appeal to the Fourth DCA on October 9, 2018 and posted a supersedeas bond in the amount of \$3 million on October 15, 2018; briefing is underway.
<i>Kaplan</i>	—	—	—	671,000	Final judgment was entered against RJR Tobacco and the remaining defendant in the amount of approximately \$2.1 million in compensatory damages and \$671,000 in punitive damages against RJR Tobacco and \$2.3 million in punitive damages against the remaining defendant on August 30, 2018; defendants filed a joint notice of appeal to the Fourth DCA on September 24, 2018; RJR Tobacco posted a supersedeas bond in the amount of approximately \$1.7 million on September 27, 2018; briefing is underway.
<i>Bush</i>	65%	—	2,300,000	1,100,000	Final judgment was entered on August 7, 2018; post-trial motions were denied on August 21, 2018; RJR Tobacco posted a supersedeas bond in the amount of approximately \$3.4 million on September 11, 2018 and filed a notice of appeal to the First DCA on September 19, 2018; briefing is underway.
<i>Bessent-Dixon</i>	58%	—	2,000,000	13,500,000	On August 17, 2018, the court declared a mistrial as to Phase II only; the court deferred entering judgment for Phase I; retrial on punitive damages began on February 4, 2019; on February 7, 2019, the jury awarded \$13.5 million in punitive damages; RJR Tobacco filed post-trial motions on February 22, 2019.
<i>Olson</i>	60%	—	5,000,000	2,500,000	Final judgment was entered on August 31, 2018; post-trial motions were denied on September 29, 2018, and an amended order was entered on November 26, 2018; RJR Tobacco filed a notice of appeal to the First DCA on November 26, 2018 and posted a supersedeas bond in the amount of \$5 million on November 29, 2018; briefing is underway.

## 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>Harewood</i>	25%	—	6,683,000		— Final judgment was entered on October 9, 2018; post-trial motions are pending and were heard on February 8, 2019; a decision is pending.
<i>Rouse</i>	50%	—	5,000,000	2,250,000	Final judgment was entered on December 17, 2018; post-trial motions are pending and are scheduled to be heard on March 7, 2019.
<i>Boulter</i>	15%	—	112,500		— Final judgment was entered against RJR Tobacco in the amount of \$112,500 and against the remaining defendant in the amount of \$112,500; RJR Tobacco paid approximately \$175,000 in satisfaction of the judgment on January 11, 2019.
<i>Kelley</i>	65%	—	2,000,000		— The parties resolved the case during the punitive damages phase. Final judgment was entered against RJR Tobacco in the amount of \$2 million in compensatory damages on January 24, 2019; RJR Tobacco paid approximately \$3.5 million in satisfaction of the judgment on February 8, 2019.
<i>Gafney</i>	25%	—	1,000,000		— Final judgment has not been entered.
<b>Totals</b>			<u>\$ 119,799,040</u>	<u>\$ 125,411,000</u>	

<sup>(1)</sup> 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.

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

<sup>(3)</sup> 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, 2018, verdicts or judgments in favor of *Engle* Progeny plaintiffs have been entered and remain outstanding against RJR Tobacco or Lorillard Tobacco totaling \$119,799,040 in compensatory damages (as adjusted) and \$125,411,000 in punitive damages, which is a combined total of \$245,210,040. 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, 2018, 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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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, 2018, there were 1,406 *Broin II* lawsuits pending in Florida. There have been no *Broin II* trials since 2007.

### *Class-Action Suits*

*Overview.* As of December 31, 2018, 20 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.

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 were 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, no “lights” class-action cases are pending against RJR Tobacco or B&W 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. On September 25, 2018, the court dismissed the case with prejudice as to the named class representatives and without prejudice as to other members of the certified class.

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. On September 28, 2018, the court dismissed the case with prejudice as to the named class representatives and without prejudice as to putative, unnamed class members.

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. On September 5, 2018, the court dismissed the case without prejudice.

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. On September 5, 2018, the court dismissed the case without prejudice.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

### *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 17 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, currently has no deadlines for either briefing or a hearing on class certification.

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 were similar to the allegations in the actions consolidated for pre-trial purposes in the transferee court described immediately above. The complaint sought injunctive and other non-monetary relief but did not seek monetary damages. On June 9, 2017, the defendants moved to dismiss. The parties resolved the case on December 14, 2018 and it was dismissed by the court in January 2019.

### *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.*

In *Parsons v. A C & S, Inc.* (Cir. Ct. Ohio County, W. Va., filed 1998), the plaintiff brought a class action against asbestos manufacturers, U.S. cigarette manufacturers, including RJR Tobacco, B&W, Lorillard Tobacco, and parent companies of U.S. cigarette manufacturers, including RJR and Lorillard, on behalf of a putative class of persons who allegedly have personal injury claims arising from their exposure to respirable asbestos fibers and cigarette smoke. The plaintiff seeks to recover \$1 million in compensatory and punitive damages individually for her purported injuries and an unspecified amount for the class in compensatory and punitive damages. In December 2000, three defendants, Nitral Liquidators, Inc., Desseaux Corporation of North America and Armstrong World Industries, filed bankruptcy petitions in the U.S. Bankruptcy Court for the District of Delaware, *In re Armstrong World Industries, Inc.* Pursuant to section 362(a) of the Bankruptcy Code, *Parsons* is automatically stayed with respect to all defendants who filed for bankruptcy. On March 5, 2018, the court entered an order of dismissal with prejudice.

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.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

### *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, 2018, Lorillard Tobacco and/or Lorillard was a defendant in 58 Filter Cases. Since January 1, 2016, Lorillard Tobacco and RJR Tobacco have paid, or have reached agreement to pay, a total of approximately \$30.2 million in settlements to resolve 137 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 occurred on March 6, 2018. On October 15, 2018, the Florida Supreme Court issued a decision reversing the Fourth DCA's opinion, which reversed the trial court's final judgment, and reinstated the full final judgment in favor of the plaintiff. RJR Tobacco filed a motion for rehearing on November 6, 2018, which was denied on December 6, 2018. RJR Tobacco paid approximately \$4.5 million on December 20, 2018 in satisfaction of the judgment.

### *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, 2018, two health-care cost recovery cases were pending in the United States against RJR Tobacco, B&W, Lorillard Tobacco, or all three, as discussed below after the discussion of the State Settlement Agreements. A limited number of claimants have filed suit against RJR Tobacco, one of its affiliates, and other tobacco industry defendants to recover funds for health care, medical and other assistance paid by foreign provincial governments in treating their citizens. For additional information on these cases, see "— International Cases" below.

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

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

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

- all claims of the settling states and their respective political subdivisions and other recipients of state health-care funds, relating to past conduct arising out of the use, sale, distribution, manufacture, development, advertising, marketing or health effects of, the exposure to, or research, statements or warnings about, tobacco products; and
- all monetary claims of the settling states and their respective political subdivisions and other recipients of state health-care funds, relating to future conduct arising out of the use of or exposure to, tobacco products that have been manufactured in the ordinary course of business.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

RAI's operating subsidiaries expenses and payments under the State Settlement Agreements for 2017, 2018 and the projected expenses and payments for 2019 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>

	2017	2018	2019 and thereafter
Settlement expenses	\$ 2,856	2,741	—
Settlement cash payments	\$ 4,612	917	—
Projected settlement expenses			\$>2,800
Projected settlement cash payments			\$>2,800

<sup>(1)</sup> The amounts above reflect the impact of the NPM Settlement and the NY State Settlement described below under “— State Settlement Agreements—Enforcement and Validity; Adjustments — Partial Settlement of Certain NPM Adjustment Claims.”

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

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

### *U.S. Department of Justice Case.*

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

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

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

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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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 compelled public statements began appearing in US newspapers on November 24, 2017 and ran serially over four months. They began appearing on national US broadcast television networks on November 27, 2017 and ran several times per week for one year. The statements also began appearing on RJR Tobacco's website in June 2018 and in package onserts beginning in November 2018. The district court is considering requiring the statements to be displayed at retail point of sale (after the D.C. Circuit vacated the prior point of sale remedy in 2009); the most recent round of briefing on this issue concluded on September 14, 2018. A decision is expected in the near term. 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 substantially all amounts were utilized by December 31, 2018.

### *Native American Tribe Case.*

As of December 31, 2018, 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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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.
- *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



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

### *State Settlement Agreements—Enforcement and Validity; Adjustments*

As of December 31, 2018, there were three 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 join 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 February 1, 2018, PM USA and the State filed a joint motion for the entry of final judgment. On August 15, 2018, the Court entered a Final Judgment in the action. On August 29, 2018, RJR Tobacco filed a notice of appeal on the Final Judgment. On September 7, 2018, PM USA filed a notice of appeal with respect to the court's ruling as to ITG. On September 12, 2018, RJR Tobacco filed a motion to consolidate RJR Tobacco's appeal with the appeal filed by PM USA, which was granted on October 1, 2018, RJR Tobacco's initial brief is due on April 2, 2019.

In total, the estimated additional amounts due were \$122.5 million, \$113.8 million to the State of Florida and \$8.7 million to PM USA.

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. On November 30, 2017, following argument, the Delaware court entered a ruling in favor of RJR Tobacco, holding that ITG's obligation under Section

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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. On January 4, 2019, RJR Tobacco filed another motion for partial judgment on the pleadings, requesting that the Delaware court find that (1) to the extent that RJR Tobacco is found liable for settlement payments on ITG's post-closing sales of the four acquired brands, that is a liability that ITG assumed under the asset purchase agreement; and (2) ITG is not entitled to unique protection from non-existent equity fee statutes under the asset purchase agreement's provisions requiring ITG to use reasonable best efforts to join certain State settlement agreements.

On June 8, 2015, RJR Tobacco, ITG and the State of Mississippi filed with the state court overseeing the Mississippi State Settlement Agreement a motion with respect to ITG's joinder to the Mississippi State Settlement Agreement. The motion was granted. PM USA then moved to vacate the order, alleging that the joinder had the effect of modifying the method of allocating among the settling manufacturers a component of their annual payments to Mississippi in a way that adversely impacts Philip Morris. The court denied the motion, and PM USA appealed. On June 13, 2017, the appeal was dismissed on joint motion by PM USA and Mississippi. On December 26, 2018, PM USA filed a motion to enforce against RJR Tobacco and ITG with respect to the calculation of the base-year net operating profits for the Acquired Brands. PM USA claims damages of approximately \$6,000,000 through 2017. PM USA also seeks a declaration that RJR Tobacco and ITG breached the Mississippi Settlement Agreement and seeks an accounting to determine the appropriate amount of base-year profits attributable to the Acquired Brands. A status conference occurred on February 21, 2019. A scheduling order for discovery was agreed at the status conference. Dates for the end of discovery or trial have not been set, but the trial will not take place until 2020.

On March 26, 2018, the State of Minnesota filed a motion against RJR Tobacco to enforce the Minnesota State Settlement Agreement, which motion seeks payments under the Minnesota State Settlement Agreement of approximately \$40 million with respect to the Acquired Brands. The motion also claims future annual losses of approximately \$15 million absent the court's enforcement of the Minnesota State Settlement Agreement. The State of Minnesota also filed a separate complaint against ITG, which complaint seeks the same payments. The State's motion against RJR Tobacco and complaint against ITG seek, among other things, an order declaring that RJR Tobacco and ITG are in breach of the Minnesota State Settlement Agreement and are jointly and severally liable to make annual payments to the State of Minnesota under the Minnesota State Settlement Agreement with respect to the Acquired Brands. In addition, on March 28, 2018, PM USA filed a motion to enforce the Minnesota State Settlement Agreement, asserting among other things, that RJR Tobacco and ITG breached the Minnesota State Settlement Agreement by failing to make settlement payments as to the Acquired Brands, which PM USA asserts has improperly shifted settlement payment obligations to PM USA. On March 27, 2018, the Minnesota court consolidated the motions to enforce and complaint against ITG into one proceeding captioned *In re Petition of the State of Minnesota for an Order Compelling Payments of Settlement Proceeds Related to ITG Brands LLC*, Court File No. 62-CV-18-1912. On June 11, 2018, the court held a scheduling conference in the case and by order dated June 21, 2018, set a discovery schedule for the case. Discovery is scheduled to be completed by March 31, 2019. No trial date has yet been set.

On January 28, 2019, the State of Texas filed motions to join ITG as a defendant and to enforce the Texas State Settlement Agreement against RJR Tobacco and ITG, seeking payment under the Texas State Settlement Agreement of approximately \$125 million with respect to the Acquired Brands that were sold to ITG in the Divestiture. The motion also claims future annual losses of an unspecified amount absent the court's enforcement of the Texas State Settlement Agreement. The State's motion seeks, among other things, an order declaring that RJR Tobacco, or in the alternative, ITG, is in breach of the Texas Settlement Agreement and is required to make annual payments to the State under the Texas State Settlement Agreement with respect to the Acquired Brands. In addition, on January 29, 2019, PM USA filed a motion to enforce the Texas State Settlement Agreement, asserting among other things that RJR Tobacco and ITG breached that agreement by failing to make settlement payments as to the Acquired Brands, which PM USA asserts has improperly shifted settlement payment obligations to PM USA.

**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.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

*NPM Adjustment Claims for 2004-2017.* 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 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 2016. The approximate maximum principal amounts of RJR Tobacco’s and Lorillard Tobacco’s shares of the disputed NPM Adjustments for the years 2004 through 2017 (in millions), as currently calculated by the Independent Auditor, and the remaining amounts after the settlements of certain NPM Adjustments claims (see below), under certain assumptions, are as follows <sup>(1)</sup>:

Volume Year	RJR Tobacco		Lorillard Tobacco	
	Disputed	Remaining after settlements	Disputed	Remaining after settlements
2004	\$ 562	\$ 136	\$ 111	\$ 27
2005	445	110	76	19
2006	419	103	73	18
2007	435	109	83	21
2008	468	117	104	26
2009	472	118	107	27
2010	470	117	119	30
2011	422	105	88	22
2012	430	107	97	25
2013	457	114	92	23
2014	436	109	93	24
2015	487	122	41	11
2016	505	126	—	—
2017	503	124	—	—

<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 2017 is approximately \$132 million and the remaining amount after the settlements is approximately \$33 million.

The 2004 NPM Adjustment proceeding is underway before two overlapping panels, with one panel hearing the issues with respect to two 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 fourth quarter of 2019. RJR Tobacco’s and Lorillard Tobacco’s remaining claim with respect to 2004 is approximately \$163 million collectively, under certain assumptions.

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. In June 2018, the PMs and the State of Montana filed an Agreement in Principal in which the PMs agreed not to contest Montana’s diligent enforcement of its Qualifying Statute during 2004, and Montana shall not be subject to the 2004 NPM Adjustment. 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 and America Samoa have, however, been ordered by their courts to participate in the nationwide arbitration, although they are appealing those orders.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

Due to the uncertainty over the final resolution of the 2004-2017 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 2004-2017 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 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 the fourth quarter of 2017, the NPM 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 2013-2015 volume years. Since the NPM Adjustment Settlement Agreement was executed, an additional ten states joined the Agreement. Thirty-six jurisdictions have now joined the Term Sheet settlement representing approximately 62.53% allocable share.

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. On May 18, 2018, the Court issued an Order reserving ruling on the agreed order and raising various issues. Following a status conference on May 29, 2018, the Court issued an Order on June 4, 2018 directing the parties to file a memorandum setting forth background information and a narrative explanation of the NPM Adjustment Settlement Agreement. On July 5, 2018, the parties filed a joint memorandum reiterating their request that the Court enter the agreed order. On July 5, 2018, the Kentucky Department of Revenue filed a Response to the Court's June 4 Order stating that it had no additional, helpful information to provide to the Court, and the Office of State Budget Director and Governor's Office of Policy and Management filed a Response stating that they have no objection to the agreed order. The agreed order remains under advisement by the Court.

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 2017 NPM Adjustments with 37 jurisdictions, representing approximately 75.29% allocable share.

For additional information related to the NPM Agreement 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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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.

*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. In the district court litigation, the court issued a claim construction order on March 12, 2018, and the parties engaged in fact discovery.

RJR Vapor filed multiple petitions for *inter partes* review against seven of the 15 asserted patents. Five of the petitions were granted, 16 were denied and five were pending. 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. Fontem appealed its adverse FWD. RJRV also appealed its adverse FWDs. All three FWDs were the subject of appeals. Oral arguments in the fourth granted IPR occurred on July 17, 2018. RJR Vapor and Fontem entered into a confidential “Settlement and License Agreement” effective September 24, 2018.

### *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 on April 27, 2018, it dismissed the claims of the 41 smokeless plaintiffs with prejudice.

### *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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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. On December 7, 2018, the North Carolina Supreme Court, with three of seven justices dissenting, reversed the Court of Appeals and reinstated the portion of the trial court's order that had dismissed claims against BAT. The plaintiff filed a petition for rehearing with the North Carolina Supreme Court on January 11, 2019. The plaintiff's petition for review was denied on January 30, 2019.

*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.

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 and the cases were dismissed.

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. Trial is currently scheduled to be held no earlier than June 2019.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

### *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.

In connection with the indemnity in connection with the sale of the international rights to the NATURAL AMERICAN SPIRIT brand name and associated trademarks, JTI has requested indemnification in connection with an audit of Santa Fe Natural Tobacco Company Germany GmbH, referred to as SFNTCG, relating to transfer pricing for the tax years 2007 to 2010 and 2012 to 2015. For the tax years 2007 to 2010, SFNTCG appealed the audit assessment. The appeal was rejected, and the assessment will be further appealed in court. The amount in issue is approximately 15 million Euros plus interest. For the tax years 2012 to 2015, SFNTCG is appealing an audit assessment of approximately 6 million Euros plus interest, but the appeals process is on hold until the dispute for the tax years 2007 to 2010 is resolved.

*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. ITG has tendered the defense of several actions asserting claims relating to the purchase or use of WINSTON, KOOL, SALEM, and/or MAVERICK brand cigarettes to RJR Tobacco, and RJR Tobacco has assumed the defense of those actions subject to a reservation of rights. The claims asserted against ITG are substantially similar in nature and extent to claims asserted against RJR Tobacco in those actions.

*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.



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

*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. Auto leases are for one year and are subject to make whole provisions with early cancellations. Total rent expense was \$27 million during each of 2018 and 2017.

Future minimum lease payments as of December 31, 2018 were as follows:

Year	Noncancelable Operating Leases
2019	\$ 22
2020	6
2021	1
2022	1
2023	1
Thereafter	1
	<u>\$ 32</u>

### **Note 10 — Shareholders' Equity**

RAI's authorized capital stock at December 31, 2018 and 2017, 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. RAI declared \$32 million and \$43 million in dividends to RJR with respect to the Series B Preferred Stock in 2018 and 2017, respectively.

Prior to the BAT Merger, RAI's board of directors declared quarterly cash dividends of \$0.51 per share on RAI common stock in the first and second quarter of 2017. Subsequent to the BAT Merger, RAI paid dividends to certain BAT subsidiaries that hold RAI's common stock totaling \$3,780 million and \$723 million in 2018 and 2017, respectively.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

### *Accumulated Other Comprehensive Loss*

The components of accumulated other comprehensive loss, net of tax, were as follows:

	Retirement Benefits	Cumulative Translations Adjustment and Other	Total
<b>Balance at December 31, 2016</b>	\$ (255)	\$ (59)	\$ (314)
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>	(112)	(32)	(144)
Other comprehensive loss before reclassifications	(80)	(25)	(105)
Amounts reclassified from accumulated other comprehensive income (loss)	(46)	—	(46)
Net current-period other comprehensive loss	(126)	(25)	(151)
Reclassification due to adoption of ASU 2018-02	(55)	—	(55)
<b>Balance at December 31, 2018</b>	<u>\$ (293)</u>	<u>\$ (57)</u>	<u>\$ (350)</u>

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, 2018 and 2017, were as follows:

Components	Amounts Reclassified		Affected Line Item
	2018	2017	
<b>Retirement benefits:</b>			
Amortization of prior service cost	\$ (31)	\$ (33)	Other expenses, net
MTM adjustment	(30)	27	Other expenses, net
	(61)	(6)	Other expenses, net
Deferred taxes	15	2	Provision for income taxes
Net of tax	(46)	(4)	Net income
<b>Total reclassifications</b>	<u>\$ (46)</u>	<u>\$ (4)</u>	Net income

### *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, RAI repurchased and cancelled 1,372,067 shares of RAI common stock for \$88 million 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.

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

RAI had 1,426,125,631 shares of common stock outstanding at December 31, 2018 and December 31, 2017.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

### Note 11 — Stock Plans

As of December 31, 2018, 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. 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 during December of the year preceding payment. Compensation expense recognized in 2017 related to the EIAP was \$14 million. No EIAP compensation expense was recorded in 2018.

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*

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 grantee payroll taxes due on 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 made in 2017, that had not subsequently been cancelled or vested, 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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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.

During 2017, 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 but were not settled as of December 31, 2017. In 2018, these stock units were settled together with 37,513 BAT ADSs that vested during 2018, resulting in the issuance of 215,206 BAT ADS net of 149,770 BAT ADSs that were withheld to cover the payroll taxes of the grantees associated with these restricted stock units for which RAI paid \$7.8 million to the relevant taxing authorities in 2018.

Additionally, in accordance with the 2017 grant agreement, there were 72,033 restricted stock units granted in 2017 that had vested as a result of qualified terminations during 2018 but were not yet settled as of December 31, 2018.

### *Annual Three-Year Grant*

The grant date fair value was based on the per share closing price of BAT ADSs on the date of issuance. The number of shares granted is determined by taking the total grant target (eligible employees' base pay times applicable incentive multiplier) divided by the average closing price of BAT ADS for the 20 trading days prior to the grant date. Once issued, the actual number of shares is fixed. As an equity-based grant, compensation expense includes the vesting period lapsed. 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.

Information regarding restricted stock unit awards outstanding as of December 31, 2018, under the Omnibus Plan was as follows:

<b>Grant Year</b>	<b>Number of Shares Granted (BAT ADS)</b>	<b>Grant Price Per Share (BAT ADS)</b>	<b>Vesting Date</b>	<b>Number of Shares Cancelled and Vested (BAT ADS)</b>	<b>Cumulative Dividends Per Share</b>	<b>Ending Date of Performance Period</b>
<i>Three-year grant</i>						
2018	815,003	\$ 55.71	March 1, 2021	137,095	\$ 1.92	December 31, 2020
2017	903,845	\$ 65.866	March 1, 2020	445,657	\$ 4.97	December 31, 2019

### *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, 2018 and 2017.

The changes in the number of BAT restricted ADS units during 2018 were as follows:

	<b>Number of Stock Units (BAT ADS)</b>	<b>Weighted Average Grant Date Fair Value Per Share (BAT ADS)</b>
Outstanding at December 31, 2017	585,919	\$ 65.87
Granted	815,003	55.71
Forfeited	(154,457)	56.85
Vested	(110,369)	65.87
Outstanding at December 31, 2018	<u>1,136,096</u>	59.81

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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	2018	2017
2014 restricted stock units	\$ —	\$ 4
2015 restricted stock units	—	10
2016 restricted stock units	1	59
2017 restricted stock units	15	35
2018 restricted stock units	9	—
Total compensation expense	<u>\$ 25</u>	<u>\$ 108</u>
Total related tax benefits	<u>\$ 6</u>	<u>\$ 37</u>

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:

	2018	2017
Other noncurrent liabilities	\$ 4	\$ 2
Paid-in capital	39	34

As of December 31, 2018, there was \$39 million of unrecognized compensation expense related to restricted stock units, calculated at the grant-date price, which is expected to be recognized over a weighted-average period of 1.9 years.

Future restricted stock grants to RAI employees will be made under the BAT Global LTIP Plan, with performance measurement metrics and weights aligned to BAT targets. Cumulative dividends will be paid upon vesting.

### Note 12 — 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.

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	
	2018	2017	2018	2017
Change in benefit obligations:				
Obligations at beginning of year	\$ 6,815	\$ 6,674	\$ 1,126	\$ 1,162
Service cost	14	17	1	1
Interest cost	243	268	38	45
Actuarial (gain) loss	(447)	285	(121)	(5)
Plan amendments	—	4	—	—
Benefits paid	(434)	(433)	(72)	(77)
Transfer from related party	21	—	5	—
Obligations at end of year	<u>\$ 6,212</u>	<u>\$ 6,815</u>	<u>\$ 977</u>	<u>\$ 1,126</u>
Change in plan assets:				
Fair value of plan assets at beginning of year	\$ 6,182	\$ 5,648	\$ 240	\$ 230
Actual return on plan assets	(248)	853	(11)	24
Employer contributions	116	114	52	63
Benefits paid	(434)	(433)	(72)	(77)
Transfer from related party	17	—	—	—
Fair value of plan assets at end of year	<u>\$ 5,633</u>	<u>\$ 6,182</u>	<u>\$ 209</u>	<u>\$ 240</u>
Funded status	<u>\$ (579)</u>	<u>\$ (633)</u>	<u>\$ (768)</u>	<u>\$ (886)</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

As of December 31, 2018, the improvement in pension benefits funded status is primarily due to employer contributions, updated mortality assumptions and an increase in the discount rate offset by lower return on plan assets. As of December 31, 2018, the improvement in postretirement benefits funded status is primarily due to updated mortality and other assumptions and an increase in the discount rate offset by lower return on plan assets.

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.

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

	Pension Benefits		Postretirement Benefits	
	2018	2017	2018	2017
Net actuarial (gain) loss:				
Change in discount rate	\$ (438)	\$ 351	\$ (61)	\$ 51
Change in mortality table	(16)	(70)	(2)	(8)
Actual return on plan assets	248	(853)	11	(24)
Expected return on plan assets	408	388	10	10
Other	6	4	(57)	(49)
Net actuarial (gain) loss	<u>\$ 208</u>	<u>\$ (180)</u>	<u>\$ (99)</u>	<u>\$ (20)</u>

Amounts recognized in the consolidated balance sheets consist of:

	Pension Benefits		Postretirement Benefits	
	2018	2017	2018	2017
Accrued benefit — other current liabilities	\$ (14)	\$ (16)	\$ (72)	\$ (73)
Accrued benefit — long-term retirement benefits	(565)	(617)	(696)	(813)
Net amount recognized	(579)	(633)	(768)	(886)
Accumulated other comprehensive loss	571	410	(123)	(130)
Net amounts recognized in the consolidated balance sheets	<u>\$ (8)</u>	<u>\$ (223)</u>	<u>\$ (891)</u>	<u>\$ (1,016)</u>

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

	2018			2017		
	Pension Benefits	Postretirement Benefits	Total	Pension Benefits	Postretirement Benefits	Total
Prior service cost (credit)	\$ 5	\$ (25)	\$ (20)	\$ 8	\$ (59)	\$ (51)
Net actuarial (gain) loss	566	(98)	468	402	(71)	331
Deferred income taxes	(192)	37	(155)	(205)	37	(168)
Accumulated other comprehensive loss	<u>\$ 379</u>	<u>\$ (86)</u>	<u>\$ 293</u>	<u>\$ 205</u>	<u>\$ (93)</u>	<u>\$ 112</u>

Changes in accumulated other comprehensive loss were as follows:

	2018			2017		
	Pension Benefits	Postretirement Benefits	Total	Pension Benefits	Postretirement Benefits	Total
Net actuarial (gain) loss	\$ 208	\$ (99)	\$ 109	\$ (180)	\$ (20)	\$ (200)
Amortization of prior service cost (credit)	(3)	34	31	(3)	36	33
Prior service cost	—	—	—	4	—	4
Transfer from related party	(2)	—	(2)	—	—	—
MTM adjustment	(42)	72	30	(27)	—	(27)
Reclassification due to adoption of ASU 2018-02	53	2	55	—	—	—
Deferred income tax (benefit) expense	(40)	(2)	(42)	51	(4)	47
Change in accumulated other comprehensive loss	<u>\$ 174</u>	<u>\$ 7</u>	<u>\$ 181</u>	<u>\$ (155)</u>	<u>\$ 12</u>	<u>\$ (143)</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

The pension MTM adjustment expense in 2018 is primarily a result of pension asset return losses of \$248 million versus an expected return of \$408 million offset by updated mortality assumption and an increase in the discount rate.

The postretirement MTM adjustment gain in 2018 is primarily a result of updated mortality and other assumptions and an increase in the discount rate and was partially offset by postretirement asset losses of \$11 million versus an expected gain of \$10 million.

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.

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, 2018 and 2017. Given the complexity of the PPACA, further adjustments to the accumulated postretirement benefit obligation may be necessary in the future.

	<b>Pension Benefits</b>		<b>Postretirement Benefits</b>	
	<b>2018</b>	<b>2017</b>	<b>2018</b>	<b>2017</b>
Weighted-average assumptions used to determine benefit obligations at December 31:				
Discount rate	4.33%	3.68%	4.31%	3.65%
Rate of compensation increase	4.00%	4.00%	—	—

The measurement date used for all plans was December 31.

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

	<b>December 31,</b>	
	<b>2018</b>	<b>2017</b>
Projected benefit obligation	\$ 6,212	\$ 6,815
Accumulated benefit obligation	6,160	6,776
Plan assets	5,633	6,182

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

	<b>Pension Benefits</b>		<b>Postretirement Benefits</b>	
	<b>2018</b>	<b>2017</b>	<b>2018</b>	<b>2017</b>
Service cost	\$ 14	\$ 17	\$ 1	\$ 1
Interest cost	243	268	38	45
Expected return on plan assets	(408)	(388)	(10)	(10)
Amortization of prior service cost (credit)	3	3	(34)	(36)
MTM adjustment	42	27	(72)	—
Net periodic benefit income	<u>\$ (106)</u>	<u>\$ (73)</u>	<u>\$ (77)</u>	<u>\$ —</u>

The estimated amortization of prior service cost for the pension plans is expected to be \$2 million during 2019. The estimated amortization of prior service credit for the postretirement plans is expected to be \$30 million during 2019.

	<b>Pension Benefits</b>		<b>Postretirement Benefits</b>	
	<b>2018</b>	<b>2017</b>	<b>2018</b>	<b>2017</b>
Weighted-average assumptions used to determine net periodic benefit cost for years ended December 31:				
Discount rate	3.68%	4.16%	3.65%	4.12%
Expected long-term return on plan assets	6.78%	7.07%	4.50%	4.50%
Rate of compensation increase	4.00%	4.00%	—	—

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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

	2018	2017
Weighted-average health-care cost trend rate assumed for the following year	6.50%	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, 2018:

	1-Percentage Point Increase	1-Percentage Point Decrease
Effect on total of service and interest cost components	\$ 2	\$ (1)
Effect on benefit obligation	43	(37)

During 2019, RAI expects to contribute \$14 million to its pension plans and \$72 million to its postretirement plans.

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
2019	\$ 442	\$ 95	\$ (2)	\$ 93
2020	438	80	(2)	78
2021	433	78	(2)	76
2022	429	75	(2)	73
2023	426	74	(2)	72
2024-2028	2,029	343	(11)	332

### *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 global 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. Global equity is comprised of the common stocks of large, medium and small companies domiciled inside and outside the United States, including those in less developed, fast growing emerging 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,



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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 in both public and private 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.

RAI's pension and postretirement plans asset allocations at December 31, 2018 and 2017, by asset category were as follows:

Asset Category:	Pension Plans			
	2018 Target <sup>(1)</sup>	2018	2017 Target <sup>(1)</sup>	2017
Global equities	16%	16%	28%	28%
Fixed income	57%	57%	45%	45%
Absolute return	14%	14%	13%	13%
Private equity	8%	8%	8%	8%
Real assets	5%	5%	6%	6%
Total	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

Asset Category:	Postretirement Plans			
	2018 Target <sup>(1)</sup>	2018	2017 Target <sup>(1)</sup>	2017
Domestic equities	21%	18%	21%	20%
International equities	21%	18%	21%	20%
Fixed income	55%	55%	55%	52%
Cash and other <sup>(2)</sup>	3%	9%	3%	8%
Total	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

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

(2) Cash and other temporarily outside of the rebalancing range at December 31, 2018 due to the timing of cash reimbursements.

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, 2018 and 2017, were as follows <sup>(1)</sup>:

Pension Plans	2018				2017			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
<b>Asset Category:</b>								
Domestic equities	\$ —	\$ —	\$ —	\$ —	\$ 557	\$ —	\$ —	\$ 557
International equities	—	—	—	—	182	—	—	182
Global equities	475	122	—	597	814	—	—	814
Real assets	24	—	—	24	26	—	—	26
Agency bonds	—	—	—	—	—	—	—	—
Asset backed securities	—	48	2	50	—	47	1	48
Corporate bonds	—	1,782	1	1,783	—	1,318	1	1,319
Government bonds	—	63	—	63	—	51	—	51
High yield fixed income	—	13	—	13	—	10	—	10
Mortgage backed securities	—	73	—	73	—	18	—	18
Municipal bonds	—	137	—	137	—	137	—	137
Treasuries	—	1,193	—	1,193	—	1,096	—	1,096
Cash equivalents and other	55	327	1	383	35	453	1	489
Total investments in the fair value hierarchy	<u>\$ 554</u>	<u>\$ 3,758</u>	<u>\$ 4</u>	<u>4,316</u>	<u>\$ 1,614</u>	<u>\$ 3,130</u>	<u>\$ 3</u>	<u>4,747</u>
Investments measured at net asset value				1,348				1,409
Total				<u>\$ 5,664</u>				<u>\$ 6,156</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

Postretirement Plans	2018				2017			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
<b>Asset Category:</b>								
Short-term bonds	\$ 8	\$ —	\$ —	\$ 8	\$ 11	\$ —	\$ —	\$ 11
Cash equivalents and other	—	6	—	6	—	7	—	7
Total investments in the fair value hierarchy	<u>\$ 8</u>	<u>\$ 6</u>	<u>\$ —</u>	14	<u>\$ 11</u>	<u>\$ 7</u>	<u>\$ —</u>	18
Investments measured at net asset value				182				210
Total				<u>\$ 196</u>				<u>\$ 228</u>

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

For the years ended December 31, 2018 and 2017, there were no transfers among the fair value hierarchy levels.

At December 31, 2018 and 2017, 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, 2018 and 2017, the fair value of pension and postretirement assets classified as Level 2 was determined using a combination of third-party pricing services for certain global equities, 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 categorized 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 observable inputs, including market-based interest rate curves, corporate credit spreads and corporate ratings. Additionally, unobservable factors incorporated into these models included default probability assumptions, potential recovery, 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 2018, by asset category were as follows <sup>(1)</sup>:

	Balance as of January 1, 2018	Purchases, Sales, Issuances and Settlements (net)	Realized Gains (Losses)	Unrealized Gains (Losses)	Transferred From Other Levels	Balance as of December 31, 2018
Asset backed securities	\$ 1	\$ —	\$ —	\$ 1	\$ —	\$ 2
Corporate bonds	1	—	—	—	—	1
Other	1	—	—	—	—	1
Total	<u>\$ 3</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 1</u>	<u>\$ —</u>	<u>\$ 4</u>

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>

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

### Defined Contribution Plans

RAI sponsors qualified defined contribution plans. The expense related to these plans was \$40 million and \$41 million in 2018 and 2017, respectively. Included in the plans is a non-leveraged employee stock ownership plan, which holds shares of the BAT Stock Fund. Participants can elect to contribute to the fund. Dividends paid on shares are reflected as a reduction of equity.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

### Note 13 — Revenue Recognition

On January 1, 2018, RAI adopted ASC 606, *Contracts with Customers*. This new accounting standard establishes principles for reporting information about the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers entered into by RAI's operating subsidiaries. RAI adopted the new guidance using the modified retrospective transition method and recorded a cumulative effect adjustment of approximately \$80 million, on a pre-tax basis, as a reduction to retained earnings in the opening balance sheet as of January 1, 2018 with a corresponding increase to current liabilities. This adjustment resulted from the acceleration in the timing of the recognition of certain discounting expenses.

Substantially all of RAI's net sales come from sales of tobacco and e-cigarette products by its operating subsidiaries under the terms of contracts with their customers. Although each RAI operating subsidiary enters into separate contracts with its customers, the contracts used by RAI's operating subsidiaries are similarly constructed. Per the terms of these contracts, upon acceptance of a customer order, RAI's operating subsidiary has a performance obligation to ship the products ordered in the quantities accepted at the list price in the contract. RAI has determined that a customer obtains control of the product when it is shipped and ownership of such product and risk of loss transfers to the customer at that time. Accordingly, the performance obligation of RAI's operating subsidiary is satisfied upon shipment and revenue is recognized at that point in time. All performance obligations are satisfied within one year and, therefore, costs to obtain contracts are expensed as incurred and unsatisfied performance obligations are not disclosed.

Net sales reported on the accompanying consolidated statements of income primarily consist of sales to customers less cash discounts for payments made within terms, payments to customers under certain sales incentive agreements and other promotional allowance programs, coupons and customer product returns. RAI's reported sales are also net of federal excise taxes that are passed through to the appropriate governmental authority. Freight costs incurred to ship the product to the customer are accounted for as fulfillment costs and expensed in cost of products sold at the time of shipment.

RAI's primary operating subsidiaries are RJR Tobacco, SFNTC and American Snuff Co. RAI's largest operating subsidiary, RJR Tobacco, is the second largest tobacco company in the United States and its net revenues come primarily from the sale of cigarettes at different price points. Its brands which are manufactured in a variety of styles and marketed in the United States include three of the top four best-selling cigarettes: NEWPORT, CAMEL and PALL MALL. RJR Tobacco also offers a smoke-free tobacco product, CAMEL Snus. SFNTC's net revenues come predominantly from the manufacture and marketing of its super-premium cigarette brand, NATURAL AMERICAN SPIRIT, in the United States. American Snuff Co. is the second largest smokeless tobacco products manufacturer in the United States. American Snuff Co.'s net revenues primarily come from its largest selling moist snuff brands, GRIZZLY and KODIAK. RAI disaggregates net revenues of its most significant operating subsidiaries as follows:

	<u>2018</u>	<u>2017</u>
Net sales:		
RJR Tobacco	\$ 10,217	\$ 10,147
SFNTC	1,152	1,059
American Snuff Co.	1,102	1,028
All Other	<u>263</u>	<u>329</u>
Consolidated Net Sales	<u>\$ 12,734</u>	<u>\$ 12,563</u>

RAI's operating subsidiaries promote their products with customer sales incentives and trade promotional allowance programs that require variable payments to their customers. These incentives and programs include discounts, coupons and volume-based incentives, among others, and are recorded as a reduction of revenues. Payments under these incentive and promotion programs are made primarily to wholesalers and retailers and are variable consideration under ASC 606. The accrual of these incentive payments requires significant estimates and judgment by the operating subsidiaries including estimated wholesale to retail sales and historical acceptance rates. Estimates are accrued at the time of shipment and are included in other accrued liabilities on RAI's consolidated balance sheets. The actual payments made under these programs may differ from RAI's estimates and such differences are recorded in the period when the actual payments are made. These differences, if any, have not had a material impact on RAI's reported income, financial condition or cash flows.

Certain tobacco products sold by RAI's operating subsidiaries have freshness dates printed on the product packaging. Smokeless tobacco products sold by American Snuff Co., CAMEL Snus products sold by RJR Tobacco, and e-cigarettes and other vapor products sold by RJR Vapor have limited shelf lives. These operating subsidiaries have policies to accept authorized product returns from their customers for products that have passed the freshness date. RAI records an estimate for sales returns, which are based principally on historical volume and return rates, as a reduction to revenues. Actual sales returns will differ from estimated sales returns. These differences between actual and estimated sales returns are recorded in the period in which the actual amounts become known. These differences, if any, have not had a material impact on RAI's reported income, financial condition or cash flows. All returned goods are destroyed upon return and not returned to inventory. Consequently, no asset for the right to recover product from customers upon return is recognized.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

RAI's operating subsidiaries generally receive payment either in advance of the shipment of product to the customer or on the date of expected delivery of product to the customer. When payment from the customer is received prior to the shipment of the product, recognition of revenue is deferred until the product is shipped and the RAI operating subsidiary's performance obligation is satisfied, generally within two days of receiving the payment. Deferred revenue for advance payments included in other current liabilities on the accompanying consolidated balance sheets at December 31, 2018 and 2017 was \$18 million and \$16 million, respectively. For product shipments where payment is not received in advance, amounts due from the customer are included in accounts receivable on the consolidated balance sheets. Accounts receivable from product sales are generally not material resulting in an insignificant amount of bad debt expense annually, therefore RAI has not provided an estimate for an allowance for bad debts.

### Note 14 — 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:

	2018	2017
<b>Current Balances:</b>		
Accounts receivable, related party	\$ 30	\$ —
Notes and interest receivable from related party	314	316
Amounts due from related party – cash management agreements:		
Zero balance agreement	—	27
In-house cash agreements	2,184	—
Note and interest payable to related party	1,201	—
Due to related party	23	4
Deferred revenue, related party	21	83
	2018	2017
<b>Significant Transactions:</b>		
Net sales	\$ 81	\$ 104
Leaf purchases	151	21
Miscellaneous Purchases	4	19
Termination of vapor collaboration agreement	—	10
Allocation of technical, advisory, information technology and integration fee	55	18
Interest income	21	10
Interest expense	11	—
Retirement benefits transfer	11	—

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 recognized the income ratably through December 31, 2018. Net sales to BAT affiliates, primarily cigarettes, represented approximately 1% of RAI's total net sales in 2018 and 2017.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

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 2018 and 2017, given that RJR Tobacco has a legal right to bill the BAT affiliates. Leaf sales revenue to BAT affiliates is recognized when the product is shipped to the customer.

RJR Tobacco purchases cigarettes at prices not to exceed manufacturing costs plus 10% from BAT affiliates. After the BAT Merger in July 2017, RJR Tobacco and BAT GLP Ltd., a BAT affiliate, signed a Leaf Management and Supply Agreement, in which RJR Tobacco purchases offshore leaf from BAT GLP Ltd. at cost plus approximately 11%. The 11% markup applies to the leaf base price only and excludes freight, storage, insurance, admin, etc. included in the transfer price. The Leaf Management and Supply Agreement governs leaf planning, purchases, logistics, transfer pricing and payment terms. A separate Service Level Agreement between RJR Tobacco and BAT GLP Ltd. covers planning and execution details.

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.

A €300 million Uncommitted Revolving Credit Facility was entered into on July 26, 2017, with B.A.T. International Finance p.l.c., referred to as BATIF, an indirect, wholly owned subsidiary of BAT, and matured on July 25, 2018. Interest was based on a rate of 0.13% over London Interbank Offered Rate, referred to as LIBOR, and was paid at maturity. The related party credit facility agreement was extended to July 25, 2019. Interest is based on a rate of 0.26% over LIBOR and is payable at note repayment.

A €263 million draw down against the above mentioned credit facility was made on July 26, 2017 to BATIF. The loan amount outstanding at December 31, 2017 was \$316 million. On October 31, 2018, an additional €1.9 million draw was made by BATIF. The total loan amounts outstanding at December 31, 2018, at the exchange rate on that date, was \$314 million.

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 would not exceed \$900 million at any one time and bore interest at a rate of 0.75% over LIBOR. The outstanding principal and interest were due and payable no later than the maturity date of July 25, 2019. Under the zero balance credit agreement, RAI's cash balances were 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 were payable to RAI on demand and bore interest at a rate of 0.275% under LIBOR. The amount outstanding was \$27 million at December 31, 2017. The zero balance account credit agreement and revolving note were terminated in November 2018.

In September 2018, in-house cash referred to as IHC, agreements were put in place between RAI and certain of its subsidiaries with B.A.T Capital Corporation, referred to as BATCAP, which replaced the zero balance account credit agreement and revolving note. Under the terms of these IHC agreements, daily cash balances for RAI and its subsidiaries are automatically swept to BATCAP. Cash swept to BATCAP is payable to each entity on demand and bears interest at a rate of 0.275% under the overnight LIBOR. If RAI or one of its subsidiaries is in an overdraft position, advances may not exceed the overdraft limits set forth in the agreements. Overdraft advances bear interest at a rate of 0.75% over the overnight LIBOR. Any outstanding advances and interest are due and payable no later than the maturity date of May 1, 2019. The net amount owed to RAI and its subsidiaries was \$2,184 million at December 31, 2018.

On September 28, 2018, RAI entered into a one-year term loan agreement with BATCAP for a principal amount of \$1.2 billion. The loan bears a floating interest rate based the three-month U.S. dollar LIBOR plus a margin of 1.14%, per annum. Interest is payable on the term loan quarterly. The amount outstanding was \$1,201 million at December 31, 2018.

Effective December 31, 2018, RAI became plan sponsor for non-contributory defined benefit pension plans and postretirement benefit plans for certain former employees of BAT subsidiaries. The impact of the plan sponsor change is reflected as transfer from related party in the changes in benefit obligations, plan assets and accumulated other comprehensive loss in Note 12.

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

RAI Services Company provides certain accounting and tax services for certain BAT U.S. affiliates under the terms of a services agreement with Louisville Corporate Services, Inc.